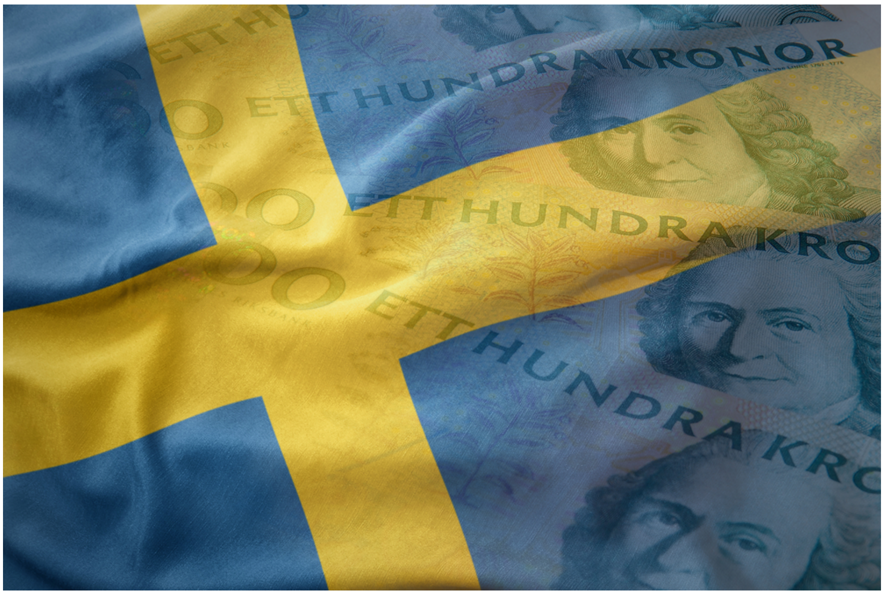
Swedish krona: Less bad, but bad nonetheless

Despite some tentative improvement in domestic drivers (no longer ultra-dovish Riksbank, stabilising current account), the outlook for the Swedish krona remains poor for the rest of the year. We stick to our EUR/SEK 11.00 forecast as trade war uncertainty and poor SEK relative characteristics weigh on the currency



Compared to previous years, we expect domestic factors to be a less of drag on the Swedish krona (SEK) - the current account surplus is no longer deteriorating, and we don't expect rate cuts from the Riksbank.

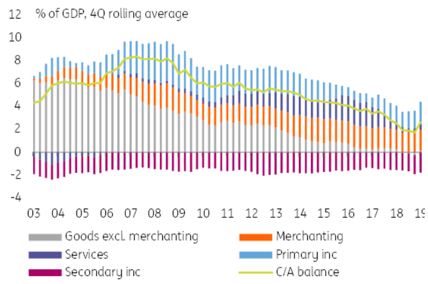
Still, the scope for the undervalued SEK to rally is limited as the currency suffers from the most negative real rate in the G10 FX space and exhibits unattractive characteristics within its G10 FX peer group.

Neither make the risk-reward to own SEK very attractive. For coming months, we see upside risks to EUR/SEK as the slowdown in global growth and possible deterioration in the trade war outlook make SEK vulnerable (even if the Riksbank is done with easing) in the context of the openness of the Swedish economy and the cheap funding cost of the currency. This should also prompt the

Riksbank to lower its forecast for projected rate hikes (without pencilling in rate cuts just yet).

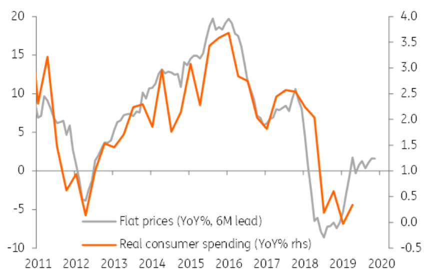
EUR/SEK should reach the 11.00 level in coming months.

Fig 1 The worst for the current account is over



Source: ING

Fig 2 Swedish flat prices started to stabilize



Source: ING, Bloomberg

Riksbank: Less need to ease as SEK remains weak

In contrast to previous years, the Riksbank's policy stance may no longer be an outright negative for SEK, as unease about an overly weak currency has grown among board members, and the Riksbank's appetite for (even more) negative rates has declined markedly. Indeed, the desire to leave negative territory was a key reason behind the Riksbank's rate hike in 4Q18 and intention to do more.

While inflation has the potential to dip back in the near-term (given a negative drag from electricity prices), this should prove temporary. This, combined with the current weak exchange rate, suggests the bar for renewed interest rate cuts is rather high. That said, we think the rate hike that the Riksbank is current projecting for later this year/early next is also unlikely to materialise.

Our thinking here is partly linked to the central bank's projection for wage growth, which we suspect could prove a little optimistic. A mixture of global uncertainty and a modest decline in inflation expectations among labour organisations suggest next year's crucial wage negotiations may end with a fairly subdued result.

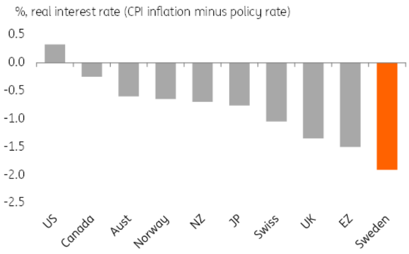
In contrast to the 2014-2015 period, we don't think the Riksbank will attempt to match the European Central Bank's easing cycle (or at least not this year), either via rate cuts or a new round of quantitative easing, given that the strong exchange rate is no longer a concern. If anything, the opposite is true. Still, this failure to match ECB easing is unlikely to be seen as SEK positive in our view, given the negative global factors (trade war uncertainty, economic slowdown – see below).

Current account: The deterioration is behind us

As is the case for the Riksbank, the current account dynamics should be a less of a drag on the currency. After the deterioration of the current account position (as well as the trade balance) over the past few years, we now expect the current account to stop worsening. In fact, it should modestly improve this year and stabilise in 2020 (Figure 1).

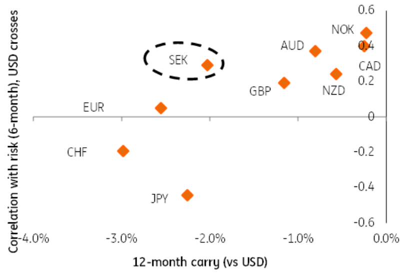
The recovery should be partly driven by the J-curve effect, but also by a rebound in services exports. Yet, any meaningful improvement in the current account position should be limited as imports are likely to remain strong (high immigration over recent years should structurally boost demand for imported goods). Still, this is enough for the current account to be no longer seen as a negative for SEK.

Fig 3 SEK suffers from the lowest real rate in G10 space



Source: ING, Bloomberg

Fig 4 SEK offers poor risk-reward characteristics



Source: ING, Bloomberg

Housing set to drag on growth, despite price stabilisation

Between August and December 2017, Swedish house prices fell by around 10%, according to Valueguard data. Since then, consumer confidence has fallen and as of the start of 2019, household spending has virtually ground to a halt.

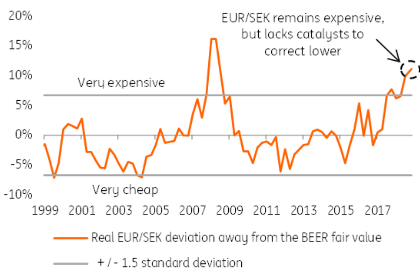
The good news is that house prices have since stabilised (Figure 2), although we expect the effects of the earlier price decline to continue to weigh on household spending. Consumption looks set to remain subdued for much of this year even though the recent plunge in global interest rates could give mortgage-holders a helping hand.

But perhaps the bigger risk lies with investment. Housing starts have slowed, although there is a clear risk of a sharper deceleration in the number of construction projects being commenced. So while the outlook for prices is tentatively brighter, the negative drag on growth from housing still looks like it has further to run.

Despite some improvements, the case for SEK strength is limited

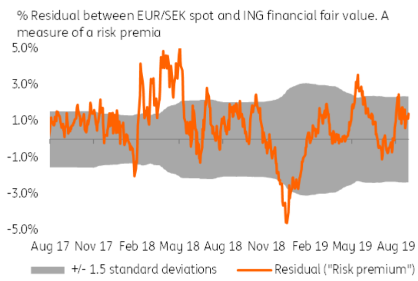
Although domestic drivers should be less of a drag on SEK (no longer ultra-dovish Riksbank, no longer deteriorating current account position and the housing market), the case for SEK strength is limited.

Fig 5 SEK remains very cheap on medium term basis



Source: ING

Fig 6 SEK short-term risk premium not at extreme



Source: ING

Trade wars don't bode well for SEK

The uncertainty on the trade war outlook remains one of key external challenges for SEK. Sweden is a small open economy reliant on global trade and the current situation does not bode well for the currency. Our trade team continues to expect things to get worse before they get better (as it will take time for the US administration to scale back its overambitious list of demands) suggesting ongoing pressure on SEK.

SEK still compares poorly to its peer group

Even though the Riksbank is no longer attempting to generate SEK weakness, the currency still compares poorly to its G10 FX peer group. As Figure 3 shows, and even after the rate hike in 4Q18, SEK offers the lowest and most negative real yield among G10 currencies. Moreover, the level of the nominal yield is unattractive for the high beta characteristics of the currency. This is evident in Figure 4, which shows that SEK offers a low yield relative to its high beta, when compared to its peer group (Norwegian krone, Canadian, Australian and New Zealand dollars). All this means a rather unattractive outlook for SEK.

Valuation attractive but not catalyst for stronger SEK

After the sell-off in 2018 and this year, SEK remains meaningfully undervalued vs the euro. Our BEER model currently sees EUR/SEK being 11% expensive vs its medium-term fair value (Figure 5). While such a misvaluation is pronounced, we don't see any catalyst that would prompt a SEK recovery towards its fair value. If anything, and as per above, the risks are skewed to EUR/SEK upside given the trade war uncertainty.

Indeed, the scope for EUR/SEK upside is corroborated by the short-term financial fair value EUR/SEK model, which does not show any meaningful risk premium being priced into EUR/SEK (Figure 6) – even after the recent SEK decline.

	Total (%)					Net increase (%)				
Change in frequency use of Online...	Less	Same	More/ started	Never use(d)	Net increase	Germany	Poland	Romania	Spain	Turkey
Shopping for food and groceries	6	34	30	30	24	9	25	23	22	38
Shopping for apparel and personal care items	9	44	36	11	27	6	29	22	17	40
Shopping for electronic and technology items	9	47	32	12	23	9	34	25	23	44
Shopping for household appliances, furniture, DIY, tools, etc.	10	46	27	17	17	6	21	15	10	36
Shopping for leisure items (sports, gaming, toys, puzzles, etc.)	8	41	33	18	25	5	6	8	3	27
Leisure content (streaming, movies, music, TV, reading, etc.)	6	39	44	11	38	9	32	20	22	46
Socials (social media, chatting, calling, games, etc.)	6	41	45	8	39	20	41	33	44	57
Education, learning, and training	6	33	37	24	31	17	41	36	44	59
News	5	42	45	8	40	10	33	35	27	53
Investments (stock market, mutual funds, real estate, other)	8	33	18	41	10	8	33	34	28	50
Banking (financial transactions, payments, budgeting, etc.)	5	49	37	9	32	30	48	36	30	57
Average	7	41	35	17	28	12	31	26	25	46

Forecast: Higher conviction on weaker SEK

As per our forecast (Table 1), we expect EUR/SEK to reach the 11.00 level over the next three months. The forecast modest SEK rebound over a 6-12 month time horizon is predicated on the assumption that the US-China trade dispute gets resolved next year. This is currently highly uncertain, pointing to a risk of weaker SEK for longer and our meaningfully higher conviction on the direction of our 3-month forecast (rather than the 12-month forecast).

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