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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

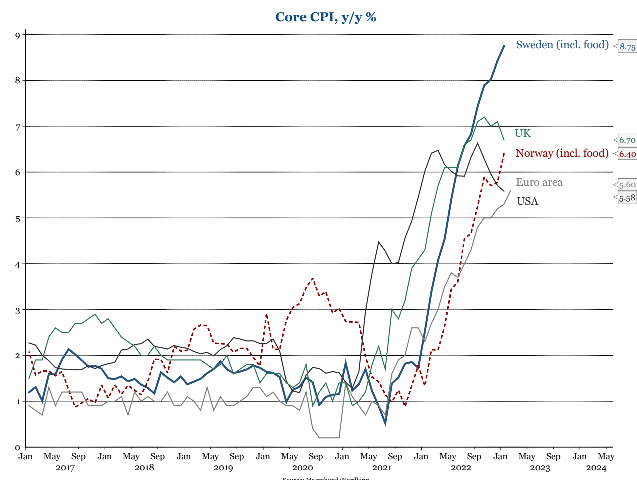
After falling in January, real and nominal bond yields rose throughout February while risky assets suffered, and the USD appreciated.

February got off to a flying start with hawkish central bank signals and exceedingly strong U.S. labour market data. Simultaneously, headline inflation fell across developed markets amid base effects from lower energy prices and slower growth in food prices compared to a year ago, but measures of core inflation proved sticker. Hence, Break-Even Inflation (BEIs) moved higher, in particular in the EUR market. Swedish BEIs lagged, but when taking inflation carry into account the Swedish real rate bonds performed as well. In all, the global theme *"Comparative inflation expectations"* contributed positively to the overall performance.

Admittedly, we sought to benefit from the first signs of a disinflationary process in the *"Easing of inflation"* theme established in January, but markets had already begun to shift their focus from the falling headline inflation to the high, and sticky, core inflation rates. Positions for steeper yield curves therefore proved premature, and we have chosen to temporarily limit allocation of risk to this theme and to momentarily close the partly overlapping theme *"Hiking into recession"* as well.

Our temporary close of the theme *"Hiking into recession"* is a testament to how strong labour markets have stayed, despite a very distinct hiking cycle from major central banks. Other macro data has also served to reinforce a more upbeat economic trend, and signals from monetary policy makers have acknowledged the rebuilding momentum of the U.S. economy in particular. This strength is a prominent feature of the post-pandemic recovery and should both inflation and labour market developments reaccelerate, scenarios to which risks continues to remain non-negligible, we expect central banks to respond in kind.

Under any circumstances, with robust demand and inflation humming along some distance above inflation targets, we see no reasons to expect a pronounced shift in the global monetary policy stance. The main takeaway from both data and policy discussions during February is also intact from January: Inflation, especially the stickier kind, is too high. To control inflation, labour markets need rebalancing, probably entailing some rise in the unemployment rate. But financial conditions are apparently not yet sufficiently restrictive (including lags), and central banks need to both hike more and to keep rates higher for longer. The visibility on exactly how much, and for how long, is at this stage unclear. As a reflection to this, we generally hold less risk in the shorter segments currently but expect that fixed income markets eventually and increasingly will display recessionary movements.



Nordic overview

The Riksbank meeting in February 2023 will be remembered, not only from the shift of governor, but from the distinct move to a hawkish stance deploying a broader range of the central bank's tools. Apart from hiking the repo rate by 50 bps to 3.00%, it also decided to commence Quantitative Tightening, QT, by selling long-dated government bonds. Moreover, in its weekly auctions the central bank will offer certificates in size relatively close to the amount of excess liquidity. Finally, attention was directed towards the SEK as being too weak. By comparison, in 2022, while hiking aggressively, the Riksbank still reinvested matured bonds, sustained excess liquidity via its issuance of weekly certificates and sold SEK.

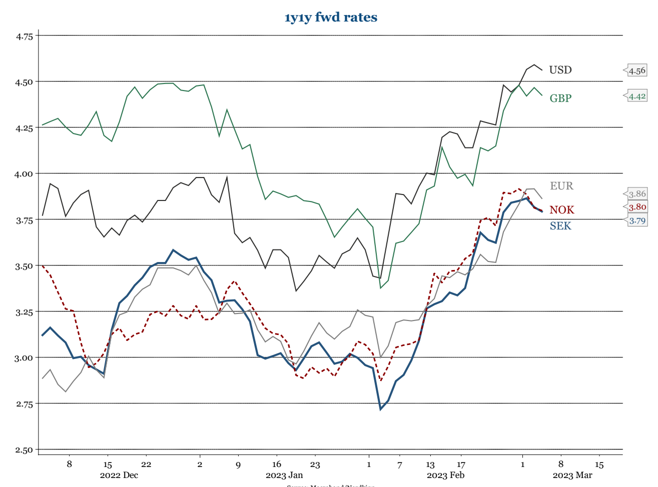
With this clear policy shift, the knee jerk market response was significantly higher bond yields, which underperformed relative to overseas rates. Also, the SEK appreciated following the announcement.

A few days later, January core inflation surprised to the upside, adding further pressure on the Riksbank. Core inflation printed 0.55% above the fresh Riksbank projection. Again, Swedish fixed income market sold off and underperformed relative to other markets, but volatility receded somewhat later in the month. Hence, the theme *"Reality bites"* subtracted from performance in February, whereas the new theme "*From QE to QT"* contributed marginally positive.

Norwegian January core CPI inflation rose sharply as well, printing 0.50% higher than Norges Bank's forecast. While the increase was broad based across items, housing rentals contributed significantly to the increase. In addition, Mainland-GDP growth was higher than expected in Q4. Consequently, the NOK fixed income market sold off swiftly on expectations that Norges Bank will need to lift the key policy rate to a higher peak than estimated in December.

While domestic data and events contributed to higher interest rates in both Norway and Sweden, there is no doubt the repricing of interest rate expectations abroad also made a meaningful impact on local markets in February, see chart for expected 1-year rates starting in early 2024 (1y1y forward rates).

Overall, the theme "*Weaker growth dampens policy rate*" was relatively resilient in February considering the sharply higher NOK interest rates. Gains from the relative performance of Norwegian to Swedish government bonds and tactical short positions ahead of the CPI figure contributed positively to performance. Nevertheless, these gains were unable to completely offset losses from NOK money market flatteners, which were implemented, in hindsight somewhat prematurely, in the latter half of the month.



Outlook

Global outlook

In February, previously early signs of moderating inflation and weakening demand was hit by an abrupt cold spell. As a consequence, the debate among market participants whether there will be a soft of hard landing shifted to whether there will be any landing at all.

Regarding an inevitable landing, we nonetheless remain firm. If labour markets were to continue on a strong note, with low unemployment rates (see chart) and high job openings, then wage growth will also stay high, and hence so will (core) inflation. This, in turn, will predicate assertive monetary policy responses from the inflation targeting central banks.

Such a scenario would not only increase the risk of an eventual hard landing but would also hint at a loss of credibility in inflation targets. Central banks would therefore need to hike even more to regain control of inflation and re-establish credibility.

Consequently, looking to the immediate future we would be surprised not to see policy makers on both sides of the Aantic committing themselves to tighten financial conditions sufficiently to stave off both existing and upcoming inflationary impulses. Recent policy communications from all major central banks are also clear on the need for additional hikes, which also current market pricing implies.

With near-term policy tied so closely to still high inflation outcomes, we think it is worthwhile to take a step back and consider the "big picture". While many tend to draw parallels to the high inflation era of the 1970's and 1980's, we are less than inclined to do so. For one, financial conditions across most developed economies are influenced by inflation targeting central banks and by floating exchange rates. Also, much larger focus is held on fiscal viability, while the business sector has a clear self interest to safeguard the stability of international supply chains from relative price shocks. We think it is, for once, safe to say: "This time is different".

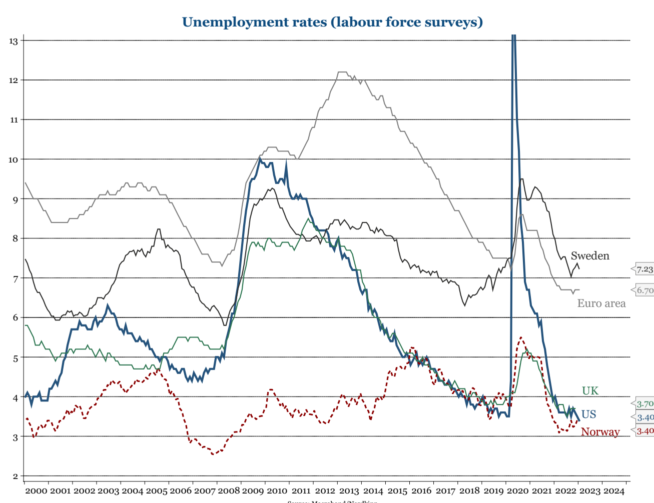
It is important to note that this does not mean that the near-term visibility is very high. In particular, central banks and economists often point at keeping inflation expectations low and stable as the key determinant for inflation returning to target. But, in all honesty, we know very little of how that mechanism really works, if at all. Measured inflation expectations are indeed (quite) low and (rather) stable (see chart), but pricing and wage formation behaviours suggest that there are other dynamics at play as well. Such dynamics range from agents trying to restore profitability or purchasing power, to fiscal responses seeking to offset supply shocks.

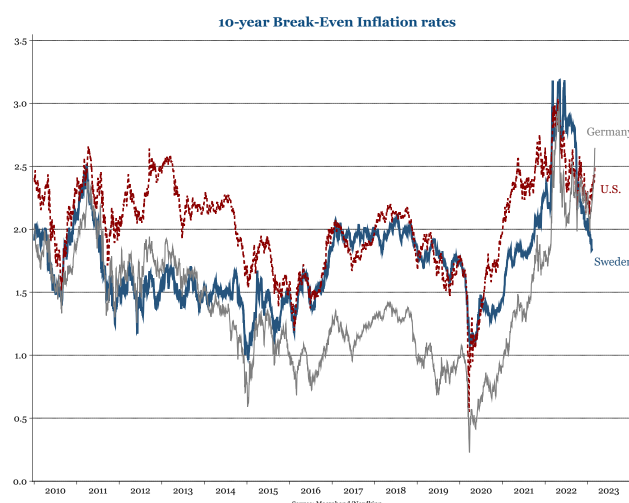
Nevertheless, what we can say with a higher degree of certainty is that central banks eventually will succeed in bringing inflation down, even if causing a recession in the process, if need be.

In this environment, where the path forward is obscured, but the end-target is reasonably clear, we believe it is wise to avoid large outright bets on highly volatile short-term rates, but instead on relative terms explore forward curves, where we can utilise the different, but more stable, macro fundamentals of different economies.

For instance, fiscal policy frameworks are quite robust in the Nordics, and we see little risk of fiscal policy stimuli in excess. Also, we see the wage setting process in the Nordics as highly coordinated, implying a much stronger forward-looking behaviour than in e.g. Anglo-Saxon economies. Furthermore, high productivity and stable growth in Gross National Income in the Nordics should facilitate relative price adjustments between labour and capital as well as between sectors, compared to countries where fundamentals are weaker.

All-in-all, we believe that this is not the time for directional bets and prefer the fixed income version of an all-weather outfit. Thus, we remain tilted towards central banks eventually lowering policy rates but prefer to express that in relation to longer-dated rates and relative to economies where the disinflationary process is set to become more complicated.





Outlook

Nordic outlook

The Riksbank´s decision to sell longer-dated SGBs will change the landscape in the Swedish fixed income market. Bond issuance has been relatively muted amid tight fiscal policy and the debt office has been the sole provider of interest rate risk to the Swedish fixed income market for many years. The issuance of risk has been offset by the QE purchases conducted by the Riksbank. Hence, the u-turn from buying bonds in QE to selling bonds in QT will have meaningful impact on the fixed income market.

The interest rate risk for the market to absorb will increase significantly compared to recent years. We are doubtful that domestic investors' risk appetite will increase at the same pace. International investors will need higher yields relative to other markets before they will engage. Hence, we see room for a gradual underperformance of Swedish government bonds over the months (or even year) to come. In addition, the shift within the Riksbank should be positive for the hard-beaten SEK. This new reality is what we seek to address in our new Swedish theme *"From QE to QT"*.

The January inflation print demonstrated that it will take time to tame inflation. This is at odds with market pricing of Break-Even Inflation, BEI. Especially forward BEIs are trading low in Sweden compared to the rest of the world. Market pricing suggests inflation over the next ten years or so will be lower than the inflation target, see chart. But only in Sweden. We like to continue exploring this deviating pricing in the global theme *"Comparative inflation expectation"*.

At the same time, in a sense the Riksbank might be in a better place than other central banks. Core inflation is obviously elevated from a cross-market perspective, but in contrast to many other countries, so far at least, it is not driven by accelerating wages. Moreover, fiscal policy is tight and not inflationary and in addition, credit growth to households (mortgages) is plunging. Hence, the Riksbank does not have to fight wages, fiscal policy and credit flows. Nevertheless, the Riksbank is paying attention to new data, and inflation data in particular. This sets-up a possible, or likely, scenario where Swedish economy will hit a wall. The growing risks for this sudden halt are addressed in our theme *"Reality bites"*.

In Norway, incoming data since the Norges Bank's macroeconomic projections were published in December implies a higher terminal rate than the Norges Bank previously anticipated. Growth in Mainland-Norway was more resilient than expected in Q4 despite the timely transmission of monetary policy to mortgage rates. Moreover, any signs of easing pressures in the labour market are few and far between, with unemployment stubbornly remaining at a historical low rate of 1.6% in January.

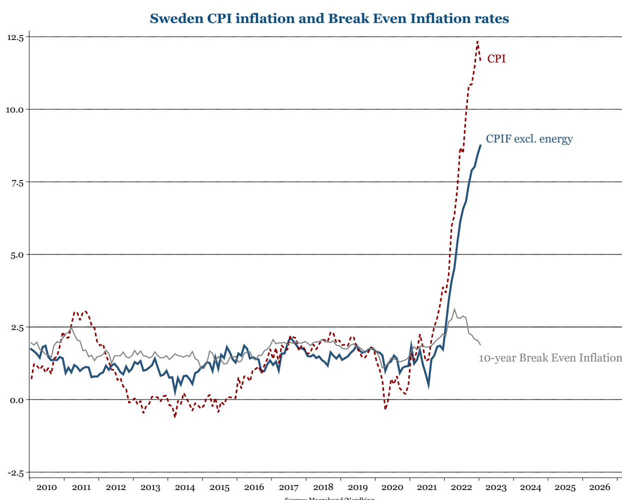
The strong economic data becomes particularly problematic in the context of higher-than-expected core CPI inflation in January, as well as slightly higher wage growth in 2022 than projected by the central bank. Furthermore, partly reflecting sharply higher interest rate expectations among trading partners since December, the import-weighted NOK exchange rate was almost 4% weaker at the end of January than projected by Norges Bank, exacerbating the inflation problem, see chart.

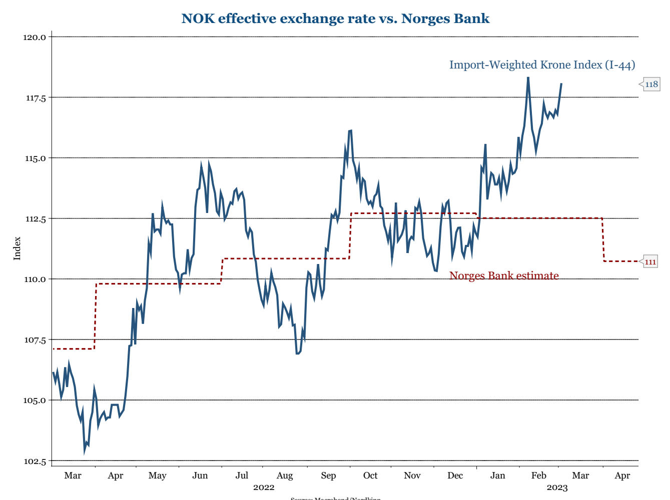
Meanwhile, there are prospects that energy prices will be lower than anticipated and, notwithstanding the most recent CPI releases, there are still signs that inflation has peaked in many countries. On balance, we do not expect Norges Bank to make any major upward revisions to headline CPI inflation – which is the most important figure for labour unions - at the upcoming monetary policy meeting on March 23rd.

Taken together, we anticipate an upward adjustment of the Norges Bank's interest rate peak in the order of 50 bps being warranted. This will imply a peak rate between 3.50% and 3.75% in late 2023, which is not far from what forward rate market currently discounts.

This notwithstanding, although we look for a higher peak rate in the projections, we are not convinced that the central bank will re-accelerate the pace of tightening. Following the decision to leave key policy rates on hold in January, the statement underscored that a more gradual approach to policy rate setting was justified in the context of previous aggressive rate hikes and signs that monetary policy is already having a tightening effect on the economy. The latter still holds true according to survey data and anectodical evidence, even though national accounts data admittedly has been more resilient than anticipated.

Summing up, organised in the Norwegian theme *"Weaker growth dampens policy rate"* we prefer to fade some of the rise in short-term interest rate expectations that occurred during February, and we continue to see value in Norwegian government bonds relative to Swedish government bonds.





About Nordkinn

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