24 May 2019

Reading the Markets Sweden

- **Q1 GDP in focus ahead of data flood in coming weeks.**
- **What to make of job data.**
- **Riksbank Financial Stability Report confirms banks are already adjusting to SEK LCR proposal.**
- **Long-dated linkers excessively dear.**
- **Is there any vacation in sight for the SEK?**

Trades

New, Sell SGBI3104 (Dec 2028) versus DBRI (Apr 2030) at -77.5bp P/L: -43bp/-93bp.

Danske Bank's market view in a nutshell

Relative value		*	Last change
Delta	We expect a minor bounce upwards in longer rates in the coming months.	2	14/03-2019
Curve view	Neutral.	1	10/05-2019
Cross country sprds	Neutral.	1	24/01-2019
Short-end (<2Y)	RB expectations scaled back too much and upward pressure on 3m Stibor. Pay 1y SEK swap.	3	16/05-2019
Index-linked bonds	Long-dated BEI excessively dear against Germany.	3	23/05-2019
Covered bonds	Buy 3Y covered bonds vs swaps. Buy the longest benchmark covered bonds vs 5Y covered in an ASW box.	3	03/05-2019
Swap Spreads	Short end SGBs could widen further.	3	25/04-2019
SEK	Stay long NOKSEK.	3	25/4-2019

Repo rate	3m	6m	12m
	-0.25%	-0.25%	-0.25%

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

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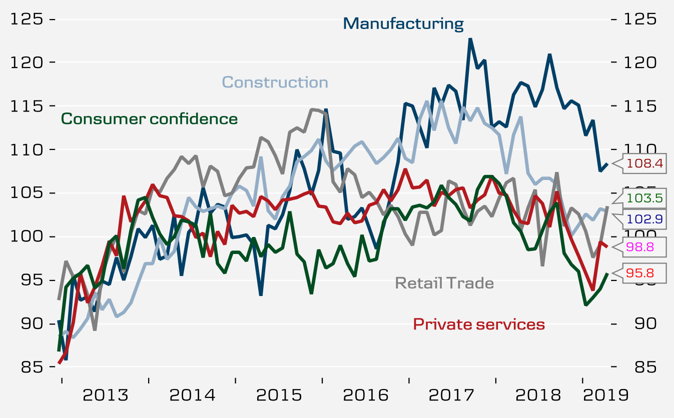
Q1 GDP in focus ahead of data flood in coming weeks

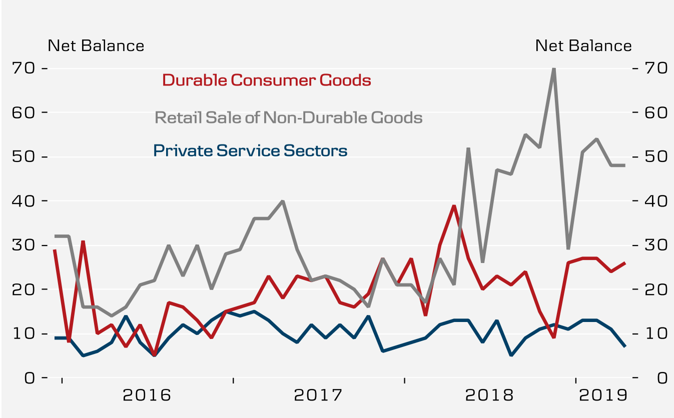
The NIER May confidence survey is due for release next week. Over the past three months, there has been somewhat of a stabilisation in the general decline seen in all sectors. We expect manufacturing confidence to decline further, as suggested by plunging German manufacturing data. We intend to keep an eye on both retail/private services price expectations to gauge whether or not SEK weakness is being pushed onto consumers. Furthermore, perhaps the most important metric is employment tendencies. A continued decline in hiring expectations would support the notion that the super-strong labour market is turning weaker.

Weaker trend in NIER confidence survey



Source: NIER

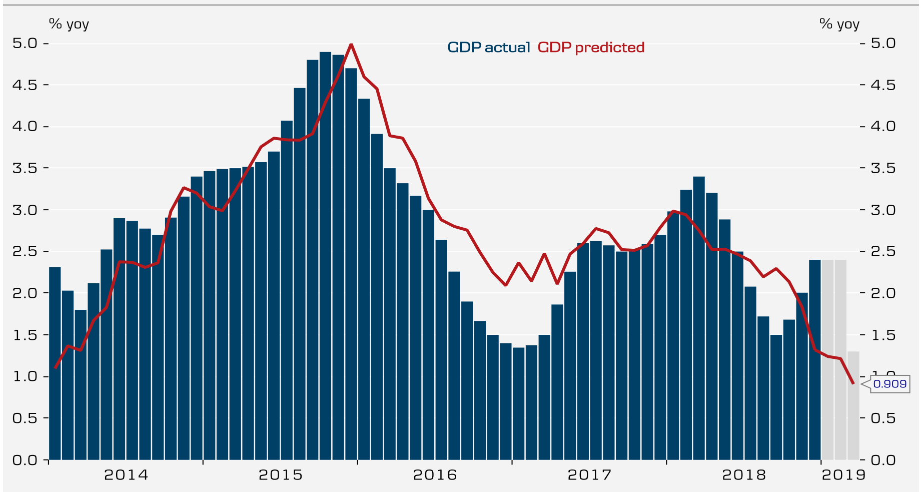
Selling price expectations moderated despite weaker SEK



Source: NIER

The April trade balance, household lending, retail sales (next week) and private production value (week after) are inputs to our GDP model, hinting at the start of Q2 growth. That said, Q1 GDP growth is set for release next week and will be in focus. Our model suggests GDP growth has slowed to c.1% y/y. This is supported by private production and the private consumption indicator, both of which grew at c.1.2-1.3% y/y. Residential investment is declining, weighing negatively, and inventory change appears to be neutral or slightly negative. Uncertainty relates primarily to net exports. In Q4 18, there was a significant unusual boost from net services exports. It seems that in Q1 it was net goods exports that provided a strong boost but for the wrong reason, i.e. plunging imports. It is hard to interpret this positively. This is an upside risk to our forecast.

GDP growth trending lower, heading towards 1% in Q1



Source: SCB, Danske Bank

May manufacturing PMI is exposed to the same German threat as mentioned above. There is a high risk we will see a print well below 50.

What to make of job data

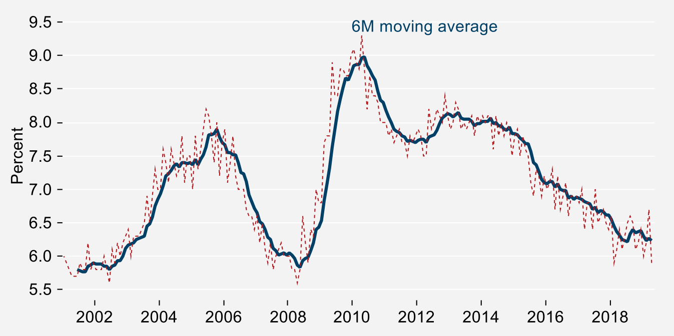
At face value, April labour market data were stronger than we expected, with seasonally adjusted unemployment falling from 6.7% to 5.9% and employment popping after being flat for four months. What should we make of this?

The first thing to keep in mind is that the official SCB job market reports are survey based (telephone interviews mainly). Second, these surveys suffer from considerable – and as far as we understand rising – sampling errors. This is why even seasonally adjusted data can move around all over the place from month to month. Indeed, the seasonally adjustment method does not work properly because there is too much noise.

Therefore, to make any sense of these statistics, we need to look at developments over a longer period of time and cross-check with other relevant data.

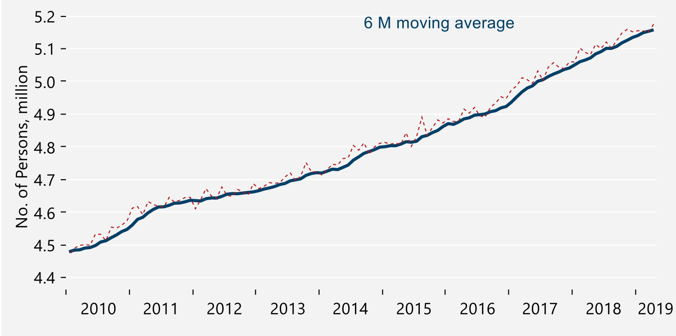
Doing this, we get the impression that unemployment has stopped declining, maybe even picked up a little, while the rise in employment has (at least) cooled off.

Unemployment appears to have stopped falling...



Source: SCB

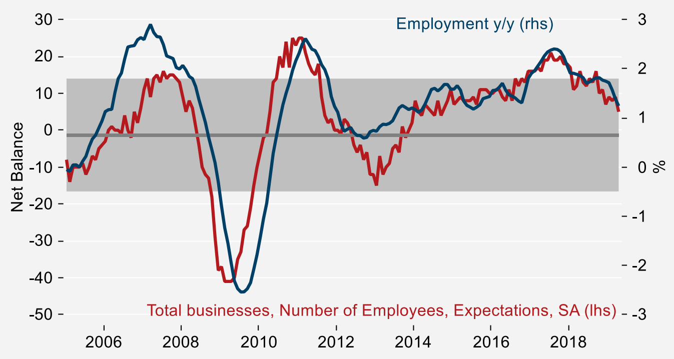
...while employment growth shows signs of levelling off



Source: SCB

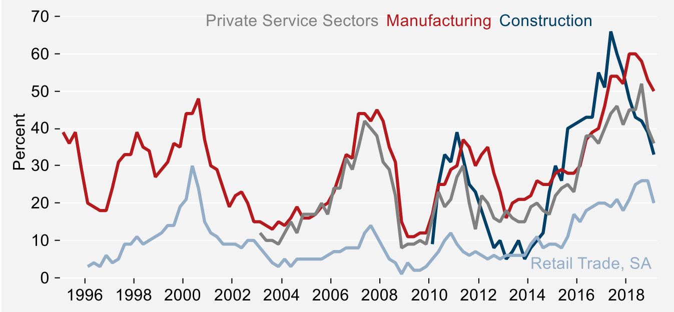
Cross-checking with other indicators (NIER surveys), our impression is the same. Private businesses' hiring plans (chart below left) peaked in summer 2017. This coincided with the peak in year-on-year employment growth. In addition, hiring plans seem to have peaked, with the possible exception of retail trade, where we need some more data to make a clear judgement. In addition, we have seen a slight tendency towards more redundancy notices of late, while the number of unfilled vacancies appears to have peaked around a year ago.

Hiring plans softer too



Source: NIER, SCB

Labour shortages less of an issue



Source: NIER

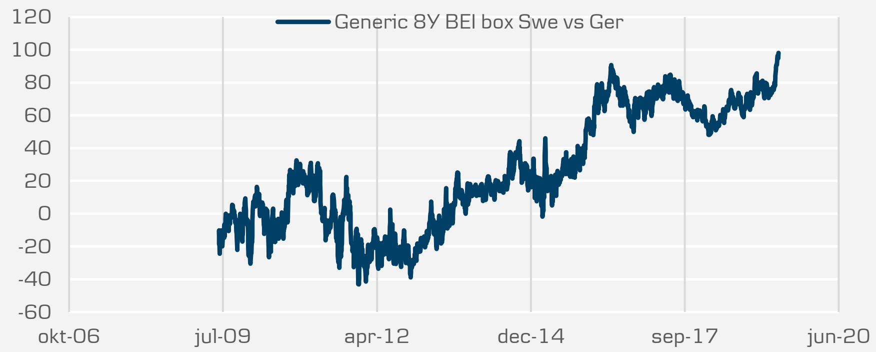
Therefore, we draw the conclusion that the labour market is cooling off. It is not a dramatic deterioration in any sense but a slowdown. Then again, for Swedish households the situation is new in the sense that unemployment has been steadily falling since 2013. There are at least another six months until the big wage round starts. It remains to be seen whether, and to what extent, a less benign outlook for the job market will affect negotiations.

Long-dated linkers excessively dear

Admittedly, longer BEI boxes versus Germany have looked challenging for quite some time and there is a case to be made that a lack of supply probably leads to an artificially low real rate. Moreover, the maturity of SGB3110 (SEK15.5bn outstanding, of which SEK10.6bn is held by market participants) on 1 June 2019 poses some near-term risks. Some reinvestment need could put buying pressure on linkers (although it is unclear how much it would affect the longer end of the linkers curve).

However, since the Riksbank's April meeting, BEI pricing has become extreme to the point where it makes little fundamental sense. A generic 8Y BEI box trades at a significant 98bp. We find it difficult to paint an economic scenario where this pricing would come to be realised. We have argued on multiple occasions that the current rate of Swedish inflation close to the Riksbank's target will be difficult to sustain unless wages accelerate substantially. We see little to no sign of this happening.

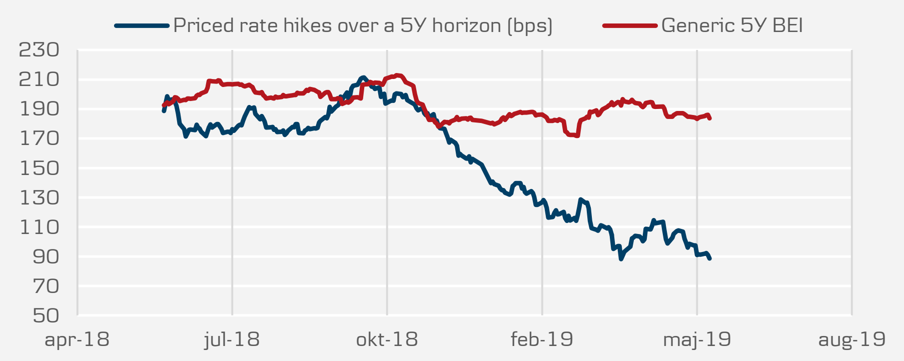
BEI levels vs Germany at extreme levels



Source: Danske Bank

One component that on average can make Swedish CPI overshoot strongly (both up and down) is the mortgage cost component. However, the significant repricing of the Riksbank that we have seen in the past few months has had a modest impact on BEI spreads. In particular, shorter BEI spreads should fundamentally have suffered much more in an environment where the chance of a near-term rate hike is fading.

5Y BEI spreads relatively unscathed despite repricing of the RB



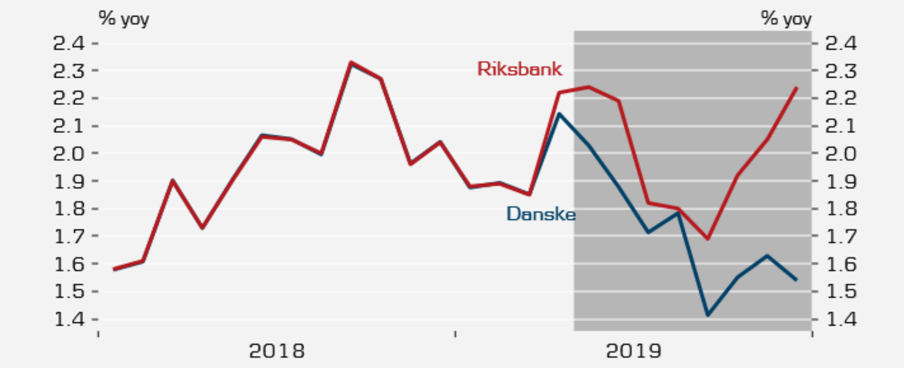
Source: Danske Bank

Another factor worth mentioning is that, although index-linked bonds are no doubt in short supply, this is not really reflected in the repo market, at least relative to nominal SGBs. On average, linkers repo some 20bp cheaper than nominal bonds. This makes current BEI levels even more challenging.

So why is Swedish BEI trading at current elevated levels, relatively consistent with the Riksbank inflation target, despite significantly lower German BEI rates and with fewer and fewer rate hikes priced in on the nominal curve?

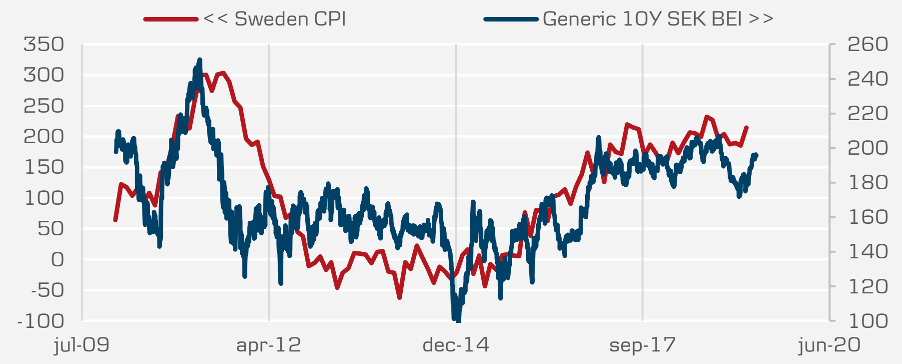
We think the answer is simply that the year-on-year rate of spot inflation tends to lead BEI rates (see chart below). Interestingly, we expect (also the case in Riksbank forecasts to a lesser extent) the year-on-year rate of inflation to decelerate substantially. Most of this is due to the base effects from energy. It would take drastic increases in energy prices to generate a contribution equal to what we saw in 2018 (i.e. a price level equal to last year's is not enough, as it would generate a null contribution). If we are not wide of the mark in our inflation forecasts, we would expect the inflation outcome in coming months to put pressure on BEI spreads in general.

Riksbank expects headline CPI to fall in coming months



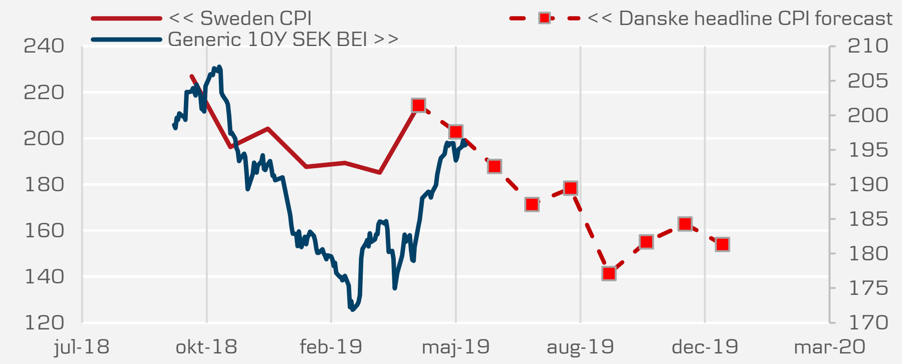
Source: Macrobond Financial, Danske Bank

Long BEI spreads have roughly followed the year-on-year CPI inflation rate



Source: Danske Bank

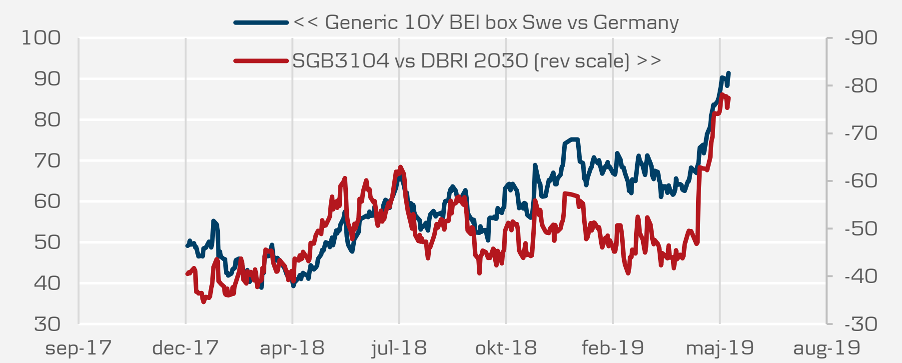
Downward path for headline CPI likely to put pressure on linkers



Source: Danske Bank

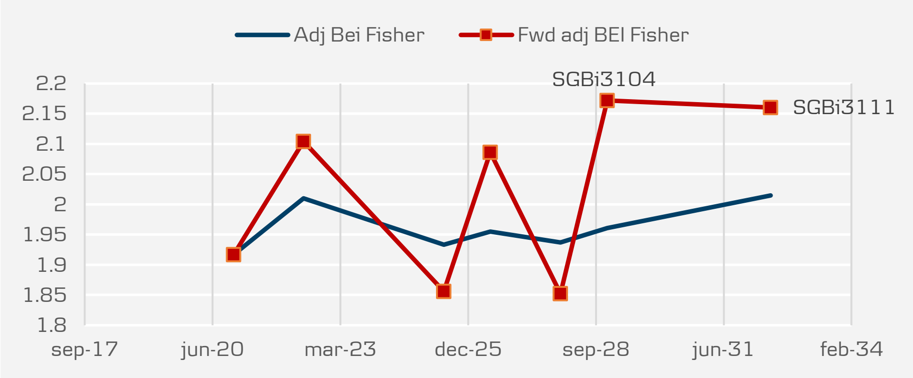
Liquidity in the SEK index-linked market has been hit disproportionally by Riksbank QE. Thus, we recommend positioning for underperformance in long-dated SEK linkers in a more long-term trade with relatively wide P/L levels. As seen in the chart below, as the real rate spread versus the German long end is well correlated with the BEI box, for simplicity we prefer to trade the real rate spread. We like buying DBRI2030 versus either only the relatively dear SGBi3104 (December 2028) or a mix of SGBi3104 and SGBi3111 (June 2032).

Real rate spread well correlated with the BEI box



Source: Danske Bank

SGBi3104 dear on the BEI curve



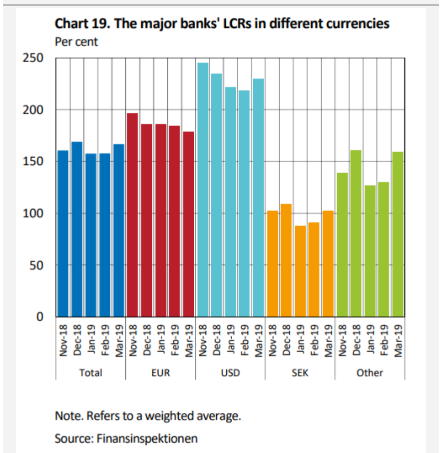
Source: Danske Bank

Riksbank Financial Stability Report confirms banks are already adjusting to SEK LCR proposal

The Riksbank Financial Stability Report is seldom of high importance for financial markets as it contains relatively broad descriptions of financial stability risks. Unsurprisingly, household debt remains the Riksbank's main concern and is identified as the biggest risk to the Swedish economy. There is nothing new in this. The report also discusses the banking sector and its associated financial stability risks. There is nothing new in this either. What was interesting this time around though was the chart showing the largest banks' LCR positions in different currencies.

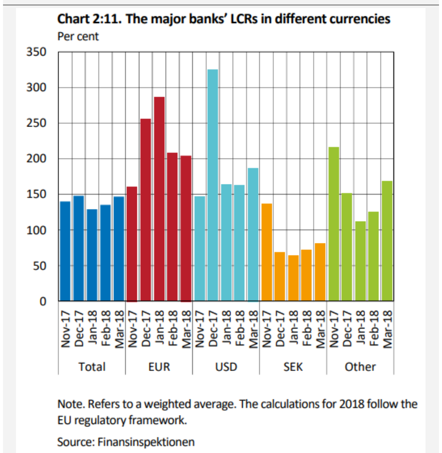
Comparing the chart showing the Swedish banks' LCR positions with the same chart from last year's report (2018:1), we note that the Swedish banks are seemingly already adjusting to the recent FSA proposal requiring a minimum SEK LCR of 75%. The weighted average of the largest banks (Svenska Handelsbanken, Nordea, SEB and Swedbank) is now around 100% for SEK LCR, significantly higher than a year ago. Another chart in the Financial Stability Report shows that, although the lowest single observation of SEK LCR among the Swedish banks has improved markedly, it is still below the proposed 75% requirement, indicating that banks are still in the adjustment phase.

LCR ratios per currency 2019:1 report



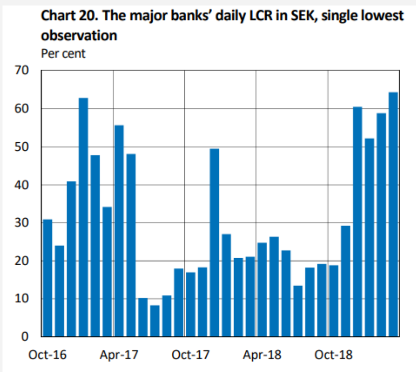
Source. Riksbank

LCR ratios per currency 2018:1 report



Source: Riksbank

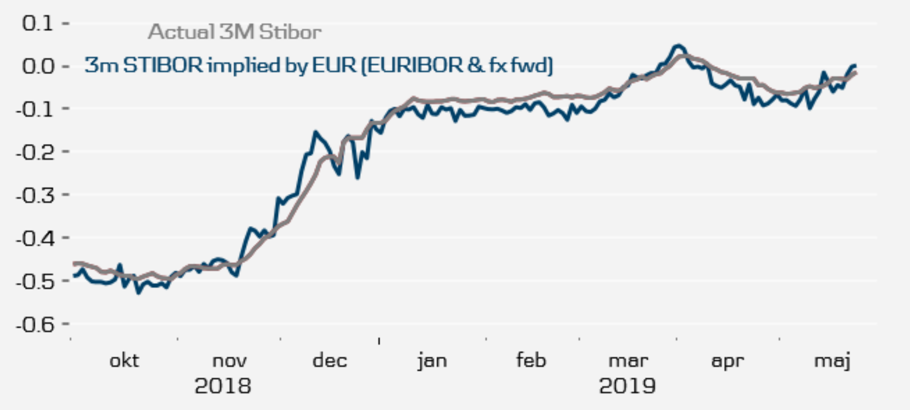
Lowest SEK LCR observation (2019:1 report)



Source. Riksbank

The above confirms our reasoning over the past couple of months that banks are already adjusting to the new FSA proposal. Based on this, we argue that the upcoming covered bond redemptions in June (around SEK80bn) will increase demand for HQLA in the form of Riksbank certificates, which would drain excess liquidity in the market and push fixings higher (there are already signs of Stibor moving higher). Note that the previous two Riksbank weekly certificates (21 May and 14 May) have been oversubscribed. The alternative to Riksbank certificates for banks is to increase SEK funding through the FX swap market, which also implies higher fixings. Based on the above, we reiterate our recommendations for positions benefiting from a higher 3M Stibor, such as paying the 1Y SEK swap, and we remain long SGB1047 (December 2020) ASW.

Signs of renewed upward pressure on 3M Stibor

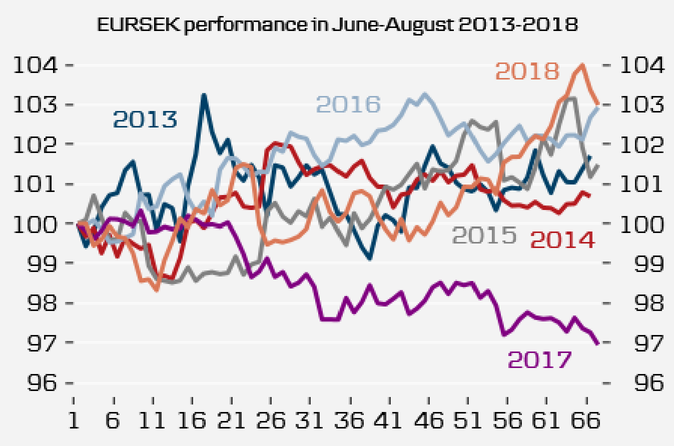


Source: Macrobond Financial

Any vacation in sight for the SEK?

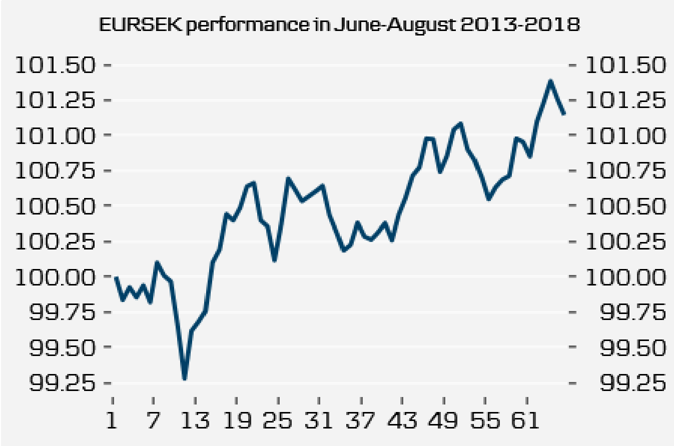
This spring has been tough on the SEK and summer is slowly approaching. Year-to-date, we have seen the SEK weaken by 6% and 9% against the EUR and USD, respectively. Soon summer will be upon us and the uncertainty is whether the SEK will get some weeks off from the relentless bashing of late In search of an answer, let us look back at the SEK's historical performance over the past six summers.

Seasonal pattern (June-August) EUR/SEK 2013-18



Source: Macrobond Financial

Average performance EUR/SEK (June-August) 2013-18



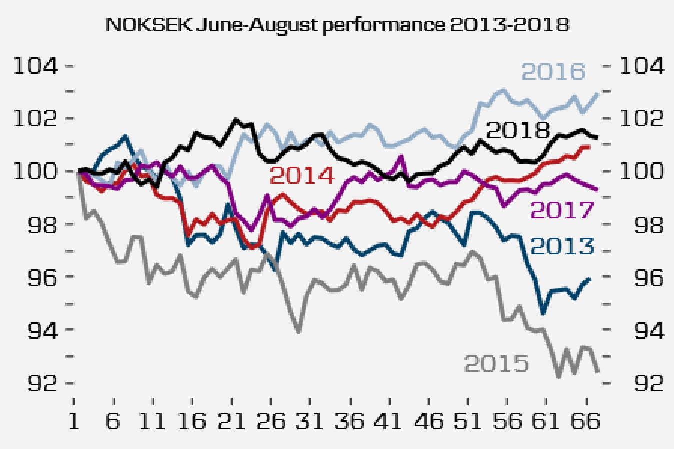
Source: Macrobond Financial

As for EUR/SEK (see above), the past six years' worth of history points to an SEK-negative seasonal pattern. In five out of the past six years, EUR/SEK has traded higher in late August than in early June, despite the beginning of June in general being a strong period for the SEK. The sole exception from the above is 2017, when EUR/SEK traded sideways until the end of June, before falling by approximately 3% over the rest of the season. The *average* performance of EUR/SEK between June and August over 2013-18 is approximately 1%, despite the SEK on average strengthening almost 1% over the first half of June. What is the underlying reason behind this pattern? As we have said repeatedly (recently in connection with the Swedish dividend season), these seasonal patterns are seldom born out of structural reasons (recurrent flows, vacation periods and thin liquidity, etc.) but are usually due to macroeconomic and/or financial events (rate decisions or other macroeconomic data, etc.).

Worth noting is that the investigated period (2013-18) is characterised by expansionary monetary policy conducted by the **Riksbank**. One potential explanation for the above pattern could thus be that soft policy actions from the Riksbank at the July meetings have been a headwind for the SEK over the rest of the summer. With this in mind, the next **monetary policy meeting** (**3 July**) is particularly interesting, even though the market's expectations ought to be relatively low following the outcome of the latest meeting. On top of this, that markets have already priced out almost all probability of an additional Riksbank hike in 2019 ought to limit the upside in EUR/SEK, at least in the short run. However, we believe there is a risk that **Q1 GDP growth (due 29 May)** was rather weak (more details on this earlier in this document), which limits the upside potential in the SEK. Our forecast indicates a marginally weaker SEK in the summer season (**3M 10.80**).

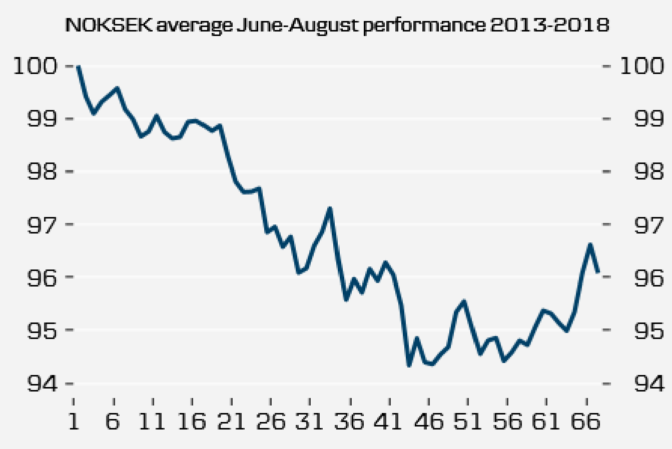
Another seasonal pattern worth noting is that in NOK/SEK. It is not as aligned as the yearly pattern for EUR/SEK but there is an even distribution of years with a stronger and weaker SEK against the NOK (see below).

Seasonal pattern (June-August) NOK/SEK 2013-18



Source: Macrobond Financial

Average performance NOK/SEK (June-August) 2013-18



Source: Macrobond Financial

Judging by history, NOK/SEK trades weaker in odd years (2013, 2015, 2017) and stronger in even years (2014, 2016, 2018). Thus, simple, and highly non-scientific, logic implies that NOK/SEK should fall this summer. This is also in line with the *average* pattern, where we have historically seen a fall in NOK/SEK by approximately 4% in the summer months. This is largely due to hefty declines in 2013 and, in particular, 2015 following surprisingly dovish policy action from **Norges Bank**. In contrast, we now look forward to a hawkish western neighbour and expect to see another hike at the **next monetary policy meeting (20 June)**. If this hike materialises, we would expect to see a rise in NOK/SEK, as indicated by our forecast (**3M 1.13)**, despite the pattern of a stronger/weaker SEK every other year, However, only time will tell whether logic or history dominates.

Open strategies

Type	Trade	Idea	Target & P/L		Status
Index-linked	Sell SGBI3104 (Dec 2028) vs Buy DBRI2030 (Apr 2030)	Longer BEI spread vs Germany trade at extreme levels. CPI a drag in coming months.	Opened	23 maj 2019	New
			Start	-77.50	
			Target/Stop	-43/-93	
			Now	-77.5	
			P/L	0.0	
Swap	Pay 1Y SEK swap	RB expectations scaled back too much and upward pressure on 3M Stibor	Opened	16 maj 2019	Hold
			Start	-2.5	
			Target/Stop	4.5/-7	
			Now	0.2	
			P/L	2.7	
Covered bonds	Buy LFH519 (Sep 2026) ASW vs SHYP1588 (Mar 2024) ASW	The longest benchmark covered bonds look cheap relative to the 5Ysegment.	Opened	29 apr 2019	Hold
			Start	27	
			Target/Stop	15/36	
			Now	18.4	
			P/L	8.6	
ASW	Buy SGB1047 ASW	SGB1047 likely to be increasingly squeezed, while short dated swaps could be pushed higher by fixings.	Opened	21 mar 2019	Hold
			Start	-48.5	
			Target/Stop	-65/-52	
			Now	-60.5	
			P/L	12.1	
Covered bonds	Buy SHYP1585 (Dec 2021) ASW	Attractive carry and roll and stability in short end ASW spreads are supportive.	Opened	31 jan 2019	Hold
			Start	7.00	
			Target/Stop	-3/15	
			Now	-1.300	
			P/L	8.3	

Source: Danske Bank

Swedish calendar for coming two weeks

				Period	Danske Bank	*Konsensus*	Previous
Monday, 27 May, 2019				Period	Danske Bank	*Konsensus*	Previous
Tuesday, 28 May, 2019				Period	Danske Bank	*Konsensus*	Previous
08:00	SWE	FSA Financial Stability Report					
09:00	SWE	NIER Economic tendency indicator	Index	May			102,7
09:00	SWE	Consumer confidence	Index	May			95,8
09:00	SWE	Manufacturing confidence	Index	May			108,4
09:30	SWE	Retail sales	m/m|y/y	Apr	0,5%|1,5%		0,5%|1,9%
09:30	SWE	Household lending	y/y	Apr			5,0%
09:30	SWE	Trade balance	SEK bn	Apr	3,0		7,0
Wednesday, 29 May, 2019				Period	Danske Bank	*Konsensus*	Previous
09:30	SWE	Wages non-namual workers	y/y	Mar			2,4%
09:30	SWE	GDP	q/q|y/y	Q1			1,2%|2,4%
Thursday, 30 May, 2019				Period	Danske Bank	*Konsensus*	Previous
Friday, 31 May, 2019				Period	Danske Bank	*Konsensus*	Previous
Monday, June 3, 2019				Period	Danske Bank	*Konsensus*	Previous
08:00	SWE	Manufacturing PMI	Index	May			50,9
Tuesday, June 4, 2019				Period	Danske Bank	*Konsensus*	Previous
09:30	SWE	Current account	SEK bn	Q1			39,6
09:30	SWE	Private sector production	m/m|y/y	Apr			-0,5%|1,1%
09:30	SWE	Industry production value	y/y	Apr			-0,3%
09:30	SWE	Services production value	y/y	Apr			0,3%
09:30	SWE	Industrial orders	m/m|y/y	Apr			--4,9%|-8,1%
Wednesday, June 5, 2019				Period	Danske Bank	*Konsensus*	Previous
08:30	SWE	Services PMI	Index	May			54,0
08:30	SWE	Composite PMI	Index	May			53,2

Source: 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), Carl Milton (Analyst), Filip Andersson (Analyst) and Jesper Petersen (First-Year Analyst).

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Date of first publication

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