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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – September 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 overview

Having shown signs of stabilising during the summer, coronavirus case growth accelerated worldwide in September driven largely by an upward trend in Europe. In some European countries, daily reported cases are currently above the levels recorded during the first wave in March and April, see chart. Despite the growth in new cases across much of the world, the number of deaths globally decreased in September. However, deaths are obviously lagging new case growth and are rising slowly in some large European countries, yet from relatively low levels.

Young people in part driving the second surge, may explain the divergent trend between new cases and deaths. In addition, an increase in testing means that the second wave of virus spread is better captured by the data. That said, policymakers do warn that we may be at a tipping point and are consequently implementing more stringent measures.

On the back of this uncertain environment, risk sentiment turned negative in September. Global government bond yields fell steadily and the USD appreciated. Following the same pattern, market-based expectations of future inflation, as reflected in Break-Even-Inflation (BEI) spreads, declined. As a result, our *"Global: Comparative inflation expectations"* theme receded in September.

On September 25th, the FOMC delivered new interest rate forward guidance consistent with their flexible Average Inflation Targeting (AIT) strategy unveiled at the Jackson Hole symposium in August. The Committee now expects to keep the key policy rate on hold until "inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time". The new forward guidance did not lead to a material change in short-term interest rate expectations as the market had already anticipated the Fed to remain on hold for a very long time. The Fed's new interest rate forecast "dots" backed up those expectations, signalling no hikes through the end of 2023.

On September 10th the Governing Council of the ECB maintained the overall size of its pandemic emergency purchase programme (PEPP) at EUR 1.35 tln and reiterated that it will conduct net asset purchases under the PEPP until at least the end of June 2021. Moreover, it repeated its forward guidance that key ECB policy rates will remain on hold until the inflation outlook has improved sufficiently.

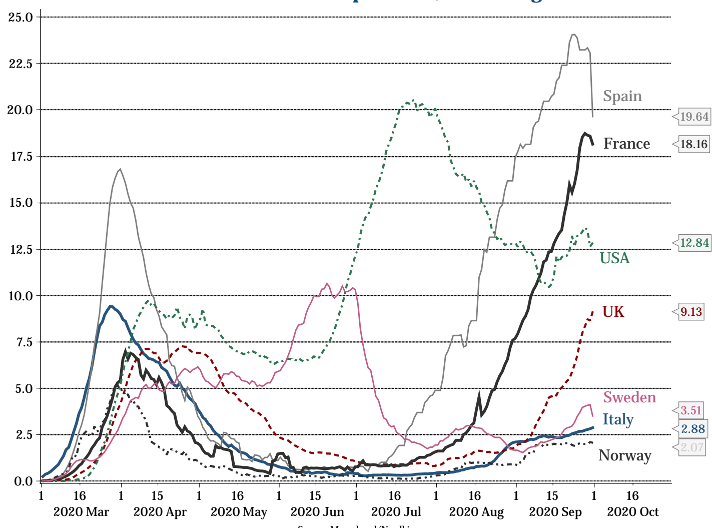
Nordic overview

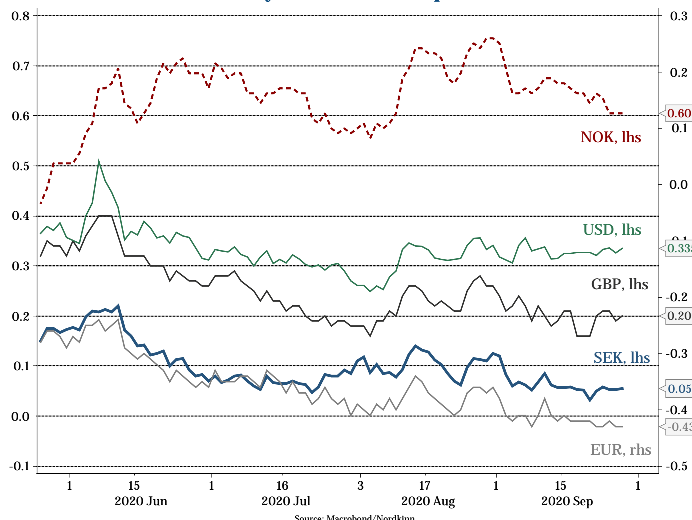
The economic recovery in Sweden continued in September with the manufacturing sector leading the gains according to surveys. The August inflation print offered less surprise as corona-impacted effects (such as surging prices for rental cars) seem to have started to fade. The CPIF excluding energy was broadly in line with Riksbank and market consensus. At its meeting on September 22nd, despite another downward revision to the inflation prognosis, the Riksbank left rates unchanged and that QE was allowed to continue according to plan as expected. The market reaction to these events were limited, yet overall supporting our *"Sweden: Hunt for yield"* theme in September.

The issue of the first green Swedish government bond at the start of the month was met with very strong demand, which seems to have contributed to the strong SGB performance throughout the rest of the month. The current 10y benchmark bond (SGB1062) hit a record low by the end of September (-0.05% in yield) and has been best performer along the SGB curve the last couple of months. We expect more supply of SGBs issued by the National Debt Office to be more broad based and not only concentrated to the 10y segment as we move forward. In September however, the strong SGB performance lead to losses from our theme *"Sweden: Rising bond supply"*.

Turning to Norway, incoming information confirmed a strong economic recovery in Q3, but business surveys report weak prospects ahead, which reflects a high degree of uncertainty about the path for Covid-19 and associated measures. House prices and credit growth continued their upward trends and core CPI inflation increased to a higher than expected 3.7%. Norges Bank admitted that new information in isolation would indicate that the first interest rate hike should be brought forward, yet it decided to make only minor changes to the interest rate outlook when new projections were published on September 24th. The Committee said it prefers to keep rates on hold until there are clearer signs of normalising economic conditions.

Because of rising infection rates, weaker risk sentiment and Norges Bank committing to wait-and-see, Norwegian bond yields declined in September and the NOK exchange rate depreciated. With Norwegian fixed income outperforming peers, see chart, our *"Norway: Relative Monetary Policy"* subtracted from performance in September.





Global markets

Until the beginning of July, the number of new Covid-19 cases were falling in a number of European countries. However, after restrictions were relaxed, in recent months the number has risen sharply, particularly in the U.K., Spain, and France. Consequently, downside risks to global growth have increased again. The service sector is already slowing again in the Euro Area, see chart.

Most countries appear to favour a different strategy than implementing nationwide lockdowns to contain the spread of the infection. There is now a greater emphasis on temporary, targeted measures in areas where infection rates are rising and on increased capacity for testing and tracing. This change in strategy likely reduces the risk of a deeper and lengthier economic downturn.

Nonetheless, in the period ahead we assume that containment measures globally will be relaxed more slowly, which will entail a somewhat weaker pace of recovery than we have seen over the previous months. Uncertainty is elevated, however. There is a risk that failure to control local outbreaks may entail a need to re-impose nationwide restrictions. On the other hand, a vaccine could be ready for widespread use globally earlier than expected, which would make a positive contribution to growth.

Taken together, our conclusion is that the second wave of Covid-19 will keep economic uncertainty elevated in coming weeks. This comes on top of rising political uncertainties associated with Brexit and the upcoming U.S. Presidential election.

Regarding the latter, it is around four weeks to the November 3rd presidential elections. Current national polling puts former Vice President Biden (Democrat) ahead of incumbent President Trump (Republican) by around seven points, see chart. Biden also leads Trump in a number of key swing states, but the margins are less than the nation-wide one. Thus, the race for presidency is tight.

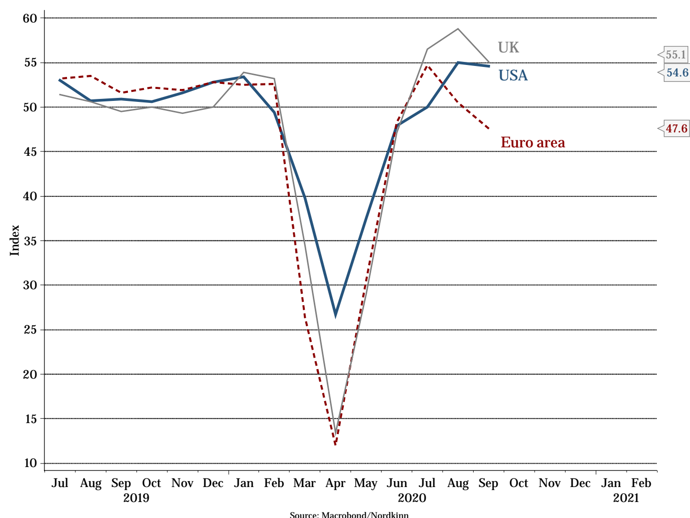
If the polls tighten in October, this could potentially drive risk premium higher. A divided outcome, whether led by President Trump or Biden, is unlikely to result in large additional fiscal spending and is therefore the worst outcome for markets. Under this scenario, we expect bond yields to fall.

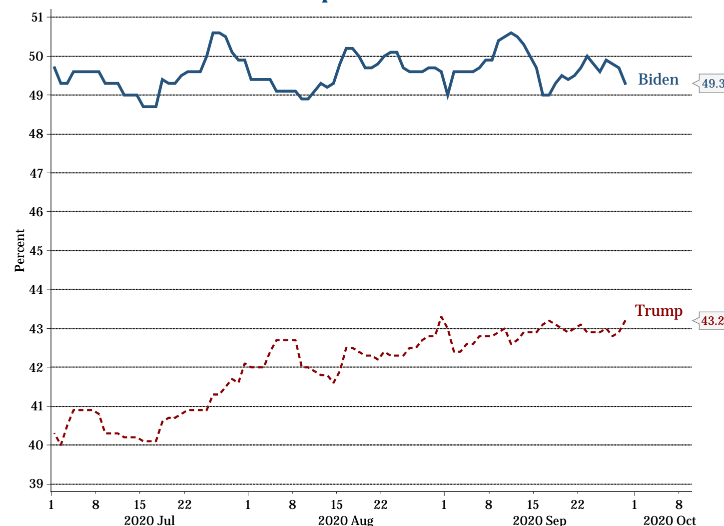
We suspect unified Democratic control of government would imply some upside to bond yields, largely reflecting the possibility of substantially higher spending. However, we do not expect a 2016-style bond sell-off because the Fed has communicated its intention to maintain rates on hold for a long time under its new flexible Average Inflation Targeting framework, whereas in 2016 the Fed had already started its tightening cycle. Besides, it is possible that higher taxes and greater regulation will influence the initial market response in the event of a Biden sweep.

A re-election of Trump, even without control of Congress, could see markets anticipate a new round of trade tensions and by extension a higher risk premium to global growth. Currencies that are more sensitive to global trade are vulnerable under this scenario.

To sum up, the U.S. Presidential election in combination with the recent worsening of Covid-19 cases add significant uncertainty about economic activity and the so-called "reflation trade" in coming weeks.

In September, we made a few adjustments to the risk in the portfolio that address these uncertain conditions. For instance, in our *"Global: Comparative inflation expectations"* theme, we have replaced some of our long exposure in U.S. and German inflation expectations with various relative value inflation related trades such as cross-market spreads and curvature trades.





Nordic markets

On the back of elevated uncertainties about the economic outlook, we expect the Riksbank to stay on current course and continue QE purchases according to plan. There have been some speculations about the need to scale down on QE in covered bonds due to the thriving domestic housing market. We however see this as unlikely. Let us highlight a few arguments why this is the case.

First, the connection between QE in covered bonds and the housing market is limited in our view. Mortgage lending rates have been very stable since the launch of the QE programme in covered bonds. Instead, we believe households understand that rates will be left unchanged for a long time. Second, the higher unemployment rate is to a vast majority related to foreign-born citizens whom to a lesser degree are owners in the housing market. Third, we believe the temporary abolishment of the mandatory amortisation has been an important driver for the high house prices. Forth, major central banks (Fed, ECB, BoJ, BoE etc) are on hold for a protracted period of time (this time interaction with fiscal policies is encouraging) which makes it difficult for the Riksbank to deviate too much. With little willingness to cut rates, but to work to exclude covered bonds from QE, would too much limit Riksbank's ability to expand its balance sheet.

The bottom line is that we still believe positive yielding covered bonds and municipal bonds will perform relatively well. As we think QE purchases still have a long way to go, we keep exploring this within our theme *"Sweden: Hunt for yield"*.

We believe that the tug-of-war between bond supply and QE will remain. In November a new 25y SGB is planned to be issued in an outright auction combined with switch auctions, where existing bonds are bought back and switched with new bonds being issued. This will cause temporary distortions in the bond market, which we seek to take advantage of in our theme *"Sweden: Rising Bond Supply"*.

The Riksbank has lowered the inflation path in their projections significantly. The current CPIF forecast peaks at the end of the forecast horison at a mere 1.8%, while CPIF excluding energy is even lower. Hence, we believe disappointments could be hard for the Riksbank to easily fend off. With this in mind, it will be very interesting to see how inflation unfolds, primarily in 2021. The previous appreciation of the SEK, lower taxes for corporates and most likely modest wage deals, will not be supportive for domestic inflation. If it disappoints despite the low Riksbank forecast, which we do not see as unlikely, it would force the Riksbank to some additional policy action.

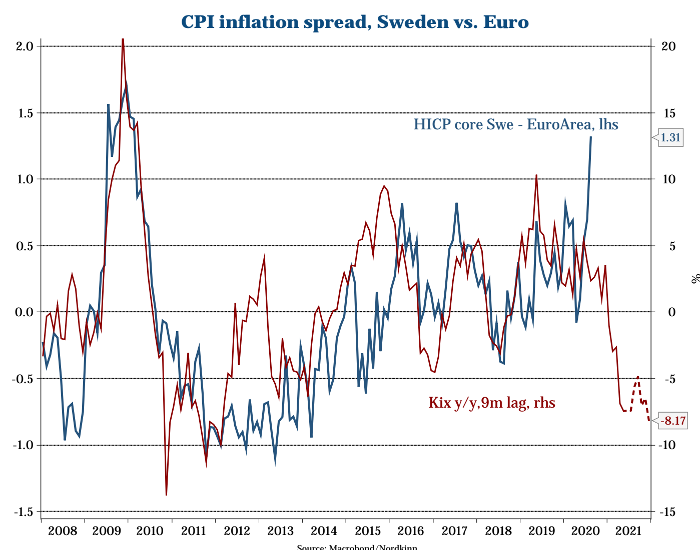
When the Norges Bank updated its monetary policy analysis in September, the Monetary Policy Committee (MPC) made only minor changes to the interest rate outlook. The lift-off date was brought forward by a couple of months only, but this was offset by a slightly flatter yield curve in 2023.

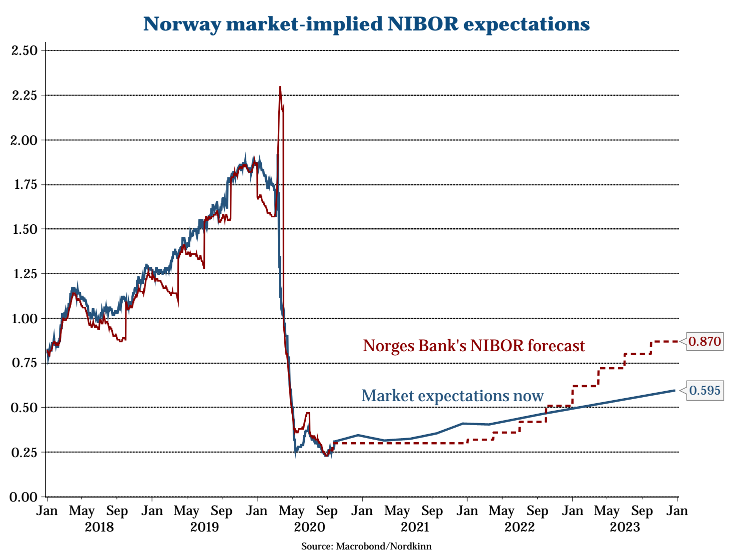
The Norges Bank emphasised "judgement-based assessments" as key behind its virtually unchanged interest rate projection. In the absence of judgement, new information warranted a higher interest rate path, also near-term. However, following an increase in infection rates in Norway and across Europe in August and September, the government is reimposing containment measures that are likely to weigh on economic growth ahead. The considerable uncertainty associated with the spread of the virus implies no changes to the monetary policy stance in coming quarters. According to the MPC, "the policy rate should be kept on hold until there are clear signs that economic conditions are normalising". This could mean that a vaccine needs to be widely availble before lift-off.

In our view, the market underestimates two risks that could motivate a higher interest rate path ahead. First, if a vaccine becomes widely availble in the first half of 2021, uncertainty about economic conditions ahead will receed and thus remove the MPC's "judgement-based" motivation for keeping its interest rate at 0%. Second, the MPC has expressed concern over the recent increase in house prices and credit growth. A policy hike may occur earlier if this trend were to continue in coming months.

Looking ahead, we expect the NOK interest rate curve to become flatter relative to peers as the economic recovery unfolds. Because the Fed, ECB and the Riksbank are committed to maintain very low interest rates to support higher inflation, offshore rate curves are likely to steepen when economic conditions normalise, hence Norges Bank will likely be the first G10 central bank to hike. We remain short NOK rates in the 1 to 5 year segment, while we are long further out the curve, relative to peers. 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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