NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – March 2021

Addressed to Nordkinn's Followers on LinkedIn for informational purposes

Please note that the content of the Nordkinn Market Review & Outlook Report may not be republished without the written consent of Nordkinn Asset Management AB.

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 interest rates continued to rise in March lead by the U.S., although the moves were generally more orderly than in late February, see chart. Interestingly, the spread between the U.S. and German 10-year government bond yields rose more than 30 bps, exceeding 200 bps for the first time since February 2020. Several factors contributed to the wider yield spreads. First, the U.S. vaccine trajectory looks increasingly promising and reopening is already happening in most states, whereas the vaccine supply in Europe has been slower than expected and most of Europe is moving towards more, not less lockdowns. Second, stronger U.S. fiscal support has led to substantial increase in the U.S. growth-trajectory versus the rest of the world.

Third, in order to prevent a further sharp rise in European bond yields, the ECB decided at its March 11th policy meeting to increase the rate of bond purchases under the Pandemic Emergency Purchase Programme (PEPP). Nevertheless, the slope of the European interest rate curve became steeper in March, which was one of the main factors behind the positive performance of our *"Global: Gradual return towards normality"* theme.

Meanwhile, the FED did not seem to worry about the rise in longer-term yields, which could be interpreted as a healthy sign of rising growth and inflation expectations. At its meeting on March 17th the FOMC left its monetary policy stance unchanged while repeating the concept of average inflation targeting. That is, interest rates will be kept at zero until inflation is on track to moderately exceed 2% for some time in a context of maximum sustainable employment.

Global inflation expectations, in general, continued to climb higher during March. In particular, the 5-year European Break-Even Inflation (BEI) rate moved an impressive 25 bps. In the U.S., while the absolute moves were smaller, current levels are now at their highest since early 2013, just before the taper tantrum. Shorter term expectations, as reflected by the 2-year U.S. inflation swap at 2.65%, is the highest recorded since 2011. The surge has occurred despite the fact that the current spot inflation rate has not really moved. The outlier in inflation markets in March was Sweden, where the entire BEI curve declined. Overall, the developments within the inflation markets in March were supportive for our theme *"Global: comparative inflation expectations"*.

Nordic overview

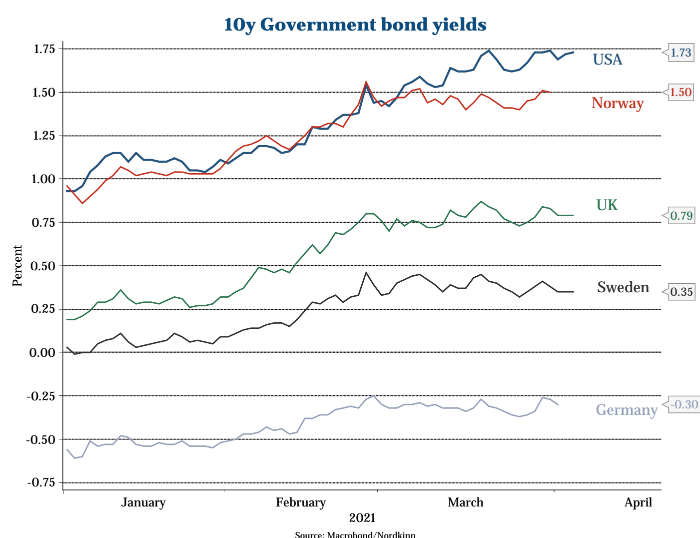
Despite the Swedish government combatting a third wave of virus infections in March, the economic outlook continued to improve as indicated by the improvement in PMI and the NIER surveys. Meanwhile, non-energy CPIF inflation fell sharply in February to 1.2%, i.e. 0.4%-points below both consensus expectations as well as that of the Riksbank's. The disappointment was broad-based and not subject to any factor in isolation. Interestingly, the components that were boosted by restrictions last year, like furniture, seem to have lost price momentum as a stronger SEK towards the end of last year is starting to take its toll. There is little evidence of upcoming inflation pressure according to the NIER survey.

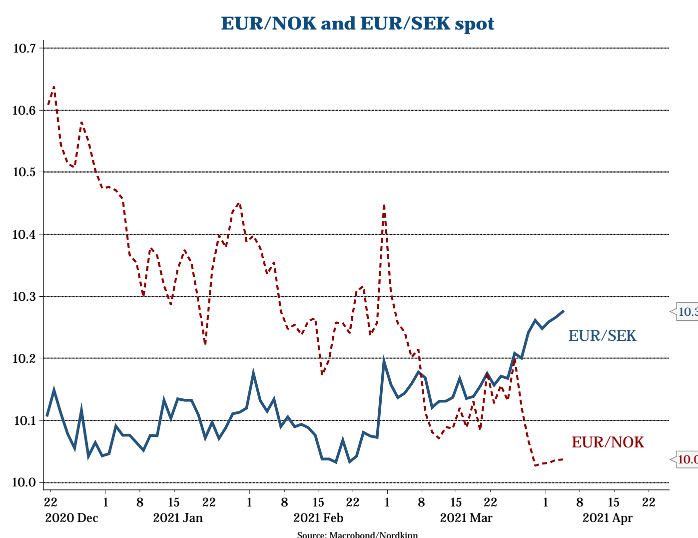
The low inflation print contributed to a SEK depreciation of more than 2% in KIX terms in March, despite the rates market continuing to discount a relatively hawkish Riksbank trajectory with 100 bps of rate hikes in the next 5 years. In addition, the dividend season April-May, which usually results in SEK outflows, seems to also have contributed.

Moves in the Swedish fixed income market were muted in March. The 10-year SGB yield traded in a +/-15 bps range, while curve spreads and spreads between bonds experienced only minor moves. Short-end rates were either unchanged or moved marginally lower. This gave support to our theme *"Sweden: Hunt for yield"*. Meanwhile, Break-Even Inflation rates moved in parallel 10 bps lower, which in part relates to the low inflation print in February.

On March 18th, following the widely expected decision to maintain the key policy rate on hold at 0.00%, the Norges Bank published updated projections for the economy and interest rates consistent with lift-off in September or December this year. Further out, the central bank forecasts the policy rate to be close to its pre-pandemic level at 1.50% by the end of 2024. The new rate path broadly matched expectations discounted in the market, hence market reactions were muted. NOK interest rates for the period 2021-2024 had moved significantly prior to the publication, resulting in a positive contribution to our *"Norway: Relative monetary policy"* theme.

The repricing of Norwegian interest rates in March did give support to the NOK, which in combination with a generally weaker SEK in March supported NOK/SEK and contributed positively to this theme as well.





Global markets

Although the FED managed to contain the rise in short-dated bond yields in March, a substantial divergence between the markets and FEDs "dots" remains. While some FOMC members increased their expected rate path at the March-meeting, and four members expect hikes already next year, the median still expects rates to stay at zero through the end of 2023. In the same time frame however, the markets discount around three rate hikes.

Ultra-loose monetary policy, unprecedented fiscal stimuli and strong pent-up demand from large forced savings by households are widely expected to lead to very strong U.S. economic growth over the next year. However, there seems to be less of a consensus as to how the inflation dynamic will play out in coming years. We do agree with the idea of higher inflation as the economy opens up, as it will unleash a pent-up demand to consume services.

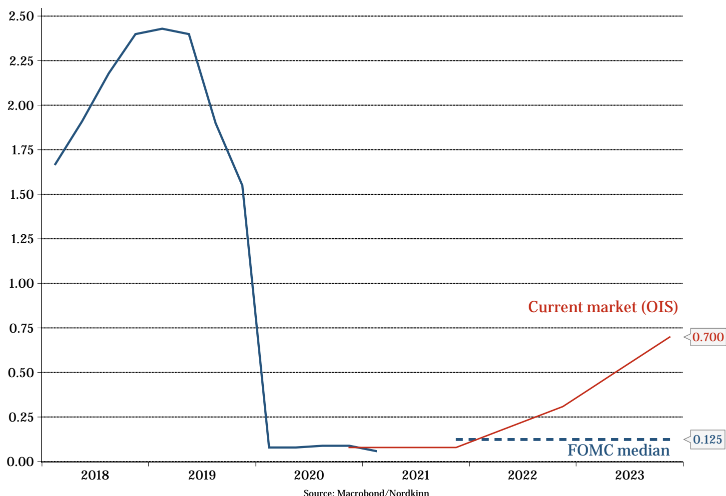
Having said that, the pent-up demand and supply restrictions will largely be temporary effects. Fiscal stimuli impulse will decline 2022, and commodity prices are now showing signs of fatigue as China demand is questioned while supply gradually picks up. Hence, in order to prolong the inflation boost beyond the first half of 2022, something else will need to do the heavy lifting. Unless wage growth accelerates significantly, market pricing is getting challenging in our view. For instance, consider the U.S. CPI 1y1y (i.e. the one-year inflation starting in one year's time) at 2.65%. Here, the burden of proof is substantial. If inflation turns out to be as expected over the next 12 months, adverse base effects will be massive the following year. On top of that, we note that the risk for a setback in goods inflation (which was boosted in 2020 by the lockdowns) is not really discussed.

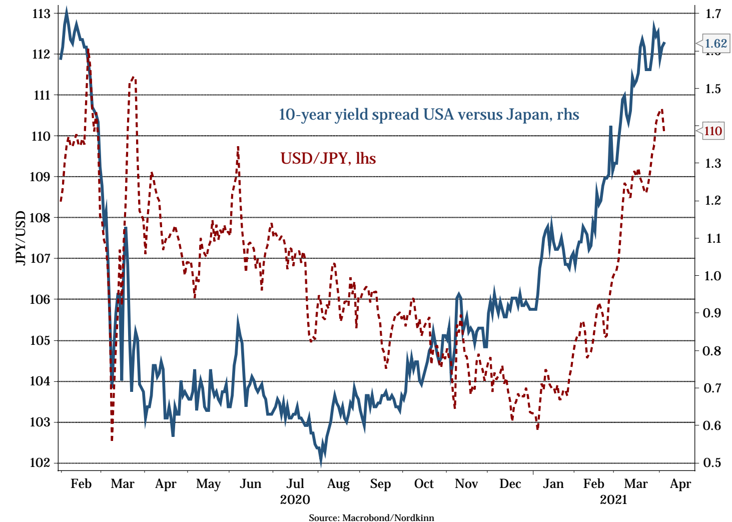
It is possible that inflation will pick-up in a more sustainable way, but this is already discounted by the markets. Despite this, as headline inflation moves higher in the next few quarters, we believe it will be supportive for current market pricing.

While we see a risk that a strong upswing in the U.S. economy and rising inflation in coming months could move the median FOMC member towards an earlier rate hike than indicated by the latest "dot-plot", we expect the committee to remain committed to its relatively new Average Inflation Targeting (AIT) framework. This suggests to us that rates will be kept on hold for longer than the markets currently discount. Hence, we are still positioned for a steeper yield curve, but now by targeted longs in the 2-year part of the curve and shorts in the 5-7 year segment.

In the longer-end of the curve, implied forward interest rates appear broadly consistent the FOMC's assessment of the long-run level of the Fed Funds target rate. We note that the rise in longer-term nominal yields have so far been driven mainly by rising inflation expectations. The U.S. 10 year real yield is still sub -60 bps, just about 50 bps above all-time lows from last year. At the same time, inflation expectations are close to 8-year highs. While the FED welcomes the rise in inflation expectations, with the new AIT regime we do not know their tolerance for a possible overshoot. However, should actual and expected inflation rise substantially in coming years, the FED should at some stage in the future react to contain inflation. Hence, we think that a further substantial rise in longer-term bond yields will be driven more by real rates than by a further increase in inflation expectations from current elevated levels. As we see limited downside to U.S. real rates in the event of an economic set-back, we now prefer to express any short duration trade via inflation-linked bonds rather than in nominal bonds, which offer better risk-reward in our view.

Against the background of a faster than expected rise in U.S. government bond yields so far in 2021, we have decided to terminate our *"Global: FX in a ZIRP world"* theme as the working thesis for theme no longer applies. At the beginning of the year, our view was that central banks would remain on hold for long and that structural factors, such as valuation and the current account balance, would dominate FX moves over interest rate differentials. However, the USD has appreciated sharply in tandem with rising longer-term bond yields, supported by large scale fiscal spending and effective vaccine roll out.





Nordic markets

So far, the depreciation of the SEK seen in March is too small to have material effect on inflation and therefore policy going forward. However, if it continues it could eventually result in some higher inflation prints, yet should not be exaggerated. Projections for Swedish underlying inflation are subdued and most forecasters, including Nordkinn, expect the core inflation (CPIF excluding energy) to go below 1% by this summer and remain there for some time. Although the Riksbank has more or less the same future inflation trajectory it will keep hopes of rate hikes in check for a long time. In this perspective we see current pricing of Swedish rates in shorter maturities (>5y) not only as out of line with forecasts, but also inconsistent with the pricing of future Swedish inflation.

The current 5-year Break-Even Inflation (BEI) rate is close to 1.50%, which is considerably below the Riksbank target, whereas market prices close to 100 bps of rate hikes during the same period. This seems inconsistent given the Riksbank's focus on the 2% target and its commitment to reaching it. Consequently, we believe Swedish short-dated real rates are too high. During March, German 5-year real rate decreased more than 25 bps, while the Swedish equivalent was unchanged. In our view, shorter rates in Sweden have room to decline in both absolute terms and relative to peers, driven by lower real rates.

The theme *"Sweden: Hunt for yield"* has been altered in terms of the nature of the positions. Amid higher bond yields and brighter economic outlook, the hunt for yield has become less intense and the theme has scaled back on positions boosted by the yield quest. Instead, we focus on trades that explore the inconsistency in short rates relative to the inflation outlook. To better reflect what the theme contains, we have changed its name into *"Sweden: Riksbank and market pricing inconsistencies"*.

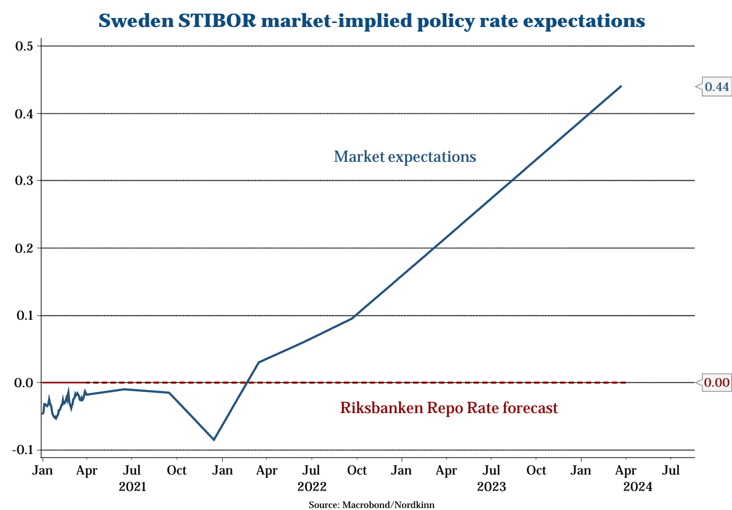
Going forward, longer dated Swedish interest rates could follow European peers higher in lock-step, as macro data gradually improves. Combined with the elevated short term interest rates, the outlook is set for steeper curves in Sweden. However, the road to get there will probably be bumpy as the Riksbank focuses its QE purchases on SGBs in the very long end of the curve.

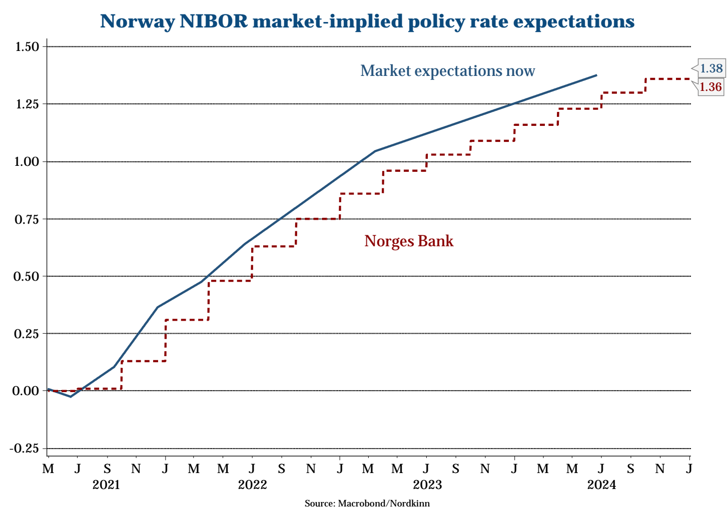
The Norges Bank's announcement on March 18th that it brings forward the expected timing of interest rate lift-off to the second half of 2021 came after a pronounced increase in nationwide infection rates and stricter containment measures. Again, Norges Bank has looked through the short-term weakness and focuses on its forecast for economic developments further ahead. These forecasts, in turn, hinge on the assumptions regarding infection rates, containment measures and vaccination rates in coming months and quarters.

The central bank's baseline scenario for vaccination is consistent with the so called "sober" scenario published by the Norwegian Institute of Public Health (NIPH) on March 12th. Under this scenario, all risk groups, including health personnel, will be offered a first dose before the end of May and the remainder of the adult population by the end of July. Based on this assumption, the Norges Bank estimates vaccination coverage of over 80% for the adult population by the end of August and that the key policy rate will be raised by 25 bps in the second half of 2021.

In an updated verision of the NIPH scenarios published on March 30th, vaccination speed was revised slightly upwards. This would in isolation imply a faster phase out of containment measures and a higher probability for interest rate lift-off in September. However, the scenarios are associated with uncertainties, including whether AstraZeneca will continue to be part of the program or not.

Our judgement is that the MPC has a bias to exit its zero interest rate policy sooner rather than later. Consequently, if incoming information does not deviate too much from expectations, we now forecast lift-off in September and an accumulated 100 bps of tightening by the end of next year. However, this is already discounted by the market. For instance, we expect the Sep21 FRA rate to fix in the range 0.45-0.50% if Norges Bank moves in September. The contract currently trades close to 0.45%, which means there is little upside left. Further out, the market discounts a key policy rate at 1.00% by the spring 2023, which is marginally more hawkish than implied by the Norges Bank's baseline scenario. Consequently, we have taken profit on several trades under our *"Norway: Relative Monetary Policy"* theme.





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.

DISCLAIMER

The content of this Report has been prepared by Nordkinn Asset Management AB (the «Company»), registered in Sweden No. 556895-3375. All rights reserved. Information in the Report is made only as at the date of the Report unless otherwise stated, and remain subject to change without notice. The Content has been prepared in good faith. However, to the maximum extent permitted by law, neither Nordkinn Asset Management AB, nor its related corporations (including Nordkinn Asset Management Oslo Branch, registered in Norway No. 999 136 354), directors, employees or agents, nor any other person, accept any liability, including, without limitation, any liability arising from fault or negligence, for any loss arising from the use of the Report its contents or otherwise in connection with it.

The Report contains forward-looking statements. Although the Company believes the expectations expressed in such forward-looking statements are based on reasonable assumptions, such statements are not guarantees of future performance and actual results. Actual results or developments may differ materially from those projected in forward-looking statements. Past performance is no guarantee of future returns. The value of investments and the income from them may fall as well as rise and is not guaranteed. Changes in rates of exchange may cause the value of investments to fluctuate. The Report is confidential information, only for the use of those persons to whom it is addressed and no part of this report may be reproduced, redistributed or passed on, in any manner, or used other than as intended, without Nordkinn's prior written permission. The report does not constitute an offer to sell or the solicitation of any offer to buy

Kungsgatan 33, 6th floor
111 56 Stockholm, Sweden
Phone: +46 8 473 40 50
Telefax: +46 8 473 40 51
E-mail: post@nordkinnam.se

Prinsens gate 22, 6th floor
0157 Oslo, Norway
Phone: +47 22 46 63 00
Telefax: +47 94 77 15 16
E-mail: post@nordkinnam.no