

## Why the Scandinavian FX selloff looks overdone

NOK and SEK have collapsed in the past two weeks. This is a result of markets exiting less liquid G10 currencies as the “Trump trade” gains traction. Domestic factors are also at play: softer June CPI prints supported dovish bets in both countries. However, technical and fundamental factors, along with potential central bank reaction, point to a recovery



### Trump trade has hit high-beta currencies

At the start of this month, we had a rather optimistic view on NOK's upward opportunities, while we saw SEK flatter due to domestic monetary policy divergence. We were aware both currencies primarily react to external factors, but the recent price action had indicated US macro was still a more important driver than US politics. Former President Donald Trump had clearly won the June TV debate, but the FX reaction had so far been relatively contained.

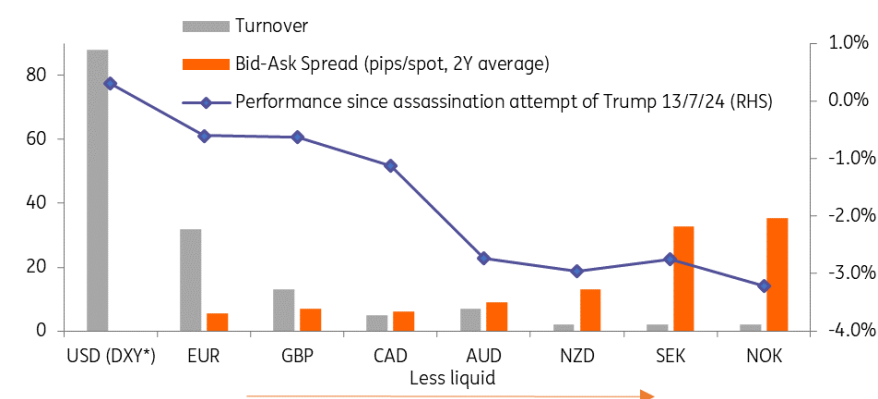
The assassination attempt of Trump on 13 July generated some tectonic shifts in G10. Markets moved to price in a much greater deal of implied risks from a Trump re-election in the less-liquid, higher-beta currencies like NOK, SEK, AUD and NZD. The dollar and safe-haven currencies rallied

and the more liquid pro-cyclical currencies held stable.

The chart below shows the performance of G10 currencies relative to liquidity measures (turnover and bid-ask spread), excluding the safe-haven JPY and CHF. This shows the liquidity-FX underperformance link, but markets may have also added some geopolitical-related risk premium on the four hard-hit currencies based on Trump agenda's expectations.

- AUD and NZD are common proxy trades for China-related sentiment, and may be suffering from US tariffs expectations under a new Trump presidency
- NOK and SEK are exposed to US protectionism as well as a potential deterioration in European sentiment should Trump – if elected – pull support to Ukraine

## Less liquid currencies are selling off



Source: ING, BIS, Refinitiv

## Domestic factors have contributed...

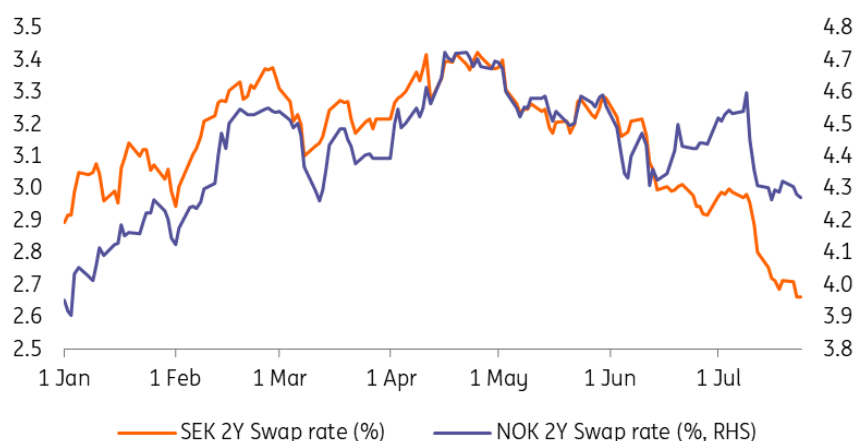
Domestic macro developments may have contributed to NOK's and SEK's demise. The CPI reports for June were published on 10 July in Norway and 12 July in Sweden, and both showed lower-than-expected inflation. That triggered some weakness in NOK and SEK already in the week before the assassination attempt of Trump.

### *Inflation surprised on the downside in June*

In Norway, headline inflation fell from 3.0% to 2.6%, and the underlying rate from 4.1% to 3.4%. That made markets doubt the Norges Bank would be able to remain hawkish for longer. When adding pressure from dovish Fed bets, the NOK OIS curve priced in around 20bp of easing by year-end – now back to around 17bp.

In Sweden, CPIF inflation plummeted from 2.3% to 1.3% in June, with the measure excluding energy also down from 3.0% to 2.3%. Remember that the Riksbank had signalled two or three cuts by year-end. Understandably, markets cemented their bets for 75bp of easing after the CPI print.

## Softer inflation has prompted dovish repricing in Scandinavia



Source: ING, Refinitiv

### ... but watch for the FX-policy link

One of the reasons why we think further upside for EUR/NOK and EUR/SEK is limited is that markets will be very reluctant to price in any extra bit of easing by Norges Bank and Riksbank after the selloff in the domestic currencies.

Remember that those are some of the most FX-sensitive developed central banks. Only a month ago, Norges Bank's statement included this sentence: "if the krone depreciates, wage and price inflation could remain elevated for longer. In that case, there may be a need to raise the policy rate". A hike may be a step too far, but the message is clear: easing is unlikely in a NOK selloff. After all, Norges Bank can count on a rather solid economic outlook and still tight labour market, meaning there is not much rush to ease policy.

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*Norges Bank said it was ready to "hike" if NOK was too weak*

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In Sweden, the situation is a tad more complicated. The Riksbank has been highly attentive of SEK developments, and constantly protested the weak and undervalued krona. However, they cut rates in May when EUR/SEK was at 11.70, a signal to markets that that level was not alarming enough to offset dovish arguments. If EUR/SEK starts trading materially above 11.70, we move to uncharted territory, where it is unclear if the Riksbank will be willing to keep cutting. That means markets may trim some Riksbank dovish bets if EUR/SEK keeps rising, which should limit the upside. Incidentally, there is a risk that the Riksbank will go ahead with cuts despite a weak SEK but also revamp FX sales via the reserve hedging programme which drove EUR/SEK significantly lower in 4Q23.

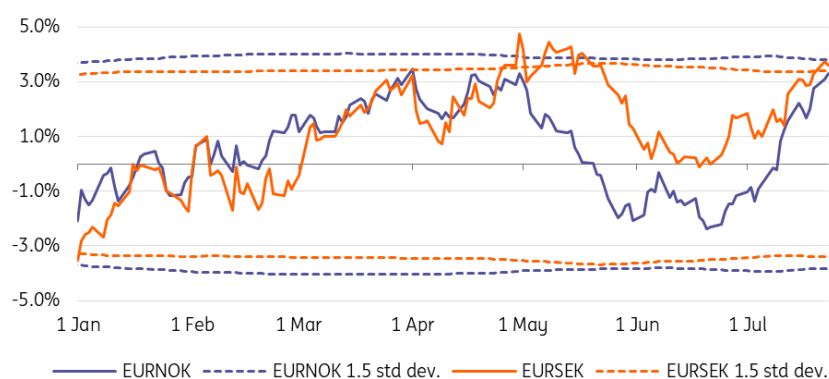
### The rally in EUR/NOK and EUR/SEK is overstretched

As shown in the chart below, our short-term fair value estimates for EUR/NOK and EUR/SEK point to stretched overvaluation at around 1.5 standard deviation. This means the move lower in short-dated NOK and SEK swap rates following the sub-consensus CPI prints this month - even when

compounding equity-related market indicators in the model - are not enough to justify the size of the rally in EUR/NOK and EUR/SEK.

This kind of risk premium is particularly large in Scandinavian currencies, and we suspect this is due to the lower liquidity conditions that have caused a Trump-trade-led move to exacerbate on the upside.

## Mis-valuation from short-term fair value (%)



Source: ING, Refinitiv

EUR/NOK is now close to 12.00, a key resistance that held well in two instances in 2023 (May and November). A break higher would push the pair to the highest since the pandemic shock. The market liquidity conditions are nowhere close to the 2020 liquidity drought, and NOK continues to count on both strong fundamentals as well as a rate advantage over EUR (around 125bp), which make it inconsistent with such high levels of EUR/NOK.

### *EUR/NOK and EUR/SEK are at key resistances*

EUR/SEK is instead close to 11.70, which as mentioned above is the level at which the Riksbank cut rates in May. This isn't as strong a resistance as 12.00 in EUR/NOK, and the next major technical level to watch in EUR/SEK is the 11.77, 1 May high. SEK's 2-year swap rate is below that of the EUR, but only by around 35bp: not enough to justify a collapse of the krona.

## Outlook for NOK and SEK

We admit that it is a risk to pick a bottom for NOK and SEK in the current high-volatility conditions. However, technical factors, fundamentals and markets cementing their Fed easing bets all point to a recovery in Scandis. We believe it is more likely that we'll see a correction in EUR/NOK and EUR/SEK as opposed to another major leg higher. The local central banks may incidentally come to the rescue with some verbal intervention should we see a break above key levels in the two pairs, which can help curb the upside. Between the two currencies, we see a greater room for rebound in NOK compared to SEK due to lingering monetary policy divergence. A return below 11.60 in both pairs in the coming months remains our base case.

Beyond the short-term, sharp overvaluation still points to a downward-sloping profile for both EUR/NOK and EUR/SEK. Both pairs are about 13% above their real medium-term fair value, according to our BEER model. In addition, NOK can still count on a rather attractive yield should we see a revamp of carry trades in a low FX-volatility environment.

While there is a high degree of uncertainty related to the US election, it's important to note that a potential Trump victory does not automatically imply weaker NOK and SEK. There is a possibility that the most hard-line part of Trump's agenda are not implemented until well into the mandate and the market impact is spread over time. In the meantime, if the Fed cuts 150bp by end-2025 as we expect, there will be some tailwind for high-beta currencies like SEK and NOK.

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