NORDKINN

ASSET MANAGEMENT

# Nordkinn Market Review & Outlook – February 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.

## Global markets

So far, risky assets have been supported by expectations of a strong pick-up in growth combined with a benign inflation outlook and supportive central banks. Growth optimism mainly reflects strong pent-up demand from large forced savings by households, unprecedented fiscal stimuli and low interest rates. Meanwhile, the modest inflation outlook hinges on the assumption that spare capacity in the economy allows supply to keep up with increased demand without bottlenecks and price pressures.

Bond markets have started to discount the risk that we may get too much of what we are asking for. There is a growing fear that strong growth leads to a faster and more persistent pick-up in inflation than generally assumed. This has resulted in a growing divergence between the markets and the Fed's expected rate paths, which culminated in dramatic movements in fixed income markets at the end of February. The market now discounts rate hikes already next year, whereas FOMC "dots" indicate a first rate hike in 2024 at the earliest.

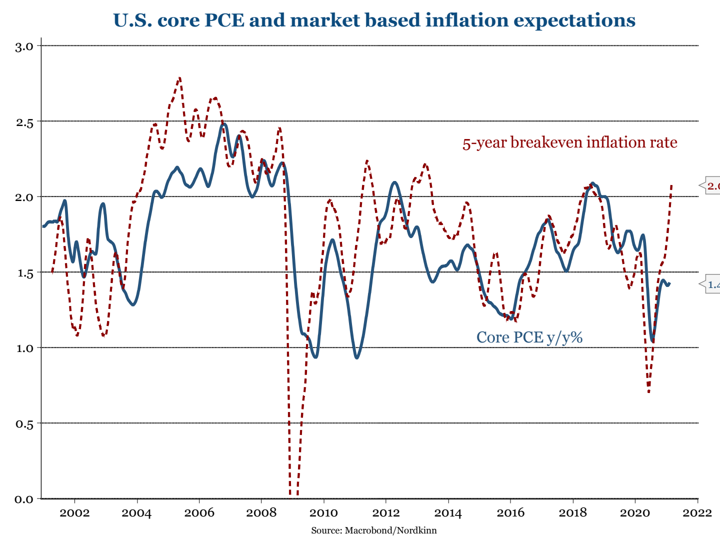
A key question is whether the market expectations will revert to the central banks projections or if central bankers will adapt towards the markets' expectations. Our main scenario is the former, at least for now. In his testimony to the US Congress, Fed chair Jerome Powell once again emphasised that the Fed expects the pick-up in inflation during 2021 to be transitory, and that inflation will be kept in check longer term. He also reiterated that the Fed will not tighten monetary policy solely in response to a strong labour market. Rather, the Fed needs to see a both a strong labour market, and inflation on track to exceed 2.00% for some time, before tightening monetary policy. Finally, he concluded that the economy is a long way from achieving substantial progress towards these goals.

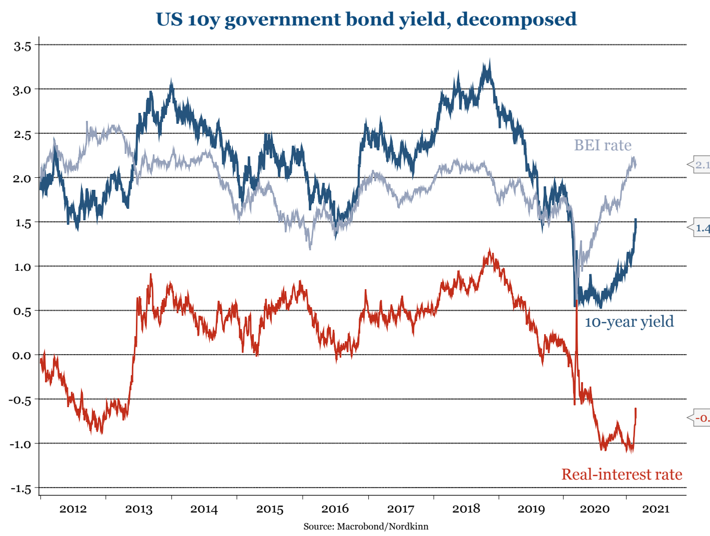
Given that the Fed has to earn credibility concerning its new monetary policy strategy, Average Inflation Targeting (AIT), expectations of rate hikes already in 2022 seems too aggressive in our view. Consequently, we maintain our overall view that growing economic optimism should result in steeper, instead of flatter, curves. As recent spikes in volatility indicate, active management of exposures will be critical.

While our base case is for moderate underlying inflationary pressures going forward, consistent with Fed remaining on hold in the coming 2-3 years, we humbly acknowledge that there is no template for the current economic regime. Monetary and fiscal policies are unprecedented and the K-shaped economic recovery with huge capacity variations between sectors, could imply that traditional economic models such as aggregated output gap analysis are misleading. We expect pockets of inflation even if there is spare capacity at an aggregated level. Commodities could be the canary in the coalmine. Food, energy and industrial metal prices have all risen strongly as supply might not be able to meet the increased demand from consumption and infrastructure and "green" investments. One simply cannot be sure how growth and inflation dynamics will play out going forward.

In this context, we argue that there is an interesting inconsistency between market-based inflation expectations and expected future rate hikes. According to the discussion above, core PCE inflation has to overshoot the Fed's 2.00% target for some time before the Fed begins to raise rates. As can be seen in the chart, the market discounts higher CPI inflation over the coming years as suggested by the 5-year breakeven inflation rate (BEI) slightly above 2.00%. However, in order to be consistent with core PCE inflation above 2.00% for some time, 5-year BEI probably needs to exceed 2.5%. Consequently, if one really does expect a spike in inflation to eventually challenge the Fed's dovish monetary policy stance already next year, market-based inflation expectations should rise a lot more in our view.

At the long-end of the curve, however, we expect continued high volatility in rates and see potentially large moves in both directions. In our main case where economies open up during the summer, the risk is still tilted towards higher long-term rates. Our main case is also that central banks maintain their credibility and are able to keep long-term inflation expectations in check. Hence, we think a further rise in nominal long-term bond yields mainly will stem from rising real yields, see chart.



# MARKET OVERVIEW

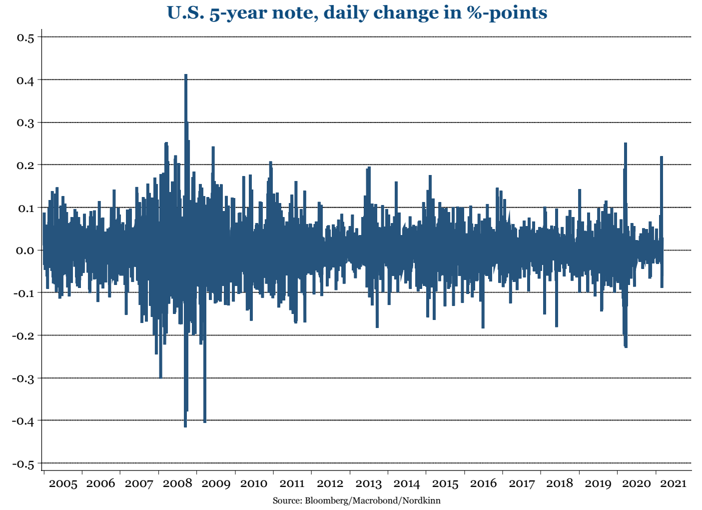
## Global overview

The market moves in the first three weeks of February were largely an extension of developments in January. A relatively orderly increase in longer-term interest rates driven by higher inflation expectations alongside historically low and stable real rates. These moves occurred in an environment of growing optimism about the likelihood that Congress will approve a U.S. fiscal package closer to the USD 1.9 trn proposed by president Biden. Further, vaccine news were largely positive during February. Pfizer said it expects to nearly half the production time and Moderna also indicated ability to ramp up production. In addition, Johnson & Johnson's single dose vaccine was approved by the FDA.

However, on February 25th the calm environment of long-term interest rate increases suddenly migrated into a dramatic turbulence across yield curve. When the auction of 7-year USTs was met with lacklustre demand, the U.S. Treasury market experienced a "mini flash crash" as the 10-year yield moved from 1.38% to 1.60%. This spilled over to shorter-term rates and was accompanied by a sharp drop in inflation expectations. Just to give an idea, in a matter of hours the U.S. 5-year Treasury yield moved a whopping 22 bps, see chart.

The situation began to resemble the 2013 taper tantrum, i.e. when the Fed tried to downsize QE, despite major central banks having tried their best to confirm dovish forward guidance. Accordingly, the turbulence during the last two days of February 2021 was market driven and not triggered by central bank rhetoric.

Prior to the turbulence, yields had slowly commenced moving higher, derailing the connection between market pricing and central bank´s forward guidance. As many investors suffered when short-term rates continued to move higher, it is likely that a wave of investors' closing of positions exacerbated the move in rates, which in turn forced even more flows. As a consequence of this, gains on our *"Global: Gradual return towards normality"* theme were unable to offset losses from *"Global: Comparative inflation expectations"*, *"Tactical risk reward trading", and "Global: FX in a ZIRP world"*.




## Nordic overview

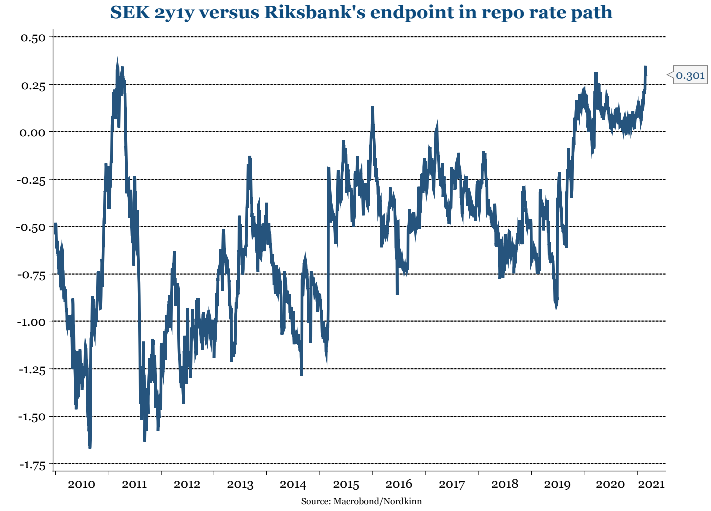
During the last days of February, the dramatic rise in short-term interest rates unfolded also in Sweden. As an illustration, the SEK 2y1y rate (i.e. the implied 1-year rate staring two years forward) rose almost 30 bps. The unusually swift and disorderly moves in Swedish interest rates during February resulted in a strong negative effect on the performance of the themes *"Sweden: Hunt for yield"* and *"Sweden: Supply/demand imbalances"* during February.

The spread between SEK 2y1y rates relative to the end-point of the Riksbank's rate path, i.e. market pricing vs Riksbank's projection, is historically wide, see chart. Expectations of interest rate hikes thus strongly contradict the Riksbank's own monetary policy outlook. This is especially striking giving the Riksbank's apparent strong commitment to bring inflation sustainably back to the target of 2.00%.

On February 9th, the Riksbank Board confirmed that it expects the repo rate to be kept at zero for a very long time, at least through Q1 2024. Interestingly, the meeting minutes, released a week after the policy announcement, revealed a more open discussion about the possibility of a rate cut back into negative, in case inflation outlook deteriorates. Rate hike expectations also contradict market-based inflation expectations: The 5-year breakeven inflation rate is trading close to 1.60%, significantly below the Riksbank's 2.00% target.

Turning to Norway, the NOK interest rate curve steepened as longer-term rates followed USD rates higher. The move in the final week of February was very aggressive and associated with signs of liquidity "stress", such as wider bid-ask spreads. The move resulted in a small negative contribution to our *"Norway: Relative monetary policy"* theme, even though growing expectations for rate hikes in the short-end of the curve contributed positively. While labour market data for January and February suggests that activity in 2021 is somewhat constrained by measures following the outbreak of the UK variant of the virus, markets are patiently looking forward to reopening amid more optimistic prospects for vaccinations. The market expects the first rate hike in the second half of this year.

Finally, Norges Bank issued a new 10-year Government bond in February, which attracted strong demand before and after the syndication. As this resulted in lower NGB yields versus swaps, the *Norway: ASW trading"* theme contributed positively to performance.



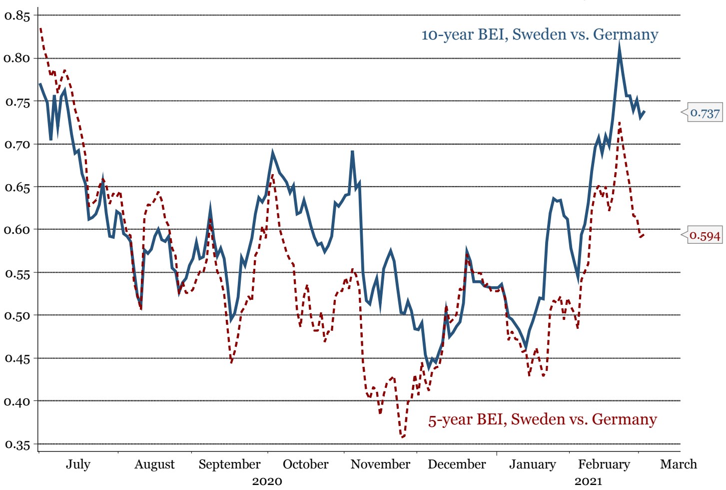
# Nordic markets

The increase in Swedish short-maturity interest rates in February, which accelerated in the last two trading days of the month, has resulted in a challenging pricing of the monetary policy path relative to economic projections. As indicated in the review section above, pricing of a more aggressive hiking path would have been reasonable if a re-pricing of market-based inflation expectations occurred, consistent with an inflation overshoot or, at least, a significant progress towards the 2.00% target over the medium-term. This is however not the case. The inconsistency between pricing of Riksbank and market based inflation expectations are significant and, in our view, even more pronounced in Sweden than in the U.S. and Europe. We do not believe it will last.

Supported by base effects from last year's plummeting oil price and the recent move higher in electricity and petrol prices, Swedish CPI inflation will most likely inch higher in the next few months. However, during the second half of 2021, we expect prices to moderate again as the underlying price pressure remains low as wage increases are muted. In addition, the stronger SEK in the latter part of 2020 will dent import prices, causing the inflation rate to ease relative to Europe. Base effects from the German VAT cut in 2020 will influence the European rate. This big shift in relative inflation rate, despite to some extent being caused by base effects, will put current pricing into question. Implied 5y5y Swedish breakeven inflation has reached 2.10% which is close to highest recorded, while European 5y5y is trading 1.30% and the US 5y5y rate declined below the Swedish rate late in February. In this context, it is interesting to note that the last time Sweden had an average inflation rate over five years that topped 2% was back in 1998(!). Inflation could of course take off, but in such a case, it will not happen only in Sweden in isolation.

Market based inflation expectations have moved significantly above survey based 5-year expectations, which is not very common. Thus, we see a hefty positive inflation risk premium in Sweden relative to survey based expectations and what history suggests. European BEIs are trading below survey expectations and in line with the historic price inflation. In sum, given the inflation outlook, the market is pricing a too aggressive Riksbank rate path, especially given short-end BEIs (<5Y), while longer BEIs (implied by forward BEIs) is trading too expensive, both relative to surveys and the outlook, but also relative to other markets/countries and what history implies. We believe it will correct and is something to explore in markets.

**Break even inflation rates, Sweden vs. Germany**




Source: Macrobond/Nordkinn

In Norway, we have become slightly more optimistic regarding prospects for economic reopening this summer. This is despite the relatively strict measures that were introduced in January, following the outbreak of the UK variant of the virus. Infection data were on a declining trend, but has increased again lately. The risk of new outbreaks suggests that containment measures will remain relatively strict also in March and April, which will hold back economic activity somewhat longer than the Norges Bank assumed in its December Monetary Policy Report. At the same time, GDP data for Q4 and labour market data for January and February seem to indicate that the economic impact of the measures are somewhat less pronounced than expected.

More importantly, vaccine news in Europe has been mostly positive recently, pointing to a faster pace of vaccination rollout than the Norges Bank assumed in December. In this context, we expect the government to wind down contatinment measures during summer, which will boost economic growth in the second half of this year.

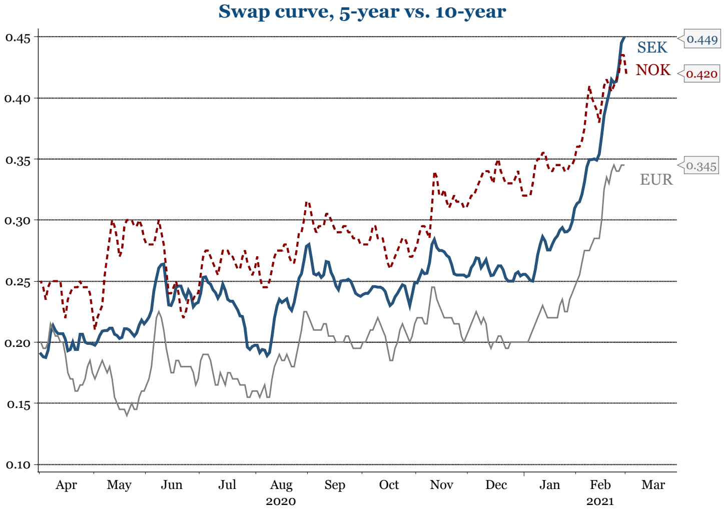
On balance, we belive stricter than expected containment measures today suggests that the Norges Bank is unlikley to bring forward the first policy hike to any large degree. With the Oslo area in lockdown, a rate hike in only six months time appears too early in our view. Higher than expected premium in the Norwegian money market, and a stronger NOK, point in the same direction. On the other hand, more positive vaccine news, stronger global growth prospects, higher oil prices and the fast rise in house prices suggest a somewhat steeper interest rate path in the Monetary Policy report due on March 18th.

Consequently, we still like positions for a steeper interest rate curve between 2021 and 2023, and a flatter rate curve further out, at least when compared to other European peers. These fixed income views are expressed in our *"Norway: Relative Monetary Policy"* theme.

We also remain structurally bullish the NOK, even if the near-term volatility will likely continue to depend crucially on the rise and fall in risk appetite. The NOK should continue to attract demand when economic activity opens up during spring and summer, supported by prospects of a Norges Bank rate hiking cycle staring at the end of this year.

Finally, we expect continued NGB performance versus swaps given the attractive yields on an FX-hedged basis in combination with lower net supply.

**Swap curve, 5-year vs. 10-year**




Source: Macrobond/Nordkinn

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