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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – January 2022

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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

Since the turn of the year, incoming U.S. data has confirmed a further tightening of labour market conditions, adding to already elevated inflationary pressures. At the press conference the FOMC meeting on January 26th, Fed chair Powell indicated that the committee members will revise their inflation forecasts upwards in conjunction with the policy meeting in March and intend to raise rates at that meeting. Moreover, as the economy is stronger and inflation higher than in the previous hiking cycle, Powell said it would be appropriate to normalise monetary policy faster and he would neither rule out interim meeting hikes, nor larger increments to the key policy rate. As of end of January, the market discounts 125 bps of hikes this year, up from 75 bps at the beginning of the year. Our *"Global: Rate hike timing, pace and duration"* theme benefitted from a more front-loaded U.S. hiking cycle.

The increased commitment by the Fed to contain inflation also caused real yields (e.g. U.S. Treasury Inflation Protected Securities (TIPS)) to increase considerably. Meanwhile, following higher than expected January CPI estimates, European market-based inflation expectations increased significantly at the end of the month. These developments benefitted the theme *"Global: Comparative inflation expectations"*.

Meanwhile, despite differences in the prospects of inflation and short-term interest rates, central banks on both side of the Atlantic have commenced reducing asset purchases, implicitly adding to the net supply of bonds in 2022. Expectations of lower asset purchases by central banks contributed to higher longer-term nominal bond yields in both Europe and the U.S., which contributed positively to our *"Global: Tapering of asset purchases"* theme.

Both the pandemic and the Russia against Ukraine conflict seemed to have play secondary roles in the markets in January. The consensus view is now that the highly contagious, but low disease severity omicron variant will transform covid from a pandemic to an endemic disease like a flue that does not go away, but allows for a return to normal life. As regards the ongoing Russia/Ukraine conflict, it is probably adding a risk premium to already high energy prices. As at the end of January a barrel of brent oil costs over USD 90. European gas prices also rose rapidly during the month. Both gas and oil inventories are tight. While there are signs that some supply chain issues are easing, rising energy prices will continue to impose impulses to inflation.

Nordic overview

Developments in the Swedish fixed income market largely reflected moves in symphony with global markets. Albeit the Swedish CPI release during the month showed a large increase, it was in line with expectations and driven by energy, mainly electricity prices. Energy made up some 58% of the headline number of 4.1%. Excluding energy, inflation remained well below 2.0% and a bit lower than anticipated.

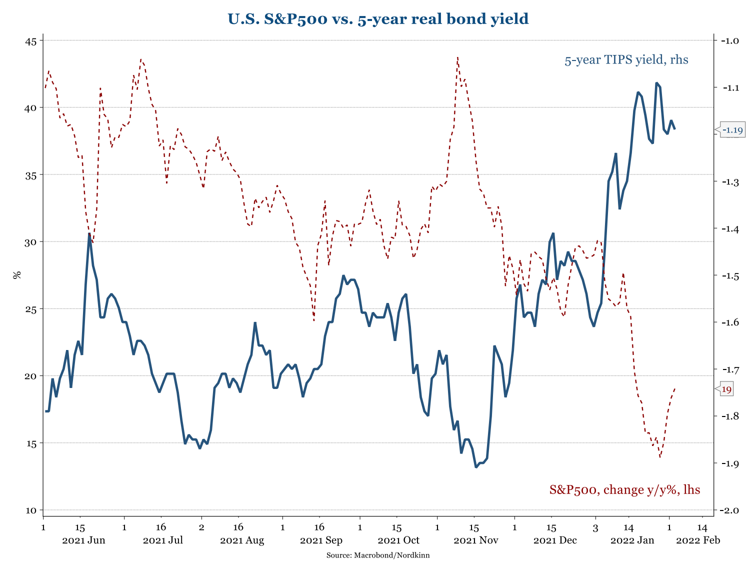
The Swedish government proposed a bill to alleviate households with unprecedented electricity bills. How this will be paid out remains to be seen. It is also unclear how this may impact the CPI data.

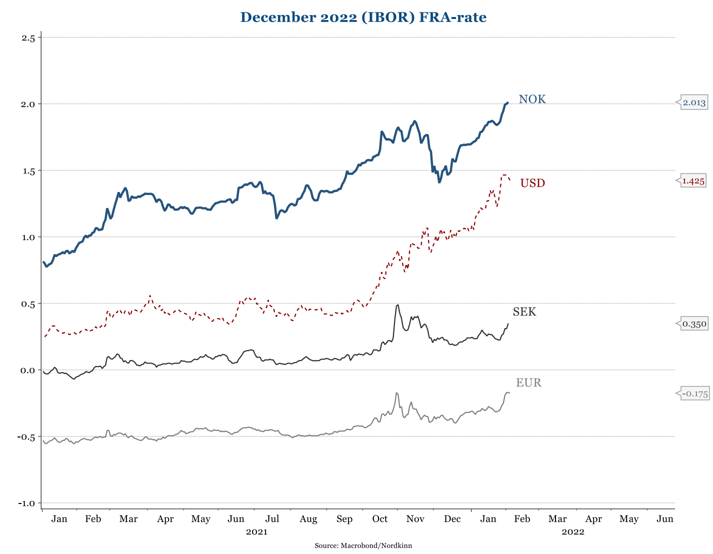
Despite the relatively well-behaved underlying inflation print, expectations of future Riksbank hikes continued to inch higher. Markets discount a 25 bps rate increase at the end of 2022. This move was triggered by shifts in international short-end interest rates, following a hawkish Fed and higher than expected CPI prints in the euro area. The substantially lower appetite for risky assets during January weighted on the SEK, which generated losses in the *"Tactical risk reward"* theme.

In Norway, infection rates reached new peaks in January, yet covid-related hospitalisations declined. The government, therefore, decided to ease some of the extensive containment measures earlier than expected. This implies a milder economic setback than the Norges Bank assumed in the December monetary policy report, as for instance reflected by significantly lower unemployment than projected. Meanwhile, underlying inflation rose sharply in December and is close to the 2.0% target. The Monetary Policy Committee, therefore, signalled on January 20th that the policy rate likely will be raised again in March.

Lower unemployment and higher inflation than projected, in combination with international developments, spurred an increase in market interest rates in January, see chart. As at the end of the month in review, the market discounts between four and five rate hikes this year as opposed to Norges Bank's projection of only three.

Gains from higher front-end yields at the beginning of the month was unable to offset losses from the relative underperformance of the 5-year segment in the second half of the month, hence Our *"Norway: Relative monetary policy"* theme subtracted from performance in January overall.



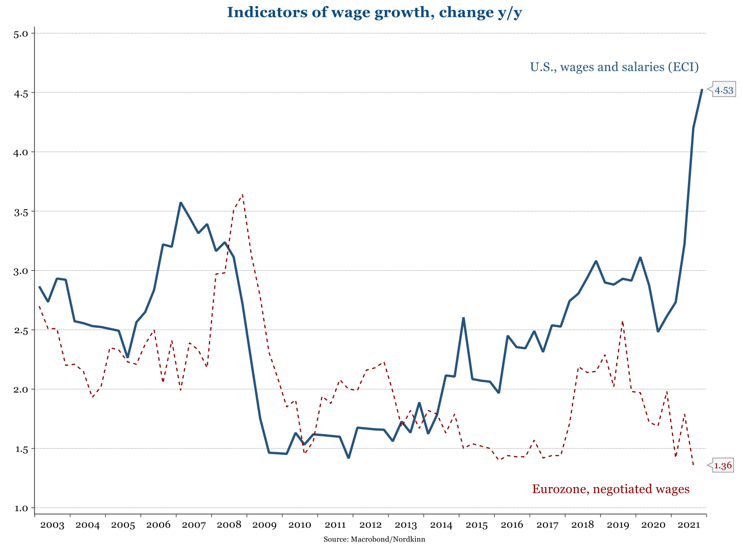


Global markets

Over the last decades central banks, and in particular the U.S. Federal Reserve, have stepped up to save "risky assets" when they have fallen. As inflation has been in secular decline and been undershooting central bank targets, low inflation has allowed central banks to stimulate growth and asset prices whenever needed. In the current regime with high inflation, this dynamic is reversed. Inflation is now the main driver of U.S. monetary policy, and higher inflation prompts central banks to remove policy accommodation, which adds to risk premia on both bond yields and equities. The simultaneous negative bond and equity returns during January is a warning that the long-lasting regime where bonds provided a hedge for equities could be over. As central banks tighten, market volatility increases and correlations become less favourable, investors should be aware of potentially lower returns and higher portfolio volatility.

In 2021 both global growth and in particular inflation surprised to the upside. The uncertainties going into 2022 are again substantial with strong economic forces pulling in opposite directions. Growth should be supported by pent-up savings as the economies reopen once the omicron wave abates, but will be restrained by rising energy and other costs and by central banks and governments pulling back stimuli. Chinese monetary policy aims to stimulate the economy, but the wobbling real estate market and China's zero covid strategy imply substantial growth risks likely skewed to the downside. Adding to the uncertainty is the build-up of Russian troops at the Ukraine border.

The sharp rise in measures of underlying CPI inflation and wage growth during 2021 pushed the Federal Reserve to signal an end to monetary policy accommodation significantly sooner than previously expected. Markets are currently discounting about 125 bps of hikes this year, including some probability to a 50 bps move at the next FOMC meeting in March. There is plenty of uncertainty as regards to both the number of rate hikes in 2022 and the absolute level of key policy rate needed to bring inflation down to the 2% inflation target. While the path for U.S. monetary policy in coming months will depend crucially on developments in realised and expected inflation, we currently expect the Federal Reserve to hike rates relatively fast in the first half of this year, before eventually slowing the pace in the second half when we anticipate inflation to recede somewhat.



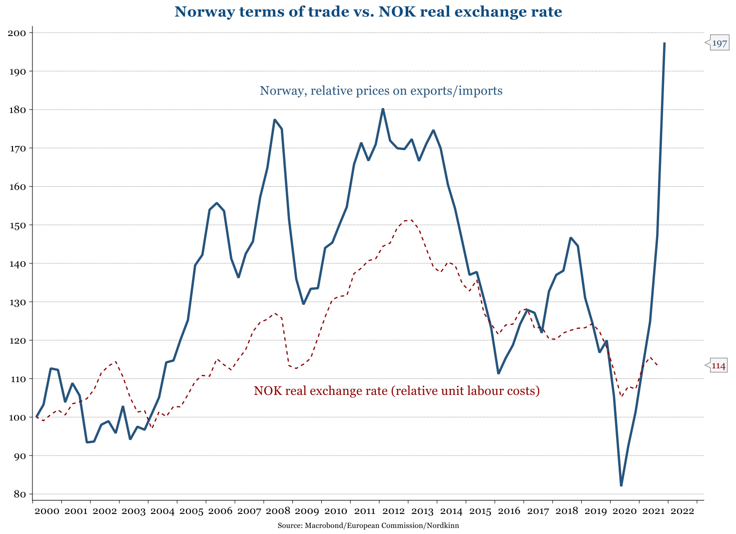
The situation in Europe is very different. While inflation is rising quickly in the euro area as well, inflation is not as broad-based as in the U.S. Energy explains roughly half of the rise in CPI and, most important, there are currently few signs of wage inflation in Europe.

That said, recent speeches from leading ECB members like Lagarde, Lane and Schnabel have confirmed the message from the monetary policy account released on January 20th that economic performance has been better and inflation higher than expected, which in December justified the largest cumulative upward revision to the inflation projections in history. As such, the ECB acknowledges that it does not expect inflation to return to the low inflation regime of the pre-pandemic period. We reckon the surprisingly high CPI estimate for January reinforced this view.

While market-based inflation expectations and ECB's own medium term inflation projections are still below its 2% target, the justification of the extreme monetary policy stance is harder when inflations risks have become more balanced. At the same time, according to the most recent ECB account and the latest speech by chief economist Lane, the ECB's inflation projections are predicated on wage growth well above average of the past two decades. The latest available data for euro area negotiated wages suggested annual growth of around 1.5% and does not point to second-round effects, see chart. Looking ahead, it will be vital to closely monitor wage outcomes across the euro area.

In the themes *"Global: Tapering asset purchases"* and *"Global: Rate hike timing, pace and duration"* we have expressed trades that should benefit from gradually less asset purchases and a measured ECB hiking cycle: We are positioned for higher long-end yields and steeper curves, both absolute and relative to the U.S. As rates have risen, we have scaled back trades that benefit from rising U.S. yields, although we have kept some exposure in the short-end of the U.S. yield curve and the mentioned U.S. flattener trades relative to euro steepeners.

In the FX space, we are long NOK versus EUR and CAD. The NOK was remarkably resilient in a month with negative equity returns, building confidence in the NOK case which is based on extraordinary strong fundamentals with incomes from oil and gas exports exploding to the highest level ever in terms of trade, see chart.



Nordic markets

On February 10th the Riksbank will announce its decision from their first of five monetary policy meetings in 2022. Since the last meeting, incoming data, primarily inflation data, has not surprised in any material way. Accordingly, we do not expect fireworks at the upcoming Riksbank meeting. We will keep in mind that in the minutes from the last meeting, for instance, Mr Flodén mentioned that a lot is required in terms of inflation outlook for the Riksbank to hike in the first half of the forecast horizon i.e. by mid-2023. Current market pricing is at odds with this notion as well as the inflation data so far, which we express in the theme *"Sweden: Riksbank and market pricing inconsistencies"*.

However, since the previous Riksbank meeting on November 24th, both the ECB and the Federal Reserve have made important decisions as regards the outlook for bond purhcases ahead. This could pursuade also the Riksbank to signal an earlier start of balance sheet run-off than previously thought. Purchases of SGBs are continuing to pressure bond yields at the longer end of the curve. For instance, the spread versus 10-year Germany is at tightest levels since summer of 2020, see chart. A decision to start the shrinking of the balance sheet could eventually have some impact on government bond yields. However, we believe it will take some time given the stock of bonds held by the Riksbank.

In this context, we will also monitor the updated forecasts on borrowing requirements from the Swedish National Debt Office (SNDO) due on February 24th. Since the last forecast in October, tax revenues have continued to surprise to the upside. Among other things, revenues from taxes on the skyrocketing electricity prices has resulted in better-than-expected public finances.

While the government has also presented new or extended financial pandemic relief measures, the sum of these are much less than the positive surprise on central government surpluses. Subsequently, there is a likelihood that the SNDO needs to adapt to this and thus cut the outlook for its bond issuance again. Such an outcome would result in a negative supply of SGBs in 2022. On top of this, the SNDO has announced that a new 10-year benchmark will be launched in April. The aim is to in a relative short period of time build the volume in the new benchmark with two larger auctions as well as one switch auction. After this, not much of bond issuance will be left for issuance in other bonds and during the rest of the year. Hence, even if the Riksbank were to decide to allow its balance sheet to start shrinking earlier, it will take time to restore the supply/demand balance of the Swedish government bond market.

In Norway, the surprisingly mild omicron-related setback to economic activity, combined with higher than expected inflation, imply that a rate hike on March 17th is essentially a done deal. Provided that the economy remains reasonably strong also in coming weeks, we expect the Norges Bank to revise its interest rate path upwards as well. We predict that the projected number of hikes in 2022 will rise from three to almost four, which implies a high probability for a return to the pre-pandemic level for the key policy rate at 1.50% before year-end, i.e. six months earlier than in the December projections. Finally, we expect that the key policy rate will reach 1.75%, consistent with Norges Bank's estimate of neutral rate, in 2023 rather than in 2024.

There is growing speculation in the market about whether the Norges Bank may have to raise rates even faster and to a higher level. The main argument put forward is upside risk to wage growth and inflation ahead. While we acknowledge such risks, we think the risk for a significantly more aggressive Norges Bank action is overstated.

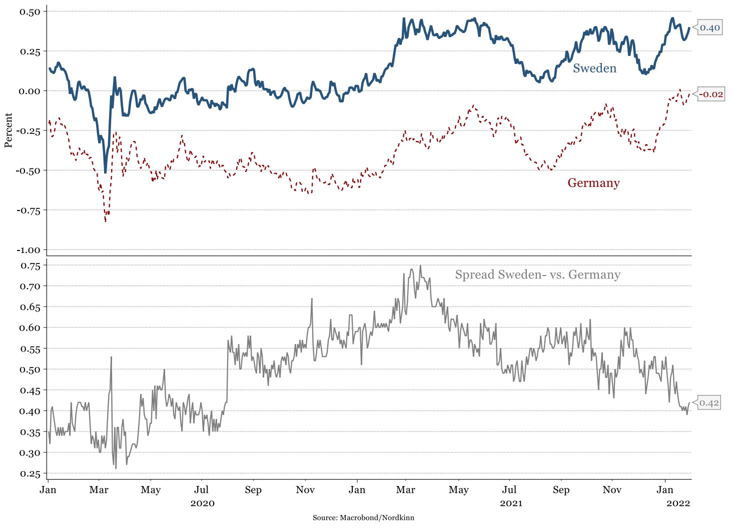
Firstly, the Norges Bank has always treated inflation in a forward-looking manner, which in practice means a high weight on growth and, to some extent, financial stability in its monetary policy deliberations. For instance, underlying inflation was only around 1.0% when the Norges Bank became the first central bank in developed markets to raise rates in September 2021, but its forecast was for inflation to rise ahead as economic growth strengthens.

Secondly, after a sharp increase in December, underlying inflation reached levels closer to 2.0%, not more. The situation is very different from the U.S where inflation has exceeded target by a very large margin and for months. And even though inflation may well exceed target in coming months, we expect the Norges Bank to focus on its medium-term forecast, which to a large extent is driven by capacity utilisation.

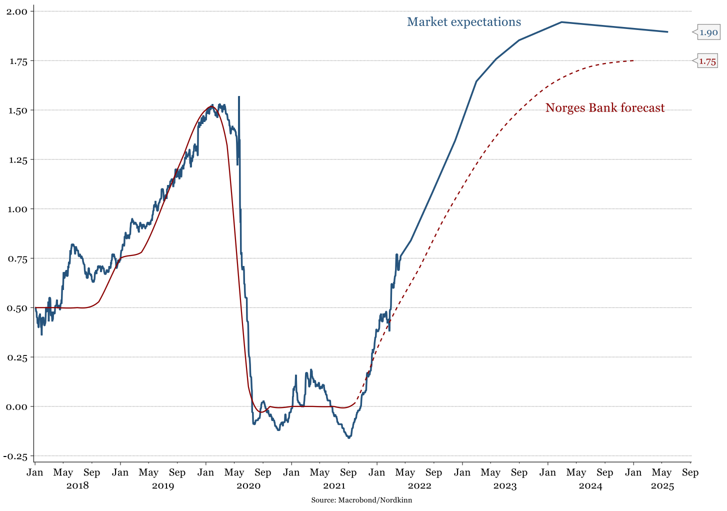
Thirdly, thanks to the earlier start of the hiking cycle, the key policy rate will reach levels close to neutral by the end of 2022 even with a gradual pace of rate increases, as opposed to the U.S. where the Federal Reserve will continue to add stimulus to the economy in February and appears to be behind the curve.

To conclude, we deem that the risk that Norges Bank moves away from its strategy of removing policy stimulus "gradually" is low. In this context, our *"Norway: Relative monetary policy"* theme now has a bias for lower NOK interest rates up to the 5-year segment, both relative to the U.S. and to the long-end of the NOK curve.

10-year government bond yields



Norway market-implied policy rate expectations



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 thirteen 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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