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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – May 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

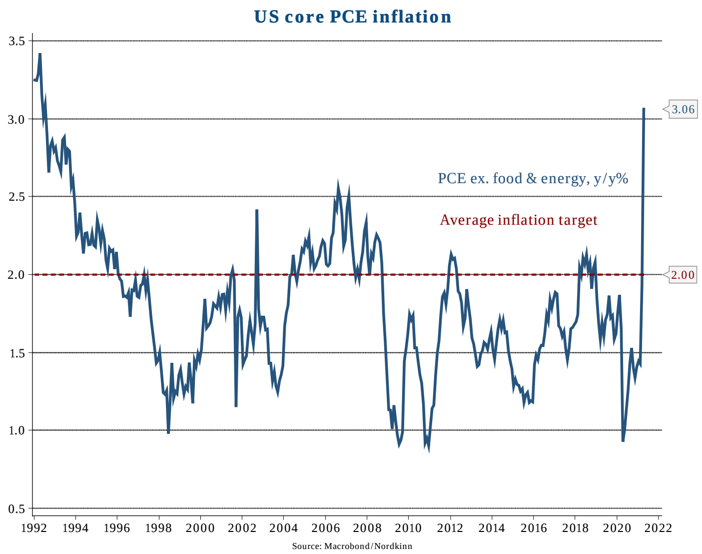
Global overview

After rising strongly in the first quarter, interest rates have since been range-bound despite data generally being stronger than expected. In particular, U.S. CPI April data surprised massively on the upside, see chart, intensifying the debate of whether the rise in inflation will be transitory or not. As significant parts of the surge were explained by base- and reopening effects after the pandemic, the 5-year U.S. Break-Even Inflation rate closed the month unchanged. After all, the current market pricing is already discounting an inflation trajectory not seen for more than a decade. Nonetheless, the relative movements of inflation across markets, including higher Euro inflation, gave positive contribution to our theme *"Global: Comparative inflation expectations"*.

The key driver of global growth is still the vaccination programs and the subsequent reopening of the economies. The number of vaccine shots continued to increase across Europe in May and the rate is currently above the U.S. where vaccination speed is trending lower. This supported the case for catch-up in European growth, which prompted speculations of the ECB reducing asset purchases under its emergency program (PEPP) already in Q3. As a result, German Bunds sold off and underperformed U.S. Treasuries during the first half of May, while the EUR/USD exchange rate appreciated to the highest level since January.

In the latter half of the month, a number of dovish Governing Council members, including ECB President Lagarde, warned that a premature withdrawal of policy support would put the recovery at risk. Isabel Schnabel, the German council member and one of Lagarde's key allies within the ECB, expressed more acceptance for rising nominal yields, yet on balance the ECB-talks were dovish in May. Consequently, the increase in German bond yields came to a halt from mid-month, as did the appreciation of the EUR exchange rate. Tactical short-term positions in German Bunds during the month contributed positively to our *"Tactical risk reward trading"* theme, but were among other factors unable to fully compensate for losses from tactical U.S. steepener positions.

The market capitalisation of digital currencies surpassed USD 2 trn or around 20% of the market value of all gold ever extracted. Consequently, the volatility of Bitcoin and other digital currencies in May spilled over to other markets, demonstrating that this market has grown into being too big to ignore.



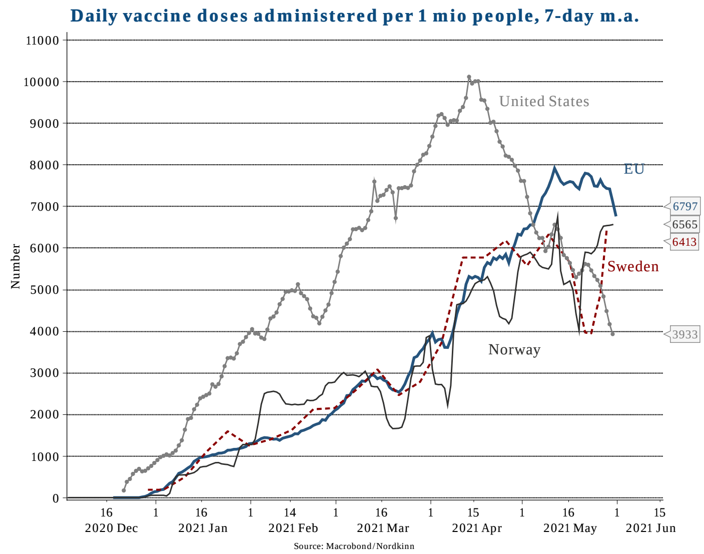
Nordic overview

The first part of May was relatively uneventful in both Norway and Sweden. Incoming macro data remained strong as the manufacturing sectors were supported by the global rebound, while vaccinations (see chart) and lower infections supported the service sectors. In Sweden, inflation data for April was in line with expectations and gave no major reaction in the fixed income market. Instead, the large index duration extension by end of the month triggered long dated government bonds to outperform. This created some headwind to the theme *"Sweden: Supply/demand imbalances"*.

The Swedish National Debt Office (SNDO) released updated forecasts of borrowing requirements on May 27th, including issuance plans. Despite hesitancy among domestic investors, the SNDO announced a 50-year bond to be issued already by mid-June. Hence, a massive amount of interest rate risk will be offered. The new bond will be the largest issue among SGB in terms of interest rate risk, equivalent to roughly SEK 40 bln of 10-year bonds. Given the very short notice, the interest rate risk must soon be absorbed by the market. At the very last trading sessions of the month, longer dated government bonds yields started to rise gradually ahead of the inauguration of the new bond.

On May 27th the Norwegian government implemented the second step of its reopening plan, laying the ground for a continued recovery of domestic activity. The unemployment rate in Norway had already fallen sharply prior to this date, reflecting higher vaccination and lower infections. Furthermore, the updated estimates for investments in oil, gas and manufacturing were revised upwards for both 2021 and 2022, signalling a positive outlook for the business sector. All this contributed to cement September as the most likely month for Norges Bank's interest rate lift-off. Consequently, expected future interest rates rose, even though the very front-end of the NOK interest rate curve enjoyed ever lower Nibor fixings during the month in review.

While higher NOK interest rates contributed positively to *our "Norway: Relative Monetary Policy"* theme, gains were not sufficient to offset losses from the sudden and unexpected flow-induced depreciation of the NOK. In addition, despite the reduction in the net supply of Government bonds, the NGBs underperformed interest rate swaps across all tenors, leading to losses in the *"Norway: ASW trading"* theme.



Global markets

Our base case is for a strong pick-up in economic growth in G10, supported by pent-up demand and ultra-stimulative monetary and fiscal policies. Various leading indicators confirm growth is picking up speed, see chart. Meanwhile, survey data also point to supply constraints that may slow growth and boost prices.

Moreover, incoming data suggests that Chinese GDP growth might have passed the peak after a blistering 18.3% y/y print in Q1. This notwithstanding, the outlook for global growth is strong and should continue to support risk sentiment and bond yields for some time, even if micro-incidents such as the Robin Hood retail community's buying of Gamestop and the extreme volatility in digital currencies are signs of exuberance and disclose underlying market fragilities.

While our base case is that the rise in inflation will be transitory, there is a risk that inflation turns out to be stickier. The new monetary and fiscal regime, structurally higher capital expenditures in both energy-efficient technology and in several other industries, potentially more "in-sourcing", as well as the "fight-inequality" political agenda are medium term factors that might cause a more sustained inflation push.

In light of this, we expect inflation to remain in the spotlight for some time. As hinted in the review section we believe U.S. inflation is priced relatively fair given what we know today, see chart. Most pundits believe U.S. inflation will peak in May while European inflation will most likely peak some time during the autumn. We stick to the idea that pricing of European inflation could have some more room to rise, at least relative to Swedish inflation, which we address in the theme *"Global: comparative inflation expectations"*.

Markets are scrutinising central bank communications for signs that monetary authorities may prepare to reduce accommodation. In May, both the Bank of Canada and the Reserve Bank of New Zeeland surprised markets by earlier than expected hints of policy tightening.

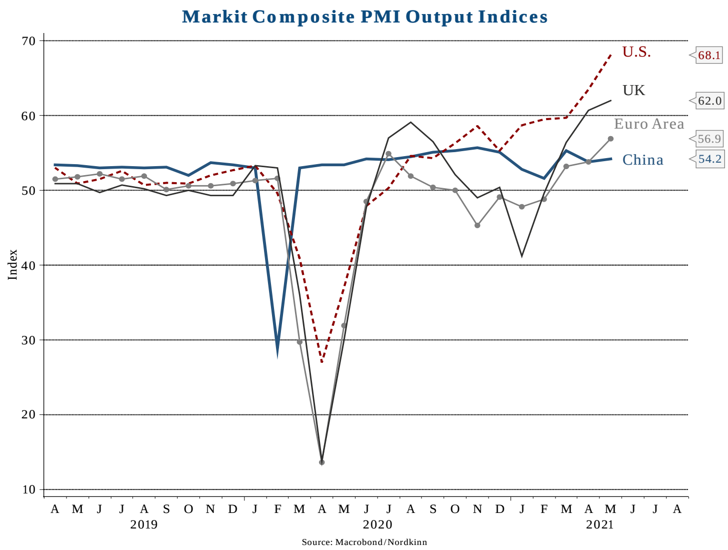
Meanwhile, the minutes of the Federal Reserve's April meeting showed somewhat surprisingly that some members think the Fed should begin a discussion of tapering at "upcoming" meetings. However, as the Fed have communicated a more outcome- and less outlook-based policy, we expect the Fed to hold back on this discussion until more evidence of progress towards full employment is presented.

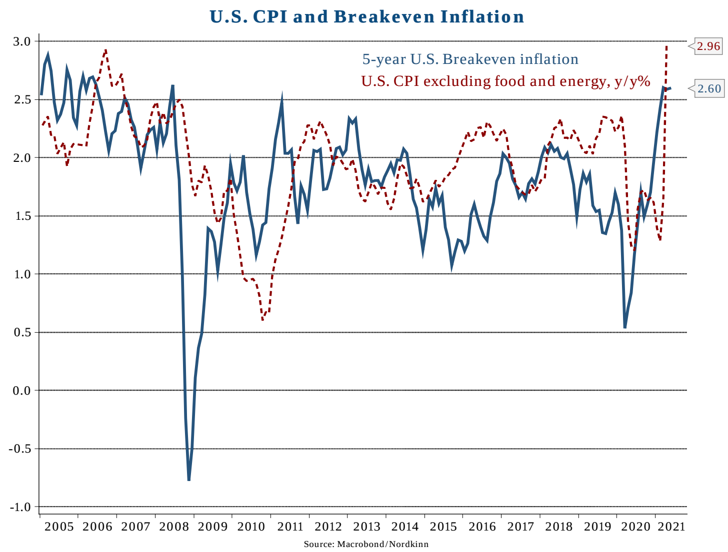
In this context, the upcoming U.S. job report on June 4th, along with inflation figures, are key data points with respect to a potential tapering discussion at the FOMC meeting on June 16th.

Turning to Europe, the ECB is due to present updated macroeconomic staff projections including a reassessment of the financing conditions at the Governing Council meeting on June 10th. We anticipate a significant upgrade to the growth outlook, which could warrant a reduction in asset purchases under the PEPP envelope in Q3. However, we expect only minor adjustments to the inflation forecasts.

While we look for a gradual reduction of the PEPP pace in coming quarters, recent speeches by ECB officials suggest that the ECB will be in no rush to taper. Looking beyond the June meeting, we expect asset purchases under the PEPP and APP at least until the end of 2023. According to the ECB's forward guidance, they will not start raising rates until asset purchases have ended. Consequently, we expect the ECB to maintain key policy rates at current levels until at least 2024. This should keep the short-end and the belly of the yield curve well supported.

Meanwhile, the "Next Generation EU" funding implies borrowing of EUR 150 bln per year in financial markets in 2021-2026. To manage the interest rate risk, a capacity to apply interest rate swaps will be in place in 2022. In addition to the stronger European growth prospects, the funding strategy of the program could add upward pressures on longer-term interest rates. This, combined with the outlook for continued accommodative monetary policy and a descent roll and carry from the European short-end, provides a good case for a steeper Euro area yield curve. Trades consistent with this view are organised under our *"Global: Gradual return towards normality"* theme.





Nordic markets

Swedish government bonds have traded strongly over the past couple of months. After the large index duration extension in May, and ahead of the 50-year bond issuance, the stage is set for a rebound. Swedish bonds with longer maturities are trading expensive compared to German peers and swaps. The mix of low Swedish 10-year real rate at -1,50%, and longer-term inflation expectations consistent with the 2% inflation target (the implied 5y5y Break-Even Inflation rate is currently at 2.10%) seems inconsistent. To offer some perspective, the last time inflation averaged 2.1% over a five-year period was back in 1997. This leaves longer dated real rate bonds vulnerable to higher global (real) rates. We struggle to identify likely scenarios where these bonds will provide descent returns, as these would require either real rates to fall even further into negative territory or actual inflation to exceed 2%. Should inflation surprise to the upside from here, markets are likely to discount higher nominal rates and real rates are likely to rise.

While the appetite for longer interest rate risk should be limited, we believe the short end has moved up too much and too fast. It is not unusual that shorter SEK rates, sub 5-year, trades in the same direction as the headline inflation, see chart. However, the inflation probably peaked in April and will most likely soften going forward. If this turns out to be the case, history suggests that pricing of rate hikes by the Riksbank will ease over the next six months or so. The theme *"Sweden: Riksbank and market pricing inconsistencies"* consists of positions that will benefit from lower short-end interest rates and steeper curves.

While European and Swedish short-term interest rates have moved higher in May, the opposite is true for U.S. short rates. In our view, the resulting spread tightening between USD and SEK rates seems to be overdone. For instance, the spread between 2-year swap rates, starting in three years (3y2y), is currently priced at 65 bps. This is down by 40 bps since early April. We believe that the Riksbank will be well beyond the Federal Reserve in terms of starting hiking and doubt that pricing will be sustained at current spread as we expect Swedish underlying inflation declines and settles in the 1-1.25% area while U.S. inflation will stay high and above the target at least over the next 12-months or so. Against this background, we are positioned for a wider U.S. versus Swedish interest rate spread in the theme *"Global: Gradual return towards normality"*.

In Norway, incoming information on balance confirms Norges Bank's projection of interest rate lift-off in the second half of this year. Mainland-GDP contracted more than expected in Q1, but higher-frequency activity data point to a firm recovery in Q2. For instance, the unemployment rate dropped sharply in May as the Norwegian Government set in motion the second phase of its reopening plan.

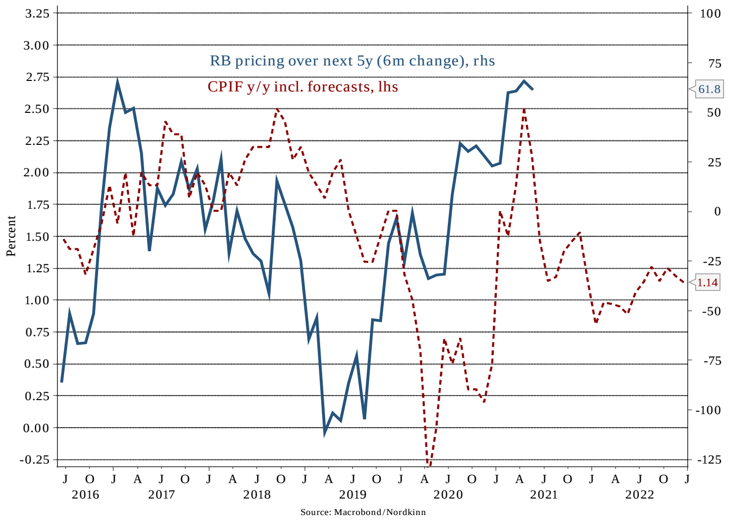
Vaccination speed picked up in May, and according to the latest projections from the Norwegian Institute of Public Health the adult population will be fully vaccinated (second dose) by September. The forecast is consistent with Norges Bank's assumption of 80% vaccine coverage by the end of August, which will pave the way for a strong economic recovery in coming months and quarters.

Our judgement continues to be that the Norges Bank's MPC has a bias to exit its zero interest rate policy sooner rather than later, hence our forecast is intact for lift-off in September. At the upcoming monetary policy meeting on June 17th, we look for a further strenghtening of the forward guidance. We expect the Norges Bank to explicitly communicate that the key policy rate "will most likely be raised in September", instead of "second half of this year". Alternatively, if the Norges Bank does not want to committ entirely to just one meeting, the statement may refer to "after summer", and the probability distribution around its forecast may be adjusted towards 60-40 or 70-30 in favour of September versus December, from 50-50 in the March report.

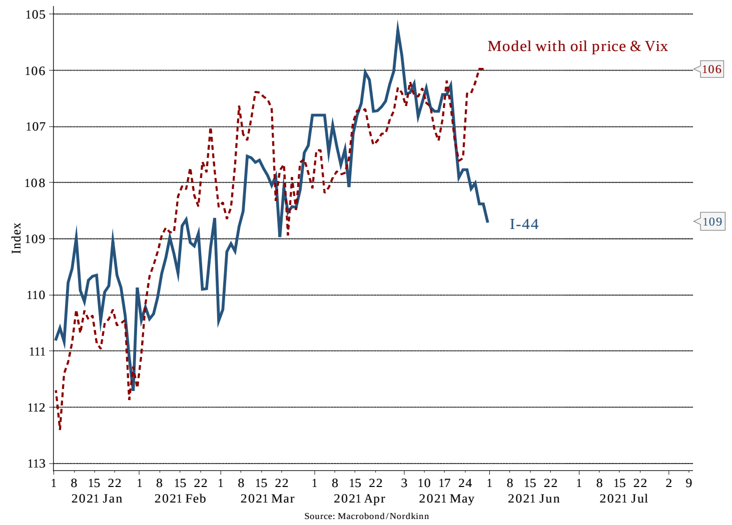
Based on the current outlook for USD and NOK money market liquidity, we see further downside risks for 3m Nibor over the summer. With Sep2021 FRA at around 0,45%, which is 21 bps above current 3m Nibor, we think a September rate hike is almost fully priced. Consequently, the downside risk significantly outweigh the risk of an increase in the Sep21 FRA rate. However, in Q4 we expect money market liquidity to deteriorate and pressure Nibor higher. On top of this liquidity effect, we would not rule our a second hike in December if we are right about our September call. In light of this, we do see further upside risks to interest rates with forward starts in December 2021 and in 2022.

Consistent with this view and also taking into consideration the developments in energy prices and risk sentiment, the recent and sudden flow-induced depreciation of the NOK exchange rate seems overdone, see chart. We have therefore increased our exposure for a stronger NOK exchange rate under our *Norway: Relative Monetary Policy"* theme.

Sweden CPI y/y% and expected Riksbank rate 6m/6m



NOK I-44 short-term fair value model



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