NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – March 2022

Addressed to Nordkinn's Followers on LinkedIn for informational purposes

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.

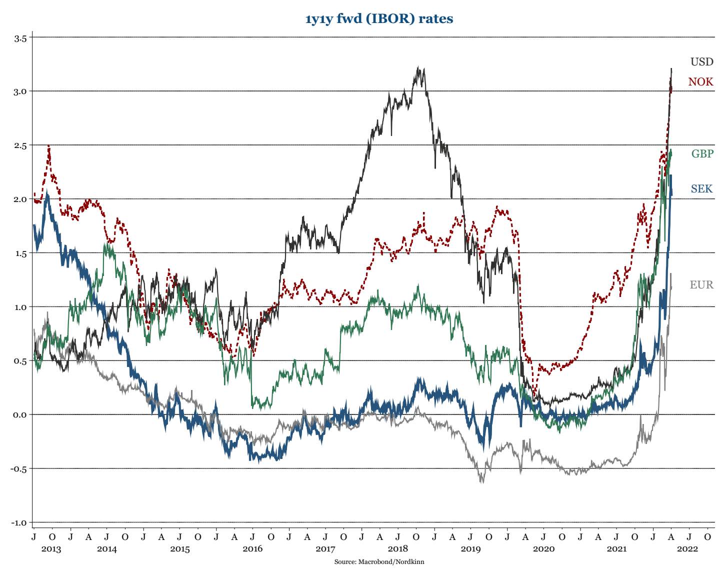
MARKET OVERVIEW

Global overview

The Russian attack on Europe's largest nuclear power plant Zaporizhzhia on March 4th coincided with peak uncertainty and market volatility since the Russian invasion of Ukraine on February 24th. Bond yields bottomed and implied volatility in rates, FX and equities peaked on March 7th. Investors faced extreme uncertainty in terms of the dynamics of the war and the economic and monetary policy implications. From the invasion and up until March 7th, "flight to safety"-flows dominated, which led the German 10-year Bund yield back into negative territory. From that Monday however, fixed income markets experienced one of the most dramatic sell-offs in the last decades. War headlines and negative growth effects had less influence on markets as the focus turned to the inflationary effects of the war.

Unfortunately in hindsight, as interest rates fell in late February due to uncertainties associated with the war, we decided to scale back some positions aiming for higher rates, which caught us wrong footed in the fast moving markets. Against this background, the theme *"Global: rate hike timing…"* subtracted from performance as gains from higher USD rates were unable to offset losses from rapidly rising short-end Eurozone rates and positions for a more gradual rather than immediate Fed tightening. The theme *"Global: Tapering of asset purchases"* gained from short positions in the long end of the curve in Sweden and Germany versus long positions in U.S. and Norway. Moreover, a long vol position in EUR/USD in the theme *"Tactical risk reward trading"* gained in March, but were unable to offset losses stemming from option structures designed to benefit from steeper yield curves and gradually higher short end rates, as well as losses on USD/SEK trading.

Global inflation markets continued to trade very strong in March as the war in Ukraine poses risks to the supply side of the economy, especially the energy sector. However, by the end of the month U.S. Break-Even Inflation rates started to slide amid hawkish rhetoric from the Fed. As more rate hikes were discounted, forward inflation expectations decreased. As a result, mid-term real rates in the U.S. have started to move higher relative to European peers. European real rates have barely moved as increasing rate hike expectations have been offset by higher break-even inflation rates. This has contributed positively to the our theme *"Global: Comparative inflation expectations"*. Positioning for higher Break-Even Inflation rates in Sweden did also contribute positively to the theme in March.



Nordic overview

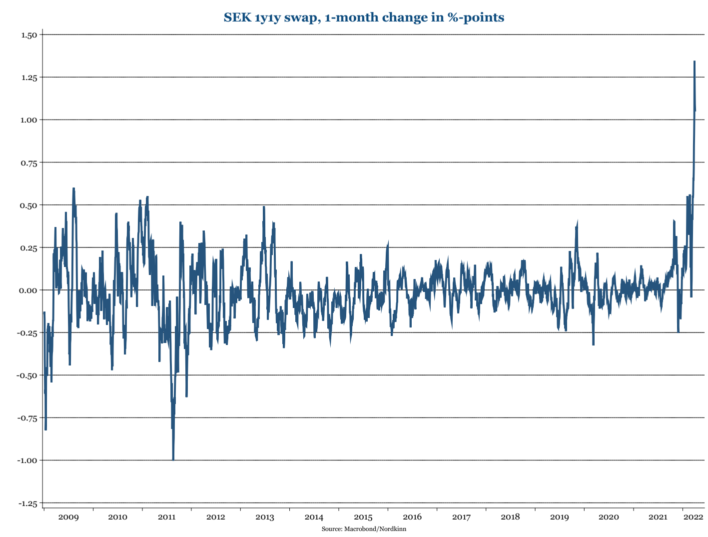
In Sweden, the February CPI print was significantly higher than expected, surprising the Swedish fixed income markets that was already struggling with spill-over effects from higher global short-term rates. Riksbank Governor Ingves announced in a radio interview that the deviation from Riksbank's February inflation forecast has become too large and will require a reassessment of the monetary policy. This was later backed by Deputy Governor Breman who argued that an earlier move would avoid a need to move much faster at a later stage.

Clearly, we misjudged the speed and magnitude of how the market could reprice the Riksbank after the high inflation print. At the start of the month the market foresaw a 25 bps hike in 2022 and at the end of month the market discounted almost 90 bps of hikes over the remaining four meetings this year. The unusual volatile and higher STIBOR fixing during March added to the upward pressure on Swedish market rates. As an illustration, the 1-year SEK rate starting 1-year ahead rose significantly more than in any month since 2008, see chart.

The spike in Swedish interest rates resulted in material losses on our theme *"Sweden: Riksbank and market pricing inconsistencies"*. We decided to close the theme and restructure Swedish short-end rates positions significantly, although we doubt the full extent of current pricing will materialise, see the outlook section below.

Norwegian interest rates were strongly affected by the move in global markets, but robust domestic economic data such as the sharp decline in unemployment and the Regional Network further added to the interest rate move in Norway. Moreover, core CPI inflation for February turned out significantly above expectations and high wage growth adds to the risk of inflation becoming entrenched. Consequently, on March 24th the central bank decided to increase the key policy rate to 0.75% and forecasted 200 bps of tightening in 2022 and 2023 combined, implying a rate peak at 2.5% (previous 1.75%) at the end of next year.

Expected NOK interest rates a couple of years ahead increased more than corresponding rates in the U.S. and Eurozone. This relative underperformance gave a negative contribution to the *"Norway: Relative Monetary Policy"* theme in March. The appreciation of the NOK exchange rate contributed positive to the result in isolation but was unable to offset losses from our interest rate exposure.



Global markets

The big picture short term implication of the Ukraine war is straight forward; slower growth and higher inflation. Inflationary pressures will rise further from already elevated levels due to higher commodity prices and new strains on global production chains. Growth will slow as households purchasing power takes another hit from rising prices and corporates pulling back on investment and employment decisions due to increased uncertainty. The economic set-back will be cushioned due to accumulated household savings during the pandemic and due to fiscal policies aimed at reducing households' energy bills.

In last month's report we described the effect of the war on the supply of key commodities ranging from oil, gas, iron, platinum, nickel to wheat and corn. Food and energy prices have risen dramatically, and in highly complex and integrated global production chains broader price pressures will emerge as more countries emphasise self-sufficiency. The omicron outbreak in China has led to lockdowns in Shanghai, Shenzhen and other manufacturing hubs and could amplify the strains on global production chains in the short run.

The long run implications of the war are also inflationary: Public budgets for defence in Western Europe and around the globe will increase substantially. Europe will aim for independence of Russian energy. The green transition will likely accelerate and so will the process of reshoring production of goods of strategic importance.

The consensus view among economists seems to be that the global growth set-back will be moderate. The global economy grew well above trend going into the Ukraine war and western labour markets were very strong with unemployment rates at decade lows in both U.S. and Europe. Both western households and corporates have solid balance sheets, and fiscal and monetary stances are still accommodative.

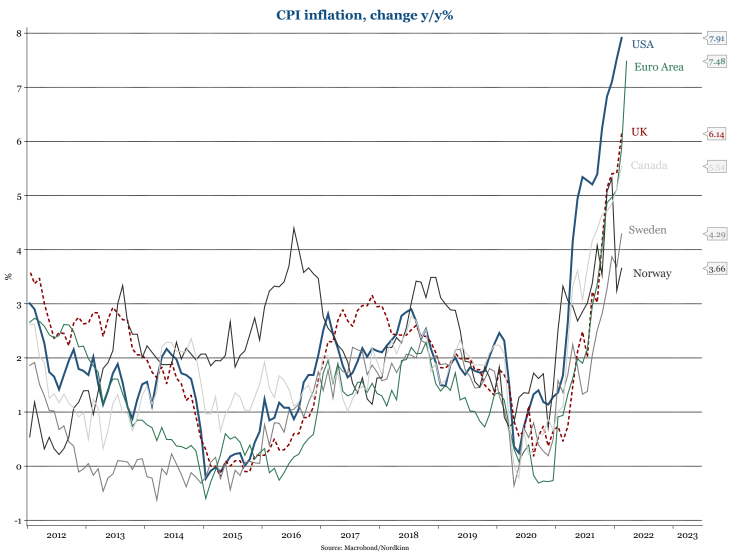
We judge the risks to this benign consensus view to be on the downside. Rising food and energy prices will leave less money for other types of spending, and interest rates are on the rise in all major economies except China and Japan. Further, global covid-cases are rising again from a high level and although mobility and economic activity in most places seems robust, China struggles with low effectiveness of its vaccine and very low immunity rates due to the zero-covid policy.

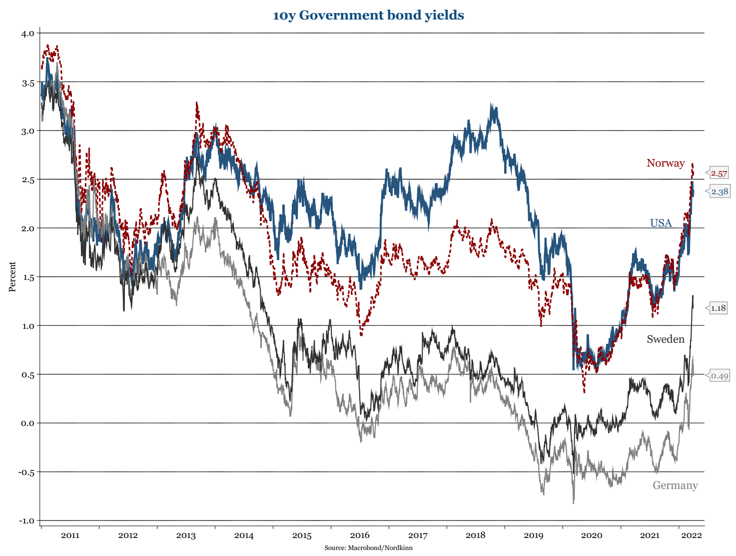
Mobility has fallen and economic growth will decline, maybe substantially. This could amplify the short-term stagflation impulse from the Ukraine war. Another risk to the base case scenario is more sanctions toward Russia and a possible Russian response to cut the gas supplies to Europa. As Russia accounts for about 40% of the EU's gas consumption, this would lead to a substantial economic set-back as parts of the production side of the economy would come to a halt. It would also lead to a short-term inflationary shock.

If the hit on growth is stronger than the consensus expects, the inflation dynamics over the next year or two could also be weaker than the expected. Markets are pricing aggressive rate hikes over the next year or so as the running inflation is high and central banks have communicated accelerated monetary tightening. These are considerations we will be building on a new global theme; *"Global: hiking into recession"*.

One of our strongest convictions within fixed income markets is that central banks asset purchases will be scaled back and reversed over time. Inflation has been structurally low and central banks have long undershot their inflation targets leading to extreme policy measures of zero or negative interest rates and large-scale asset purchases. Inflation has been low due to structural dis-inflationary forces of which some will likely reverse as discussed above.

Following the sharp decline in inflation expectations driven by the oil price collapse in 2014, the ECB and the Swedish Riksbank have pursued very aggressive monetary policies aimed at restoring credibility to their respective inflation targets. As a result, bond yields fell and curves flattened substantially. When these purchases stop and are being unwound, not to mention the funding needs of public deficits as spending on military and energy rise, we believe longer end bond yields over time should converge and revert towards the pre-2014 levels, see chart below. Trades benefitting from the convergence of long-term yields across markets are expressed within the new theme *"Global: Quantitative tightening"*, replacing *"Global: Tapering asset purchases"*.





Nordic markets

Swedish inflation is rising and broadening due to indirect effects from high energy and food prices. So far we see little second round effects as wage pressures are still very muted. Expectations are for slightly higher wages compared to the last few years, but "wage drift" (i.e. wage increases in excess of negotiated wages) seems so far modest. Consequently, while we closed down our outright positions for lower interest rates in the short end of the curve, we do see opportunities in market pricing of Swedish rates relative to EUR rates, see chart. We seek to exploit these prerequisites on relative value basis within a new theme *"Sweden: Measured policy shift"*.

Also, we see supply distortions generating upside risks to inflation in the short term, hence, we remain positioned for higher Swedish Break-Even Inflation rates in the short term. Such inflation is effectively taxing away any income growth for Swedish households. Given historically high debt ratios, households and corporates are highly sensitive to even small increases in interest rates, reinforced by the introduction of mandatory amortisation rules. We suspect that this will weigh on consumption and the general growth outlook.

Contrasting with this, market-based forward inflation expectations suggest that the era with too low inflation and the struggle to meet the inflation target is behind us. This is of course a conceivable future if average wage increases adjust upwards somewhat and if the greening of the energy sector imposes higher (indirect) costs on transport, goods, food and alike. This is a very plausible scenario. If that were to materialise, the ECB and the Riksbank will leave negative and zero interest rate policy behind. Additionally, unconventional policy, such as asset purchases, should be an instrument of the past.

Interestingly, long term interest rates still imply a shallow path of policy tightening rates and low (even negative) term premia. As the future inflation has been repriced higher, while uncertainty and volatility have increased, there is an argument for longer term rates to adapt to such reality. As monetary policy "normalises", we see arguments for Swedish longer bond yields to narrowing the gap to, for instance, U.S. and Norwegian government bonds. This gap opened and widened when central banks in Europe conducted zero and negative interest rate policy as well as asset purchase programmes. We see opportunities to building positions for such a long-term adjustment.

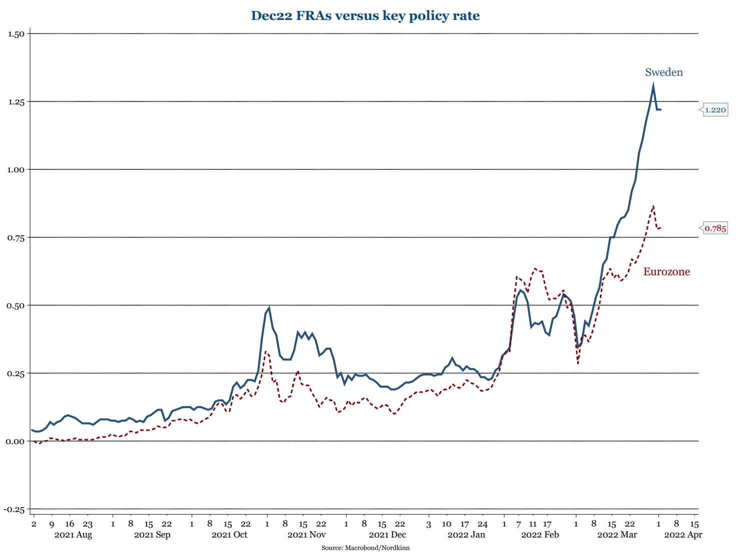
According to the Norges Bank's projections presented on March 24th, the monetary policy committee envisages a gradual increase in the key policy rate to 2.5% by the end of next year. This will bring interest rates above the Bank's estimate of a neutral monetary policy stance (i.e. the level of rates that is consistent with stabilising the economy at its long-term potential and reaching the 2% inflation target). Like the U.S. Federal Reserve, the Norges Bank believes monetary policy needs to become restrictive next year to bring inflation down to the 2% target over the medium term.

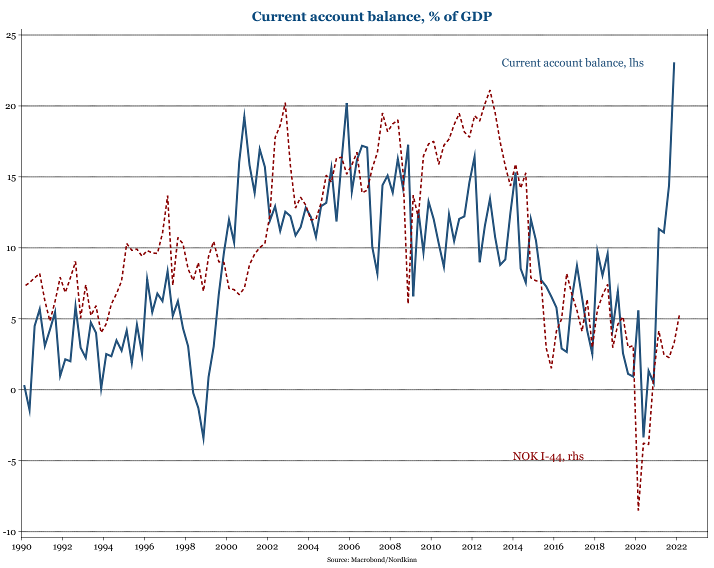
To be sure, the level of economic activity and the inflation outlook warrant a faster increase in interest rates than implied by the Norges Bank's interest rate profile. However, given elevated uncertainties associated with the war in Ukraine and the impact of higher rates on private consumption due to high debt ratios, the central bank prefers a more gradual rise in interest rates that traditional monetary policy models imply. At the same time, Governor Ida Wolden Bache warned that if upside risks to price and wage inflation were to materialise, the central bank will not hesitate to speed up the pace of tightening.

Incoming data about the labour market and wage formation that have become available after the policy meeting highlights these risks. The labour market report for March indicates slightly tighter conditions than expected, whereas the outcome of industry-workers wage negotiations turned out on the high side relative to Norges Bank's forecast of 3.7% overall wage growth in 2022.

In this context, we have cut exposure for performance of Norwegian fixed income relative to Europe, while we have kept exposure for tighter interest rate differentials versus the U.S, which is part of the *"Norway: Relative Monetary Policy"* theme.

Regarding FX, the sharp increase in net cash flows from petroleum activities and the outlook for a significantly higher current account surplus over coming years have the potential to become important drivers for the NOK in coming months and quarters. On top of this flow, we also expect substantial investments in energy, including renewables, that is likely to attract direct foreign investments. Long NOK is currently our top conviction in the FX space. Trades are organised under both the "*Norway: Relative Monetary Policy*" and *"Tactical risk reward trading"* themes.





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.

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