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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – August 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

Having surprised to the upside since last summer, global economic growth appear to have slowed somewhat in Q3, as suggested by the decline in the global all-industrial PMI index, which fell for the third consecutive month in August. The slowdown is, in part, related to the new wave of infections fuelled by the highly infectious delta variant of the Coronavirus. Global case count rose sharply during the summer, see chart, and led to mobility restrictions in countries with low immunity rates.

The outbreak in China is particularly disturbing as Chinese authorities aim to achieve zero Covid-19 infections, which implies strict controls and persistent supply bottlenecks. The economic costs associated with this policy magnifies the drag from the removal of credit and fiscal supports in China, as well as from regulatory reforms in the tech sector.

While interest rates broadly stabilised in August after the heavy drop in yields during July, central banks are on divergent paths. On the dovish side of the spectrum, the ECB continues to purchase more bonds than the net supply. Supported by these purchases, our positions for lower Eurozone real bond yields relative to U.S. yields, both nominal and real, contributed positively in the theme *"Global: Gradual return to normality"* in August. However, gains on the nominal spread position were trimmed towards the end of the month as the anticipated Jackson Hole speech by Fed-chair Powell disappointed markets in the absence of new hints about the outlook for monetary policy.

Meanwhile, Philip Lane, the chief economist of ECB, hinted in an interview with Reuters about a possible reduction in the monthly PEPP (Pandemic Emergency Purchasing Program) purchases already in coming months. This took markets by surprise, triggering a sell-off in Eurozone government bonds. Finally, the underperformance of European bonds continued on the final day of the month after Eurozone HICP inflation surprised sharply to the upside, even though most of the increase was related to energy and base effects. The relative steepening of the Eurozone bond curve vis-à-vis the U.S. curve contributed positive to the fund's performance as well.

Nordic overview

Macro data passed relatively unnoticed in the month. CPIF inflation excluding energy reached a seven years low at 0.5%, which is at odds with the richening during the month of Swedish Break-Even Inflation (BEI) and real bond yields.

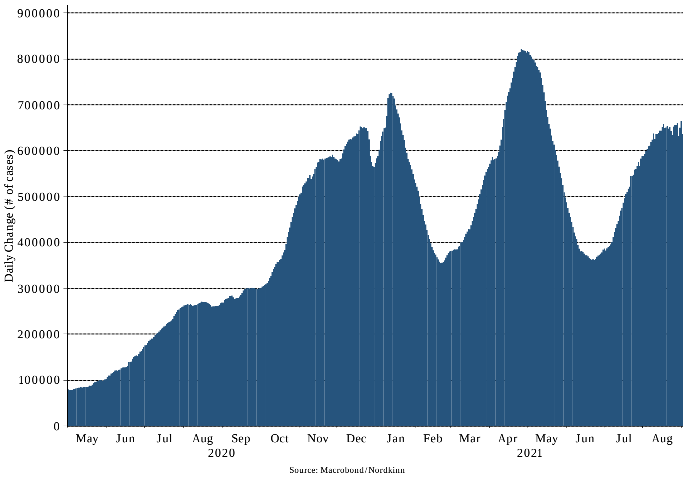
August was uneventful in the Swedish fixed income market with most domestic investors still away for vacation at the start of the month. A week into August demand for covered bonds increased and yields tightened accordingly. In addition, during the latter part of the month longer-dated interest rates started to climb. These developments benefitted the theme *"Sweden: Supply/demand imbalances"*.

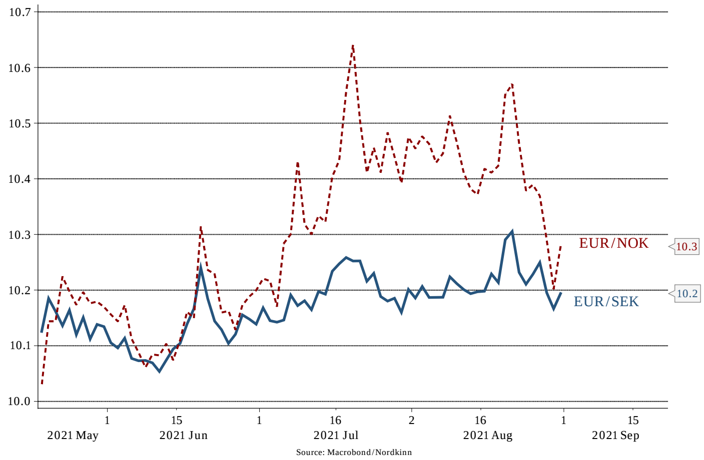
In the inflation market, BEIs traded relatively strong during the month. Eurozone BEIs firmed as well while US BEIs were more or less unchanged. At the very front end of the Swedish swap curve, rates moved higher, which generated losses to the theme *"Sweden: Riksbank and market pricing inconsistencies"*.

In Norway, new registered Covid-19 cases rose sharply during August to fresh highs as students and children went back to school. The number of patients with corona in hospitals is rising too, but remains far below previous peaks. Meanwhile, the share of population fully vaccinated against Covid-19 accelerated during August and is currently close to 60%. Against this backdrop, Norwegian health authorities believe the current wave of infections, which is so far the largest in the pandemic, will not threaten the capacity of hospitals. The government appear reluctant to re-introduce restrictions.

As overall economic activity has expanded broadly in line with projections, on August 19th the Norges Bank's policy committee reiterated that the key policy rate will most likely be raised in September. According to the statement, vaccination implies that the economic impact of higher infection rates is expected to be relatively mild.

NOK interest rates rose in August lead by the belly following a sharp drop in July, and the NOK exchange rate recovered from the drop in July, see chart. As a result, the theme *"Norway: Relative monetary policy"* contributed positively to the fund's performance.





Global markets

Despite this year's strong economic growth and rising inflation globally, during the summer interest rates retraced the first quarter's rise. The market narrative contributes two main factors to this summer's drop in yields: 1) Signs of global economic growth momentum peaking. 2) Significant bond purchases by major central banks (and private investors), combined with limited bond supply issuance over the summer. The latter factor has led to a stronger drop in yields than economic fundamentals imply.

While we carefully monitor potential signs of further slowdown in growth, we still expect decent economic growth ahead, driven by pent-up demand, increased robustness with respect to infection rates, rapidly improving vaccination rates (see chart) and effects of extraordinary policy stimulus. Importantly, the global case count that bottomed out in June, seems to be peaking now. Vaccine scepticism has left U.S. vulnerable to the spreading of the virus and the case count there is high and rising. However, the global picture seems to be improving in terms of both immunity and case count. Hence, we believe yields on longer-term bonds are too low given the economic outlook.

Regarding bond flows, the ECB has over the summer bought significantly more bonds then the net supply, pushing longer dated rates even lower. As falling European yields have made U.S. rates relatively more attractive, non-U.S. investors have stepped up their buying, contributing to falling U.S. yields. As shorter-dated bonds are less flow-sensitive and more tied to the central bank's rate outlook, the flow dynamic led to general flattening of yield curves around the globe.

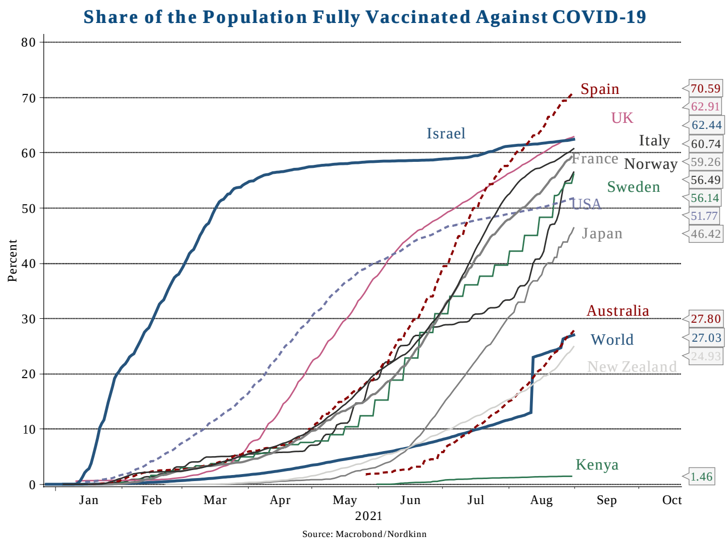
These dynamics are however set to change as both the ECB and the Fed intend to taper bond purchases. In his Jackson Hole speech, Fed-chair Powell confirmed that if the labour market continues to improve, tapering will most likely start later this year. Meanwhile, the ECB is set to terminate net asset purchases under the PEPP (currently running at EUR 80 bln per month) once it judges that the Covid-19 crisis is contained, most likely by the end of March 2022, and we anticipate that ECB policymakers will agree on a Q4 tapering at the upcoming meeting on September 9th. The ECB's ordinary asset purchase program APP (currently at EUR 20 bln per month) will continue for a long time, yet total purchases will fall even though APP would increase in size.

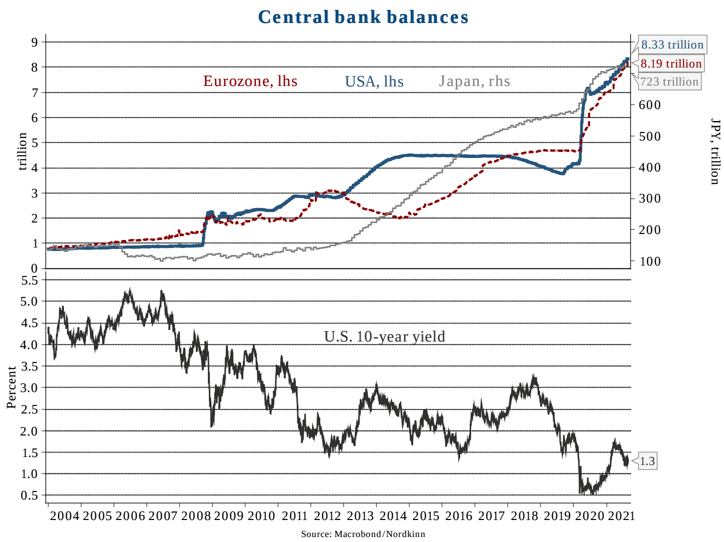
While downsising of the asset purchases is likely for both the ECB and the Fed this autumn, rate hikes are a different matter. In the aforementioned speech, Powell stressed that a prerequisite for raising rates is that the economy reaches conditions consistent with not only maximum employment, but that inflation has reached 2% and is on track to exceed 2% for some time. The labor market is still far below pre-pandemic levels. Moreover, we expect underlying inflation to moderate in 2022, driven by retracement in durable goods prices. Most analysts, including us, do not expect rate hikes until 2023. In Europe it will probably take much longer to reach conditions for rate hikes.

With rate hikes far away and gradually less support for the longer-end, yield curves should steepen going forward, particularly in Europe. In the U.S. we expect the 5-year segment to underperform going forward, as we see room for market discounting more rate hikes over this horizon. Consequently, we have a clear bias for European curves to steepen relative to the U.S. In addition, we have added option trades that would gain from a steeper Swedish yield curve, while being protected should rates fall further in a potential bull flattening scenario. These trades are organised under the *"Global: Gradual return to normality"* theme.

Once tapering commences in Q4, while we do not forsee a bond sell-off in the magnitude during the so called taper tantrum in May 2013, we do caution the market potentially being complacent about the implications that tapering can have on the capital markets dynamics. Central banks will be tested on the importance of proper market communication once they start amending their use of the balance sheet, which have grown beyond substantial (see righthand chart) over the years.

Flow dynamics have also impacted real interest rates, and we believe they are lower than fundamentals imply. As U.S. spot inflation has increased, inflation protection ETFs (investing in TIPS) has seen huge inflows. On top of this, the Fed keeps buying TIPS under its QE program and has during 2021 absorbed more than the net supply. We do not know when these dynamics will reverse, but slowing spot inflation is one obvious trigger and tapering is another. As we expect U.S. inflation to moderate during 2022 and the Fed to begin tapering later this year, we expect real interest rates to rise. We exploit these dynamics in our theme *"Global: Comparative inflation expectations"*.





Nordic markets

The short end of the Swedish yield curve is still too steep in our minds and at odds with the inflation outlook. In addition, since the last monetary meeting, at the beginning of July, ECB has presented their strategy review with a clearer link between realised inflation and the policy reaction function. Hence, rate hikes are not really worth contemplating until underlying inflation has durably reached inflation target. This is in line with earlier Riksbank reasoning, but still, if ECB is reluctant to hike, it will hold back Riksbank actions as well. Consequently, we aim to take advantage of the steep yield curve up to three years under our "*Sweden: Riksbank and market pricing inconcistencies*" theme.

The next Riksbank meeting later in September will most likely be undramatic. While inflation and growth has been a slightly higher, the delta variant creates uncertainties. Moreover, the ECB has announced their new dovish strategy. This should balance things up at the meeting in our view. We doubt the Riksbank is ready to announce its plans for asset purchases in 2022 already at the upcoming meeting. Postponing this decision until the next meeting in November, might provide more clarity about tapering by the Fed and the ECB.

Riksbank´s current rate path is completely flat (up to Q3 2024) and while a possible rate hike three years from cannot be ruled out, the market is already pricing 40 bps of rate hikes by Q3 2024, see chart. More, the current inflation trajectory is below 2% all the way up to the end of the rate path period and it probably needs to be lifted further by then in order to justify a rate hike at the back end of the rate path.

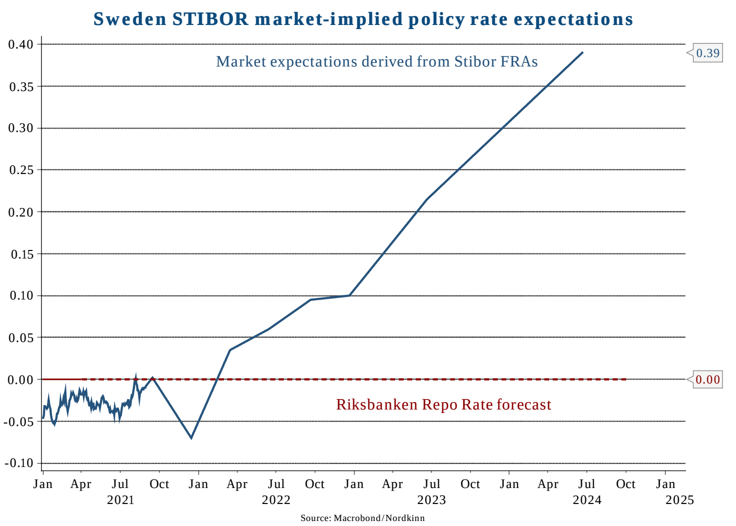
Long dated bond yields in Sweden followed international peers lower during the summer. All equal, the move in Sweden was driven by real rates. Yield curves have flattened but in particular the real rate curve. Although the real rate curve steepened somewhat in the last sessions of the month, it remains flat by historical standards. We expect global real yields to gradually move higher as tapering and investor flows ebb, or even reverse. In our view, it is a question of timing. Historically, Swedish real yields follow global real yields, which we seek to explore within our *"Global: Comparative inflation expectations"* theme.

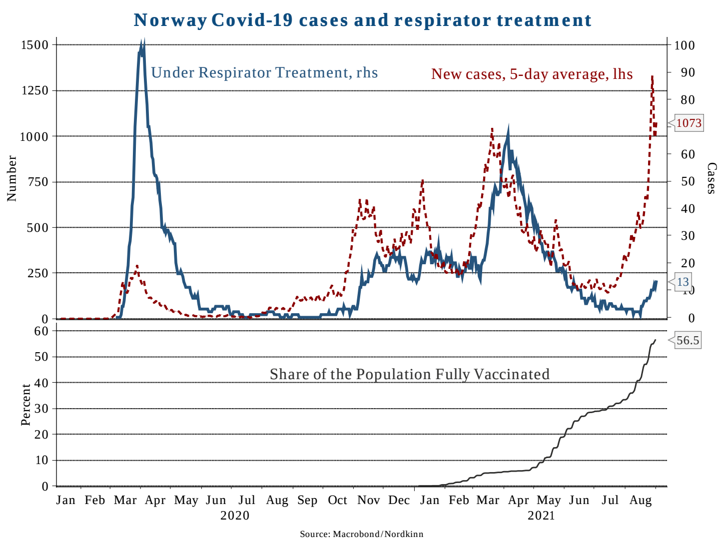
In Norway, while infection rates have risen much faster than expected, we do not anticipate a significant hit to economic activity. More than 70% of the population (or around 90% of all adults) have received at least one vaccine dose, and almost 60% of the population is fully vaccinated. The share of fully vaccinated will continue to increase markedly, and this implies that the health effects of the current Covid-19 wave should be less severe than previous waves. While the number of patients with corona in hospitals is likely to increase somewhat futher, it is unlikely to exceed hospital capacity. Added to that, because a very high share of the population in "risk groups" is vaccinated, the number of patients in intensive care remains low, see chart. Consequently, although we cannot rule out retightening of some restrictions, priority number one for health authorities is to speed up vaccination during September.

The government intends to proceed with its plan to reopen the society entirely when mass vaccination is complete at the end of September. Even with delays, we see a robust outlook for economic growth over coming quarters. This will allow Norges Bank to unfold its normalisation plan with rate lift off on September 23rd and a total of 100 bps of tightening by summer 2022. We continue to believe that the near-term path is relatively robust to minor disturbances in the macro and markets environment.

As the market discounts a somewhat shallower rate outlook than Norges Bank presented in July, we see moderate upside risks for NOK interest rate in coming months. This comes on top of an expected increase in the spread between money market rates and the key policy rate, as structural bank liquidity is set to tighten from September and we see upside risks to USD Libor-OIS spreads ahead. At the same time, we actively trade NOK rates from both sides when deemed appropriate.

Meanwhile, following the recent appreciation of the NOK exchange rates, we have trimmed our long NOK positions as we see a risk of increased market turbulence during Q4 associated with QE tapering discussions on both side of the Atlantics and instead stand ready to act as opportunities present themselves.





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 twelve 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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