Norway: Rates and Saudis hold the key for the krone

The Norwegian krone has been battered by tumbling oil prices and rising risk aversion. Saudi's intervention in the oil markets and a possible hawkish signal from the Norges Bank next week will be needed to avert another leg lower in the currency

A toxic combination for NOK

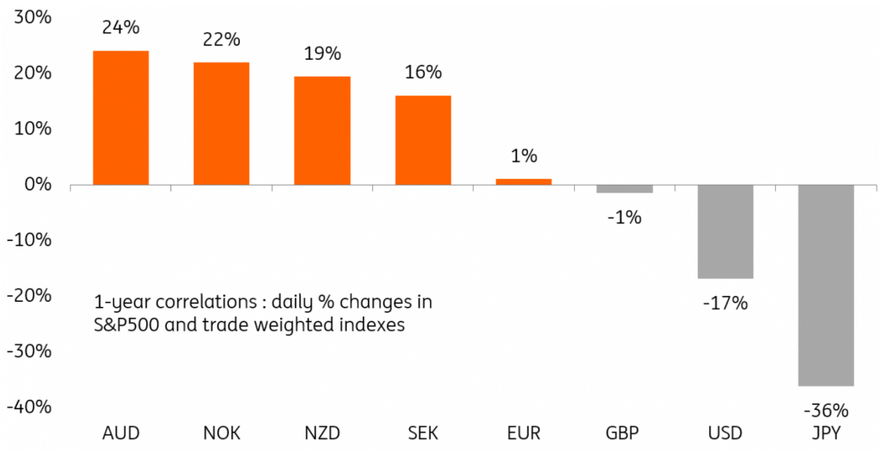
The Norwegian krone has been the major underperformer in the G10 space in the past few weeks. We identify two main factors for this NOK weakness and discuss how they are likely to play out in the short and medium term.

1 Trade tensions: things will get worse before getting better

The imposition of new US tariffs on China and the sharp depreciation of the Chinese yuan have dampened market risk appetite, pressuring global risk assets. In the currency space, the spillover effect has not been limited to the Australian and New Zealand dollars but has also hit the krone and Sweden's krona. The krone's sensitivity to swings in global sentiment is evident by its high correlation with moves in the equity markets (Fig. 1)

Looking ahead, our view is that US-China trade relations are likely to get worse before they get any better. First, it will be key to see how the Chinese government retaliates against the freshly-imposed tariffs and whether the yuan will be allowed to depreciate further. At the same time, the US has not run out of trade "weapons" yet and may still hike current tariffs on the remaining $300 billion of Chinese goods from 10% to 25%. In turn, we expect trade tensions and the consequent weakening in risk appetite to continue weighing on the risk-sensitive NOK in the short term. In the longer-term, our trade team remains confident that trade tensions will abate towards the end of the year as the US and China move closer to a deal. Should this be the case, we expect NOK, along with other risk-sensitive assets, to stage a rebound, given its high beta to market sentiment.

Fig. 1 - NOK shows relatively high correlation with the S&P500



Source: BIS, Bloomberg, ING

2 Oil market: Saudis may come to the rescue

The oil and gas sector accounts for 22% of Norwegian GDP and 67% of the country's exports to the world. It is therefore little surprise that the currency has historically been closely tied to the energy market. Crude oil prices have declined by nearly 12% since the start of August, which has inevitably triggered an extended selloff in NOK. This weakness in oil prices is related to trade tensions, given the potential negative implications for global demand.

Our commodities team has recently updated its forecasts for crude oil prices (Fig. 2). We remain of the view that there is room for a recovery in prices in the short-term as strong overall compliance to OPEC+ production cuts has reduced supply. But we acknowledge that concerns about weak demand will persist in light of recent trade developments. A key factor that oil bulls will likely hold onto will be the reported activism of Saudi Arabia in preventing further slips in oil prices. The Saudis will likely start by ensuring that all members are complying with the output cuts (Iraq and Nigeria have actually increased production), before proposing further supply tightening. Overall, oil prices remain a big question mark on the krone's outlook in the short-term, and much will likely depend on the impact of Saudi activism on oil prices. In the longer term, we expect oil prices to keep rising in 4Q19 and fuel a recovery in the currency.

Fig. 2 - ING crude oil forecasts

	2019		2020			
	3QF	4QF	1QF	2QF	3QF	4QF
ICE Brent (US$/bbl)	65	68	63	61	65	70
NYMEX WTI (US$/bbl)	57	60	56	54	58	63

Source: ING

Norges Bank to keep going against the easing tide?

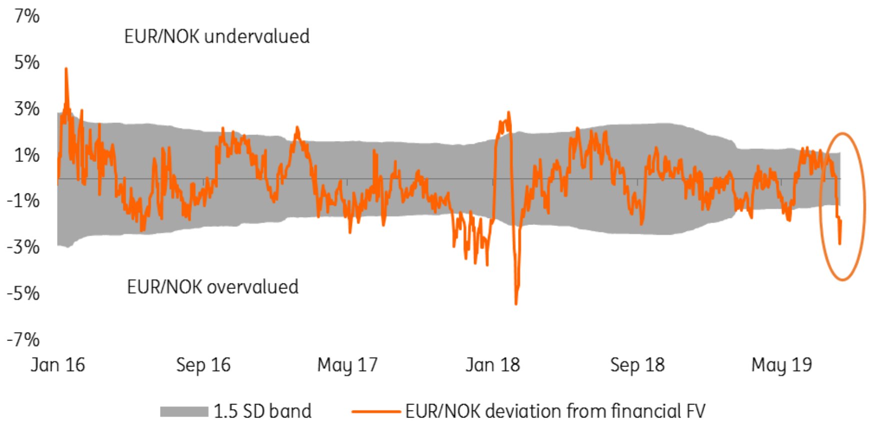
Despite the deteriorating global growth backdrop, the Norwegian central bank has hiked interest rates twice since the start of the year. And while there's a clear risk that trade tensions intensify further, the strong domestic story suggests Norges Bank could hike rates again in the second half of this year.

Despite a decline in oil prices since the June meeting, 2019 oil investment is projected to be the highest since 2015. According to the central bank, cost-cutting measures taken over recent years mean that break-even production costs are substantially below current market prices – ranging between $10-35 bbl – and this is incentivising firms to lift capital spending. This is contributing to tight conditions in the jobs market, and is translating into higher wage growth.

So it's really a question of "when" rather than "if" when it comes to another Norges Bank rate hike. We have been pencilling in December for the next move, although it looks increasingly likely that it could occur as soon as September. It's worth remembering that while trade tensions have been escalating, this is not exactly a new phenomenon, and has not proven to be a major hurdle to the Norges Bank tightening at previous meetings.

The central bank has a habit of explicitly flagging rate hikes at the meeting prior to the move, so we'll be watching next week's statement for a clearer signal – although given that a lot could still change on trade between now and September, policymakers may choose to keep their options open.

Fig. 3 - Our financial fair value model shows EUR/NOK overvaluation



Source: ING

We are reluctant to bet on the end of the NOK downturn just yet. The high beta to swings in risk sentiment still suggests downside risk if trade tensions ramp up further (as we are inclined to believe). In addition, uncertainty about the oil outlook in the short-term is unlikely to revive appetite for the krone just yet, with most hopes currently resting on Saudi's reported pledge to halt the decline in prices. This suggests that it will be mostly up to the Norges Bank and its determination to stick to its hawkish stance to put a solid floor under NOK.

All in all, we expect EUR/NOK to have limited downside potential in the short-term and we definitely don't exclude the pair advancing further in the 10.00 area, possibly exploring the 10.20/10.30 region. Nonetheless, our financial fair value model suggests that EUR/NOK has moved into deep overvaluation territory (Fig. 3), currently displaying almost 2% of risk premium that was last seen at the beginning of 2018. This may hint at a quick downward correction in the pair as soon as the twin negatives of trade and oil dissipate. The possibility of the European Central Bank delivering a substantial easing package in September should further assist such correction. In the meantime, we see NOK holding its ground relatively better against other risk-sensitive currencies such as SEK, AUD and NZD. In the longer-term, we remain of the view that a rebound in risk sentiment and supported oil prices towards the end of the year will pave the way for a steady recovery in the krone across the board.

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