

Sweden: Krona feeling the winter blues

Weak inflation and (an even more) dovish central bank puts the Swedish krona under renewed pressure



Source: Shutterstock

At the end of last week, EUR/SEK traded through the important 10.00 level, which has only been breached during the 2008-09 crisis. After a strong start to the year, the KIX trade-weighted index is now down nearly 2% in 2018 and more than 5% since August.

Aside from the Winter Olympics that saw the neighbour and arch-rival Norway win a record number of medals, what explains the krona's midwinter blues?

We see three factors that have contributed to the SEK weakness.

1 Softer data

Inflation is the key variable for SEK, with currency and rates markets responding strongly to both positive and negative surprises. Headline inflation disappointed both in December and January, with weak non-energy prices suggesting momentum has stalled.

Other indicators have also somewhat softened, suggesting GDP growth is slowing down, albeit from high levels. Broadly speaking, the export-oriented manufacturing sector is benefiting from stronger global demand, but not enough to offset weaker domestic growth.

2 Central bank caution

The Riksbank has responded to weaker data by signalling a later rate hike.

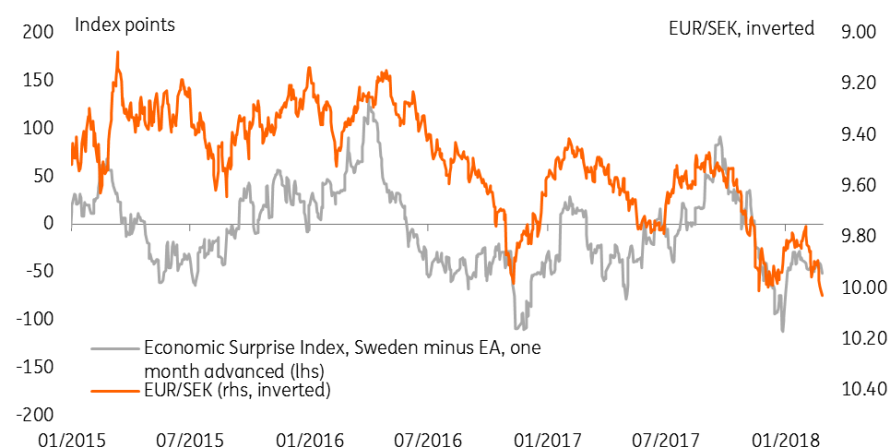
At the February policy meeting, rate-setters downgraded their inflation forecast and slightly altered the guidance on rate hikes to suggest a later hike. The minutes also showed a dovish shift on the committee: while one member surprisingly voted to hike rates, the other five all indicated concern about inflation dynamics.

3 Continued housing market concern

The sharp fall in house prices over the autumn contributed to bringing SEK (and NOK) lower in the fourth quarter. Prices rose in January, though partly for seasonal reasons. But the weakness of both SEK and NOK during the VIX-shock episode in early February suggests markets are still concerned and pricing some risk premium.

Also, the momentum associated with breaking a key technical level combined with poor liquidity (due to winter school holidays in Stockholm this week) is likely to keep the pressure on SEK in the near term.

Economic surprise index (Sweden minus EA) vs EUR/SEK



Currency and inflation outlook remain intertwined

So far the Riksbank has not appeared overly concerned by SEK depreciation; policy-makers have continued to reiterate the need to avoid a rapid appreciation that would threaten the inflation outlook. If anything, a weaker currency that helps to offset downside risks to inflation has been welcomed.

It's not difficult to see why. Consider that the Riksbank's current forecast has inflation at 1.7% on average over 2018. This assumes a 3% appreciation in the KIX over 2018 and another 2% in 2019. If instead, the KIX index remained around current levels, that would add perhaps 0.2-0.3pp to inflation towards the end of 2018. That would likely put inflation more comfortably around 2%.

But should the currency continue to fall, the Riksbank's view may start to change. Given that EUR/SEK remains overvalued on a fundamental basis (fair value according to a BEER model is

around 9.30), sustained weakness would indicate that something more worrying is going on in the economy. And a much weaker currency would threaten to push inflation above target.

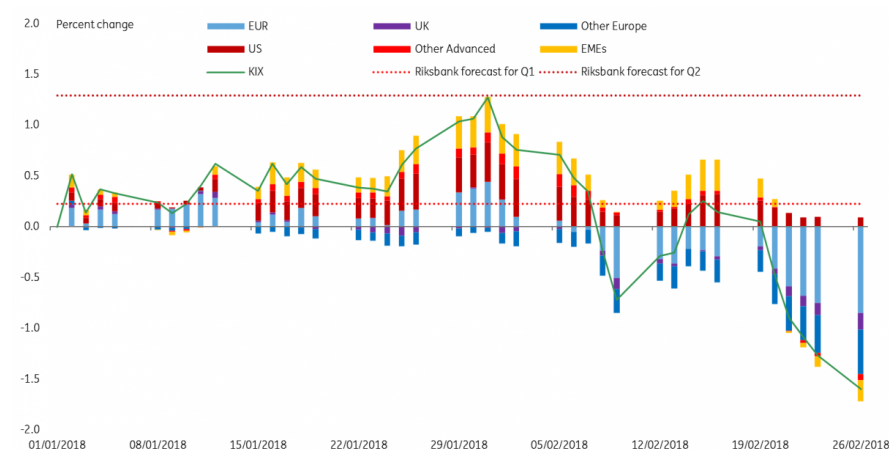
Where do we go from here?

Like most forecasters, we had expected SEK to appreciate gradually in 2018. That remains the most likely outcome; we think it would take a severe housing market downturn and divergence between the Riksbank and ECB (as in Riksbank loosening policy, not just delaying rate hikes) to justify EUR/SEK trading above 10 for a sustained period.

But the weakness we've seen in February suggests SEK may continue to struggle. In particular, it is likely to continue to underperform against other small European currencies where the positive cyclical story is more clear-cut.

KIX trade-weighted index in 2018

(cumulative change vs trade partners)



Source: Macrobond