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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – November 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

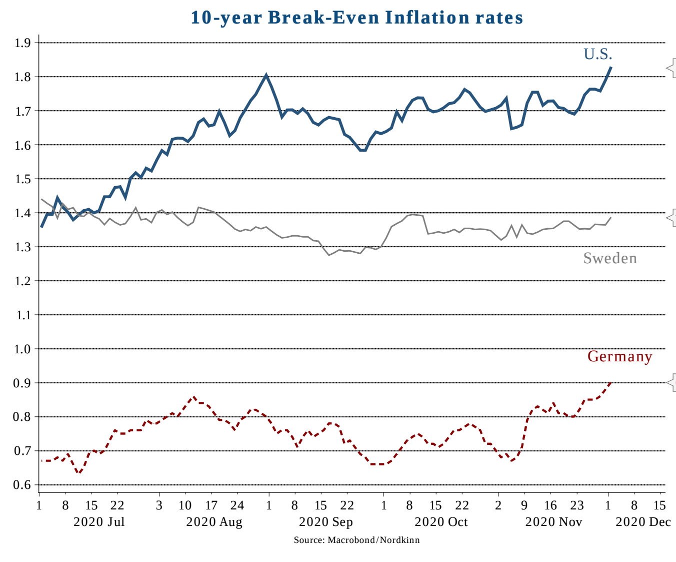
Global equity markets rose sharply along with commodity prices, while the USD depreciated on a broad basis after positive vaccine news lifted global growth forecasts. Meanwhile, global government bond yields fluctuated in November as investors kept balancing the optimistic vaccine scenario with near-term headwinds to growth from mounting Covid-19 case growth, lockdowns and the uncertain outlook for U.S. fiscal policy under a split Congress.

Markets reacted very positively to the interim results from third phase vaccine candidates. Pfizer-Biontech said its vaccine candidate was found to be more than 90% effective in preventing Covid-19. Moderna announced a similar result from its vaccine, whereas the candidate developed by AstraZeneca showed an overall efficacy readout of 70%. However, unlike the vaccines from Pfizer-Biontech and Moderna, which must be stored and transported at negative 20-80 degrees Celsius, the AstraZeneca vaccine can be transported under normal refrigerated temperatures, which means it can be distributed both cheaper and faster. This caused yield curves to steepen slightly, consistent with our *"Global: Gradual return towards normality"* theme.

The surge in global commodity prices like oil and industrial metals prompted similar moves in U.S. and German break-even inflation rates (BEIs) in November, see chart. This supported the theme *"Global: comparative inflation expectations"* as Swedish BEIs on a relative basis barely moved and lagged behind foreign peers during the month.

On November 23rd, almost three weeks after the U.S. election, the General Service Administration (in charge of managing the presidential transition process) acknowledged former vice president Joe Biden as winner of the election. While the final composition of the Senate is to be decided on January 5th, the most likely outcome is for Republicans to remain in control of the Senate. This drastically limits the scope of Biden's economic agenda.

Meanwhile, major central banks pledge to continue supporting the recovery. According to the minutes of the November FOMC meeting, participants argued that "circumstances could shift" to warrant changes in the "pace and composition" of bond purchases. Moreover, the account of the October ECB Governing Council meeting revealed broad support to the view that a recalibration of the monetary policy instruments is warranted at the upcoming meeting on December 10th.



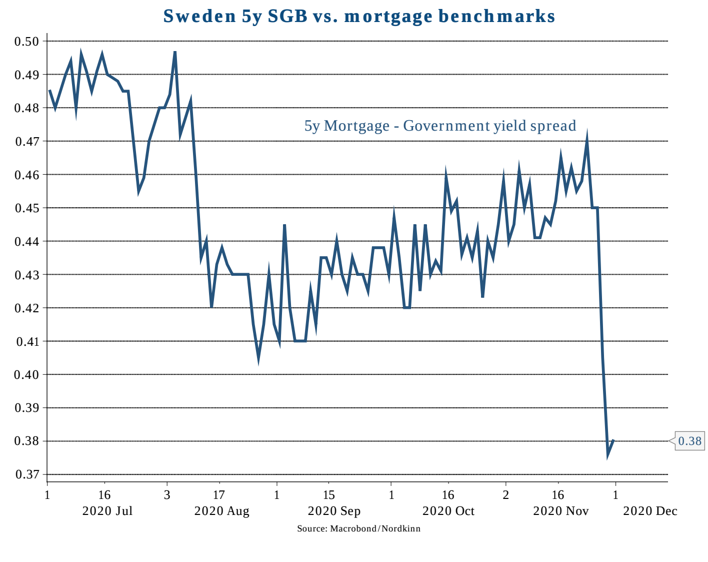
Nordic overview

On the surface, there were only small movements in the Swedish fixed income market in November. The 10-year government bond yield only rose by 5 bps during the month. A new 25-year Swedish Government bond (SGB) was issued and especially foreign real money investors piled in. In spite of small overall movements, our portfolio benefitted from significant moves in pricing of assets relative to each other. The main reason behind this significant repricing was the Riksbank's policy announcement on November 26th. While leaving the repo rate unchanged, the Riksbank surprised the market by already at this meeting announcing a SEK 200 bln extension of the current QE program, now reaching to the end of 2021. Most pundits expected the move to come at a later stage, while others anticipated the volume to be considerably smaller.

In addition, the central bank also released the composition of the planned asset purchases in the first quarter of 2021. The updated plan added T-bill to the "shopping list" while intended government bonds (SGBs) purchases was cut compared to previous quarters. Volumes of planned acquisitions of municipal and covered bonds were increased dramatically. The market took instant notice and bought covered/municipal bond at the expense of SGBs. The 5-year spread, covered bonds over SGBs, tightened around 10 bps over the last trading sessions of the month, see chart. This spread normally moves in only small steps and had traded in a tight 5-6 bps interval from the start of August up to the Riksbank November meeting, see chart below. The repricing of the assets relative to each other benefited mainly the themes *"Sweden: supply & demand imbalances"* and *"Sweden: Hunt for yield"*.

Despite the Riksbank's move by the end of November, the SEK did not budge. In fact, the SEK closed the month on a stronger footing, almost 2% stronger in KIX compared to at the start of the month.

Finally, a few words on Norway: November saw a consistent paying flow in the 10-year segment of the curve, leading to a steeper rate curve. As Nordkinn were positioned for a relative flatter NOK curve against peers, the theme *"Norway: Relative Monetary Policy"* subtracted from performance in November. Meanwhile, *"Norway: NOK FX recovery"* contributed positively amid rising oil prices.



Global markets

The string of positive headlines on Covid-19 vaccines, which seem to be more effective than expected, have promoted optimism regarding the medium-term outlook for global growth. Hence, the path of least resistance is for higher bond yields over the medium-term. This reduces the attractiveness of owning longer-dated government bonds at current levels.

Having said that, following the recent sell-off, the near-term risk for bond yields is more balanced and perhaps even tilted slightly to the downside. This is because worsening virus news, particularly in the U.S., along with reinstatement of restrictions, mark a setback to the post-pandemic recovery story. This could prompt central banks to provide further support to the economy. The ECB has already announced a recalibration of its instruments on December 10th and the Federal Reserve will likely consider extending the maturity of bond purchases at the upcoming FOMC meeting on December 16th.

Additionally, a divided U.S. Congress is now the most likely outcome. This implies that U.S. fiscal policy is unlikely to be a key driver for global growth. Furthermore, despite our optimistic view on global growth next year due to likelihood of mass vaccination, inflation will probably remain subdued amid low resource utilisation. It will most likely take years before inflation will sustainably move above 2%, and short-term interest rates will stay low for long.

Still, while the near-term outlook for bond yields is uncertain given above-mentioned factors, we expect steeper curves by end-2021 than being priced by forwards. We base this view on a number of observations. First, interest rate curves are still relatively flat in a historical context and long-dated yields are very low considering the improvement in global growth since April this year, see chart.

Second, given positive vaccine news, we anticipate a relatively strong economic recovery during 2021 and 2022. On a global basis, this will bring resource utilisation substantially higher. The trend for commodity prices is likely to continue upwards and some inflationary pressures will build as a result, pushing longer-term inflation expectations higher. This will likely support a steepening of the yield curve.

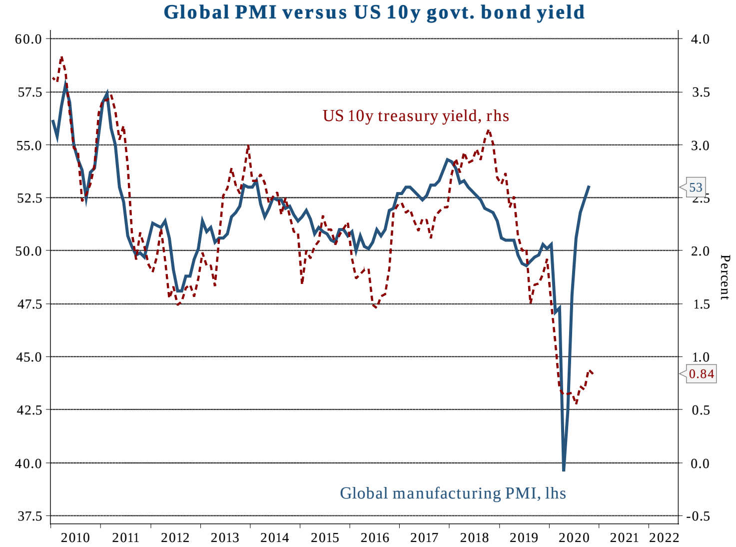
Third, fiscal and monetary stimulus to support the economy in the current crisis is significantly more accommodative than in the Global Financial Crisis during 2008-2009. This could imply very different inflation dynamics ahead.

Fourth, although we remain of the view that the output gap is the most important determinant for inflation over the medium-term, it is possible that some longer-term, slow moving factors that captured so many inflation discussions over the past decade are changing too. Globalisation was already retreating before the pandemic, which only accelerated the process. Although a Biden presidency may reduce tensions, trade policies have clearly become more cautious towards global supply chains.

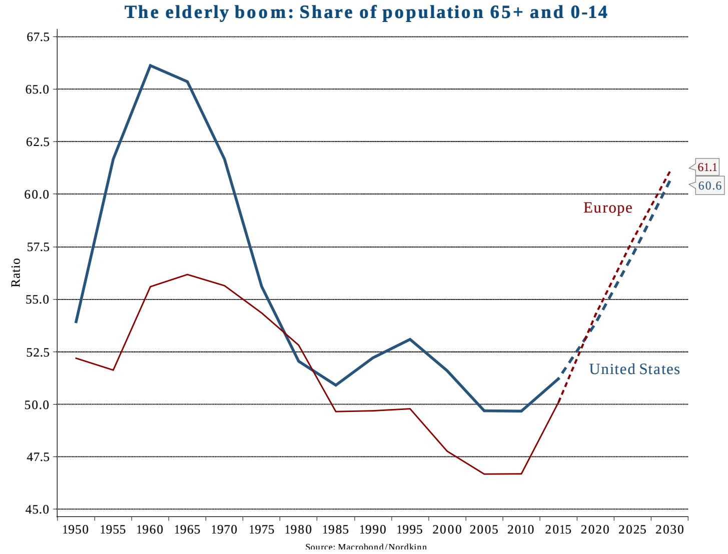
Moreover, while not in isolation important for our 2021 forecast, we do note that there is an increasing focus on the impact of changes in demography on inflation. Inflationary pressures subside when the share of working age population increases, but rise when the share of dependants (children and old-age pensioners) grows. As the chart below shows, the dependency ratio has been very low in recent years, thus contributing to the low inflation environment, but is projected to increase sharply going forward, to levels not seen since the high-inflation period of the 1970s.

Turning to FX, as global growth is projected to gradually recover during 2021, we expect the USD to underperform. The EUR should benefit from the expected USD-weakness and also benefits from large current account surpluses. We remain long EUR/USD, which we implement via options to exploit its underlying pricing of volatility. We expect currencies that benefit from a cyclical recovery to do well going forward and look for better entry points in SEK and the commodity currencies NOK, AUD and CAD. These ideas form part of our *"Global: FX in a ZIRP world"* theme.

Global PMI versus US 10y govt. bond yield



The elderly boom: Share of population 65+ and 0-14



Nordic markets

The Riksbank decision announced on November 26th to expand QE is very supportive for covered bonds and municipal bonds, while less so for SGBs due to the composition of purchases. Moreover, we expect more fiscal measures will be needed in order to support the service sector in the economy in particular. Thus, we see a risk for more supply of government bonds rather than the opposite in 2021. The QE purchases will also result in more liquidity in the financial system, which, if anything, will flood the bank deposits with even more money. As a result, supply of covered bonds will be smaller as market funding needs among the banks will be exceptionally small. At the same time, the quest for yield will continue well into 2021, and with short-end bond yields seemingly stuck below 0%, the relatively lower risk in bonds issued by municipals and housing credit institutions do still offer some positive yield and roll down. We expect spreads to continue to compress, albeit at a slower pace.

As the SEK continues to appreciate, see chart, the outlook for core inflation deteriorates, at least on a relative basis. Headline inflation can be boosted by energy prices or global demand, but imported goods and service prices will be in check as long as the SEK does not weaken. A slowing core inflation will eventually challenge the Riksbank's pledge to stabilise inflation at 2%. Unless the global economy rebounds very quickly, and other central banks starts normalising much earlier than we expect, the low core inflation can result in lower long-term inflation expectations and higher real rates.

Given that extended QE purchases have been unsuccessful in preventing an appreciation of the SEK, perhaps there is only one potent way to stop a spiraling appreciation as things stand now, namely an undesirable rate cut into negative. Rather than just cutting the deposit rate back into negative territory, the Riksbank could introduce som kind of tiered interest rate system. This would alleviate the negative impact on bank profitability by exempting some excess reserves from negative rates. At the same time, some market interest rates that are important for the SEK would move lower.

Swedish longer market-based inflation expectations, like 5y5y, trade well above Europe and in line with the highest recorded 5y average inflation in the 2000s (the five years up to 2008). Both the U.S. and the Euro Area 5y5y BEIs trade well below the recorded 5y average inflation peak in the 2000s. We do not see any good reasons why longer Swedish BEIs should trade much higher than peers, in fact the opposite.

Turning to Norway, the main event is the December 17th monetary policy meeting with new projections for growth, inflation and interest rates. We expect the Monetary Policy Committee to lower its estimate for economic growth in the near-term due to the introduction of new restrictions. While the impact of the second Covid-19 wave will be dramatically less severe than the first wave, incoming data do point to a slowdown in economic activity and a rise in unemployment for the first time since April. This will in our view motivate the Norges Bank to continue supporting the economy by maintaiting the key policy rate low for a long time.

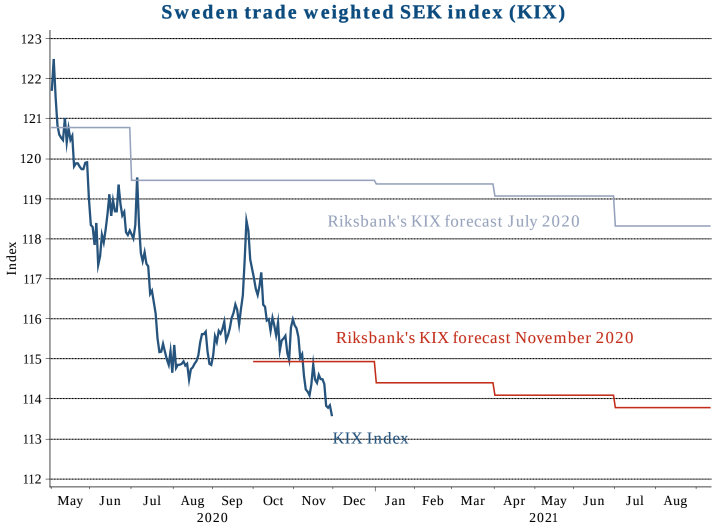
At the same time, the likelihood that a vaccine will be widely available already in the first half of 2021 appears to be greater than it did when the Norges Bank published it previous Monetary Policy Report in September. This reduces the downside risk to the economy and should motivate a higher growth projection further out in time.

When balancing the weaker short-term prospects against the more optimistic medium-term outlook for the economy, the Norges Bank's new 2022-2023 projections for the level of aggregate demand, production and capacity utilisation may not have changed very much from September. This suggests that the Norges Bank will probably continue to expect interest rates to remain on hold well into 2022, broadly in line with the September outook.

Despite the resurgence in infections and the fact that other central banks in Europe have eased further (Riksbank), or is about to take additional action (ECB), expected future market interest rates from 2022 and onwards have increased since September and are now well above the Norges Bank's previous projections. The market now price in a 50-50 chance of a rate hike by end-2021 and a full hike by mid 2022. In light of this pricing, combined with our expectations for the outcome of the December monetary policy meeting, we have removed our exposure for higher short-dated NOK interest rates and look for better levels to re-enter shorts.

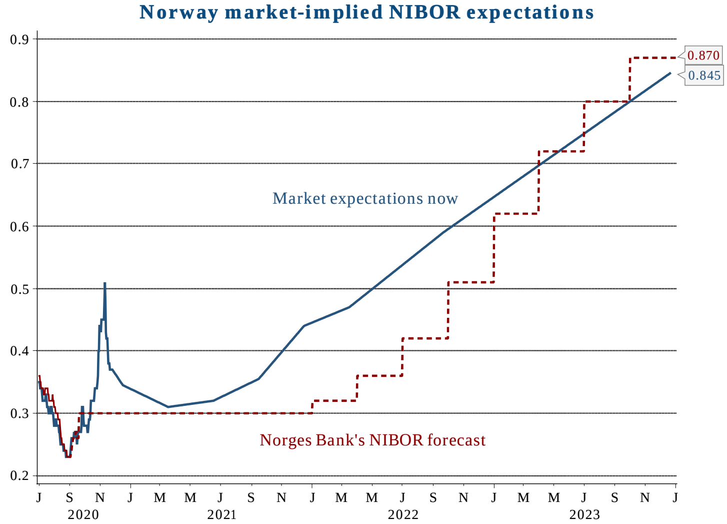
Meanwhile, we remain long NOK against shorts in EUR, SEK and GBP as we expect the Norwegian currency to perform relatively well in a context of the improved medium-term outlook for global demand.

Sweden trade weighted SEK index (KIX)



Source: Macrobond/Nordkinn

Norway market-implied NIBOR expectations



Source: Macrobond/Nordkinn

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