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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – June 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

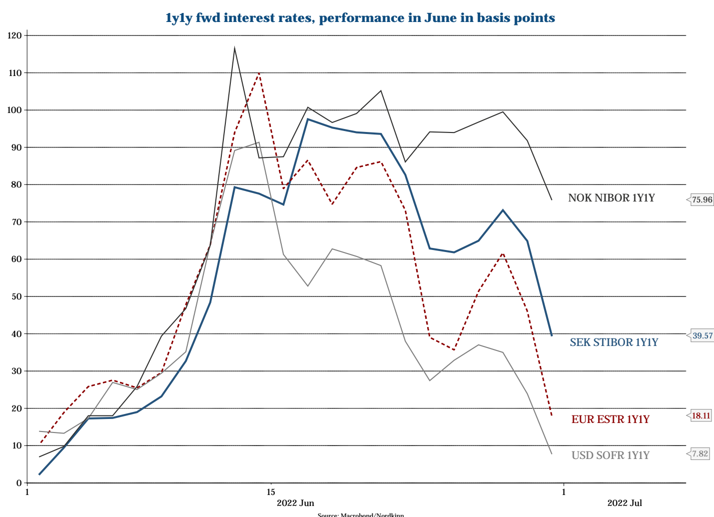
CPI inflation reached new historical peaks of 8.5% in the U.S. (May) and 8.6% in the Eurozone (June estimate). On June 15th the U.S. Fed firmly responded by hiking its key policy rate by 75 bps, which was more than Chairman Powell guided just a few weeks earlier. While the ECB on June 9th kept rates unchanged with its deposit rate still at -0.5%, it not only guided for a 25 bp hike in July but signalled much larger increments thereafter in its quest to combat inflation getting out of control.

Adding to complexity, growth indicators tumbled in June. Global PMIs fell more than expected and inflation concerns fuelled further deterioration in consumer confidence, reaching levels on or near all-time lows in many contries. The inflation and growth dynamics led to massive moves in fixed income markets, where both realised and implied (i.e from option markets) volatility climbed to new highs. Interest rates rose substantially in the first half of June, before rapidly receding in the latter half, see chart. This dramatic roller coaster illustrates how market were torn between inflation fear and a massive deteriorating outlook for the global economy.

Despite elevated CPI prints, global inflation markets took a leg down in June amid lower commodity prices and signs of supply bottlenecks easing, freight prices declining and delivery times in PMIs improving. Our theme *"Global: Comparative inflation expectations"* ended the month flat in terms of performance contribution.

The volatile and large moves up and down in interest rates were accompanied by spectacular rotations in yield curves, in particular in Europe. This became challenging for our theme *"Global: Quantitative tightening"* designed to explore the impact on long-term government bonds and yield curves from the wind-down of unconventional monetary policy. As longer-term yields in current environment are dominated by inflation versus growth risks, we decided to terminate this theme in June as it has not worked as intended. Our tactical positions for higher, but contained German yields, suffered in June, hence *"Global: Tactical risk reward trading"* subtracted from performance.

Our theme *"Global: Rate hike timing, pace and duration"* also struggled with the extreme volatility in interest rates in June, largely owing to losses on positions related to money market rates in Sweden, which we explain in the next section.



Nordic overview

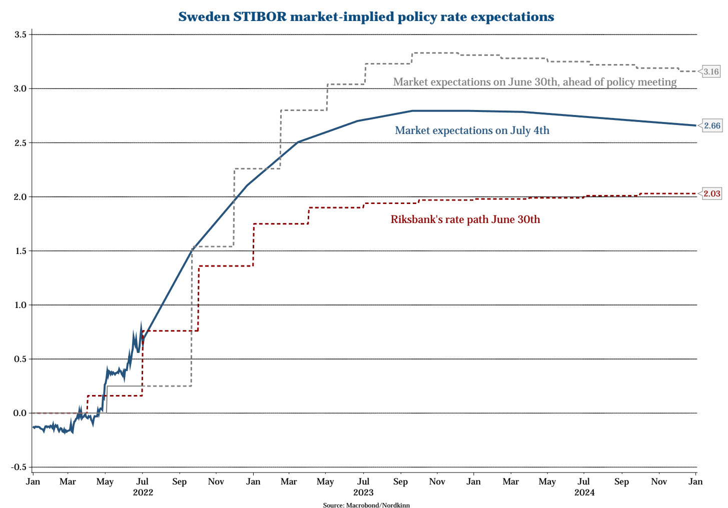
Also in Sweden, inflation in May was yet again higher than expected, resulting in elevated short-term interest rates in much of June. This said, Swedish interest rates largely mirrored developments abroad; they spiked in the first half of the month as elevated inflation data and aggressive central bank responses were in focus but fell in the latter half of the month on the back of mounting recession signs.

On June 30th the Riksbank announced a 50 bps hike to 0.75%, in line with expectations. Moreover, the Riksbank's new rate path peaked in 2025 at 2.06%, well below the market pricing, which discounted above 3% going into the meeting, see chart below. Market expectations have fallen significantly since the monetary policy meeting, yet they remain substantially above the Riksbank's projection.

The dramatic interest rate moves in June became a major challenge for our Swedish rate positions organised under *"Global: Rate hike timing, pace and duration."* Positions for lower Swedish rates suffered in the first half the month, triggering stop-losses in accordance with our protocol. Regrettably, the fund therefore did not benefit from the retracement in interest rates in the latter half of the month.

Given higher inflation in Norway than previously projected, the Norges Bank pre-emptively raised its key policy rates by 50 bps to 1.25%, against consensus expectations of only 25 bps. According to the MPC's forward guidance, the key policy rate will most likely be raised further by 25 bps to 1.50% at the next meeting in August. The current projection suggests +25 bps increments on every monetary policy meeting until the key policy rate reaches around 3% by summer 2023. However, the Bank did not rule out a faster pace of tightening if there are prospects for a more prolonged period of high inflation.

Norwegian short-term interest rates increased sharply following the Norges Bank's decision to frontload rate hikes, which lead to a flatter slope of the Norwegian yield curve became. This flattening contributed positively to our *"Global: Hiking into recession"* theme. Meanwhile, longer-term NOK interest rates swaps failed to keep up with European peers, which rose sharply in June. Consequently, the theme "*Norway: Flow effects on long-end"*, designed to benefit from demand/supply flows supporting higher long-term NOK rates on a relative basis, subtracted from performance and was terminated in June.



Global markets

In its annual Economic Report, the Bank of International Settlements (BIS) warned of a possible "tipping point" if "inflationary psychology spreads and becomes entrenched" and sent a clear message to policy makers for "decisive action" to restore low and stable inflation. Consequently, front loading of interest rate hikes is now the norm.

Developments in wages is key for the outlook for inflation over the medium-term and the drivers for wages are supply and demand of labour. Right now, labour is in high demand and short supply in the U.S. and in most of Europe. Powell describes the U.S. labour market as "extremely tight" with the unemployment rate near 50 year lows. This provides employees with bargaining power to get compensated for rapidly increasing cost of living. Once wage growth starts rising, broad price pressures typically follow.

Inflation has been low and falling for four decades and we need to return to the 1970s to find similar inflation dynamics as we have today. U.S. inflation (including wage growth) moved in three cycles, with three peaks during the 1970s, each higher than the previous one. Today U.S. inflation and wage growth are similar to the first peak in the 1970s, as shown for core inflation in the chart below. The chart also illustrates that it was not until Paul Volcker was appointed new chair of the Federal Reserve and raised rates significantly higher than the running inflation rate, that inflation fell on a sustained basis.

It seems clear that the Fed needs to manufacture a slowdown to reduce the demand for labour. At the ECB forum in Sintra in June the Fed Chair Powell acknowledged that slowing down the economy without going into a recession is "getting tougher". The big question is how high policy rates will have to go to weaken the labour market enough for wage growth to slow. If the 1970s is of any guidance, policy rates will have to go much higher than markets currently discount. However, while employment and inflation dynamics are similar, there are structural economic differences today compared to 1970s. Debt levels and hence economic sensitivity to rates are much higher, central banks across the globe have clearly defined inflation mandates and technology is developing at a rapid speed, which over time should reduce production costs and the demand for labour. Geopolitics, de-globalisation and covid on the other hand may argue for further inflation pressures.

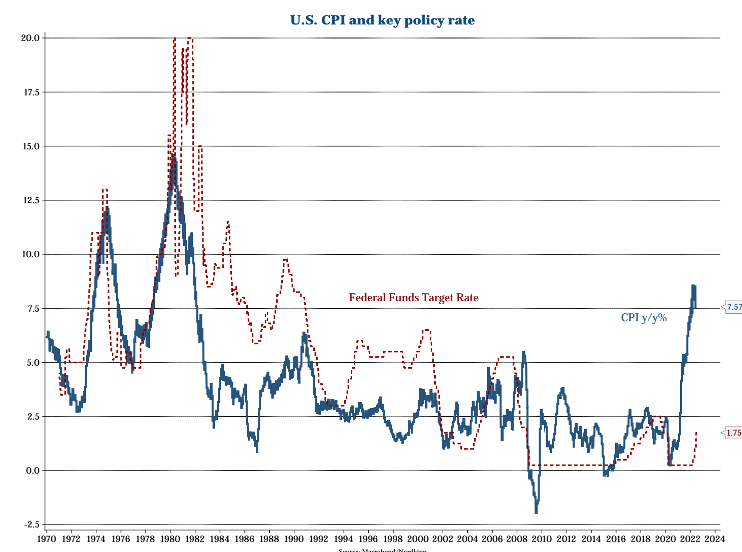
In the short-term economic growth is slowing and broad inflation pressures are running high. Prices of some cyclical components like commodities and goods are now falling and some supply frictions are easing, but central banks must target the stickier inflation components with wages being the key. U.S. wages are already rising rapidly, and while wage dynamics in Europe is both less potent and lagging the U.S., it is rising in there as well and is high on ECBs radar.

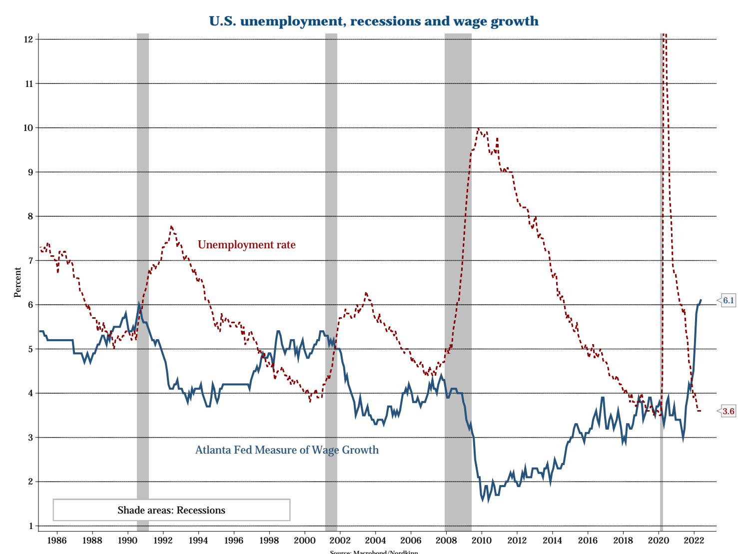
Wage growth is lagging the economic cycle and it will likely require a significant economic slowdown and reduction of demand for labour to change the wage dynamic. Lessons from the past show that a recession resulting in a 2-3% increase in the unemployment rate is necessary to slow wage-growth towards levels consistent with the 2% inflation target. Hence, it could be that the U.S. Fed, and other central banks, must keep rising rates or at least refrain from lowering rates even as economic activity slows or contracts.

However, higher debt levels today could lead to faster economic setbacks than in the 1970s. Markets are already questioning the debt service ability of e.g. Italy which has about 150% public debt to GDP, the highest in G7. Italy is not alone; the U.S. government debt is about 125% of GDP. High government debt will constrain Federal Reserves' ability to raise rates, as rates well above the running inflation rate like they did in the late 1970s, will impede U.S. debt service ability.

On top of the rate hikes, the Fed expects to reduce its balance sheet by roughly USD 1 trillion over the next year to around USD 8 trillion, a significantly faster reduction than during its previous quantitative tightening (QT) in 2018 and 2019. Most other central banks are also in the process of reducing their balance sheets.

The so called "Fed put" i.e. where markets expect the Fed to eventually step in to support risky assets is long gone, but now also the "Fed economic put" appears far away as the Fed is clear on its focus for unemployment to rise. While the current regime is unprecedented in terms of uncertainties for the economic and market outlook, in the shorter term central banks will continue to front-load rate hikes until "something breaks". We continue to exploit this dynamic in the theme *"Global: Hiking into recession."*





Nordic markets

The Swedish household sector is already showing signs of weakness, as reflected by the large drop to close to 30-year lows in consumer confidence. Released on June 29th, the Swedish NIER survey showed the financial situation of the household over the next 12 months a record low last month (data going back to 1996) on higher energy bills and rising mortgage costs, see chart. Meanwhile, the weaker economic sentiment abroad has not yet transpired into gloomier outlook for manufacturers judging by the resilience in NIER survey data. However, as global demand slows, we expect the Swedish export sector to follow suit, even though the weak SEK will provide a bit of support.

This dire outlook for the Swedish economy will be a delicate situation for the Riksbank to navigate amid elevated inflation. In the strive to prevent high inflation prints to translate into growing inflation and wage expectations, we believe the Riksbank will continue to hike rates in 2022. The outlook for more rate increases in 2023 is much more uncertain in our view, because of the deteriorating economic outlook.

We expect the adherence to the inflation target will trump growth uncertainties in the short-term. As we expect global growth concerns and the repercussions for commodity prices, delivery times etc to prevail, we foresee some continued flattening pressure of the Swedish yield curve. At some point however, the forward implied curve will start to steepen, which is something we will look for in the coming months. The global theme *"Global: Hiking into recession"* include among other things positions for a flatter short end of the Swedish yield curve.

Market pricing of Swedish inflation has been heavily influenced by low liquidity due to Riksbank's purchases. Supply in inflation-linked bonds is very small, turnover has been low and demand during spring has been patchy but healthy. This has sent Break-Even Inflation (BEI) rates higher, in particular at the longer end of the curve. The long-end BEIs also trade rich relative to peers like German BEIs. However, in the short-end of the curve, pricing relative to Europe looks more attractive as 3y BEI rates are roughly at the same level as the 3y HICP inflation swap. The Swedish base index (CPI) contains mortgage costs, while interest costs do not impact HICP in the same way. In addition, the SEK is on a weakening path given the uncertain global economic outlook and a faltering Swedish housing market. Together this speaks in favour of higher inflation in Sweden compared to the Euro Area (CPI vs. HICP ex Tobacco) over the next couple of years. We explore this outlook in our theme *"Global: Comparative Inflation Expectations"*.

The Norges Bank has become much more attentive to the risk of entrenched inflation, as reflected by the decision on June 23rd to pre-emptively raise interest rates in larger steps. Evidently, the risk of elevated inflation for a protracted period of time trumps the uncertainty related to households' response to higher interest rates, previously highlighted as an important argument for gradual rate increases.

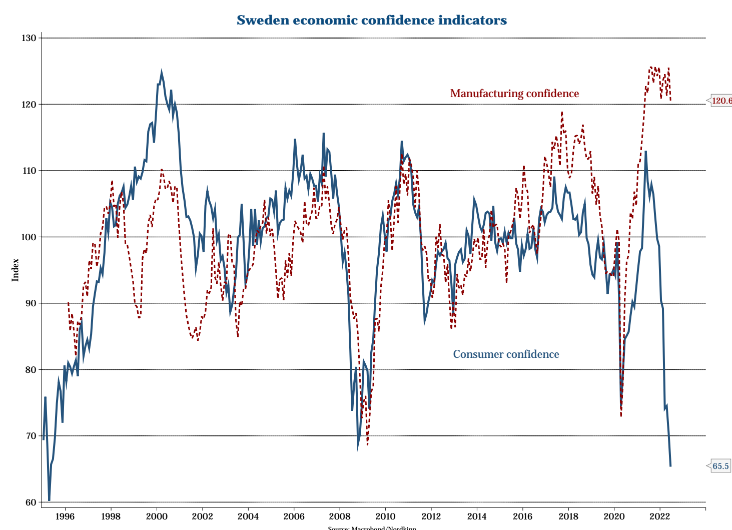
In its discussion of risks, the monetary policy committee expressed three concerns that pose upward risks to inflation: 1) Little spare capacity in Norway; 2) Global inflationary pressures; 3) Weaker NOK. Norges Bank's preferred measure of spare capacity – the registered unemployment rate – stood at 1.6% in June according to data released on July 1st. This was in line with Norges Bank's projection. If anything, there are tentative signs that the labour market conditions are peaking, as for instance suggested by the drop in new vacancies.

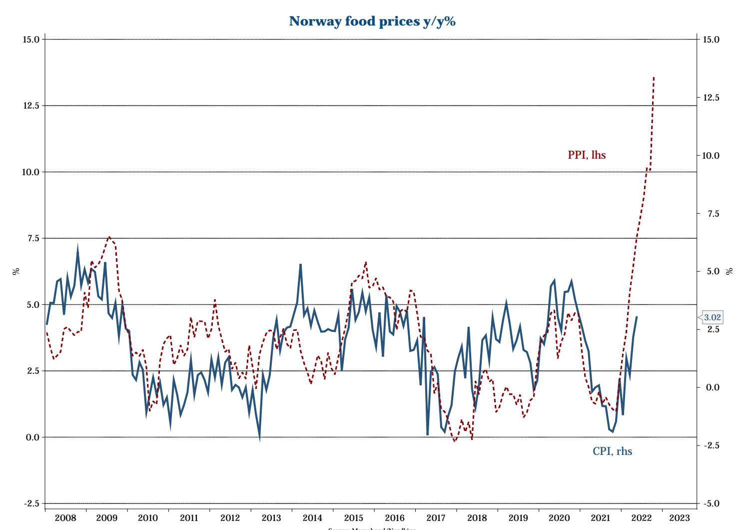
As regards global inflationary pressures, CPI inflation reached new historical highs last month in several countries. On the other hand, prices on many commodities have fallen sharply recently, signalling that a peak in headline CPI inflation may not be far away. Third, the NOK exchange rate has remained broadly stable and in line with Norges Bank's projection. Overall, therefore, the risk to inflation has not changed much since the monetary policy meeting in June.

Nonetheless, the short-term risk to inflation is on the upside in our view. Food prices in the CPI basket have so far been lagging international developments and producer prices substantially, see chart. As part of the agricultural income settlements in Norway, farmers have been given the option of raising their selling prices from July 1st. In light of this, we expect food price inflation to spike by several percentage points during summer. Food accounts for 11% of the CPI.

With upside risk to Norwegian inflation in coming months, we would not rule out another 50 bps hike at a meeting in the second half of 2022. In light of this, we are positioned for higher money market rates around the turn of the year in the theme *"Tactical risk reward trading"* and flatter NOK rate curves in the theme *"Global: Hiking into recession"*.

After terminating *"Norway: Flow effects on long-end"*, we do not have any separate Nordic investment themes in July. The current market environment largely reflects a global synchronized inflation shock to which central bank responses as well as market dynamics appear harmonized. Nonetheless, a majority of the trades in the global themes are executed with the use of Nordic fixed income and FX instruments.





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