Sweden's Riksbank set to lower rates and cut twice more this year

Sweden's central bank should deliver a 25bp cut at the 20 August meeting. There is more uncertainty about the path ahead: we expect two 25bp decreases after August this year, but there is a chance there could be three. Riksbank easing is denting the krona's rate profile, but the external environment is improving for high-beta currencies

Erik Thedéen, Governor of the Riksbank

A widely expected 25bp cut

Sweden's Riksbank is poised to cut rates for a second time when it meets this month. The central bank is grappling with disappointing economic growth and core inflation that's proving increasingly benign. We expect a 25 basis point cut, taking the policy rate to 3.50%.

If we're right, then it shouldn't be massively surprising. After all, the central bank doubled down on its easing bias by signalling at least two more rate cuts this year. Where other central banks are being deliberately vague about the easing cycle to come, the Riksbank has made no secret of the fact that rates can't stay this high for much longer.

In part, that's simply because the strains of higher interest rates are showing through more clearly in Sweden than they are elsewhere. That's a result of the country's higher prevalence of variable rate lending. Unemployment has risen more noticeably than in the US or elsewhere in Europe, while consumer spending and, indeed, growth more generally looks weak. Admittedly some of the confidence indicators have turned higher this year, but some of this is no doubt on the anticipation of lower interest rates.

Higher confidence on stable inflation

More importantly though, the Riksbank, much like its counterparts at the European Central Bank and Bank of England, is showing greater confidence in its inflation forecasts. The latest core CPIF figure was 2.2%, bang on the Riksbank's most recent forecast. And those same projections show inflation staying benign for the foreseeable future.

Next spring's wage negotiations are a key driver of that forecast, and with inflation expectations among both employee and employer groups back under control, policymakers are confident that those talks won't generate a settlement that's inconsistent with the Riksbank's inflation target.

Two or three cuts by year-end after August

The central bank is also not immune to what other central banks decide. The most recent meeting minutes didn't hide the fact that policymakers are eagerly watching to see how quickly the Fed and ECB start cutting rates. Assuming the Fed, in particular, delivers the more aggressive easing that markets now expect, then that gives the Riksbank greater space to cut rates more readily later this year.

We expect two additional rate cuts this year in addition to the one we expect this month. But there's a risk that the Riksbank decides to cut at every meeting from now on, which would mean an additional three cuts from here. Markets are favouring the latter scenario, pricing in 100bp in total by year-end.

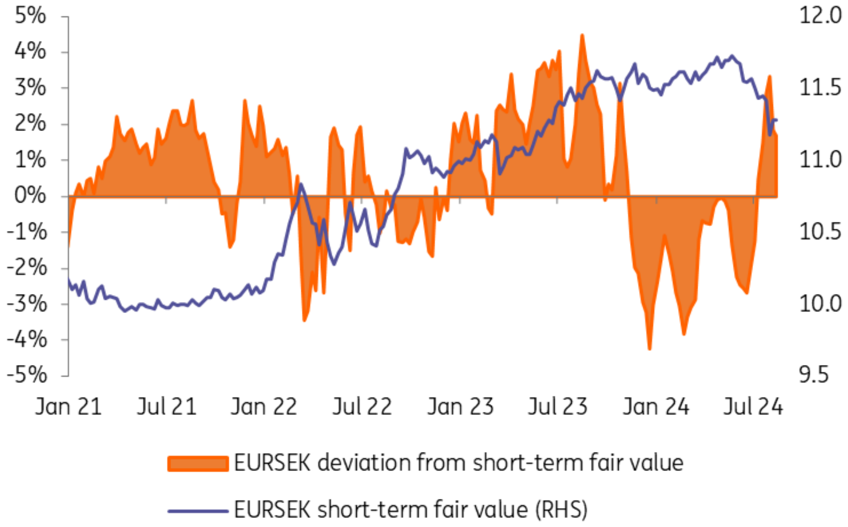
The Riksbank has been quite vocal about forward guidance at its latest meetings. In June, they signalled that "*if inflation prospects remain the same, the policy rate can be cut two or three times during the second half of the year*". Much of the market reaction after the August meeting will depend on how this sentence will be tweaked. We expect they will reiterate "*two or three*" more cuts by year-end, effectively giving a nudge to market pricing.

EUR/SEK: Rate differentials point to gradual decline

EUR/SEK has followed the rollercoaster trajectory of most high-beta currencies. Interestingly, markets did not price out Riksbank easing when EUR/SEK spiked above 11.75. This is the result of the Riksbank cutting when EUR/SEK was around 11.70 in May, signalling to markets they are not excessively worried about a weak krona.

EUR/SEK short-term fair value is now close to 11.30 in our calculations. This indicates some downside potential in the near term, but we must note that there is less room for a drop in EUR/SEK compared to EUR/NOK given the sharp widening of the 2-year EUR:SEK rate gap over the past few months on the back of rising Riksbank dovish bets.

Fair value and short-term mis-valuation of EUR/SEK



Source: ING

That said, markets are fully pricing in 100bp of easing by year-end and around 33bp for this August meeting, which implies some modest speculation of a 50bp move. So, it is fair to believe the downside potential for SEK front-end rates is probably limited at this stage. Two-year SEK swap rates are at a 2-year low of 2.32%, and the 2- to 10-year segment of the SGB yield curve is sitting below 2.0%.

From an FX perspective, reduced appetite for receiving SGB rates doesn't automatically imply a significantly lower EUR/SEK in the near term. That's because the EUR OIS curve is also pricing in a good deal of easing – 70bp over the next three meetings – and at least the September ECB is anything but guaranteed. In other words, we wouldn't heavily rely on a tighter EUR-SEK front-end rate gap to drive EUR/SEK lower, and our bearish bias on the pair largely depends on an improving risk environment into a September 50bp Fed cut.

Incidentally, our medium-term fair value model continues to point at nearly 10% EUR/SEK overvaluation. We believe that the Fed's cutting cycle and a weaker dollar should keep the pair under pressure before the US election risk kicks in.

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