NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – December 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

Central banks surprised hawkishly in December. The Federal Reserve (Fed) decided on December 15th to double the pace of tapering and indicated a faster increase in future policy rates starting in 1H 2022.

The ECB decided on December 16th to slow down PEPP (Pandemic Emergency Purhcace Program) during Q1 and to end it in March. To smooth the transition, the regular APP (Asset Purchase Program) will increase in Q2, but gradually slow again in Q3 and Q4. While inflation forecasts were revised up, the 2023 and 2024 projections were still below ECB's 2% target, which suggest stable policy rates through 2022.

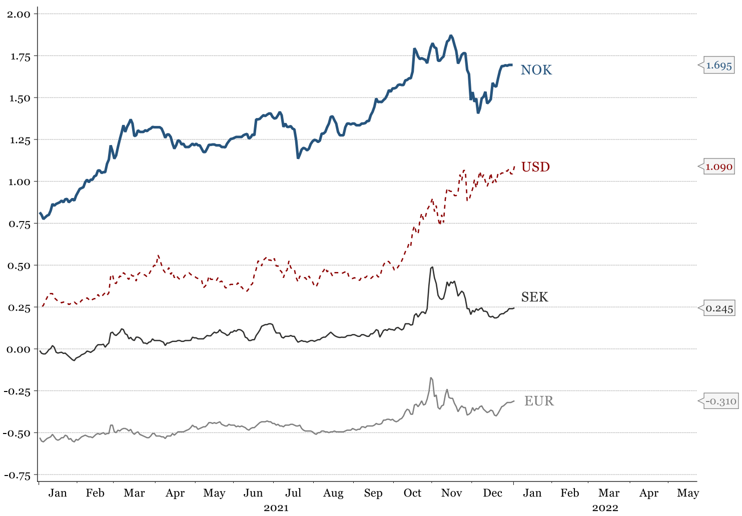
Across the channel, Bank of England on December 16th surprised markets with a 15 bps rate hike despite a large Omicron outbreak. Broader and faster inflation, tighter labor markets, increasing wage pressures and signs of higher longer-term household inflation expectations were BoE's main reasons for the hike.

The core reason for the surprisingly hawkish stance of these central banks is an increased uncertainty whether inflation is transitory or not. The Fed removed the "transitory reference" from its statement, while the ECB and the BoE also acknowledged that inflationary pressures could be longer lasting. The hawkish narrative came despite rapidly spreading of Omicron, which led to restrictive measures across Europe and elsewhere as governments seek to avoid bursting capacity of hospitals. Though spreading much faster than the Delta variant, the data so far strongly indicate that the Omicron is less severe.

To capitalise on anticipated market implications from tapering of asset purchases on both sides of the Atlantic, Nordkinn lanched a new investment theme: *"Global: Tapering of asset purchases"* which contributed positively to performance in December. Even though the main central banks have affirmed hawkish stances, markets in December continued to reprice towards more divergent inflation dynamics and central bank actions across regions after the October indiscriminate short end panic sell off, see chart.

The theme *"Global: Rate hike timing, pace and duration"*, gained from these developments, in particular reflecting steeper Euribor and Sonia curves and active trading in short-term U.S. rates. The theme *"Global: Comparative inflation expectations"* subtracted from performance following a net decline in U.S. real interest rates.

December 2022 (IBOR) FRA-rate



Source: Macrobond/Nordkinn

Nordic overview

Swedish CPI inflation continued higher in November, primarily driven by soaring electricity prices which extended into December. This supported CPI index-linked bonds. However, there is little evidence of inflation beyond energy. CPIF excluding energy rose only 1.3% m/m aggregated up to November 2021, which is totally in line with the years prior to the pandemic, see chart. Consequently, Swedish short-term rates were contained, which benefitted the theme *"Sweden: Riksbank and market pricing inconsistencies"*. Moreover, the combination of higher market-based inflation expectation and stable nominal rates resulted in lower Swedish real interest rates.

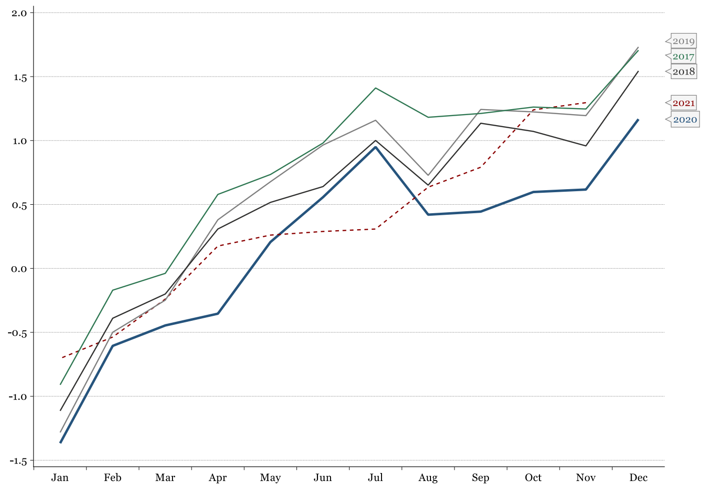
Meanwhile, bonds attracted strong demand, primarily in shorter maturities, as banks sought to trim their balance sheets before year-end. This resulted in a tighter spread between Swedish and German government bond yields at the beginning of the month, but the move reversed by the middle of the month. In the currency market, the SEK depreciated following the PPM (Premiepensionsmyndigheten) flow in early December, as normal, but appreciated again during the last days of the year after this flow had ended.

In Norway, infection rates and Covid-related hospitalisations reached new peaks since the onset of the pandemic. To limit virus transmission, the government reintroduced extensive national and local containment measures, which resulted in a decline in economic activity and employment around the turn of the year. In the weeks prior to the reintroduction of containment measures, economic data revealed rising activity and significant capacity constraints across industries.

Consequently, at the monetary policy meeting on December 16th the Norges Bank had to balance the Covid-related headwinds to activity in the near-term against longer-term prospects for growth and inflation once infection rates subsides on the other. The Norges Bank decided to raise the key policy rate by 25 bps to 0.50%, but lowered the probability of another hike in Q1 somewhat due to the uncertainty regarding path for the pandemic.

Given the opposing macro news, NOK interest rates struggled to find direction during the first half of December, but eventually increased in the second half. Our *"Norway: Relative Monetary Policy"* theme benefitted maily from higher expected future market interest rates and a stronger NOK exchange rate.

Sweden CPIF excl. energy, m/m%, aggregated annually



Source: Macrobond/Nordkinn

Global markets

Going into 2021 there was a strong consensus that ample production capacity would keep inflation contained and leave policy rates close to zero for many years to come. That consensus view changed dramatically as inflation in most countries consistently surprised to the upside during 2021.

The tremendous inflation miss by most economists can be explained by a combination of supply and demand side effects. While supply side issues, such as semiconductor supply chain, have played a role, strong demand has broadened throughout 2021 and reinforced the impact on inflation. Demand has been fuelled by ultra-stimulative monetary and fiscal policy and by extraordinarily strong private sector credit creation. While credit creation normally plunges during recessions, the credit creation boomed during the Covid crisis.

Most economists and central bankers underestimated the strong demand effect from the unprecedented monetary and fiscal stimuli. Going forward strong private sector demand seems likely to continue as both households and businesses still have excess savings and credit conditions are still extremely easy amid negative real yields across developed economies.

The Covid-virus has most likely led to permanently lower labour participation rates in the US as Covid also limits mobility and increases frictions in labour markets. On top of this, longer term structural factors have the potential to create lasting inflation pressures. These include demographics, globalisation, a potential super commodity cycle, "green investments" and "just in case" as opposed to "just in time" inventory management.

Consensus expects global growth around 4.5% next year, well above trend. While significant output gaps (ample production capacity) did not prevent inflation to rise during 2021, continued strong growth will tighten or close those output gaps, see chart below. However, as illustrated by the chart and as discussed in earlier monthly reports, regional differences persists. The U.S. economy is already operating at full capacity according to several estimates.

In response to rising inflationary pressures, we expect at least three hikes by the Fed in 2022, whereas the ECB will wait until at least 2023 before lift-off as we expect inflation to recede. Combined with less bond purchases from central banks, we anticipate higher nominal bond yields across most countries and maturities during 2022.

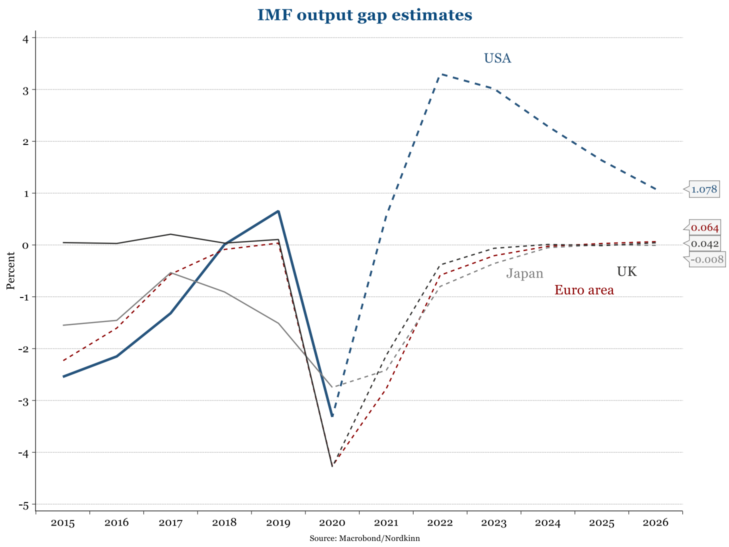
There are several risks to the growth outlook. First, new and highly transmissible and more severe virus mutations may emerge. That said, a return to some new normality during 2022 seems likely as the global population obtains better natural and vaccine immunity.

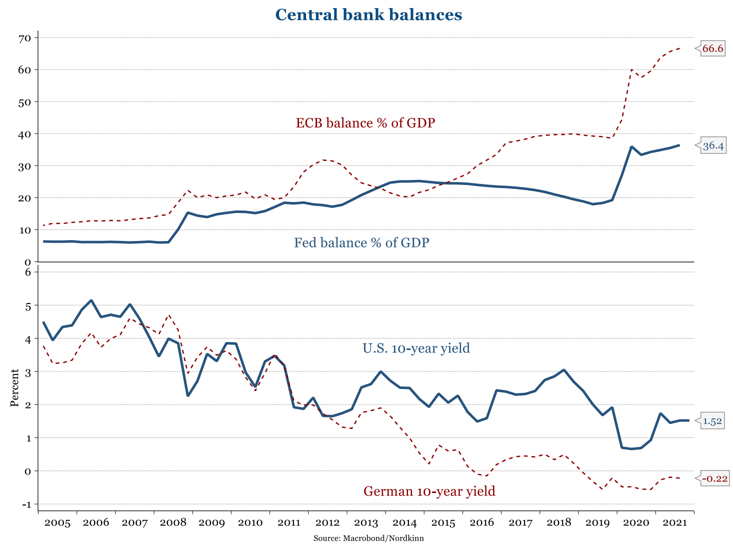
Second, as the Fed and other central banks reduce asset purchases and raise policy rates, there is an obvious risk that rising global bond yields will harm equity and credit markets, exaggerating a tightening of financial conditions with negative effects for real economic activity.

Third, there is no lack of geopolitical controversies around the globe, with the potential for Russian invasion of Ukraine and Chinese invasion of Tawain as perhaps the two most prominent risks.

Fourth, Chinese growth is expected to slow markedly in 2022 towards around 5% which would be the slowest rate since early 1990s, except for 2020. The risks around this estimate are probably tilted to the downside. Chinese corporate debt has risen fast over the last decade and exceeds that of most western countries. Two large and highly leveraged property developers, Evergrande and Kaisa, have already defaulted on payments to foreign bond holders exposing possible systemic vulnerabilities.

On balance, risks are plentiful and we expect high market volatility in the year ahead. With this caveat in mind, our baseline scenario is for still strong global growth and inflation driven by pent-up demand in the service sector and still ultra-stimulative policies. In all, as we are going into the new year, we expect 2022 to be centered around various nuances of inflation and a gradually growing pressure for global nominal bond yields to increase.





Nordic markets

Energy was a key driver of inflation during last year and we expect that to continue. Predicting energy inflation is hard, however, as it involves predicting factors such as weather, Russian gas taps, Iran negotiations and OPEC supply.

While inflation has been broad-based in the U.S., energy accounts for most of the rise in headline inflation in Europe and Sweden as illustrated in the graph below. As year-over-year inflation is hard to interpret due to volatile price moves during the pandemic, the graph shows annualised core inflation over rolling two-year periods. Core inflation over the last two years has risen substantially in the U.S. while this is not the case for Europe and Sweden.

A key question for Swedish monetary policy is whether inflation broadens as has been the case in the U.S.. This is plausible, but even if it should, we still think it is very unlikely the Riksbank will hike in 2022. This would require 1) inflation to broaden, 2) this broadening in turn to be deemed persistent by the Riksbank, 3) this in turn to be communicated such that the repo rate path is adjusted accordingly. We believe that the time period is too short for for all of these conditions to materialise in 2022.

Rate hikes in 2023 may become viable if inflation turns out to broaden and to be persistent. However, market pricing is roughly consistent with the Riksbank hiking 3-4 times bps by the end of 2023. Hence, the market already discounts broadening and longer lasting inflation. The Riksbank expects the balance sheet to remain unchanged in 2022, but if inflation surprises to the upside balance sheet run-off could be on the cards this year, and it will probably precede rate hikes. Given market expectations of fairly rapid rate hikes and the potential for less central bank support for the long end, we believe the upside risks to Swedish interest rates should primarily be in longer maturities.

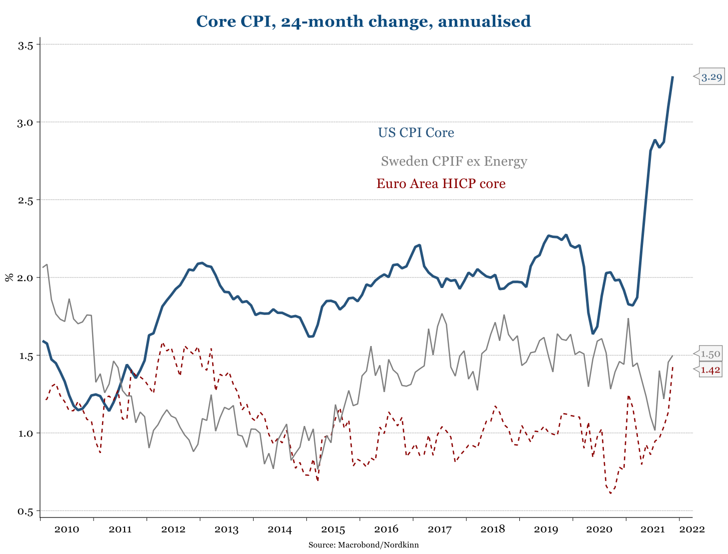
In particular, the SEK yield curve is still very flat in the 5 to 10-year segment with the swap curve spread at around 25bps. Hence, the scope for the curve to eventually steepen should increase with inflation rising, given the short end pricing and the likely sequencing of policy reaction by the Riksbank.

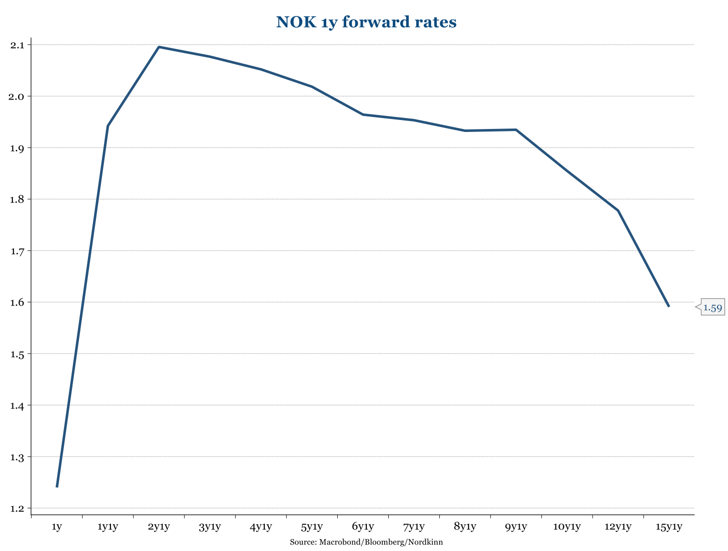
Turning to Norway, the reintroduction of national and local containment measures in December will likely result in a fall in activity and a rise in unemployment in early 2022. In particular, household services such as culture, entertainment, accommodation and food services will be affected. However, if these containment measures are gradually unwound through Q1, as the Norges Bank expects, economic growth will pick up again in Q2 and onwards. Under this assumption, the Norges Bank will most likely hike its key policy rate to 0.75% in March and to 1.00% in June.

It is very difficult to predict how the Omicron variant will spread and affect hospitalisation going forward, but the most recent infection trend is promising. Moreover, the government has announced that a large portion of the population will receive a third vaccine dose in Q1, which should reduce the need for protracted containment measures. However, if we are wrong on these assumptions and containment measures applies for a longer period, the Norges Bank may postpone the next rate hike until measures are being unwound. Against this backdrop, we prefer front-end steepener trades in the NOK rate market.

For the first time, the Norges Bank's debt office will issue a Norwegian Government Bond with a maturity of 20-years. According to the Strategy and borrowing program for 2022 released in December, issuing a longer NGB bond than 10-year maturity is belived to foster well-functioning markets. This is something we at Nordkinn strongly supports. There has been very high demand for corporate long bonds in NOK during 2021 from particularly life insurance and pension funds. As issuers of long bonds have swapped their exposure from fixed to floating, the NOK forward interest rate has become inverted, see chart. We expect the introduction of the new 20-year NGB to add some steepening pressures on the entire NOK rate curve in 2022.

The near-term outook for the NOK exchange rate is in our view positive given attractive valuation and, in particular, developments in terms of trade. The balance of risks around oil prices in 2022 is skewed towards the upside in our view. In addition, higher Nibor rates relative to abroad also makes the currency look increasingly attractive. While seasonality tends to be positive for the NOK in Q1, we caution that this seems to be correlated with overall risk sentiment.





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