NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – September 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

Peaking COVID-19 cases globally and more hawkish tones from central banks contributed to rising interest rates during September, see chart. On September 22nd the FOMC published updated "dots" showing higher expected future interest rates as committee members revised their expectations for inflation upwards. Half of the committee now expects lift off in 2022. Meanwhile, Fed chair Powell also signalled that it is soon time to start tapering the asset purchases, unless the economic outlook deteriorates substantially. November now seems the most likely month to announce and to commence tapering.

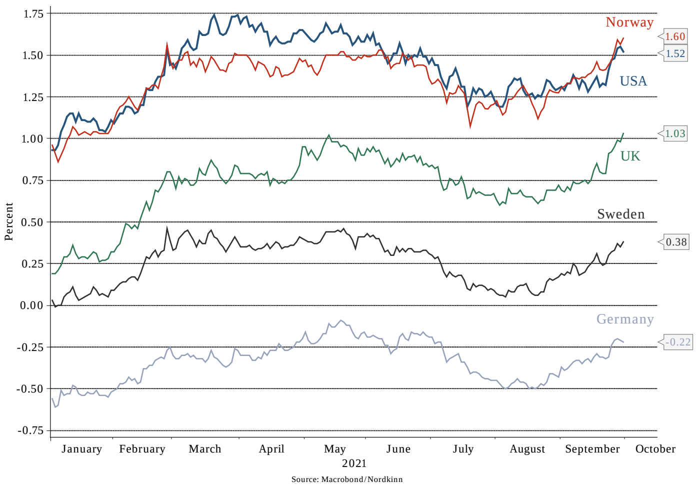
These developments supported higher U.S. relative to Eurozone interest rates and a relativly flatter U.S. curve, contributing positively to our *"Global: Gradual return to normality"* theme in September.

Inflation continued to be in focus in September, especially in Europe where energy prices took off to new highs. European energy demand has increased as the economy has recovered from the pandemic. Moreover, the price for EU carbon allowances moved to new highs in the month, which lead to a switch from coal to gas. At the same time, Russian limited its pipeline exports of natural gas to Europe. On top of this, power generation from wind and water has been limited due to calm and dry weather. Both realised inflation and expectations about future inflation, as reflected in Break-Even Inflation (BEI) rates, surged during the month in Europe. Moves were more contained in the U.S., while real rates rose slightly. These developments contributed positively to our theme *"Global: Comparative inflation expectations".*

As prices on coal and gas have spiked, some Chinese power producers have shut down the power generation, intensifying worries about downside risks to growth associated with regulation of credit supply and the tech sector. On top of this, fears of default by the real estate developer and conglomerate China Evergrande Group is a particular source of concern, exposing vulnerabilities in the huge Chinese housing sector. The group has USD 300 bln in debt and investors fear a Chinese "Lehman moment".

Another market worry is the U.S. debt ceiling currently at USD 28.4 tln. Janet Yellen warned of "catastrophic consequences" should the ceiling not be raised. So far, market participants seem to be fairly relaxed about both the Chinese growth slowdown and the U.S. debt ceiling simply as they anticipate authorities to step in and solve these issues.

10y Government bond yields



Nordic overview

In Sweden, as inflation data for august surprised to the upside, short-term real rates declined. Headline CPIF reached 2.4% y/y while CPIF excluding energy also inched higher to 1.4%. The surprise was rooted in much higher than expected energy prices. The real rate curve steepened as long-term nominal rates moved higher in tandem with global yields, benefitting the theme *"Global: Comparative inflation expectations".*

At the September 20th meeting, the Riksbank kept monetary policy unchanged and downplayed the recent move higher in inflation as being transient. The minutes showed no significant change in reasoning compared to the June meeting, with no rush to alter policy stance. While the Riksbank is very relaxed (like ECB), the market tells another story. The Riksbank sees a rate increase Q4 2024 at the earliest, whereas the market currently prices a 25 bps increase in the repo rate already by early 2023. This mismatch in pricing relative to policy outlook was a negative contributor to our theme *"Sweden: Riksbank and market pricing inconsistencies"*. Reflecting adverse movements in various asset spreads relative to our expectations, our theme *"Sweden: Supply/demand imbalances"* detracted from performance as well.

Norges Bank became the first western central bank to lift interest rates after the pandemic: On September 22nd, the central bank decided to raise its key policy rate by 25 bps to 0.25% and signalled that it will most likely move again in December. Moreover, the Bank revised its forecast for the key policy rate slightly upwards due to prospects for higher inflation, reflecting higher capacity utilisation, stronger wage growth and a weaker NOK than previously projected. The interest rate forecast implies a key policy rate of 1.25% by end-2022 and a peak of 1.50-1.75% in 2023 - consistent with estimates of a "neutral" monetary policy.

Against this backdrop, and with help from global developments, NOK interest rates rose in September across maturities. The spread between NOK and offshore rates widened. The very front-end of the curve was more contained, however, reflecting already high expectations of rate hikes over the coming year. Supported by wider interest rate differentials and higher energy prices, the NOK exchange rate appreciated in September. Because of these developments, our theme *"Norway: Relative monetary policy"* contributed positively to the fund's performance.

Interest rate swaps 2y2y fwd, spreads vs. NOK

Global markets

There are currently strong opposing forces for global growth. With COVID-19 cases globally having peaked and vaccination rates rapidly improving, the pent-up demand from excess savings should be released as societies return to some sort of new normal. Furthermore, as demand for goods long have outstripped production rates, inventories are generally at low levels compared to sales, in particular in the U.S. Hence, even though demand for goods will likely fall as consumers shift to services, it seems likely that production-growth will need to be ramped up and exceed sales-growth for some time.

Meanwhile, the supply chain issues and the energy crisis in Europe and China described in our Market review section complicates the picture. Production constraints will hold growth back and lead to continued price pressures. Price pressures, be it for power, cars, food or restaurants will harm consumers' purchasing power and eat into households' excess savings.

The fiscal stimulus with extraordinary support for households has or is about to expire both in Europe and the U.S. In addition, there has been a shift in central banks communication in a less dovish direction and tapering are getting closer for both the ECB and the Fed. We expect Fed tapering to start in November and to be completed by summer 2022. As central bankers put great effort in communicating this well in advance, this will not be a shock and probably will not cause a sudden disruption in the market as experienced in the infamous "taper tantrum" in May 2013.

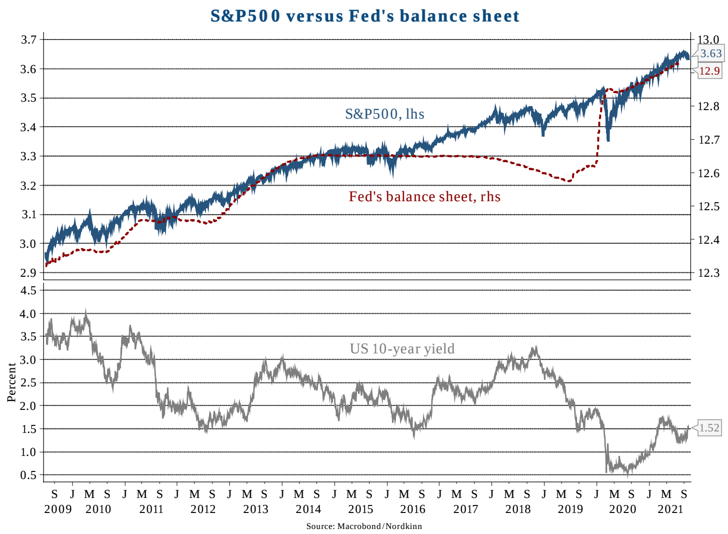
Having said that, the Fed has never in history had to pullback from such a dramatically accommodative position before. During the past year and a half, bond purchases have added more than USD 4 trl to the Fed's balance sheet, which now stands at USD 8.5 trl. These purchases have helped keeping bond yields low and have provided support to broader markets, including the equity markets, see chart. Valuation is streched across virtually all asset prices, and it may be difficult to avoid higher volatility as central banks gradually shift away from very easy money. There is a risk that market participants are complacent.

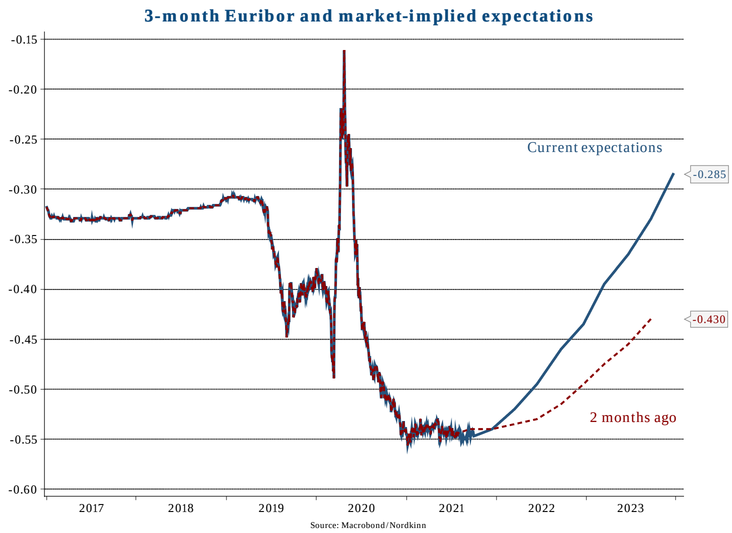
While the "taper" story seems to be relatively straight forward, of course barring an unexpected sharp slowdown of the economy in coming weeks, it is not clear when the criteria for interest rate lift-off will be met. We expect core PCE inflation in the U.S. to slow quite sharply next year as some of the pandemic-related price increases in goods reverse. If we are right, the Fed will remain patient for quite some time after tapering is complete before raising rates. In the end, we believe the Fed would like to see tighter labour market conditions prior to lift-off, and that may take time. In this respect, wage growth will be key to watch going forward. This said, things could get complicated near-term if inflation continues to run above the Fed's expectations.

For the ECB, it will take much longer time before the conditions for lift-off will be met, and we strongly disagree with interest rate expectations currently prevailing in the European market, see chart.

Through direct investments and indirect channels, the Chinese real estate sector is estimated to contribute to almost 1/3 of the Chinese economy. As at 2017 the average residential space (square meters per person) was already at par with European countries. The sector has since grown dramatically and been a major contributor to Chinese growth, but the authorities are now aiming at a managed slowdown of the real estate sector. This has implications both short term as the Evergrande story illuminates and longer term for the structural growth rate of the Chinese economy. How the Chinese slowdown and in particular the real estate sector will play out will also be a major factor for global growth going forward.

Hence, the global outlook for growth is murky. While we expect strong growth over the next months, we acknowledge several risks to this outlook. Equities, real estate and fixed income have all had strong gains and seem expensive on most measures. There are many signs of exuberance and the risk of setbacks are high, especially now as monetary and fiscal support is being scaled back. Given this background we think market implied volatility is too low, in particular in the G3 FX crosses, and we have bought long term option structures that would gain from a rise in volatility.





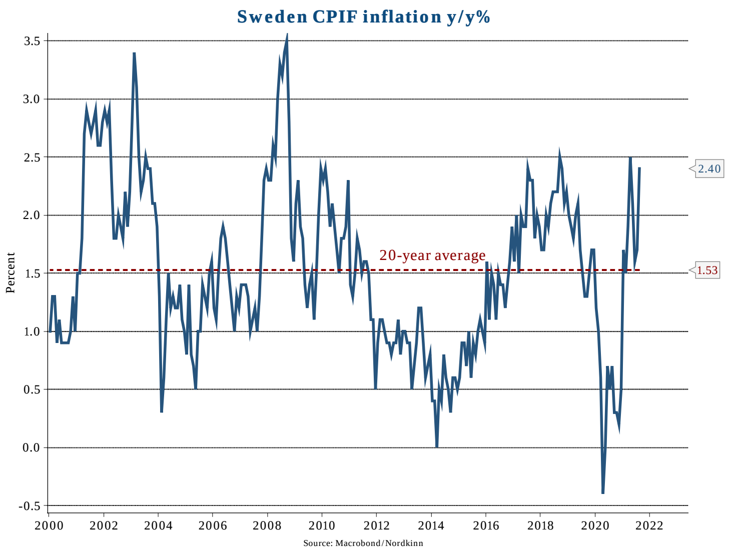
Nordic markets

The Swedish fixed income market is seemingly having doubt about the Riksbank's policy stance and outlook. The Riksbank's way to conduct policy is clearly biased by their legacy of falling short of the inflation target. Over the past ten years, CPIF has averaged 1.25% and CPIF excluding energy only a touch higher at 1.3%. In addition, so far we see (like the Riksbank) no clear evidence that the inflation pressure has or is about to alter in a structural way. Hence, we believe that the shape of the Break-Even Inflation curve is at odds with the pricing of rate hikes. The curve is upward sloping to the 10y segment with the 4-year Break-Even inflation rate trading below Riksbank's target and longer forward BEIs above 2%.

One one hand the market prices more than three full hikes over the next 4 years (90 bps), while inflation is expected to stay below the target on the other. These two expected outcomes contractict themselves. This becomes even more evident when taking into account the fact that rate hikes will have a relatively large impact on CPI (base index in the real rate bonds) due to the currently low floating mortgage rates.

The upbeat pricing of forward starting inflation beyond 4-year is also an argument for a steeper real rate curve. In case of higher global bond yields, the driving force, in our view, would be real rates and not Break-Even inflation rates. In Sweden, the case for steeper real curve is attractive due to the pricing of shorter term BEIs, which gives a hedge in case inflation continues to surprise to the upside. We continue to expect inflation to remain elevated in the near term due to energy prices and supply chain disruptions, which should be supportive for shorter term BEIs and real rates.

Higher energy prices will, however, continue to have no impact on Riksbank´s policy stance. We think Governor Ingves summed it up well in the minutes from last meeting; "The average rate for CPIF inflation in the past 20 years has been around 1.5 per cent. With this background: the fact that inflation is now according to our forecasts going to slightly overshoot our target of 2 per cent is not a major problem (…) we should proceed with caution when it comes to making monetary policy less expansionary". This, we argue, is the concept of so called Average Inflation Targeting (AIT) in practice, yet not formalised.



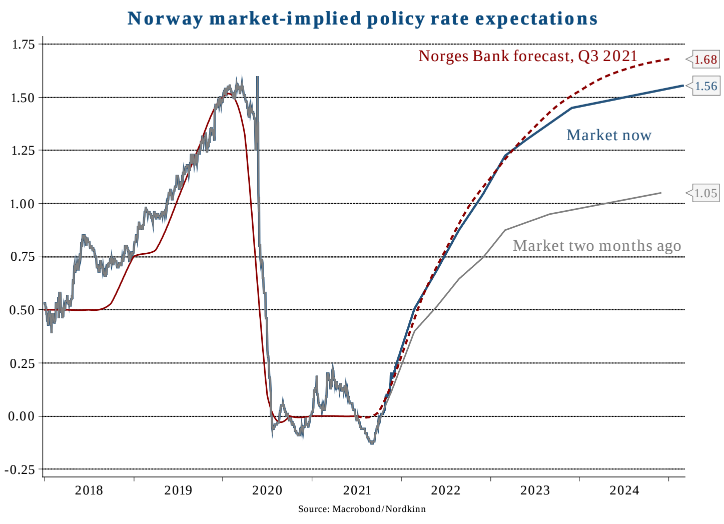
According to its interest rate projection, the Norges Bank envisages another rate hike in December 2021 and three more hikes next year, taking the key policy rate to 1.25% by end 2022. This is not very different from the interest rate projection made in June. Indeed, the first 12 months of the projection was identical to the previous one: Hikes on every "Monetary Policy Report" meeting until the key policy rate reaches 1.00%.

The main difference from June is that the new rate path implies a somewhat higher interest rate path from late 2022 and onwards. The end-point of the Norges Bank's rate forecast, 1.68% in Q4 2024, is now more consistent with the Bank's estimate of the "terminal" or "neutral" interest rate, which is 3-month Nibor at 2%. Overall, our main take is that this was not a major hawkish shift.

While the Norges Bank clearly seems determined to remove policy accommodation ahead, it does not mean that the path to 1.00% by summer 2022 is 100% certain. Shocks may hit the economy underway. What we do know is that the Norges Bank has a strong preference for taking a gradual approach during hiking cycles. This was further emphasised at the press conference following the montetary policy meeting in September: As the "uncertain impact of higher interest rates warrants a gradual policy rate rise (…) the upward revision of the rate path is thus smaller at the start of the projection than implied by the model-based analysis". On top of that, Governor Olsen went a long way at the press conference effectively dismissing chances of interim meeting hikes or 50 bps increments.

As the market is already discounting the new Norges Bank rate path, we see poor risk-reward associated with further paying of short-dated NOK interest rates at current levels. Accordingly, we booked profits on this exposure during September. Looking ahead, any further rise in global rates is likely to affect the long-end the NOK curve more than shorter term rates. Given the low probability of interim meeting hikes, we currently seek to exploit the very flat slope of the NOK yield curve within our *"Norway: Relative Moneteary Policy"* theme.

Regarding FX, as we are now entering a season that historically has been challenging for the Norwegian currency, we booked profits on our long NOK exposure during September. Rather, considering the downside risks to global risk sentiment as major central banks are becoming more vocal regarding future removal of policy accommodation, we prefer a tactical short NOK exchange rate exposure for October.



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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