13 May 2019

FX Strategy

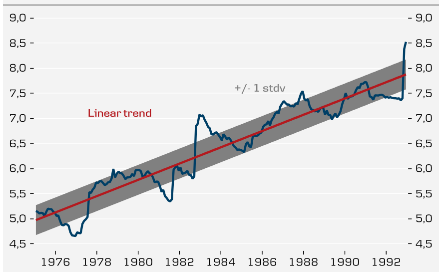
Hardships for the SEK

The Riksbank has been successful in keeping SEK appreciation at bay. However, continued muted inflation pressure and a rising media storm, also from an unexpected side, raise the question of how effective this really is. In this piece we discuss the recent SEK sell-off as well as the recent years' trend depreciation; its causes and how we assess the outlook for the SEK. We argue that the Riksbank, in relation to other central banks, is the main, albeit not sole, driver.

The background is that the SEK has lost 50% of its value vs the USD since 2014. Against the EUR the loss is 22% over the same period and 31% from the trough. Mr Ingves tried to avoid blame by pinpointing other currencies (NOK, NZD, AUD, CAD) that have weakened sharply vs the USD. The depreciation of these currencies is related to the oil price, though, not least the collapse from USD110 to USD30 per barrel. We believe it is hard to escape the fact that the sell-off in the SEK is highly correlated to the Riksbank's (1) negative rates, (2) significant bond purchases and (3) verbal FX interventions.

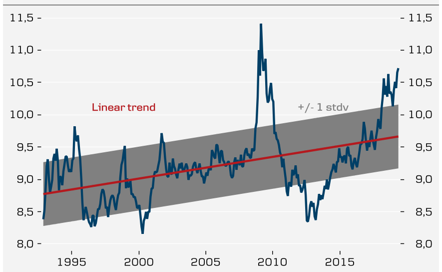
So, mission accomplished? Yes, in terms of weakening the SEK. No, because that is the ultimate goal, but only one of the means. The goal to get inflation to 2% has only partially succeeded and probably only temporarily unless underlying cost pressure start to pick up. We look forward to the re-take on the FX analysis that is requested by Mr Ingves in the Minutes. If we are allowed to guess, they will conclude that fundamentals have changed too and thus the Riksbank is not the only one to blame. Maybe they will end up with a **less aggressive KIX forecast**. Of course that could have market impact: "not even the central bank believes in its currency". But why should the market care about the KIX forecast: it has lacked credibility for so long.

Fixed xr: EURSEK +19 fig per year...



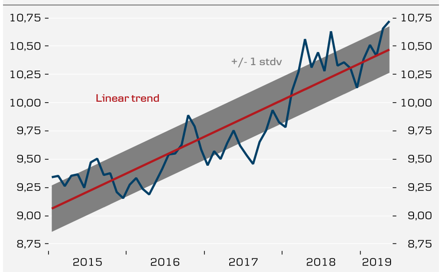
Source: Macrobond Financial, Danske Bank

Floating xr: +8 figures per year...



Source: Macrobond Financial, Danske Bank

Negative rate, QE: +32 figures per year



Source: Macrobond Financial, Danske Bank

The "Swedish model" since the 1970s seems to be that a weaker currency should solve any economic challenges. From 1975 until today (45 years), EUR/SEK has risen 13 figures (2.4%) per year on average. Under the fixed exchange rate regime that ended in 1992 and which was characterised by too high wage and inflation growth (double-digit), weak competitiveness and poor public finances, EUR/SEK rose 19 figures per year on average. Under the floating exchange rate regime the economic backdrop improved considerably, but soon there were new problems to handle, namely too low wage and inflation growth.

Senior Analyst
Stefan Mellin
+46 8 568 805 92
mell@danskebank.se

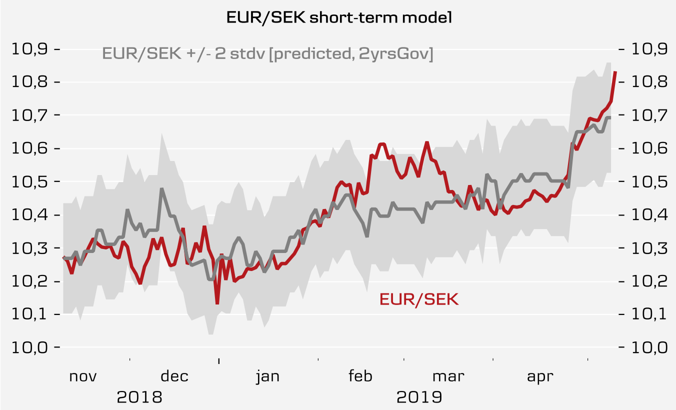
The solution? A weaker SEK, of course. Since 1993 EUR/SEK has risen 8 figures per year. Since the RB entered negative territory and started QE, EUR/SEK is up 32 figures per year.

The question is if the currency depreciation model really does solve or in fact conserves underlying economic problems. In relation to this we note that **several high-profile representatives of Swedish industry, arguably short-term winners from a weak SEK, claim that it is bad for Sweden: it erodes long-term competiveness.** The idea makes sense but has recently been dismissed by some Riksbank Board members.

Also, this year monetary policy expectations have had a visible impact on the krona. YTD 20bp of rate hikes have been removed on the back of the inflation misses and the Riksbank softness in April. This has helped push EUR/SEK higher (left hand chart). Currently, the money market is pricing only 3-4bp for the remainder of 2019. Limited room to take away much more from that now, in our view, and hence not in itself an obvious SEK negative. USD/SEK has continued higher even though the Fed has been re-priced. This is partly related to the fact that carry trades are a dominant theme, where SEK is an attractive funding vehicle (spillover to higher EUR/SEK, too). Maybe the most attractive as it lacks the safe haven properties that are associated with JPY and CHF.

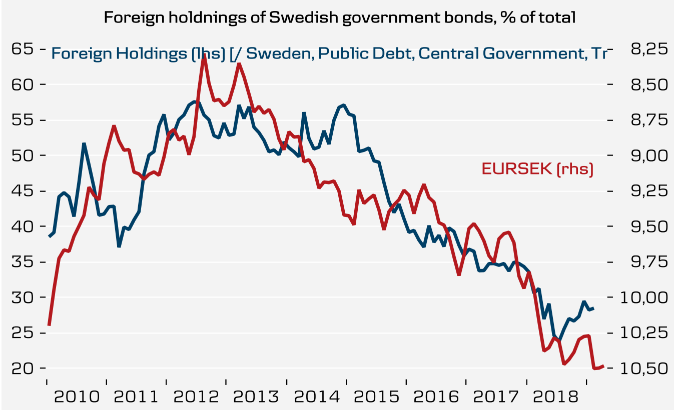
We think that it is here, in monetary policy expectations, where one eventually could get a trigger for a SEK turnaround. Such a turnaround is hard to see now, though, given that Swedish inflation will probably force the RB to stay on hold for longer. Carry will continue to a negative for the SEK in the foreseeable future and while this is related primarily to USD/SEK, it tend to have a spill-over effect on EUR/SEK. That said, pricing of the Riksbank is already extremely soft and unless you go for cuts (not justified according to us), that could be a stabilising factor for EUR/SEK.

Weaker SEK when market re-priced the RB



Source: Macrobond Financial, Danske Bank

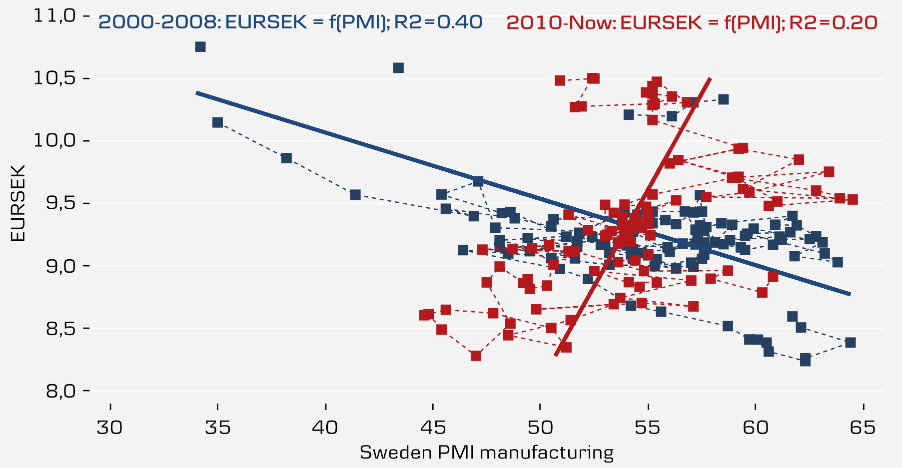
QE negative for SEK until 2017, but not after that



Source: Macrobond Financial, Danske Bank

Another cyclical observation is that there is a before and after the financial crisis, regarding how the krona behaves in relation to the business cycle. **Before the crisis, a better/worse growth outlook meant a stronger/weaker SEK. After the crisis it has been the other way around** (see chart below, where PMI is a proxy for growth). Why? Because the currency is driven by the Riksbank, which is driven by inflation which has decoupled from growth. Hence, the win-win situation that exporters and Swedish portfolio managers have felt the last couple of years, could be followed by lose-lose if the SEK appreciates in a slowing economy with negative equity markets. A risk that may suggest a higher hedge ratio for exporters and portfolio managers.

SEK from pro- to counter cyclical



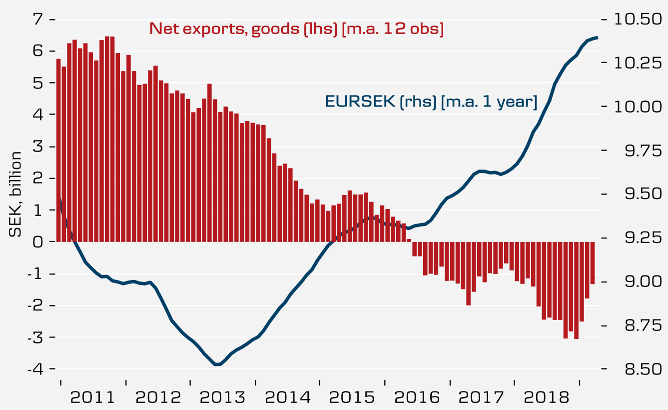
Source: Macrobond Financial, Danske Bank

Even though growth has been strong during the depreciation trend since 2013, it is not due to the krona**: net exports are the only part of the economy that have not contributed positively to growth**. That should raise an eyebrow or two, since it is at odds with general wisdom. The currency channel in the Riksbank's transmission scheme is partially broken. There are different explanations: cyclical where strong domestic demand has raised imports, and structural related to global supply chains and a bigger import content in Swedish exports.

The RB is not the only one to "blame" though. There are other fundamental reasons.

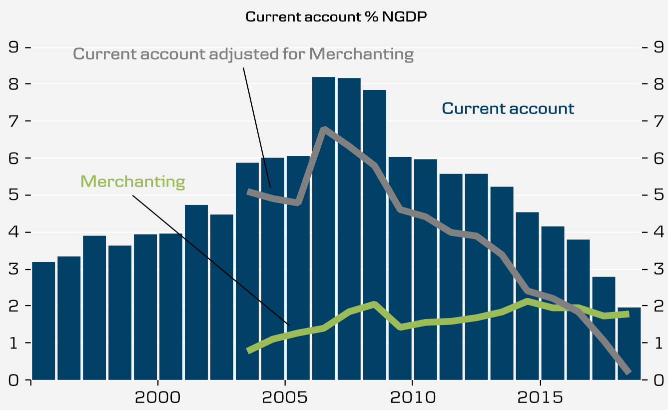
The way the **current account** has developed over the last couple of years suggests that Sweden's competiveness has worsened. While the trade balance in goods has gone from plus to minus, the current account surplus has shrunk from 6-7% to 2% of NGDP. What previously was a strong and often-used argument that the SEK was undervalued is effectively gone. It may even be that the deterioration of the current account is a reason for the depreciation of the real exchange rate. If we adjust for "Merchanting", the C/A surplus is zero. Hence, there are fundamental reasons to believe that long-term equilibrium for EUR/SEK and USD/SEK is higher today than it was, say, 10 years ago.

Trade balance (goods) from surplus to deficit



Source: Macrobond Financial, Danske Bank

Current account surplus gone

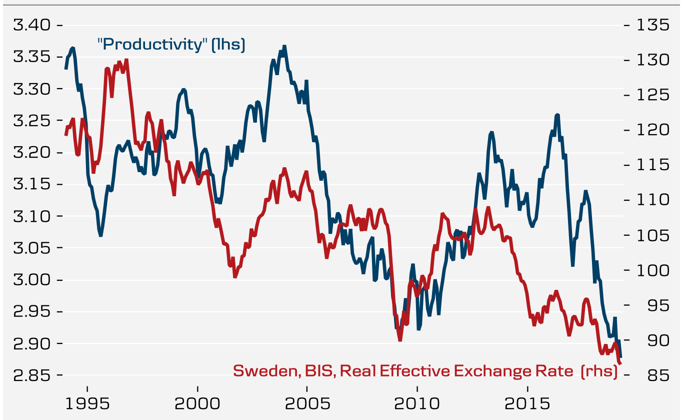


Source: Macrobond Financial, Danske Bank

It is the same thing with **productivity growth**, another measure of competiveness. There are different ways to measure productivity, e.g. GDP per capita. A study in *Ekonomisk Debatt* (Swedish) shows how Sweden has slid compared to other OECD countries. Another approach is based on Ballassa-Samuelson and uses PPI and CPI as input variables representing tradables and non-tradables. This approach suggest that there is a trend decline since during the floating exchange rate regime. After stabilising following the financial crisis, it has dropped again in the last few years, capturing the krona's depreciation during that period. **When it comes to productivity, the risk is that we get a negative spiral where a weaker SEK eases the pressure on companies to make the business more effective. Which in turn weakens the currency…**

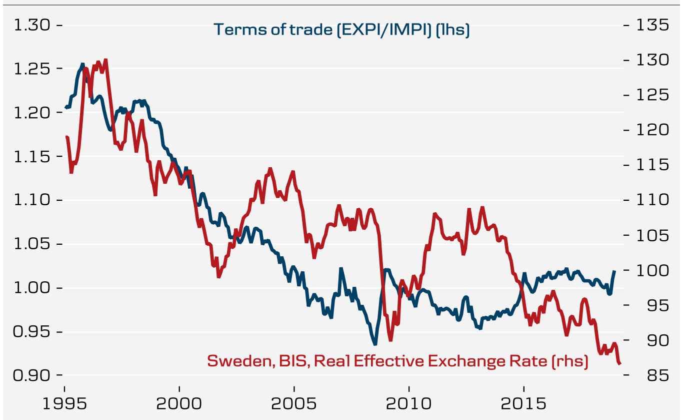
Finally, we note that for many years **terms of trade** was moving in a negative direction, when the price on exports decreased in relation to the price on imports. Maybe the deterioration of terms of trades around 2000 – together with the negative trend for productivity that we described above – helps to explain why the krona refused to appreciate like many economists then argued it should as a result of the then big C/A surplus. The downtrend in terms of trade has faded though and during the last five years, it has actually improved. Hence, terms of trade cannot explain the last years' depreciation of the krona, which is in our view highly and mostly related to the Riksbank's easy policies. **If we combine terms of trade and productivity, we get Danske Bank's MEVA model, which is able to explain some of the krona's hardships.**

Productivity may be able to explain recent SEK weakness…



Source: Macrobond Financial, Danske Bank

…while terms of trade suggests it is not



Source: Macrobond Financial, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Stefan Mellin (Senior Analyst).

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Weekly.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research report has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 10 May 2019, 17:41 CEST

Report first disseminated: 13 May 2019, 07:00 CEST