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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – October 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

Globally equities fell in October as a new wave of coronavirus infections unsettled investors. Case growth surged to record highs, driven largely by dramatic spikes across Europe, see chart. Policymakers in Europe announced fresh and severe restrictions to stop the exponential increase in coronavirus cases.

Some countries, including the United Kingdom, France and Germany, reintroduced national lockdowns to stop the acceleration in infections and to reduce the risk of hospital system capacity being exhausted. According to health authorities' forecasting models, countries could face hospital capacity constraints in just a couple of weeks if case growth were to continue upwards.

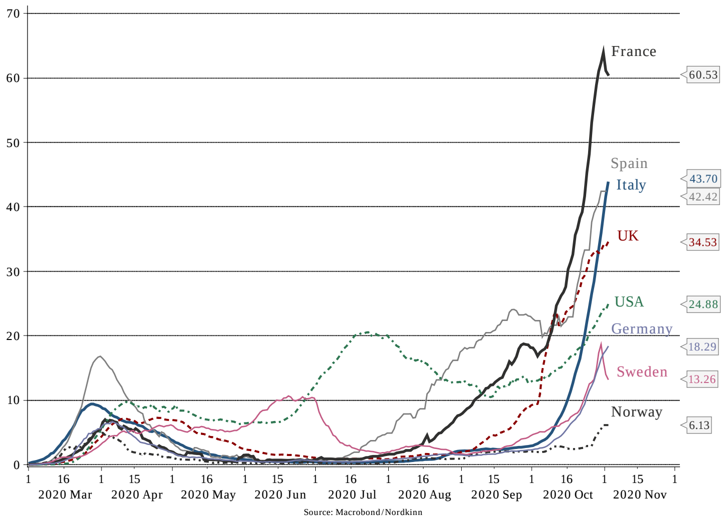
Meanwhile in the U.S., a third wave of infections is underway, especially in rural areas. While the current situation in the U.S. is far more benign than in Europe, market participants are watching for signs that the country could be heading in the same direction. There seems to be a correlation between temperature and the spread of the virus.

Apart from the Pandemic, the upcoming U.S. Presidential election on November 3rd is a major theme across markets. During October investors priced in a higher probability of a Democratic sweep — the so called Blue Wave. Treasury yields rose and the slope of the yield curve became steeper on expectations such outcome could open the door for significantly more U.S. fiscal stimulus.

European rates did not manage to follow the U.S. rates higher. Rather, the yield on German Bunds fell in October on expectations that growth will falter amid lockdowns and that the ECB will deliver more easing measures. While the ECB left all instruments unchanged at its monetary policy meeting on October 29th, President Lagarde confirmed that they will "calibrate" all their instruments in conjunction with the new macroeconomic projections in December. The spread between 10-year U.S. Treasury and German Bund yields widened by 30 basis points in October to 150.

Meanwhile, the oil price plummeted by 10% to USD 35 per barrel, being dragged down by estimates of a surge in inventories as accelerating coronavirus case growth and re-introduction of national lockdowns are denting growth expectations. In spite of murkier global outlook, inflation expectations held up well, especially in longer maturities.

New Covid-19 cases per 100k, 7d- average



Nordic overview

The Swedish manufacturing sector continued to recover according to survey data. However, surveys like PMIs are tricky to interpret after the plunge earlier in the year. For instance, the hefty rebound in exports in the summer seems to have plateaued and with more European countries in lockdown, the outlook is less upbeat. The increased spread of the virus is a challenge for the already struggling service sector. Inflation data for September disappointed markedly as food prices and service sector prices were more subdued than expected. Both the SEK and Break-Even Inflation rates (BEIs) have been relatively resilient despite tougher market sentiment.

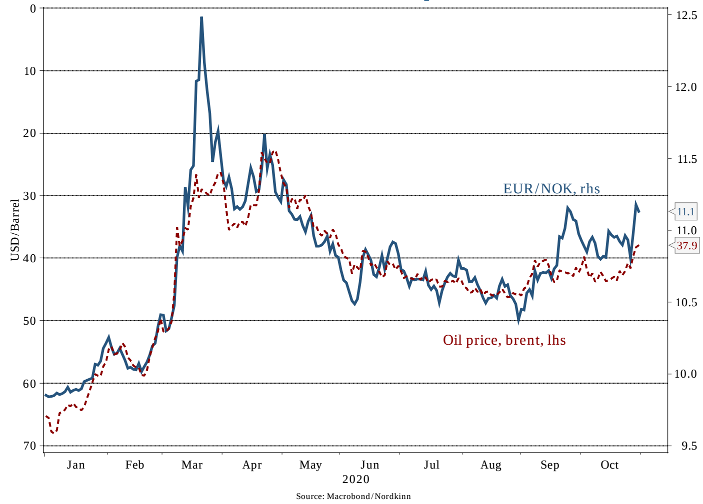
In the fixed income market, government bonds had a good month with strong performance. This weighed on our theme *"Sweden: Rising Bond supply"*. As we have highlighted earlier, the costs for corona-measures introduced by the government have been less than initially feared. In addition, the Riksbank extended the bond purchase program in the summer. Taken together, the increasing bond supply will have less outright effect on the market. Still, we expect a tug-of-war between bond supply and QE-purchases over time and the net effect to deviate along the yield curve. Hence, as the theme name *"Sweden: Rising bond supply"* has become misleading, we have altered the theme's name to *"Sweden: Supply/demand imbalances"*.

In Norway, new coronavirus cases remained relatively modest in the first half of October, but spiked significantly at the end of the month. As a response to this development, authorities introduced somewhat stricter measures nationwide, but especially in areas hardest hit by the virus spread. Consequently, although incoming data on growth were decent and broadly as expected, the outlook has deteriorated.

Norwegian interest rates remained on balance steady in October. The short-end of the money market curve rose however sharply due to a classic liquidity squeeze amid upcoming tax payments in November and banks unwilling to use the F-loan facility as we approach year-end.

Meanwhile, the NOK exchange rate plummeted at the end of October, triggered by negative risk sentiment and the sharp decline in energy prices.

EUR/NOK versus oil price



Global markets

The upcoming U.S. Presidential election on November 3rd and the deteriorating trend in new coronavirus cases are two of the main themes for financial markets near term. Heading into the very final stretch of the race, Senator Biden is leading President Trump in national surveys, though with a smaller edge in the battleground states. According to an analysis made by Moody's analytics, Biden's substantial fiscal plan would push the economy much more quickly to full employment out of the Pandemic than under Trump, see chart below.

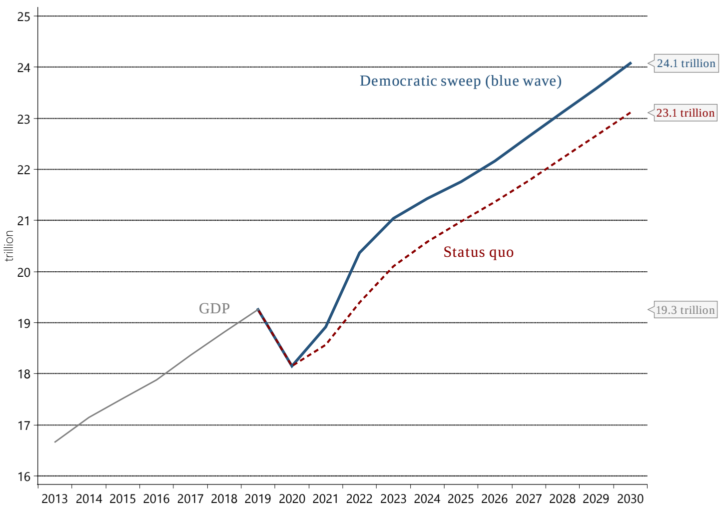
However, implementing such a comprehensive economic jolt will not be simple in a spilt congress scenario. Republicans on Capitol Hill are likely to turn towards fiscal discipline should Biden become president, which would make it difficult to get sufficient support for big changes in tax and government spending policies. Consequently, the Biden economic plan depends crucially on whether Democrats will be successful in gaining control of the Senate.

The sell-off in U.S. Treasuries during October suggests that the markets have priced in increasing probability of a Democratic sweep. We suspect unified Democratic control of government could imply some further upside to bond yields. Yet, we do not expect a 2016-style bond sell-off as the Fed has communicated its intention to maintain rates on hold for a long time under its new flexible Average Inflation Targeting (AIT) framework. Following the recent bond sell-off, the market is in our view already pricing in too many Fed hikes over the coming years.

Perhaps more critical is the question whether the third coronavirus wave will be raging across the U.S. after the election, threatening to further slow the economic recovery. The recent trend in new coronavirus cases in the U.S. is worrying. So far, the spike in new coronavirus cases during October seems to have had limited impact on U.S. Treasury yields as markets have turned their focus on the macroeconomic consequences of a Democratic sweep, pushing yields higher, see chart to the right.

On balance, all this suggests that there is potential for significant volatility in the U.S. fixed income market in the coming weeks.

U.S. GDP on different election scenarios



Source: Moodys Analytics/Macrobond/Nordkinn

Looking beyond the near-term headwinds to growth, we see compelling reasons for a structural return to somewhat higher long-term interest rates when governments can re-open again after the Pandemic. While we expect major central banks to keep key policy rates very low for several years, the long-end of the yield curve should nevertheless adjust gradually higher as the economic recovery unfolds and government bond supply increases. In particular, long-end steepening trades in Europe offer attractive risk-reward and even positive roll in many cases. Against this backdrop, and given today's very low level of interest rates across the maturity spectrum, on October 1st we initiated a new theme named *"Global: Gradual return towards normality"*. We plan to expand risk exposure gradually when deemed appropriate.

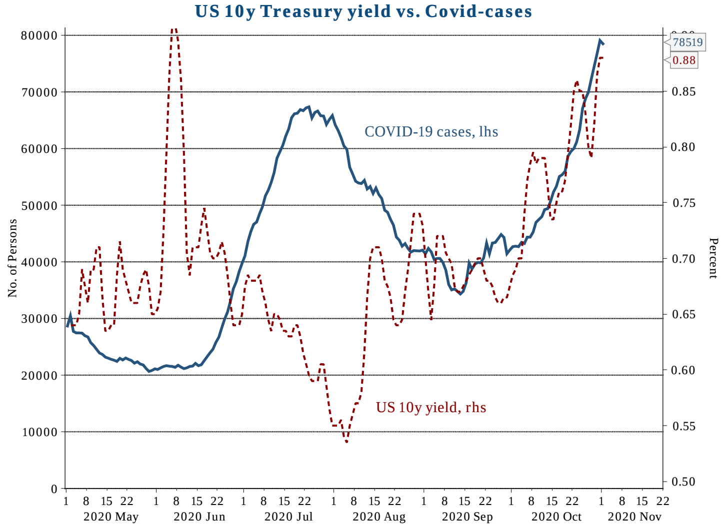
In the FX space, differences in interest rates, and expectations about how those could evolve in the future, have often been one of the most dominant factors influencing short-term movements. However, this has changed dramatically in 2020 as this important traditional driver of short-term G10 currency movements have disappeared. All G10 central banks have slashed their rates closed to their respective effective lower bounds.

Moreover, this situation is unlikely to change much, if at all, over the medium-term as central banks grapple with low resource utilisation and inflation below targets. Even if the economic outlook were to improve faster than expected next year, the adaption of AIT suggests interest rate differentials will remain very low for years to come.

This could have significant implications for the FX markets over the medium-term. First, a lower degree of yield-seeking FX flows will in isolation supress FX volatility. Second, currencies could become more sensitive to more slower-moving fundamental drivers, even in the short-term.

With central banks conducting Zero Interest Rate Policies and in order to benefit from the transition from carry trading to more medium-term drivers of currencies, in October we introduced a new theme named *"Global: FX in a ZIRP world"*. We select currency pairs based on evaluation of medium-term fundamentals, including current account balances, as well an assessment of real effective exchange rate levels.

US 10y Treasury yield vs. Covid-cases



Source: Macrobond/Nordkinn

Nordic markets

While Swedish economic activity most certainly rebounded significantly in Q3, with Europe re-entering lockdowns and the domestic service sector still struggling, the recovery might rather come closer to a stand still. To make things even more challenging for the Riksbank, the latest inflation data release did raise questions regading the centralbank's current path of future inflation. On top of this, the wage negotiators struck a deal at the end of October, which will keep domestic core inflation in check over the next few years. In isolation, the deal totals wage increases of approxiamately 5.4% to March 2023. However, it is effectively a three year deal starting from April 2020 since wages have been on a freeze since then. This means that the deal translates into an annual wage growth of only 1.8% over the time period. This is the lowest recorded three year deal ever in the current regime, and with more or less non-existing wage drift it will not contribute to any acceleration of domestic inflation. Rather the opposite.

This leaves Riksbank in an inconvenient situation. The SEK has remained resilient, especially against the EUR. Hence, with domestic inflation pressure faltering and with the currency that has ceased to weaken like in 2015-2018, achieving the inflation target of 2.0% seems very distant. Also, we expect an extension of QE purchases. While a rate cut is not desired, we believe the market will discount a chance for a cut if inflation disappoints. Current pricing implies an upward sloping repo rate path starting end of 2021. In our view this is too early. Hence, we think that the short-end of the Swedish yield curve trades too cheaply compared to the outlook as well as relative to other markets.

In November, the National Debt Office (NDO) will issue a new 25 year bond in a syndication. This is a lot of intrest risk for the market to digest. We believe this could weigh on longer-dated government bonds up to the inauguration. As counterweight to this however, the Riksbank will support the market in their weekly purchases.

Swedish long-end real rate bonds trade, in our view, expensive both in real rates as well as in Break-Even Inflation rates (BEIs). The Swedish real rate curve is negatively sloped in the 5y to 10y segments, which is very uncommon. Forward implied BEIs like 5y5y trades close to 1.75%, well above European peer rates and in line with the U.S. market. More, as a reference, the Swedish core inflation rate (CPIF ex. Energy) has averaged 1.3% over the past ten years, see chart. Hence, the long-end remains expensive both in a historical context and relative to peer markets.

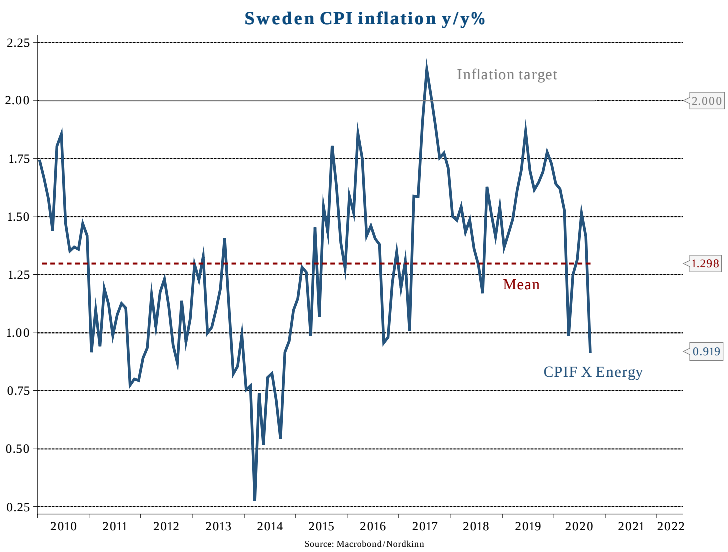
Turning to Norway, the upcoming monetary policy meeting on November 5th is an interim meeting with no new macroeconomic projections and no press conference. Incoming data on economic activity has on balance been broadly in line with projections in the September Monetary Policy Report, but paints a marginally better picture if you focus on the labour market, not to forget the strength of the housing market. Meanwhile, core CPI inflation fell more than expected in September, but is still well above the 2.0% target.

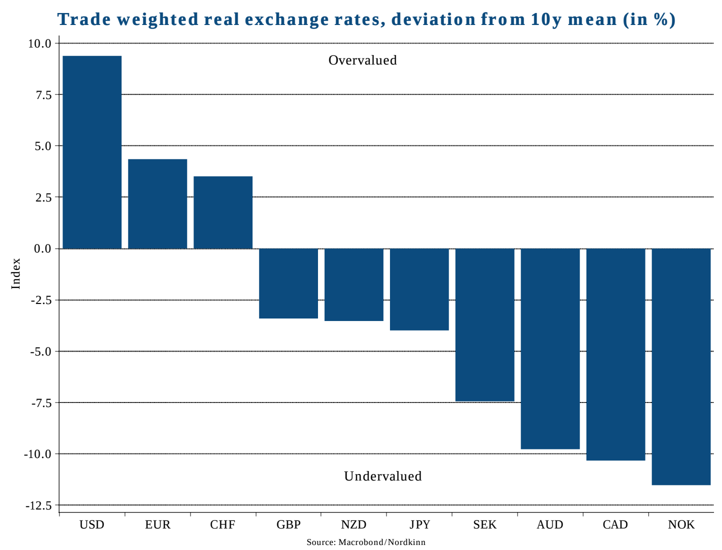
Nonetheless, the most important news since September is the dramatic increase in Covid-19 cases in Europe. Case growth has also picked up significantly in Norway, although from a low base. Governments across Europe have imposed stricter containment measures, Norway included. Various forms of national lockdowns have put renewed downward pressures on oil prices. This arguably implies increased downside risks to growth in Q4 and at the beginning of 2021.

We expect the Norges Bank to reiterate its forward guidance that the the policy rate should be kept on hold for some time, until there are clear signs that economic conditions are normalising. If anything, Norges Bank may give a nod to increased downside risks to growth in light of rising infection rates across Norway and Europe.

While we still expect the Norges Bank to be the first G10 central bank to raise the key policy rate after the Pandemic, in light of recent developments we have reduced our exposure for relaively higher NOK interest rates and flatter curves versus other markets ("*Norway: Relative Monetary Policy*"). The NOK market is already pricing in a somewhat more hawkish monetary policy stance over the coming couple of years and risk/reward has become less attractive near-term in our view.

Appetite for Norwegian government bonds has been quite high on auctions, but in between auctions they have occasionally been sold quite aggressively as holders have adjusted portfolio duration amid rising long-term interest rates. Looking ahead, we still consider NGBs as being relatively cheap, when adjusted for FX hedging cost and in light of lower supply. We currently remain long NGBs as part of our *"Norway: ASW trading"* theme.





ABOUT NORDKINN

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