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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – May 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

With few exceptions, inflation around the globe continued to surprise to the upside, intensifying the already high pressures on central banks to act. At the same time, economic growth data disappointed expectations, in particular in the U.S., see chart. These two dimensions summarises the central banks' complex dilemma: to control inflation without killing growth. While deteriorating growth expectations lead to flatter yield curves, the sell-off in risky assets paused on hopes that central banks will be unable to hike rates as aggressively as currently discounted.

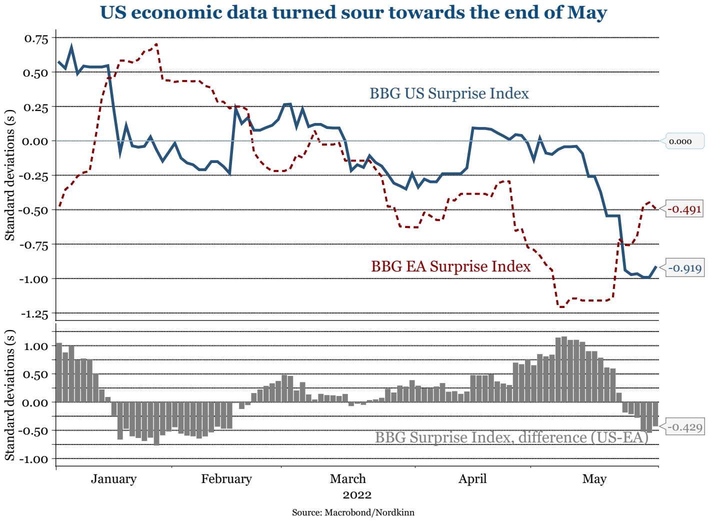
That being said, regional differences came into sight. While growth concerns have led markets to scale back expectations for FED hikes during May, ECB officials made it clear they will exit negative rates by the end of September and end net bond buying during the summer. Moreover, several members of the Governing council said 50 bps increments may be appropriate, which contributed to an underperformance of German Bunds relative to U.S. Treasuries in May.

Energy and food prices stayed elevated or continued to rise during May, further erasing household's purchasing power. Leading indicators for consumer spending have continued to fall, for some countries to multi decade lows. The UN and others warn of a much deeper crisis, however, as Russia's invasion of Ukraine and its weaponising of grain exports can lead to the largest food crisis in history, with potential social, economic and political upheaval. Moreover, the rise in infections in China and the government's zero covid-19 policy has led to comprehensive shutdowns and a collapse in economic activity in major cities.

The decline in U.S. Treasury versus German Bund yields and flatter yield curves contributed positively to the theme *"Global: Hiking into recession"* in May. Regrettably, these gains were unable to offset losses in the *"Global: Quantitative tightening"* theme following a remarkable rally in Swedish government bond yields, see Nordic overview.

Break-Even Inflation (BEI) rates declined in general in May and most in Germany where 10-year BEI fell some 60 bps. Late in the month a gloomier outlook for the U.S. economy, underpinned by data surprising to the downside, resulted in lower U.S. real rates along the entire yield curve. At the same time, supply of EUR denominated real rate bonds, and the market pricing in a much more hawkish ECB, sent European real rates higher. This tightening of the real rate spread contributed negatively to the theme *"Global: Comparative inflation expectations"*.

US economic data turned sour towards the end of May



Nordic overview

A surprise rally in Swedish government bonds (SGBs) in May contributed negatively to our *"Global: Quantitative tightening"* theme. The chart below shows 10-year SGB compared to its maturity matched SEK swap and relative to the corresponding spread in Germany (i.e. a "SGB/Bunds Asset Swap Box"). As evident by the illustration, the move in SGBs in May was an extreme outlier in a 22-year historical context.

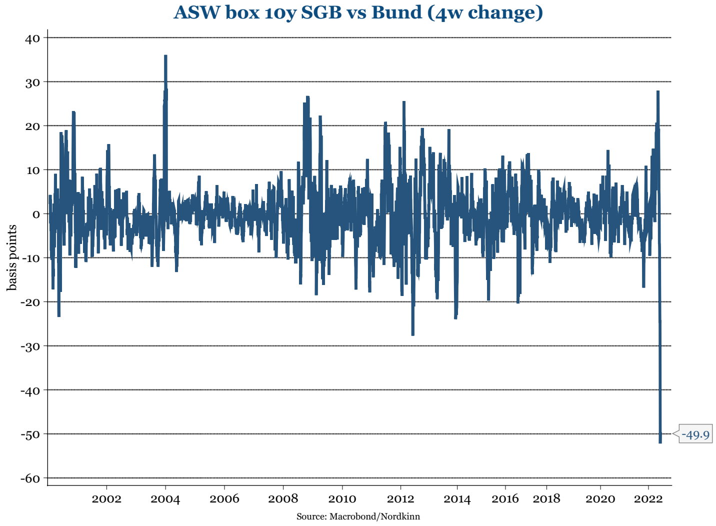
Without obvious drivers to this erratic move in the macro landscape, it was instead caused by market flows. When 10-year bond yields climbed above 2% in early May and risky assets wobbled, it had logic that demand for safer SGBs returned. But demand grew into a historical bond market squeeze, which was further inflated on May 24th when the National Debt Office updated their borrowing requirement plans to cut the issuance of SGBs in spite of higher borrowing needs. The free float of SGBs is now merely 5,3% of GDP compared 13,5% to pre-QE.

The market squeeze in SGBs impacted the whole cash bond market, putting further stress on a market already struggling with liquidity. The subsequent relative underperformance of Swedish covered bonds and short-term rates contributed negatively to the theme *"Sweden: Rate path to align with peers"*. The theme was terminated at the end of the month, see Nordic outlook.

In Norway, inflation surprised to the upside in April: CPI rose 5.4% from a year earlier, while CPI-ATE increased 2.6%. This was 0.9 and 0.3 percentage points respectively above Norges Bank's projection. Meanwhile, the outcome of the central wage negotiations for 2022 looks pretty much in line with Norges Bank's 3.7% projection. The downward pressure on real wage growth seems to weigh on consumer confidence, which plummeted in Q2.

Contrary to a general flattening trend abroad, the slope of the Norwegian yield curve became somewhat steeper, partly reflecting lower demand for ultralong "SPIRE" bonds, while ample structural NOK liquidity led to a further compression of short-term Nibor spreads. The new theme *"Norway: Flow effects on long-end"* contributed to performance as a result. Meanwhile, the NOK exchange rate suffered from the deterioration in global growth prospects and risk sentiment in May. Consequently, the theme *"Global: Terms of trade FX implications"* subtracted from performance.

ASW box 10y SGB vs Bund (4w change)



Global markets

The current macro and geopolitical environment remains highly complex. The outbreak of the covid-19 pandemic in 2020 triggered a collapse in the world economy and the unprecedented and synchronised policy response laid the foundation for a V-shaped economic bounce. Households in Western economies were compensated for their income loss and as people could not travel, eat out or go to the movies, they had extra money to save or spend on other items. Consequently, demand for goods increased dramatically. As production was constrained by covid-19, prices for goods rose rapidly.

Strains on global supply chains got even worse when Russia invaded Ukraine in 2022. Commodities are weaponised, energy is scarce, and countries aim for self-sufficiency of key commodities and strategic products. In addition, China's zero-covid policy amplifies and prolongs the supply constraints in the world's top manufacturing hub. Consequently, consumer price inflation has continued to rise sharply in recent months, exceeding expectations in most countries, see chart.

Rapidly rising food and energy prices, rising interest rates, falling equity markets, a rising USD and shutdowns in China all imply dramatically worsening prospects for economic growth. While market participants broadly agree that recession risks are increasing, there are large discrepancies among market participants regarding the future path for inflation. One camp ("inflation hawks") argue that the supply issues described above are not going away anytime soon and will keep inflation elevated for a long time.

The other camp ("inflation doves") argue that the cure for high prices are high prices and that demand destruction is already on its way. A severe slowdown or a global recession will lower demand in general and for energy and other commodities in particular, which takes care of the supply demand imbalance. In many countries, including the U.S., there are already clear signs of e.g. slowing construction activity and cooling housing markets. As a material slowdown / recession is already in the brewing, with the current elevated level of many commodities and other goods like used cars, price levels will be significantly lower a year from now. This will all translate into deflationary pressures.

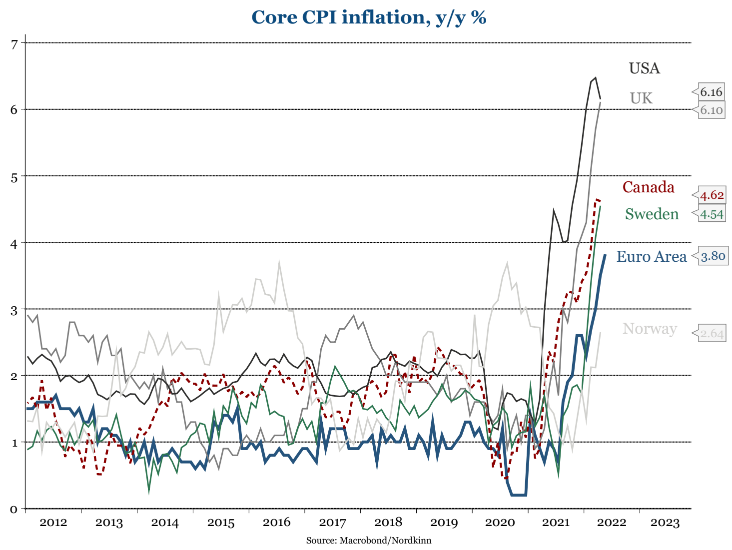
Monetary policy makers face the challenge of safeguarding credibility of their inflation targets whilst avoiding recession. Currently they have an easy job as inflation is high and employment is low and still falling. Consequently, the discussion for most central banks is the pace and duration of rate hikes, not if policy rates are to go up.

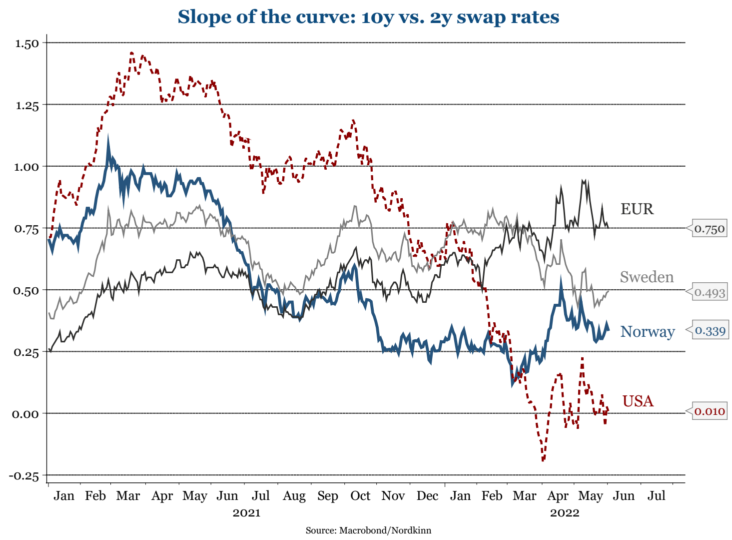
While acknowledging structural price pressures, we expect cyclical forces to dominate the inflation outlook in the short term. Economic growth is slowing and recession risks are rising. We expect central banks to raise rates quite aggressively in order to bring inflation under control, but they will slow down and eventually stop when there are clear signs of a sharp economic slowdown or a recession.

While the Fed have downplayed the likelihood of 75 bps hikes, we think 50 bp hikes for a few more meetings are in the cards. The Fed wants an economic slowdown to reduce demand more in line with supply and they will not stop hiking because of falling equity markets (i.e. the "Fed put" is something of the past) or moderately slower growth. Meanwhile, the ECB have consistently pushed forward the timing of tightening. However, the ECB will remain on hold in June due to self-imposed constrains in its forward guidance, but a July hike is almost a done deal now. The question is rather whether the ECB will hike by 25 or 50 bps.

Turning to investment implications, our reasoning above implies that interest rate curves will have a flattening bias. In particular, the EUR curve looks too steep in our view, particularly in a cross-market perspective. We have added exposure for a relative flattening of the EUR curve vis-à-vis other currencies, which are organised under the theme: *"Global: Rate hike timing, pace and duration"*.

In the theme *"Global: Hiking into recession"* we are running yield curve plays that will gain from aggressive rate hikes which is likely to cause a significant slowdown, and expectations of a possible reversal of monetary policy later on. While we have yield curve steepeners in the UK in the theme *"Global: Quantitative tightening"* based on expectations of moderate rate hikes and less support for the long end from Bank of England, we have unwound risk related to SGBs in the theme due to inadequate market functionality.





Nordic markets

While the SGB market squeeze in May impacted all cash bonds, we appreciate that the Swedish swap market remains well functioning. But as the lack of market depth and liquidity makes the SGB bond market unpredictable, we currently deem its market functionality as inadequate and hence the pricing mechanisms as impaired. We have therefore decided to close all SGB exposures in our theme *"Global: Quantitative tightening"* in which SGBs represented significantly of the losses in May. Also, we decided to close the theme *"Sweden: Rate path to align with peers"* as the relative alignment of Swedish short term rates versus peers has not materalised as we had forecasted.

In terms of inflation outlook, we expect elevated Swedish inflation in the immediate future. Business sector inflation expectations are the highest in decades and price plans in the retail sector are at all-time highs and still rising. We keep positions for elevated Swedish inflation in the near term, but rising interest rates can relatively quickly move market's focus to growing risks in housing market and growth outlook.

So far, variable mortgage rates have only risen some 25-50 bps but will continue to rise in tandem with Riksbank's hikes. Because variable and short duration fixed rate mortgages are still the norm in Sweden, and the high savings ratio is mainly built on forced savings, rate increases will dramatically impact household's purchasing power. The interest rate sensitivity of Swedish households results in immediate impact from monetary policy tightening. In scenarios developed by Finansinspektionen (the Swedish FSA), house price could drop almost 30% should interest rate costs and energy costs stay elevated for a longer period of time.

Needless to say, this would push Sweden into an outright recession, which ultimately will force the Riksbank to cut down on foreseen interest rate hikes. This is something we seek to explore as part of our theme *"Global: Hiking into recession"*.

Expectations on Riksbank hikes remain very aggressive. Governor Ingves and the rest of the Executive Board have, nonetheless, been coming out in force to supress any second-round effects of the current high inflation, which many read as confirmation of current market pricing. That said, as of now, markets suggest that the Riksbank will hike by 50 bps at the three upcoming meetings, and 25 bp hikes thereafter, which would imply a stronger policy reaction from the Riksbank than most other major central banks, including the Fed. Given that second-round effects are already visible in the U.S., and considering the high interest rate sensitivity of the Swedish economy, we continue to believe this is much too aggressive.

In Norway, the Norges Bank will present revised economic projections in conjuncture with its monetary policy announcement on June 23rd, where we expect a 25 bps hike in the key policy rate to 1.00%. The question is whether the central bank will stick to its strategy of raising rates gradually, i.e. 25 bps per quarter, or whether it will indicate faster rate hikes with next move projected at the interim meeting in August.

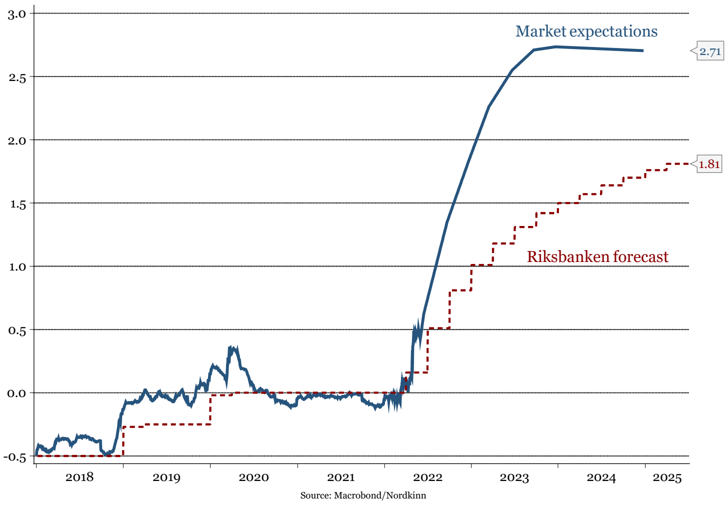
Higher inflation is the main argument for faster and more rate hikes. This notwithstanding, we expect the central bank to continue its strategy of quarterly rate increases. Norges Bank can do little about current inflation rates, but it will not hesitate to speed up the pace of tightening if there are prospects that inflation will be persistently high. So far, there is no evidence that wage growth is spiralling out of control. The outcome of the central wage negotiations is consistent with 3.7-3.8% wage growth in 2022, pretty much in line with Norges Bank's projection. As CPI inflation has exceeded expectations, real wage growth is developing negatively. Consequently, the condition of persistently high inflation outlook has not been met, in our view.

The uncertainty regarding the economic outlook was put forward as the main argument for a gradual pace of tightening. If anything, uncertainty is even higher now than it was in March. Indicators of global growth are rolling over and global financial conditions have tightened. In Norway, consumer confidence plummeted in Q2, see chart, which supports moving interest rates in a gradual fashion.

While our base case is a gradual hiking pattern in line with Norges Bank's projection, we acknowledge that the risk is skewed towards faster rate increases. As interest rate expectations discounted by the market are now broadly aligned with our view, we decided to terminate the theme *"Norway: Relative monetary policy"* in early May.

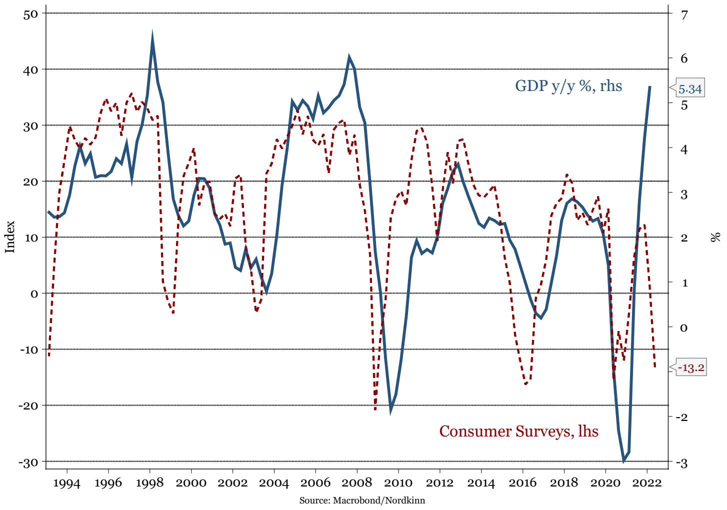
Meanwhile, we have introduced a new theme that seeks to benefit from demand and supply flows in the long-end of the curve: *"Norway: Flow effects on long-end"*. In recent years, Norwegian life and pension funds have been actively involved in buying ultra-long bonds issued by a repacking entity ("SPIRE") offering yield pickup in an environment of generally low interest rates. This demand led to significant flattening of the Norwegian yield curve. As bond yields have risen this year, demand for such products seems to be fading. Furthermore, for the first time in history the Norwegian government will issue a 20-year government bond after summer. Taken together, these developments should improve the supply-demand balance, which would support a cheapening of the long-end in Norway.

Sweden STIBOR market-implied policy rate expectations



Source: Macrobond/Nordkinn

Norway consumer confidence versus GDP



Source: Macrobond/Nordkinn

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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