NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – January 2021

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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

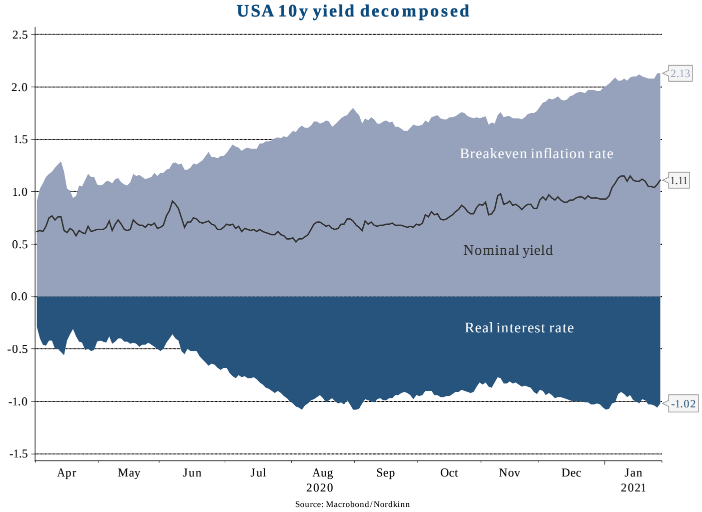
The year 2021 started on a positive note as economists significantly revised their estimates of U.S. fiscal stimulus upwards, following the surprising Democratic sweep of the two Georgia Senate runoff elections on January 5th. In combination with the vaccine rollout, stimulus prospects supported risky assets and elevation in bond yields.

However, optimism faded later in the month due to uncertainty regarding size, timing and composition of the U.S. fiscal package as the Senate is 50-50 split with Vice President Harris holding tiebreak vote. Moreover, Covid-19 and vaccine news were mixed. Reports of delays in vaccine production from both Pfizer and AstraZeneca lead to concern about bottlenecks in vaccine and delays in the vaccination programs, in particular in Europe. Moreover, increased spreading of mutated and more contagious versions of the virus lead to stricter countermeasures in some countries that will further delay economic recovery. Consequently, risky assets lost the gains in the latter half of the month.

The rise in long-term U.S. bond yields in January reflects a further rise in break-even inflation (BEI) rates, while real interest rates remained unchanged, see chart. Prospects of a transitory spike in inflation in 2021, a risk that was reinforced by rising energy prices and the unexpected surge in German and Spanish CPI inflation rates, lead to even higher short-term BEI rates, hence the slope of the BEI curve became flatter. Against this backdrop, our *"Global: Comparative inflation expectations"* theme contributed to performance in January.

On January 21st, the ECB confirmed its current stance of maintaining its negative interest rate policy (NIRP) and its asset purchase programs for a long time. With respect to the NIRP-policy, the ECB commits to current low or ever lower rates until "the inflation outlook robustly converge to" a level close to, but below 2%. A few days later, ECB "officials" were quoted saying markets underestimate the likelihood of more ECB rate cuts, which contributed to a rally in short-dated EUR interest rates.

In combination with higher long-term bond yields, the rally in short-dated EUR rates supported curve steepeners in January, which benefitted our *"Global: Gradual return towards normality"* theme. On top of this, several short-term trades also contributed to performance via our *"Tactical risk reward trading"* theme.



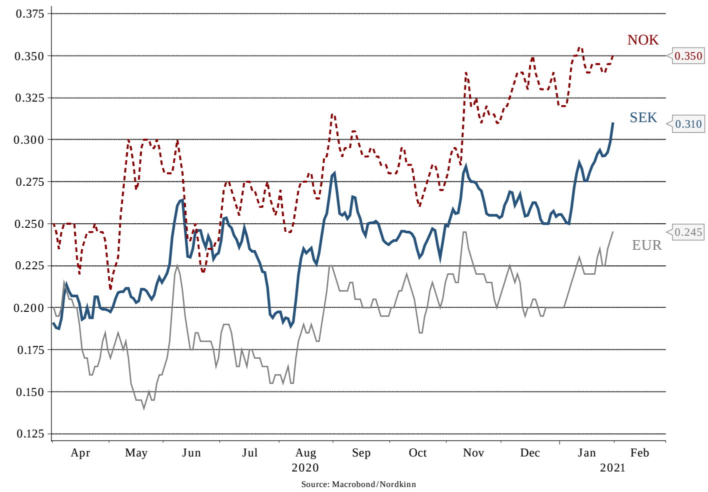
Nordic overview

Swedish data points towards a K-shaped recovery as manufacturing data surprised on the upside while data like retail sales disappointed. The second wave of the virus, triggering stricter restrictions, is clearly having a toll on domestic economic activity. On January 13th, the Riksbank announced it will purchase foreign currency in an amount averaging SEK 5 bln per month until the end of 2023. The intent is to fund the foreign exchange reserves by purchasing foreign currency in the market instead of having the Debt Office issuing bonds. This triggered a pause of the SEK appreciation.

Regarding the Swedish fixed income market, government bonds underperformed versus other instruments, while the yield curve steepened as short-end interest rates declined while longer dated rates moved higher, see chart. This contributed to performance from the themes *"Sweden: Supply/demand imbalances"* and *"Sweden: Hunt for yield"*. In addition, the outlook for inflation in the short term improved as energy prices jumped. This resulted in a flattening of the SEK break-even inflation curve, adding to the performance from the theme *"Global: comparative inflation expectations"*.

NOK interest rates continued higher in the beginning of 2021, rising more than European peers in anticipation of a rate hiking cycle commencing by year-end. The Norges Bank's statement on January 21st gave additional ammunition to NOK bulls as the committee signalled confidence regarding its projection that economic growth will pick up further out in 2021 as "it appears that vaccination rollout will be somewhat faster than assumed earlier".

The sentiment began to turn only a couple of days later after Norway's Government suddenly introduced the strictest measures since March 12th 2020 following concerns about the spread of the more contagious variant of the coronavirus first discovered in the UK. On January 23rd, the Government ordered all shops except for food stores, pharmacies and petrol stations to close in 15 counties including Oslo. Then on January 27th, the Government announced it would close borders to essentially all non-residents. Along with weaker risk sentiment in global markets, these measures raised concerns that the slowdown in the economy will persist somewhat longer than expected, triggering a rally in NOK rates in the final days of the month. The theme *"Norway: Relative Monetary Policy"* subtracted marginally from performance.



Global markets

Risky assets have long taken comfort in the prospects of a strong pick-up in growth once we get the upper hand in the fight against Covid-19. The optimism is based on three main drivers: 1) Continued ultra-loose monetary policy; 2) Continued massive fiscal stimulus; 3) Strong pent-up demand from large forced savings by households.

The latest signals from the main central banks reaffirm a continuation of the current monetary policy for a long time. They are aware of short-term inflation pressures as economic activity is expected to rebound strongly in 2021, but they believe significant output gaps will keep underlying inflationary pressures muted for years and will therefore look through short term spikes, see left hand chart. Moreover, the Fed's average inflation targeting (AIT) deliberately allows inflation to overshoot for some time without triggering a policy response.

In the U.S., total fiscal stimulus in 2020 and in 2021 combined will most likely exceed USD 5 trn or about 25% of GDP. European numbers are smaller, but the 3% limit on fiscal deficits are long gone. We believe authorities will sustain high levels of public spending, even though the fiscal deficits will have to come down from the 2020-levels.

On average, U.S. households have been more than compensated for their income loss and have excess savings in the magnitude of 7% of GDP. Households in several other developed economies also have huge excess savings. A significant rise in consumer spending is likely once the economies reopen.

In the very short term however, the economic outlook hinges on the virus and vaccine development. Based on what we know, our working thesis is that the vaccination programs will gather pace and herd immunity will allow for a return to normality at some stage during the second half of this year. In combination with current shutdowns and warmer weather, this should hopefully rapidly improve infection and death rates over the next few weeks and allow for earlier reopening.

Consequently, we remain constructive on the outlook for global growth and we stick with our *"Global: Gradual return to normality"* theme, which includes a combination of yield curve steepeners and FX reflation trades.

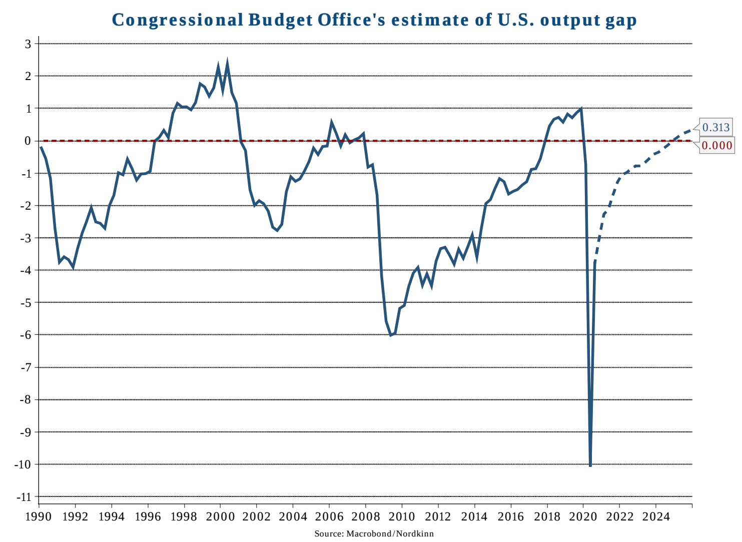
However, there are risks to this benign outlook. For one, the size, composition and the timing of the U.S. fiscal package remain highly unclear given the risk that some Democrats could vote against Biden's proposals and that Republicans might apply the tactics of filibustering to obstruct voting power in the Senate.

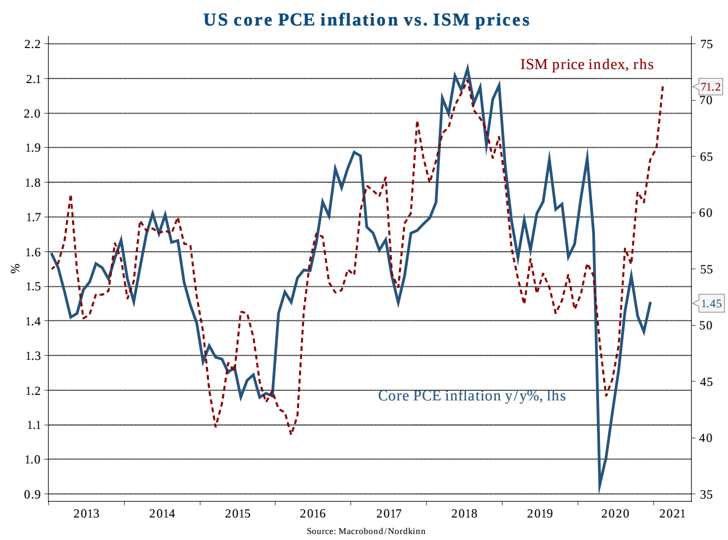
Another more fundamental concern is that we see an increasing risk of an inflation scare at some stage. In the short term, strongly rising commodity prices and, for the U.S., a weaker dollar, will most likely contribute to higher inflation already in 2021, see right hand chart. Moreover, as economies reopen and growth accelerates, spare capacity might disappear much faster than expected. As the impact from Covid-19 has be very uneven across sectors, there might be less slack than the headline unemployment and utilisation rates currently imply.

Furthermore, the monetary and the fiscal response exceed any templates that we can find in our lifetime. There is a danger that policy makers will not be able, nor willing to, exit these policies when the world eventually recovers from Covid-19. If these policies are the new norm, there is a significant risk of galloping inflation in the longer term.

As a baseline scenario, we tend to agree that prices will be contained in the medium term, but we expect rising inflation during 2021. Such a pick-up, combined with the inflation risks outlined above, could change the consensus "ample capacity" - narrative. On balance, we continue to expect global BEIs to outperform against Swedish BEIs, which is reflected in our *"Global: Comparative Inflation Expectations"* theme.

Finally, given consensus optimism on global growth and the strong rally in risky assets in recent months and even quarters, we could see significant market volatility in the near-term. The explosive price gains in GameStop and a few other stocks last month were as interesting as they were concerning as a new phenomenon. The tail-risk is that this micro story leads to failure of some big entities that could be systemic, which would have major macro consequences. While we continue to expect gains from reflation / normalisation trades in coming months, discipline is essential and we stand ready for the balancing act of adding or reducing exposure when deemed appropriate.





Nordic markets

In Sweden we expect inflation to rise over the next few months. The "basket effect" in January will probably have a less dampening effect on the annual rate. Normally SCB alters the basket weights every January to reflect consumption two years earlier, but this year´s weights will be based on consumption in Q1-Q3 2020. This in an attempt to measure inflation more accurately as consumption patterns have changed dramatically due to the pandemic. Indeed, CPI flash data for Germany and Spain showed sings of a significant "basket effect". Moreover, higher electricty prices will push headline higher as well, see chart, as will commodity prices. These factors pose upside potential to Swedish CPI for January, to be published on February 18th. If upside materialises, we expect short term BEIs to benefit more than longer BEIs, which already are relatively expensive. This view we adress in the theme *"Global: comparative inflaiton expectations"*.

A higher inflation rate, although transitory, will also have other repercussions for the Swedish interest rates market. Inflation expectations could increase somewhat on the back of higher realised CPI inflation. Together with, at least for now, a pause in the appreciation of the SEK, higher realised and expected inflation could offer some relief to the Riksbank, which in turn could generate some upward pressure on interest rates, at least relative to other economies. Recently the Riksbank has, in various speeches, sounded more alert to the appreciation of the SEK, which probably is an indication that Board members are concerned about the stronger currency and the likely effect it will have on imported inflation later in the year.

Despite a temporary upward move in inflation, we do not see shorter rates moving considerably, although longer term yields are more likely to increase. The size of such a move will of course be decided by global forces, but some relative underperformance is plausible. Moreover, the least attractive bond category for an investor, i.e. government bonds, will almost certainly have the most to fear in such a "sell off". In addition, the swap curve should experience some steepening pressure. Ahead of the turn of the year there were some uncertainties about where the 3m STIBOR would settle. For now it has stabilised around -5 bps, which is lower than market pricing suggested entering into the new year. The Riksbank's decision to fund the foreign exchange reserve by purchasing foreign currencies will result in even more (permanent) excess liquidity. Hence STIBOR fixing will remain low for a long time. The relative value positions in the themes *"Sweden: Suppy/demand imbalances"* and *"Sweden: Hunt for yield"* are set to benefit from such scenarios.

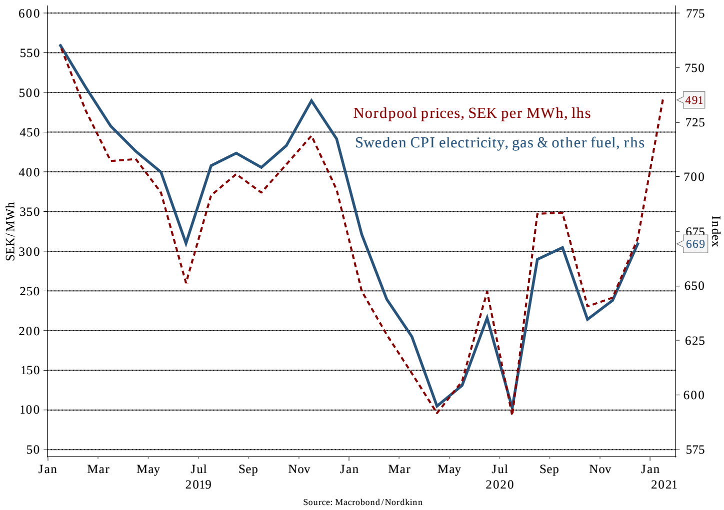
Turning to Norway, expectations in the NOK interest rate market is broadly consistent with the recent projection by the Norges Bank of an accumulated 100 bps of rate hikes during 2022-2023, with a couple of nuances. First, the market prices in a relatively high probability (approx. 75%) of a rate hike already by the end of 2021, whereas the Norges Bank's latest projection signals lift-off in the first half of 2022. Second, the market prices in a slightly more protracted hiking cycle where the key policy rate reaches 1.00% in late 2024 rather than end-2023.

Incoming information since the December Norges Bank meeting has been mixed. GDP held up better than expected in November, but will likley show a much weaker development from December and into 2021. Containment measures are stricter than the Norges Bank assumed in its report. The Norges Bank acknowledged this risk in the statement following the interest rate announcement on January 21st, but since then the government has introduced even stricter measures. Although vaccination is likely to lay the ground for a strong rebound later in 2021, the current situation is fragile and uncertainty is high. Consequently, the risk-reward of shorting shorter term FRA rates does not look good in our view. Rather, we are positioned for a steeper 2021/2023 rate curve, a flatter 5s10s area and a stronger NOK exchange rate via our *"Norway: Relative Monetary Policy"* theme.

Speaking of the NOK, the near-term volatility will likely continue to depend crucially on the rise and fall in risk appetite. Looking beyond short-term fluctuations, we expect the NOK to appreciate during 2021. Having been one of the worst performing G10 currencies in 2020 amid the Covid-19 shock, we believe the NOK could become one of the best performing currencies in 2021 as the global economy recovers from the pandemic. Rising commodity prices is one of the key features of the recovery, and given lack of investments in recent years, the oil price should see additional upside potential when economies open up.

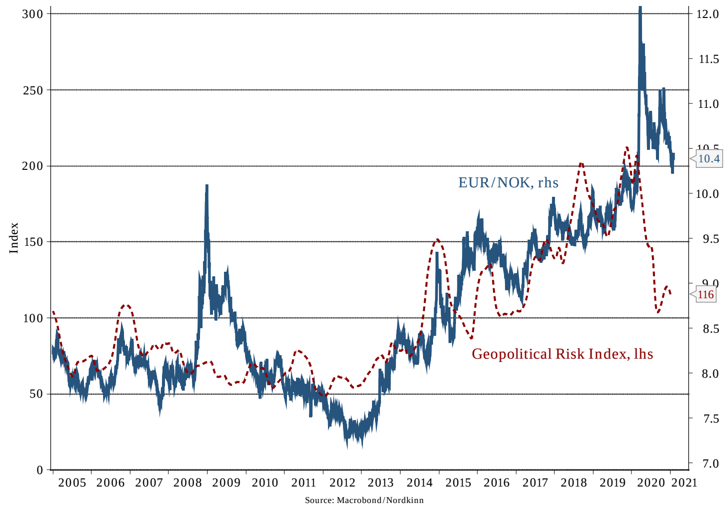
In addition, we have previsouly highlighted the evidence of negative correlation between geopolitical risks and the NOK, see chart. While not disappeared, the uncertainties associated with the U.S. vs. China trade dispute and Brexit are arguably lower now, which may also support the NOK in coming months and quarters. Furthermore, prospects of Norges Bank rate hikes over the coming couple of years should eventually benefit the NOK as other central banks are expected to remain on hold for long. Finally, the unexpected decision to scale-up NOK purchases on behalf of the government to NOK 1.7 bln per day in February from NOK 0.8 bln in January will also contribute positively.

Sweden CPI electricity prices



Source: Macrobond/Nordkinn

EUR/NOK and Geopolitical Risk Index



Source: Macrobond/Nordkinn

ABOUT NORDKINN

Nordkinn Asset Management aims to create and preserve wealth by consistently providing investors with stable risk-adjusted absolute return through its unique team and local expertise. Operating from Stockholm and Oslo, the team of ten capitalises on their specific fixed income and absolute return backgrounds. Nordkinn aspires to be the leading hedge fund in the Nordic region as measured by risk-adjusted performance, operational excellence and investor appreciation.

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