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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – October 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

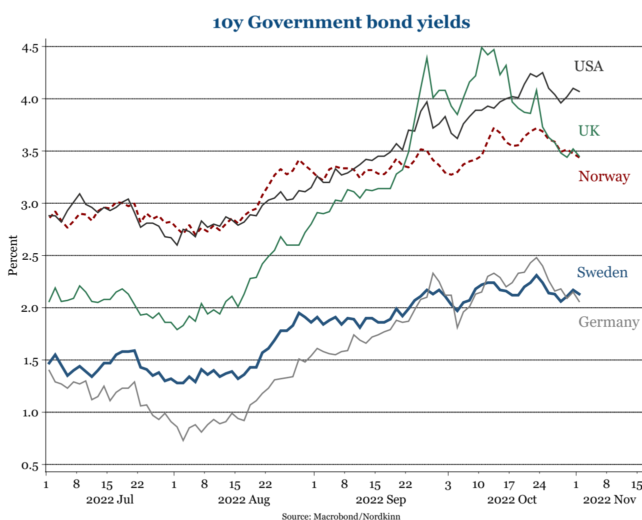
Global overview

Fixed income market volatility continued unabated in October as both UK Finance Minister Kwarteng and PM Liz Truss stepped down while leaving the UK fiscal policy outlook in an uproar. As the fiscal hawk Rishi Sunak took over the premiership and Bank of England said it would tweak the QT programme by e.g. holding off from selling long-dated bonds, the recent outsized impact from UK markets on global markets has, nonetheless, been tempered. On the geopolitical front risks keep building as Russia announced the annexation of occupied territories in Ukraine, threatening with the use of nuclear weapons in the process.

On the back of continued volatility, high inflation and still decent economic data – in particular labour market data – global interest rates continued their upward trajectory during October. That said, as central banks have made substantial progress in raising interest rates after summer and considering the lags in the economic response to monetary policy, the pace of tightening may be about to decrease.

Indeed, communications during the month from major central banks seem to vindicate the view of a of smaller increments ahead. For instance, Fed Vice Chair Brainard and SF Fed President Daly have indicated that the pace of hikes could come down near-term. From the ECB, President Lagarde, Chief Economist Lane and many others have underlined that there is no commitment to very large policy rate increases, in particular as ECB staff, according to Reuters, have suggested that neutral (deposit) rates are near 2%, only 50 bps higher than the current level. Other central banks, notably BoC and RBA, have even acted accordingly, hiking with 50 bps and 25 bps respectively, despite expectations for bigger steps and despite elevated inflation.

The market response to these signals, rightly or wrongly, has been to assume that we are approaching the peak in interest rates, albeit at a higher level than expected in September. Consequently, curves have flattened, which by and large benefitted trades in the theme *"Global: Hiking into recession"*. Moreover, *"Global: Too soon for dovish pivot"* contributed marginally positive even if our belief that frontloading of hikes would be interchanged for a more stretched-out hiking cycle in smaller steps proved premature. Meanwhile, *"Global: Market implications of energy crisis"* subtracted from performance as lower energy prices and less concern regarding sustainable fiscal policy benefitted European bonds, both nominal and real.



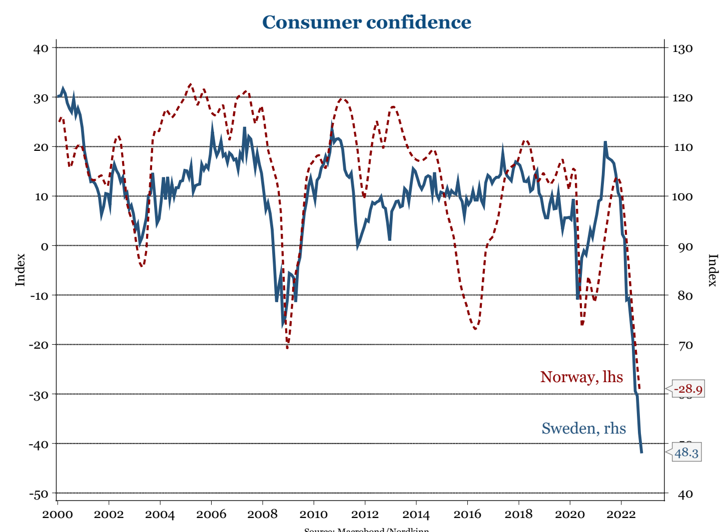
Nordic overview

According to survey data, the Swedish economy is entering a tough economic period. Consumer confidence declined to another historical low and the outlook for sectors like hotels, travelling and restaurants are deteriorating. On top of this, business surveys reveal slowing orders from foreign trade. Meanwhile, for the first time in a while core CPIF inflation for September was in line with expectations. Consequently, the fixed income market, which was discounting a much more hawkish rate outlook than the Riksbank had projected, was to a lesser extent than other markets affected by the global bond sell-off early in the month.

Both households and companies are highly leveraged and at short durations, making the Swedish economy highly exposed to changes in interest rates. As we expect more pain ahead, in October we opened a new investment theme, "*Sweden: Reality bites*". The theme's performance suffered initially, but eventually pared losses as incoming data confirmed the weakening economic outlook, pushing short-term interest rates down. In addition, high headline CPI inflation spurred performance in break-even inflation rates, contributing positively to the theme *"Global: Comparative inflation expectations".*

In Norway, most business indicators deteriorated further and point to a clear slowdown in activity. Meanwhile, consumer confidence is record low as interest rates and energy prices depress real disposable income. As a result, the housing market has begun to weaken as demonstrated by falling prices and lower sales. On the other hand, the GDP slowdown over the summer was less pronounced than previously thought according to revised data. Moreover, the registered unemployment rate stood at a remarkably low 1.6% in October, slightly below Norges Bank's forecast. Furthermore, core CPI inflation rose 5.3% from a year earlier, 0.3%-points more than projected by the Norges Bank.

As a result of stronger than expected data for GDP, the labour market and CPI, Norwegian interest rates rose sharply during the first couple of weeks in October, underperforming peers. Following this spectacular move, one position in the theme *"Norway: Weaker growth dampens policy rate"* reached the pre-defined stop-loss level and was closed out. Consequently, even though the Norwegian fixed income market recovered later in the month, the rest of this theme was unable to offset previous losses, resulting in a negative contribution to performance overall in October.



Global markets

A global recession is drawing nearer. On the surface, developed economies showed decent growth rates in Q3. Looking at details, it nonetheless stands clear that private demand is weakening, which could very well turn into a trend given what reliable and timely indicators are currently suggesting. In particular, the U.S. Treasury 10y-3m spread is in negative territory, indicating that a U.S. recession is imminent, see chart. The rapid worsening of housing markets is also a historical precursor to a considerably weaker U.S. economy.

That said, other indicators suggest that the U.S. economy seems to be holding up reasonably well. The so called Sahm-rule - an oft-cited recession indicator - posits that it is only when the three-month moving average of the U.S. national unemployment rate (U3) rises by ½ percentage points relative to its low during the previous 12 months that a recession is brewing. Currently, the unemployment rate remains at a 12-month low, indicating some leeway before expecting a recession.

Admittedly, job openings have come down somewhat over the past couple of months, but the U.S. labour market is still short almost 4 million workers (!) to fill all available positions. Consequently, wages are rising at a fast clip and some measures are even outpacing inflation in consecutive terms.

In a sense, measures on corporate price plans are moderating, but the net balance of companies foreseeing hikes versus cuts in prices is still overwhelmingly positive, implying that price pressures might not yet be receding. Small companies, in particular, are indicating very weak earnings developments, providing a litmus test of the Fed's inflation fighting resolve as there is a non-negligible risk that future price hikes will exceed rising input costs, including wages, stoking a wage-price spiral. The very weak productivity growth and the, conversely, very high unit labour cost growth give further testament to the untenable situation the Fed finds itself in.

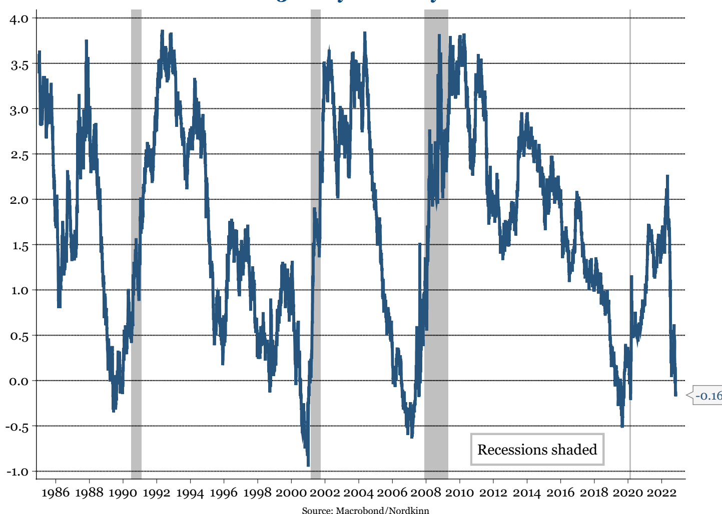
According to ECB, such developments are not (yet) visible in the euro area as margins and prices rise in tandem despite (somewhat) higher wages and input prices. However, the firmness of key mechanisms for preventing a situation akin to the wage-price spirals of the 1970's and early 1980's is in jeopardy: (1) Longer-term inflation expectations are close to the inflation target, but show clear signs of rising, see chart.

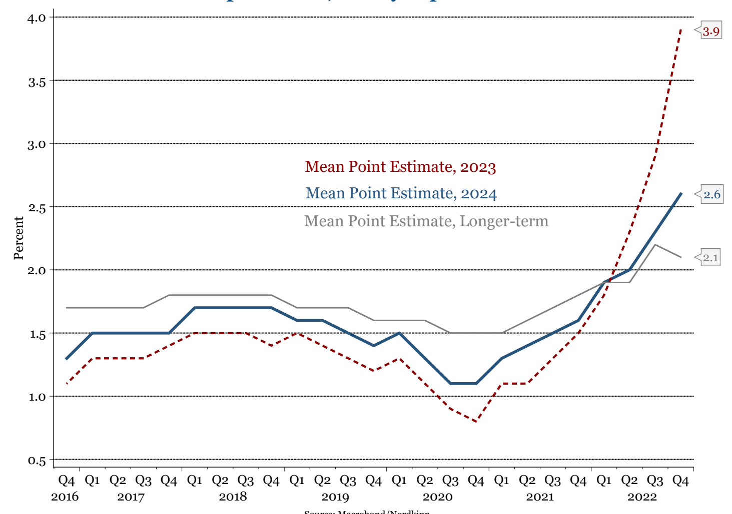
(2) Fiscal policy frameworks have come under severe strain as even fiscally conservative countries such as Germany are now accepting budget deficits clearly in excess of what is recommended. And with massive looming investments in energy, defence, etc., it is difficult to see the fiscal situation improve in any meaningful way over the coming years. In addition (3), the very tight labour markets suggest that the bargaining power of unions and workers is stronger than in a very long time. Indeed, nominal compensation growth is now higher than at any time since the introduction of the Euro, and anecdotal evidence hint at a high result from the ongoing wage bargaining round.

Hence, the lasting impression is that neither the Fed nor the ECB is set for a near-term policy pivot. Markets are, nonetheless, paying more attention to recessionary signals that are, admittedly, flashing more frequently now than just a few months ago. Importantly, this is mainly a trait of European economies as they are both more exposed to the ongoing energy crisis in the wake of the war in Ukraine and often also more sensitive to higher interest rates. This tug of war between policy makers and markets is something that we continuously exploit via shifting risk between the investment themes *"Too soon for a dovish pivot"* and *"Hiking into recession"*. The relatively stronger impact on euro area economies from higher energy prices is also something we try to capitalise on in the theme *"Market implications of energy crises"*.

Demand has been remarkably resilient in the face of massive hikes from all major central banks and, in particular, the labour market has held up well. The prospect of a "soft landing" is, thus, getting farther away as (core) inflation shows only scant evidence of receding. To put it bluntly, we are of the opinion that Fed, ECB and other central banks have little option but to continue hiking until something – i.e. the economy – eventually breaks.

In a closer time frame, the foreseen growth deceleration coupled with policy rates approaching or even exceeding neutral rates, suggest that the size of hikes should soon normalise. This is something that complicates central bank communications and the up until now straightforward task of tightening financial conditions. From our perspective, this is a clear indication that relative value and curve trades will become more interesting ahead, as central banks diverge in their need and ability to tighten financial conditions.





Nordic markets

The Swedish economy is slowing. Perhaps not a big surprise given the high interest rate sensitivity. Inflation is still running high, though, and are too elevated for the Riksbank to react to slower economic outlook. The labour market is tight and there is little evidence of an immediate worsening. The risk for a more persistent inflation is often referred to how much wages will increase over the next years. Unions from the industry presented their demands ahead of the negotiations early next year. The demand for a one-year deal was relatively subdued, at 4.4%. If this sets the benchmark for the labour market, the risk for a wage-price-spiral over the next one to two years will be curbed, and arguably positive for the Riksbank. However, if inflation remains at a higher level throughout 2023, a new round of negotiations in early 2024, will be much more challenging. Needless to say, the Riksbank need to get inflation lower in 2023.

Contrary to when going into the monetary policy meeting in September, the Riksbank´s inflation projections are now in line, or above, the latest inflation data. Evidence of a slower economy is also piling up while wage demand seems to be relatively muted. Does this set the stage for a less hawkish RIksbank at the next meeting late November? The Riksbank stresses its dependence on neighbouring central bank the ECB, which hiked another 75 bps at their October meeting. This shrank the distance between the two central banks' policy rates which poses a problem for the Riksbank as the weak SEK affects imported inflation. While market pricing of future Riksbank hikes seems a bit stretched, more is coming. And the more hikes, the more pain to the Swedish economy. In the new theme *"Sweden: Reality bites"* we address this pain in positions for lower 2 to 3-year interest rates and for steeper forward rate curves.

Late in October, Swedish market-based inflation expectations and real rates cheapened relative to euro area peers. Over the next few years Swedish headline inflation, CPI, is expected to unfold pretty much in line with European HICP and real rates are expected to be higher. We think risks a clearly to the upside. Admittedly, Swedish underlying inflation normally moves close to HICP, but deviations are often explained by movements in the currency. Even more importantly, hikes affect Swedish CPI (ECB hikes are not affecting EUR HICP in the same way) and will therefore result in higher headline inflation and lower real yields. So, the weak SEK and rising mortgage costs will push Swedish inflation higher relative to the euro area.

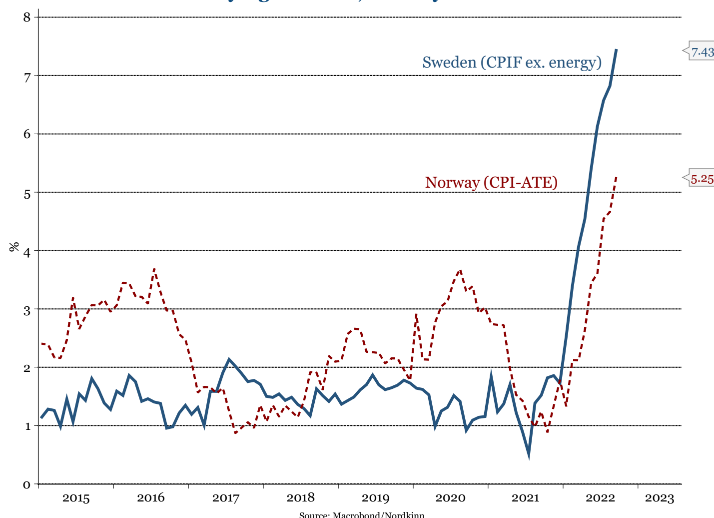
In Norway, the market once again casted doubt on Norges Bank's interest rate intentions after higher CPI inflation and lower registered unemployment than projected in the September Monetary Policy Report. After all, the Norges Bank hiked 50 bps in both June and August even though the the Norges Bank prior to both meetings had explicitly signalled that 25 bps increments were most likely.

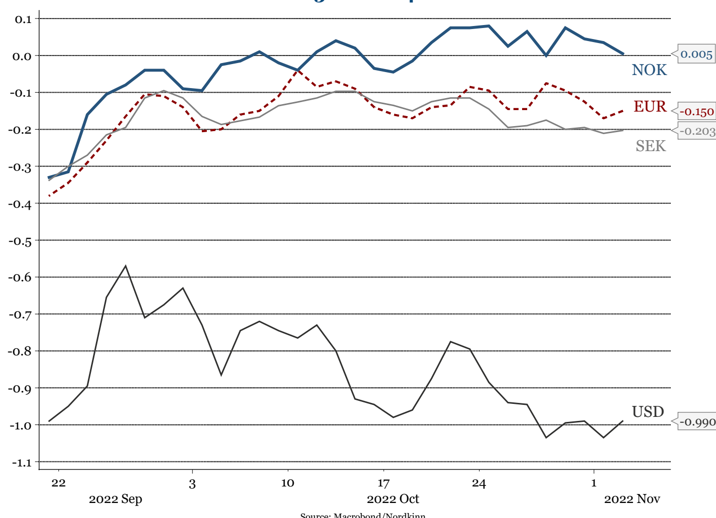
Nonetheless, the situation now is a bit different than it was during summer, for three reasons: 1) The inflation shock, i.e. the deviation between Norges Bank's forecast and the actual outcome, was much larger during spring and summer than we are witnessing now; 2) The key policy rate was below estimates of "neutral" during the summer months, but are presumably in restrictive territory now; 3) Although revised GDP data were better than previously thought, and the registered unemployment rate remains stubbornly low, there are undisputable evidence that the economy is cooling as monetary policy is having a tightening effect on the economy.

Consequently, the combination of a restrictive monetary policy stance and signs of cyclical slowdown is still expected to curbing inflation over the medium-term. In this context, while we expect the key policy rate to be raised further in December and possibly in January as well, it is appropriate to move ahead with smaller steps.

Turning to investment implications, the NOK interest rate curve continues to discount a higher terminal rate than we expect to be realised, yet at current levels and in considering the uncertain environment for global bond yields, the risk-reward associated with outright receiving trades are not overly compelling in our view. Rather, the relatively steep interest rate curve between 2023 and 2024/2025 is in our view attractive to fade. The outlook for weak economic actively and lower inflation over the medium-term will likely put rate cuts on the agenda a year from now. This could in our view be insufficiently discounted even in the U.S. curve, not to mention in Europe, see chart. Positions for flatter NOK FRA curves are organised under the *"Global: Hiking into recession"* theme.

Added to that, Norwegian government bonds offer in our view good value relative to other markets that are in the process of unwinding QE, which we express within the theme *"Norway: Weaker growth dampens policy rate"*. Finally, having been supported by a positive risk sentiment during the second half of October, we expect the NOK exchange rate to face renewed selling pressure from the weaker economic outlook, which is likely to weigh on risk appetite towards the end of the year.





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