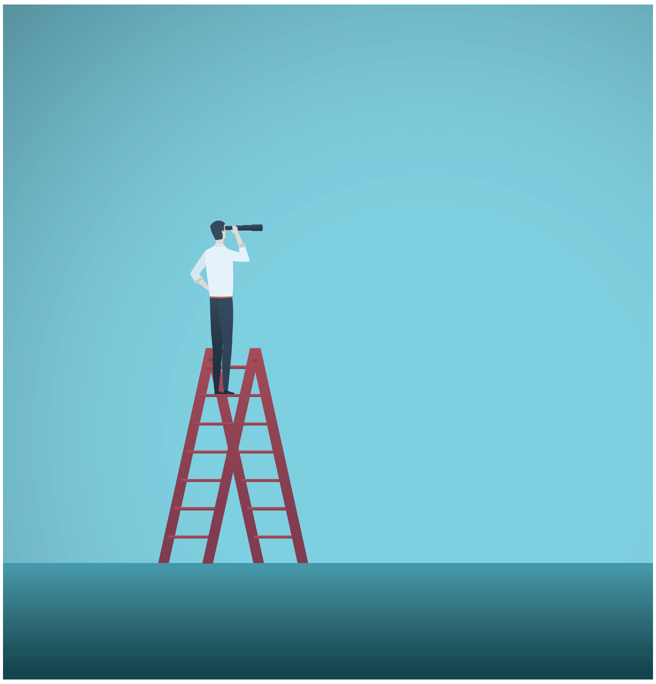
Nordics outlook for the second half of 2022



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With the Nordic region entering the second half of 2022 from a position of strength, there are still headwinds in the form of higher unexpected inflation and higher interest rates.

By *Juhamatti Pukka* and *Jani Kurppa*

The Nordics are entering the 2022 financial crisis from a position of comparative strength. While the region's recovery from the pandemic was slow, the Nordics are back at a level similar to or higher than before the COVID-19-pandemic, which is not the case for Western Europe, a region that has different exposures to higher energy and food prices.

The current account and budget balances are at a good level. The downward revisions that have been made for GDP growth expectations for this and next year are between 0.5-1.0 percentage points. The average revised expected growth rate in the Nordics for 2022 is estimated at 2-3%.

From a Nordic perspective, one of the key things to follow is the housing market. The Nordic housing markets have risen sharply over the past ten years and the pandemic gave them an extra boost. In Sweden, the sector has a notable weight in small- and mid-cap equity indices and has underperformed notably YTD and QTD against the overall index. The underperformance reflects the regime shift seen in the SEK interest rate markets during the last six months. Thus, for the real estate sector, and equity markets in general, inflation and resulting interest rate expectations will be closely monitored by investors.

Nordic drivers are far more than just energy

Norway is an outlier on both a Nordic and a global scale because of its vast oil and gas reserves. When analysing different sector exposures between the Nordic economies in the second half of this year, energy is just one of several drivers.

Industrials is the biggest sector across the Nordics, aside from Denmark, where healthcare dominates. Industrials makes up almost a quarter of the weight of the VINX Small Cap Index, commonly used to track small and mid-cap companies on a Nordic level – finance, information technology and healthcare each make up around 12%, whereas energy has only a weight of around 5%.

From the country weight perspective, Sweden makes up almost half of the benchmark, Denmark around one fifth, Norway and Finland about 12% each and Iceland just 3%. The export-oriented countries have produced many listed market leaders in different industrial and consumer durables niches. Consequently, Nordic small cap companies have offered and continue to offer alpha potential from several other sources alongside the energy sector.

Norwegian and Swedish central banks step ahead of ECB

The ECB made headlines in July with a 50 basis point hike in interest rates

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and probably more to come in September. However, both the Norwegian and Swedish central banks had already begun hiking rates earlier. Norway is always an early mover, but this time Sweden was also faster than the ECB.

While Finland is part of the eurozone, Sweden, Norway, Denmark and Iceland all have their own currencies and central banks. The Danish krone is pegged to the euro and Iceland has a small economy, so the Norwegian and Swedish central banks are the only meaningful independent Nordic central banks.

Even though the non-euro countries have no official synchronization with ECB rates, their economies all face the same inflation challenges, so it is likely that we will see similar rate hikes of around 2 percentage points across all Nordic currencies. Different currency areas within a portfolio enable significant diversification in terms of sectors, economies and the use of monetary policies – these can provide stable returns over credit cycles when fully hedged to euro.

Floating rate bonds avoid the negative price effect

Nordic bond markets are reacting to this tectonic change by widening their credit spreads in a similar way to the larger European credit markets. The non-euro markets are being supported by the fact that they consist mainly of floating rate bonds and are avoiding the negative price effect from rising interest rates, as they add very little duration to the portfolio.

Compared to European corporate bonds, Nordic bonds are a unique asset class because the market doesn't have a benchmark for international passive asset management investors. Local investors with a 'buy and hold' view dominate the market, keeping asset volatility relatively low. In addition, many Nordic companies are in the crossover segment (between BBB and BB ratings), which historically offers better risk-adjusted returns.

Both the European and Nordic markets also have less liquidity now, which is typical during big market reactions. The last time price reactions were this high was at the start of the pandemic, but the liquidity situation is better now than back in March 2020.

Nordic companies are currently in a good shape

The main question for credit investors is whether the companies are in a good state of health or not. Namely, is the balance sheet solid? Regardless of the recessionary fears present in the market, it is clear to see that Nordic companies are extremely healthy.

Accounting for the current prolonged inflationary outlook and higher energy prices, there hasn't been a significant change in credit quality at a company level. Companies have been able to adequately transfer inflation to their end clients. It seems that visibility is much better now than it was at the start of the COVID-19 crisis, when many businesses came to a total stop.

At present, the best relative value in the Nordic bond market is being found in unrated investment grade-types on Nordic issuers and spreads have widened against similar risk-rated issuers. For the longer-term investor, the yield level for a crossover Nordic portfolio with average BBB-credit quality has risen to well above 4%. These levels were previously only seen during the worst moments of the pandemic. This extra yield has solid support because many of these are crossover companies, as well as companies that are high quality but unrated, which can easily find funding in a large market. In the current environment, this could be an intriguing investment opportunity. ■

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SUMMARY

Nordic companies enter the second half 2022 in a very healthy condition.

The local currency Nordic bond market is mainly a floating rate note (FRN) market with very short duration.

Nordic unrated credits offer a constant 50-150 basis points excess return versus similar risk level euro corporates.

Current spreads and yields are at similar levels as during the darkest moment of the pandemic spring 2020, creating an interesting opportunity for the long-term investor.

PHOTOS: ARCHIVE EVLI FUND MANAGEMENT COMPANY