Norway: Our updated Norges Bank and NOK calls

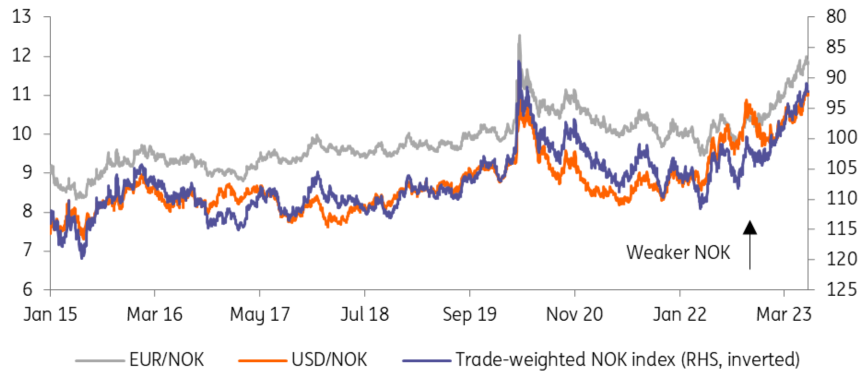
Norges Bank kept trimming daily FX purchases, but not enough to turn the tide for the weak Norwegian krone. NOK's underperformance is what will – in our view – prompt hikes beyond the projected peak, to 3.75% or potentially even 4.00%. We expect the undervalued NOK to outperform in 2H23 thanks to a risk sentiment improvement and solid fundamentals

Another challenging month for the krone

May was never supposed to be the month for a big rebound in the Norwegian krone: we had discussed it exactly four weeks ago in this article, and we had our 1-month EUR/NOK target at 11.80 in the May edition of FX Talking. In line with our expectations, volatility in the illiquid krone has remained elevated throughout May and in early June and the safe exit for risk assets from the US debt ceiling saga actually left European currencies rather fragile, with Scandies staying at the bottom of the G10 scorecard.

On the domestic side, Norges Bank hiked rates to 3.25% in May, and signalled that krone weakness could warrant more tightening. The latest projections imply one last 25bp increase in June. April inflation figures were stronger than expected (6.4% year-on-year) and GDP growth came in at 0.2% quarter-on-quarter. Norges Bank trimmed daily FX purchases from NOK 1.4bn to 1.3bn, a welcome sign in our view considering the government's rather optimistic petrol revenue estimates, but surely not enough to help turn the tide for NOK.

Norwegian krone close to 2020 lows



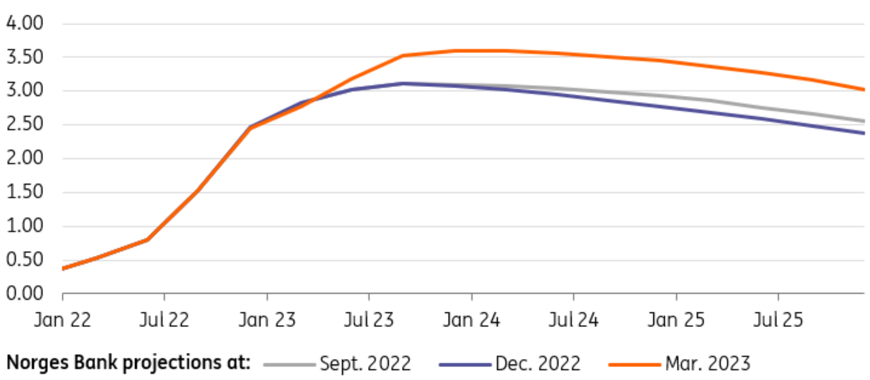
Source: ING, Refinitiv

Our Norges Bank call: a 3.75% peak

Norges Bank is set for another 25bp rate hike on 22 June, and it's increasingly unlikely that this will be the last move we see this year.

The central bank, known for being more mechanical and model-driven in its monetary policy formulation, had envisaged a peak rate of 3.5% (3.25% currently). But since those last projections in March, the major change is that the krone is around 5% weaker on a trade-weighted basis relative to Norges Bank's had expected for the second quarter. Global interest rate expectations are up too of course, given the last meeting too place amidst the US banking crisis – by about 50bp in the US and 25bp in Europe, if we look what's priced in swaps markets for the end of this year. That's generally a factor that would lift the central bank's rate projections in the near term, while oil prices, another important ingredient in the bank's model for obvious reasons, are roughly stable compared to late March. Inflation came in a tad hotter than expected in April too.

Norges Bank rate projections



Source: Norges Bank, ING

In other words, if Norges Bank were to run its model today, we suspect the peak would be at 3.75% and perhaps slightly above. For now, we expect two more 25bp rate hikes, one this month and another in August or September. We certainly wouldn't rule out a 4% peak, though given our house view on the Fed – that it will be cutting aggressively by year-end – we think that may not be necessary. Much depends on whether NOK stabilises later this year as other central banks end their respective tightening cycles.

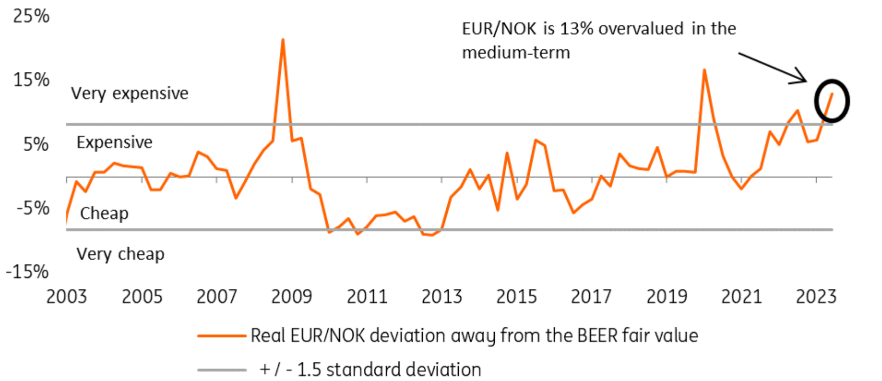
Our NOK call: Short-term woes, but 2H23 recovery still expected

We are not ready to call for a reversal of the NOK bearish trend in the near term. The krone's low liquidity character still makes it the market's favourite short (along with SEK) at a time when the threat of more Fed tightening is preventing a re-rotation towards European FX. In other words, external factors need to favour a NOK recovery before any domestic factors can seriously become part of the equation.

However, a re-softening of the dollar, and prevalence of the European growth story over the US one, paired with pre-emptive easing by the Fed in late 2023 could combine to generate a more benign environment for the krone in the second half of the year. This is when idiosyncratic factors can come into play, and we think there is a compelling domestic story for NOK. Along with a respectable carry if rates are taken to 3.75% as we expect or to 4.0% (also a possibility), Norges Bank has still plenty of room to provide support to NOK by cutting FX purchases more aggressively later in the year.

Incidentally, the krone's starting point is very low. EUR/NOK is up by around 12% YTD and 17% YoY, but economic fundamentals have not justified such a move, despite the deterioration in the Norwegian terms of trade and the improvement in the eurozone one. According to our BEER valuation model, EUR/NOK is currently overvalued by 13% in the medium term.

EUR/NOK is overvalued



Source: ING

Our EUR/NOK target for year-end is 11.00, which clearly falls in the rosier side of the spectrum for global (and especially European) risk sentiment, but is fully in line with a convergence of NOK with its good economic fundamentals captured by our BEER model. In particular, we see NOK as a more attractive currency than SEK once sentiment stabilises thanks to considerably lower domestic tail risks.

We must reiterate that the downside risk to our positive baseline scenario for NOK are non-negligible, and a stickier inflation environment in the US, more Fed tightening, a resurgence of geopolitical risks are all factors that can hurt the high-beta krone for a prolonged period of time.

Authors

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

James Smith
Developed Markets Economist
james.smith@ing.com

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