Swedish economic and FX update: Pessimism reality check

Sweden is facing some rather severe economic headwinds, and recent evidence of negative growth paired with lingering concerns about a fragile real estate sector have contributed towards keeping the Swedish krona under pressure. From some angles, however, investors may be overestimating the downside risks to Sweden's activity outlook. In this bundle, we take a deeper look into the country's economy and how we're expecting the Riksbank to respond.

On the FX side, the krona is trading at all-time lows. We suspect that more pain may be on the cards in the near term as the environment for pro-cyclical currencies remains challenging. EUR/SEK may touch or even break 12.00 soon, but the Riksbank will likely play a key role in halting the rally. Looking ahead, we expect a SEK rebound. The question is more timing than direction since the krona is very undervalued. External, more than domestic drivers, hold the key to that rebound.

In this bundle

Sweden

Riksbank set for at least one more hike despite fragile economic backdrop

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By James Smith

FX | Sweden

Swedish krona still searching for the bottom, but the Riksbank can help

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By Francesco Pesole

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Riksbank set for at least one more hike despite fragile economic backdrop

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Erik Thedeen, Governor of the Riksbank

Riksbank set for at least one more hike

There are two weeks to go until the Riksbank's September meeting and another 25bp rate hike looks pretty likely. Services inflation is uncomfortably high and the trade-weighted value of the krona is back to its lows. A follow-up rate hike in November can't be ruled out.

Yet the economy is clearly reacting to higher interest rates. A 0.8% decline in second quarter GDP, while not as bad as initially reported, shows the economy is under strain. On a year-on-year basis, Sweden is in the bottom five performers in the EU when it comes to growth.

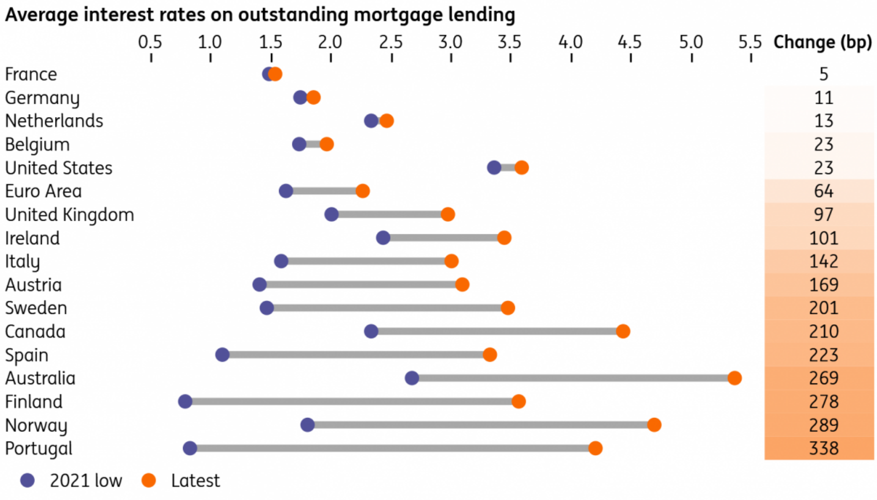
Still, the story isn't universally bad and there are some bright spots. The jobs market is still very tight by historical standards, the housing market has stabilised, confidence is rebounding and consumer spending is showing signs of levelling out.

Here, we look at how the economy is performing in several key areas.

Housing market

Housing is a well-known vulnerability for Sweden, and the 16% peak-to-trough fall in prices during 2022 was not hugely surprising. Compared to other European economies, Sweden has a much greater percentage of variable rate mortgages, and that proportion has only increased since interest rates started to rise. According to the Riksbank, 90% of loans have a remaining fixation period of below two years, and in the majority of cases, these are not fixed at all. The result is that the average rate on outstanding mortgages has increased by 200bp since the Covid low, compared to 64bp for the eurozone as a whole, and much less still in France/Germany.

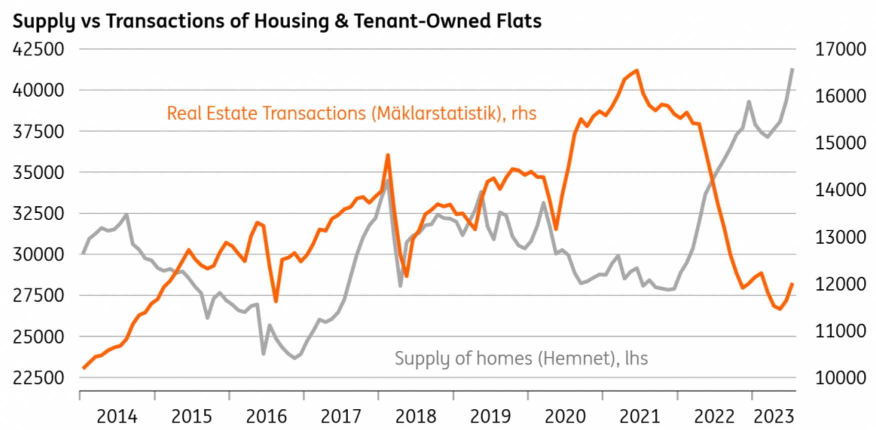
How average mortgage rates have changed since 2021



Source: Macrobond, ING calculations

That said, housing prices have stabilised this year and household sentiment towards housing has improved noticeably. But the fundamentals of the market still look challenging, and data from Hemnet – a property search site – shows housing supply at multi-year highs, while separate figures show transactions are at a low. We tend to agree with the Riksbank's forecast that further price falls are likely.

Supply of housing has increased as transaction volumes fall



Source: Macrobond

Jobs market

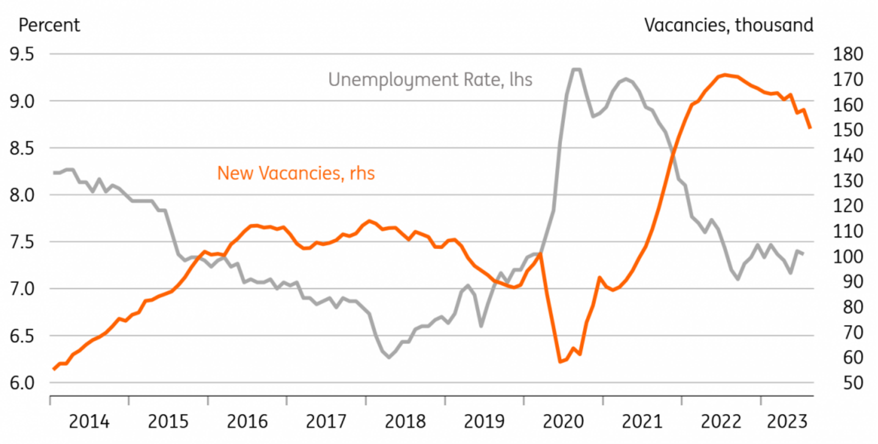
Sweden's unemployment rate is at a post-pandemic low, and that resilience has been helped by a pronounced reduction in joblessness among foreign-born workers. One of the key issues for a number of years has been a skills mismatch and poor integration of migrant workers into the Swedish jobs market – and the gulf between native unemployment (below 5%) and foreign-born workers (near 14%) is still large, but has narrowed.

There are signs that the jobs market is cooling, however. The number of layoffs has started to rise, though from a low base. Vacancy numbers have been falling too, though so far the decline in the ratio of job openings to unemployment has been less sharp than in other economies, notably the US and UK. The proportion of service-sector businesses that see labour as a constraint on production has fallen from 45% to 30% in just over a year.

Still, there are signs that firms are "hoarding" staff – i.e. they are afraid of letting people go given rehiring concerns. This is helped by the fact that nominal wage growth is relatively contained given the level of inflation, with the benchmark negotiated pay deal set at 3-4% for the next couple of years. That's noticeably below the rate we've been seeing in some other advanced economies.

As a result, while we're assuming that unemployment will increase over the coming months, the rise is likely to be gradual.

Vacancy numbers are falling, albeit slowly

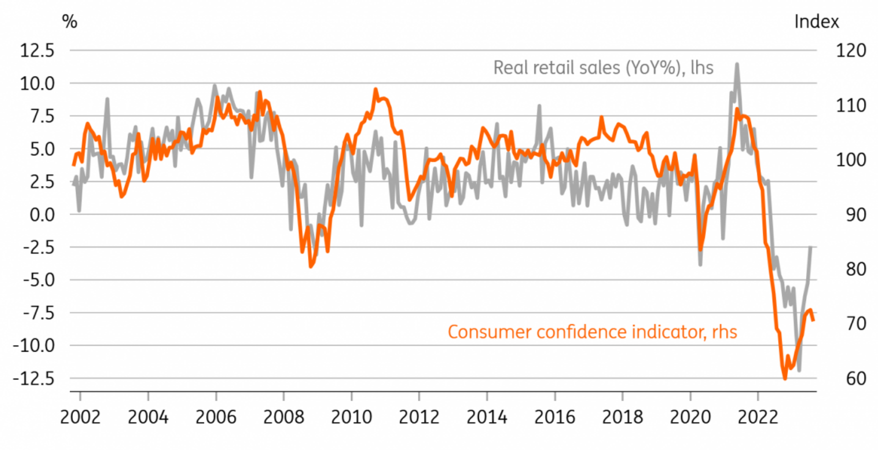


Source: Macrobond

Consumer spending

Consumption has been falling consistently for a year now, though this masks big differences across spending categories. Furniture sales are down 15% on pre-pandemic levels while spending on recreation/culture is up by a similar percentage. Even in the weaker areas though, the story is stabilising. Consumer confidence has risen noticeably, and real wage growth is slowly becoming less negative. Still, with interest payments set to consume an ever-increasing share of household budgets, we don't expect consumer spending to return to meaningful growth any time soon.

Higher consumer confidence points to stabilisation in retail sales



Source: Macrobond

Production

Like consumer spending, and like pretty much everywhere, Sweden's manufacturing sector is also in contraction, at least according to the PMIs. Admittedly, this weakness hasn't entirely been borne out in the official production data, and Swedish manufacturing has been operating 5-10% above pre-pandemic levels for much of the last year – in sharp contrast to the likes of France/Germany where production remains below early-2020 levels.

This growth has been heavily concentrated though, primarily in chemicals/pharmaceutical products, and more recently in a sharp recovery in vehicle production. The latter is up almost a third since the start of 2022 on improved supply chains, but we suspect this is more of a catch-up story and can only last for so long. We expect the weaker manufacturing numbers to show up more clearly in the official data over the coming months.

Bottom line

Assuming there's a renewed fall in house prices, some gradual weakness in the jobs market and ongoing pressure on consumer spending and production, we're likely to see further declines in economic output through the remainder of this year. While the Riksbank clearly isn't quite done with rate hikes, the fragile economic backdrop suggests we're near the peak.

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Swedish krona still searching for the bottom, but the Riksbank can help

EUR/SEK is close to the 12.00 level, trading at historic highs as external and domestic factors have added pressure to the already weak krona. In the medium term, we have few doubts SEK can recover and converge with higher fair value, but the timing is highly uncertain, and will be more dependent on the global market environment than on Sweden's economic woes

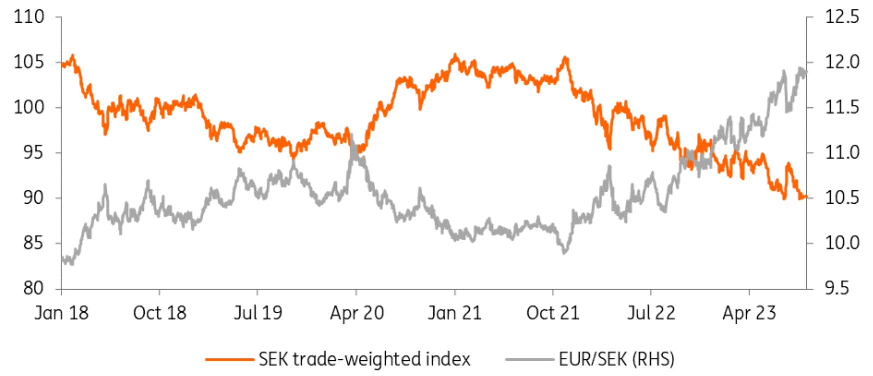
Why it's still hard to pick the bottom for the krona

Back in May, we published a note entitled "Sweden: Hard to pick a bottom for the unloved krona". More than three months later, it is still hard to pinpoint an end to the EUR/SEK rally, and the key drivers behind the strength in the pair have not changed materially. Back then, the Riksbank had just lifted the cap on the pair with a dovish surprise, and while it later attempted to restore a currency-supportive hawkish stance, markets have continued to price a good deal of domestic downside risk into SEK.

In the broader FX picture, pro-cyclical currencies like SEK are primarily responding to US data at the current juncture: the recent resilience in activity indicators has kept market expectations for Fed easing capped, global rates elevated, the dollar strong and high-beta currencies under pressure.

Remember how NOK and SEK emerged as the two biggest underperformers during the core of the Fed tightening cycle? As the higher-for-longer narrative in the US consolidates, investors are once again turning their backs on the illiquid Scandinavian currencies. And with Sweden facing domestic headwinds and the eurozone's economic outlook deteriorating, EUR/SEK is trading at fresh highs, and at risk of touching the 12.00 pain level.

SEK slump continues

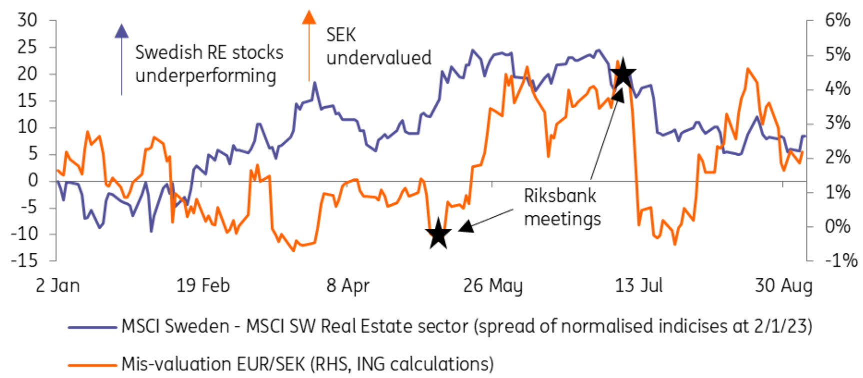


Source: ING, Refinitiv

The Riksbank can cap krona weakness

The chart below shows the risk premium (orange line) that has been built in for the krona (against the euro) since the start of the year. That tells us how much higher EUR/SEK is trading compared to what we estimate is its fair value according to market drivers (like rates and equities).

Riksbank has had a big impact on SEK misvaluation



Source: ING, Refinitiv

Despite perceived real estate concerns building steadily into the end of April, EUR/SEK traded close to its fair value thanks to the Riksbank's currency-supportive hawkish tone. The shift in narrative at the April meeting (when two members voted against a 50bp hike, and the rate path was more dovish than expected) led to a spike in SEK undervaluation, which lasted for two months. Crucially, the return of a currency-supportive hawkish stance at the Riksbank's June meeting saw the EUR/SEK mis-valuation drop to zero. The following build-up in the EUR/SEK risk premium was much more short-lived compared to the one in May-June, and primarily a consequence of the bond selloff in the US.

The Riksbank can still impact the krona substantially

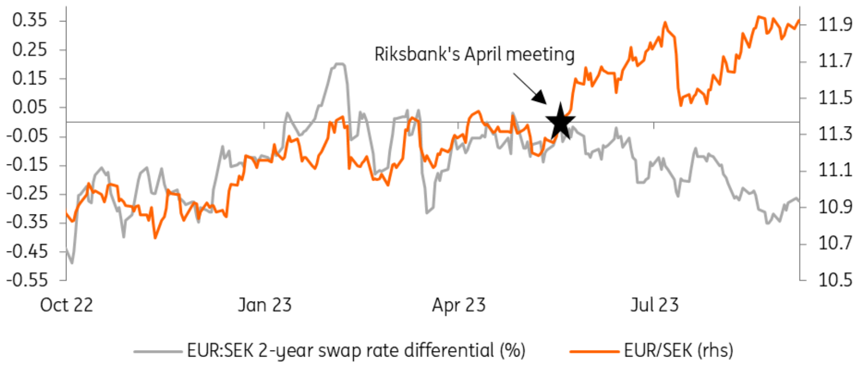
So, what is this telling us? The Riksbank can still impact the krona substantially. Despite not being able to fully insulate a high-beta currency like SEK from external drivers, it can prevent it from trading below its short-term fair value. To do this, it must meet or exceed market expectations on future rate tightening (i.e. via rate path projections), which has the additional benefit of signalling that the Bank is not so worried about the economic outlook and the risks to financial stability as to overlook its inflation mandate and the need to stabilise the currency.

Markets are fully pricing in a 25bp hike in September, with a 50% implied probability of another 25bp hike at the November meeting. The Riksbank will likely have to signal one more hike in its rate path projections to support the krona when it raises rates in September.

Our SEK forecast: the question is timing, not direction

One aspect of the lingering SEK risk premium is that it has detached from short-term rate dynamics, which had been a key driver until April/May last year. Based on the EUR:SEK two-year swap spread alone, EUR/SEK should be trading around 11.00 (chart below). In the current market conditions that is, obviously, inconceivable.

EUR/SEK has diverged from short-term rate dynamics



Source: ING, Refinitiv

We continue to base our medium-term forecast on the evidence that the krona is significantly undervalued, both against the euro and the dollar. On the back of this, our forecast profile for EUR/SEK is downward-sloping for 2024, and we expect the pair to trade below 11.00 by next summer.

The timing of the SEK recovery remains quite uncertain

We must admit, however, that the timing of the SEK recovery remains quite uncertain. In our view, this is not excessively dependent on domestic factors; the krona is already pricing in a sizeable amount of weakness in the domestic economy, and markets will either see the most dramatic scenarios for the real estate sector materialise (not our base case) or will have to price them out of the krona next year. Missteps by the Riksbank, if anything, have a higher chance of causing FX damage.

External drivers hold the key to the recovery

We think, instead, that SEK's reconnection with its stronger fundamentals will be driven by the global FX narrative. A strong dollar on the back of higher-for-longer rates in the US is incompatible with a recovery in the krona. The past few months have been a clear testament to this.

We expect US activity data to start turning from 4Q23, and the Federal Reserve to start cutting from March 2024, and that is the window when pro-cyclical currencies like SEK can stage a good rebound. However, we admit that the resilience in US economic data could persist for longer than we estimate, and delay as well as reduce the scope of the recovery in pro-cyclical currencies. A further deterioration in the eurozone growth outlook can also make the krona's recovery harder.

> *Until a US data/dollar turn occurs, the krona will remain vulnerable*

Until a US data/dollar turn occurs, the krona will remain vulnerable, and we only see 12.00 as the really strong resistance level for EUR/SEK. So far, the Riksbank has ruled out FX intervention but might start throwing that idea around to gauge market reaction (the effective applicability remains doubtful) should we break above the 12.00 mark.

We see room for a SEK rebound around the Riksbank's upcoming meeting when we expect the SEK-supportive narrative to prevail and a good chance of another hike to be added to the rate path. EUR/SEK could be easing back to 11.70 by the end of September.

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