NORDKINN

ASSET MANAGEMENT

Nordkinn Market Review & Outlook – April 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

Both the World Bank and the IMF substantially cut their forecasts for global GDP growth this year. The downgrades were mainly the consequences of the Ukraine war and the Chinese lockdowns. Despite the deteriorating growth outlook and falling equity markets, future inflation expectations and interest rates continued to rise during April. Data releases showed headline inflation rising to 8.5% and 7.5% in the U.S. and the Eurozone, respectively. As both the Fed and the ECB are fighting to maintain their credibility, their emphasis is less on growth implications and more on price pressures from rising commodity prices and bottlenecks in global supply chains caused by the Ukraine war and the Chinese lockdowns.

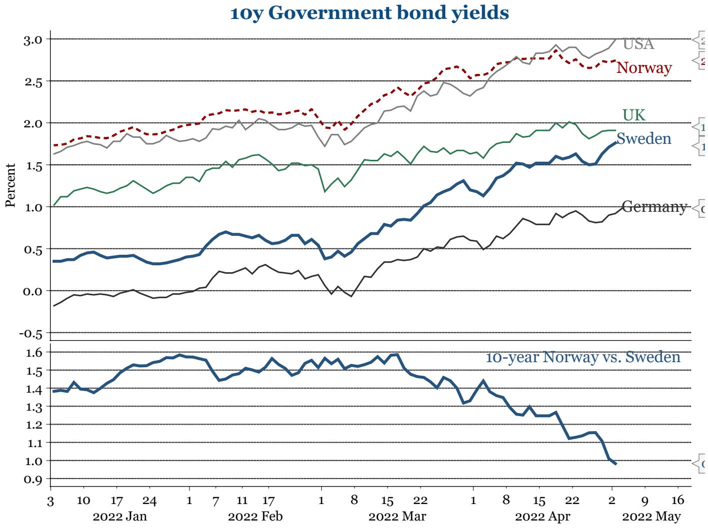
Inflation markets discounted even more risk premia during April, also in Europe where second round effects of higher energy and food prices have become evident. Although long term Break-Even Inflation (BEI) rates climbed in April, inflation curves flattened in Europe, steepened in the U.S. and moved higher in parallel in Sweden. The combination of higher-than-expected inflation in the euro area and higher U.S. real rates contributed positively to the theme *"Global: Comparative inflation expectations"*. Strong Swedish inflation print also contributed to the positive returns within the theme.

The ECB communication shifted into a hawkish direction during April and markets now discount more front-loaded rate hikes, bringing the deposit rate well into positive territory before year-end. The Fed also hinted at a faster hiking pace and markets discount a series of 50 bps hikes at the next four policy meetings. In addition, the Fed is likely to start reducing its balance-sheet already at the May meeting.

Yield-curves have flatted dramatically as central banks are expected to hike rates rapidly. However, central banks' unwinding of asset purchases are also putting upward pressure at the longer end of the yield curves. The theme *"Global: Quantitative tightening"* gained from the sell-off in Swedish versus Norwegian long-term government bonds, see chart, as well as from the re-steepening of yield curves in the UK.

Both the economic and political uncertainties have risen sharply, and volatility remains extraordinarily high. The USD's rise versus JPY and Chinese CNH since early March are on par with the biggest moves seen for decades. As the EUR weakened less, our tactically long volatility EUR/USD position contributed positively during April.

10y Government bond yields



Source: Macrobond/Nordkinn

Nordic overview

In the first three months of 2022 Swedish consumer prices increased by 2% according to the underlying inflation measure CPIF excluding energy. This is more than during the whole of 2021 (1,7%). Just like in many other countries, goods inflation is the main factor behind the surge. However, compared to other countries (goods) inflation in Sweden took off much later so there was a clear catch-up effect in January this year. Service inflation is also relatively high with for instance hotel prices having moved back to pre-pandemic levels, thus indicating a reopening effect.

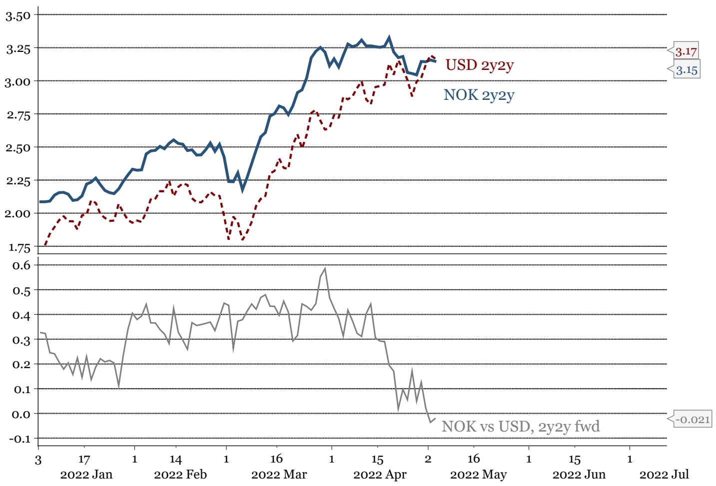
The March CPI data, released mid-April, was clearly an important piece of information to the Riksbank. During the month, Governor Ingves, among others, signalled a need for a prompt shift in policy. The strive to achieve the inflation target from the downside is a struggle of the past as inflation is now running way above the target (currently at 6.1% YoY). At its monetary meeting on April 28th, the Riksbank executive board saw no need to await further information, but to immediately hike by 25 bps and signal more to come. This is an explicit attempt to stop inflation expectations and wage compensations to increase.

While the higher-than-expected inflation data in Sweden benefitted the theme *"Global: Comparative inflation expectation"* the theme *"Sweden: Rate path to align with peers"* suffered losses when the Riksbank hiked already in April combined with less proportional accumulation in expected hikes in Europe relative to Sweden.

Having underperformed in March, Norwegian fixed income performed well in April relative to peer markets, including the U.S., see chart. A few factors seemed to have contributed to this development. First, NOK interest rates were already at elevated levels relative to peers at the beginning of the month. Second, the lower-than-expected core CPI print at 2.1% reduces the probability of hiking the key policy rate with larger increments or at interim meetings.

Finally, the Nibor-OIS spread tightened markedly in April following the announcement on March 31st that the Norges Bank will sell NOK 2 bln per day on behalf of the Government Pension Fund Global. The roller-coaster in Nibor fixings in March and April were transmitted through-out the NOK interest rate curve. As a result of these developments, the *"Norway: Relative monetary policy"* theme contributed positively to performance in April.

Interest rates, 2y starting 2y forward (2y2y)



Source: Macrobond/Nordkinn

Nordic markets

Potential inflation overshoots in the short run will dictate how fast the Riksbank will hike rates. Although the bar has been raised substantially by the Riksbank in their inflation projections, more CPI surprises to the upside is possible. Market pricing now implies a hiking cycle in line with Riksbank's alternative scenario, where inflation rates persist well above the target for a longer period. But unless wage inflation starts to build in Sweden compared to the Euro-area, we believe that Swedish inflation will continue to develop in line with European inflation. With inflation broadly aligned, we do not expect the Riksbank to 'outhike' the ECB as significantly as current pricing suggests. To better reflect our view, we have rephrased the name of the theme *"Sweden: Measured policy shift"* into *"Sweden: Rate path to align with peers*".

Interestingly, while the higher rate path scenario is priced-in by the market, the corresponding higher inflation path is not priced-in by the Break-Even Inflation market. We remain positive on short-end BEI rates, but less constructive in longer maturities. This is covered in our theme *"Global: Comparative inflation expectations*".

The shift in monetary policy will also result in less reinvestments of maturing bonds and coupons. As purchases are scaled back, the Riksbank's asset portfolio will start to shrink. The net supply of government bonds (adjusted for Riksbank purchases) will become positive after seven years of consistent negative supply. We expect long-end bond yields to gradually adjust to the new reality with a fading QE-premia. Positions benefitting from such a transformation is held in the theme *"Global: Quantitative tightening".*

External factors are driving up cost of living and input prices for Swedish households and corporations alike. There is at current very little evidence of wage growth rising enough to balance these developments. Therefore, real income growth will remain negative for some time. What's worse, the Riksbank's foreseen hiking cycle risks adding insult to injury given the highly indebted domestic private sector where Swedish households look vulnerable in particular. Put simply, if the Riksbank were to hike according to current market pricing, households' costs would exceed income and likely force a cut on spending. This also highlights the risk that households may choose to downgrade into cheaper living, which in turn could provoke a viscious spiral where negative house price dynamics would push for even more savings. In sum, the effects of interest rate hikes on a on a highly indebted private sector will need to be analysed continuously as it constitutes a major downside risk to the growth and inflation outlook.

This particular risk is not isolated to Sweden and we seek to cover these implications in the theme *"Global: Hiking into recession".*

In Norway, the central bank has signalled a strong preference for raising rates in a gradual fashion, reflecting uncertainty about the economic outlook and how households will respond to higher interest rates given elevated debt ratios. Consequently, the Norges Bank's interest rate path implies a much more gradual hiking cycle than traditional monetary policy models imply. At the same time, the central bank warned that it will not hesitate to speed up the pace of tightening if upside risks to inflation were to materialise.

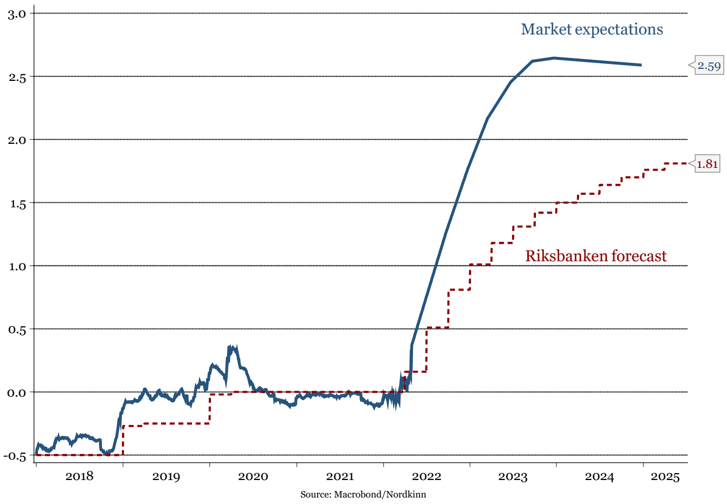
Incoming data since the previous Board meeting on March 24th does not suggest that inflation is overshooting Norges Bank's projection, at least not yet. Rather, its preferred measure of underlying inflation, CPI-ATE, rose only 2.1% in March from a year earlier compared with its forecast of 2.5%. Meanwhile, the outcome of ongoing wage negotiations appears so far broadly consistent with Norges Bank's forecast of 3.7% overall wage growth in 2022, even though the risk is admittedly that the actual number will be somewhat higher eventually. Against this background, we expect the Norges Bank to leave monetary policy unchanged at the upcoming interim meeting on May 5th.

However, looking further ahead we judge that the risk around Norges Bank's inflation forecast is skewed to the upside. We do not see any compelling reason why core CPI inflation in Norway should lag Sweden and the Euro-area. Take food as an example. In Norway food prices have barely risen when comparing with a year earlier, whereas the have risen sharply in Sweden and Euro-area, see chart. However, judging from the producer price index (PPI), which leads CPI by a few months, Norwegian food prices are set to spike substantially in coming months. The food component in the PPI index has risen 9% from a year earlier.

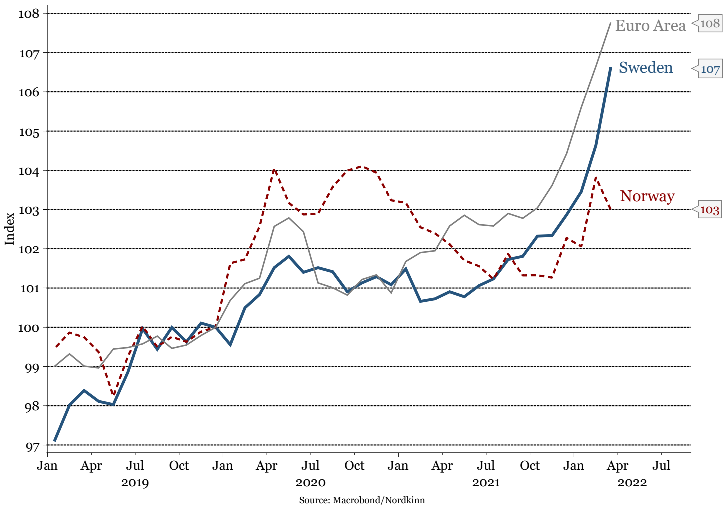
Moreover, with labour market conditions tightening, wage pressures continue to build. The unemployment rate was 1.9% in April, a 14-year low, while new vacancies is record high and rising.

The bottom line is that we see a rising risk that the Norges Bank, like other central banks, will eventually abandon its gradual hiking strategy and instead front-load rate increases in respond to higher inflation outcomes ahead. Consequently, we have decided to tactically scale down risks within our *"Norway: Relative monetary policy"* theme, which benefitted from the performance of Norwegian fixed income relative to peer markets in April.

Sweden STIBOR market-implied policy rate expectations



CPI food, index, December 2019=100



OUTLOOK

Global markets

Most Western economies currently experience low unemployment and high inflation. In such environment the policy choice is theoretically easy: Bring interest rates to neutral, or beyond, to reduce demand more in line with supply to tame inflation. However, the policy trade-off becomes more delicate in a situation when weaker growth results in higher unemployment rates. How far, then, are central banks willing to raise rates to defend their inflation mandate? This is essentially the key issue to follow as the policy shifts of central banks are being rolled out.

For sure, economic growth is already being downgraded rapidly as leading indicators are rolling over, energy prices have spiked, equity markets are falling, and credit spreads are rising. The probability of a global recession is clearly rising, as also indicated by the flattening of yield curves to levels that historically have predicated recession.

As described in last month's report, the Ukraine war and the Chinese lockdowns will amplify risks for weaker growth and prolonged price-pressures. Despite this, it is likely that the latest inflation readings have peaked in year-over-year terms. Pre- Ukraine and China lockdowns, global supply chain pressures had started to ease. While these pressures likely are set to increase again, energy and other commodity prices seem to have stabilised, freight rates have fallen significantly in the last few months, and car producers report that the chip shortages that led to the production shutdowns will be less of a constraint.

Nonetheless, unless addressed by central banks, there is a risk that inflation will remain too high for a long time. Central banks are therefore in the process of rapidly tightening monetary policy as they aim to contain inflation. Considering this, in April we initiated yield curve trades that we expect will gain from weaker growth. These trades are organised within our new theme: *"Global: Hiking into recession"*.

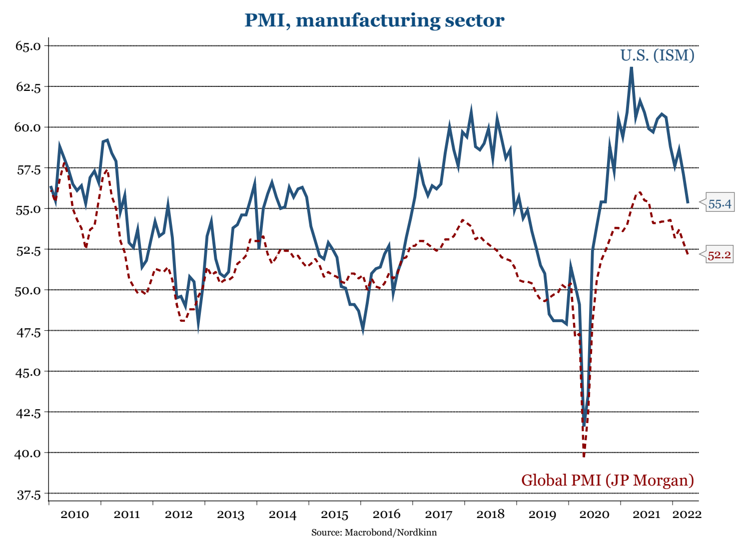
We are not yet committing full risk to this theme for the following reasons. First, while markets discount aggressive rate hikes compared to the previous hiking cycles, inflation is on levels not seen since 1970s and real yields (nominal yield minus market expectations for inflation) are still low. In the U.S. real yields are still negative all the way out to 10+ years, while German real yields are deeply negative.

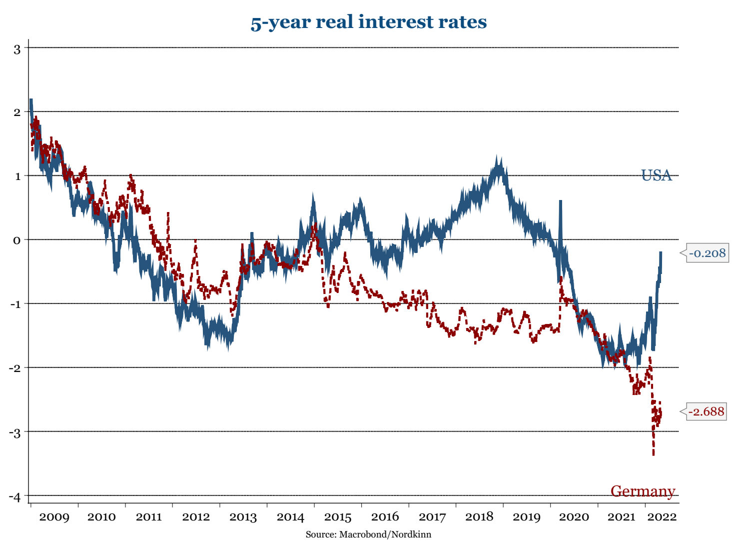
Second, unemployment rates within G10 are historically low and income growth in the U.S. is rising rapidly. Third, corporate profits, capex outlook and hiring intentions are generally still strong in Western economies. Fourth, although households suffer from a large loss of purchasing power due to rising prices, they are cushioned by excess savings during the pandemic and in many countries by compensation-schemes for high energy-prices. Fifth, while the manufacturing sector is clearly slowing, leading indicators for the much bigger service sector, apart from in China, are generally pointing to continued strong growth. Hence, while we believe the recession risk is rising rapidly, economic growth could sustain for some time.

Also, inflationary pressures differ between the U.S. and the euro area. In the U.S., there is a significant supply-demand imbalance for labour and a dynamic negotiation process, which has resulted in wage growth at multi-decade highs. So far there are no signs of slowing, and a wage inflation spiral could be evolving.

To reduce that risk, the Fed will likely continue to tighten even if the economy will stall. Apart from the UK, the labour markets in Western European economies are more balanced, and wage growth is still muted. While the ECB will tighten rapidly to gain credibility and contain inflation expectations, we think they are less likely to continue to tighten policy if economic growth is strangled and unemployment rates rise. Added to that, because European households have floating rates and have taken on more debt than Americans, they are more sensitive to rising rates. This implies that U.S. real rates will probably continue to rise more than real interest rates in the Euro-area, which we exploit in the theme *"Global: Comparative inflation expectations"*.

Finally, we decided in early May to terminate the theme "*Global: Rate hike timing, pace and duration"*. The theme was originally designed to benefit from the expected tightening profile of key policy rates across developed markets, whilst exploiting differences in the outlook for inflation. Since then, most central banks have embarked on a tightening cycle and the ECB is widely expected to lift its key policy rate this summer. Looking ahead, trades related to nominal yield levels and curves will be organised within our themes *"Global: Quantitative tightening"* and *"Global: Hiking into recession"*.





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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