NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – July 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

Interest rates fell sharply during July, triggered by growth concerns owing to the spread of the Delta-variant of the virus and signs of moderation in the pace of global growth. Also, excess global liquidity continues to provide structural support for the bid in bonds. In perspective, the 5y5y forward USD interest rate (5-year interest rate starting 5-year into the future) fell from around 1.90% at the end of June to a low of 1.45% on July 20th, before stabilising around 1.60% by the end of the month, see chart. The dramatic decline in rates during June and July combined has erased almost the entire increase in bond yields since the start of the year. This has occurred despite very positive surprises regarding economic growth in 2021, driven by fiscal policy, vaccination and reopening, which all fed the spike in inflation since the turn of the year. The substantial movements in interest rates were mirrored in the FX market: Traditional "reflation currencies" like CAD, AUD and NOK suffered large drawdowns over the summer.

Interestingly, the retracement in long-term U.S. bond yields has been driven by a collapse in the real rate component to a new all-time low of -1.16% for the 10-year benchmark. Meanwhile, Break-Even Inflation spreads rose marginally in July to 2.40% after U.S. CPI inflation numbers printed significantly above market expectations. Headline and "core" CPI inflation rose to 5.3% and 4.5% respectively, but this was not sufficient to prevent a decline in expected future key policy rates.

The key market driver seems to be the Delta-variant of the virus, which has become the dominant variant in many countries, including the U.S., UK and many countries in Asia. It is estimated to be about twice as infectious as the original strain from early 2020. Some countries with low vaccine rates have been forced to re-establish lockdowns (e.g. Australia, Singapore, South Korea and Japan). In the UK, the case count is rising rapidly and will likely continue to rise for several weeks as the UK government insists on Britons returning to normal life. The good news is that hospitality and mortality rates are low for the vaccinated. The bad news is however that the case count might continue to rise, potentially leading to higher hospitalisation and death numbers.

As a consequent of these market developments, our *"Global: Gradual return towards normality"* theme subtracted from performance, mainly reflecting a sharp decline in longer-term bond yields relative to short-dated yields, and lower real interest rates.

Nordic overview

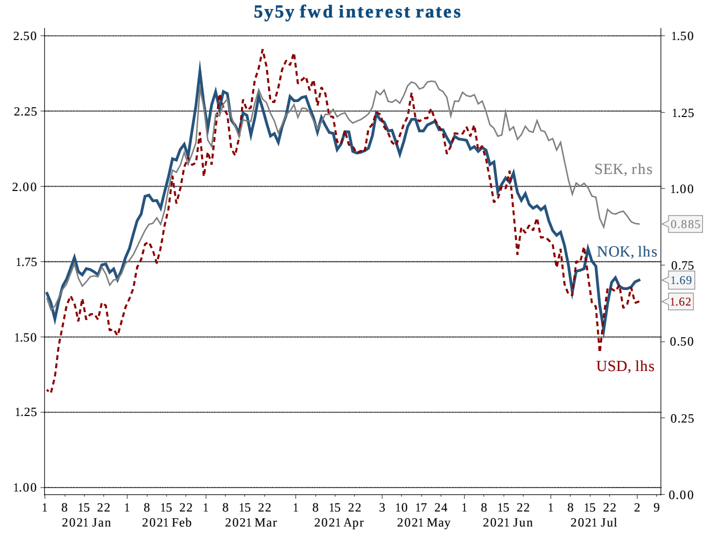
In Sweden, markets kicked-started with a Riksbank monetary policy meeting on July 1st. The Board left the repo rate path completely flat at 0% throughout the entire forecast horizon, to Q3 2024. This was in line with what we expected, but more dovish compared to expectations implied by market pricing, as well as those of some local economists prior to the meeting. The minutes from the meeting revealed that Board members still deem downside surprises of inflation to be more problematic than upside surprises, and that a rate cut could be considered if inflation were to disappoint. In accordance with this, and also with significant support from the global fixed income market, Swedish interest rates declined sharply during July. The move lower in short end Swedish interest rates benefitted our theme *"Sweden: Riksbank and market pricing inconsistencies"*.

In line with developments abroad, longer-term Swedish bonds outperformed the short-end of the curve, resulting in a 15 bps tighter spread between 10-year and 2-year yields. Meanwhile, the SEK proved resistant against the dramatic moves in global FX markets in July. For instance, the EUR/SEK traded in a tight range 10.14-10.26.

Turning to Norway, incoming information during July largely confirmed a strong economic momentum amid reopening. Mainland-GDP grew a blistering 1.8% in May from the previous month, twice as much as expected. While the Norwegian government decided in July to delay the transition to step 4 of its reopening plan (full reopening) due to concerns about the Delta variant, the macro implications are considered to be relatively mild due to the high vaccination rate.

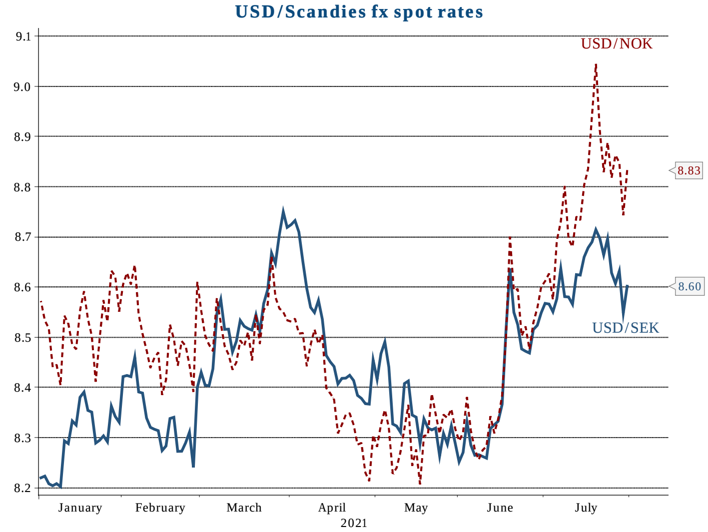
Longer-term NOK interest rates continued to exhibit a very high correlation with USD rates in July, which has been the situation for most of this year, see left hand chart. With domestic investors on holiday in July, even the front-end of the yield curve fell significantly. In addition, the NOK exchange rate sold off dramatically amid global growth concerns. The USD/NOK spot rate rose 10% from June lows to the July peak and is now much higher than at the beginning of the year, see right hand chart. Our long NOK FX and short duration exposure within the theme *"Norway: Relative monetary policy"* suffered as a result.

5y5y fwd interest rates



Source: Macrobond/Nordkinn

USD/Scandies fx spot rates



Source: Macrobond/Nordkinn

Global markets

Following a significant bond rally over the summer, the fixed income markets seem to discount drastically slower economic growth going forward. As noted in the review section, the U.S. 5y5y forward interest rate swap has erased almost its entire increase so far this year. Recall that the rise in bond yields in Q1 was triggered by factors such as positive news on vaccination and fiscal policy, which boosted the economic outlook to a greater extent than previously expected. On top of this, inflation has risen much more than expected in 2021.

As the chart below illustrates, the spread between the U.S. 5y5y forward interest rate and the FOMC's estimate of long-term "neutral" Fed policy rate has until recently exhibited a relatively strong correlation with the Global manufacturing PMI – an indicator of global economic growth. Has the outlook really changed as much as markets seem to indicate? Or has the bond rally been reinforced by other factors, such as need for bond duration from "real-money" accounts at a time when "fast-money" accounts were already short while central banks remained committed to their large-scale asset purchasing strategy?

True, PMIs have retraced from peak levels. The global manufacturing PMI fell to 55.4 in July, down from a 56 peak in May. However, the number is still very high by historical standards. More worryingly, the spread of the Delta-variant of virus has the potential to dampen economic growth momentum, especially in regions were vaccination rates are low. For instance, Australia could be heading into another recession after it had to re-impose restrictions amid low vaccination rate and higher infection rates.

Although vaccination rates are now slowing in G10, to some degree due to vaccine scepticism, the outlook is for vaccination-programs to spread globally. In not long, vaccine availability will not be a constraint anymore and we will learn to live with the virus without closing down economies. Moreover, although some central banks are considering to raise interest rates soon, the big picture is that both monetary and fiscal policies still provide very strong support, and will continue to do so for an extended period of time. Consequently, we believe that a strong economic recovery remains on track, even if the pace is moderating. The story we have told throughout 2021 about pent-up demand and still super accommodative monetary and fiscal stimulus remains intact.

In addition, inflation took a back seat as a market driver in July despite very high inflation prints both in the U.S. and UK. This may change if inflation continues to surprise on the upside in coming months.

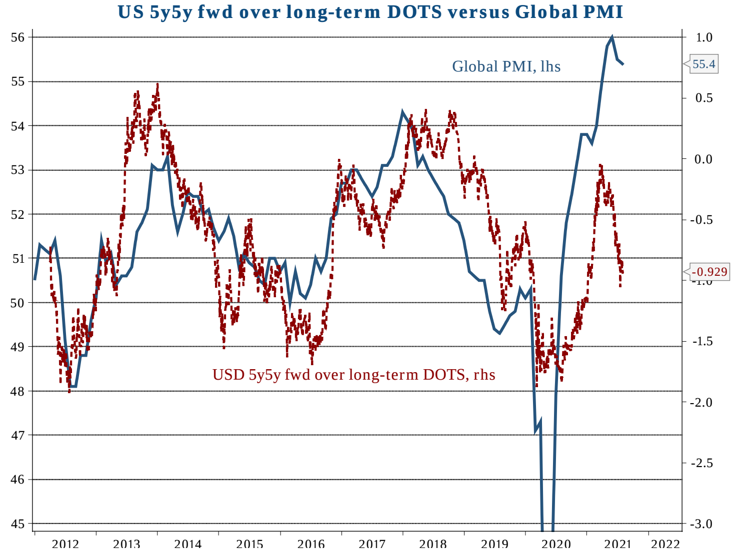
As we remain relatively optimistic on the outlook for global growth, we expect the downward trend in longer-term yields to come to a halt soon. In particular, the current level of U.S. 10-year real bond yields at around -1.15% seem unreasonably low, see chart. While the 10-year Break-Even Inflation rate seems broadly fair at current levels, it is just a matter of time before real bond yields start moving higher in our view.

The outlook for the European bond market is somewhat more complex given the ECB's amendments to its monetary policy strategy. According to its updated forward guidance presented on July 22nd, the Governing council *"expects the key ECB interest rates to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon"*. Given its forecast that HICP inflation will average only 1.4% in 2023, our interpretation of the new forward guidance is that the ECB does not envisage rate hikes before the second half of 2024 at the earliest. A change in both realised and expected inflation are crucial preconditions for any changes in the monetary policy outlook.

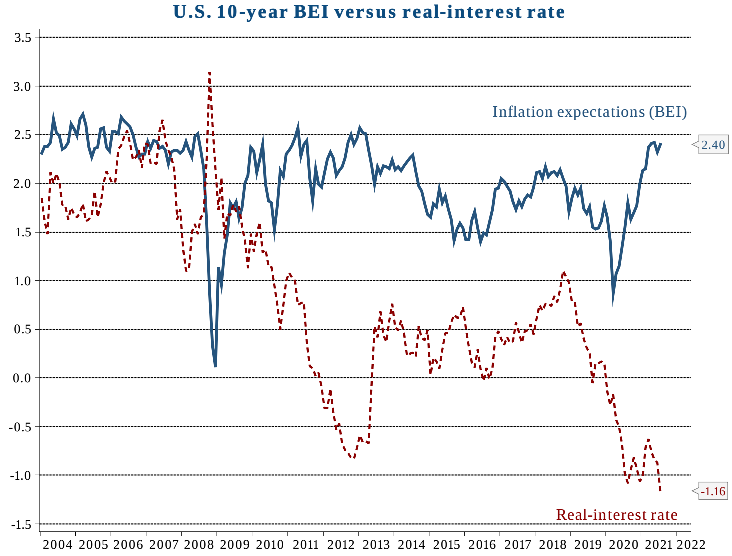
As opposed to the ECB, the Federal Reserve pushed forward expectations of rate hikes at its June meeting, forecasting two rate hikes by the end 2023. This should in our view support wider interest rate spreads between the U.S. and Europe going forward, having tightened significantly since Easter. In this context, the EUR should become an even more popular source of funding, especially if we are wrong on our positive outlook for global growth. Consequently, short EUR exposure could serve as an attractive hedge against various reflation-type trades.

Finally, although ECB rate hikes are unlikely for years, longer-term EUR interest rates may still rise as the economic recovery unfolds. We believe the flat EUR interest rate curve underestimates future growth and inflation risks.

US 5y5y fwd over long-term DOTS versus Global PMI



U.S. 10-year BEI versus real-interest rate



Nordic markets

The minutes from the Swedish Riksbank's monetary policy meeting confirmed our view that inflation will continue to be the top priority for the central bank. Stronger growth outlook alone will not be enough for the Riksbank to turn more hawkish in our view. Stabilising inflation around the 2.0% target matters most of all. Furthermore, the ECBs policy review, which we think ties forward guidance and policy closer to actual inflation, not just forecasted inflation, is in line with Riksbank thinking. If anything, it will increase Riksbank's focus on current CPI data releases. While pricing of rate hikes has eased, the curve is still relatively steep out to five years and offers a decent roll down effect, see chart. Moreover, the curve is still at odds with pricing of Break-Even Inflation over the next 4-5 years, which is trading close to 1.5% and well below the 2.0% inflation target.

The movements at the long end of the yield curve are mainly decided by global activities. Having said that, the QE purchases that have been conducted by the Riksbank, more or less constantly since February 2015, is having an effect on the bond yields as well. The spreads to swaps are trading wide but as long as Riksbank keeps buying, and holds roughly 50% of the stock, we do not expect a swift change in the market. The effect is even more severe in the inflation-linked bond market. Here, the number of market participants were few already at the start of the QE in 2015. As the Riksbank is buying more inflation-linked bonds this year, that market has become even more distorted. We doubt that Break-Even Inflation rates offer a good insight to what the market actually expect inflation to be. Inflation-linked bonds seem to offer very little or no value at all to investors given the low real rates and the implied expectations of long-term future inflation.

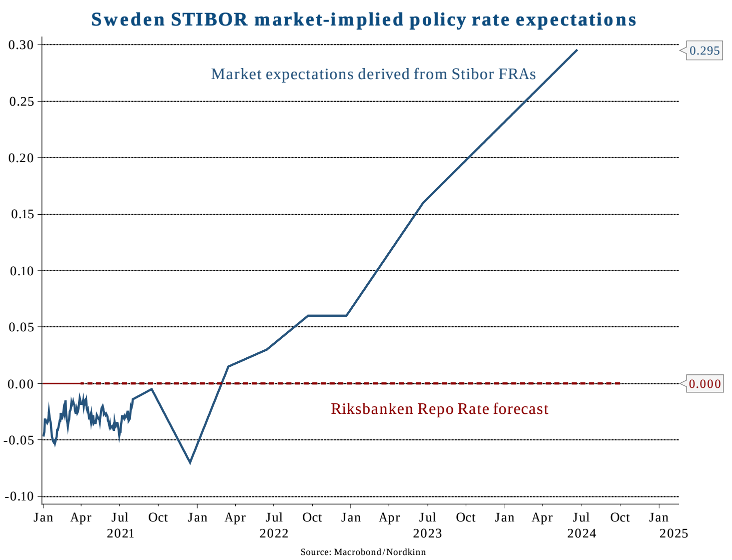
The room for continued QE purchases beyond 2021 seem a bit limited. The Riksbank has expressed concerns about holding more than 50% of the stock, as it would become too close to monetising the debt. Hence, the pace of SGBs purchases can only be done in lockstep with the bond supply. Left for the Riksbank to buy is covered bonds. This market is much bigger and could be target for a larger share of purchases in 2022, even if there will only be reinvestments of redemptions and coupon payments. These are structural market prerequisites which we seek to explore within our *"Sweden: Supply/demand imbalances"* theme.

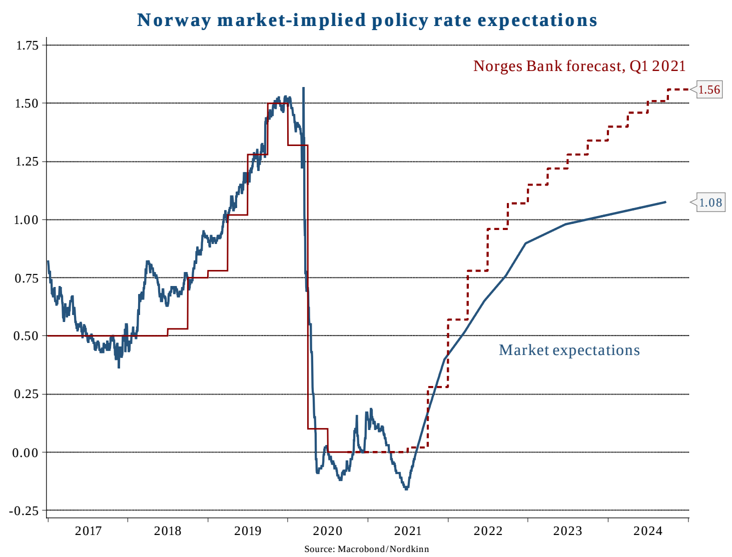
Turning to Norway, incoming information during July will not materially change the outlook for Norges Bank's monetary policy in our view. Recall that the projections presented in late June implies interest rate lift off in September followed by quarterly hikes until summer 2022. As outlined in the previous monthly report, we believe the near-term path is relatively robust to minor disturbances in the macro and markets environment. For instance, we do not believe that the Norges Bank will postpone tightening due to the Government's decision to delay Step 4 of its reopening plan amid the Delta-variant of the virus. One reason is that more than 2/3 of the Norwegian population has received at least one dose of the Covid-19 vaccine. Moreover, surveys show that the proportion who say they want to accept vaccine is very high. As much as 93% of the population in Norway have said they want to be vaccinated against Covid-19 or have already been vaccinated.

Consequently, the outlook for vaccination means that a rate hike in September remains very likely. When the Norges Bank meets again in September, we would not rule out a "dovish" rate hike, i.e. a rate hike that is accompanied by a projection showing a somewhat lower interest rate projection further out. Lower global interest rates could be one reason for that. On the other hand, the depreciation of the NOK exchange rate should neutralise this effect, at least for 2021 and 2022.

On balance, therefore, we think the fixed income market has gone too far recently. The market discounts a much shallower rate outlook than Norges Bank presented just a few weeks ago, see chart.

Moreover, we expect the 3-month Nibor "add-on" to 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 tighten from September. Furthermore, the expected increase in USD Libor-OIS spread from Q4 and onwards will also put upward pressures on Nibor. In light of this, we have added risk to our short positions in the 2022 segment of the curve as part of 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.

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