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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – December 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

Benign macro data during December was overshadowed by decidedly hawkish messages from major central banks, not least the ECB. In response, global interest rates rose, while global stock markets fell and other risky markets deteriorated in tandem.

November inflation data coming in slightly better than expected, lured fixed income markets towards expecting for both the Fed and the ECB to acknowledge an improving inflation outlook and raised hopes for a slower and lower hiking cycle going forward.

While the Fed did deliver the widely expected 50 bps hike at its two-day meeting on December 13-14th, the updated projections demonstrated a broad-based consensus on continuing the historically aggressive tightening cycle and – importantly – to keep interest rates elevated for the remainder of 2023. Fed Chair Powell reiterated that "the historical record cautions strongly against prematurely loosening policy".

In Europe, overall inflation moderated, and the somewhat warmer weather than normal also helped stave off tail risks from energy supply to both inflation and growth. That said, during the last couple of months, information pointing to higher cost pressures, with obvious second round effects from energy and food prices, but also indirect effects on wage formation, have all been building. Ultimately, the latter set of data proved more important and pushed up ECB's staff projections on future inflation to levels far above the ECB's mandate. The ECB "hawks" seized this opportunity to push for the policy rate to rise "significantly and at a steady pace" and for an unexpectedly detailed commitment to start reducing ECB's balance sheet.

As a consequence, global macro developments during December have resulted in markedly rising bond yields, see chart. This development has been more pronounced in the Euro area, which benefitted both directional and relative value positions in our global theme *"Market implications of the energy crisis"*.

In addition, the hawkish ECB announcements together with lower consumer prices moved European market-based inflation expectations markedly lower during the month, although they recovered somewhat later in the month. In Sweden electricity prices were disturbingly elevated. Hence, Swedish Break-Even Inflation outperformed European peers in the month and the theme *"Global: Comparative inflation expectations"* contributed positively to the month´s return.

Nordic overview

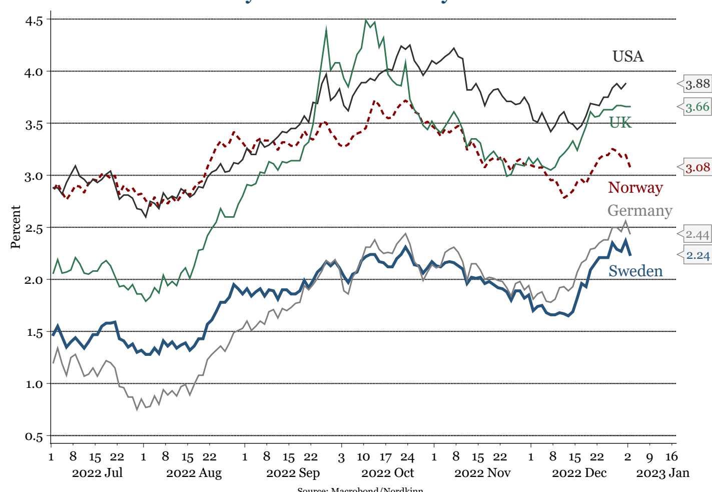
Reverb from the very hawkish ECB meeting on December 15th had large impact also on the Swedish fixed income market. The market repriced the Riksbank's peak rate by late summer 2023 to 3.5%, from 3.0% at the end of November. Meanwhile, as central banks worldwide signal higher policy rates for longer, combined with investors preparing for the upcoming shrinking of central banks' balance sheets, long-term rates rose even more than short term rates, causing the Swedish yield curve to steepen.

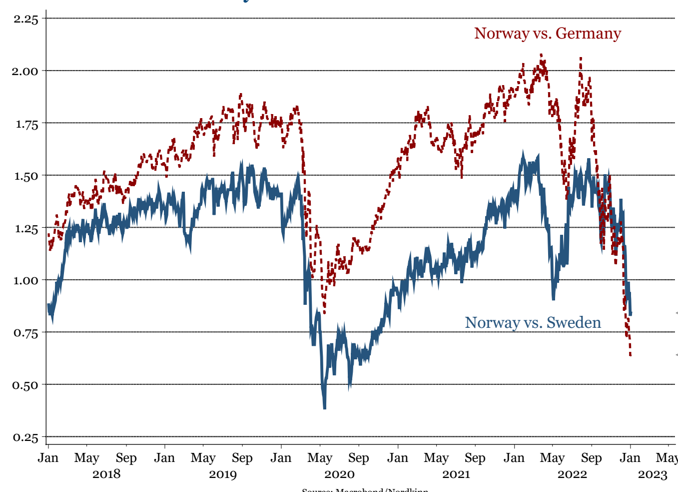
The Riksbank conducted its last bond purchases in December, thereby ending a seven-year-old era of quantitative easing of monetary policy. As reinvestments are discontinued, the balance sheet will start to shrink in tandem with redemptions in 2023. Perhaps in response to this development, the Swedish yield curve adapted a somewhat more normal shape in December, with the 10-year yield ending just 10 bps below the key policy rate, compared to -75 bps at the beginning of the month. The steepening of the Swedish yield curve benefitted the theme *"Sweden: Reality bites"*.

The SEK struggled in the month and approached all-time lows vs. the EUR, possibly related to the worsening economic outlook due to the highly interest rate sensitive Swedish households. As profits from tactical NOK/SEK trading were unable to offset losses on EUR/SEK, our *"Tactical risk reward trading"* subtracted from performance.

In Norway, the Norges Bank hiked its key policy rate by 25 bps to 2.75% as expected. However, the Bank's updated interest rate projection was broadly unchanged from September, indicating a peak of between 3.00% and 3.25% in 2023. This was more hawkish than consensus expectations, as lower than expected inflation in December and a weaker than expected Regional Network report had pushed interest rate expectations markedly lower prior to the announcement.

Despite the hawkish Norges Bank, the Norwegian fixed income market performed strongly relative to peers in December, see chart. This was one important element behind the positive performance of our theme *"Norway: Weaker growth dampens policy rate"*. In addition, our tactical short positioning ahead of the more hawkish Norges Bank meeting and steeper forward starting NOK interest rate curve trades, contributed positively as well.





Global markets

Key policy rates are now in restrictive territory in all major economies. With the recent renewed central bank hawkishness and subsequent market developments, we believe that we are approaching something that could be labelled "peak hawkishness". To us, this suggests that our theme *"Global: Too soon for a dovish pivot"* will gradually fade in importance.

In most economies, current expectations of further hikes and/or a further extension of the expected period of rates in restrictive territory will be very hard to achieve without also observing a clear de-anchoring of inflation expectations. We see little evidence of that materialising. Rather, now that international prices on food and energy and other input goods seem to be stabilising, we believe that risk-reward may increasingly shift in favour of trades that benefit from recessionary signals. As such, the investment themes *"Hiking into recession"* and *"Market implication of energy crisis"* remain ever more relevant.

While our expectations of recession remain, we anticipate reasons to differentiate more clearly between the relatively robust U.S. economy and the not-so-robust European economies, and perhaps also from the highly interest rate sensitive Nordic economies and commodity-driven developing economies.

The U.S. economy has become a beacon of strength, with labour markets indicating a shortage of workers amounting to approximately 4.5 million persons, even if all those currently unemployed were to find employment. As a result, wages have soared to levels not seen since the early 1980's, see chart. As overall inflation is coming down, the outlook for consumption is in fact improving and there is even a non-negligible chance that a recession may be avoided. The main risk for the U.S. economy is spill-over effects on demand from a weaker U.S. housing market (driven in turn by higher mortgage rates).

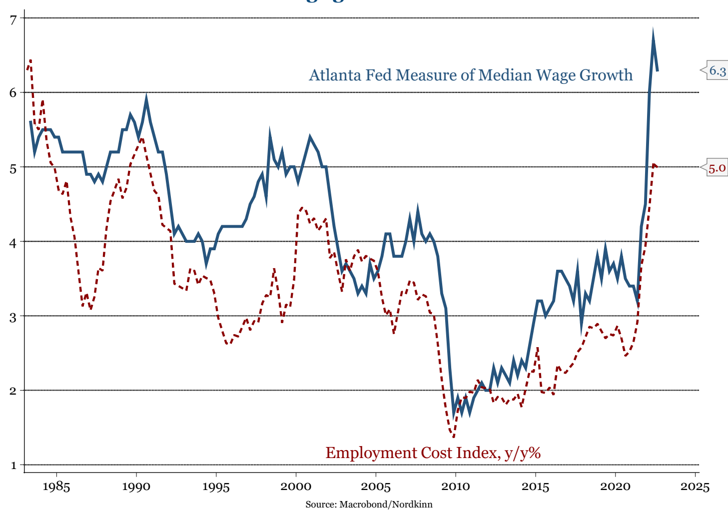
Another important factor to monitor is the reopening of China. The all-new official Chinese view is that as vaccination rates and herd immunity (i.e., the number of previously infected) have increased, the death rates from current covid strains are indistinguishable from normal seasonal flues. As covid is no longer seen as posing a major threat to public health, zero-covid policies have been relaxed, despite very high infection rates in part of the country.

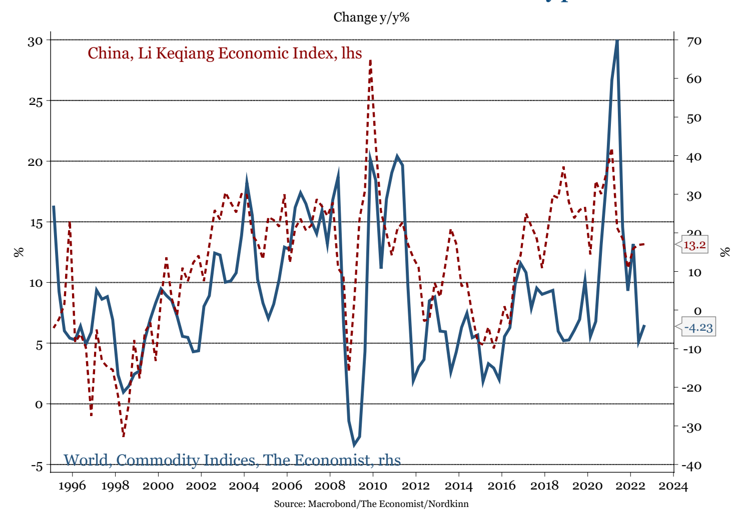
Assuming this new direction is sustained, China's reopening will have a number of consequences for global economic developments, including but not limited to: 1) Any excessive number of patients falling ill will have short term negative effects on global growth; 2) Remaining supply chain problems stemming from previous lockdowns are expected to soon be resolved; 3) Demand for industrial commodities in general and energy commodities in particular will likely soar, pushing commodity prices higher, and; 4) Chinese demand for investment goods will also rise as projects previously halted are now expected to be resumed.

The first-order effects on supply chains and commodity prices are probably the most relevant from a near-term investment perspective. As the global supply chain issues have by and large already been resolved, we believe that the commodity price effect will probably be more important going forward, see chart. This, in turn, reinforces our impression of a two- or even three-speed global economy, where the Euro area is most at risk of becoming a laggard, which would benefit our theme *"Global: Market implications of the energy crisis"*.

Supply and cost of energy have indeed guided European economic developments during the past few months. As we are now approaching the final leg of the heating season, optimism has been growing with energy futures becoming cheaper by the day. Unless an unusually severe cold snap were to materialise, Europe should be able to enter spring and summer with gas inventories well above the seasonal average of the last ten years. Of course, this will also make it easier to refill inventories before next winter, but it is important to note that the unusually mild weather has been the key driver behind lower consumption during the past few months. Even with inventories filled, should temperatures next winter prove more "normal", stocks would on aggregate be completely depleted within only a few months.

Summing up, we find it easier to believe the Fed will be able to hike more or less as expected. For the Euro area, we think that expectations of continued large hikes, very modest rate cuts in the medium term, together with aggressive ECB balance sheet reduction, have come too far and too fast. The interplay between these regional factors and the idiosyncrasies of our home markets Sweden and Norway should continue to provide opportunities over the coming weeks and months.





Nordic markets

2023 will most likely prove challenging for the Swedish economy. In a number of aspects, Sweden may be one of the most vulnerable economies given the developments in 2022. We see three important factors that will weigh on the economy. Firstly, Sweden is one of the most interest rate sensitive economies with a highly indebted private sector and a relatively low usage of fixed rate mortgages. Secondly, as electricity prices have sky-rocketed by tracking European natural gas prices, Swedish households have received modest financial backing from the government. Thirdly, wage growth has remained muted despite a tight labour market.

More worrisome for households is that the signals so far ahead of new wage deals, to be concluded by the end of March, have not been very encouraging. The industry unions (benchmark for the entire labour market) have demanded some 4% while employers seem to offer a mere 1%. This indicates that real wage growth will be clearly negative also in 2023, and nominal wage growth will be a bit lower than what has been negotiated in Europe and Germany so far. The weak SEK might be beneficial to the export sector, but this will be more than offset by weaker global demand.

At the same time, inflation (CPIF) will probably reach double digits at the early stage of the year. Hence, the Riksbank will need to continue focusing on restoring price stability. At 2.50% the key policy rate is probably at restrictive levels already, yet the market discounts another 115 bps or so by rate hikes in the next six months. However, uncertainty is unusually high. Amidst elevated inflation, the long-term governor Stefan Ingves was on January 1st 2023 replaced by Erik Thedéen. The February meeting will also be the first meeting for the new board member Aino Bunge. Nevertheless, given encouraging signals ahead of the wage negotiations, we reckon that the balance of risk is skewed towards a somewhat less pronounced tightening of monetary policy than the market currently discounts.

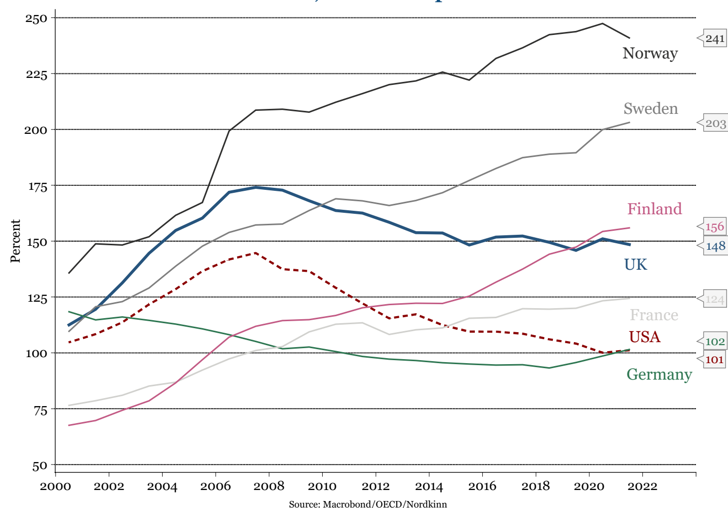
It is not all about the policy rate, though. The Riksbank ended its bond purchases, and the selling of SEK, as 2022 came to end. A big part of the balance sheet will roll-off relatively quickly, but it also contains a large amount of long-dated government bonds. In our view, the long-end of the Swedish yield curve is trading very expensive and in one way or another we expect it to gradually reprice when the Riksbank as the price insensitive bond buyer is out. Also and eventually, as bond yields reprice and as the Riksbank has ceased to buy foreign currencies, the SEK could see tendency to gradually appreciate.

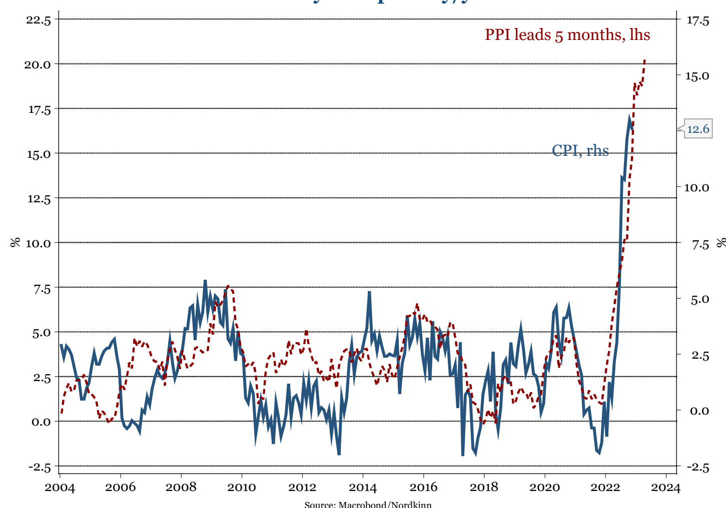
Like Sweden, the household sector in Norway is very sensitive to rising interest rates. With debt-to-income ratio at almost 250% and more than 90% of all mortgages on floating interest rates, the Norges Bank's rate hikes during 2022 is a having an instant and powerful effect on household's real disposable income, which comes on top of sharply higher consumer prices. Consequently, many households, in particular those unable to draw on savings, will have to cover higher interest rate and electricity payments by lowering consumption.

At 2.75%, the key policy rate is probably having a very restrictive effect on economic activity and is close to a peak already, at least according to the Norges Bank's latest projections, as well as expectations currently prevailing in the market. The December projections were consistent with stable interest rates at the upcoming meeting on January 19th and another 25 bps hike to 3.00% at the meeting in March.

Nonetheless, in the end the outlook for monetary policy in 2023 will depend crucially on the prospects for inflation returning towards the 2.0% inflation target in a timely manner, i.e., over the medium term. In this regard, we see a couple of obstacles emerging in the first half of the year. Firstly, the grocery chains have announced new sharp price jumps on food from February 1st due to increased costs. The chart below illustrates that producer prices, which leads CPI by a few months, continued to rise at the end of 2022. Second, higher CPI inflation has yet to feed over to housing rents in a more pronounced manner. Last but not least, the combination of tight labour market conditions and surprisingly high CPI inflation imply upside risks to the upcoming wage negotiation round.

On balance, therefore, we share the consensus view prevailing in the market that the Norges Bank will hike at least once more, and even see upside risks to short-term NOK interest rates relative to for instance SEK and EUR. This view has been implemented within our *"Norway: Weaker growth dampens policy rate"*, hedging a long exposure in the NGB market, as well as more tactically within our *"Global: Too soon for dovish pivot"* theme.





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