NORDKINN
ASSET MANAGEMENT

Nordkinn Market Review & Outlook – February 2022

Addressed to Nordkinn's Followers on LinkedIn for informational purposes

Please note that the content of the Nordkinn Market Review & Outlook Report may not be republished without the written consent of Nordkinn Asset Management AB.

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

On February 24th Russia invaded Ukraine after weeks of fruitless talks. The invasion from the North, East and South is brutal, with circa 150.000 troops and advanced weapons. Despite being militarily inferior, Ukraine's immediate resistance has been strong.

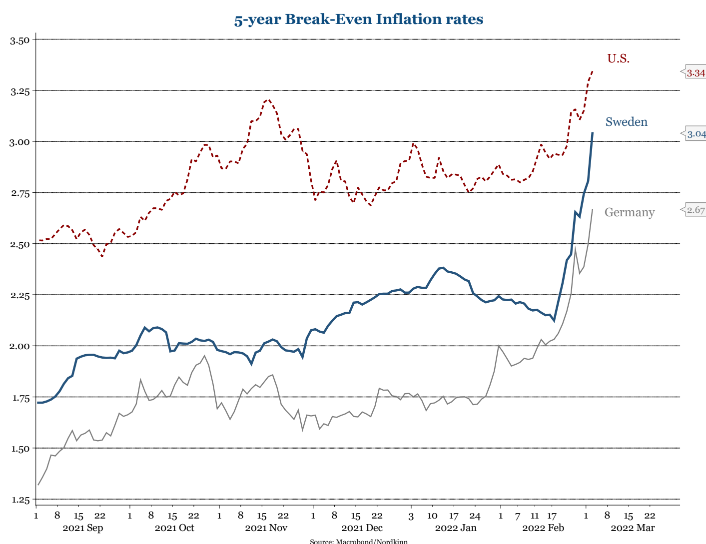
The West has launched sanctions unprecedented in both scale and coordination. The most damaging sanctions for Russia are the freezing of the Russian central bank's reserves and the exclusion from the international payment system Swift. Other sanctions target against the private funds of Putin, oligarchs and other Putin supporters. Also, the West is supporting Ukraine with weapons. Germany announced a substantial increase in defence spending and will change their energy supply strategy as the building of the Nord Stream 2 gas pipeline has halted. The war will have long lasting effects across many dimensions.

Both Ukraine's resistance and the strong sanctions have most likely taken Putin by surprise and he might feel pushed into a corner. The danger now is that Putin will employ even more brutal tactics including larger-scale bombing. He has also threatened with nuclear weapons.

The war has led to dramatic movements across financial markets, especially within commodities as energy and food prices have spiked, but also within fixed income markets. Despite mounting inflationary pressures due to spiking energy and food prices, bond yields in advanced economies fell dramatically after the Russian attack on Ukraine. The moves were most pronounced in the shorter end of the yield curves as markets reassessed the scope for rate hikes this year and next. These developments gave positive contributions to our "*Global: Rate hike timing, pace and duration*" theme.

The inflation market was literally on fire amid the war, but also due to elevated inflation prints. The U.S. 5y Break-Even Inflation rate was just a few basis points shy of the 2021 peak and the German peer recorded its highest in over a decade, see chart. In Europe and Sweden real rates plunged while U.S. equivalents were unable to follow. This contributed positively to the "*Global: Comparative inflation expectations" theme.*

FX option positions benefitted from volatility and contributed positively to our theme *"Global: Tactical risk reward trading"*. However, these gains were offset by losses on various tactical currency positions and asset swap spreads, leaving the theme's result flat on the month.



Nordic overview

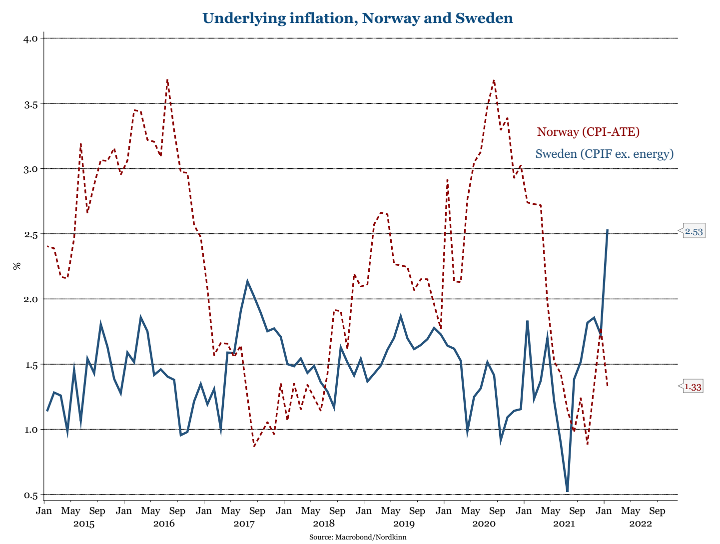
In Sweden, core inflation (CPIF excluding energy) rose significantly more than expected in January, see chart. The high print challenged the dovish monetary policy stance of the Riksbank that was confirmed only a few days prior to the CPI release and expected future market interest rates rose as a result. The repricing for a more hawkish ECB monetary policy that commenced earlier in February also affected Swedish interest rates significantly.

Parts of this move higher in Swedish rates were trimmed after the Russian attack on Ukraine, as investors fled to safety and repriced the European growth outlook. Nonetheless, the events during February contributed negatively to our *"Sweden: Riksbank and market pricing inconsistencies"* theme.

The theme also suffered from the relative performance of Swedish government bonds relative to other fixed income instruments following the updated forecasts from the Swedish National Debt Office (SNDO). The SNDO saw lower reborrowing needs, which will result in less issuance of government bonds, both nominal and real. This reinforced the "flight-to-safety" move following the Russian attack on Ukraine.

In Norway, the economic rebound remained on track in February as the government decided to unwind remaining covid-related containment measures. As a result, the unemployment rate dropped to 2.1% in February (seasonally adjusted), matching the pre-pandemic lows. By comparison, Norges Bank forecasted 2.9% in its December monetary policy report. While core CPI inflation eased to 1.3% in January (see chart), significantly below consensus expectations, the tighter labour market conditions contributed to boost wage growth expectations this year as employee organisations demand positive inflation-adjusted wage growth in 2022. According to a survey conducted by Norges Bank, labour market participants expect wage growth north of 4% this year.

The relative underperformance of NOK interest rates in February gave a negative contribution to the *"Norway: Relative Monetary Policy"* theme. However, this was largely offset by a positive contribution from long NOK currency exposure that appreciated on spiking energy prices. The Brent crude oil price rose by USD 30 per barrel after the attack on Ukraine, to the highest level since 2008. On balance, the result from the theme was virtually flat.



Global markets

It is hard to see a peaceful resolution to the Ukraine conflict. The two sides met for negotiations on February 28th and March 2nd, but there is no real hopes these talks can end up in a positive outcome. The two sides seem far apart. Understandably, Ukraine insists to defend its independence and that Russian military forces must leave the country. Sadly, President Putin says he will not back down until he has completed his mission.

Putin probably did not foresee neither the strength of the military resistance from Ukraine, which could grow even stronger as the West provides Ukraine with weapons, nor the substantial and synchronised sanctions from the West. He seems to have few good options and a continued escalation of the conflict seems at this point more likely than a peaceful resolution.

Ukraine and Russia will suffer enormous humanitarian and economic costs. The Ruble has fallen by almost 40% and many expect Russia to default on its government debts. Due to the sanctions, Russia will likely be unable to provide funds to cover its war costs, imports and payment obligations. To stem the Ruble selling, the Russian central bank rose interest rates to 20%, more than doubling the rate. This seems to have stabilised the Ruble in the short-term, but will obviously meaningfully hurt both households and corporates in Russia.

However, the consequences of the conflict will be felt around the globe. Russia is the world largest exporter of gas and the second largest exporter of oil. It is also a large exporter of various metals and fertilisers. Both Russia and Ukraine are large exporters of wheat and other agricultural products. Many countries depend on Russian and Ukrainian exports to cover their basic needs for energy and food. For instance, Europe covers more than 1/3 of its gas consumption from Russia, while Turkey and Egypt cover around 2/3 of their wheat consumption from Russia and Ukraine. The Ukraine war has intensified the tightness of the food and energy markets and prices have risen rapidly over the past weeks. The oil price has more than doubled since the beginning of last year, while wheat prices have gone up by 70-80% in the same period. Many other commodities have seen similar price rises. Global inflation pressures will intensify, and a full-scale food and energy crisis may be evolving.

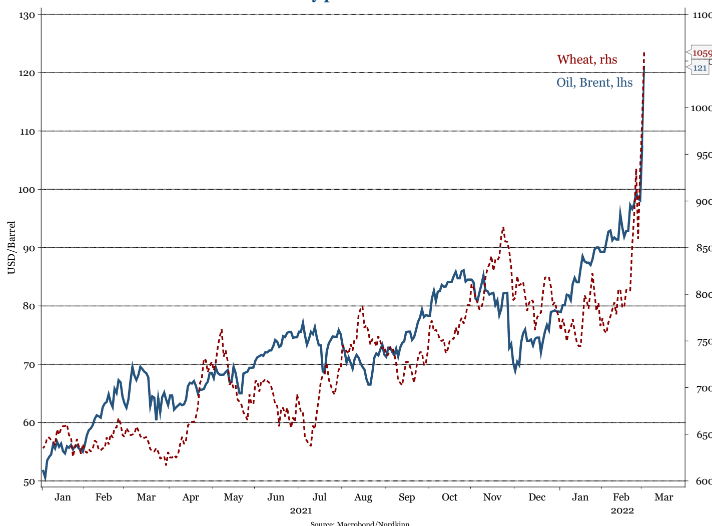
Prior to the war, the surge in global inflation has largely been driven by excess demand, as low rates, central banks asset purchases and fiscal stimuli have triggered governments, households and corporates to spend. However, the inflation push from the Ukraine war is a negative supply shock. While the commodity price rise will lead to additional inflation pressures globally (directly and indirectly as the energy costs filters through to goods and services), the war will hurt economic activity through various channels. This is a dilemma for central banks.

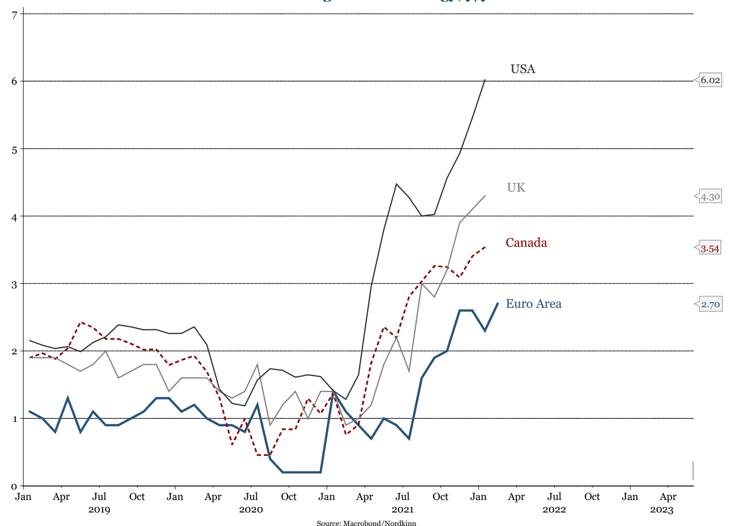
We expect the hit to European growth to be harder than in the U.S. even in the baseline scenario where Russia still provides Europe with gas supplies. Russia is a sizeable economy in a European context and its economy is predicted to contract by double digits during the spring. Russian trade will collapse with negative spill-overs to the rest of Europe. European corporates and households will most likely become more cautious, and financial conditions might continue to worsen.

Because the underlying inflationary pressures via for instance wages is relatively contained in Europe, the ECB will likely delay the interest rate normalisation if the war continues. Several ECB members have already hinted that the ECB should await more clarity before action is taken.

The situation is different across the Atlantic. U.S. inflation is already very high and broad-based given the strong economy, tight labour market and high wage growth. While the Fed over the last two-three decades has been quick to ease policy in times of geopolitical unrest to support assets and economic growth, today the Fed is forced to address its imminent inflation problem. The U.S. economy will feel much less direct pain from the Russia-Ukraine war compared to Europe, barring an escalation to any Nato country. True, the spike in energy prices could become disinflationary over the medium-term, due to lower purchasing power for other goods and services. Nonetheless, as the Fed has to address the current high inflationary pressures by raising rates, we expect a 25 bps hike in March and see upside risks to market pricing for 2022 and 2023.

We exploit these dynamics through relative value curvature trades on expected Fed and the ECB policy paths in the theme "*Global: Rate hike timing, pace and duration.*"





Nordic markets

The higher-than-expected inflation print in January will probably be followed by more elevated readings in the spring, not least due to possibly renewed supply chain issues stemming from the Russian attack on Ukraine and the subesquent international sanctions. According to surveys, retailers already suggest that prices are set to increase further over the coming months. At the same time, the growth outlook has weakened somewhat – even before the Russian attacks on Ukraine started – and the risks of more acute financial disturbances have increased.

How will the Riksbank react to all this? While we have so far heard Ingves merely commenting, his remarks seem to imply that inflation has taken a backseat as the economic outlook has darkened considerably due to the war in Ukraine.

In that context, it is worth noticing that previous speakers, Flodén and Jansson, also came across as rather complacent regarding the latest high CPI print. Both of them focused more on the upcoming wage negotiations, which will be completed in early 2023. Higher wages are required to keep inflation close to 2% in a sustainable way.

Hence, even if the current economic uncertainties subside in the near-term, inflation overshoots will probably need to be underpinned by domestic service inflation in order to trigger a faster moving Riksbank. Otherwise, current Riksbank reasoning suggests that the Executive Board will not be ready to react until they see clear signs of higher wage growth.

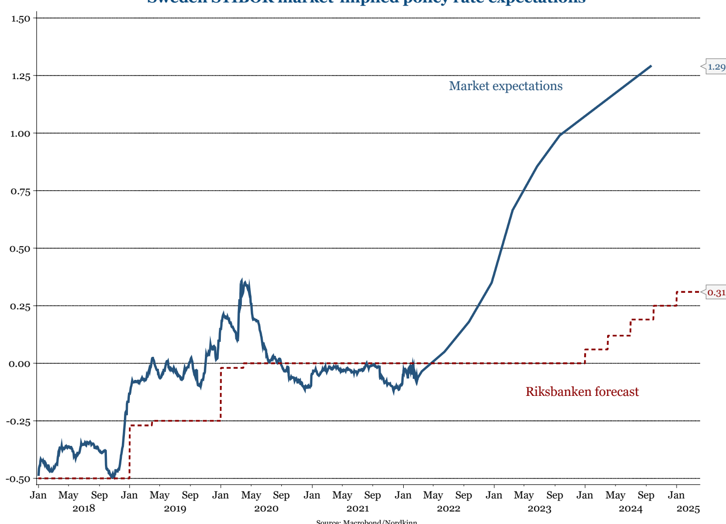
Under any circumstances, as long as the war in Ukraine is intensifying and economic and financial sanctions on the Russian economy are being implemented, market expectations of near-term monetary policy tightening from the Riksbank and the ECB should decrease in response to the increased economic uncertainty.

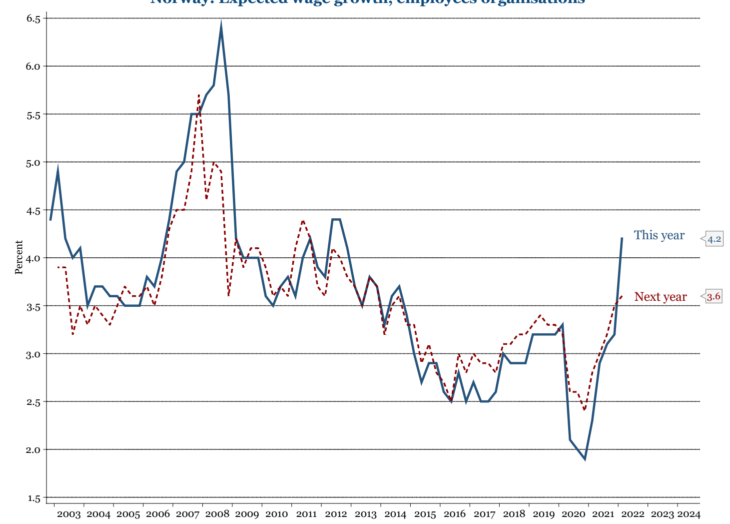
Prior to Russia's invasion of Ukraine, incoming data clearly supported another 25 bps interest rate hike by the Norges Bank at the upcoming meeting on March 24th, accompanied by an upward revision of the interest rate path from three to four hikes in 2022. The economic rebound in Norway has been stronger and the decline in unemployment steeper than expected. Pressure for higher wage compensations is building, which, in combination with rising price pressures on commodities and imported goods, implies a higher inflation forecast by the central bank.

However, the uncertainty associated with the Ukraine war complicates the outlook for Norwegian interest rates going forward. The main argument put forward by the central bank to initiate a hiking cycle in September last year was prospects of a more normal economic situation as the effect of the pandemic eases, not a response to elevated inflation. In fact, core CPI inflation was barely 1.0% at the time of lift-off, but was forecasted to rise over the medium term as the economic situation normalises.

The new geopolitical situation in Europe may weigh on economic growth in Norway and Sweden, two small open economies. It will also lead to higher inflation as global supply-issues intensifies, especially related to oil and gas supply, but that is nothing central banks can solve. Rather, we expect the Norges Bank to give more weight to the potential negative growth effects from this war.

With core CPI inflation below target and a hiking cycle already underway, we expect the Norges Bank to proceed with a gradual process of unwinding monetary policy accommodation. The war, and the new geopolitical uncertainty in general, are additional arguments supporting a careful approach towards a more normal monetary policy stance. We continue to expect 100 bps of rate hikes this year, but the risk is skewed towards less tightening if the economic impact of the war escalates.





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.

DISCLAIMER

The content of this Report has been prepared by Nordkinn Asset Management AB (the «Company»), registered in Sweden No. 556895-3375. All rights reserved. Information in the Report is made only as at the date of the Report unless otherwise stated, and remain subject to change without notice. The Content has been prepared in good faith. However, to the maximum extent permitted by law, neither Nordkinn Asset Management AB, nor its related corporations (including Nordkinn Asset Management Oslo Branch, registered in Norway No. 999 136 354), directors, employees or agents, nor any other person, accept any liability, including, without limitation, any liability arising from fault or negligence, for any loss arising from the use of the Report its contents or otherwise in connection with it.

The Report contains forward-looking statements. Although the Company believes the expectations expressed in such forward-looking statements are based on reasonable assumptions, such statements are not guarantees of future performance and actual results. Actual results or developments may differ materially from those projected in forward-looking statements. Past performance is no guarantee of future returns. The value of investments and the income from them may fall as well as rise and is not guaranteed. Changes in rates of exchange may cause the value of investments to fluctuate. The Report is confidential information, only for the use of those persons to whom it is addressed and no part of this report may be reproduced, redistributed or passed on, in any manner, or used other than as intended, without Nordkinn's prior written permission. The report does not constitute an offer to sell or the solicitation of any offer to buy

Hamngatan 11, 3rd floor
111 47 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