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ASSET MANAGEMENT

Nordkinn Market Review & Outlook – April 2021

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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

Despite economic data generally surprising on the upside, U.S. bond yields retraced somewhat in April after the dramatic rise during Q1. Several explanations have been put forward for why this happened: First, covering of short positioning from "fast money" like CTAs (systematic trend-followers). Second, new Covid cases globally reached all-time highs during April, in particular in India, but also in Germany and Japan. Third, geopolitical unrest, in particular the build-up of tensions in Ukraine. Forth, a renewed focus on taxes and financing of the growing U.S. fiscal deficits. Fifth, strong real end-user demand as higher yields made U.S. treasuries more attractive for investors. Finally, some market participants claim that global growth momentum may be peaking.

Elsewhere in G10, yields moved mostly sideways or higher leading to a narrowing spread relative to U.S. yields. Narrowing yield differentials pushed the USD weaker, reversing much of the USD appreciation from Q1. A rebound in EUR/USD and a steeper EUR interest rate curve were among the developments contributing positively to our *"Global: Gradual return towards normality"* theme.

Market based inflation expectations generally rose further during April, driven by higher commodity prices and growing fears of supply being unable to meet strongly rising demand as economies open up. Positions in U.S. and European Break-Even Inflation (BEIs) gave some support to the theme *"Global: Comparative inflation expectations"* but were offset by increasing Swedish BEIs (see more in the Nordic overview section).

The key factor for global growth near-term is the reopening of economies. Although there have been setbacks in the vaccination programs, the big picture is that the vaccine roll-out is gaining momentum globally. Europe is catching up, see chart. In late April vaccinations in EU countries exceeded 2.5 million per day, close to matching the U.S. numbers. EM countries are still lagging, but as the U.S. vaccination program matures and the production capacity increases, more vaccines will be available elsewhere. Most importantly, the case count in countries that are ahead in the vaccine roll-out are very promising. In Israel for instance, where more than 60% of the population was vaccinated as of mid-March, new cases dropped to close to zero even as the economy opened up.

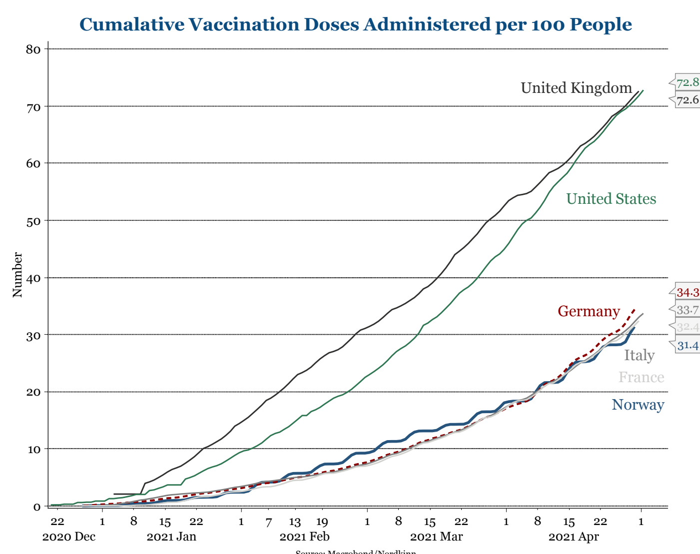
Nordic overview

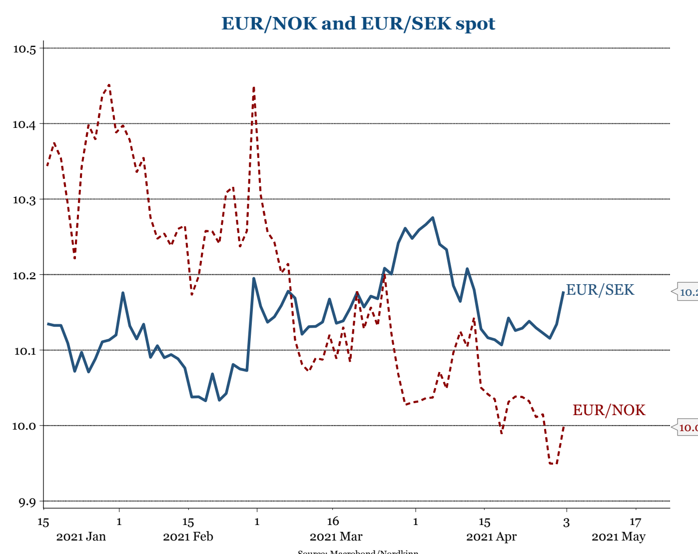
April saw another strong month in terms of pick-up of economic activity and confidence in the Swedish economy. The monthly business cycle survey from NIER was solid and showed a robust rebound in retail sales. Inflation in March was marginally higher than expected. In all, none of the strong data had any major impact on interest rates. Rather, Swedish bonds outperformed German peers in a month were supply of government bonds (SGBs) was low due to Easter. In addition, bond yields came under downward pressure as the Riksbank concentrated its QE purchases to longer-dated bonds, while the market focused on the major index duration extensions due in May and June.

Despite the Riksbank having already started tapering, i.e. slowing its pace of purchases, SGBs with longer-dated maturities trade particularly expensive relative to swaps. The strong performance of Swedish fixed income contributed positively to our two Swedish themes *"Supply/Demand imbalances"* and *"Riksbank and market pricing inconsistencies".* The real rate bond market was even more effected by the upcoming index extension, resulting in some 10 bps higher 10-year Break-Even Inflation rate in April. This weighed on the performance of our *"Global: comparative inflation expectations" theme.*

Turning to Norway, on April 16th the government implemented the first step of its reopening plan as new coronavirus infection rates had been steadily declining since Easter. The market ignored the dip in monthly activity data for February and March as lower infection rates and easier restrictions laid the foundations for a spring rebound. The revitalisation of the so-called "reflation/reopening trade" provided plenty of tailwind for the NOK, with EUR/NOK breaking below 10.00 at the end of the month, see chart.

After rising sharply in Q1, NOK interest rates declined across the whole yield curve for much of April amid yield-hungry investors buying duration. Meanwhile, the front-end of the NOK interest rate curve declined in tandem with lower Nibor fixings as structural bank liquidity eased. Despite lower NOK interest rates in April, our *"Norway: Relative Monetary Policy"* theme benefitted from a stronger NOK exchange rate, lower money market rates and active trading in longer-dated tenors during the month. The *"Norway: ASW trading"* theme suffered as NGBs sold off relative to swap rates.





OUTLOOK

Global markets

During April some market observers argued that global growth is close to peak momentum. If they are right, markets could experience a setback in this year's trends, which include higher bond yields, steeper curves, stronger equity markets, higher commodity prices and stronger currencies of commodity producers. In our view, however, global growth should continue to accelerate as more countries reopen. Among the major economies the U.S. and the UK are in the lead, with the rest of Europe and later on EM set to catch up. Global growth momentum should in our view stay sufficiently strong to keep the "reopening trade" alive, even though rotations across sectors and regions are likely.

Longer-term EUR interest rates have lagged the move in U.S. rates this year. From the term structure of U.S. government bond yields the 5-year government bond yield starting five years into the future (5y5y) is currently around 2.4%, which is broadly consistent with the FOMCs forecast for the Fed Funds target rate in the long run. In Germany for comparison, the equivalent 5y5y forward government bond yield is around 30 bps, thus well below what the ECB would consider a neutral monetary policy rate stance.

Activity in the Euro area service sector remains weak, see chart, but we expect it to catch up with U.S. amid accelerating vaccine coverage. As Euro area growth speeds up, we expect the ECB to modify its super dovish rhetoric. As they see an exit from the pandemic, the rationale for the Pandemic Emergency Purchase Program (PEPP) will be questioned. A taper plan might be communicated already at the June policy meeting. Also, a potential victory for the Greens in the German election in September could lead to more expansionary fiscal politics in Europe. In the light of this outlook, we have shifted some curve steepener exposure from the U.S. to Europe, which are organised under the *"Global: Gradual return to normality"* theme.

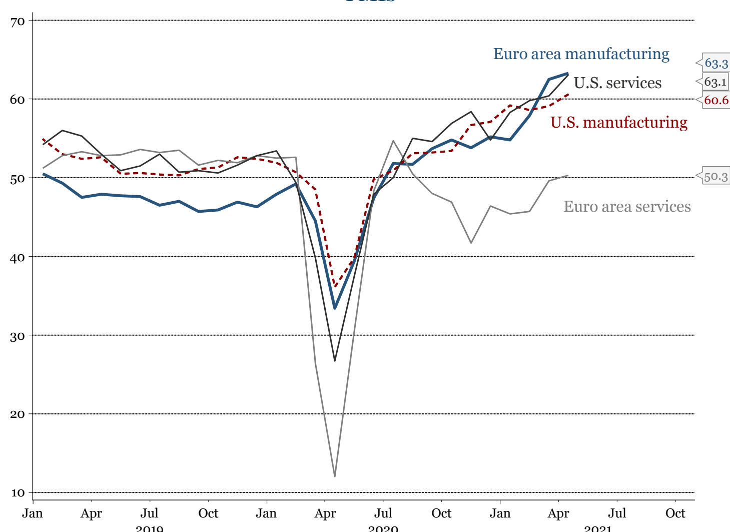
Within FX we increased our short GBP exposure during April. The GBP have strengthened so far this year driven by the early vaccine roll-out and the Brexit-deal from late last year. We think these positive effects have played out and that fundamental factors like international capital flows should drag the pound lower from here. In addition, if the Scottish National Party (SNP) and its allies get a majority at the election on May 6th another vote for independence from the UK could be in the cards.

The outlook for inflation has received a lot of attention recently, and there are split views among market participants and economists. One camp, represented by the FED and Treasury Secretary Janet Yellen, believes that there is plenty of employment and production slack for supply to keep up with demand to contain inflation in the medium term, even if a near-term pick-up in inflation is likely. The other camp, represented by former Treasury Secretary Lawrence Summers and former chief economist at the IMF Olivier Blanchard, are less sanguine and see a real risk of overheating and runaway inflation.

In previous reports we have argued that there simply is no template for the current economic regime. Monetary and fiscal policies are unprecedented and the K-shaped economic recovery having huge capacity variations between sectors, could imply that traditional economic models such as aggregated output gap analysis are misleading. Commodity prices on average have kept rising, see chart, and are expected to continue to rise as supply will struggle to meet increasing demand from consumption and investments. Anecdotally, there are many examples of companies that experience bottlenecks or increased input costs, which will filter through to higher consumer prices. As demand recovers more broadly, this dynamic will become more widespread in the short term. Some economists also argue that two longer term structural forces - globalisation and demographics – could put upward pressures on inflation in coming years. We see a real risk of some uncomfortably high inflation prints in 2021, which would create renewed uncertainty around the inflation dynamics further out in time as well.

As European growth accelerates we see a risk that shorter-term inflation expectations in the Euro area pick up. Current expectations are for annual Eurozone HICP inflation slightly above 1% over the next 2-3 years. In our view, rising food prices, pent-up demand for services and supply restriction could easily push prices higher than markets currently discount. As we have scaled back exposure to U.S. inflation, we have added European exposure to the shorter-end of the inflation-curve within the theme *"Global: comparative inflation expectations".*

PMIs



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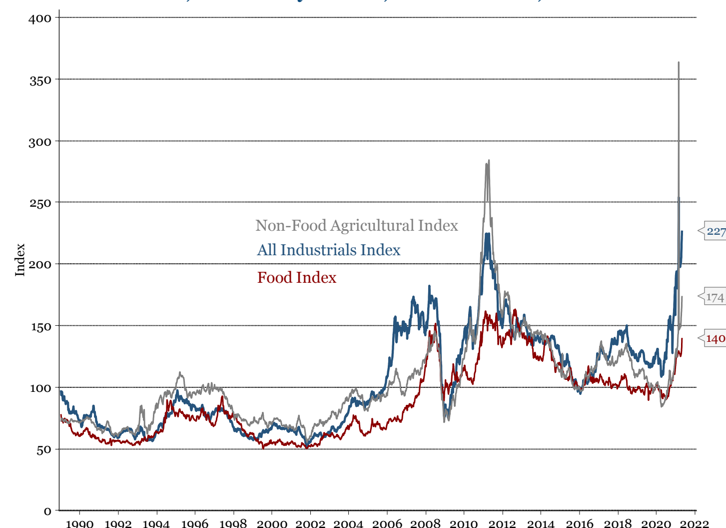


Nordic markets

In April the Riksbank left its repo rate projection unchanged and announced QE purchases for the third quarter in line with expectations. The Riksbank holds close to 50% of all outstanding SGBs, except for the longer dated ones (+10y). In earlier statements the Riksbank has argued that bond holdings at a 50% share of issued amount is a limit. Hence, we expect the Riksbank to concentrate its future purchases to longer-dated bonds. This expecting buying frenzy in longer maturities together with the upcoming index duration extensions have lead to a rally in SGBs. The spreads relative to swaps are back to levels not seen since the midst of the market turbulence in March 2020. We expect this to gradually reverse when the index extentions have passed.

Against the backdrop of a subdued inflation outlook, in April the Riksbank lowered its inflation projection for 2021. With such a low base forecast, upside surprises due to commodity prices, supply restrictions etc., will likely have limited effect on monetary policy prospects. In additon, any inflation rebound developing from such forces would stem from a global rather than a domestic phenomenon.

We still believe longer term inflation expecations in Sweden are too elevated compared to the surrounding world, see chart. Even more remarkable is how the market is pricing the sequencing of Riksbank rate hikes relative to the inflation outlook. Over the next five years the market is discounting some 110 bps of hikes, while inflation is expected to be 1.6%, i.e. well below the Riksbank's 2% target. In the next five years to follow (year five to ten) hikes are expected to be close to 60 bps and inflation to average at 2.10%. Thus, the pricing of the timing of rate hikes relative to how inflation is expected to evolve over time does not make sense either. This scenario suggests a future where, in the beginning, the Riksbank will hike rates despite inflation being below target (contrary to how the Riksbank is arguing for an overshooting before hiking). And then the Riksbank will be reluctant to hike rates when inflation is at/above target over a longer period of time.

As the economies slowly opens up, and while forward starting inflation expectations is at, or above, policy targets, the Riksbank may accept a gradual rise in longer-term real interest rates as they slowly reduce asset purchases. The Swedish 5y5y real rate is trading at -1.2% and the corresponding 5y5y BEI rate close to 2.1%. In all, investing in longer dated real rate bonds with positive returns requires, in essence, an overshooting of inflation while real rates are kept unchanged. To say the least, a very challenging pricing in our view, which we seek to capture within the theme *"Global: Gradual return towards normality"*.

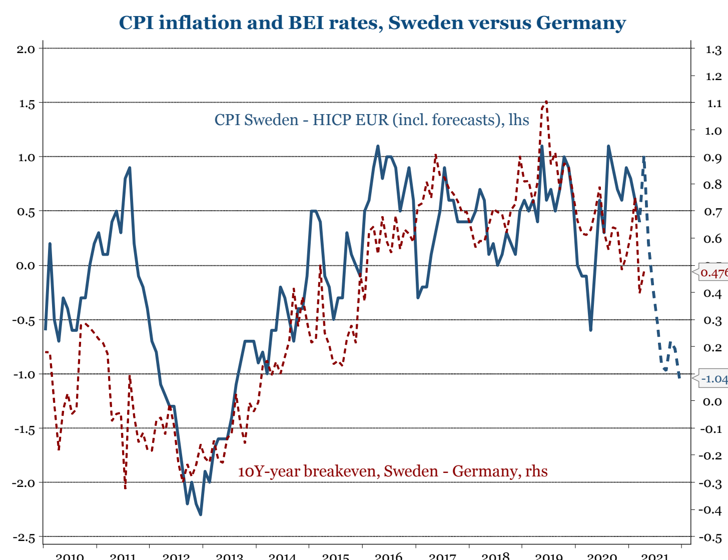
In Norway, incoming information suggests that the Norges Bank is on track to start hiking interest rates in the second half of this year. There are four scheduled monetary policy meetings in the second half of 2021, but September and December are more extensive meetings that contain updated projections and it is therefore more likely that the first rate hike will occur at one of these.

While there is a lot of relevant data that could tilt the probability in one way or the other, the most important condition for lift-off is undoubtly when a sufficiently large part of the adult population is vaccinated, which will pave the way for a pronounced economic recovery. The Norges Bank has based its forecast on a 80% vaccine coverage by the end of August. This assumption is broadly consistent with the most recent "vaccine calendar" published by the health authorites on April 15th, even without Astra Zeneca and the J&J vaccines.

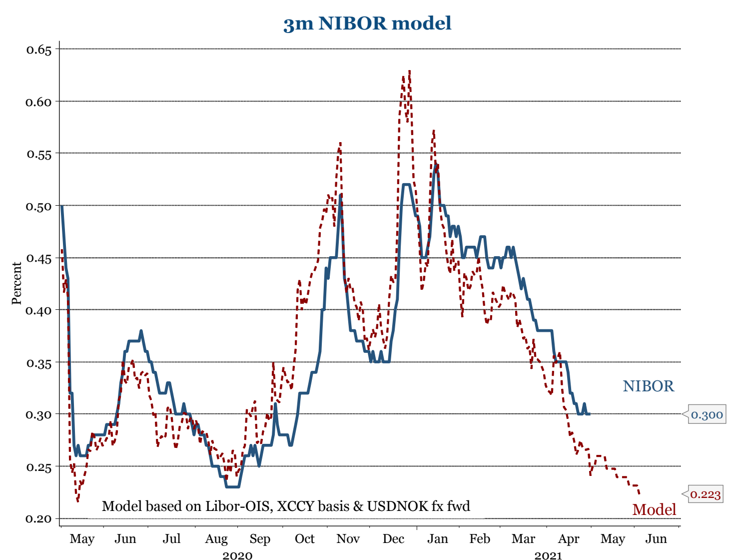
Our judgement is that the Norges Bank's MPC has a bias to exit its zero interest rate policy sooner rather than later, hence our forecast is intact for lift off in September. A removal of monetary accomodation over the next couple of years would contribute to stabilising inflation around the 2% target over time, while at the same time reducing the risk of a build-up of financial imbalances. If we are right about our September call, we would not rule out another 25 bps rate hike to 0.50% already in December. An interest rate of 0.50% is still exceptionally low. The speed of the forthcoming interest rate normalisation hinges on incoming data including how the NOK exchange rate reacts to a relatively higher interest rate level. If the NOK were to appreciate sharply and to an extent not justified by oil prices, we expect that the Norges Bank will instead take a more gradual approach.

We booked profits on several bearish interest rate trades during March, but have gradually rebuilt exposure again in April as interest rates gradually have come down. Given that the market already discounts a relatively high probability for a September hike, and as we expect a significant increase in money market liquidity to add downward pressures on Nibor fixings during spring and summer (see chart), we currently favour a combination of steepening trades and long NOK exchange rate exposure under our *"Norway: Relative Monetary Policy"* theme.

CPI inflation and BEI rates, Sweden versus Germany



3m NIBOR model



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