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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – November 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

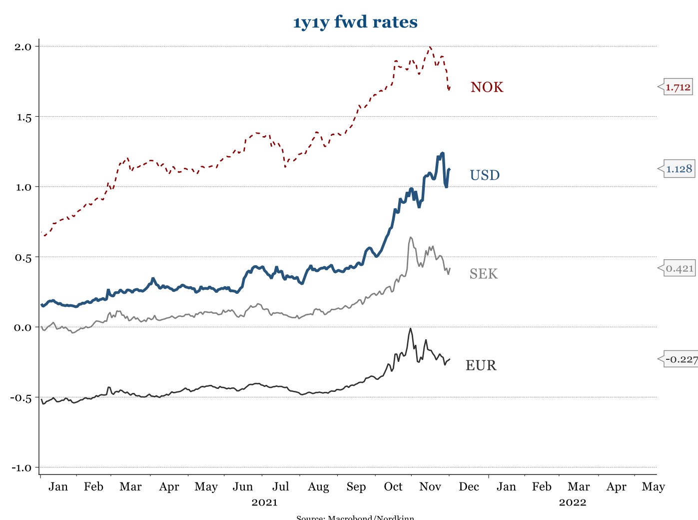
Following the turmoil isolated to short-term interest rates in October, rates gradually declined in most regions in early November. As the dust settled, rate markets became less synchronised and scaled back elevated expectations of early rate hikes in Europe, while expectations for hikes in the U.S. kept up during the month despite the Omicron outbreak, see chart. As a result, our new theme *"Global: Rate hike timing, pace and duration"* contributed positively to performance.

High U.S. inflation numbers and hawkish Fed speeches caused U.S. rate expectations to rapidly increase during the first half of the month, while the Omicron variant led to significant uncertainty and caused volatility to spike later in the month. The short end of the U.S. market experienced some of the biggest moves, both up and down, seen over the last 10 years. Moreover, post Omicron, volatility was no longer contained to fixed income markets as equities tumbled and FX had some massive moves characterised by forced liquidation. USD/JPY tumbled almost 2% on November 26th, the biggest daily move since the Covid outbreak in March 2020.

Regarding Omicron, the Covid variant, data so far indicates that the new strain is much more transmissible than previous variants, but it also indicates a less severe disease course. WHO expects that adjustments to the current vaccines are necessary to improve their efficacy.

The surprisingly high CPI inflation prints caused inflation market-based inflation expectations to rise further. U.S. inflation swaps peaked in the middle of the month and descended during the second half, closing the month slightly below where they started. Meanwhile, U.S. real rates moved considerably higher in the latter part of November. Together with a strong performance in shorter Swedish inflation-linked bonds, this benefitted the *"Global: Comparative inflation expectations"* theme.

The Fed consensus seemed to move in the direction of an accelerated tapering pace of asset purchases relative to the USD 15 bln monthly reductions decided at the policy meeting in early November. The change in Fed's rhetoric followed surprisingly high CPI inflation and rising employment costs, questioning the "transient" narrative as price pressures broaden. Although Fed chair Powell warned in a testimony that the Omicron outbreak increases downside risks to growth and adds uncertainty to the inflation outlook, he confirmed that it may be appropriate to quicken the pace of tapering due to inflation risks.



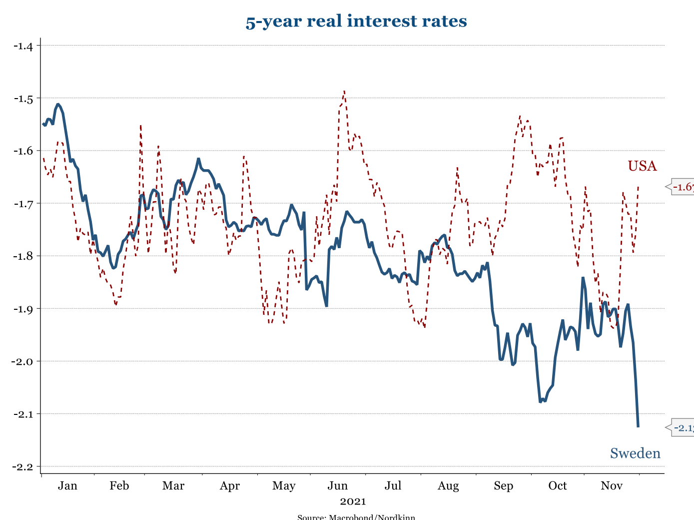
Nordic overview

After the fastest and largest rise in Swedish short-end rates in over a decade, November was calmer. Despite slightly higher than expected CPI data, interest rates gradually moved lower throughout the month. The monetary policy announcement on November 25th was supportive, as the Riksbank signaled patience in their assessment of inflation and the impact on policy. The new rate path included a hiking bias in the second half of 2024, as widely expected.

Moreover, planned QE purchases in Q1 2022 showed full reinvestments in 2022 of maturing bonds on a quarterly basis, also as expected. Yet, the composition was somewhat surprising. The QE share of government bonds (SGBs) and municipal bonds rose, whereas the share of covered bonds fell markedly compared to the previous quarters. This resulted in strong performance of SGBs, in particular relative to covered bonds, which in isolation had a negative impact on our portfolio. However, this was more than offset by the decline in Swedish interest rates during November, resulting in a positive contribution from the theme *"Sweden: Riksbank and market pricing inconsistencies".*

Turning to Norway, incoming data during November confirmed that the economy and the labour market are rebounding, in line with Norges Bank's projections. However, consumer sentiment deteriorated, largely reflecting the spike in electricity prices, posing downside risks to private consumption ahead. Meanwhile, core CPI inflation, which strips out energy prices, fell to 0.9%, well below the 2.0% target. While the inflation print was in line with Norges Bank's forecast, it nevertheless shows that Norway stands out, at least so far, compared with the inflationary spike seen in other markets. Finally, as the Covid situation deteriorated sharply in November, some restrictions were introduced to slow the spread. However, prime minister Støre said the government wants to avoid new lockdowns, which suggests that the economic impact will be mild.

NOK interest rates rose in tandem with USD rates during the first half of the month, but fell sharply in the latter half of the month. The tightening of NOK versus USD rates contributed positively to our *"Global: Rate hike timing, pace and duration"* theme. Moreover, our *"Norway: Relative Monetary Policy"* theme also captured profits on volatility in NOK rates and curve steepeners.



Global markets

Fed chair Powell has for some time described U.S. inflation as "transitory", but in his testimony for the Senate at the end of November he acknowledged that "it's probably a good time to retire that word". He keeps reiterating that the surprisingly high inflation rate is caused by disruptions to the supply side, yet these seem set to linger.

While we agree that supply side bottlenecks are playing a role, we believe the demand-side plays an equally important role. As a result of coordinated fiscal and monetary policies, U.S. households were over-compensated for their loss of income during the pandemic leading to the strongest household income growth in this century. High spending power and lack of service spending possibilities led to an explosion in demand for consumer goods. As the U.S. had the most generous income compensations, the demand push and the goods inflation pressure have been significantly stronger than in Europe, see chart. Moreover, partly because many workers lost their jobs during the pandemic, the U.S. labour market is also very tight and have caused wage growth to rise more than we see in most other countries.

As a result, several Fed officials admitted in November that the risk of persistently high inflation risk has risen, which implies that a faster pace of tapering will be discussed at the upcoming FOMC meeting on December 15th. A faster pace of tapering would allow the Fed to bring forward interest rate lift-off if deemed necessary.

Until now, a rebound in labour market conditions to levels consistent with maximuim employment has been a necessary condition for interest rate lift-off. However, given the risk that the massive inflation is becoming entrenched, there is pressure on the Fed to act even before their perceived maximum sustainable employment target has been met. This arguably justifies additional risk premia in shorter term rates.

Europe is a different story. Governments compensated companies as opposed to direct compensations to households to avoid mass redundancies. The supply of labour was maintained, and household incomes rose slower than in the U.S. Relatively lower demand for goods and more labour market slack have contained goods prices and wage pressure.

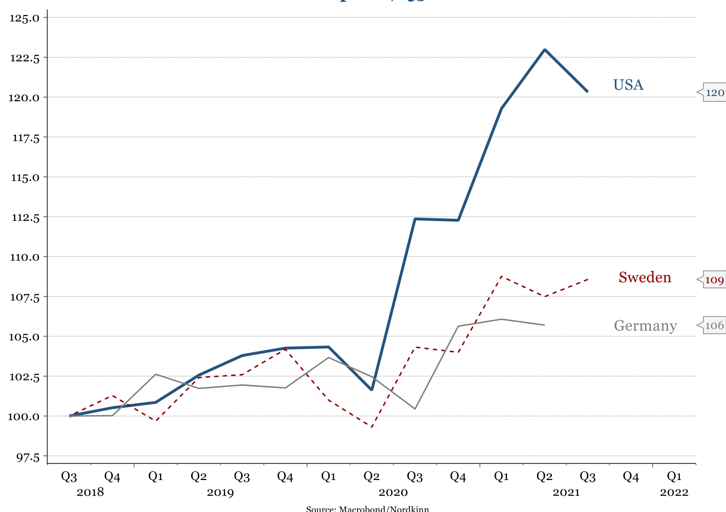
While acknowledging that inflation risks have risen and hinting at downscaling asset purchases at their December meeting, the consensus among ECB members is still that rate hikes are unlikely over the next year or two.

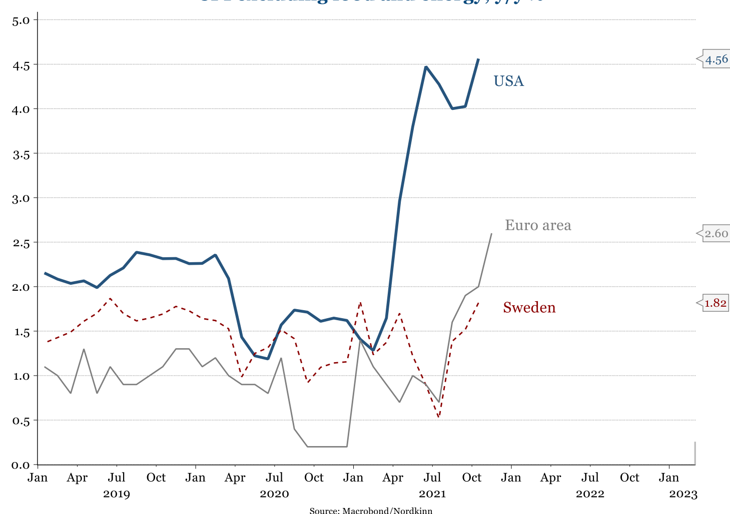
Consequently, we continue to think that the ECB will leave interest rates unchanged for a long time. Moreover, we also believe Sweden and Australia will see more muted inflation and wage dynamic than the U.S. and that neither the Riksbank nor the RBA will be in a rush to hike rates. We also question the hiking profile discounted in some countries, such as the UK, where markets expect higher rates very quickly, but also that the hiking cycle will be very short. Furthermore, Norway stands out as the only place were markets fully discount rates to return to "neutral" by the end of 2023. Accordingly, we see significant opportunities in relative value space in the the next 3-6 months and our new theme *"Global: Rate hike timing, pace and duration"* exploits these ideas.

Should the Omicron variant lead to more severe restrictions and a fall in economic activity, the impact on growth is clearly negative. However, despite lower economic activity, a shift away from services back to goods and more supply frictions, implies that a bad Omicron scenario probably poses upside risks to inflation. This combination complicates an already cloudy outlook for both policy makers and market participants. Early indications suggest that the variant is very contagious, and its many mutations will most likely imply adjustments to the current mRNA vaccines. There is therefore a risk that the variant will add additionally pressures on the health sector even if preliminary results point to a milder disease course than for the Delta variant.

Volatility in rates markets was already high and has now spread to equities and currency markets. One risk is that market liquidity dries up during December, potentially causing excessive moves, which to us means both risks and opportunities.

In the *"Global: tactical risk reward trading theme"*, a position that gains from increased volatility in EUR/USD has performed well and we expect that to continue in the current market regime.





Nordic markets

We expect the Swedish economy to stay relatively strong as spending in services is picking up rapidly. While the air-travelling sector is still struggling, other parts of the service sector is booming: Restaurant bookings are now above pre-pandemic levels. Short-term we see some upside risk in inflation data due to global prices, but with the service sector could also pose some re-opening price effects. Nontheless, we believe that the Riksbank will be very patient and wait until they are certain about the inflation being persistent at or above target. Hence, we continue to be long short dated Swedish rates.

Real rates shorter than five years look particularly attractive as short nominal rates still imply a fast turnaround by the Riksbank in 2022 while Break-Even Inflation (BEIs) rates are still at or below the 2%-target. Thus, these real rates can potentially decline from reduced Riksbank pricing or a higher expected inflation outcome ahead.

The signal from Fed by the end of November that taper can be speeded up has triggered a sell-off in U.S. BEIs and real rates (TIPS bonds). We believe there is potential for more upside to U.S. real rates ahead and continue to be short these versus Swedish and European real rates in shorter tenors. The Swedish real rate bond market experiences the same problem as the nominal bond with a scarcity premium attached to the bonds. With inflation running close to 3%, and some upside risk short-term, the scope for performance persists.

The Riksbank's cut in purchase plans for covered bonds sparked an initial underperformance of these bonds (relative to government bonds). However, we prefer to keep exposure to covered bonds relatively low due to uncertain prospects for both demand and supply dynamics in the short term. Our exposure to SGBs is also kept low due to the current low liquidity in the SGB market as the free float following QE is at all time lows.

Turning to Norway, we expect the Norges Bank to deliver the second rate hike in this cycle at its upcoming meeting on December 16th, taking the key policy rate to 0.50%. This is in line with the Bank's interest rate projection and the forward guidance from the November meeting. Looking further ahead, we continue to expect the Norges Bank to proceed with quarterly rate hikes until the three-month Nibor reaches around 2%, which the Bank sees as neutral. This forecast is somewhat more hawkish than expectations currently prevailing in the market, after market expectations eased significantly at the end of November.

That being said, we see the balance of risk surrounding this forecast being skewed towards a more dovish outcome for a number of reasons. Firstly, the risk of a more aggressive pace of tightening is limited by Norges Bank's strong preference for a gradual removal of policy accommodation, reflecting "uncertainty surrounding the effects of higher interest rates". Consequently, Governor Olsen has downplayed chances of interim meeting hikes or 50 bps increments.

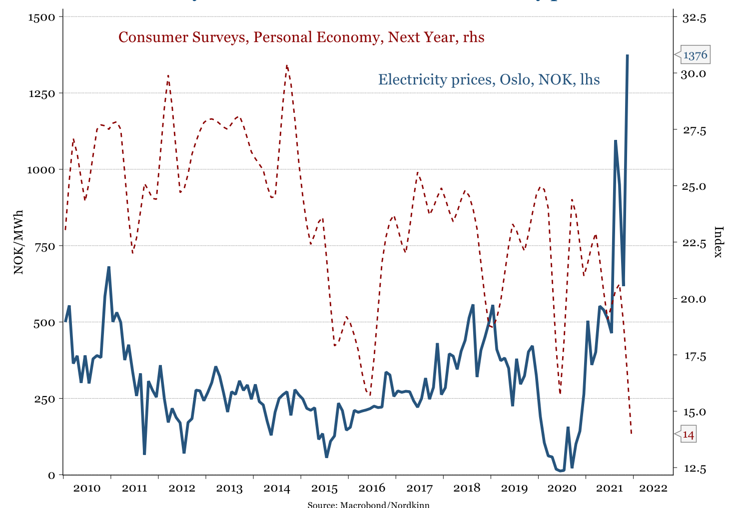
Secondly, the inflation picture in Norway is benign as core CPI inflation declined to 0.9% y/y in October, which is well below the 2.0% target.

Thirdly, the spike in electricity prices is hurting household's purchasing power. As a result, households have become rather depressed regarding the outlook for their own economic situation the year ahead, even if they are very optimistc about the country's economy, see chart.

Fourth, recent Covid news have been more negative than expected. Infection rates are record high again and hospitals have come under pressure. While we do expect the economic consequences of this Covid wave to be mild, mobility may decline and downside risks to the economy has arguably risen following the emergence of the Omicron variant.

After a sharp decline in rates at the end of November, we closed down most of our receiver positions in NOK rates space. We will continue to trade NOK interest rates actively, from both sides, as opportunities present themselves going forward.

In the FX space, after cheapening in November, we see upside potential for the NOK in the context of a positive terms of trade outlook and higher interest rates. As a result, we have started to rebuild long NOK exposure again and we intend to add on dips in December.



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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