NORDKINN

ASSET MANAGEMENT

# Nordkinn Market Review & Outlook – November 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

On November 2nd, the Fed hiked policy rates by another 75 bps as generally expected, bringing the Fed Funds Rate Target band to 3.75%-4.00%. In its accompanying statement, the FOMC stated that future rate increases "will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments." Markets interpreted this as the Fed will be moving in smaller increments of 25-50 bps. October CPI-inflation provided further support for a slower hiking phase as both headline and core data came in 0.2 percentage points lower than expected.

At the time of writing the market discounts near 50 bps hikes in both December and February, with the risk tilted to the downside at the latter meeting. Soon thereafter, the Fed is expected to reach a "terminal rate" (peak rate in this cycle) of just below 5.00%.

Lower inflation and prospects of a more measured pace of hiking (and an eventual policy "pivot") have resulted in some moderation of still elevated volatility on financial markets, providing strong relief for risky assets. Meanwhile, better-than-expected activity data in some major developed economies and speculation that China is about to ease its covid policy have also buoyed risky assets and industrial commodities. The above developments served to pull the USD down from highs early in November; intra-month the USD is down by more than 5% measured in Fed's advanced foreign economies currency index. From a fixed income perspective, the main result has been flatter money market curves, driven by the long-end in particular. Almost by definition, this has benefited our global theme *"Global: Hiking into recession".*

U.S. inflation markets also took notice of lower-than-expected U.S. CPI-data. Break-Even Inflation (BEI) rates declined across the curve in most markets. To some extent this was offset by the positive inflation carry during the month, especially in SGBi's. Swedish inflation, including carry, performed better than peers in Euro Area and contributed positively to our theme *"Global: Comparative Inflation expectations"*.

Finally, our belief that the frontloading of hikes would be interchanged for a more drawn-out hiking cycle in smaller steps was ultimately vindicated, providing strong returns also to our theme *"Global: Too soon for a dovish pivot"*, where we have been trading actively during the month, to lock in profits from early November.

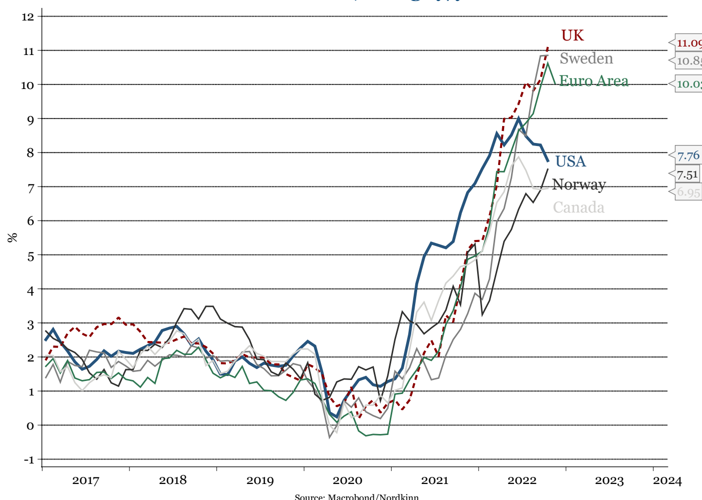
## Nordic overview

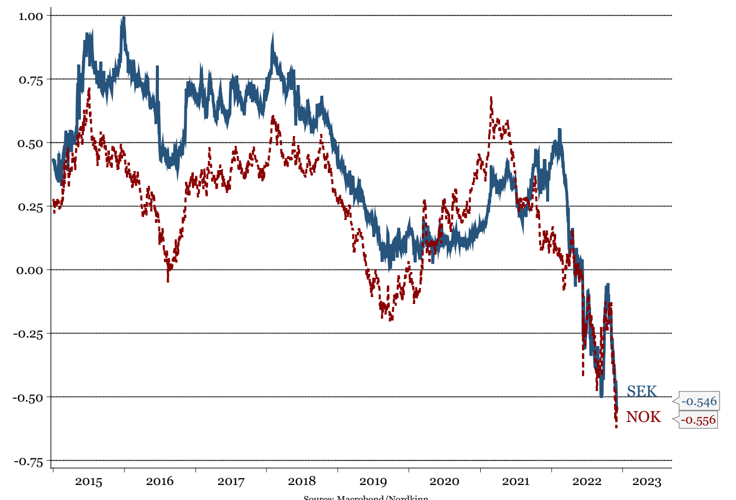
Swedish interest rates fell in line with the surrounding world as global yield curves flattened extensively. Only the very front-end of the SEK curve moved higher as core inflation (CPIF excluding energy) surprised markedly to the upside, even though headline inflation was slightly lower. The monthly change in the core measure was the third biggest after the financial crisis. This suggests underlying inflation is yet to slow. The inflation data underpinned performance of CPI linked bonds. The decline in Break-Even Inflation rates did not offset the positive inflation carry. In addition, pressure remained on the Riksbank to continue hiking and at the November meeting the policy rate was lifted by another 75 bps to 2.50%, in line with expectations. The Riksbank projects the rate to peak at 2.84%, so another 25-50bps of rate hikes.

While the yield curve has been flattening for some time, now the short end of the curve, i.e. the money market curve, started to flatten more significantly as the market started to pricing rate cuts beginning late 2023. This move benefitted the theme *"Sweden: Reality bites"*, which was however partly offset by losses on long-end shorts in Sweden.

In Norway, the Norges Bank hiked its key policy rate by 25 bps to 2.50% as we expected, while consensus was for a 50 bps hike. This contributed initially to a decline in NOK rates, though it was short-lived. A few days later, core CPI data for October surprised significantly to the upside and Q3 GDP data was better than expected as well. Combined, incoming data during the month in review challenged the Norges Bank's endeavour of returning inflation to its 2% target in a timely manner, hence implying upside risks to the current interest rate projection.

As a matter of fact, they also questioned the rationale behind our theme *"Norway: Weaker growth dampens policy rate"*. Even so, the theme contributed to performance predominantly for two reasons. First, we managed positions within the theme very actively during the month, such as taking partial profit after the "dovish" Norges Bank hike and working with hedges ahead of the CPI release to which we estimated the risk was skewed towards the upside. Second, the increase in Norwegian interest rates in the first half of the month triggered issued-related receiving interest from real money investors in the latter half of the month, pushing rates downwards. Finally, positions for flatter NOK money market curves organised under "*Global: Hiking into recession*" contributed to performance as well.



## Global markets

Financial markets' focus continues to be squarely on inflation. While this is understandable, prices are not set in a vacuum and, as previously mentioned, economic data in developed markets surprised to the upside recently, see chart. In addition, with labour markets historically tight, wage indicators are high and, in many instances, rising.

We have little dissent with the theoretical argument on stable inflation expectations making wage and price inflation a self-correcting process. However, whether inflation expectations in practice will be able to pin down future wage hikes or not is still an open question, especially since current measures of inflation expectations are both poorly defined and dubious from a policy making perspective.

Hence, before full-on embarking on recessionary trades such as falling short-term rates, money market flatteners or forward starting steepeners, we would like to see more concrete evidence of wages and inflation coming down in sectors that are less interest rate sensitive.

It is not surprising that interest rate sensitive sectors of the economy, e.g., housing and durable goods, are softening given the amount of tightening already in the pipeline and currently working its way through the financial system. Instead, turning focus more narrowly on services prices and wages that are not directly affected by tighter financial conditions, we attempt to distinguish between the direct effects of higher financing costs versus price changes governed by the expectations of economic agents such as labour union wage negotiators. In the service sectors, the evidence of a slowdown is less obvious. For example, consumption growth of non-durable goods (excl. energy) and services is still very high, and employment growth as well as job opportunities and wage growth are still strong in industry sectors such as Business Services, Information etc.

Also, with wage growth high and productivity weak, unit labour costs have soared, eating into profits and margins in the business sector. Our call is that demand has not yet slowed sufficiently to stop companies from adjusting this situation by hiking prices. From that perspective, we pay extra notice to surveys of small businesses, predominantly in different services industries, indicating that price and compensation plans are, again, on the rise. The improvement, albeit admittedly small, in earnings only serves to highlight that impression.

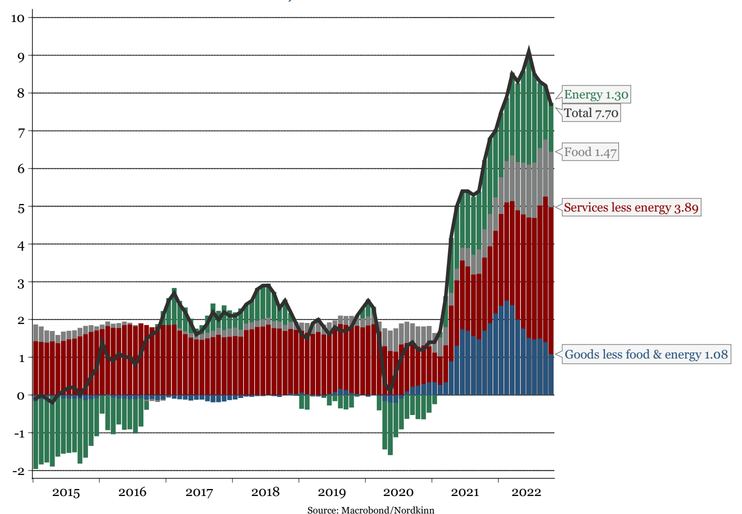
The short version, then, is that we continue to see risk of inflation outcomes above market expectations and will continue to allocate risk in and out of our two main global themes *"Global: Hiking into recession"* and *"Global: Too soon for a dovish pivot"* exploiting perceived inefficiencies on and between financial markets.

This begs the question if we should not position for higher short-term rates? To provide some colour, our disposition is indeed for terminal rates to be a tad higher than currently priced, but risk-reward is not yet sufficiently attractive and, importantly, markets seem increasingly eager to "trade the pivot". Therefore, as we expect headline inflation to come down but core and services inflation to prove more persistent, we feel more confident in positioning for somewhat higher rates past the immediate near term. These positions should also react positively to continued demand growth and benign labour market data.

Looking further out the curve, the current flow of data is also supportive for our theme *"Global: Hiking into recession".* If the Fed needs to hike further and/or at least keep rates "higher for longer", the eventual downturn should prove more difficult to manage. A more severe downturn can be framed in numerous ways, but we prefer to express it farther out on the yield curve.

Against the backdrop of modest liquidity and elevated volatility on fixed income markets, risks are plentiful. Fed's Quantitative Tightening is in full swing and the ECB will soon commence a similar process, as will the Riksbank. Liquidity-driven events are not something we can easily shield the portfolio from, other than to keep risk utilisation contained and under strict control while focusing on taking liquidity risks into account already at initiation of each trade.

Mindful of risks to our outlook, we do consider that the global economy is weakening, a more abrupt drop into recession cannot be ruled out, with sharp rises in unemployment rates and falling core inflation on one hand. On the other hand, a reacceleration of the global economy on the back of, e.g., a swift China reopening or an end to Russia's war on Ukraine, with rising medium- and long-term rates is also a distinct possibility. Both these scenarios could incur losses on some of our positions.



# Nordic markets

Market pricing implies a rather optimistic economic outlook. The market expects the Riksbank policy rate to peak sometime during summer next year, around 3%, before falling only very gradually back to 2.50% by summer 2025. In our view, this is only achievable in a soft-landing scenario, despite the tightest monetary policy seen in many years, or very sticky inflation above target. However, judging from professional forecasters and market implied expectations, the consensus view appears to be that inflation will move back close to target by end of next year. Further out in time, forward Break-Even Inflation (BEI) rates implies a return to the low inflation environment before the pandemic. The 5y5y (i.e. 5-year rate 5 years from now) BEI rate, for instance, traded near 1.65% at month close.

We believe that the market is too complacent, not only in Sweden but also in other markets. History shows it might take longer time to tame underlying inflation when it has been so elevated. The notion that inflation will 'normalise' relatively quickly while the damage on the economy will be limited is a very favourable scenario. It is true that economies have been relatively resilient so far, but inflation has also been higher and more protracted than expected. We doubt the economic macro landscape will quickly return to an environment of very low and stable inflation as well as with extremely low interest rates. There are several forces that will work in the other direction, such as demographics, de-globalisation and adaptations to climate change. This might, however, be hard to detect during a plausible cyclical decline in inflation in the next year(s).

We continue to believe the Riksbank has further work to do to get inflation under control by front loading hikes (the Fed playbook). At the February meeting inflation will still be very elevated, hard to neglect. The risk for overtightening is evident and thus the short-end of the yield curve will have more room to flatten. However, we will continue to be active and opportunistic in trading the markets amid the elevated volatility. We also expect inflation and economic data to be volatile. This will need us to continue to be nimble.

In Norway, growth is slowing as tighter monetary policy keeps transmitting throughout the economy. Having said that, developments in GDP and the labour market suggest a somewhat more resilient economy than the Norges Bank had projected. To be sure, any evidence of slowing labour market conditions is few and far between, suggesting upside risk to the centralised wage negotiation round that will commence early next year.

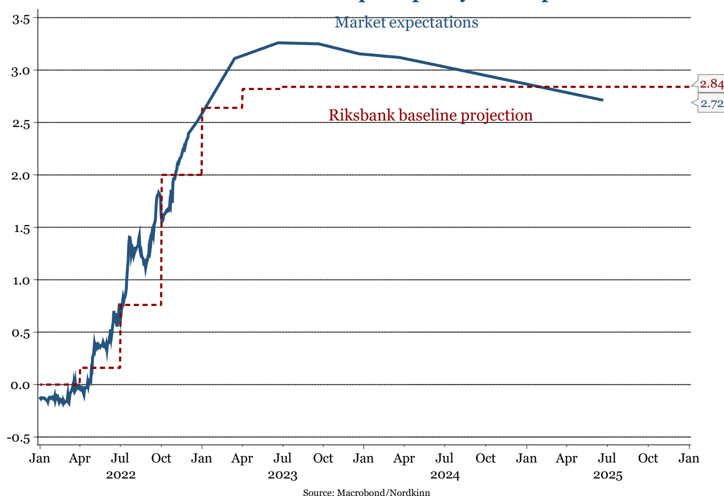
Moreover, in October core CPI inflation was 0.9%-points above Norges Bank's projection, a significant deviation. Taken together, incoming data supports a higher peak in the key policy rate compared with the September projection by the MPC.

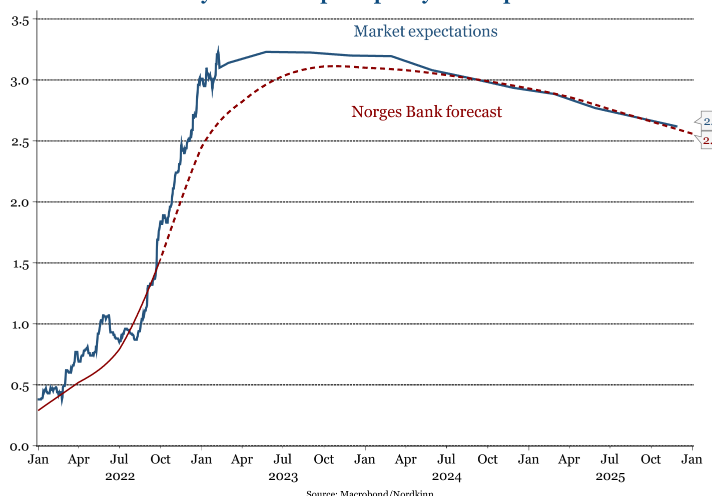
Having slowed the pace of tightening to 25 bps steps in November when hiking to 2.50%, we doubt the Norges Bank will accelerate the pace of tightening back to 50 bps steps again in December. After all, the key policy rate is above estimates of "neutral" and the Committee will consider the cumulated tightening and the lags with which monetary policy affects the economy and inflation. It is therefore appropriate to move ahead in a more gradual, yet resolutely manner. In our view, instead of hiking by 50 bps in December, the Norges Bank will add more 25 bps rate hikes to its interest rate projection next year. We expect the Norges Bank to signal an interest rate peak of between 3.25 and 3.50%.

Turning to investment implications, we broadly agree with current market expectations regarding the likely interest rate peak next year, see chart. On the one hand, we see upside risks to core CPI inflation among other factors stemming from housing rentals and the upcoming wage negotiation rounds. On the other hand, household demand is very interest rate sensitive and a further slowdown in economic activity is inevitable in our view.

Consequently, our *"Norway: Weaker growth dampens policy rate"* theme continues to make perfect sense in our view. The Dec22 FRA is too elevated in our view, and we see scope for a decline vis-à-vis the other front FRAs as inflation and growth appear more resilient in the near-term. But given our expectations that cyclical inflation and growth will slow markedly a year from now, implied interest rate expectations prevailing in the market a few years ahead are too high in our view. In this context, we are positioned for steeper forward starting interest rate curves. Furthermore, longer-term government bonds offer good value relative to other markets that are in various stages in commencing to unwinding QE.

As regards the NOK exchange rate, the combination of higher global bond yields and a challenging global macroeconomic environment warrants a cautious approach to both risky assets and the NOK in December – a month where liquidity sometimes dry up.



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