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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – July 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

The outlook for the global economy deteriorated further in July. In China growth remains weak due to the zero-covid policy and its dramatic slowdown in the property market. In the U.S., GDP contracted for the second quarter in a row in Q2, which indicates that the economy is heading towards recession. Meanwhile, Europe is suffering from Putin's decision to weaponise gas supply. The price of gas has skyrocketed again and the risk of energy rationing in Germany during the winter which may force closedowns of industries has dramatically increased. As a result, consumer and business confidence in all of these three regions point to significant slowdown near-term. At the same time, inflation continues to surprise to the upside as headline inflation in both Europe and the U.S. reached new highs, close to double digits.

The Fed hiked interest rates by another 75 bps at the late July meeting with its target rate now being in the 2.25 – 2.50% range. While the size of the rate hike was expected, Chair Powell said in the following press conference that rates are now "broadly in line with our estimate of neutral interest rates" and that future rate decisions will "depend on the data" and decisions will be taken on a "meeting by meeting" basis. Investors interpreted the Fed to have made a pivot. Despite the large rate hike, market rates fell along the curve, while equities rallied hard.

The ECB hiked rates by 50 bps at their July meeting to bring the deposit rate to zero, despite having guided a 25 bps hike one month earlier. Like the Fed, the ECB also scrapped forward guidance. Ironically, like in the U.S., interest rates fell sharply along the curve post the ECB rate hike. The 2-year German government bond closed the month below 30 bps, i.e. about 100 bps lower than its peak in June.

The spread between yields on Italian versus German government bonds increased further in July despite ECB's launch of a so-called "transmission protection instrument". Lack of details and complex bureaucratic conditions in how the tool will be applied, led to investor scepticism. Moreover, the renewed political turmoil in Italy does not bode well for Italy's ability to serve its debt.

Regarding fund performance, developments in the USD and EUR interest rate markets contributed positively to our *"Global: Hiking into recession"* theme in July. Moreover, the relatively and unexpectedly high Swedish inflation outcome led to performance of the theme *"Global: Comparative inflation expectations"* during July.

Nordic overview

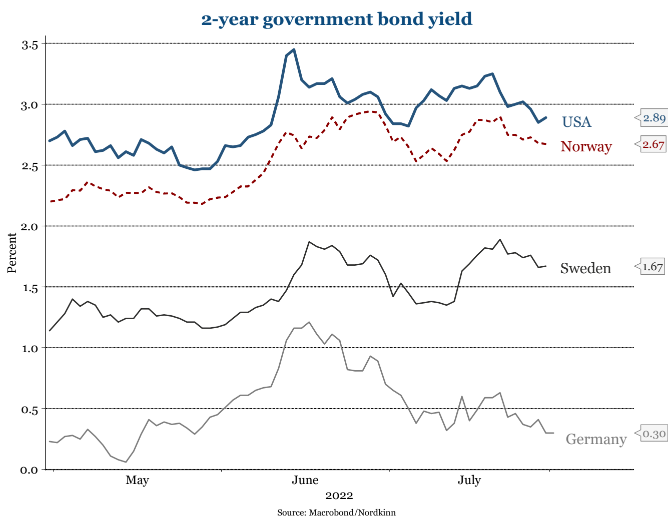
As fears of major central banks' over-hiking intensified and global recession risks mounted, expectations of continued Riksbank hikes were scaled back during the first half of July. However, inflation data released on July 14th provided another stark reminder that the Riksbank is still struggling to regain control of inflation as CPIF rose by 8.5% from a year earlier, the highest recorded inflation since 1991 (i.e. since long before the establishment of the inflation targeting regime). Consequently, short-term interest rates spiked during the week after the CPIF release amidst market chatter about interim meeting hikes.

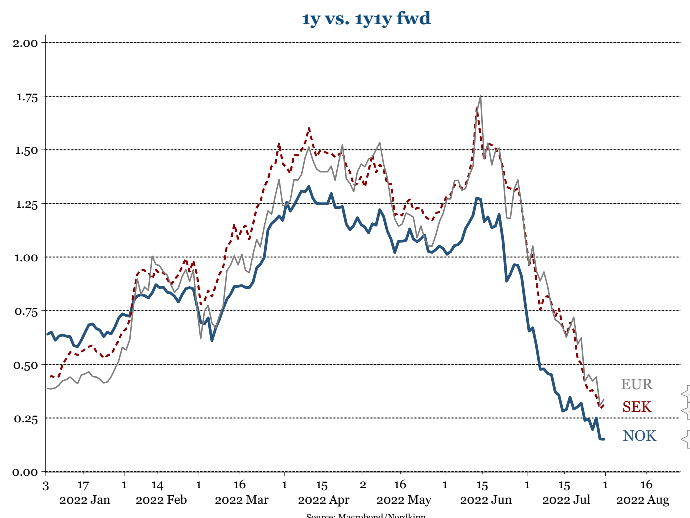
Later in the month the downward trend in rates resumed in the wake of surprisingly weak international macro data. International growth indicators, such as PMIs, also provided important signals for the export dependent Swedish economy. Fixed income markets took note, with ever flatter yield curves as a result.

Short intertest rate volatility continues to be high, and liquidity is very low. After closing most open positions already in June, we have had limited remaining exposure to Swedish interest rates, hence the impact on our performance has been negligible.

Norwegian underlying inflation as measured by CPI-ATE rose by 3.6% in June from a year earlier. While this was 0.2 percentage points above Norges Bank's projection, it was in line with consensus expectations. Consequently, the Norwegian fixed income market was virtually unaffected by the release. Nonetheless, short-term Norwegian interest rates rose and the slope of the short-term yield curve flattened in July, mirroring developments abroad, see chart. The flatter NOK yield curve benefitted the theme *"Global: Hiking into recession"* in July.

Meanwhile, the NOK exchange rate appreciated by 4% as measured by the import-weighted index I-44, supported by spiking gas prices and positive risk sentiment, as reflected by the relief rally in equity markets. The NOK move yielded only limited gains to our theme *"Global: Terms of trade FX implications"* as exposure was relatively light during July.





Global markets

Up until mid-June interest rates in the U.S. and Eurozone were on a steep rising trend this year as inflation rose dramatically in both regions. Growth slowed during the spring, but that did not prevent most central banks from tightening aggressively, including two consecutive 75 bps hikes from the Fed in two months, a 100 bps hike from Bank of Canada and a 50 bps hike from the ECB. Central banks around the globe have not hiked this aggressively and coordinated since the 1970s, see chart.

The combination of loss of households purchasing power, rising interest rate costs and loss of wealth imply a marked slowdown in growth. Leading indicators point towards further economic weakness ahead. While both the ECB and the Fed hiked aggressively in July, the economic slowdown led them both to exit precommitment to rate hikes, as both say that future monetary decisions will be data dependent and conducted on a meeting-to-meeting basis.

Despite realised inflation continuing to surprise on the upside to almost double digits rates, since mid-June markets have shaved off more than 100 bps of accumulated expected rate hikes over the next year in both the U.S. and Eurozone. Growth worries is currently dominating inflation as the decisive market driver. In addition, Chair Powells' statement at the press conference following the 75 bps hike in July that the current policy rate is now "broadly in line with our estimate of neutral interest rates", drove nominal interest rates lower and fuelled a rally in equities and commodities.

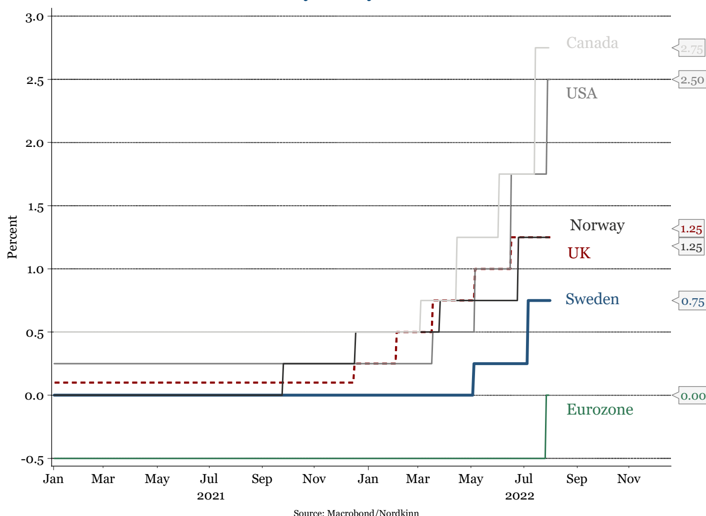
The recent rally in risky assets seems striking considering the macro economic developments. Following the contraction in U.S. GDP for the second quarter in a row, there has been a loud debate whether the U.S. economy has already entered into recession or not. The reason behind the contrasting developments between economic data and equity performance is expectations, or perhaps hope rather, that central banks will soon pause interest rate hikes and then begin stimulating the economy again in not too long. This is indeed what fixed income markets are discounting. The problem is, however, that elevated, and potentially sticky core inflation, limits central banks' ability to loosen monetary policy in response to weaker growth.

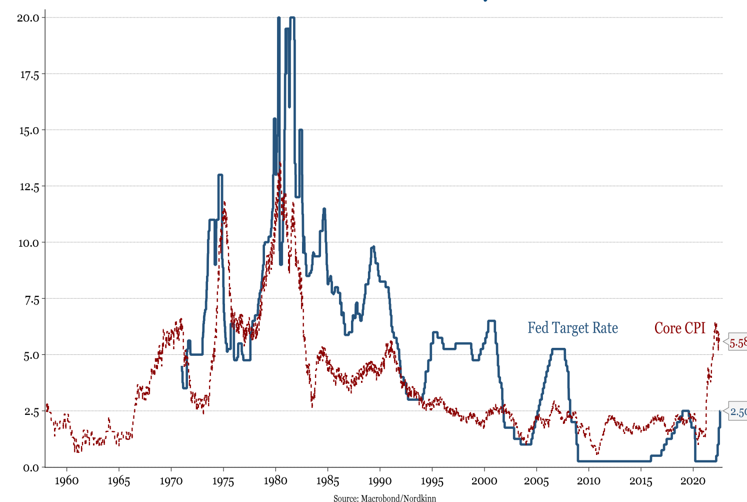
BIS has warned about a possible "tipping point" in the inflation psychology if inflation were to remain elevated for a sustained period. In the 1970s, the last time inflation was this high, it was not until the policy rate was well above the running inflation rate that inflation fell on a sustained basis. Another lesson from the past is that a significant rise in the unemployment rate is necessary to cool wage growth.

Further, the current energy crisis is also reminiscent of the 1970s and could even be worse according to Fatih Birol, head of the International Energy Agency: "This energy crisis is much bigger than the oil crises of the 1970s and 1980s. And it will probably last longer." Considering all this and Powell's own statement from late June that "going too far with tightening is not the biggest risk, the biggest risk is failing to restore price stability", we expect Fed speakers to counterbalance some of the perceived dovishness in the weeks to come and we express trades around this dynamic in the portfolio.

The food and energy crises are robbing low-income consumers of buying power after they have filled the tanks and their stomachs. In some places like Sri Lanka and Pakistan the crisis are turning into political crises. For the Eurozone, the nightmare scenario, and with the current low flow of Russian gas unfortunately likely increasing, is approaching winter with low inventories of gas. The probability of energy rationing is rising and if parts of the German industry is forced to shut down, this will have dire consequences for the European and global supply chains. The IMF estimated significantly lower growth and higher inflation for Germany should this scenario play out, but the stagflationary consequences will be felt throughout Europe and the world.

Going forward the key for markets will be the speed of the slowdown and its disinflationary impact versus the potential for energy related supply chain disruptions and the longer-term inflationary push from tight commodity markets, strained labor markets and the de-globalization. There is no playbook for the current regime and the uncertainty in the economic and geopolitical outlook is substantial. Disregarding the great financial crisis, fixed income and FX option markets are discounting close to a record degree of future volatility. As we enter August when liquidity is often poor, risk management will be critical to performance as ever.





Nordic markets

Inflation outcomes continue to be elevated in Sweden. Looking ahead, upstream prices, including PPI-data, as well as surveys and anecdotal evidence suggest a deceleration in price increases and a long sought-after alleviation of stress in supply chains. At the same time, there is only scant evidence of second round effects on wages, but we remain cognisant about those risks as we move ever closer to the conclusion of the 2023 wage agreements.

Notwithstanding signs of easing future inflationary pressures, consecutive growth rates in prices are still incompatible with the inflation target and warrant continued rate hikes from the Riksbank.

Growth indicators started to weaken already in June and these developments now extend into July. The one bright spot was a dramatic uptick in household consumption, but this was a product of revisions to earlier outcomes rather than a break of the downward trend. Importantly, household finances are becoming more stretched as house and stock prices are falling and interest rates rise further. Consumer confidence is continuing lower, and is now on levels last seen around the Swedish banking crisis of the early 1990's, see chart. Higher rates also have a direct effect on household purchasing power and with a very low financial savings rate (savings outside mandatory and locked-in savings) we believe that households cannot sustain strong consumption growth for much longer.

Gradually, we also see the darkening outlook for domestic and international consumption seeping into the outlook for the Swedish business sector. In particular, order and forward-looking survey data is deteriorating, which implies we should see a more broad-based weakening of Swedish macro data during the coming months.

The key difference to earlier such episodes is that neither the Riksbank nor other important central banks can react to the weakening of the real economy before reining in inflation. High inflation will also impede central banks from trying to offset lower asset prices. This is an important constraint not least for the Riksbank, as ever-rising property prices have been a key characteristic of the Swedish economy during the last few years. From our perspective, the interplay between still high inflation and a weakening growth outlook will, hence, be an important driver for market movements and for investment implications.

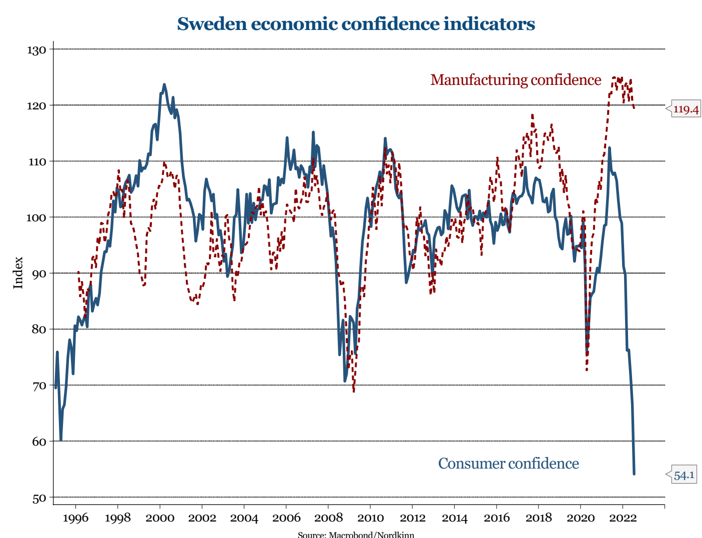
In Norway, the near-term risk to inflation remains significantly skewed to the upside in our view. As part of the agricultural income settlements in Norway, farmers have been given the option of raising their selling prices from July 1st, which may result in a spike in food prices by several percentage points in the upcoming CPI report which is due on August 10th. Food accounts for 11% of the CPI basket.

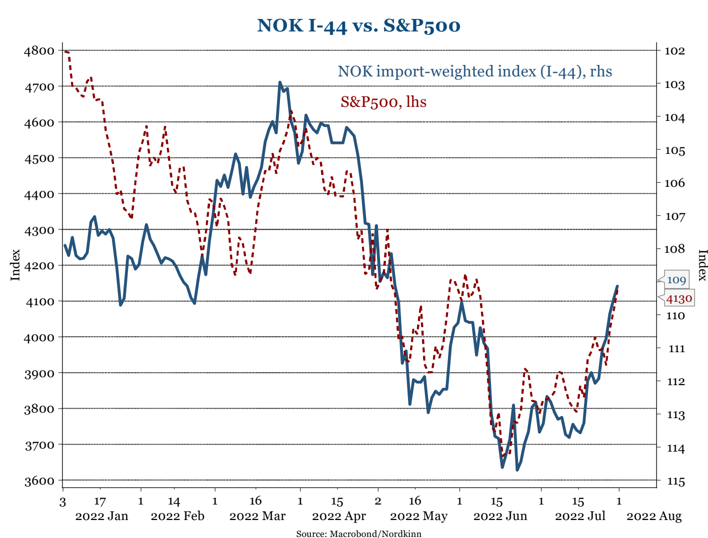
As a result of this upside risk to inflation, and reflecting the most recent decisions by other central banks, we would not rule out another 50 bps hike at the upcoming monetary policy meeting on August 18th. While such scenario is already discounted in the market, we see upside risks to Norwegian short-term money market rates around the turn of the year. This view is partly reflected in the themes *"Tactical risk reward trading"* and *"Global: Hiking into recession".*

Looking beyond the upcoming CPI release, the outlook for inflation in the medium-term has not changed materially in our view. The registered unemployment rate – probably Norges Bank's preferred measure of capacity constrains – fell to 1.6% in July. While this was 0.1 percentage points lower than Norges Bank's projection, other indicators point to some easing of labour market pressures. For instance, new vacancies and various employment surveys are coming off their respective peaks. Meanwhile, economic growth is slowing, as illustrated by the contraction in GDP in both April and June. Business surveys signal weakness ahead, not to mention consumer sentiment that has dropped to very low levels.

The NOK exchange rate is currently 4% stronger than Norges Bank projected in its June report, which in isolation implies lower price growth in imported goods in coming quarters. However, the NOK performance in July can, at least in part, be attributed to the recent rally in risk sentiment (see chart), which we do expect to extend. Consequently, we believe the environment for the NOK could become less favourable later this autumn.

Finally, note that we currently deliberately do not have any separate Nordic investment themes. The current market environment largely reflects a global synchronised inflation shock to which central bank responses and market dynamics appear harmonised. 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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