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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – August 2020

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Nordkinn Asset Management is a Nordic Fixed Income specialist based in Stockholm and Oslo. Nordkinn manages the Nordkinn Fixed Income Macro Fund, which seeks to generate stable absolute returns in all market environments.

MARKET OVERVIEW

Global government bond yields moved higher across maturities in August, taking them in many cases to levels not seen since mid-June. As visualised in the chart below, the move higher in 10-year U.S. yield was largely a story of investors' demanding higher compensation for future inflation risks. The 10-year Break-Even-Inflation (BEI) rate has returned to the levels from early January, prior to the Covid-19 outbreak. Meanwhile, 10-year real bond yields stabilised in August at an all-time low of sub -1.0%, having declined relentlessly since the stress-induced spike in March.

After rising sharply in July, EUR/USD consolidated as investors cautioned a potential breakout above 1.20 in an environment of already stretched positioning. Data released by the U.S. Commodity Future Trading Commission shows that investors in August accumulated the largest net long position in EUR since records began in 1999.

In support of higher U.S. inflation expectations, on August 27th Fed-chair Powell outlined important revisions to the central bank's dual mandate. With regard to the employment side of its mandate, the new framework will allow the labour market to become stronger and hotter without prompting pre-emptive policy tightening. This reflects the FOMC's new understanding that a robust job market can be sustained without causing an inflation outbreak. Regarding price stability, the FOMC shifts to a flexible form of Average Inflation Targeting (AIT) that will compensate for periods of low inflation by aiming for inflation moderately above the 2.0% target for some time.

Organised under the theme labelled *"Global: Comparative inflation expectations"*, the rise in global Break-Even Inflation rates contributed meaningfully to performance in August. Moreover, we were tactically positioned for steeper yield curves across several G10 countries as part of our *"Tactical risk reward trading"* theme.

Nordic overview

August was relatively quiet in terms of market movements in the Swedish fixed income market. The yield curve steepened in line with international peers as the 10-year yield sold off 12 bps, yet the market gave most attention to the inauguration of the 10-year SGB Green Bond. Meanwhile, the short end of the yield curve was well supported.

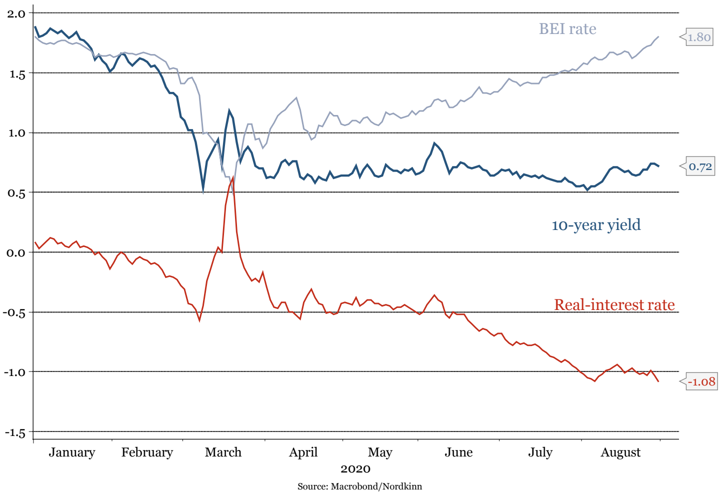
The economic recovery in Sweden continued, as evidenced by both manufacturing and service PMI moving above 50. Meanwhile, CPIF was again higher than anticipated in July, boosted by higher than expected price increases in rental cars and clothing. Our shorts in Swedish BEIs suffered from the positive inflation carry that offset a small decline in SGBs in August. Still, as mentioned in the global overview, the theme *"Global: comparative inflation expectations"* contributed positively to the result following the rise of U.S. BEIs.

The Riksbank QE purchases picked-up speed again in August after a slower pace during the summer lull. Already at this stage, when roughly one-third of the total volume announced up to mid-2021 has been bought, we see a clear impact on the market. QE in SGBs that started in 2015 was easy to fill as foreign institutions dumped their SGB holdings and domestic investors moved into covered and credit bonds instead. QE in covered/municipal/credit bonds in 2020 may however prove much more difficult to execute, as alternative assets are few. Covered and municipal bonds have continued to tighten relative to SGBs and swaps, alongside steeper yield curves. This resulted in positive performance of our themes *"Sweden: Rising bond supply"* and *"Sweden: Hunt for yield"* during the month.

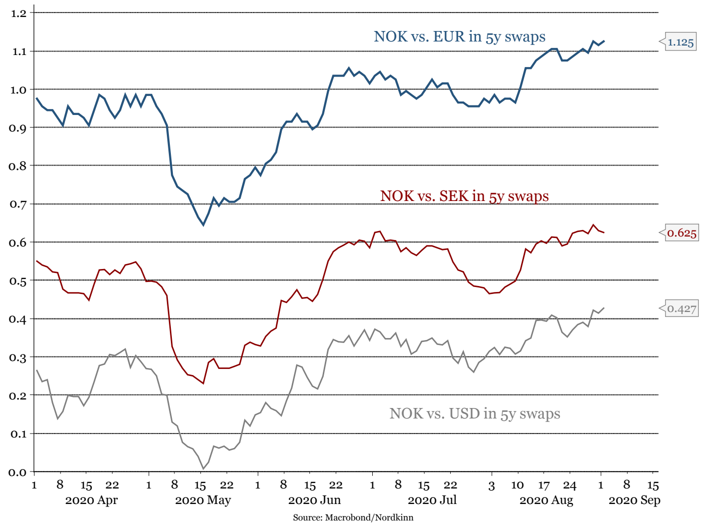
Norwegian interest rates rose sharply in August as investors began to eye an earlier exit from zero interest rates on evidence of strong domestic recovery, rising house prices and a spike in core CPI inflation. While the Norges Bank Board left its key policy rate unchanged on August 20th, the committee emphasised its focus on housing market developments and seems prepared to lean against it. At the same time, the Bank also gave counter-weight to the uncertainty related to the spread of Covid-19 that had increased prior to the meeting.

Because Norges Bank is the only G10 central bank signalling rate hikes within a two-year horizon, we decided to rename our *"Global: Relative Monetary Policy"* theme to *"Norway: Relative Monetary Policy"*. Paying flows dominated the Norwegian interest rate swap market in August, resulting in wider cross-country spreads across the curve. Consequently, the theme contributed to performance. Meanwhile, our *Norway: ASW trading"* theme subtracted slightly from performance as NGBs underperformed versus swaps.

US 10y government bond yield



5-year NOK interest rate swaps vs. other currencies



Global markets

Across maturities, global bond yields moved higher in August. The sell-off in the 5-10-year segment of the curve was dominated by higher inflation expectations, while longer-dated yields got an additional boost from rising real bond yields. Looking ahead, our near-term view is that the bond sell-off will encounter near-term drags and is thus unlikely to persist.

Having recovered forcefully since March, BEIs are now back to pre-crisis levels and are actually well above the levels from last summer. The adoption of flexible average inflation targeting by the Fed could trigger a rise in inflation over the coming years, but this appears largely to be discounted in 5-year BEIs already, see left hand chart.

That said, there are now factors in play that differ a bit from the post Great Financial Crisis (GFC) era. The crisis is this time not fought with austerity, but with broad based fiscal spending, i.e. fiscal and monetary policies are working together. Money supply post GFC boosted the monetary base (M0) but not broad money supply (M2), meaning that liquidity from QE were stuck at the Fed as deposits. This time M2 is also boosted, i.e. money is put to work. Another possible inflationary force is the altered supply chains globally, that may translate into higher consumer prices. Admittedly, there are still forces like digitalisation and low wages that continue to curb inflation. Nevertheless, we see more factors that can lift inflation ahead compared to ten years ago.

For these reasons, we continue to be long U.S. and Euro inflation, while being short Swedish inflation as part of our strategic *"Global: Comparative inflation expectations"* theme. Swedish BEIs have cheapened in the month, but given the stronger (less weak) SEK we believe Swedish inflation will underperform over the medium-term.

Still, if inflation expectations were to move higher, this does not necessarily mean higher nominal bond yields. Under the new Fed framework, which means more weight on bringing inflation higher when conducting monetary policy, markets will expect Fed policy to remain on hold for a significant period. In particular, we believe the Fed will refrain from hiking rates in response to a tightening labour market (as was the case in 2015-2018), unless inflation responds more immediately to the labour market than it did last.

This means real interest rate will fall if Break-Even Rates rises. We see similarities with the Riksbank's fight for a credible inflation target in 2015-2019. With Fed on hold for a long time, bonds across the curve will remain supported. Even 10-year interest rates tend to follow very closely the expected path for short-term interest rate over the next 1-2 years or so. This is illustrated by the close relation between 10-year swaps and 1y1y forward in the righthand chart. On average, the 10-year swap rate has traded some 50 bps above 1y1y forward Overnight Index Swap (OIS) since the summer of 2017. The current spread is 71 bps.

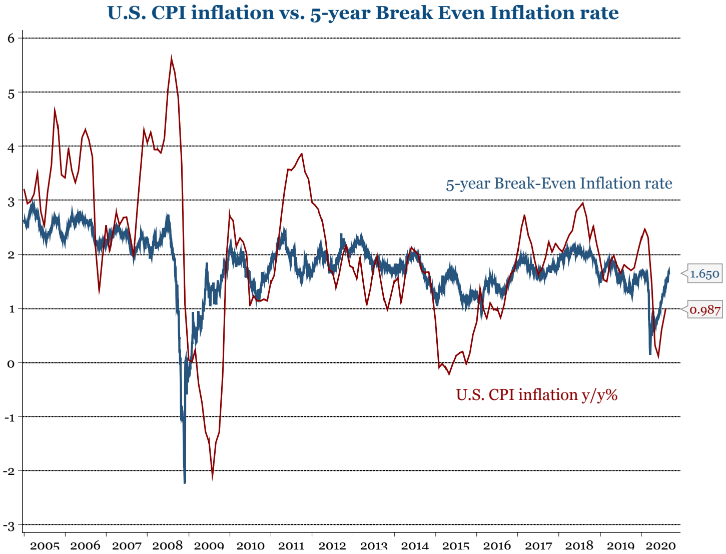
Finally, lingering uncertainties about the path for the Coronavirus spread, as well as the outcome of the U.S. fiscal deal, may reassert themselves and pressure bond yields back lower in the near-term.

Looking at longer-term horison, we see more compelling reasons for higher rates as the economic recovery unfolds. The U.S. Treasury is dramatically increasing duration supply, which should motivate higher real risk premia on longer-term bonds. Moreover, long-term inflation expectations (e.g. 5y5y forward) are trading only marginally higher than the 5-year segment, despite a current low CPI inflation rate.

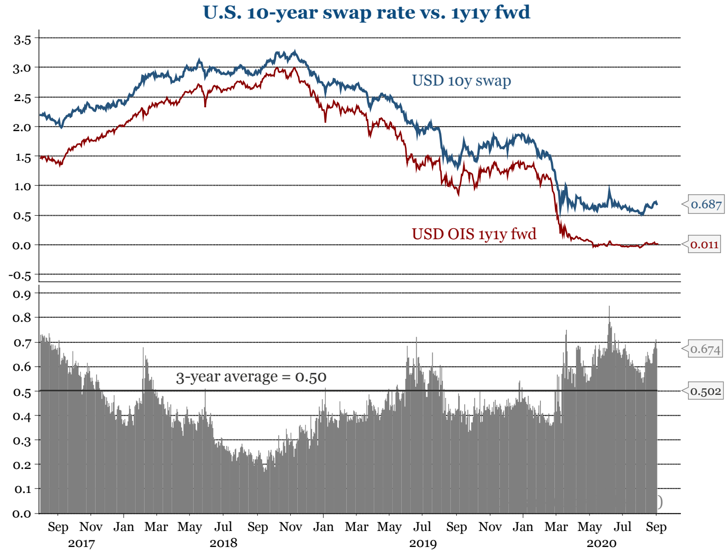
Turning to FX, the EUR/USD saw more two-way price action in August, which largley matches the near-term story we conveyed in our previous monthly report. Higher EUR/USD has already become a consensus trade and data confirms record longs in EUR/USD by non-commercial investors. Consequently, any setbacks to the long EUR/USD story could provoke a significant correction.

In our view, the case for structual USD weakness over the medium-term remains intact. The case is based on four pillars. First, the global economy will in our view be on a synchronised upward path following a coronavirus recession. This is a standard receipe for sustained USD weakness. Second, short-term U.S. real interest rates will likely remain deeply negative for a number of years and the cost of shorting USD has fallen dramatically this year. Third, the USD remains above its long-term historical average. Fourth, the U.S. budget deficit has balloned and should weigh on the USD over time. On balance, we are prepared to re-enter short USD relative to trading partners when appropriate.

U.S. CPI inflation vs. 5-year Break Even Inflation rate



U.S. 10-year swap rate vs. 1y1y fwd



Nordic markets

Although Swedish recovery at least currently seems more robust compared to Europe, we do not expect this to have any material impact on interest rates. However, it could potentially be supportive for the SEK. This, in turn, will most likely result in lower Swedish inflation compared to peer countries. Historically, Swedish inflation has tended to underperform in good times as a result from an appreciating SEK. Moreover, the negative impact on Swedish core inflation from a weaker USD has been more prononced than in the Euro Area. Consequently, we remain short Swedish inflation versus U.S. and Euro area, even though we have decreased exposure in both Sweden and the U.S following strong performance recently.

A couple of key factors speak in favour of a relatively higher global inflation in the future, at least compared to the period after the GFC. As discussed in previous section, the current crisis is met with both monetary base (M0) and broad money supply (M2) being boosted, see chart. As a consequence, even if digitalisation and wages continue to be disinflationary, conditions for future global inflation are probably better than compared with those after the GFC.

In the Swedish fixed income market, we see room for more general spread tightening due to the Riksbank's massive QE purchases. The central bank absorbs a lot of the interest rate risk issued in the domestic AAA market. Moreover, funding needs among banks are subdued due to a massive inflow to bank deposits. Unlike government bonds, covered and municipality bonds still trades with a positive yield and are therefore still favoured by most real money investors. With a big weekly buyer (Riksbank), little issuance and small sell flows (as alternatives are limited for investors), we see demand/supply dynamics for covered bonds changing faster today compared to when Riksbank started QE in 2015 when they only bought SGBs.

During the summer, public finances have been better than initially feared, partly due to better tax income and a merely marginal useage of the measures in place to tackle the pandemic's impact on the economy. This has triggered speculations that the debt office will cut its supply outlook for SGBs. In our view, we see this as premature. Last week the finance minister indicated a very expansionary budget for 2021. Stronger public finances today make room for more spending next year. In all, we expect borrowing to be lower in 2020 but higher in 2021, and as a result, a cut in bond supply volumes in 2021 might not materialise despite the improved situation during the summer. Instead, it will result in less issuance of T-bills during the autumn.

Turning to Norway, despite repricing of interest rate expectations in August, the market underestimates in our view the likely path for Norges Bank's key policy rate over the coming few years. Incoming data continue to support the picture of a strong recovery in domestic demand, in particular from households. The experience with Norges Bank's policy in past years is that domestic factors are very important for the rate outlook even in times of international uncertainty.

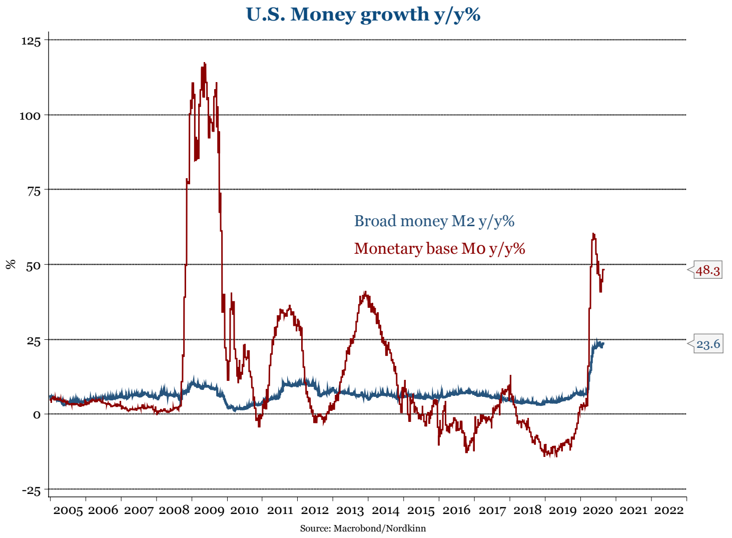
While the interim meeting on the Monetary Policy Committee (MPC) meeting on August 21st did not contain any updated projections, the wording in the statement largely confirmed the prospects of a relatively hawkish interest rate outlook relative to other central banks. We see three important take aways from the press release following the decision to maintain the key policy rate stable at 0%. First, the statement explicitly mentioned the housing market as one of the main focus areas for the Committee, supporting our view that persistently high house price growth is a seen as a threat to the Bank's objectives and that the MPC could be willing to lean against it.

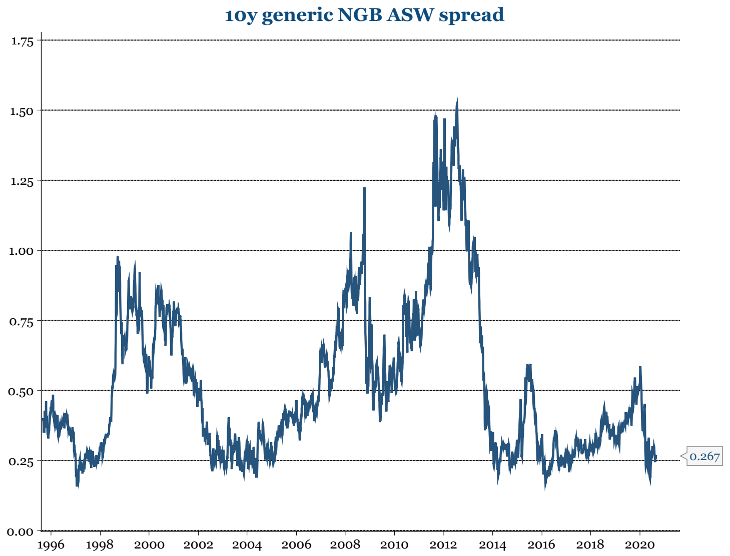
Second, the MPC gave weight to the spread of Covid-19 that had increased in the days prior to the monetary policy meeting and the containment measures that have been reintroduced. However, recent data shows a stabilising trend of new Covid-19 cases that should reduce the risk of a major second wave prior to the upcoming MPC meeting on September 24th.

Finally, when balancing incoming data, the MPC concluded that "the policy rate will most likely remain at today's level for some time ahead". This is an interesting change from the forward guidance in June when the MPC signaled an unchanged rate "over the next couple of years". In our view, "some time ahead" will prove to be much shorter than "the next couple of years".

Looking ahead, we anticipate the 1 to 5 year segment of the NOK curve to underperform other G10 rates on select and relative basis. We also expect the NOK curve to flatten relative to G10 curves. Trades consistent with this view are organised under our *"Norway: Relative Monetary Policy"* theme.

Meanwhile, given the cheap FX hedging cost, relatively low valuations and prospects of much lower supply ahead, we expect the long-end of the NGB curve to attract increased demand from global investors and perform relative to swaps, all part of our *"Norway: ASW trading"* theme.





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