Riksbank set for 25bp rate hike as September move hangs in the balance

We expect the Riksbank to sound the alarm about recent krona weakness, but we doubt policymakers will want to pre-commit to another hike in September just yet. Officials are now walking a narrow path between bolstering the currency and minimising damage to the real estate market. Lingering dissent within the board can send EUR/SEK to 12.00 in the near term

The Riksbank is set to dial back the pace of rate hikes

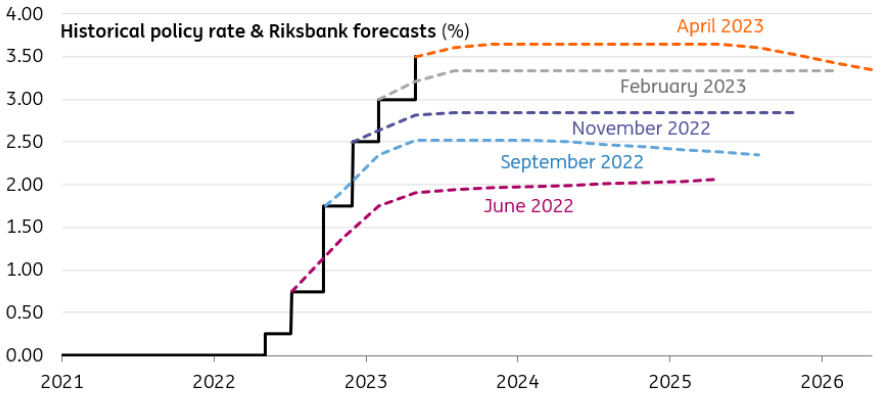
Having hiked rates by 50 basis points in April, Sweden's Riksbank is likely to dial back the pace to a 25bp move on 29 June.

That's consistent with the bank's interest rate projection from its April meeting and also reflects growing division among policymakers on how far rates should rise. Two officials voted against the last 50bp move, although the subsequent meeting minutes suggested these policymakers weren't averse to further hikes should the data warrant them.

With new forecasts due at this month's meeting, the question is whether policymakers try to call the top in their interest rate cycle or point towards more hikes in the autumn. While we suspect the bank may not be as explicit about hiking again in September as it was in April, the newly released interest rate projection will probably keep the door open to another move if needed.

Recent communication – most recently via a speech from Governor Erik Thedéen in May – suggests that the weaker krona remains a key concern for the Riksbank. On a trade-weighted basis, SEK is roughly 3% weaker than the central bank had been forecasting for the second quarter on average. Meanwhile, first quarter GDP was higher than the Riksbank had expected, and unemployment was lower. May core inflation was higher than most forecasters expected too, though that followed a sub-consensus figure for April, and that means the most recent reading was actually only fractionally above what the Riksbank had most recently forecasted.

Riksbank rate projections over time



Source: Riksbank

Another rate hike in September isn't a slam dunk just yet

None of this is necessarily a slam dunk for rates to rise again in September to 4% (from 3.5% currently), but there's a reasonable chance should the krona continue to weaken. The issue for the Riksbank is that the European Central Bank looks set to hike again in July and September, and officials have spoken before about trying to stay out in front of their neighbours on hikes. Bear in mind too that Sweden's central bank meets only twice more this year, compared to four more meetings for the ECB.

The Riksbank will be hoping that the Federal Reserve is indeed done with tightening and that the market begins bringing forward rate cut expectations, alleviating some of the pressure on SEK coming from the dollar.

Ultimately Sweden's housing market is one of the most exposed to interest rate hikes owing to a large share of variable-rate mortgages. Prices are already down 11% from the peak, and despite some recent stability, the risks are clearly tilted towards a renewed downtrend. As alluded to by the doves in the last set of minutes, the trade-offs between hiking to protect the krona and damaging the housing market are clearly rising.

We think the chances of a final September hike are 50:50 at this stage.

A united hawkish front is needed to limit SEK's weakness

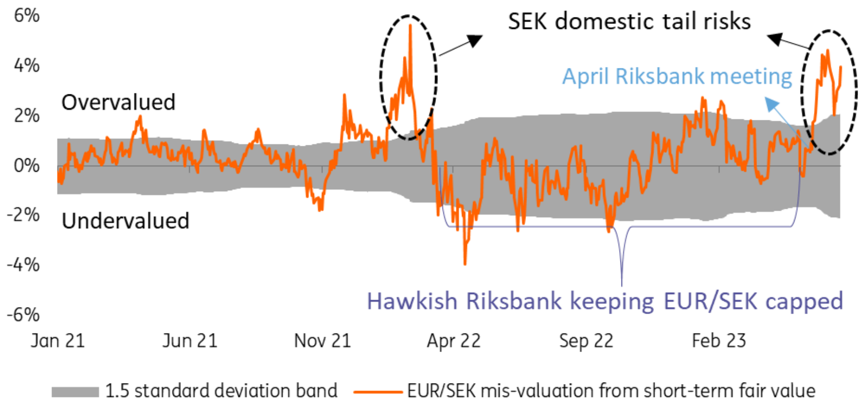
EUR/SEK faced significant upside pressure in the aftermath of the ECB meeting and just touched record highs (11.80). That can obviously be distilled to idiosyncratic EUR strength, but SEK and NOK have emerged as underperformers among European currencies since the ECB announcement. The softness of Scandinavian currencies has been the norm over the past months – although SEK and NOK have taken diverging paths since the start of May, with NOK/SEK having rebounded from 0.95 through to a 1.01 peak last week.

What drove this marked divergence between these two highly correlated currencies? In short: monetary policy and domestic risks. We discussed the FX implications (negative for SEK) of the emergence of two dovish dissenters within the Riksbank Board in these two articles: Sweden: How the Riksbank has made the krona's path to recovery even narrower, and Sweden: Hard to pick a bottom for the unloved krona. Those two dissenters will have an opportunity at the June meeting to re-align with the predominantly hawkish rhetoric of the board, given that the latest core CPIF figures signalled a slowdown in the disinflationary process.

As highlighted above, there is still a very thin line to walk between the negative implications for the troubled real estate market and supporting the weak krona. In our view, lingering dissonance within the Riksbank's Executive Board will leave the krona once again without a floor and expose Sweden to severe imported inflationary pressures.

So, a re-aligning with the pre-April currency-supportive hawkish stance remains key to capping EUR/SEK, in our view. Whether this will materialise at the June meeting, however, is not guaranteed. Admittedly, the April meeting and the post-meeting comments by Riksbank members demonstrated some difficulties in aligning the explicit desire for a stronger krona with the necessary communication to achieve that goal. It also remains to be seen whether the Riksbank will try to deploy more aggressive quantitative tightening or threaten FX interventions (the former more likely) as part of a hawkish package, which we doubt would have the desired market effect compared to a hawkish revision of the rate projections.

EUR/SEK displaying risk premium



Source: ING

Domestic tail risks remain elevated

A hawkish retuning is a necessary but not sufficient condition for a short-term recovery in the krona. Aside from the prevalence of external factors in driving a high-beta currency like SEK, the Swedish currency is having to bear a big deal of domestic tail risks. This is demonstrated by our financial fair value model in the chart above.

It is clear how the Riksbank held an important role in keeping EUR/SEK capped in the face of domestic tail risks, primarily related to a troubled commercial real estate market. The combination of the Riksbank lifting its FX support in April and one of Sweden's largest landlords, SBB, facing serious financial struggles prompted a build-up in EUR/SEK risk-premium comparable to the early 2022 dynamics – before the new Riksbank Governor, Erik Thedeen, stepped in with a hawkish and currency-supportive stance.

The turmoil surrounding SBB has likely put the troubled Swedish real estate and economic outlook back on investors' radar. Our model suggests that it's the period when markets see risks of a dovish Riksbank turn (for example, around the change in governor and after the April meeting) that markets prices tail risks into SEK.

A Riksbank misstep could send EUR/SEK to 12.00

Since EUR/SEK is now trading at record levels, it's hard to point at key resistances. A breach of the 12.00 level raises the risks of FX interventions, although we often discuss the fact that Sweden does not have the firepower in terms of FX reserves to enter an intervention campaign. A threat of intervention would still be possible if SEK weakness accelerates.

When factoring in the ECB-induced EUR strength, more dissent within the Riksbank board and a dovish surprise on 29 June could send EUR/SEK to 12.00. Should the Riksbank signal more tightening – even without formally pre-committing to a September hike – we could see a cap around 11.70/80 in the near term, barring a material deterioration in sentiment.

Given that EUR/SEK is sharply overvalued in the short and medium term – as well as our expectations of the external environment of proving rather benign for pro-cyclical currencies – we target a return below 11.50 in EUR/SEK in the second half of the year. Still, we admit SEK is the currency facing the largest amount of domestic risks in G10, and the Rikbsank's recent communication hiccups add to the upside risks to our baseline scenario.

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