

Reading the Markets Sweden

- Riksbank indicates a hike earlier than we had thought.
- Energy and SEK boost inflation.
- Two-year segment is exposed to Riksbank and supports curve flatteners.
- Riksbank hike – temporary tailwind for the SEK.

Trades

Profit taken, Receive FRADEC18. Close after Riksbank decision today. Small profit +5bp.

Loss taken, Receive 6M9M. Close after today's Riksbank decision. Loss -4.3bp.

| Danske Bank's market views in a nutshell | | | |
|--|---|--------|-------------|
| Relative value | | * | Last change |
| Delta | Neutral, flatter curve | 2 | 06/09-2018 |
| Curve view | Flatter curve 3Y-7Y. Relative flatteners vs EUR | 3 | 17/05-2018 |
| Cross country sprds | Neutral, consider pay SEK2Y vs EUR | 1 | 06/09-2018 |
| Short-end (<2Y) | Neutral to short SEK risk | 1 | 06/09-2018 |
| Index-linked bonds | BE3102/BEI3108 using swaps vs. FRASEP19 | 3 | 27/04-2018 |
| Covered bonds | Flattening pressure could remain. | 2 | 30/08-2018 |
| Swap Spreads | Sell SGB1056 (June 2032) against SGB1057 (nov 2023) in a fwd ASW. | 3 | 24/05-2018 |
| SEK | EUR/SEK: stay on the sideline over the election and then look to sell | 2 | 06/09-2018 |
| Repo rate | 3m | 6m | 12m |
| | -0.50% | -0.25% | -0.25% |

* Grade of conviction 1-3, where 3 = strongest
Source: Danske Bank

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Riksbank indicates a hike earlier than we had thought

We think today's policy announcement is interesting.

First, the Riksbank made it clear that it is thinking in terms of steps of 25bp, rather than anything smaller, when it starts to normalise the repo rate.

Second, it (once again) indicated a minor change in its view on the timing of the first hike by telling the market that October is out of scope. Instead, it could hike (by 25bp) in December or February. We doubt it has a clear view on the exact timing itself.

As we see it, the reason for the Riksbank's change in the likely timing of the first hike is (a) low modest underlying inflation and (b) still no clear signs of accelerating wage increases and (c) elevated global risks (trade war, emerging markets and probably Brexit).

Third, growth still plays a secondary role for policymaking, with inflation the focus. The press release points out that the board sees too-low inflation as a bigger concern than too-high inflation. Underlying inflation is a key input and this time it explicitly points out that the median value of several underlying measures remains modest (at 1.5%).

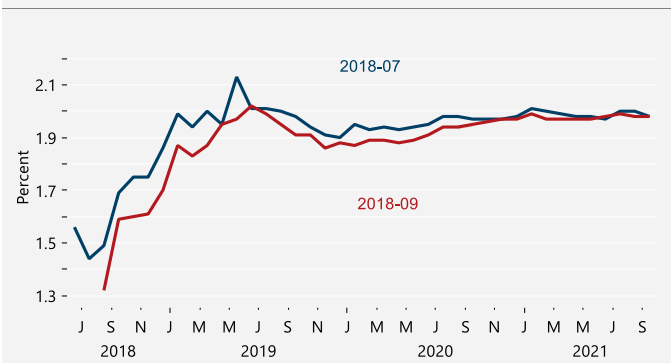
Fourth, now the Riksbank has mentioned the December and February meetings more specifically as candidates for a first hike. The current rate path (as before) implies around two hikes (or 50bp) per year through to end-Q3 21.

December or February is earlier than we previously thought, although admittedly we have become more uncertain of late, which is why we have moved out of receiver positions with exposure two to three years out, for instance SEK 1Y 1Y.

Inflation forecasts

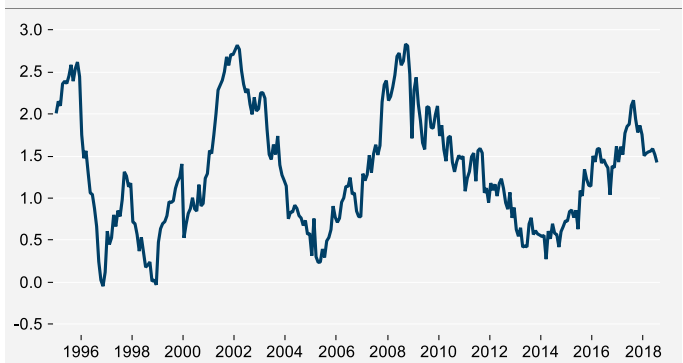
The Riksbank has lowered its forecast somewhat for CPIF excluding energy a year out. However, the slope of the curve is basically intact, so we believe the revision reflects that actual data have come in below the old forecasts.

Chart 1. CPIF excluding energy - July and September forecasts



Source: Riksbank

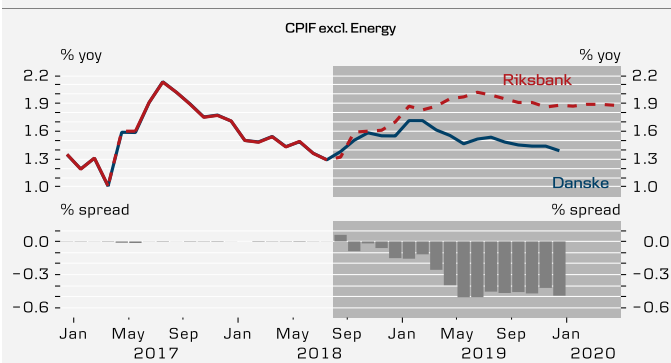
Chart 2. Median of CPIF excluding energy - Und24 and Trim85



Source: Danske Bank

How does the Riksbank's current forecast compare with our forecast? We focus here on CPIF excluding energy.

Chart 3. CPIF excluding energy



Source: Riksbank, Danske Bank

Chart 4. Mean values for various measures of inflation

| Measure | Latest reading | LR mean* | +1 stddev | -1 stddev | deviation gap** |
|--------------|----------------|----------|-----------|-----------|-----------------|
| CPIF | 2.2 | 1.6 | 2.3 | 0.8 | 1.5 |
| CPIF ex en | 1.3 | 1.4 | 2.0 | 0.7 | 1.3 |
| Trim85 | 1.5 | 1.3 | 2.2 | 0.3 | 1.9 |
| UND24 | 1.4 | 1.3 | 2.0 | 0.6 | 1.4 |
| Core HICP*** | 0.9 | 1.5 | 1.6 | 0.4 | 1.2 |

*LR mean calculated from 1995 except for core HICP

** difference between +1 and -1 standard deviations

*** calculated from 1997

Source: Danske Bank

As shown in the chart above, the differences between the two forecasts are insignificant until early 2019. Considering that the Riksbank is now quite clear on its intentions, the logical conclusion from an inflation point of view is that it will actually deliver a hike in December or February. Provided that inflation turns out as expected, the timing might depend on how international risks evolve. If EU-UK negotiations result in an orderly Brexit and trade tensions calm down, the Riksbank might move in December.

We would place probabilities of 60% and 40% on December and February, respectively. The market is currently pricing in 18bp of hike by end-February and 28bp by end-July, which we think is reasonable.

As mentioned, the rate path implies approximately two hikes per year, meaning a second hike in summer 2019. In our view, this is more uncertain. First, we believe that by then, we will have more evidence of a slowdown in growth. More importantly, by summer 2019 our two inflation forecasts start to deviate again (our forecast is lower). The thing here is that we have different views on 'equilibrium inflation'. Keep in mind that the Riksbank's forecasts are by default set to converge close to 2%. The problem is that there are few or no historical examples of periods in which inflation is sustained at 2% or higher. As shown in the table above, the long-run average is instead around 1.50% (1.33% since 1995 to be precise). Note that these averages cover a period in which the economy has gone through many cycles. We think that around 1.5% is a better unbiased estimate of longer run inflation.

We assign a 40%/60% probability to no second hike/second hike by next summer. Thereafter, our inflation forecast does not suggest a further hike in 2019: 0.6×25 (December) plus 0.4×25 (summer) = 25bp. The market is pricing 28bp, which appears close enough to what we have in mind.

Energy and SEK boosts inflation

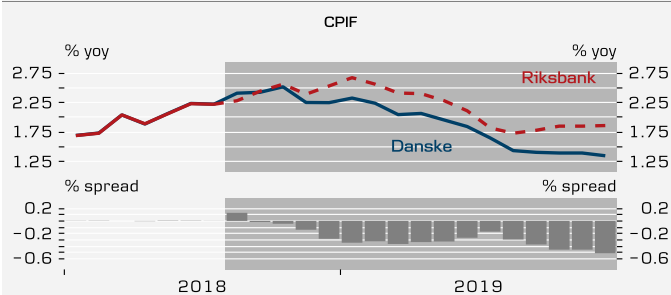
We see around 0.1pp higher inflation in August than the Riksbank's new forecasts. This is true for both headline CPIF and core CPIF excluding energy. The main drivers are seasonally higher price hikes on clothes, which are balanced by sharply falling prices on international airline tickets and charter packages. To these, we have to add additional price increases on energy, both electricity and petrol.

Chart 5. Market pricing

| RIKS Implied fr RIBAs | | |
|-----------------------|------------|-----------|
| 31 okt | +1 | -5 |
| 09 jan | +11 | +5 |
| 20 feb | +6 | +1 |
| 08 maj | +5 | +0 |
| 03 jul | +5 | -0 |
| 11 sep | +5 | +0 |
| 30 okt | +5 | +0 |
| 08 jan | +5 | -0 |
| Σ | +43 | +1 |

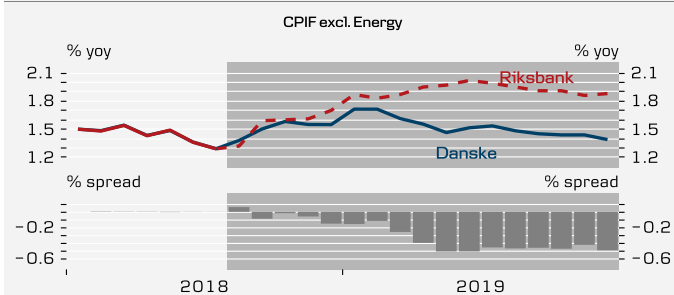
Source: Danske Bank

We are close – for a while...



Source: Riksbank, Danske Bank

...but we believe core inflation will fall back sharply in 2019



Source: Riksbank, Danske Bank

Looking at risks, there is great uncertainty about the impact of this summer’s drought on food prices. Another, more important, uncertainty relates to how much the weaker SEK may have raised prices of import goods.

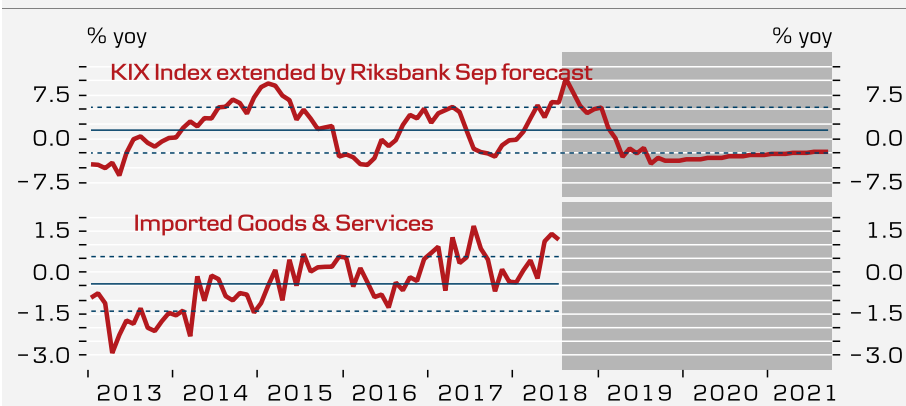
August inflation forecasts

| | CPI | %mom | %y/y | CPIF | %mom | %y/y | CPIFxEn | %mom | %y/y |
|------------|--------|------|------|--------|------|------|---------|-------|------|
| 2018-08-01 | 330.37 | 0.01 | 2.22 | 216.32 | 0.03 | 2.41 | 202.86 | -0.14 | 1.38 |

Source: Danske Bank

Looking ahead, the Riksbank’s new core CPIF forecast has come closer to our own but from March 2019, the paths diverge again. A look at the chart below, in which we have extended the most recent KIX outcome with the Riksbank’s new forecast, suggests a certain upside risk on imported inflation (30% of the CPIF basket) in the near term, which transforms into a bigger downside risk in 2019.

SEK raises import prices this year but risks cut them next year



Source: SCB, Riksbank

Forecast details

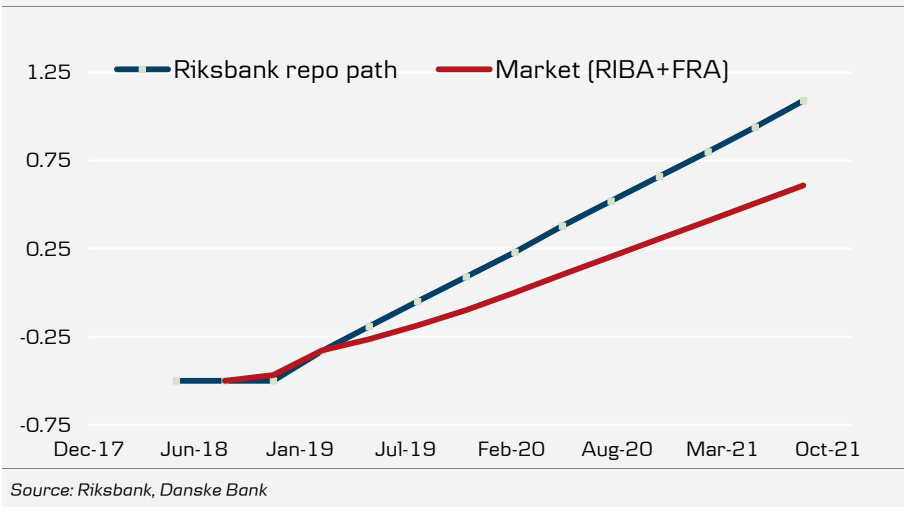
| Next month forecast | Contribution |
|--------------------------|--------------|
| Food | 0.00 |
| Alcohol | 0.00 |
| Clothing | 0.38 |
| Rent | 0.00 |
| Mortgage cost | 0.00 |
| Mortgage rates | 0.00 |
| Capital stock | 0.02 |
| Electricity | 0.08 |
| Furniture | 0.00 |
| Health | 0.00 |
| Fuel | 0.09 |
| Cars | 0.01 |
| Transportation services | -0.26 |
| Communication | 0.00 |
| Recreation | -0.33 |
| Restaurants | 0.03 |
| Miscellaneous | 0.02 |
| CPI | 0.01 |
| CPIF | 0.03 |
| CPIF excl. Energy | -0.14 |

Source: Danske Bank

2Y segment exposed to Riksbank and supports curve flatteners

An important piece of news in the statement is that the Riksbank seems to have decided to move at least initially in a 25bp step (with Stefan Ingves ruling out smaller steps at the press conference). In our view, it is likely that the following moves will be in 25bp steps as well. As the December 2018 meeting is now firmly in play, received positions in the short end look increasingly risky and do not leave much margin for error. Current pricing is significantly below the Riksbank’s new repo rate forecast (see chart below).

Riksbank pricing vs Riksbank's repo rate path



For a long time, we have argued in favour of receiver positions in the short end, albeit with a more selective stance recently. Given the new information and the poor risk/reward, we now recommend closing received positions in the short-end altogether.

With the December meeting in play, we see no reason to keep our received position in FRADEC18 and close it with a small 5bp profit. Similarly, our received position in SEK 6M 9M, trading at around -0.12% would face clear upside risks if the Riksbank managed to deliver more than one rate hike. We close this recommendation with a 4.3bp loss.

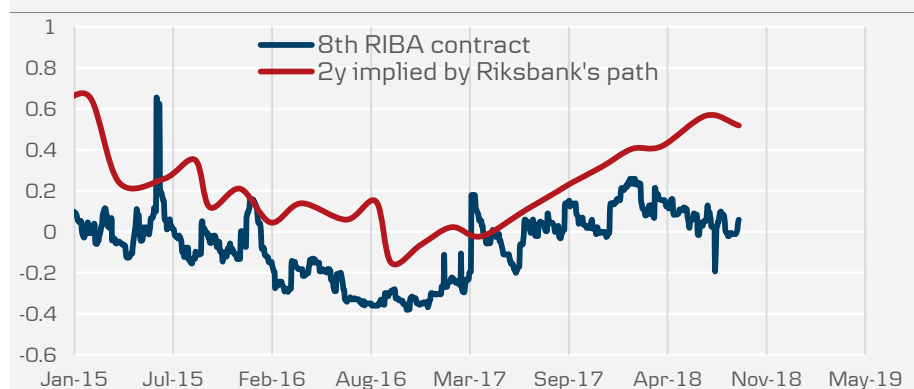
However, we think the case for flatter curves has strengthened. Fundamentally, we still view the Riksbank's medium-term forecasts as very challenging given the clear lack of pickup in wage pressures. The necessary conditions for a long hiking cycle are not in place. Thus, the increased likelihood of actual rate hikes should primarily hit the short end. We reiterate our call to receive 7Y versus paying 3Y SEK.

The willingness to move clearly ahead of the ECB supports our 3Y/7Y relative flattener versus EUR. The position trades close to our starting level. We see further potential and reiterate our view.

Index-linked bonds in the shorter end should continue to receive some support from the possible rate hikes (and energy prices). Despite this, the chance of a hike in the winter has increased the position where we have combined a receiver in FRA SEP19 with buying a BEI SGBi3102 (December 2020), where we pay a matching IRS. We keep this trade on our book. The FRASEP19 implies close to 40bp of rate hikes, which is not far from the Riksbank's new path.

Instead, it is the two-year segment, at least relative to the Riksbank's repo rate path, that stands out to us as especially exposed to a scenario where the economy and inflation unfolds according to the Riksbank's plan and hikes are coming in winter (see chart below). An alternative trade to the 3s7s mentioned above is to flatten the 2s5s or 2s10s curve in either bonds or swaps. Another possible trade to consider is to pay SEK 2Y versus EUR.

Repo rate in 2 years according to pricing vs what repo rate path implies in 2 years



Source: Danske Bank

Riksbank hike – a temporary tailwind for the SEK

The Riksbank decision to lower the probability of a near-term hike (October) while more explicitly stating that the first step will be 25bp (not smaller) in December or February effectively bought it time to take in more inflation information before deciding whether to move or not. Hitherto, the Riksbank's CPIF excluding energy forecast has been markedly higher than ours for the next couple of months. Since the Riksbank cut its forecast today, this is no longer the case. Instead, our forecast and that of the Riksbank are almost identical until March 2019, when the paths start to diverge.

Based on almost identical inflation forecasts until November, when we get the final piece of inflation data ahead of the December meeting, we pencil in a first 25bp hike in December (60%), with a smaller likelihood that the Riksbank waits until February (40%). After this, we expect it to stay on hold. The market is pricing in 12bp until December and 18bp until February. RIBA is indicating 28bp until next summer.

What is the implication for EUR/SEK based on this scenario? One way to see it is that delivering the first hike in seven years is a game changer, which should lend substantial support to the 'cheap krona', particularly given that it would presumably be almost one year earlier than the ECB. The first caveat to this line of reasoning is that a mere 25bp followed by a very slow or even flat path thereafter is hardly a game changer: Swedish rates will still be relatively low. Another caveat is that 25bp is almost discounted already, at least until February.

If the Riksbank does move in December, as we now expect, it should lend support to the SEK and pull EUR/SEK sharply lower in a 3M perspective. At the same time, if we get a 'one and done' hike, where it kicks the 'planned hikes' for 2019 down the road – our new base scenario – EUR/SEK is not likely to continue to trend lower over time. Instead, based on current pricing in the money market, we expect EUR/SEK to move more sideways in a 6-12M perspective.

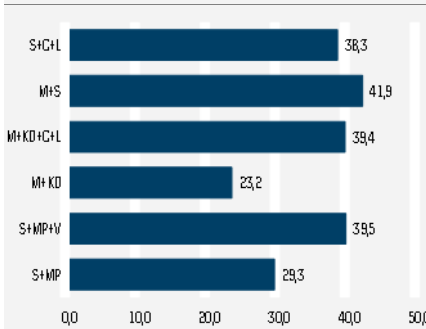
Opinion polls 5 August: Christ Dem's (KD) above 4%, wide spread for SD

| | Average* | Lowest | Highest |
|----------|----------|--------|---------|
| S | 24,3 | 22,1 | 26,5 |
| V | 10,2 | 9,4 | 11 |
| MP | 5,0 | 3,6 | 6,2 |
| M | 17,6 | 16,3 | 19,4 |
| L | 5,9 | 4,9 | 6,8 |
| C | 8,1 | 6 | 9,6 |
| KD | 5,6 | 4,8 | 6,8 |
| SD | 19,8 | 16,3 | 24,8 |
| S+MP | 29,3 | 25,7 | 32,7 |
| S+MP+V | 39,5 | 35,1 | 43,7 |
| M+KD | 23,2 | 21,2 | 31,6 |
| M+KD+C+L | 39,4 | 32,0 | 48,0 |
| M+S | 41,9 | 38,4 | 45,9 |
| S+C+L | 38,3 | 33,0 | 42,9 |

* Novus, Sifo, Demoskop, Ipsos, Inizio, Sentia, YouGov, Skop

Source: valdigital.se

Some possible coalitions, no one gets near 50% (5 August polls)



Source: valdigital.se

For the SEK, monetary policy is key but not the only factor. In our view, the cyclical slowdown in 2019 is on the margin a headwind for the SEK. **We have highlighted the uncertainty related to the general election.** It is fair to have a political risk premium in EUR/SEK and it currently helps to keep the cross elevated. For the next couple of weeks, we could have a very messy political situation. We should know the result late on Sunday night but we will probably not be able to say for sure who will be the next Prime Minister. A new Prime Minister will be elected no earlier than when parliament opens on 25 September. The first challenge will be to get a budget through the Riksdag. This is critical for the SEK, because if it fails, we will have a government crisis and an extra election could be on the cards. That said, our best guess is that we get a Moderate-led government, which should lower the risk of a near-term government crisis. For more detail on the election, see *FX Strategy – SEK and the general election – risk for a bumpy ride*, 24 August, and *Reading the Markets Sweden*, 31 August.

Given the revised outlook for the Riksbank, we see a need to lower, in particular, our 3M forecast for EUR/SEK, which will be in play over the December meeting when we now expect a 25bp hike. We see EUR/SEK at 10.50 (previously 10.50) in 1M, 10.20 (previously 10.60) in 3M, 10.20 (previously 10.40) in 6M and 10.30 (previously 10.20) in 12M.

| Open strategies | | | | | |
|-----------------------|---|--|--------------|-------------|--------------|
| Type | Trade | Idea | Target & P/L | | Status |
| Delta MM | Rec SEK 6M 9M | Hold on to roll down positions but now outright in SEK | Opened | 16 aug 2018 | Loss taken |
| | | | Start | -0.19 | |
| | | | Target/Stop | -0.3/-0.09 | |
| | | | Now | -0.15 | |
| | | | P/L | -4.3 | |
| MoneyMarket | Receive FRADEC18 | Receiving the FRADEC18 offers great risk/reward | Opened | 14 jun 2018 | Profit taken |
| | | | Start | -0.36 | |
| | | | Target/Stop | -0.52/-0.27 | |
| | | | Now | -0.41 | |
| | | | P/L | 5.0 | |
| Fwd ASW | Buy SGB1057 vs. Sell SGB1056 vs. the matching fwd swaps in a fwd ASW spread | The SGB1056 can be the loser when the new 10y bond SGB1061 is to be introduced | Opened | 24 maj 2018 | Hold |
| | | | Start | -50 | |
| | | | Target/Stop | -25/-70 | |
| | | | Now | -46.5 | |
| | | | P/L | 3.5 | |
| Relative curve spread | Rec SEK 7Y Pay SEK 3y and do opposite in EUR | Rec SEK 7Y Pay SEK 3y and do opposite in EUR in relative flattener | Opened | 17 maj 2018 | Hold |
| | | | Start | 13.9 | |
| | | | Target/Stop | -10/27 | |
| | | | Now | 11 | |
| | | | P/L | 3.0 | |
| Curve flattener | Recieve SEK 7Y and Pay SEK 3Y in a curve flattener | Room for flattening as belly trades to elevated ahead of seasonal factors | Opened | 27 apr 2018 | Hold |
| | | | Start | 82.00 | |
| | | | Target/Stop | 60/98 | |
| | | | Now | 68.700 | |
| | | | P/L | 13.3 | |
| BEI vs MM | Buy SGBi3102 Pay matching swap and receive in FRASEP19 | Riksbanks focus on core linkers dependent on headline CPI | Opened | 27 apr 2018 | Hold |
| | | | Start | 258.00 | |
| | | | Target/Stop | 295/225 | |
| | | | Now | 259.2 | |
| | | | P/L | 24.3 | |

Source: Danske Bank

Calendar

| Monday, 10 September, 2018 | | | | Period | Danske Bank | Konsensus | Previous |
|-------------------------------|-----|--|-----------|--------|--------------|-----------|------------|
| 01:50 | JAP | GDP, final | q/qlann. | Q2 | | 0.7% 2.6% | 0.5% 1.9% |
| 08:00 | NOR | Core inflation (CPI-ATE) | m/mly/y | Aug | | | 0.6% 1.4% |
| 08:00 | DEN | CPI | m/mly/y | Aug | | | 0.7% 3.0% |
| 08:00 | NOR | CPI | m/mly/y | Aug | -0.2% 1.2% | | 0.8% 1.1% |
| 09:30 | SWE | Household consumption | m/mly/y | Jul | | | 0.3% 4.3% |
| 10:30 | EZ | Sentix Investor Confidence | Index | Sep | | | 14.7 |
| 10:30 | UK | Construction output | m/mly/y | Jul | | | 1.4% 2.2% |
| 10:30 | UK | Monthly GDP estimate | m/m q/q | Jul | | | 0.1% 0.4% |
| 10:30 | UK | Industrial production | m/mly/y | Jul | | | 0.4% 1.1% |
| 10:30 | UK | Index of services | m/m 3m/3m | Jul | | | 0% 0.5% |
| 10:30 | UK | Manufacturing production | m/mly/y | Jul | | | 0.4% 1.5% |
| 10:30 | UK | Trade balance | GBP mio. | Jul | | | -1861 |
| 21:00 | US | Consumer credit | USD bn | Jul | | 14.0 | 10.2 |
| Tuesday, 11 September, 2018 | | | | Period | Danske Bank | Konsensus | Previous |
| 10:30 | UK | Unemployment rate (3M) | % | Jul | | | 4.0% |
| 10:30 | UK | Average weekly earnings ex bonuses (3M) | y/y | Jul | | | 2.7% |
| 11:00 | EZ | ZEW expectations | Index | Sep | | | -11.1 |
| 12:00 | US | NFIB small business optimism | Index | Aug | | 108.2 | 107.9 |
| Wednesday, 12 September, 2018 | | | | Period | Danske Bank | Konsensus | Previous |
| 08:00 | SWE | Prospera inflation expectations | | | | | |
| 10:00 | ITA | Industrial production | m/mly/y | Jul | | | 1.7% 1.7% |
| 11:00 | EZ | Industrial production | m/mly/y | Jul | | | -0.7% 2.5% |
| 11:00 | EZ | Employment | q/ql/y/y | Q2 | | | 0.4% 1.4% |
| 14:30 | US | PPI | m/mly/y | Aug | | 0.2% 3.3% | 0.0% 3.3% |
| 14:30 | US | PPI core | m/mly/y | Aug | | 0.2% 2.7% | 0.1% 2.7% |
| 16:30 | US | DOE U.S. crude oil inventories | K | | | | |
| 20:00 | US | Fed Beige Book | | | | | |
| Thursday, 13 September, 2018 | | | | Period | Danske Bank | Konsensus | Previous |
| 08:45 | FRA | HICP, final | m/mly/y | Aug | | | 0.6% 2.6% |
| 09:30 | SWE | GDP, final | q/ql/y/y | Q2 | | | 1.0% 3.3% |
| 08:00 | GER | EU-harmonized CPI | m/mly/y | Aug | | | 0.0% 1.9% |
| 08:45 | FRA | EU-harmonized CPI | m/mly/y | Aug | | | 0.6% 2.6% |
| 13:00 | UK | BoE minutes | | | | | |
| 13:00 | UK | BoE Bank rate | % | | | | 0.8% |
| 13:45 | EZ | ECB policy announcement | % | | | | 0.00% |
| 14:30 | EZ | ECB's Draghi speaks at press conference | | | | | 0 |
| 14:30 | US | CPI headline | m/mly/y | Aug | | 0.3% 2.8% | 0.2% 2.9% |
| 14:30 | US | CPI core | m/mly/y | Aug | | 0.3% 2.4% | 0.2% 2.4% |
| 20:00 | US | Budget statement | USD bn | Aug | | | -76.9 |
| Friday, 14 September, 2018 | | | | Period | Danske Bank | Konsensus | Previous |
| 06:30 | JAP | Industrial production, final | m/mly/y | Jul | | | -0.1% 2.3% |
| 09:30 | SWE | CPI | m/mly/y | Aug | 0.01% 2.22% | | 0.5% 2.1% |
| 09:30 | SWE | Underlying inflation CPIIF | m/mly/y | Aug | 0.03% 2.41% | | 0.5% 2.2% |
| 09:30 | SWE | CPIIF ex energy | m/mly/y | Aug | -0.14% 1.38% | | 0.4% 1.3% |
| 10:00 | ITA | HICP, final | m/mly/y | Aug | | | ... 1.7% |
| 11:00 | EZ | Trade balance | EUR bn | Jul | | | 16.7 |
| 11:00 | EZ | Labour costs | y/y | Q2 | | | 2.0% |
| 14:30 | US | Advanced retail sales | m/m | Aug | | 0.6% | 0.5% |
| 14:30 | US | Import prices | m/mly/y | Aug | | -0.3% ... | 0.0% 4.8% |
| 15:15 | US | Capacity utilization | % | Aug | | 78.2% | 78.1% |
| 15:15 | US | Industrial production | m/m | Aug | | 0.3% | 0.1% |
| 16:00 | US | University of Michigan Confidence, preliminary | Index | Sep | | 96.1 | 96.2 |

Source: Various sources, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Michael Boström (Chief Analyst), Michael Grahn (Senior Analyst), Marcus Söderberg (Analyst), Carl Milton (Analyst) and Stefan Mellin (Analyst).

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