Norges Bank rate cut isn't that surprising

We had argued that this was the best possible time to cut, and while we thought August was more likely, today's non-consensus cut makes a lot of sense from a macro perspective. We expect two more by year-end, but this doesn't automatically mean a weaker krone

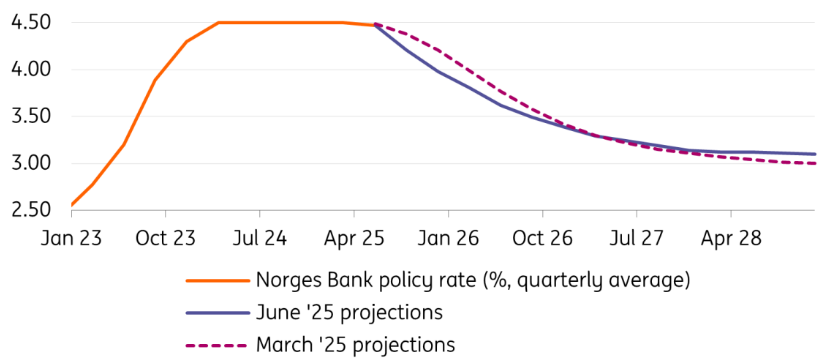
Cutting simply made a lot of sense

We, alongside the markets and consensus, were calling for a hold by Norges Bank at this June meeting. We had previously been major subscribers of a June cut before reluctantly aligning with consensus and pricing last week on the view that Norges Bank did not want to surprise markets. But as discussed in "How Norges Bank might be missing its window to cut rates", we thought holding in June would be a mistake, as the window for easing policy could have shrunk rapidly given that the stability in the krone could soon evaporate.

It turns out our considerations were shared by Norges Bank policymakers, which delivered a non-consensus 25bp rate cut to 4.25% today and signalled they can cut once or twice more this year. The new rate projections have been revised lower in the near term, but interestingly point to a slightly higher terminal rate ahead. The way we interpret this is that growth now plays a bigger role in monetary policy considerations, and argues for some pre-emptive easing.

On inflation, Norges Bank decided to overlook some of the upside volatility in headline CPI, and focused on the faster-than-expected decline in underlying inflation to 2.8%. Factoring in the downside risks from global trade tensions, a policy rate at 4.50% did look too restrictive, and taking it below 4.0% by year-end seems entirely reasonable to us.

New Norges Bank rate projections



Source: Norges Bank, ING

NOK likely played a key role

But in our view, the key reason for cutting now and not waiting another one or two meetings relates to FX dynamics. The Norwegian krone has enjoyed a period of good performance despite the multiple risks to global trade and risk sentiment. But Norges Bank is aware that the illiquid NOK can sell off abruptly due to external events, and cutting the rate in the midst of a NOK selloff is a risky move given the potential exacerbation in imported inflation.

So, it looks like Norges Bank agreed with us that the market conditions for a cut now are ideal. EUR/NOK is trading 0.6% higher on the day, after having spiked over 1.0% after the rate cut. But the starting point was one of NOK strength, and EUR/NOK at 11.50-11.60 is not ringing any alarm bells at Norges Bank.

Two more cuts, but NOK can stay resilient

We expect two more 25bp cuts this year, in August and November. That's because we think 2Q growth may well prove sluggish and underlying inflation should re-stabilise below 3.0%. Obviously, Middle East tensions and oil price implications and US trade policy can swing the balance to a more conservative path, with more cuts delayed until next year. But we think Norges Bank implicitly admitted today that it was late in starting its cutting cycle, and the bar to justifying restrictive policy is higher.

In terms of FX, we are not concerned about excessive NOK depreciation due to Norges Bank. If Sweden serves as an example, rate cuts do not do much lasting damage to a fundamentally undervalued currency in the current environment. And according to our BEER medium-term real fair value model, NOK is even more undervalued than SEK.

Incidentally, with ECB rates falling below 2.0% in 3Q, according to our estimates, seriously eroding NOK's rate advantage over the euro will take quite a lot of cutting. We remain committed to a downward-sloping EUR/NOK profile, with upside risks almost entirely stemming from external factors. A move to 11.00 by year-end remains a tangible possibility.

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