SEK: Struggling to find the silver lining

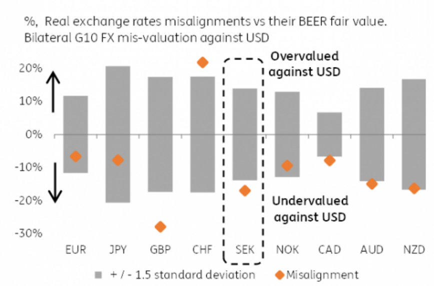
As one of the most negative SEK forecasters, we reiterate our bearish view on the krona. With January inflation disappointing and domestic data to deteriorate further, there are few reasons to be cheerful. We revise our EUR/SEK forecast and now expect it to break above the post-crisis high of 10.7291 in 2Q. And we don't rule out a convergence towards 11.00

Source: Shutterstock

Undervaluation on its own is not a strong enough reason to buy

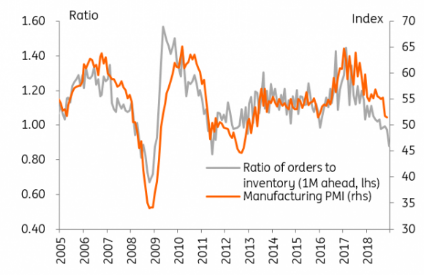
Despite the meaningful decline this year in the Swedish krona and the currency's medium-term undervaluation (arguably the only SEK positive factor at this point, with SEK currently being the second cheapest G10 currency – we see limited scope for a SEK recovery. If anything, we continue to see downside risks to SEK in coming months, largely due to the domestic economic outlook and krona's poor relative attributes vs its G10 peers (many of which also remain meaningfully undervalued - as per Fig 1).

Fig 1 SEK is the second cheapest currency in G10 space



Source: ING

Fig 2 Swedish PMI surveys suggests contraction



Source: ING, Bloomberg

Soft domestic data to translate into more SEK weakness

We expect Swedish economic data to continue deteriorating. PMI surveys have fallen as global economic momentum slows down, and is likely to move into contractionary territory in the coming months (Fig 2). Sweden depends heavily on exports, and with both Europe and China now clearly weakening, the outlook looks considerably worse.

On the domestic side, the housing market will continue to struggle, and household consumption will remain anaemic. While prices stabilised in 2018, construction output is falling sharply – new starts were down 16% compared to 2017, and are likely to fall further in the first half of 2019. House prices could easily start sliding again, and even with support from the modest tax cuts in the 2019 budget, it is unlikely consumption spending will pick up materially. Also, real wage growth remains weak (adjusted for inflation, wages grew by 0.5% in 2018), so the outlook for the housing market looks quite uncertain.

Weak krona failing to deliver expected inflationary pressures

With the disappointing inflation readings, core CPI, in particular, this suggests the Riksbank will struggle to deliver the next planned rate hike in the second half of 2019, even if the krona weakens further.

> *The basic inconsistency in the Riksbank's forecast remains that it expects core inflation to rise to 2% even though it thinks the krona will appreciate gradually*

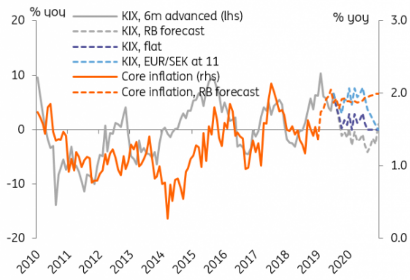
In Fig 3, we look at the impact of the SEK weakness on CPI. A simple mapping suggests that core inflation is highly dependent on currency movements, though last year's SEK depreciation hasn't yet shown in the core inflation data as the Riksbank expected. And while core inflation may pick up a bit over the coming months, we think it is likely to fall back in the second half of the year and will continue to disappoint relative to the central bank's forecast.

Indeed, the basic inconsistency in the Riksbank's forecast remains that it expects core inflation to rise to 2% even as it thinks the krona will appreciate gradually. Experience suggests this is unlikely given the absence of domestic price pressure (i.e. higher wage growth). So at least until 2020, when the new wage bargaining round could potentially result in stronger wage pressure, the

Riksbank's forecast will likely remain too optimistic.

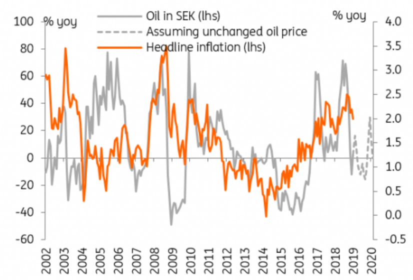
We think that until then, the only way to get core inflation to reach the target is through further SEK depreciation. And our simple mapping suggests that even if EUR/SEK were to rise to 11.00 (an additional 4% appreciation), this would only push core inflation to around the 2% level. Also, the fall in oil prices in the last quarter of 2019 means that headline inflation will also fall back in the first half of 2019 (Fig. 4).

Fig 3 Core inflation vs KIX



Source: ING, Bloomberg

Fig 4 Headline inflation vs oil



Source: ING, Bloomberg

It's difficult for Riksbank to lean against SEK strength

This means that we see limited scope for another Riksbank hike.

Even in December, the case for raising rates was marginal at best, and with both domestic and global economic data deteriorating since then, the potential for a defensive hike to support the currency isn't strong.

> *Hiking rates in a low inflation/weak growth environment would be a very questionable policy choice*

So although the Riksbank reaction function arguably shifted a bit over the past quarters (see Has the Riksbank finally had enough of SEK weakness?), and the central bank is no longer looking to generate SEK weakness actively (instead it seems to be preventing SEK from weakening further), in the current domestic and external environment the Riksbank may struggle to credibly lean against SEK weakness.

In short, hiking in a low inflation/weak growth environment would be a very questionable policy choice, and we think that ultimately the Riksbank policymakers would rather accept further krona weakness than raise rates in a slowing economy, which would risk a return to the near deflationary environment seen in 2014-2016.

While we don't rule out a Riksbank hike in the fourth quarter, this would in our view be a response to a more material SEK weakness rather than a response to domestic data. This suggests that SEK needs to weaken first before the Riksbank delivers another defensive hike which would then help to stabilise the currency. Hence, frontloaded SEK weakness in the coming months is not inconsistent with a potential Riksbank hike - a case which has nonetheless diminished materially.

External environment does not favor low yielding SEK

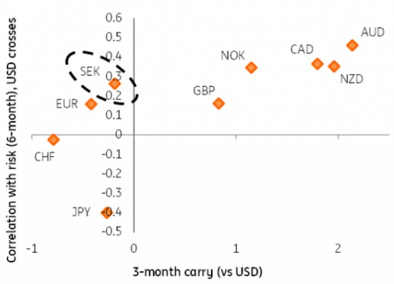
The external environment isn't in favour of the krona either. In the late stage of the global economic cycle, which is currently characterised by the ongoing threat of trade wars and declining global trade, the currency of a small open economy levered to global trade is unlikely to do well, particularly if it offers a negative yield.

> *The currency of a small open economy levered to global trade is unlikely to do well, particularly if it offers a negative yield*

The negative yield in what is perceived as a higher beta, activity currency is indeed a large headwind for SEK and makes the currency materially less attractive vs its G10 peers. As you can see in the figure below, the krona is in the undesirable quadrant vs other pro-cyclical, activity G10 currencies. That's why in our view, the SEK has failed to benefit during the recovery of risk assets in January. Unfortunately for the currency, SEK didn't reap the benefits during the risk-on periods and is exposed during the risk-off periods - attributes that make a case for going long SEK rather weak.

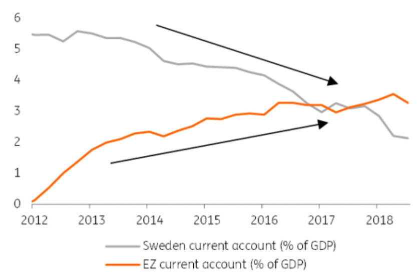
Moreover, with EUR/USD under pressure and fairly limited prospects for any near-term EUR/USD appreciation, SEK is not attractive even from the USD-based investor's point of view.

Fig 5 SEK in the undesirable quadrant



Source: ING, Bloomberg

Fig 6 Swedish current account surplus deteriorating

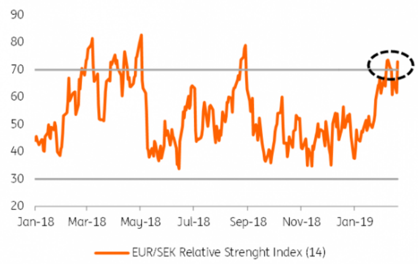


Source: ING, Bloomberg

Current account surplus continues deteriorating

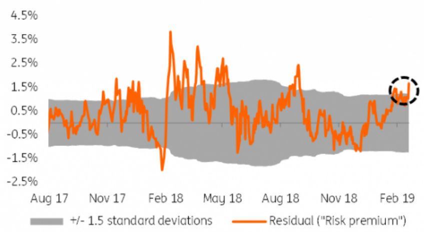
Moreover, as we flagged earlier - [SEK: Swimming naked?], the Swedish current account surplus continues to decline, and the trade surplus virtually disappeared. This yet again reduces the attractiveness of the low yielding SEK as support from the flow factor has been vanishing. As Fig six shows, for the first time in decades, the eurozone and thus the euro now benefits from higher current account surplus than the krona.

Fig 7 SEK looks oversold on short term basis...



Source: ING

Fig 8 ...with short-term fair value looking modestly stretched



Source: ING

Forecast revision: More SEK weakness in store

With the case for the Riksbank to facilitate SEK strength sharply diminishing and the Riksbank rather facing a puzzle of how to prevent SEK weakness in the low growth and low domestic inflation environment, we look for more SEK weakness to come in the months ahead. The soft domestic data and mildly dovish Riksbank April meeting should keep SEK under pressure.

We revise our EUR/SEK forecast higher and look for EUR/SEK to reach 10.75 in three months – and we're also upgrading our 12-month forecast

After reaching our 1-month target of EUR/SEK 10.60 today (see FX Talking: Clear and present danger), we revise our EUR/SEK forecast higher and look for EUR/SEK to reach 10.75 in 3 months – that is a new post-financial crisis high. We also upgrade our 12-month forecast to 10.30, though our conviction is much higher for the three months view. We remain firmly bearish on the currency and continue to struggle to find good reasons (bar valuation) to own the krona.

We recognise that the currency currently looks oversold on a short term basis, be it based on the relative strength index or our short-term financial fair value model (as per Figures 7 and 8). Hence, some EUR/SEK stabilisation over the near term is likely before renewed appreciation in the second quarter this year.

ING EUR/SEK forecasts

	1-month	3-month	6-month	12-month
New	10.60	10.75	10.40	10.30
Previous	10.60	10.50	10.30	10.20

Source: ING

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