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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – August 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

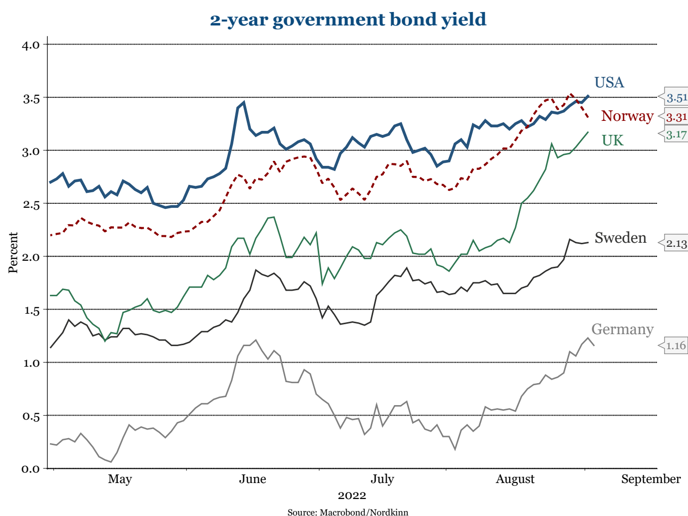
Global overview

The dovish turn that fixed income markets discounted post the July Fed and ECB meetings was distinctly rejected by policy makers at the Jackson Hole Economic policy symposium in late August. While slowing growth dominated the market narrative in July, inflation regained the driver-seat in August.

Fed Chair Powell's speech on August 26th made it clear that restoring price stability will likely "require maintaining a restrictive policy for some time" and "a sustained period of below-trend growth". He referred to lessons learnt from the 1970s and 80s and not only stressed the importance of keeping rates higher for longer but to "keep at it until the job is done". While this "will bring some pain to households and businesses", "failure to restore price stability would mean far greater pain". A clear message that rates will be kept elevated even as the economy slows. An equally hawkish message was delivered from ECB member Isabel Schnabel who also argued for a path of "determination" where "policy responds forcefully to the current bout of inflation, even at the risk of lower growth and higher unemployment." Schnabel and Powel were accompanied by hawkish talk from several other ECB and Fed members, underscoring the hawkish consensus. 75 bps hikes are now on the table for both the ECB and the Fed at their September policy-meetings.

In the beginning of August, we established a new investment theme, *"Global: Too soon for dovish pivot"*. The theme received support by the above-mentioned speeches and contributed positively to the fund's result. During August markets added about 50 and 100 bps to the respective expected Fed and ECB policy rates at end of Q1 next year. The yield on German 2y government bonds reversed all of its 100 bps drop from mid-June to end of July to close August back near the highs from June, see chart. Moreover, as yield curves flattened during the month, our *"Global: Hiking into recession"* theme benefitted as well.

The growth outlook around the globe continued to deteriorate. Leading indicators like PMIs and consumer confidence generally continued to fall and as rates are rising, housing markets around the globe are cooling. Europe is also suffering hard from the energy crises that intensified during August. Gas prices in Europe and Asia skyrocketed fuelled by Gazprom's decision to close-down the Nord Stream pipeline for maintenance. Energy intensive industries in Europe like fertiliser and ironically solar panel producers, are now shutting down production.



Nordic overview

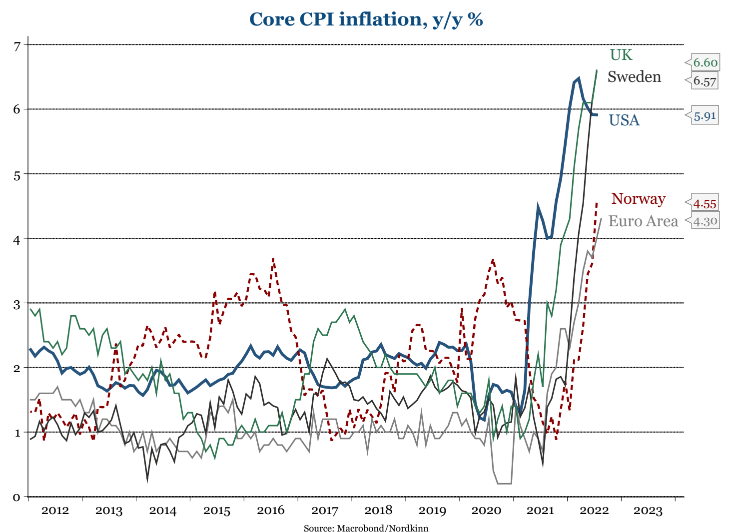
As Swedish domestic investors returned from summer holidays, covered bonds performed at the beginning of August. SEK covered bonds had some catch-up to do after the global risk rally in July. However, the performance petered out gradually as risky assets struggled, interest rate expectations rose and the weaker housing marked came back in focus.

Market expectations of future policy hikes by the Riksbank eased temporarily as the July inflation report showed a slightly lower outcome than anticipated for the first time since January. Still, inflation remains much higher than the Riksbank's forecast. Moreover, as electricity prices rose to unprecedented levels in August and worries regarding the upcoming wage negotiations began to stir, expected rate hikes moved a leg higher again later in the month. Hawkish comments from the first Riksbank speeches after the summer break also added to this narrative. A position for steeper Swedish money market curve contributed positively to the new theme *"Global: Too soon for dovish pivot"*, while positions for higher Swedish rates vis-à-vis peers and a weaker SEK contributed positively to the *"Tactical risk reward"* theme.

Norwegian underlying inflation exceeded consensus expectations significantly in July when rising 4.5% from a year earlier. This was 1.3 percentage points above Norges Bank's projection. The surprise largely owed to a sharp increase in food prices, although details also indicate a broad-based rise in inflation. In response to the higher-than-expected inflation outcome, the Norges Bank decided to deviate from its forward guidance for a second consecutive meeting by raising rates by 50 bps to 1.75%. By raising interest rates faster than projected, the Norges Bank hopes to avoid a sharper tightening of monetary policy at a later stage.

Against this backdrop, Norwegian interest rates rose substantially in August, with forward rates exceeding 4.00% for the first time since 2008. By trading NOK rates actively from both directions during August, we captured profits from the volatility in interest rates. Given their tactical nature, these trades were part of *"Tactical risk reward trading"*.

Meanwhile, supported by higher gas prices spiked, the NOK exchange rate continued to appreciate for most of August, but gains faded by the end of the month as global risk sentiment deteriorated and after Norges Bank announced a dramatic increase in daily FX purchases (from 1.5 to 3.5 bln) on behalf of the Government Pension Fund Global.



Global markets

When China entered the WTO around the turn of the last century, the world experienced positive supply shocks in a prosperous and relatively peaceful period. These positive tailwinds are gradually turning to headwinds. The prospects of peace in Ukraine seem dim, and the U.S.-China tensions over Taiwan - the world's largest chip makers by a large margin - keep rising. U.S. president Joe Biden signed the Chips and Science Act into law in August and will allocate USD 50 bln to bring more chip manufacturing to the U.S. The era of increasing globalisation and outsourcing seem to be over.

Moreover, the working age population is now falling in many large economies and immigration policies are also pointing towards further friction in the supply of labour. Furthermore, long term underinvestment in oil & gas and Western political resistance towards both oil, gas and nuclear point to energy scarcity for years to come.

All told, scarcity of energy and labour, in-sourcing and potential supply chain disruptions from geopolitical conflicts seem likely to imply a structurally different inflation regime compared to the last decades.

For these reasons, while headline inflation seems likely to peak in not too long amid base effects, core CPI inflation may prove sticker. In addition, the experience from the 1970s suggests that inflation could become entrenched at high levels unless addressed forcefully by central banks.

This has three implications for how we consider the outlook for markets. First, we believe market-based inflation expectations in some countries underestimate that it will take time for underlying inflation to return to target. This view is being addressed in the theme *"Global: Comparative inflation expectations"*. Second, we expect central banks to remain on the path of being determined also in coming months. This is addressed in the theme *"Global: Too soon for dovish pivot"*. Third, central bank will choose such path even at the risk of recession, which we address in the theme "*Global: Hiking into recession"*.

Regarding recession risks, leading indicators for growth such as consumer confidence and PMIs point to significant economic slowdown in most parts of the world. Housing affordability globally has fallen and indicators point to lower building activity and falling house prices.

A further rapid increase in interest rates will amplify the slowdown in household demand.

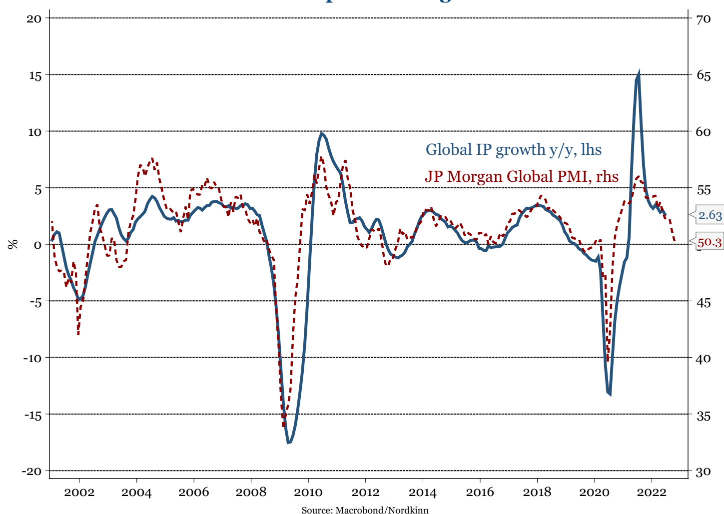
On top of that, the economic slowdown in China is another risk to global growth. The Chinese central bank has lowered policy rates and provides a rare exception to the global synchronised monetary tightening. Despite Chinese authorities' attempts to stimulate the economy and stabilise the housing market, people are losing confidence and stories of homeowners that are refusing to pay mortgages on unfinished homes are plentiful. Households and banks suffer losses as real estate developers are defaulting. The Chinese housing market has been a key driver for Chinese (and in turn global) economic growth over the last decades. Prices have risen consistently over many years, rewarding speculation along the way, and fuelling a self-reinforcing bubble.

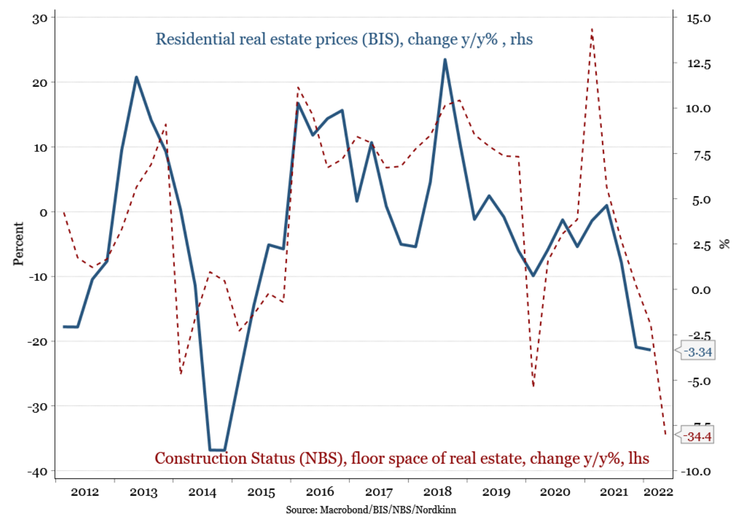
Chinese real estate is said to represent the most valuable asset class in the world as its market cap exceeds even that of the total U.S. stock market. It remains to be seen if the authorities can stabilise the market. In addition to this risk, China continues with its zero-tolerance covid policy, as the vaccination rate among the elderly is considered too low and the health services too weak to allow the virus to spread.

In the last four decades, policy makers in Europe and the U.S. have been quick to stimulate as soon as growth has weakened. But as highlighted in the market overview section, the prospects of a dovish policy pivot today appear dim. Central banks are explicitly set to tighten and keep policy tight "until the job is done".

Having said that, this cycle is very different from what we have seen in the past, warranting a humble approach when it comes to investment implications. Since the covid-outbreak, Europe and the U.S. have evolved through several distinct phases that normally plays out over a much longer time span.

In a scenario with a strong economic downturn and rapidly rising unemployment, central banks could still pivot sometime next year, even though a full return to ZIRP and QE seems unlikely given the outlook for sticky inflation. Central banks have lost credibility over the last couple of years and market participants are likely wise to think through their statements considering their limited ability to forecast inflation.





Nordic markets

After the seesaw developments on summer markets being marred by lower liquidity, we are now heading towards a winter of extreme macroeconomic uncertainties. Not only is the looming pan-European energy crisis brought to a head as heating demand kicks in with colder weather, but the unclear government response will either way strongly affect relative inflation outcomes. Also, wage negotiations will be finalised in key competitor economies, where early (albeit small) agreements point toward accelerating second-round effects.

Much as for other central banks, the Riksbank is thus faced with the challenge of balancing higher prices with weaker growth, perhaps even a recession. While markets seemed to pinch hope that weak growth would suffice to push wage and inflation growth rates lower, recent data demonstrate that price pressures are broadening and, as mentioned, indications of wage growth above what is compatible with the inflation target. In essence, this is suggestive of a first full circle of a 1970's style wage-price spiral.

Our deeply held belief is that neither the Riksbank nor other central banks will horse-trade with drifting inflation expectations and their inflation targets. Doing so would constitute a failure of their primary institutional objective. This is a view we mainly express in the theme: *"Global: Too soon for a dovish pivot"*. Consequently, we expect the Riksbank to continue hiking rates at a pace well in line with peers. And given the weakening SEK contributing further to cost pressures, an even faster pace cannot be excluded. From that perspective, having a fewer numbers of monetary policy meetings than peers, adds to the perceived difficulties in stabilising the SEK vs. other currencies.

Further, Sweden also faces the risk of a much deeper recession if housing market takes a turn for the worse. As house prices have already fallen some 8% since the February peak, even without variable mortgage interest rates rising much, we need to be very cognisant of worsening dynamics, as demonstrated in our theme *"Global: Hiking into recession"*. A deep recession – near-term – would, of course, imply a smaller risk of runaway inflation becoming entrenched in wages and inflation expectations.

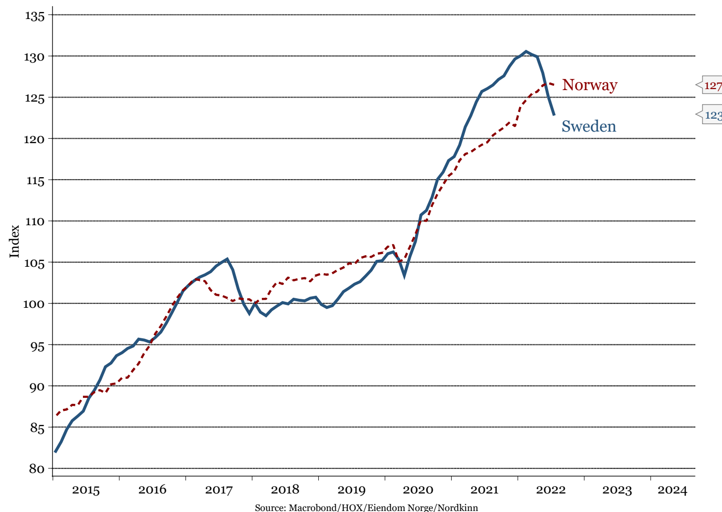
In Norway, the central bank has left behind its "gradual" tightening approach for good after CPI-TE inflation rose sharply during summer, to 4.5% in July. The Norges Bank hiked its key policy rate by 50 bps in both June and August despite explicitly guiding for 25 bps increments prior to both meetings. As a result, Norwegian forward interest rates rose sharply during August, underperforming peers. The market currently discounts a 3-month NIBOR around 4% by next summer, consistent with a key policy rate around 3.75%. This is 2 %-points above Norges Bank's estimate of neutral.

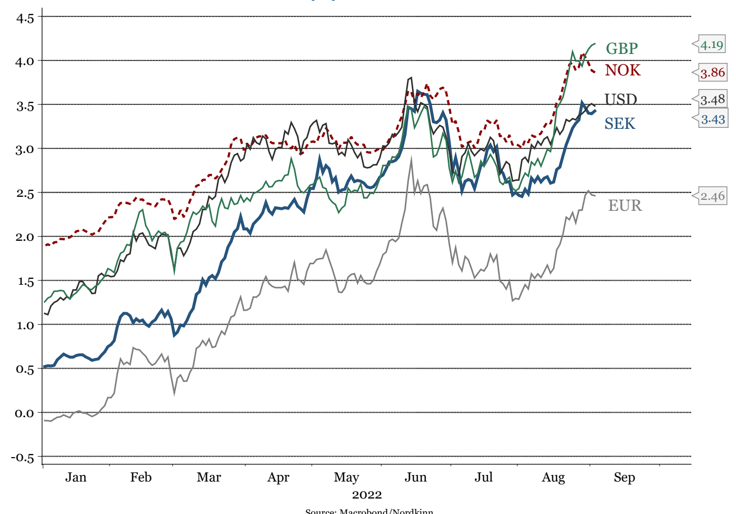
The latest repricing of interest rate expectations may have gone a little too far in our view. The new strategy of tightening monetary policy faster does not necessarily mean that the key policy rate will peak at a much higher level than the Norges Bank projected in June (3.10%). If the 3-month Nibor were to stabilise around 4% next year discounted by the FRA-market, mortgage rates will exceed 5%. Household's debt-to-income ratio is around 240% and the share of households with a fixed-rate mortgage is only 10%. Consequently, the transmission from higher interest rates to household's demand will likely prove strong and fast.

Moreover, while inflation is far above the 2.0% inflation target warranting a restrictive monetary policy stance, inflation is still well below relative to the inflation rates in most other countries. This notwithstanding, expected future money market rates are higher than in most other countries. To put it differently, the implied forward real interest rate in Norway is already well above peers.

Because inflation has surprised to the upside this summer, the Norges Bank has no alternative but to revise its interest rate path higher, especially in the near term. Meanwhile, the rise in the terminal rate will, in part, be offset by deteriorating growth outlook. On balance, we predict a key policy rate at 3.00% by year end, consistent with hikes of 50+50+25 bps at the next three meetings.

Moreover, we expect the Norges Bank's terminal rate in the upcoming report to be in the interval 3.25-3.50% as opposed to market expectations of almost 3.75%. However, because we expect weaker growth amid vulnerable households, we suspect that the Norges Bank's hiking campaign will come to an end before Christmas this year, at a lower interest rate level than currently discounted by the market. We express this view through cross market interest rate tightening trades.





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