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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – December 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

Political agreements were reached in the last minute of 2020 in both the Brexit negotiations and in the pandemic aid negotiations in the U.S. This, in combination with the roll out of the Covid-19 vaccination program, boosted expectations for a strong global economic rebound in 2021-2022, supporting overall market sentiment at the end of 2020. Market participants looked through news of rising coronavirus case growth and news of a mutated and more contagious version of the virus given prospect of herd immunity during the second half of this year.

Consequently, global inflation expectations rose, see chart, and in particular the USD depreciated vis-à-vis currencies that tend to benefit from global growth revival. These developments supported our "*Global: Comparative inflation expectations*" and "*Global: Gradual return towards normality*" themes respectively. In addition, the underlying capital flows gave positive contributions to our "*Global: FX in a ZIRP world*" theme.

After countless breached deadlines, a Brexit deal was finally agreed upon some 4,5 years after the UK voted to leave the EU. The deal removes uncertainty and the risk of chaos, even if most economists see the UK economy significantly worse off than if it had remained a member of the EU. In addition, there are still several unsolved issues, including such as the UK financial services' access to EU markets. While the GBP strengthened on the news, gains were contained as investors expect the UK economy to struggle after the divorce.

In the U.S. Congress the Democrats and Republicans finally agreed on a deal that provides another USD 900 bln in pandemic aid, which amounts to circa 5% of GDP. Meanwhile in the EU, the European Commission approved a EUR 1,800 bln fiscal stimulus package partly financed by joint debt.

Monetary policy also continues to support the recovery. On December 10th, the ECB extended its pandemic purchase program by EUR 500 bln and extended the excepted duration of the program to December 2022. On December 16th, the Fed repeated its promise to keep its Fed funds target rate at zero and continue QE until they see substantial further progress towards maximum employment and higher inflation. As inflation have undershot the 2% target in recent years, the average inflation target regime means that the Fed will keep rates close to zero even if / when inflation picks up.

Nordic overview

The SEK continued its relentless appreciation in December, uneffected by fluctuating risk sentiment during the month. The currency finished the month almost 4% stronger relative to the USD, while the trade weighted SEK index KIX recorded a 1.6% gain. During 2020, the SEK strengthened more than 12% to the USD and 4% to the EUR, see chart. That is the strongest year-on-year performance since mid-2011.

The Swedish fixed income market saw only limited moves during the month. The exception were Break-Even Inflation (BEI) rates that moved higher and mostly in shorter maturities. Our combined short positions in longer dated BEIs relative to longs in U.S. BEIs, which outperformed, contributed positively to the return within our theme "*Global: Comparative inflation expectations*".

Swedish government bonds (SGBs) performed relatively well and regained lost ground compared to swaps and covered bonds. Interest from overseas investors seems to have picked-up, as reflected by a whopping 71% share of foreign buying in the new 25-year bond. This contributed further to the stronger SEK at the end of the year.

Norwegian interest rates continued underperforming in December following a surprisingly hawkish Norges Bank announcement on December 17th. While the key policy rate was left unchanged at 0.00%, the expected timing of lift-off was moved to March 2022 from September 2022. The end of the rate path was lifted +35 bps, which is the largest upward revision since 2011. The new rate projection is consistent with an accumulated 100 bps of tightening during 2022-2023.

This is quite remarkable considering the rise in new Covid-19 infections since the previous monetary policy report, which forced the government to re-introduce stricter containment measures. It also stands out against the recent monetary policy outlooks recently presented by other central banks across the globe. The main contributing factor to the higher interest rate profile was the news on vaccine availability, which will likely speed up the recovery through 2021 compared with that projected in the September Report. Losses on our "*Norway: Relative monetary policy*" theme were broadly offset by the strong NGB performance via our "*Norway: ASW trading*" theme.

Global markets

Forced household savings during the pandemic imply potentially strong consumer demand once the Covid-19 vaccination program is rolled out and herd immunity allows for full opening of the economies, see chart. The broad consensus among economists, supported by scientists' optimism of the effectiveness of the vaccine, is that this pent-up household demand, combined with still extraordinary expansionary fiscal and monetary policy, will lead to strong economic growth starting in the second half of this year. On top of that, the Democratic victories in both Georgia run-off elections on January 5th pave the way for greater fiscal stimulus in the U.S.

Taking the horrific events at the U.S. Capitol on January 6th aside, the consensus believes in a supportive geopolitical backdrop in 2021. The Covid-19 fiscal and monetary responses have led to a more united EU and the removal, at least for now, of the risk for a Euro break-up. The Brexit deal is finally in place, and by January 20th we look to have a more co-operative and predictable U.S. president. In addition to a lack of known geopolitical events (e.g. no scheduled major elections) this year, these are contributing factors to the geopolitical optimism.

Despite expectations of a sharp pick-up in economic growth, everybody expects wage inflation to remain contained over the coming few years amid spare production capacity and labour resources. While we agree on this narrative, we anticipate a temporary rise in consumer prices in 2021 as demand for travel and other services hit by the pandemic will soar. Higher commodity prices will also contribute in the same direction. However, inflation is unlikely to rise on a sustained basis before the labour market becomes tight.

Although there are downside risks, our main scenario is for a successful vaccine roll-out and herd immunity sometime during the second half of 2021. This allows for spending of the pent-up savings, and with continued strong support by policymakers, we largely agree with the consensus' optimistic view on economic growth for the latter half of this year. In terms of markets, the question is how much of the good news is already discounted. The dramatic recovery in risky assets has been strong and quick, where a lot of good news and optimistic expectations have been discounted by now.

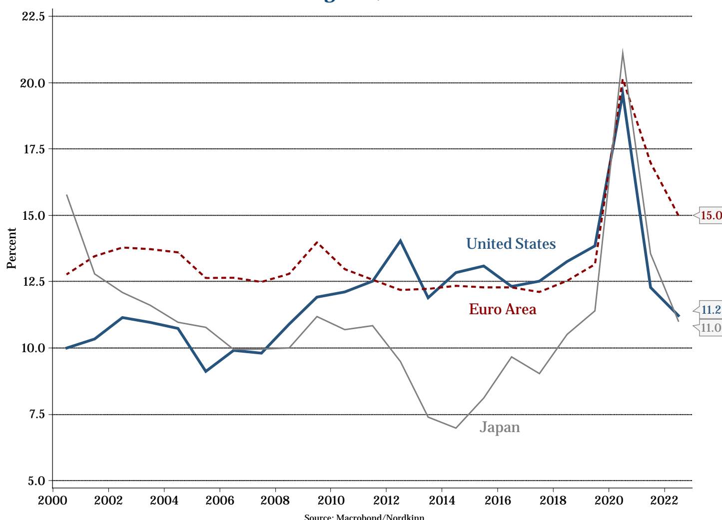
Historically, when the growth outlook improves and markets are "risk friendly", the USD have tended to weaken. Even though this is now a consensus view, and despite the current optimistic market sentiment, we think there is more to this trade. Consequently, we are still positioned for a weaker USD. In the theme *"Global: Gradual return towards normality"* we are short USD and CHF versus a basket of NOK, SEK, AUD and CAD. The latter four typically outperforms when global growth accelerates.

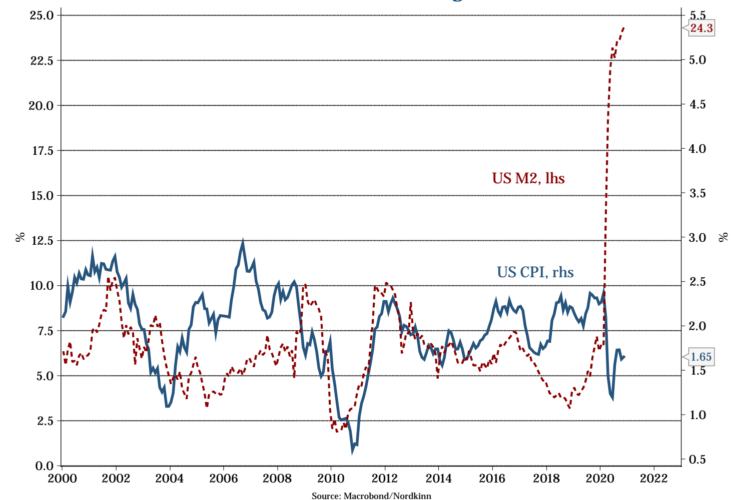
Moreover, we believe valuation and underlying capital flows reflected by current account imbalances will become more relevant with interest rates remaining stuck at their respective effective lower bounds. Against this backdrop, in the theme *"Global: FX in a ZIRP world"* we are short the USD and GBP, versus a long basket of JPY, SEK and NOK.

We do however see several risk factors to the constructive macro and market outlook described above. The policy measures taken come at several costs. Aggressive rate cuts incentivise investments and consumption today, but may lead to lower growth further down the road. Debt has increased substantially both for state and corporates. High levels of debts create fragilities and the current regime seems increasingly dependent on low interest rates. QE has supported economies and markets. What might the unintended consequences be?

Broad monetary aggregates are growing at a speed not seen in generations, see chart. Money growth is a necessary, but not sufficient, condition for inflation. The velocity of money is also important, as there can be no inflation unless money is spent. Should inflation pick up, while market participants start to question the sustainability of the current policy regime, risky asset will be in for a very rough ride. We think this is the biggest risk, but currently attach a low probability to it in the near-term as spare capacity is ample, keeping wage growth low. The potential long-term unintended consequences from aggressive policy support is a theme for further debate going forward.

One of the key short-term risks stem from the danger of the strong and optimistic consensus view. Markets often move towards maximum pain and corrections often happen when most investors are optimistic and fully invested.





Nordic markets

The second wave of virus spread has put renewed focus on social distancing, but there is a clear difference compared to the situation back in spring last year. This time the Swedish manufacturing sector is relatively unharmed. China has recovered fast without any clear second wave, supporting manufacturing recovery and global growth, hence supporting the SEK.

We believe that the appreciation of the SEK in 2020 will have repercussions for both policy and markets in 2021. Potentially also in the years that follow. During 2015-2018 the Riksbank kept its policy rate at record low, -0.50%, despite a gradual recovery in economic activity both domestically and abroad. In fact, the annual inflation rate (ex. Energy) surpassed the 2% target briefly in 2017 without any policy response. The goal was clearly to (re-)establish the credibility for the inflation target.

The average inflation (CPIF ex. Energy) over the five years running up to mid-2015 was roughly 1.00%. The stronger SEK between 2009 and 2014 pushed inflation downwards. In the following five years (up to early 2020) the average inflation was at 1.50%. This move higher in the average inflation was undeniably the result of the SEK depreciation. Between mid-2014 and mid-2019 USD/SEK moved from 6.65 to 9.90. A weakening of almost 50%.

Historically the USD cycles have been gradual and prolonged with repercussions for Swedish inflation. If we are about to witness anything similar again, we can expect that over the next few years Swedish inflation will be subdued, especially relative to global inflation.

With low inflation compared to both expectations and to other countries, Swedish interest rates will be low for a long time yet. Swedish BEIs will likely underperform European peers and as a result, real rates will increase relatively, barring a rate cut. This will imply yet another round of SEK appreciation and thus lower inflation still. It is likely that the Riksbank eventually will face renewed problems with an undershooting inflation rate as the SEK continues to trade on strongly, see chart. Core and service inflation, together with the SEK and inflation expectations in 2021, will be critical to watch in 2021.

How would the Riksbank address a too low inflation? Another round of QE purchases would only have marginal effect on interest rates given the already flat yield curve and compressed spreads. Hence, a Riksbank cut back to negative cannot be ruled out.

According to the new forward guidance of the Norges Bank's monetary policy committee, the key policy rate shall remain *"at the current level for over a year ahead, followed by a gradual rise from the first half of 2022 as activity approaches a normal level"*. However, as uncertainty surrounding vaccine availability remains high, the confidence band surrounding the baseline interest rate forecast is wide and depends crucially on the speed and the effectivness of the vaccination program.

The baseline scenario assumes that vaccination of risk groups begins in Q1 and that the general population is vaccinated in Q2, Q3 and Q4 of this year. It also assumes somewhat less restrictive containment measures in Q1, but that "some" containment measures will be needed thoughout the year.

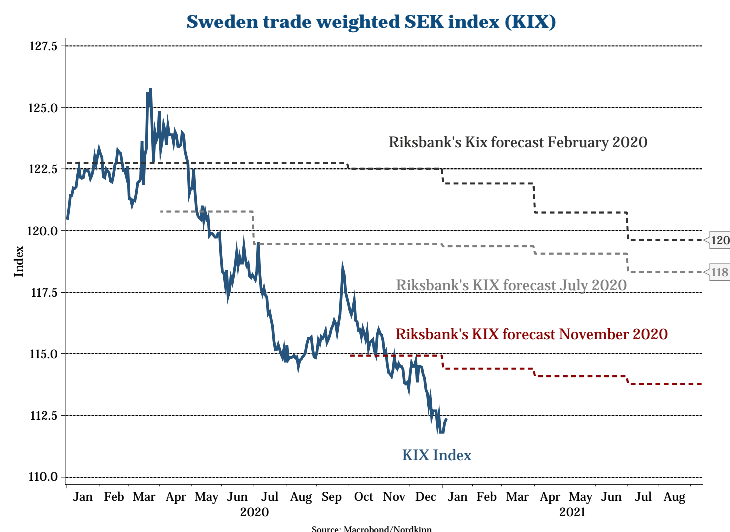
In the upside scenario, production capacity for already available vaccines is stepped up quickly and other vaccines in their final development phases are approved and also go into production. In this scenario, containment measures will be relaxed and there will no, or just a few, containment measures in place after June.

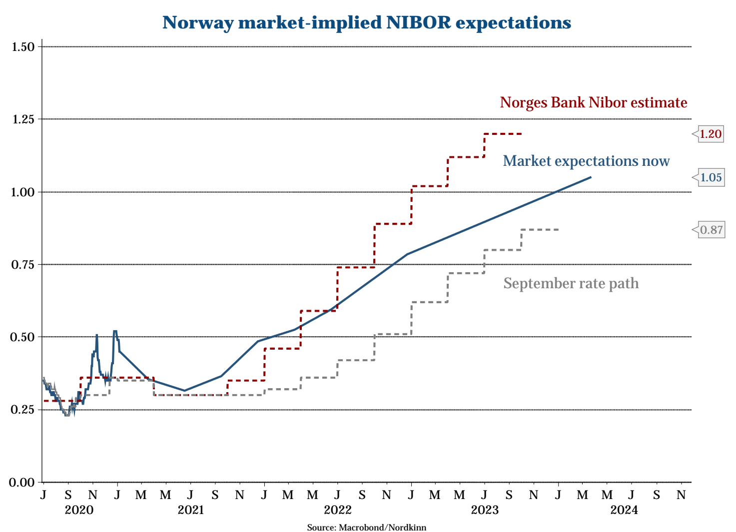
In the downside scenario, production and distribution bottlenecks lead to a delay in vaccination and strict containment measures need to remain in place also in Q1, before easing only very gradually from Q2. This implies a slower recovery and that policy support needs to remain in place for longer.

So far in Q1, containment measues are much stricter than assumed in the baseline scenario and the Government may even step up restrictions further given the sharp increase in new Covid-19 cases. However, the vaccination program appears to be unfolding broadly as expected in the baseline scenario.

The market currently prices in an interest rate trajectory consistent with the baseline scenario for 2021 and most of 2022, but below in 2023. In our view, the risk is skewded towards an earlier lift off, already in Q4 this year, provided that the vaccination program is sucessful.

At the same time, the current plan of hiking an accumulated 100 bps by end of 2023 appears too optimistic, in particular because we expect all other central banks in G10 space to keep interest rates near their effective lower bound in this period. The rise in interest rate differentials between Norway and its trading partners may add upside pressures on the NOK exchange rate, which would dent growth and inflation prospects.





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