NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – June 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

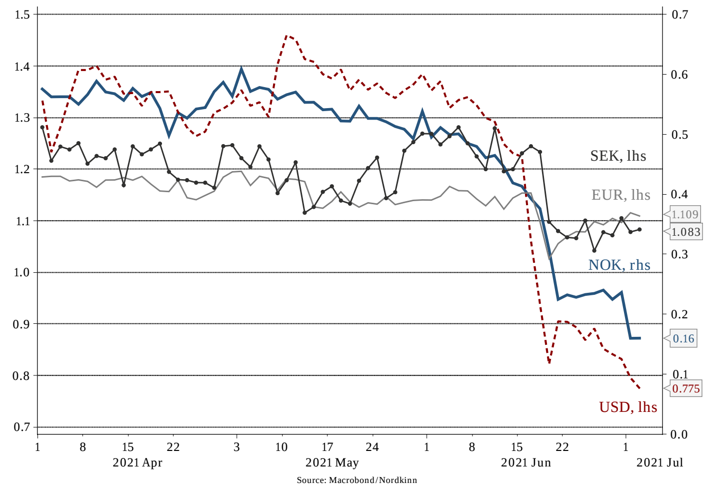
The slope of the interest rate curves became dramatically flatter throughout June, a move that did not fit investors' exposure as indicated by positioning data. The flattening trend intensified in a dramatic fashion after the June 16th FOMC announcement, where members surprised markets by raising the "Dots" for expected future policy rates. The median FOMC member now expects two hikes by the end of 2023 compared to previous expectations of no hikes. Moreover, several members now forecast a rate hike next year. Consequently, expected Fed Fund rates 3-4 years out rose sharply, while longer-term bond yields fell. Despite significantly different rhetoric by the ECB and the Riksbank, the U.S. curve dynamic spread to Europe, see chart. Consequently, the U.S. led flattening of yield curves resulted in losses on several of our investment themes in June.

The Fed provided no news regarding the asset purchase program in their official statement, yet it was clear from post meeting comments that the tapering discussion has indeed started. The more hawkish Fed statement reflects stronger than expected data on growth and inflation this spring. Nonetheless, since the Fed has consistently communicated that the average inflation targeting framework warrants continued patience, the change in the Dots was a surprise. Consequently, market based inflation expectations fell after the Fed meeting.

Aside from the Fed, several central banks around the globe have either started to hike rates (Mexico, Hungary Czech Republic, Brazil, Turkey and Russia) or hint at coming rate hikes (U.K., Canada, Norway, South Korea and New Zealand). One exception is the ECB, which in spite of upward revisions to growth and inflation in June left its forward guidance unchanged and maintained a high pace of asset purchases under the PEPP-program.

The ramp-up in vaccine production has been impressive. Soon, vaccine availability globally will not be a constraint anymore. While there are reasons to be increasingly vary about mutations and lock-downs in e.g. Australia (where the vaccination rate is very low), market participants now focus more on the balancing act of removal of the extraordinary fiscal and monetary stimulus and unlocking the pent-up demand.

Swap curves: 2y2y - 10y5y fwd



Nordic overview

The inauguration of the 50-year Swedish government bond attracted solid demand as, in particular, foreign investors took advantage of the "new issue premium". Despite SEK 10 bln of ultra-long supply, Swedish government bonds performed surprisingly strong relative to German Bunds and relative to other Swedish instruments such as covered bonds and swaps, and curves became flatter. This created headwinds to our theme *"Sweden: Supply/demand imbalances"*.

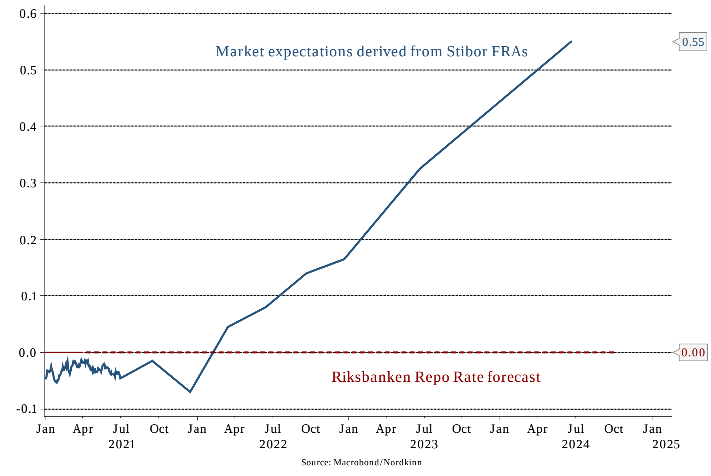
Meanwhile, the substantial move higher in short-end USD interest rates spilled over to the short-end of the Swedish curve, which had a negative impact on *Sweden: Riksbank and market pricing inconsistencies"*. Expectations for future interest rate hikes currently prevailing in the market is much higher than the outlook for inflation and the monetary policy strategy of the Riksbank. The updated projection for the repo rate published on July 1st indicates a repo rate at 0% throughout the entire forecast period, see chart.

While growth indicators like PMI and the NIER Economic Tendency Index continued to show impressive strength during the month in review, inflation remains in focus for monetary policy in Sweden. CPI data for May was a concern for the Riksbank as core inflation (CPIF excluding energy) disappointed and declined to 1.20 %, a new 2021 low.

On June 17th the Norges Bank left its key policy rate unchanged at 0.00%, but the new interest rate forecast was somewhat higher than in the March report as vaccination and relaxing of Covid-related restrictions were expected to give a boost to economic activity. The new projections imply quarterly increases in the key policy rate starting in September this year. Expected future money market interest rates rose following the announcement, but longer-term tenors tightened relative to trading partners amid lower global bond yields combined with significant flow-induced receiving before the end of the quarter. Neither the hawkish Norges Bank, nor higher oil prices, were enough to appreciate the NOK exchange rate.

While higher short-dated NOK interest rates contributed positively to our *"Norway: Relative Monetary Policy"* theme, gains were not sufficient to offset significant losses from the relative decline in longer-term rates and from the broad-based depreciation of the NOK.

Sweden STIBOR market-implied policy rate expectations



OUTLOOK

Global markets

Global growth is accelerating to an even faster extent than expected. Supported by reopening, pent-up demand and still ultra-simulative monetary and fiscal policies, we continue to expect strong economic growth ahead. The process of phasing out the extraordinary policy measures will be slow and should not interrupt the recovery. Various leading indicators still confirm a very strong growth outlook and the pandemic relief packages in both U.S. and Europe will continue to support economic growth. The headlines on the bi-partisan agreement in June on the infrastructure package in the U.S. did not have much market impact, but an agreement of a potentially much bigger relief package could push U.S. rates higher and the USD stronger.

Despite economic growth, yields on longer-term maturity bonds have fallen recently. For instance, the U.S. 5y5y swap yields (i.e. the yield on a 5-year swap starting 5-year into the future) declined by about 50 bps during the second quarter. This tendency is at odds with the historical relationship between longer-term rates and growth. When adjusting for the downward trend in the estimated "neutral" interest rate as reflected by longer-term FOMC "dots", the U.S. 5y5y forward interest rate exhibits a strong correlation with global PMI, see chart.

The relatively steep yield curve has probably attracted some real money demand for duration. Moreover, concerns about rising infections of the more contagious Delta-version of the virus may have contributed to the decline in yields as well. Furthermore, covering of short bond positions post June 16th FOMC seems to explain the sharp drop in yields in the aftermath of the announcement: The 2y2y swap rate rose around 25 basis point in the days after the meeting, whereas the 5y5y rate fell by around 20 basis points. Thus, the slope of the yield curve became dramatically flatter.

In essence, we believe that the flattening of the curve was reinforced by unwinding of steepener positions, which is one strategy that many fixed income investors have used to obtain exposure to the so-called reflation theme. Accordingly, we believe some of this flattening, and in particular the drop in longer-term bond yields, was unjustified by fundamentals.

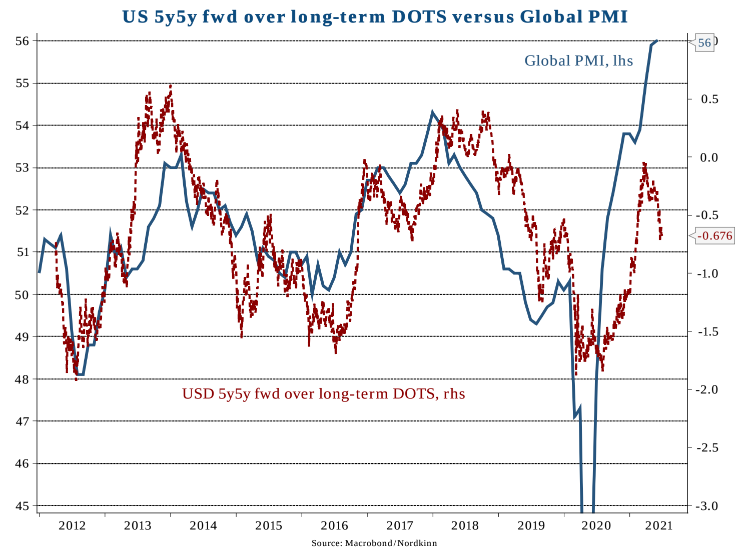
As we do not believe a broad-based global slowdown in growth is imminent, we expect the downward trend in longer-term yields to come to a halt this summer. Moreover, while we have some sympathy for the flattening case in the U.S. as Fed lift-off is moving somewhat closer, the situation is very different in the Euro area and Sweden. Curve flattening in Europe in June was in our view mainly driven by spill-over effects from the U.S. markets and market repositioning, not by changes to the expected path for monetary policies of the ECB and the Riksbank.

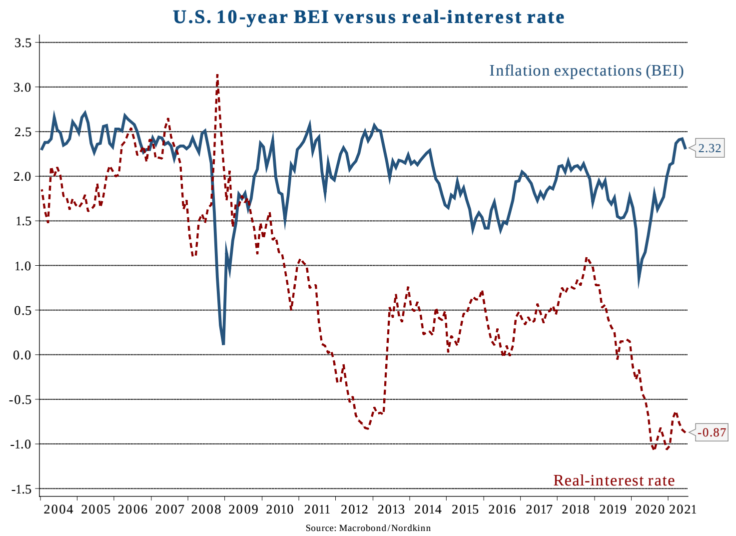
Indeed, the ECB's forward guidance is to maintain a negative interest rate policy until asset purchases have ended, which seem unlikely to happen before the end of 2023. Consequently, market expectations of an ECB rate hike in 2023 seem premature. However, our base case is for the ECB to announce tapering of the PEPP-program during the autumn and to exit this emergency program as planned next year. This should in our view support a re-steepening of the EUR yield curve.

Another observation to highlight, if markets seriously think the FOMC will need to tighten monetary policy to address future inflation risks, the current level of U.S. 10-year real bond yields at around -0.80% seem unreasonably low, see chart. While the 10-year Break-Even Inflation rate seems fair at current levels, we think it is just a matter of time before real bond yields start moving higher.

Regarding FX markets, we now think that the decoupling of the rhetoric from the ECB and the Fed will re-establish monetary policy as a key driver of the foreign exchange markets. Hence, we have not only covered our long EUR/USD exposure, but turned it around. We have done the same with EUR/GBP as we expect the Bank of England to follow the Fed and bring the timing of rate hikes forward.

Finally, as Mid-summer is behind us, we approach a season that historically has been challenging for risk assets. With equity markets at elevated levels and central banks planning to start tapering asset purchases, we think the likelihood of a market correction is increasing. We believe the EUR/JPY cross should have limited upside potential in a benign market scenario and it usually performs poorly in a "risk off" environment. Against this background, we have added a short EUR/JPY position to the *"Tactical risk reward trading"* theme.





Nordic markets

As we argue in the Nordic overview section above, the Riksbank pricing is at odds with the inflation outlook in our view. The growth outlook has admittedly improved over the last months, but will this matter for monetary policy as long as inflation is subdued? We doubt it. Let us return to the key question: "What is normal?" In our view, in terms of growth, nothing has really happened in the 2000s. In the period, 2000-2014, Swedish GDP growth averaged roughly 2.5%. Roughly the same average growth rate was recorded between 2014-2020 (in fact, somewhat higher in the most recent period). At the same time, the repo rate averaged 2.3% between 2000-2014 and -0.35% in the years 2014-2020. Hence, economic growth has clearly not been the driver for Swedish monetary policy over the past seven years.

Rather, it has all been about inflation. Inflation (CPIF) averaged 1.6% 2000-2014 and 1.4% in the years 2014-2020. We see no obvious reason as to why the Riksbank should alter the way they conduct policy going forward. Instead, board members keep arguing that it is better to risk overshooting inflation than to tighten too soon. We would even argue that the Riksbank´s way to conduct policy (influenced by their legacy) is even more evidence-based than that of the Fed, although not formalised.

As we see it, inflation is decisive for the Riksbank's conduct of monetary policy, where the monthly CPI prints are more important than the Riksbank's forecasts. In fact, the focus on bringing inflation permantely close to 2% has been the main focus since 2014, when the Government decided to give responsibility of macro prudentials to the Swedish FSA.

So what to expect in terms of the inflation outlook? Short-term, we expect inflation to disappoint the Riksbank's forecast, partly as an effect of the strength of the currency this year, see chart. Moreover, we see few reasons to forecast significantly higher inflation over the medium-term. The last wage deal was set at a low 2.2% and will run for another two years. The link to commodity prices and similar factors (like freight costs) is very weak over longer periods. More, Swedish core inflation tends to track European inflation with deviations explained by moves in the SEK currency

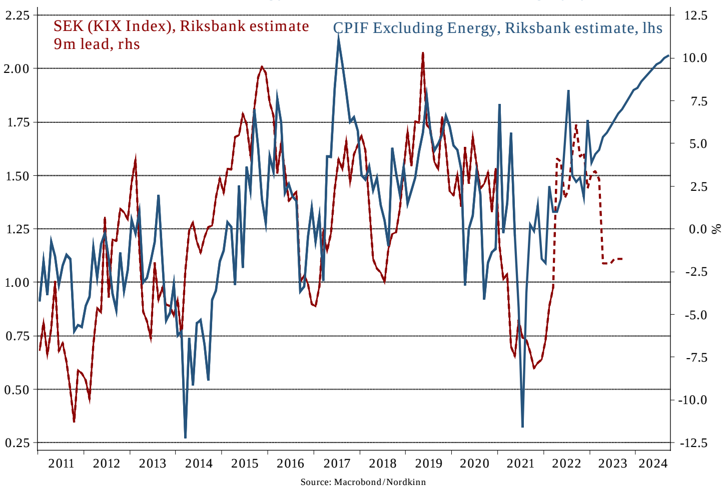
We stick to our belief that Swedish curve is too steep in the short-end and that inflation will decline, especially relative to European inflation, in the second half of 2021. We are positioned in trades that will benefit from such a developments.

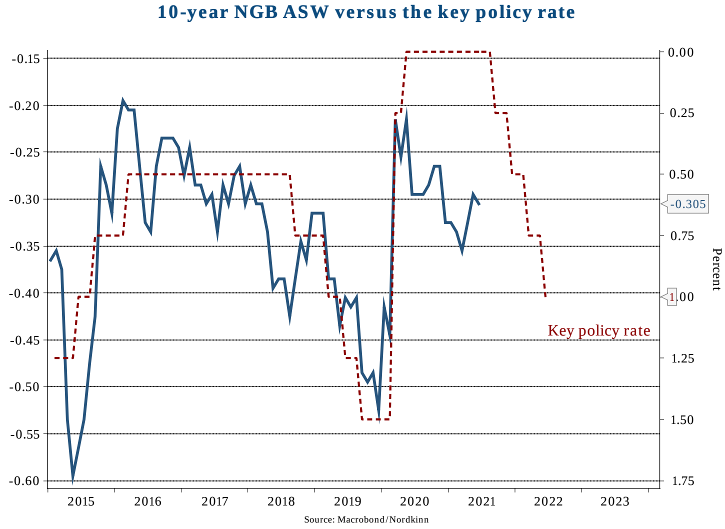
The Norges Bank deviates from other central banks when arguing that it will soon be appropriate to raise the policy rate from the current level of 0.00%. The central bank of Norway is conducting a relatively flexible policy. While the mandate is to stabilise inflation around 2.0% over the medium term, depending on the shocks to which the economy is exposed the central bank also aims to stabilising the real economy and to avoid build-up of financial imbalances. The main argument for higher rates now is that the gradual reopeing of society is expected to bring the economy quickly to more normal conditions.

Looking at the interest rate projection in detail, the central bank envisages lift-off in September followed by hikes every quarter until summer 2022. Although this is a projection and not a commitment, we think the near-term rate path is relatively robust. Recall that in 2019 the Norges Bank consistently hiked rates by an accumulated 75 bps in spite of the trade war and the global economic slowdown. Consequently, unless new major shocks hit the economy, the key policy rate will likely stand at 0.50% by end-2021 and at 1.00% at the end of June 2022. After that, the path for the key policy rate is much more uncertain and will be more data-dependent in our view.

In addtion to rate hikes, we expect the 3-month Nibor "add-on" to hit rock bottom this summer and increase during the autumn. Structural liquidity in the banking system - i.e. the level of reserves in the banking system before Norges Bank conducts market operations – will remain ample in July and August before tightening in September, October and November. On top of this domestic factor, the expected increase in USD Libor-OIS spread from Q4 and onwards will also put upward pressures on Nibor. In light of this, we expect some furher increase in short-term rates with forward starts between December 2021 and June-2022. The NOK has so far been unaffected by the increasingly hawkish Norges Bank rethorics, yet we see more upside than downside from current levels going forward.

Spreads between Norwegian government bond yields and interest rate swaps tightened this spring, in part reflecting front loading of issuance volumes. As 78% of this year's funding is done already, we see assymetric risk/reward for NGB ASW spreads in coming months. Another feature to highlight, we tend to see a performance in NGB ASW spreads during Norges Bank hiking cycles, see chart. Taken together, we hold on to our long NGBs versus swaps as part of our *"Norway: ASW trading"* 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.

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