February 7, 2023

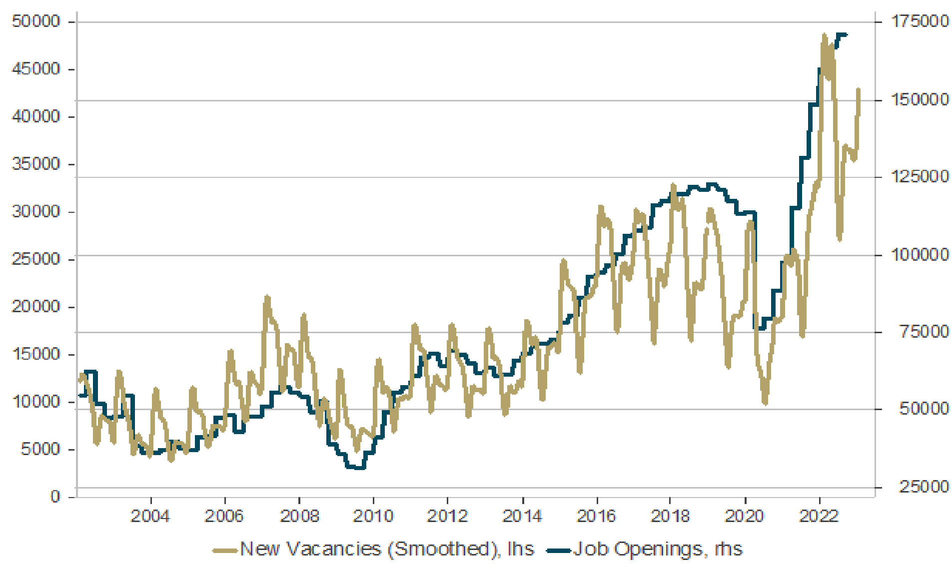
Wrong Peak For Riksbank

By almost every measure we utilise – iFlow holdings, valuations, central bank expectations, general performance – the Swedish krona has been one of the weakest currencies in recent months. It's facing pressures on several fronts and the ECB's hawkish tone and pre-commitment to essentially move its own terminal rates above that of the Riksbank is already a game-changer. Given the potential output differentials between the Eurozone and Swedish economies, such a phenomenon would have been considered impossible during previous tightening cycles. While the ECB still used the refinancing rate as its benchmark, the Riksbank's repo rate peaked 50bp higher during both the 2008 and 2011 cycles. Based on current pricing, the market currently has a 40% chance of Riksbank terminal rates at 3.25% (after a 50bp move expected this week), which would be at least 25bp below the ECB equivalent. Considering the upside growth and price pressures arising from the ECB's hawkish path and a better outlook for the Eurozone economy already representing additional tightening risk to the policy cycles of the Eurozone's immediate neighbours, we think the Riksbank would be hard-pressed to justify keeping its terminal outlook at 3% or lower through 2026. The main downside drag would mostly likely be attributed to domestic weakness, which at present we believe is not strong enough to justify ongoing caution.

> ***Domestic weakness is not strong enough to justify ongoing Riksbank caution***

Sweden's December's CPI-F figure for underlying inflation came in at 0.8% m/m, which points to strong underlying demand. Considering Sweden's unique approach to COVID, there may have been expectations that the 'reopening' supply shocks which pushed up both domestic and international inflation would not be as strong, especially for the former. However, current evidence suggests that the Swedish economy is behaving no differently when it comes to labour requirements. As the chart below indicates, new vacancies have rebounded sharply after a sharp decline from the initial reopening peak. This has resulted in openings staying at extremely elevated levels. The upside wage pressures will be obvious.

Sweden New Vacancies And Openings

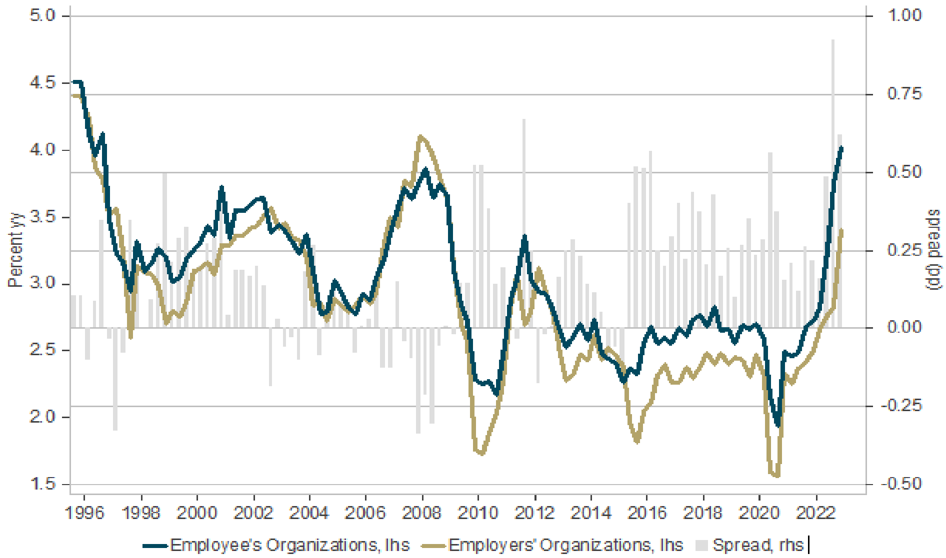


Source: Macrobond, BNY Mellon

> *The Swedish Trade Union Confederation (LO) is demanding a 4.4% rise (well below inflation) but only for a one-year agreement*

The Riksbank will be following wage negotiations as the last vestiges of pandemic-era emergency settlements roll off. The Swedish Trade Union Confederation (LO) is demanding a 4.4% rise (well below inflation) but only for a one-year agreement. On the one hand, this means that the Riksbank does not need to fear a wage spiral for now. However, if inflation is still running at excessive levels by the next round in a year's time, de-anchoring risk would be material, in our view. As the chart below shows, employee associations are expecting 4% wage growth for the first time since the late 1990s. While employers' associations are attempting to keep up, the spread is extremely wide and will represent a risk to corporate margins and general inflation expectations, should the labour costs ultimately be passed on.

Wage Expectations, Prospera Survey

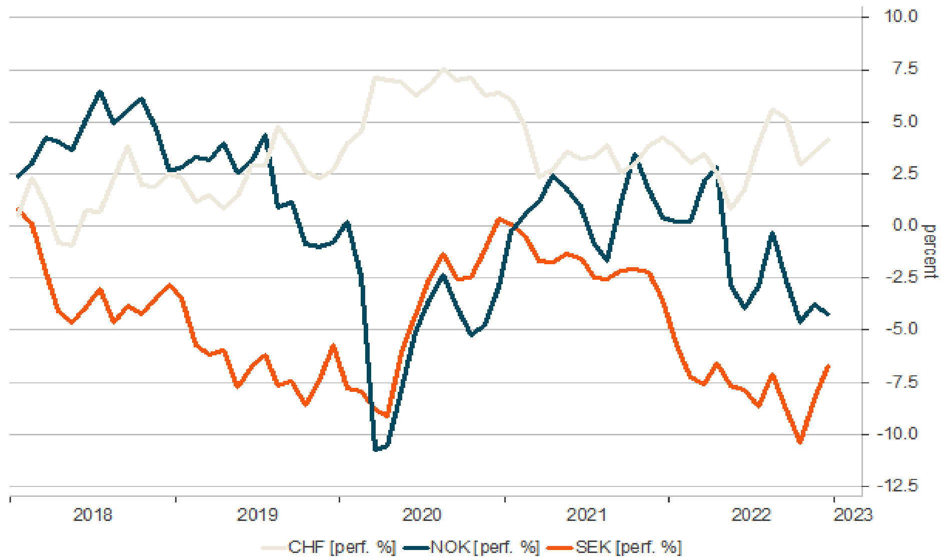


Source: Macrobond, BNY Mellon

> ***Keeping the repo at 3% will mean missing the inflation target through the forecast horizon under the alternative scenario***

Upside risk to the SEK from any hint of Riksbank hawkishness is evident, but on top of that we would also expect the Riksbank to acknowledge that current SEK valuations now add to upside risks. As we can see below, even on a real effective rate basis, and taking into account high Swedish inflation, the SEK is severely underperforming the NOK and CHF. Notwithstanding the abnormal balance of payments situation in 2022, some normalisation should come through this year. However, rate differentials means that the prospect of outflows is stronger and limiting SEK strength. To maintain even a semblance of fair value, the SEK REER would have to recover through higher inflation only, which would seem unadvisable under current conditions.

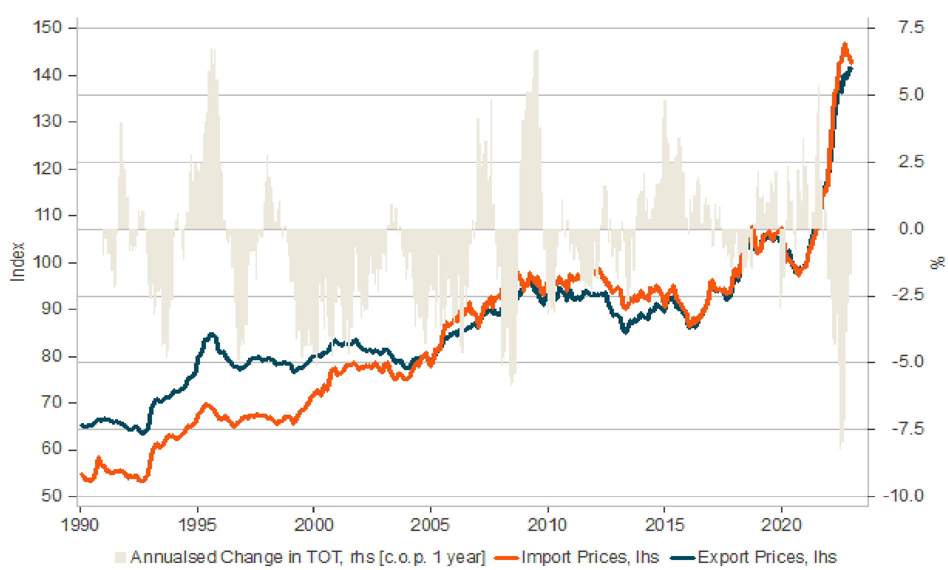
REER Comparison, SEK, NOK & CHF



Source: Bloomberg, BNY Mellon

The Riksbank would not seem in a position to undertake an FX programme. SNB-style warnings wouldn't seem credible, either. This leaves revisiting rate differentials the only viable path. If anything, encouraging a stronger SEK can limit excess hikes down the line, which the Riksbank is very wary of due to the household debt situation. We can see below that import prices are not declining materially and the terms-of-trade declines last year were the strongest in three decades. Sweden's scope for a commodity terms-of-trade bounce from China reopening is very limited. The lack of industrial demand globally will heavily shift the burden to lowering export prices to avoid further terms-of-trade erosion.

Terms of Trade, Sweden



Source: Macrobond, BNY Mellon

The Riksbank does have an alternative scenario in place regarding the repo path and repeats the process in most of its quarterly Monetary Policy Reports (MPRs). In the November iteration, simulations pointed to the risk of companies raising prices and wages rising “substantially faster” than the Riksbank’s main scenario, which would demand a policy rate of nearly 4.75% by the end of this year. Based on the Riksbank's inflation assumptions, the shift to the alternative path would see CPI-F inflation fall to only around 4% by the end of this year, irrespective of whether the repo rate follows the main scenario (staying at 3%) or follows the more aggressive path. The only difference is more in line with our ‘higher for longer’ narrative for the Fed, whereby to ensure that inflation falls back to target, the repo rate would have to stay at an elevated rate through most of H1 2024, and even stay at above 4% through the Riksbank’s forecast horizon. Based on the December print alone, where CPIF stayed above 10%, the Riksbank already seems to have fallen behind the curve and more to the alternative path. But, so far, there has not been any Riksbank guidance on a need to reassess their path in the same way that the ECB has.

One data print does not mean the Riksbank is already off course, but the risks are clearly skewed to the upside. As keeping the repo rate at 3% will mean the Riksbank will miss its inflation target through the forecast horizon under the alternative scenario, new guidance – if and when it comes – means that the market is heavily mispriced for the alternative path – up to 100bp out to 1y based on current OIS levels. The February meeting may be too early for such a significant repricing, but we think any latent SEK shorts will now be at risk as it is difficult to see any additional dovish risk from the Riksbank.

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