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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – October 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

Short-term interest rates gapped during October as markets repriced expected future monetary policy across developed economies, leading to unprecedented flattening of yield curves. In fact, the upward move in very short end rates was the most violent seen in almost a decade and reflected a combination of increased inflation fears and hawkish central bank communication, further reinforced by stop-outs.

For the first time in a at least a decade global inflation is advancing at a rapid pace due to higher energy prices and supply bottlenecks. The rise in inflation has been labelled "transitory", but markets now fear that inflation could be higher and stickier than most economists and policy makers thought. Consequently, market-based inflation expectations increased substantially in both Europe and the U.S. during October.

Several hawkish central bank signals ricocheted across bond markets in October. On Sunday October 17th, Bank of England Governor Bailey said the Bank "will have to act" to curb inflationary pressures. This caused massive moves in UK money market instruments. Similar price-action was seen after Bank of Canada late in the month pulled forward projected interest rate lift-off from the second half of 2022 to the "middle-quarters of 2022". Finally, after the Reserve Bank of Australia declined to enter the bond market to defend its 0.1% yield target on the three-year Commonwealth debt, the yield on this bond soared to eight times that level.

Although these incidents should not in themself lead to large market repricing, the market moves caused some large, forced liquidations, in particular going into month-end. The turmoil spilled over into other markets as repricing of monetary policy expectations have occurred across the board (see left hand chart), including Euro area and Sweden. Expected policy rates in these markets now diverge substantially from the respective central bank's projections and forward guidance.

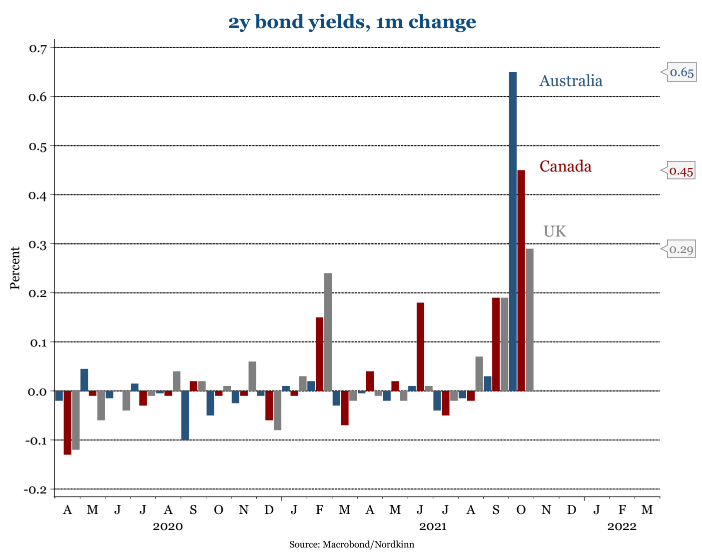
Although being humble with respect to inflation dynamics, ECB's Lagarde confirmed on October 28th that the ECB expects the current inflation rise to be largely transitory, which implies that markets are far ahead of ECB expectations in terms of policy rate hikes. Meanwhile in Sweden, Governor Ingves said on October 19th that the Riksbank's expansionary monetary policy needs to be sustained in order to maintain inflation close to target in the longer-term. This notwithstanding, market participants relentlessly increased their bets for earlier rate hikes from the ECB and Riksbank as global developments spread across markets.

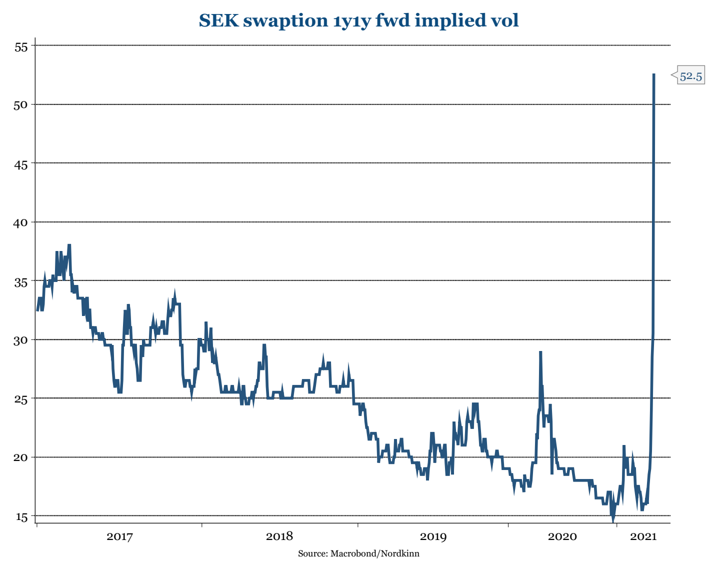
The Swedish CPI release on October 14th calmed the Swedish markets for a couple of days. CPIF excluding energy printed 1.5%, below expectations and far below the 2.0% inflation target. Nevertheless, in the following week the market reacted to hawkish signals from the Bank of England, the Bank of Canada and the Reserve bank of Australia as mentioned above. Interestingly, the move in European and Swedish rates not only implies a rapid elevation in policy rates back to the situation just before the pandemic, but also implies policy rate hikes over the coming year to levels not seen since 2014.

When entering October, our thinking was that the post-pandemic recovery would discount monetary policy responses that differ across central banks. However, soaring inflation in some countries resulted in a "tide lifts all the boats" reaction across the markets, sending all short-term rates significantly higher and resulting in an explosion in volatility (of short term interest rates) at a pace not seen since the Lehman collapse in 2008. This caused the Swedish short-term interest rate market to become dysfunctional towards the end of October, see right hand chart. Our reasoning that short rates in individual countries will be tied to the respective central bank´s conditions and patience (legacy) proved wrong. As a result, the themes *"Global: gradual return towards normality"* and, in particular, *"Sweden: Riksbank and market pricing inconsistencies"* suffered tremendously in the portfolio.

Remarkably, longer dated government bond yields barely moved during the month, despite the fact that the move in short term rates was fostered by inflation fears. These sets of unprecedented combinations of rate moves also created great losses for our theme *"Sweden: Supply/demand imbalance"*. Further, falling real rates in the U.S. as investors fled into break-evens on the amid revised inflation forecasts, led to losses in the theme *"Global: comparative inflation expectations"*.

While realised and expected inflation have increased, global growth expectations have lately been revised down. Rising default risk of Chinese real estate conglomerates, falling purchasing power for consumers as prices rise and growing Covid-19 case count have all contributed to the expected slowdown. After a wobble in September, equity markets have continued to rise despite slowing growth expectations, rising inflation, stretched valuations and monetary tightening. As we were expecting some market turbulence, we were positioned for elevation in FX volatility combined with weaker NOK and stronger JPY. These positions led to losses in the theme *"Tactical risk reward trading"*.





Global markets

Inflation in many countries has risen further and has been more persistent than most market participants and policy makers expected only a few months ago. The strength and duration of inflation, and central banks' policy responses to inflation dynamics, is undoubtly the key theme for fixed income markets at the moment.

The Norges Bank, Royal Bank of New Zealand, and several EM central banks including Russia and Brazil have already raised rates. Others, like the Fed, Bank of England and Bank of Canada have communicated intentions of doing so during 2022, while the ECB and the Riksbank continue to communicate a strong commitment to maintain the current interest rate levels in place for a long time.

Despite difference in forward guidance, the market has to some extent been indiscriminate in discounting future monetary policy moves. In the case of the UK, inflation is currently running well above the inflation target of 2% and is expected to rise further. Market-based measures of inflation expectations have soared above 4%. The labour market is extraordinarily tight in some sectors, as the supply of labour has dropped after Brexit, leading the Bank of England to fear a wage-cost dynamic that could lead to more sustained inflation pressures. Hence, the Bank has indicated that it will have to act to contain inflation. There are also signs of accelerating wage growth in the U.S., which has lead the market to reprice the timing of Fed-hikes.

In Europe, in contrast, there are no signs of accelerating wage growth. This is why President Lagarde, at the press conference post the ECB policy meeting on October 28th, again confirmed that the ECB expects inflation to be transitory. The ECB expects inflation to fall back during 2022, which makes sense in our view. We doubt market participants really expect lift-off from ECB nor Riksbank already next year, but the sharp moves in other markets have produced a tsunami of flows out of receiver-positions in short-dated swap rates. We have clearly underestimated the potential for rate hike expectations globally to spread to Europe, despite divergent inflation dynamics and affirmative central bank communication. Looking ahead, we will carefully examine the degree of dislocations that have emerged across markets, assets and instruments, and we stand ready to take advantage of the opportunities that have arisen.

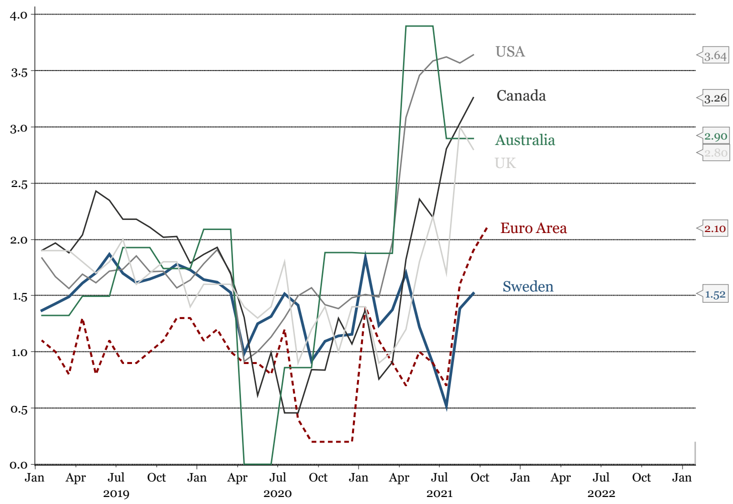
One important theme that we expect to grow in importance over coming months is the outlook for rates beyond the front-end. As volatility has moved to the short-end, there is almost no focus on whether upcoming tapering of central bank's asset purchases could have an impact on the performance of longer-term bonds, and risky assets for that matter. We remain convinced that quantitative easing has depressed term premia and led to lower bond yields. In isolation, therefore, a decline in asset purchases by central banks in coming months should structurally push bond yields higher unless economic activity is being compromised.

Added to that, the market discounts that central banks across the world are about to embark on a hiking cycle very soon, but that the tightening cycle will be very short by historical standards. In other words, the slope of the money market curves are already unusually flat as markets are pricing a combination of aggressive lift off and low terminal rates. While incoming inflation and growth developments have the potential to put further flattening pressures on curves in the near-term, our view on inflation in 2022 should imply a more gradual and longer-lasting hiking cycle than markets currently discount, and that the ECB and Riksbank will lag the Anglo-Saxian central banks significantly.

Another key question for markets will be the inflation outlook looking beyond the reopening supply demand dynamic. Structural factors like demographics and globalisation could point to higher inflation over time. Indeed, market-based inflation expectations does price higher for longer inflation than in recent years. At the same time, however, long-term bond yields remain very low. These potential market dislocations provide opportunities ahead.

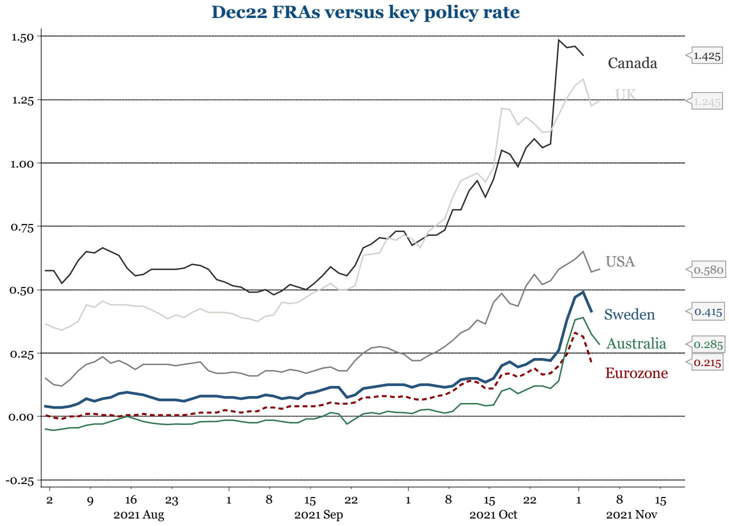
One key risk associated with the outlook for higher bond yields is that growth expectations currently are falling as households suffer from rising consumer prices. In addition, Covid-19 case count is rising again in many countries and the Chinese real estate sector is slowing Chinese growth expectations. Consequently, it is therefore hard to express strong conviction that global growth, in isolation, will be positive for risk assets and longer-term bond yields in coming months.

CPI excluding food and energy, y/y %



Source: Macrobond/Nordkinn

Dec22 FRAs versus key policy rate



Source: Macrobond/Nordkinn

Nordic markets

The surge in Swedish short term swap rates lacks justification from current domestic inflation data and inflation outlook, as well as the Riksbank's communication and its monetary policy outlook. The left hand chart illustrates the implied pricing of the repo rate compared to the Riksbank repo rate path. The difference between the end-point in Riksbank's forecast and market expectations has not been greater since the Riksbank started to publish repo rate forecast in 2007.

Even if underlying inflation indeed were to move higher and stay there for a longer period of time, which is not our baseline scenario, it will be difficult for the Riksbank Board to lift policy rates in 2022. In a first step, any increase in underlying inflation needs to be recorded and assessed in a careful manner by the Riksbank. It will be critical whether inflation is driven by factors that a-priori are deemed temporarily, or whether positive output gap and rising wage growth are causing underlying inflationary pressures to build.

Secondly, Riksbank will gradually prepare the market and households for a regime shift before raising rates. Our estimate, which we elaborate on below, is that a first hike reasonably can be delivered at the February 2023 meeting at earliest. This requires both higher and sticky underlying inflation as well as an upbeat growth outlook.

The main reason why inflation will be so cautiously evaluated by the Riksbank prior to any shift in policy is the 'inflation legacy'. Underlying inflation (CPIF excluding energy) has averaged 1.3% over the last ten years, weighing on inflation expectations and central bank credibility. This permits the Riksbank, just like the ECB, to be very patient before altering monetary policy. The mistake to react to higher energy prices in 2011 still haunts the Riksbank, as well as the ECB.

As of now, conditions are currently not even close to be consistent with a rate hike by mid-2022, which is what the market currently discount. CPIF excluding energy, which is the policy-relevant measure of inflation, stood at 1.5% in September, well below the 2.0% target. Wage growth is still very subdued.

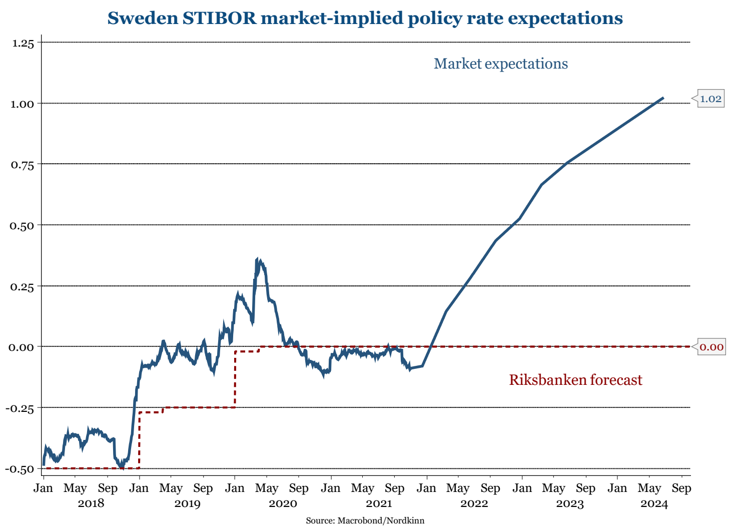
Accordingly, unlike the UK, Canada and the U.S., where markets have reacted to a combination of both underlying inflation and signals from central banks, pricing in Sweden lacks such backing.

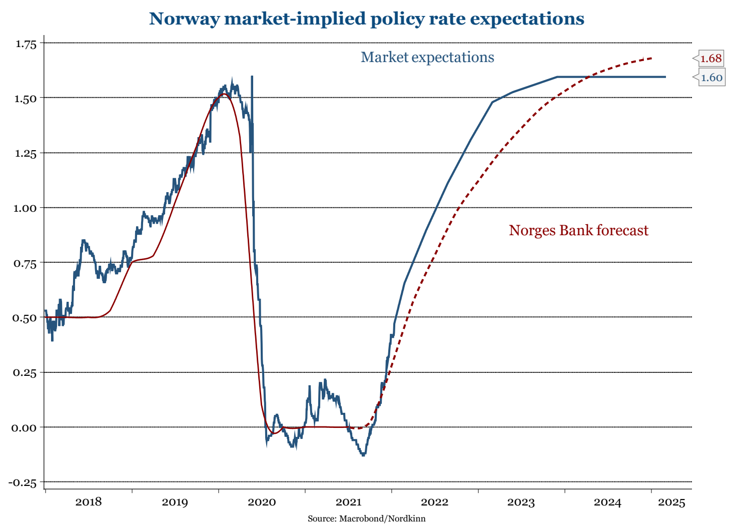
Still the market discounts 25 bps hike from Riksbank in June, one month ahead of the Fed. According to their most recent projections, the Riksbank intends to maintain a 0.0% key policy rate throughout Q3 2024, whereas the Fed envisages lift off in late 2022 or early 2023. It is difficult to argue against higher short term rates in the countries where central banks have indicated that a policy shift is approaching. However, sending short end interest rates in Sweden (and Europe) to levels that implies policy rate hikes within the next six to twelve months is ungrounded in our view.

Although we have scaled back massively on risk, we believe that the market has been driven by other factors than fundamentals. We look for opportunities to exploit this as soon as the market stabilises.

The theme *"Sweden: Supply and demand imbalance"* was closed down at the end of October. The theme generated strong returns in 2020 as covered bonds performed relative to Swedish government bonds (SGBs), but during 2021 the SGB market functioning has deteriorated significantly as Riksbank has been forced to buy long-dated bonds. The Riksbank avoids to hold more than 50% of any issuance and held already that share of the market in shorter maturities when 2021 started. The purchases of SGBs by the Riksbank has dwarfed the supply in 2021. This has forced short covering among investors that have positioned for a normalisation of the bond market in 2021. The widening of asset swap spreads (SGBs vs. swaps) over the last month has only been greater on three occasion, the Lehmann crisis, the Dot-com bubble burst and during the Euro debt crisis. As the pricing of SGBs now reflects a scarce commodity and we neither expect the demand supply balance to recover nor a return to a well-functioning market any time soon, we decided to close down the theme.

Finally, a brief comment on Norway. We expect the Norges Bank to proceed with 25 bps hikes every quarter until the second half of next year, which is a somewhat slower pace of tightening than Norges Bank's projection from September. We think the market will struggle to discount a policy rate well above 1.50-1.75%, which is Norges Bank's estimate of neutral. Finally, we believe that the curve is too flat from summer 2023 and onwards.





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.

Kungsgatan 33, 6th floor
111 56 Stockholm, Sweden
Phone: +46 8 473 40 50
Telefax: +46 8 473 40 51
E-mail: post@nordkinnam.se

Prinsens gate 22, 6th floor
0157 Oslo, Norway
Phone: +47 22 46 63 00
Telefax: +47 94 77 15 16
E-mail: post@nordkinnam.no