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ASSET MANAGEMENT

Market Review & Outlook

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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

Interest rate volatility receded and government bonds rallied during January overall, even if bonds pared gains in the latter half of the month. Macro data has, in general, continued to stabilise in all major currency areas, and the muddled inflation outlook cleared somewhat. With headline inflation numbers and interest rates easing, risky assets – both stocks and credits – have rebounded. Volatility in market-based inflation expectations has abated over the last couple of months amid less of inflation data surprises.

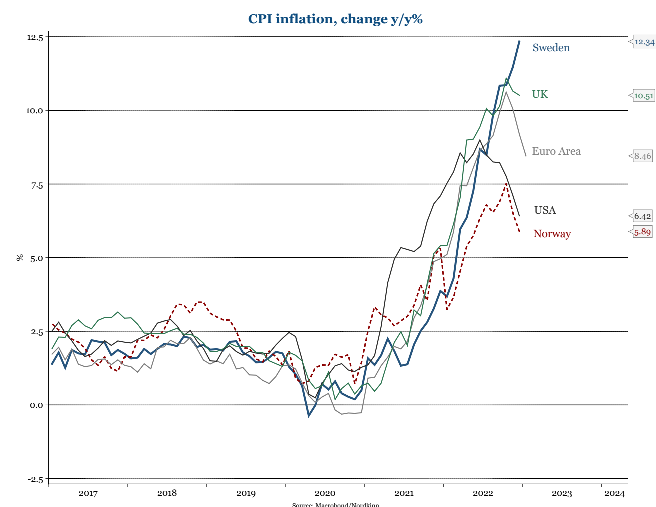
Even money market risk indicators, such as the TED spread, is signalling a less uncertain environment ahead. This has not gone unnoticed by neither markets nor forecasters. IMF's Chief Economist, Pierre-Olivier Gourinchas, recently stated that "[…] adverse risks have moderated since October and some positive factors gained in relevance".

The moderating adverse risks that Professor Gourinchas is referring to are connected to the improving outlook on prices and inflation. Inflation is calculated as the percentage change of a prices of a basket of goods and services in a given month compared with its price in the same month one year previously. Hence, if prices are flat, or just start to rising slower than previously, the rate of inflation must come down. This arithmetic observation is what is referred to as "base effects".

Studying the December inflation numbers, base effects are strong in the U.S., in particular on goods and non-core items. Core services prices, which are predominantly wage driven, are instead holding up quite well. In the Euro Area, as well as is Sweden and Norway, inflation was in line or lower than expected for December.

However, the benign outcomes are primarily a result of lower energy inflation, concealing the fact that core inflation is instead coming in higher than expected. Core inflation is, by definition, more related to service prices and wage developments. Current labour market developments is the main positive factor that Professor Gourinchas refers to in the quote above. Labour markets seem robust on both sides of the Atlantic, with job openings almost inexplicably strong.

Nonetheless, the undoubtedly positive developments described above also constitute a difficult challenge for central banks and, by extension, financial market pricing. This is why we have chosen to close two of our global themes; *"Market implications of energy crisis"* and *"Too soon for dovish pivot"*, having contributed positively to performance also in January. For the same reasons, we have opened a new global theme: *"Easing of inflation"*. We discuss this in more detail in the "Global Outlook" section on page 3.



Nordic overview

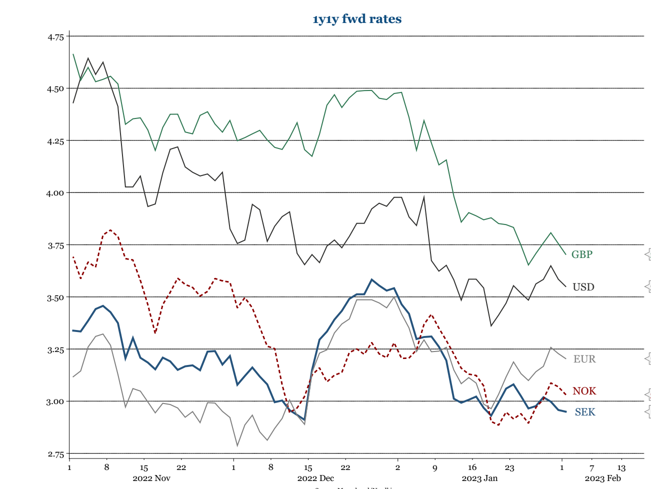
The year started with an outperformance of SEK interest rates relative to EUR, most notably at the front end of the curve as Riksbank rate expectations eased amid weak domestic macro data and global signals of easing inflation. Hence, the SEK curve steepened both outright and on a relative basis, which profited our theme *"Sweden. Reality bites"* in January.

Fundamentally, we believe several underlying factors are supporting the front end of the curve. Firstly, signals from the labour market agents ahead of the wage negotiations, to be concluded by end of Q1, is comforting for the Riksbank. Secondly, the new government has not embarked on a spending spree. Rather, fiscal policy is tight relative to what we have seen in Europe in terms of support for costly energy bills. These two factors are key for inflation and monetary policy in 2023 in our view, which we discuss more thoroughly in the outlook section on page 4. Thirdly, the grim economic reality for Swedish households is negatively impacting consumption and the outlook.

On the other hand, the SEK exchange rate continued depreciating in January, presumably related to a combination of a relatively hawkish ECB and a weak economic outlook in Sweden. The SEK trajectory over the past few months is to some degree offsetting the disinflationary forces mentioned above.

Norwegian interest rates underperformed peers in the first half of the month and outperformed in the latter, leaving interest rate differentials broadly unchanged in January as a whole. Intramonth volatility largely reflected uncertainty ahead of the Norges Bank monetary policy meeting on January 18th, where interest rates were left unchanged for the first time since spring 2022. Following stronger than expected macro data around the turn of the year, market participants gradually increased their bets for a 25 bps hike at that meeting. However, these bets were partly trimmed following the release of December CPI data mid-month, which broadly matched Norges Bank's forecast.

The positive performance from the theme "*Norway: Weaker growth dampens policy rate*" largely reflected gains on tactical trades in the short-end of the NOK curve, predominantly expressed as cross-country spreads versus equivalent SEK rates, and to some degree as outright exposure.



Outlook

Global outlook

From an economic perspective, global developments have by and large been benign over the past few months. In particular, and similar to the updated IMF outlook, we also see headline inflation coming down and labour markets remaining quite robust.

That combination is nonetheless something of an economic oxymoron, i.e a contradiction in terms. Should labour markets remain strong, with low unemployment rates and high job openings, wage growth will also stay high and, hence, so will (core) inflation.

Looking back, we (perhaps naïvely) might have put too much reliance on "divine coincidence"; the possibility of higher input costs (e.g. higher cost of energy) helping central banks in taming demand without necessarily leading to higher wage demands (due to a high confidence in inflation targets). As time has passed, we can see that higher input costs have not only led to higher wage demands, but also higher prices more broadly, as companies have sought to compensate themselves for the higher input costs. With higher wage demands increasingly being met by employers, there is now a chance that companies will need to compensate themselves again, this time from higher labour costs.

Put another way, there is a non-negligible risk that a classic wage-price spiral is forming, despite real wage growth being negative and despite inflation targeting central banks. Why? Simply put, we worry that this could be the result of central banks being very much "behind the curve". With nominal policy rates finally now approaching neutral while real rates are still much too low in many currency areas, real rates are perhaps unable to fully contain a spike in true inflation expectations.

In addition, in many countries, global relative prices have weakened terms of trade, and real Gross National Incomes (GNI) are in many instances lower now – in levels – than at the start of the covid pandemic. Here, we would expect to see a fierce distributional conflict over "scarce resources", and incomes, thus further fuelling the wage price spiral.

The central banks balancing act does not stop there, however. Governments have, often in countries with already weak GNI-developments, tried to bridge the economic hardships of voters/households and companies with unusually generous fiscal policies. Policies which will be politically difficult to remove in a situation where both households and corporations already hurt from falling incomes and welfare.

In other words, central banks are – still – at the very center. But this time they will need to push (real) rates higher and keep them both higher and for longer than what we have grown accustomed to over the past few decades. Central banks will inflict pain on economies and cannot stop until other economic actors have yielded.

Now, being economists, there is of course an "other hand" to the above hypothesis. Fact is, we have never been in the current circumstances with high inflation and independent, inflation targeting, central banks having a great deal of confidence (as demonstrated by stable measured inflation expectations) and free-floating currencies. Hence, there is "on the other hand" a chance that as central banks' policy rates are rising, things will rather swiftly return to normal and both inflation and, eventually, interest rates will come down.

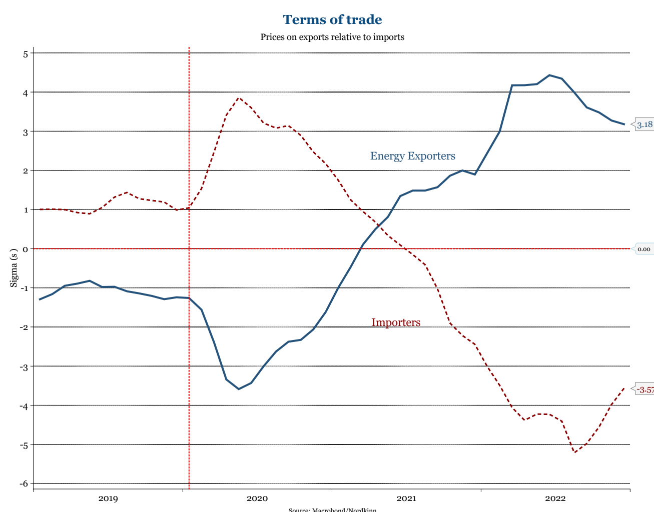
Taking all perspectives in aggregate, we are torn on the issue of what it will take to "put the inflation genie back in the bottle", especially taking national preconditions into account. Given the uncertainties, treading cautiously in the near term is called for. From an investment perspective, this means we are trying to avoid outright directional positions and instead there should be ample opportunities to exploit the relative economic weaknesses and strengths of different economies and sectors.

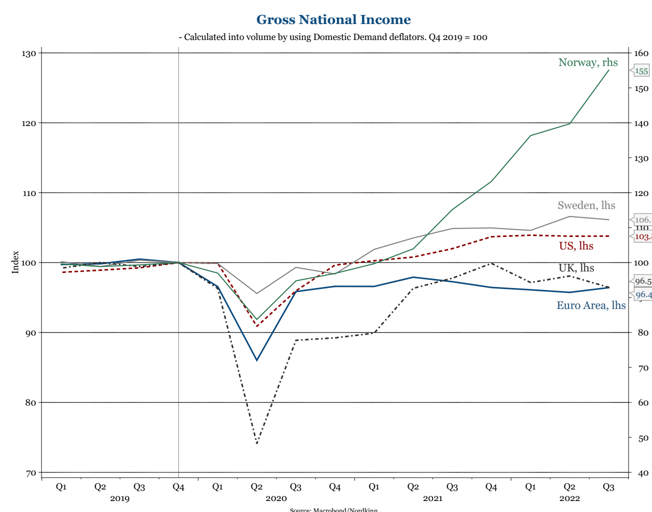
To give additional colour, we believe the U.S., and even more Sweden and Norway, are set to experience a rather controlled disinflationary process (even though Norway is lagging as we discuss further on page 4). Primarily because the distributional conflict should be lesser (as incomes have increased), but for the two latter economies also because the wage formation processes are highly coordinated and changes to the fiscal stance are conducive to the control of inflation.

Polar opposites, we see the UK and the Euro Area where we fear, and already see, a more fraught relationship between labour and capital. To some extent, we also believe there is a higher (relative) risk for fiscal dominance of the ECB and the Bank of England.

We launched a new theme in January, *"Global: Easing of inflation"*, to benefit from some of the ideas outlined above. In this theme, we have added trades designed to benefit from the market response to the expected differences in the disinflationary process on both a global and regional scale.

All things told, our key messages are: (1) We avoid outright directional exposure, and; (2) We see lots of opportunities in relative space.





Outlook

Nordic outlook

It will probably take some time before the elevated core inflation rates peter out and reach a level where central banks are comfortable to start cutting rates back towards neutral. However, we believe the preconditions could allow for a faster drop in prices in Sweden relative to many other countries for the following two reasons. Firstly, employers and unions share the view to reach a wage deal that does not risk set a wage-price-spiral into motion. Signals indicate muted centralised wage deals relative to what has been the case in Europe. Secondly, the new government has avoided going on a spending spree. Rather, fiscal policy continues to be strict with very limited support for tackling energy costs (and mortgage costs). Clearly, a unique consensus view among all domestic institutions has formed in order to ensure that inflation does not get entrenched. Compared to other countries the stride from households to get compensated is less evident.

The sharp rise in Swedish core inflation in 2022 was all about global forces, a weak SEK and high electricity prices, while wage growth remained stable. The new pieces of information on wages and fiscal policy support the view that this situation will remain. Our conclusion then, is that as global price pressures gradually dissolves, Swedish (core) inflation could drop faster than in peer countries.

Swedish monetary policy is not only effective in the sense that policy rate increases have an immediate impact on demand, given the high level of household debt and the big share of adjustable mortgage rates. Riksbank´s monetary policy is also effective in the sense that it does not have to fight a faster wage growth and a supportive and inflationary fiscal policy in the same way as we have seen in European countries.

Having said that, the inflationary impulse from the weak SEK is a major concern for the Riksbank. We doubt an overly hawkish Riksbank that focus on the rate differential to ECB is the best way for an appreciation. Admittedly, a disappointing smaller than expected rate increase at the upcoming monetary meeting on February 9th is unlikely to strengthen the SEK in the short-term. However, the long-run implication on the currency could indeed be positive if a deep recession is avoided. Consequently, although a 50 bps rate hike is our base case at this meeting, we do expect the Riksbank to consider the economic outlook in Sweden when conducting monetary policy, rather than following the ECB mechanically. Most of our views on the Swedish market is expressed in the theme *"Sweden: Reality Bites"*.

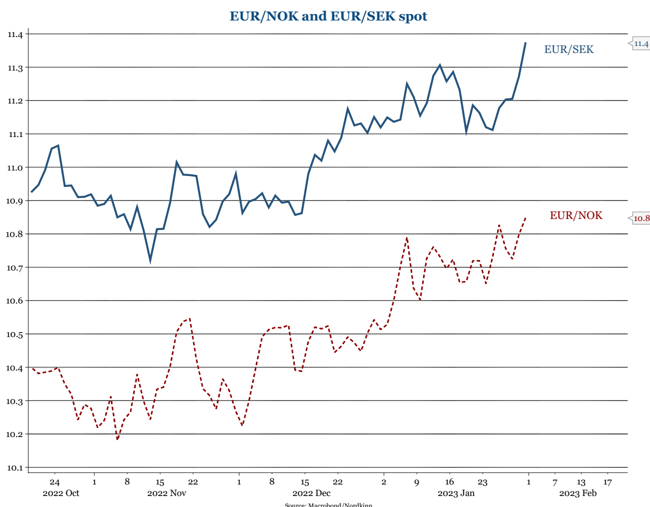
In Norway, interest rates are in restrictive territory and are having a dampening effect on the Norwegian economy, which has motivated a more gradual approach to adjusting the monetary policy stance. Having left its key policy rate unchanged on January 18th for the first time since May last year, the Norges Bank indicated in its statement that the policy rate will most likely be raised by 25 bps to 3.00% on March 23rd.

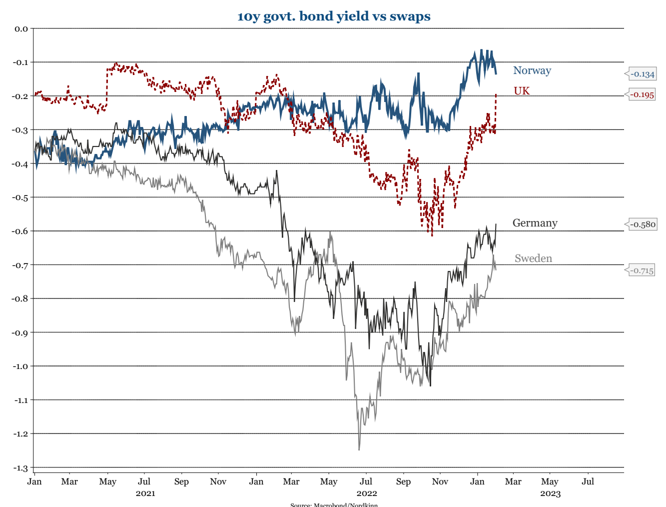
Incoming data since the Norges Bank's macroeconomic projections were published in December suggests, on balance, some further upside risks to short-term interest rates ahead. Mainland-GDP was higher than expected in November, but also labour market data and core CPI inflation have surprised positively on the margin. In addition, the NOK is currently somewhat weaker than projected.

Moreover, while there are now signs that global inflation has peaked, we see upside risks to Norwegian core CPI outcomes in coming months owing to lagging housing rents and domestic food prices, which combined accounts for a significant share of the CPI basket. Furthermore, while our base case for wage developments is in line with Norges Bank's forecast, the balance of risk is skewed towards a higher outcome in our view.

If these upside risks to CPI were to materialise in coming months, Norwegian market rates will most likely rise and fully discount another rate hike after March. Against this background, we actively hedge our long NGB cross-market exposure in our *"Norway: Weaker growth dampens policy rate"* theme with using interest rate swaps in the short-end of the curve when deemed appropriate.

Speaking of NGBs, a new 10-year government bond will be issued though syndication in February. NGBs appear attractive priced on most metrics, be it relative to short-term market rates, maturity matched swaps or equivalent bonds in G10 space, see chart. Moreover, with fixed income returns becoming much more compelling as Norwegian as well as most G10 key policy rates will likely peak during 1H, we anticipate investor rotation into bonds in 2023. Consequently, we have tactically increased our NGB exposure prior to this syndication.





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