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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – September 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

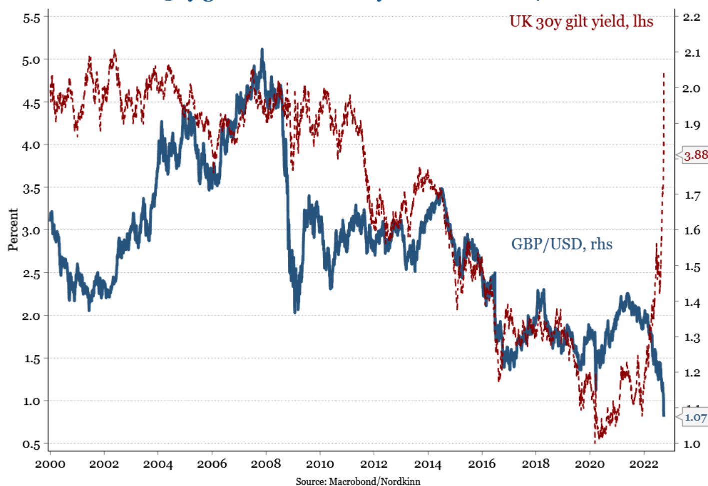
Much as seen through-out the whole third quarter, capital markets were highly volatile also in September. Investors had few places to hide as rapidly rising rates, broad and swift USD-strength, and a worsening global growth outlook led to consecutive sell-offs across fixed income, equity markets and commodities alike.

As government budgets deteriorate when costs to service public debt are on the rise, public finances are quickly becoming a market driver. The UK is the epicentre of this currently. With backdrop of the cost-of-living crisis, the new UK government's plan is to increase spending and cut taxes. In a structurally low inflation environment of the last decades, politicians got away with spending their way out, but not this time around. The announcement triggered a dramatic rise on UK gilt yields and a collapse to 50-year (!) lows in the GBP versus the USD, see chart. A few days later, yields retreated after the Bank of England announced purchases of longer dated gilts to restore orderly market conditions.

Having seen the market dynamics in the UK, sovereign rates rose in other weak(er) countries as well, including Italy following the right-wing populist Brothers of Italy's victory in the election. With a political program indicating unfinanced reforms worth circa 5% of GDP, yield on 10-year Italian government bonds has risen to around 4.5% and any further increase relative to German yields will likely test ECBs willingness and ability to contain non-core government bond yields.

Both the Fed and the ECB hiked policy rates by 75 bps in September signalling that there is more to come despite significantly weaker growth prospects. Fed members' expectations for future rates ("the dots") were shifted upwards indicating that the policy rate will stay "higher for longer". Chairman Powell repeated his promises to get inflation back to target and warned of more "pain" and a possible recession. In addition, the Fed will continue to reduce its bond holdings.

Our theme *"Global: Too soon for dovish pivot"* benefitted from higher U.S. real yields and steeper U.S. money market curve. Our new theme *"Global: Market implications of energy crisis"* was launched during September and contributed positively as well, amid higher German real yields. Our theme *"Global: Hiking into recession"*, positioned towards various curvature trades designed to benefit from downward pressure on the 3-5-year segment relative to the very short-end and the long-end of the curve, lost marginally as European yield curves sold-off in parallel during the September turbulence.



Nordic overview

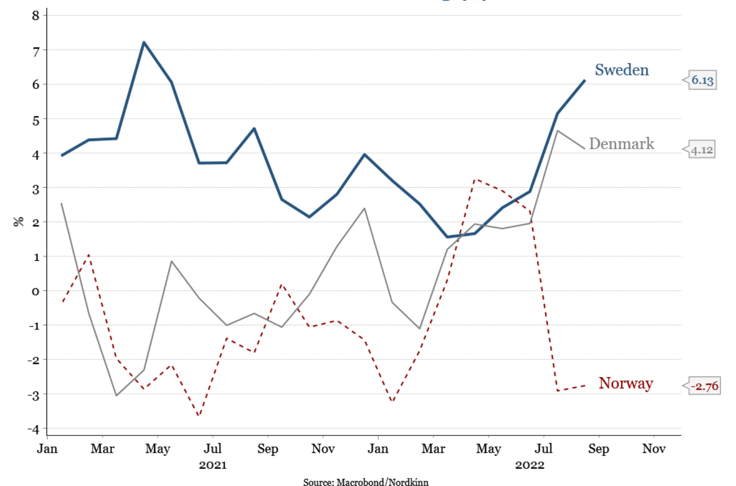
After an encouraging inflation outcome in July, Swedish inflation data in August disappointed the inflation fighting Riksbank, as e.g. furniture and clothing prices soared. Partly owing to the weak SEK, Swedish clothing prices have clearly been marked upwards compared to neighbouring countries, see chart. In short, the inflation outlook remains challenging for the Riksbank, and despite its 100 bps rate hike in September, the SEK failed to appreciate. The SEK exchange rate is at its weakest level since the financial crisis and will impact inflation via imported goods.

The interest rate peak in the new Riksbank projection was surprisingly low, only adjusted some 50 bps upwards to 2.50%. Hence, the Riksbank expects that no more than 75 bps of rate hikes are necessary to gain control over inflation. On one hand, this seems a bit modest given the persistent inflation challenges and the weakening currency. On the other, the interest rate sensitivity in the Swedish economy remains a big threat to the economic outlook. Furthermore, the new government is set to introduce new relief packages, such as compensations for energy costs, which ultimately will add to inflation.

As a result of the relatively low peak in the new Riksbank projection, Swedish fixed income performed well against e.g. German bonds, which helps to explain the weakening of the SEK post the Riksbank meeting.

In Norway, incoming data points to a clear slowdown in economic growth. Mainland-Norway GDP declined in July and the level was lower than in March. The Regional Network survey indicates lower activity and easing capacity constraints. Meanwhile, core CPI inflation rose further to a new peak of 4.7% in August, but this was marginally below consensus expectations. Against this background, we successfully captured profits from long fixed income positions in Norway early in the month as part of the *"Global: Tactical risk reward trading"* theme.

Later in the month we launched a new theme; *"Norway: Weaker growth dampens policy rate"* that seeks to exploit the elevated interest rate expectations in a context of a dovish Norges Bank pivot on September 22nd. While the Norges Bank hiked its key policy rate by 50 bps to 2.25% as expected, it indicated a slower pace of tightening at upcoming meetings. The cooling of the economy is projected to curb inflation over the medium-term and the projected peak rate was left unchanged at 3.1%. The new theme contributed slightly to performance despite massive headwinds from the European bond sell-off before month-end.



Global markets

Global economic growth prospects continue to deteriorate. OECD recently downgraded expected world GDP growth in 2023 to 2.2% from 2.8% previously, and the downgrades were broad-based. The German economy is expected to contract, the U.S. to basically stand still, while China is expected to grow only by 3.2%. The war in Ukraine, the synchronised tightening of monetary policies and China's zero COVID-policy were the main factors behind the downgrades. Despite growth projections falling rapidly, OECD expects inflation to remain high and sticky as inflationary pressures are broadening, and tight labour markets are leading to wage growth.

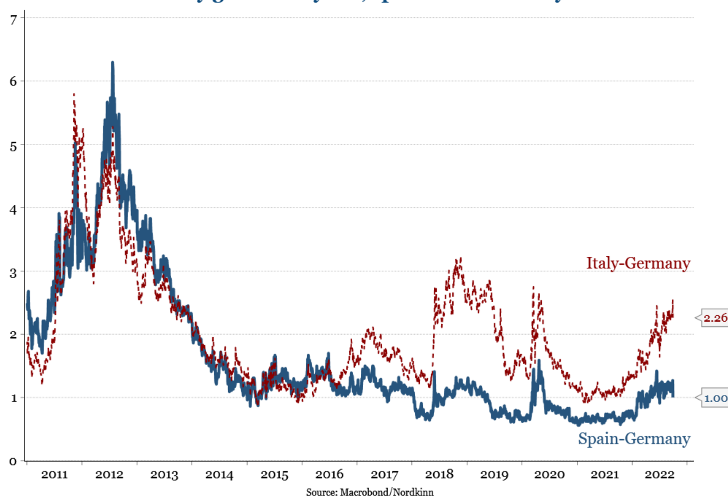
Before the pandemic disinflationary tailwinds from a rising global labour force, energy abundance, and expansion of global supply chains kept inflation at bay. Recently, these have all now turned to headwinds. As described in the overview section, an additional inflation risk came to the forefront with the UK government's intentions to spend their way out of the economic slowdown. While the severe market reaction could work as a warning to other politicians, we think the inflation versus growth trade off will become increasingly challenging going forward. Unemployment rates are still historically low, but as growth slows and unemployment rises, the political reflex to stimulate the economies will strengthen. Fiscal stimulus can however both prolong and worsen the inflation problem, as well as raise risk premiums on government bonds especially in countries with high debt levels.

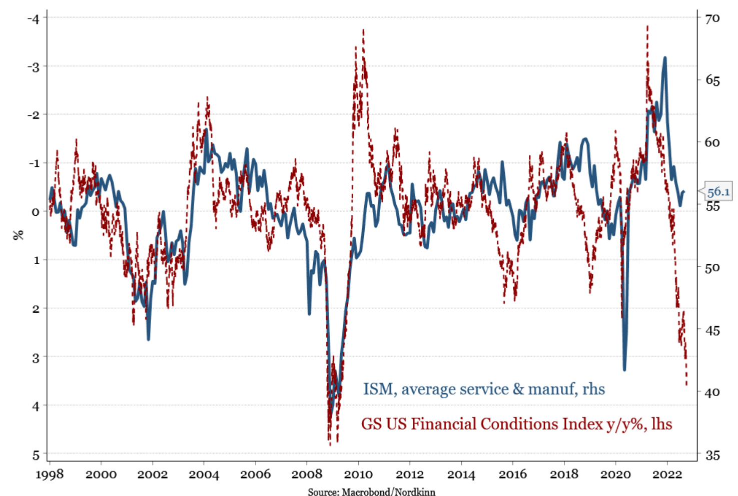
Europe, in particular the UK, is at the core of this dynamic as the energy crisis amplifies the economic downturn. Markets will question the debt sustainability for highly indebted countries that lack fiscal prudence. Within the Eurozone, Italy and Greece are the weakest links. Post the Italian election, yields on Italian government bonds have risen to new cycle highs both in absolute levels and relative to German bonds. ECBs willingness and ability to contain non-core government bond yields is likely to be tested. However, high inflation and ECBs path towards monetary tightening will constrain ECB in their support for peripheral countries. Hence, political risks are rising in the context of the energy crisis. Based on this dynamic we have entered trades that gain from higher European real bond yields and higher German longer-dated bond yields relative to the U.S. in the theme *"Global: Market implications of energy crises"*.

While the above factors point to upside risks to inflation, there are downside risks as well. With growth outlook deteriorating quickly, headline inflationary pressures are abating. Supply chain frictions are lower, most surveys point to less price pressures, energy and other commodity prices have been falling rapidly and market implied inflation expectations have fallen. Leading indicators also point to lower company earnings which should lower demand for labour. In the U.S., the supply of labour could also increase as the fall in asset values will incentivise workers to return to the labour force. Whether these cyclical factors will dominate the more structural inflationary forces or not, will depend on the strength of the downturn. Going forward inflation is expected to come down somewhat, but the key to a sustained fall is wage growth. Therefore, markets will likely be very sensitive to falling inflation and to signs of weakening labour markets.

The Fed expects a mild economic setback with unemployment to rise around 1%-point while keeping rates above 4% over the next two years. We believe that leading indicators for growth, company earnings and rapidly deteriorating financial conditions point to a stronger downturn, see chart. If the labour markets weaken more than expected, the Fed is likely to be the first major central bank to pivot as wage growth should ease, inflationary pressures from high energy prices are lower than in Europe and Asia, and the strong USD will lead to cheaper imports. Having observed the speed that the economies have evolved from trough to peak since the Covid-outbreak and how quickly both central bank narrative and markets can turn, we seek to remain nimble in the current environment. Consequently, following the sharp rise in bond yields in September, we have tactically reduced exposure to our *"Global: Too doon for dovish pivot"* theme.

Meanwhile, risks and market stress keep rising. This past month's developments in the UK with sovereign rates exploding higher and the currency collapsing have exposed new vulnerabilities. The USD with all its flaws and weaknesses still stand out as the safest harbour in turbulent times and the USD strength has indeed accelerated since mid-August. Rapid rise in the USD often precedes economic crises as companies and countries often have liabilities in USD and it seems likely that this time will be no different. In the theme *"Global: Hiking into recession"* we remain exposed to interest rate curvature trades that are designed to benefit from increased recession risks.





Nordic markets

At its September monetary policy meeting, the Riksbank lifted the policy rate (formely, the repo rate) by 100 bps, the biggest hike in the history of the Riksbank's inflation targeting regime. Despite this, financial markets reacted with something that can only be labelled as disappointment. The SEK weakened and, after a moment's hesitation, rates resumed an upward trajectory. However, when studying the Executive Board Minutes from the decision, it stands clear that the foreseen additional hikes of 75 bps (50 bps + 25 bps) could very well be considered a floor. The Riksbank board members are very clear, also in following speeches, that they must: (A) keep pace with leading central banks; (B) counter broad fiscal stimuli measures (which seem to be in the pipeline, following communication from the winning right-wing coalition), and; (C) neutralise any signs of second-round effects on wage formation which would fuel core inflation.

We, nonetheless, see many risks of second round effects during the autumn as companies at least partly try to compensate for surging costs on wages, but also other inputs. We also assume that the higher cost of living for households transpires into higher wage demands and/or job-switching into higher paying jobs, pushing not only negotiated wages higher, but also increasing wage drift. Forward electricity prices are also rising and rents are set to increase above normal for a couple of years. Media reporting suggests higher food prices (among other things due to higher electricity and higher interest rate costs), as companies have troubles maintaining production as costs keep rising.

In addition, productivity growth is weak and with higher input costs in general, unit costs are soaring. This is why companies will be forced to keep prices high(er) and be reluctant to cut prices, even in the face of weaker demand.

Spiking energy prices, together with rapidly rising interest rate costs and a possibly very weak housing market do, nonetheless, pose a non-negligible risk for a full-stop in the Swedish economy. This would, of course, also entail a rapidly changing outlook on inflation and interest rates. This tug-of-war between strong current demand and prices versus building recessionary forces and, eventually, fading inflation are now the main balancing act for us at Nordkinn. These are factors that we seek to explore by allocating risks between the two themes *"Global: Too soon for a dovish pivot"* and *"Global: Hiking into recession"*.

One year ago, the Norges Bank became the first Western central bank to raise interest rates after the pandemic. The reason had nothing to do with spot inflation, which was well below target at the time. Rather, the argument was that strong growth were expected to move inflation up towards target further out in time.

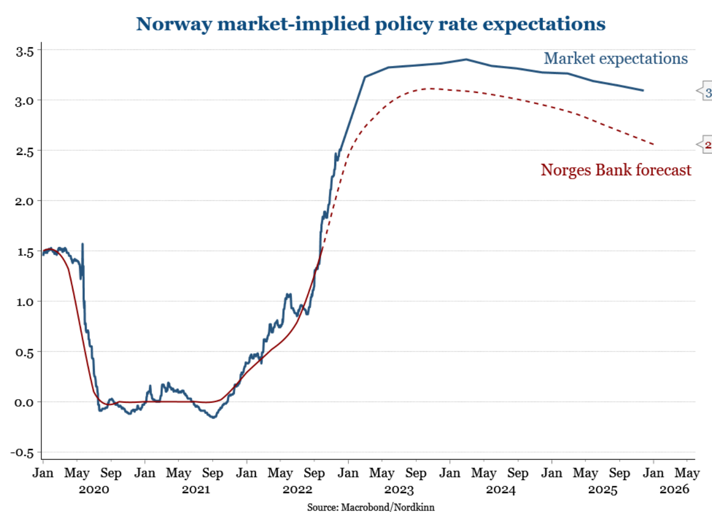
Now, the situation is the opposite. Inflation is high and still rising, but economic activity is stagnating as higher interest rates are starting to bite. Weak growth will, in turn, contribute to curbing inflationary pressures over the medium term. This implies that a more gradual approach to interest rate setting ahead is appropriate.

In other words, the Norges Bank is firmly holding on to a flexible, forward-looking monetary policy strategy. The new interest rate path is consistent with 2 x 25 bps of tightening at the remaining two meetings this year to 2.75% by year-end. Furthermore, the Norges Bank envisages one to two additional rate hikes next year. However, the actual number of rate hikes will depend on incoming data for both growth and inflation. As things stand now, we see significant downside risks to economic growth in coming months and more limited upside risks to inflation. On balance, this may imply that the key policy rate will peak below 3%, which is well below interest rate expectations currently prevailing in the market, see chart.

To capitalise on our pessimistic growth outlook in the context of the dovish Norges Bank pivot on September 22nd, we have launched a new investment theme *"Norway: Weaker growth dampens policy rate"*. In short, the theme is designed to benefit from lower NOK interest rates. Implementation will vary between directional and spread exposure when deemed appropriate and conditional on our macro view.

At instrument level, Norwegian government bonds appear particularly attractive in our view. 10-year government bonds cheapened substantially relative to swaps prior to the new 20-year bond syndication issued on September 27th. As the syndication attracted strong demand from life insurers and pension funds, Norwegian government bonds performed well relative to both swaps and against German Bunds, yet there is in our view substantial room for additional richening in coming months.

On that note we would add that the debt sustainability risk premium that has become visible in certain European countries could become another supportive factor for Norwegian high-quality sovereign bonds, on top of the already attractive valuation.



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