

Reading the Markets Sweden

- Riksbank in wait-and-see mode.
- Long dated ASW spreads could be under tightening pressure but entry levels are unattractive.
- Risk on → sell SEK but it is beginning to look stretched.

Trades

Profit taken, sell SGB1056 (June 2032) versus SGB1057 (November 2023) in a tail versus matching swaps. Profit: 3.5bp.

| Danske Bank's market view in a nutshell | | | | |
|---|---|---|-------------|--------|
| Relative value | | * | Last change | |
| Delta | Fear of a recession may be overdone - rates could bounce higher in the coming months. | 2 | 24/01-2019 | |
| Curve view | Steeper curve SEK 3Y-10Y. | 3 | 24/01-2019 | |
| Cross country sprds | Neutral. | 1 | 24/01-2019 | |
| Short-end (<2Y) | Receive FRA SEP19 outright. | 3 | 01/10-2019 | |
| Index-linked bonds | Steeper 5y/10y real rate curve. | 3 | 29/11-2018 | |
| Covered bonds | Buy 3Y covered bonds vs swaps. | 3 | 31/01-2019 | |
| Swap Spreads | Buy Kommuninvest K2410 ASW. | 3 | 02/07-2019 | |
| SEK | Stay long NOKSEK. Buy 3M EURSEK Straddle. | 3 | 31/1-2019 | |
| Repo rate | | | 3m | 6m |
| | | | -0.25% | -0.25% |
| | | | | 12m |
| | | | | -0.25% |

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

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Riksbank in wait-and-see mode

We are in a rather confusing situation. Fixed income markets seem to be increasingly convinced that Europe is heading towards recession and rates are going down. At the same time, equity markets show a significant upward correction. Credit spreads widened along with falling equity prices late last year but are now tightening again. The SEK typically trades weaker when equity prices are down and vice versa. That correlation appears to have reversed of late.

After the January board meeting, ECB president Draghi explained that the board was in assessment rather than decision mode. We take that as a sign that any alteration of policy guidance will rely on the ECB's assessment of the medium-term outlook for growth and inflation as expressed in the new staff forecast.

Our guess is that the Riksbank is in a similar position, except the Riksbank presents updated forecasts at each policy announcement. As a minimum, we would argue that the Riksbank would acknowledge that growth risk has intensified both internationally and in Sweden. Having said that, one should remember that the Riksbank has already made rather significant downward revisions to the 2019-20 GDP forecasts and compared with private banks' forecasts the current Riksbank projection does not really stand out in a meaningful way. Therefore, at this stage we think that the most likely outcome is more emphasis on downside risk but no changes to the rate path. That would allow the Riksbank to wait for the outcome of Q4 GDP and more information about the ECB's updated view on the EZ-outlook and possible policy implications.

In the meantime, recent German order data showed a y/y drop of no less than 7%. It does not appear to be the car industry and its issues with new emission tests that is creating problems, as orders for cars and part have recovered of late. Instead, other industries are in reverse. Admittedly, we have some trouble grasping what is going on in Germany. However, considering the strong correlation between Swedish and German manufacturing it is a little worrying. Our base view is that while the global (and Swedish) economy are slowing, fixed income markets are too gloomy and we see some correction in long-term yields as warranted. However, more data of the kind we got from Germany would not help the case.

Chart 1. German orders - what is going on?



Source: Macrobond Financial

Chart 2. 2021-2024 maturity looks good from ASW RD+carry perspective

| SHYP bond | Maturity | Yield | 3M | | 3M Total carry+ RD on ASW |
|-----------|------------|-------|--------|-----------|---------------------------|
| | | | ASW RD | ASW Carry | |
| 1582 | 2019-09-18 | -0,23 | 3,75 | -1,52 | 2,23 |
| 1583 | 2020-06-17 | -0,09 | 1,92 | 1,10 | 3,02 |
| 1584 | 2021-03-17 | 0,06 | 1,68 | 1,38 | 3,06 |
| 1585 | 2021-12-15 | 0,22 | 2,31 | 1,67 | 3,98 |
| 1586 | 2022-09-21 | 0,38 | 1,95 | 2,06 | 4,01 |
| 1587 | 2023-06-01 | 0,54 | 1,69 | 2,00 | 3,69 |
| 1588 | 2024-03-01 | 0,71 | 2,05 | 2,07 | 4,11 |
| 1594 | 2028-09-01 | 1,47 | 0,86 | 2,00 | 2,86 |

Source: Danske Bank

At the same time, the current environment is positive for covered bonds, considering the steepness of the curve, the yield pick-up covered bonds offer versus govies and from a carry and roll-down perspective. From a repo-financed investor's point of view, the total

ASW carry+roll down profile is quite flat between 2021 and 2024 maturities (see chart) for instance buying SHYP1585 ASW.

Long dated ASW spreads could be under tightening pressure but entry levels are unattractive

Fundamentally, we see clear supply-related factors that could affect longer ASW spreads. As we wrote earlier, we think the Riksbank is unlikely to extend QE beyond June 2019. In addition, we see upside risks to the latest SNDO forecast. So far, the accumulated deviation relative to the forecast is some SEK15bn and the SNDO probably needs to revise its growth assumptions (next forecast is due on 20 February).

For quite a while (mid 2018) we have been short the SGB1057 (Nov 2023) versus SGB1056 (June 2032) tail versus swaps. We reasoned that the very long end (>10Y) traded expensive given that the loans are not particularly dear in the repo market and would likely suffer from the introduction of SGB1061. The position has yielded a tiny 3.5bp profit but we acknowledge that the pricing has been slow to materialise and thus we close the trade.

We close our short position in the SGB1057/SGB1056 tail versus swaps



Source: Danske Bank

Fundamentally, it could be argued that the Swedish long-end ASW spread should gradually move tighter as spreads are significantly wider than where the bonds trade in the repo market, given the possible turnaround in the supply balance. However, given the very reduced free float (no bond even reaches as little as SEK30bn in the 10Y segment), we think that it will take a long time for this repricing to occur.

In the meantime, the relative pricing versus Bunds looks clearly less attractive. Swedish long-end ASW spreads have cheapened steadily versus Bunds. Since May 2018, the ASW box has moved by around SEK15bp. Thus, we feel that entry levels are currently not attractive enough and decide to remain on the sidelines for now.

SGB long end ASW have cheapened substantially versus Bunds

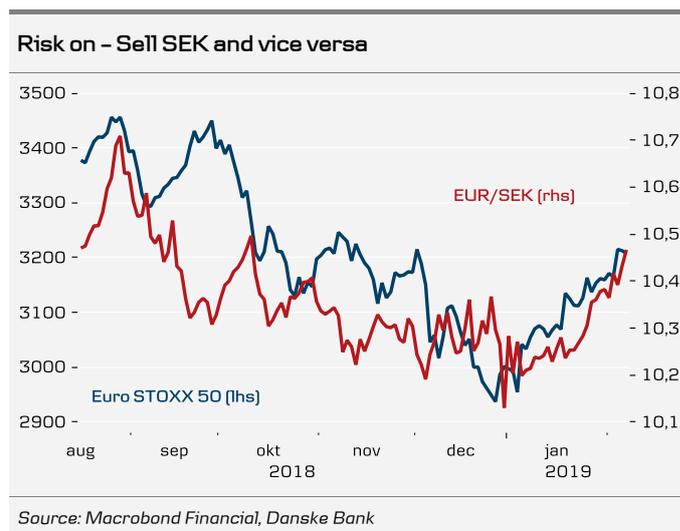
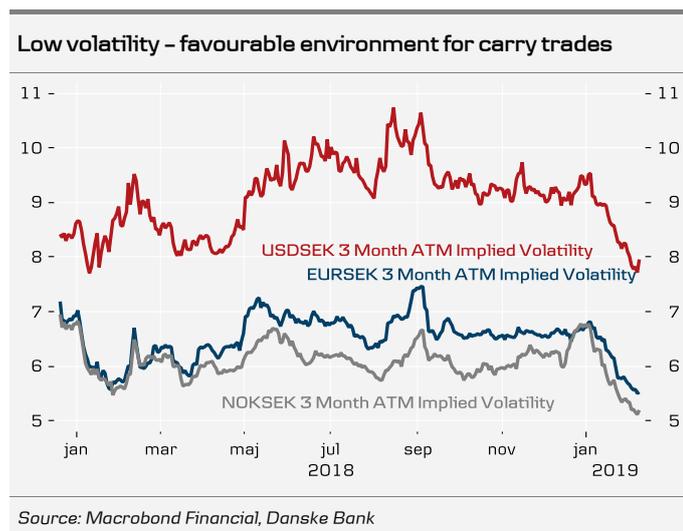


Source: Danske Bank

Risk on → sell SEK but it is beginning to look stretched

Not much has gone the SEK's way at the start of this year. We have already pointed at surprisingly weak macro data and revised **growth assessments** (IMF, Fed, ECB and other analysts as well as the Riksbank in December) with lower expectations regarding both the global and the Swedish economy. We ought to also mention the Fed's and ECB's signalling, or confirmation, of slower rate hikes from now on, where Draghi refers to weaker domestic conditions whilst Powell is mainly concerned with global risks. The Fed's softer stance has mostly to do with factors that – maybe even to a higher extent – one could argue should be hampering Europe, the ECB and the Riksbank as well. With this in mind, we are not surprised to see EUR/USD trading lower and USD/SEK higher following the Fed's unexpected U-turn: if the Fed turns dovish because of global risks, this should not be interpreted as a step towards policy-convergence where the Riksbank and ECB carry on as if nothing has happened. On the contrary.

Another observation is that the SEK since some time is acting more like a **funding currency**. Since last fall, we have seen EUR/SEK and USD/SEK disconnect from 'normal' stock market correlations. The typical pattern has been to buy SEK with rising stock markets and the other way around. This pattern now seems reversed. One possible interpretation is that investors largely use the SEK as funding for carry trades. USD/SEK is one obvious winner of this, NOK/SEK another. It is quite remarkable that this happens despite the Riksbank's rate hike in December. However, Ingves's careful, dovish, baby step has done nothing to reduce the rate gaps towards the Fed or Norges Bank. Possible rebalancing flows, e.g. when the stock market rises, might then make a smaller impact in the market.



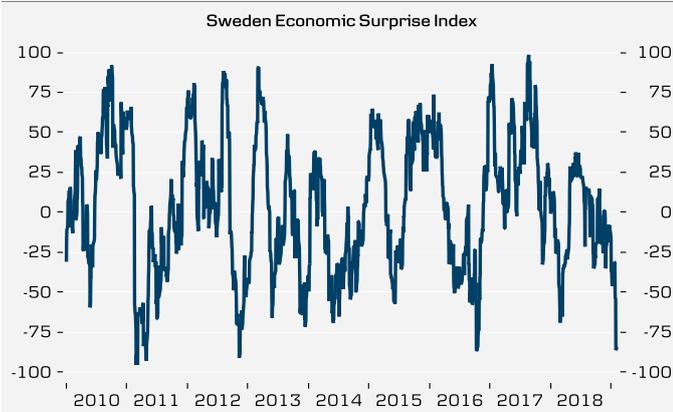
Since the turn of the year, **implicit volatility** in the currency market has generally all but vanished. This might seem odd considering the global event risks, trade war, uncertain economic outlook and central banks that cannot decide whether the next move will be a hike or a cut. Nonetheless, this reflects an equally depressed realised volatility. If actual movements are small, one tends to believe that future movements will be small as well. At least until ‘something’ happens, a trigger. Furthermore, the stock markets have rebounded and Powell has signalled that the Fed does not want to cause the markets to enter ‘recession-mode’ if this can be avoided. The extremely low implicit volatility offers the best conditions for such positions. As we have said, implicit volatility is generally depressed in FX markets, where for example NOK/SEK (implicit 3M) is trading at the lowest levels since the mid-00s. For example, 3M implied volatility in NOK/SEK is 5%, which implies an expected daily movement of about +/- 30 pips. For EUR/SEK, corresponding expected movement is +/- 3.5 figures. Almost nothing! In other words, it is ‘cheap’ to buy volatility (puts, calls, straddles). On this theme, we have recommended 3M straddles in EUR/SEK. **We remain long NOK/SEK (from 1.0570).**

We believe that surprisingly weak macro data, a re-evaluated view on the cyclical outlook and carry trades to a high extent can explain the sell-off in the SEK, i.e. if there is carry, there is a clear risk that this will continue. However, we feel that the recent rally in **EUR/SEK has gone far enough**. The Swedish surprise index is at historical lows and thus it should be easier to match or exceed expectations. Our (simple) model based on relative rates indicates that the spot is currently trading two standard deviations above ‘fair value’. As the SEK has collapsed, the rate spread has remained stable, indicating that EUR/SEK has overreacted. ‘Fair value’ is in the neighbourhood of 10.25 to 10.30, where we also find Fibonacci retracement levels of 50% and 61.8%, respectively. RSI is at 76, which indicates that the cross is overbought from a technical point of view, and thus ready to recoil.

Next week’s rate decision from **the Riksbank** is on top of the agenda for the SEK. As we have already discussed in this publication, we see no significant revisions for this meeting, even though the board might choose to express higher uncertainty regarding the global economy (could be SEK negative). At the same time, market pricing on the Riksbank is soft whilst KIX is approximately 5% above its Q1 forecast. One thing worth looking out for is that the mandate for FX interventions expires. This could be removed and it would not be unreasonable to do so in our view. If so, we might see some positive response from the SEK. However, can the Riksbank stomach this? The options market does not expect this to be a big deal, just slightly more volatile than a normal day: approximately 50% larger

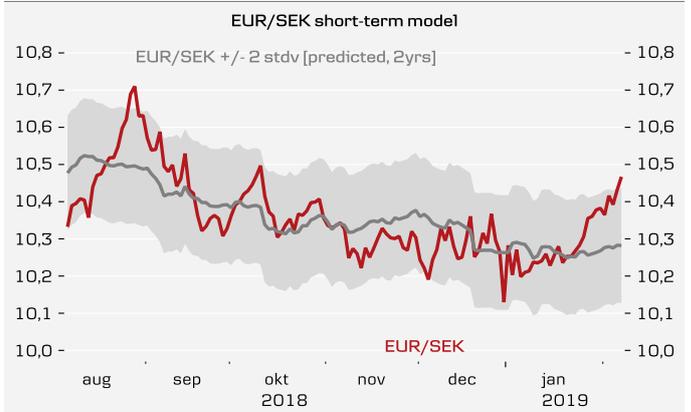
intraday movement than what is normal, corresponding to about five figures up or down. Even if the Riksbank does not make any major adjustments, we still feel this is low.

Historical lows in Swedish surprise index



Source: Macrobond Financial, Danske Bank

EUR/SEK 'on the high-side' according to rates model



Source: Macrobond Financial, Danske Bank

Open strategies

| Type | Trade | Idea | Target & P/L | Status |
|-------------------|---|--|---|-------------------------|
| Covered bonds | Buy SHYP1585 (Dec 2021) ASW | Attractive carry and roll and stability in short end ASW spreads are supportive. | Opened 31 jan 2019 Start 7.00 Target/Stop -3/15 Now 5.81 P/L 1.2 | Hold |
| Money Market | Steepen 3Y-10Y SEK swap. | Risk of a rebound in global rates, while the SEK short-end could remain well anchored. | Opened 24 jan 2019 Start 86.1 Target/Stop 105/70 Now 83.08 P/L -3.0 | Hold |
| Kommuninvest | Buy KI2410 vs swaps. | Long dated Kommuninvest bonds have cheapened too much. | Opened 17 jan 2019 Start 23 Target/Stop 12/31 Now 19.39 P/L 3.6 | Hold |
| Money Market | Receive FRA SEP19 outright. | Short Kommuninvest bonds trade cheap after underperformance | Opened 10 jan 2019 Start 1.5 Target/Stop -10/10 Now -2 P/L 3.5 | Hold |
| Real curve spread | Buy SGBi3108 vs SGBi3113 in a real rate steepener | Real rate curve to steepen amid dear longer real rates | Opened 29 nov 2018 Start 69.00 Target/Stop 84/57 Now 78.000 P/L 9.0 | Hold |
| 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 Start -50.00 Target/Stop -25/-70 Now -46.5 P/L 3.5 | Profit taken 2019-02-07 |

Source: Danske Bank

Calendar

| Monday, 11 February, 2019 | | | | | Period | Danske Bank | Konsensus | Previous |
|------------------------------|-----|--|------------|-------------|-----------|-------------|---------------|----------|
| 00:00 | JPN | National Foundation Day | | | | | | |
| 00:00 | USA | GDP, preliminary | q/q AR | 4th quarter | | 0.026 | 0.034 | |
| 00:00 | USA | Personal spending | m/m | Dec | | 0.3% | 0.4% | |
| 00:00 | USA | Building permits | 1000 (m/m) | Dec | | 1290 | 1322.0 (4.5%) | |
| 00:00 | USA | Unit labour cost, preliminary | q/q | 4th quarter | | 1.7% | 0.9% | |
| 00:00 | USA | Housing starts | 1000 (m/m) | Dec | | 1255 | 1256.0 (3.2%) | |
| 00:00 | USA | Trade balance | USA bn | Dec | | | -49.3 | |
| 00:00 | USA | Retail sales control group | m/m | Dec | | 0.4% | 0.9% | |
| 00:00 | USA | Core capital goods orders, preliminary | % | Dec | | 0.1% | -0.6% | |
| 00:00 | USA | Advance goods trade balance | USA bn | Dec | | -76.3 | | |
| 00:00 | USA | New home sales | 1000 (m/m) | Dec | | 575 | 657.0 (16.9%) | |
| 00:00 | USA | PCE core | m/mly/y | Dec | | 0.2% 1.9% | 0.1% 1.9% | |
| 00:00 | USA | PCE core, preliminary | q/q AR | 4th quarter | | 0.016 | 0.016 | |
| 00:00 | USA | PCE headline | m/mly/y | Dec | | 0.0% 1.7% | 0.1% 1.8% | |
| 08:00 | NOR | Core inflation (CPI-ATE) | m/mly/y | Jan | | | 0.0% 2.1% | |
| 08:00 | NOR | CPI | m/mly/y | Jan | | | 0.0% 3.5% | |
| 08:00 | DEN | CPI | m/mly/y | Jan | .. 0.9% | | -0.3% 0.8% | |
| 10:30 | UK | GDP, preliminary | q/qly/y | 4th quarter | | | 0.6% 1.5% | |
| 10:30 | UK | Monthly GDP estimate | m/m q/q | Dec | | | 0.002 0.003 | |
| 10:30 | UK | Index of services | m/m 3m/3m | Dec | | | 0.3% 0.3% | |
| 10:30 | UK | Trade balance | UK mio. | Dec | | | -2904 | |
| Tuesday, 12 February, 2019 | | | | | Period | Danske Bank | Konsensus | Previous |
| 12:00 | USA | NFIB small business optimism | Index | Jan | | | 104.4 | |
| Wednesday, 13 February, 2019 | | | | | Period | Danske Bank | Konsensus | Previous |
| 00:30 | USA | Fed's Mester (voter, hawkish) speaks | | | | | | |
| 01:30 | USA | Fed's George (non-voter, hawkish) speaks | | | | | | |
| 02:00 | NZ | Reserve Bank of New Zealand (cash rate decision) | % | | | | 1.8% | |
| 09:30 | SWE | Riksbank, rate decision | % | | -0,25% | | -0,25% | |
| 10:30 | UK | PPI - input | m/mly/y | Jan | | | -1.0% 3.7% | |
| 10:30 | UK | CPI | m/mly/y | Jan | | | 0.2% 2.1% | |
| 10:30 | UK | CPI core | y/y | Jan | | | 1.9% | |
| 11:00 | EZ | Industrial production | m/mly/y | Dec | | | -1.7% -3.3% | |
| 14:30 | USA | CPI headline | m/mly/y | Jan | | 0.1% 1.5% | -0.1% 1.9% | |
| 14:30 | USA | CPI core | m/mly/y | Jan | | 0.2% 2.1% | 0.2% 2.2% | |
| 14:50 | USA | Fed's Mester (voter, hawkish) speaks | | | | | | |
| 16:30 | USA | DOE U.S. crude oil inventories | K | | | | | |
| 20:00 | USA | Budget statement | USA bn | Dec | | -10.5 | -204.9 | |
| Thursday, 14 February, 2019 | | | | | Period | Danske Bank | Konsensus | Previous |
| 00:50 | JPN | GDP deflator, preliminary | y/y | 4th quarter | | -0.4% | -0.3% | |
| 00:50 | JPN | GDP, preliminary | q/q ann. | 4th quarter | | 0.3% 1.4% | -0.6% -2.5% | |
| 01:01 | UK | RICS house price balance | Index | Jan | | | -0.2 | |
| 07:30 | FRA | ILO unemployment | % | 4th quarter | | | -0.2% 1.1% | |
| 08:00 | GER | GDP, preliminary, (sajwda) | q/qly/y | 4th quarter | | | | |
| 08:00 | DEN | GDP indicator | q/q | 4th quarter | | | 0.7% | |
| 09:30 | SWE | Unemployment (n.s.a. s.a.) | % | Jan | 6.9% 6.4% | | 6.0% 6.4% | |
| 10:30 | EZ | Portugal, GDP, preliminary | q/qly/y | 4th quarter | | | 0.3% 2.1% | |
| 11:00 | EZ | GDP, preliminary | q/qly/y | 4th quarter | | | 0.2% 1.2% | |
| 11:00 | EZ | Employment, preliminary | q/qly/y | 4th quarter | | | 0.2% 1.3% | |
| 14:30 | USA | Initial jobless claims | 1000 | | | | | |
| 14:30 | USA | PPI | m/mly/y | Jan | | 0.1% 2.3% | -0.2% 2.5% | |
| 14:30 | USA | PPI core | m/mly/y | Jan | | 0.2% ... | -0.1% 2.7% | |
| Friday, 15 February, 2019 | | | | | Period | Danske Bank | Konsensus | Previous |
| 05:30 | JPN | Industrial production, final | m/mly/y | Dec | | | -0.1% -1.9% | |
| 08:00 | NOR | Trade balance | NOR bn | Jan | | | 25 | |
| 08:00 | EZ | New car registrations | | Jan | | | | |
| 10:30 | UK | Retail sales ex fuels | m/mly/y | Jan | | | -1.3% 2.6% | |
| 11:00 | EZ | Trade balance | EZ bn | Dec | | | 15.1 | |
| 14:30 | USA | Import prices | m/mly/y | Jan | | | -1.0% -0.6% | |
| 14:30 | USA | Empire Manufacturing PMI | Index | Feb | | | 3.9 | |
| 15:15 | USA | Capacity utilization | % | Jan | | 78.8% | 78.7% | |
| 15:15 | USA | Industrial production | m/m | Jan | | 0.2% | 0.3% | |
| 15:15 | USA | Manufacturing production | m/m | Jan | | 0.2% | 1.1% | |
| 16:00 | USA | University of Michigan Confidence, preliminary | Index | Feb | | 93.0 | 91.2 | |
| 22:00 | USA | TICS international capital flow, Net inflow | USA bn | Dec | | | 31.0 | |

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, Carl Milton, Analyst, Stefan Mellin, Analyst, and Jesper Petersen, First-Year Analyst.

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Expected updates

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Date of first publication

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