Macro & FICC Research

SEK Views

Wednesday 16 October 2019

Market perceived to be record-short SEK

Our bi-annual survey of Financial Institutions and Corporates estimate the FX market to be record-short SEK. Summarising our surveys for both FX and Fixed Income investors, a whopping 45% of respondents expect the Riksbank to hike the repo rate at the December or February meeting. The Fixed income survey participants also expect the Riksbank to keep its rate path largely unchanged at the upcoming October meeting. The FX survey ranks the Riksbank as a neutral driver for SEK – should the Riksbank surprise it is easy to project SEK appreciation. A majority of the survey participants blame the Riksbank policy for the weak SEK.

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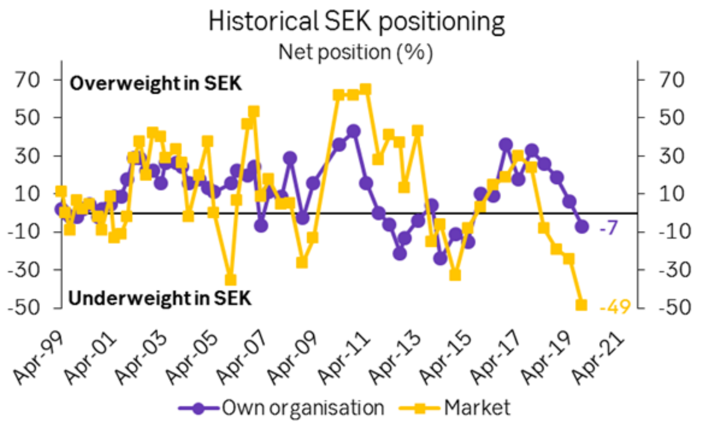
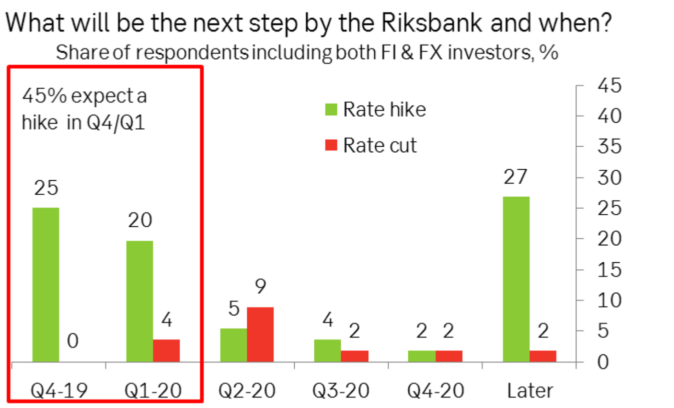
Riksbank rhetoric not fully in doubt

We have polled Financial Institutions and Companies on various topics including the Riksbank and SEK outlook. As mentioned above, the skew is for positive surprises given stated and perceived SEK positioning as well as expectations on the Riksbank. Of particular interest is of course the latest downturn in the global and Swedish economy which stands in contrast to the Riksbank's intention of raising the repo rate in December or February. Almost 50% of respondents believe the Riksbank will deliver which would surely contribute to a stronger SEK outlook. In the report we have written a number of hopefully interesting articles including: 1) A deeper look at some of the flow categories in the balance of payments – we find that three factors can be attributed to have pushed the SEK lower in the past few years primarily weaker foreign interest in Swedish government debt; 2) Regulatory requirements and developments that underpin the 30-year trend of lower interest rates; 3) Swedish labour market outlook in the context of 4 months of steady deterioration; 4) Brexit and the effect it may have on the Swedish economy and 5) Our analysis of our client flow data. SEB has had FX forecasts pointing in a weaker direction with EUR/SEK targeting 11.00 in Q4 2019. As a consequence of primarily SEK positioning and Riksbank expectations we have revised our SEK forecasts in a slightly stronger direction with EUR/SEK to trade around current levels in 2019 before cautiously heading lower in 2020. For hedging purposes we think EUR/SEK offers good value given the positive SEK carry but we leave USD exposures open for now. Our trading recommendations can be found on page 3.





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Trades & Recommendations

- Buy Nordea 05/21 Covered vs. Mar20 SEK FRA
- Sell NOK/SEK on seasonality
- Hedging EUR exposure through selling EUR/SEK calls at 11.00 (rather than outright short EUR/SEK)

FX and Fixed Income forecasts

Government bonds (constant maturity, %)

Germany	2019-10-15	Q4 19	Q1 20	Q2 20	Q3 20
2y	-0.70	-0.80	-0.80	-0.80	-0.80
5y	-0.66	-0.80	-0.80	-0.80	-0.80
10y	-0.42	-0.70	-0.70	-0.70	-0.70
US	**2019-10-15**	**Q4 19**	**Q1 20**	**Q2 20**	**Q3 20**
2y	1.60	1.50	1.25	1.25	1.25
5y	1.58	1.33	1.16	1.16	1.18
10y	1.74	1.40	1.35	1.30	1.30
Sweden	**2019-10-15**	**Q4 19**	**Q1 20**	**Q2 20**	**Q3 20**
2y	-0.56	-0.63	-0.60	-0.60	-0.60
5y	-0.50	-0.59	-0.57	-0.52	-0.50
10y	-0.19	-0.35	-0.35	-0.30	-0.25
10y spreads vs. Germany (bps)					
Swe	23	35	35	40	45
US	216	210	205	200	200

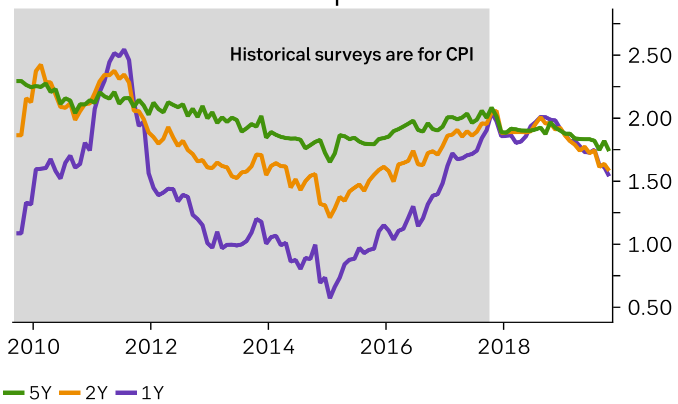
		FORECASTS							
FX	16 Oct	1 mth	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q4 21
EUR/USD	1.10	1.08	1.07	1.10	1.12	1.15	1.17	1.18	1.20
EUR/SEK	10.83	10.90	10.90	10.80	10.70	10.60	10.50	10.40	10.00
EUR/NOK	10.08	10.10	10.20	10.10	9.90	9.75	9.75	9.50	9.30
EUR/CHF	1.10	1.10	1.08	1.09	1.10	1.12	1.13	1.14	1.15
USD/JPY	108.7	107.0	105.0	105.0	106.0	108.0	110.0	110.0	112.0
USD/CAD	1.32	1.30	1.28	1.32	1.34	1.36	1.36	1.34	1.34
EUR/GBP	0.86	0.91	0.90	0.88	0.83	0.85	0.86	0.87	0.88
USD/SEK	9.82	10.09	10.19	9.82	9.55	9.22	8.97	8.81	8.33
GBP/SEK	12.52	11.98	12.11	12.27	12.89	12.47	12.21	11.95	11.36
NOK/SEK	1.07	1.08	1.07	1.07	1.08	1.09	1.08	1.09	1.08
JPY/SEK	9.03	9.43	9.70	9.35	9.01	8.53	8.16	8.01	7.44
CAD/SEK	7.43	7.76	7.96	7.44	7.13	6.78	6.60	6.58	6.22
AUD/SEK	6.61	6.76	6.72	6.58	6.50	6.36	6.28	6.35	6.25
CNY/SEK	1.38	1.42	1.42	1.37	1.32	1.27	1.23	1.22	-
CHF/SEK	9.84	9.91	10.09	9.91	9.73	9.46	9.29	9.12	8.70

Riksbank in October

Trying to keep a rate hike alive

We expect a lower rate path in the October *Monetary Policy report,* but expect the path to continue to signal a hike in the first half of next year. We expect the board to be unwilling to feed market expectations for a rate cut, but also think it will be difficult to ignore the weakening outlook for growth and declining inflation expectations. A lower rate path but with still an upside bias would support our forecast that the Riksbank will stay on hold.

Money market inflation expectations CPIF, Prospera



Trying to keep a rate hike alive

Swedish economic data since the Riksbank presented its latest Monetary Policy report on 5 September has been disappointing to say the least. The only bright spot is that CPIF inflation in September returned to the Riksbank trajectory, although CPIF ex energy was once again lower than expected, if only marginally so. GDP growth in the first half of this year was revised 0.3-0.4pp lower and with sentiment according to PMI falling below the growth threshold (50) for both manufacturing and services, downside risks to the near term outlook have increased significantly. Furthermore the labour market weakened even further in August with unemployment rising to 7.4%, 0.8pp above the Riksbank's forecast for Q4. Together with an increasing number of central banks easing policy, the pressure to reverse policy is mounting and we expect the board to take a step back in October. However, our main scenario is that the board will be reluctant to fuel market expectations for a rate cut in order to avoid pushing the already weak exchange rate.

Our main scenario is that the Riksbank will lower its near term rate path so it signals 5bps chance for a December hike and that the rate path will indicate April next year as the most probable time for a hike. Risks around our main scenario is assessed to be balance and we outline two scenarios, one hawkish with the repo rate path almost completely unchanged and a dovish scenario with the board signalling unchanged rates until the second half of next year. Read more in our Riksbank preview here.

Despite that we expect the Riksbank to continue signal a rate hike in October, although somewhat later, we have not changed our view that headwinds for rate hikes will continue to grow. A continued tightening bias would, however, signal that the board is unwilling to follow the ECB which would support our forecast that the repo rate will remain on hold through-out next year. If the board leaves the repo rate path unchanged in line with our hawkish risk scenario it would be a strong signal that the board will follow through with its plans and actually hike rates, probably already in December. A larger downward revision to the rate path would on the other hand open for a shift to an easing bias and possibly a rate cut next year.

Fairly small market movements in our main scenario

The recent large movements in the short end of the Swedish rate curve suggest that the market is very confused regarding the Riksbank's policy strategy and the October meeting has potential to once again create large movements. However, after the recent repricing in the short end of the rate curve, we expect relatively small market movements in our main scenario. The somewhat lowered path suggests that the market will continue to question the Riksbank's plan to hike the rate in the near term but limit speculation of a rate cut within the next year. EUR/SEK is expected to continue to trade on the weak side just below 11.00 before grinding lower 2020.

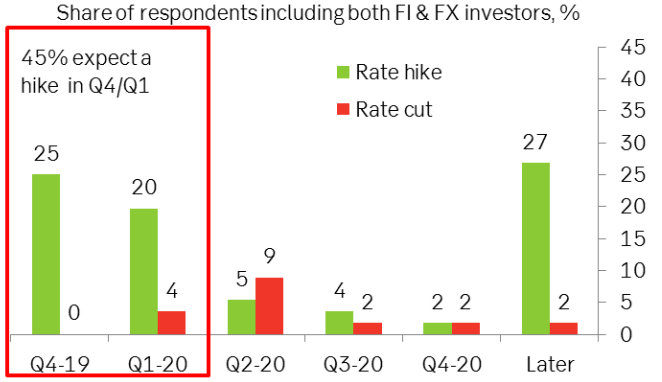
Riksbank survey

45% expect a near-term hike

According to our surveys among Fixed Income and FX investors, 45% expect the Riksbank to hike the rate in December or February. Furthermore, market reactions are expected to be strong if the Riksbank leaves the rate path unchanged in October. While a majority blame the Riksbank for the weak SEK, they still think the board is currently more worried about inflation and growth than the SEK at these levels. In general FI investors seem to have more hawkish expectations than the FX universe.

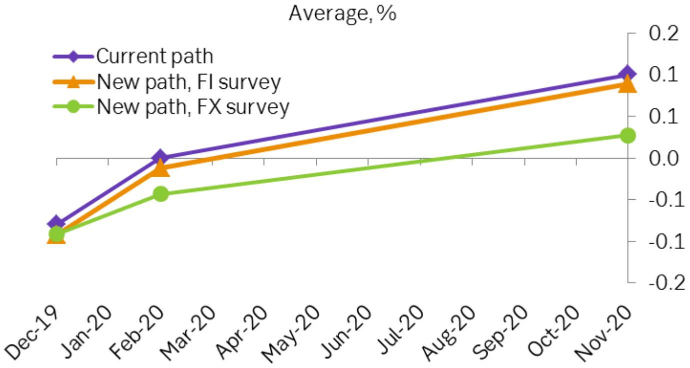
What will be the next step by the Riksbank and when?

Share of respondents including both FI & FX investors, %



Current and expected new path in October

Average, %



Almost half of respondents expect near-term hike

There have been large shifts in market pricing regarding the repo rate over recent weeks. The pricing has shifted back and forth between markets seeing a high probability of a rate cut to price some chance of a rate hike in the near term. After the upside surprise in September CPIF the market is currently pricing in a 6bps chance of a rate hike by February (5.5bps in December).

The more hawkish expectations are also seen in our Fixed Income investor survey. According to the survey, 91% now expect the next move by the Riksbank to be a rate hike and 45% foresee this to happen in December or February – in line with the plan in the September MPR. This can be compared with the survey ahead of the meeting in September where only 19% expected a hike around the turn of the year and 23% instead predicted the next step to be a rate cut. On average the respondents expect the Riksbank to leave the rate path largely unchanged in October (lowering the rate forecast by only 1bp) and to signal a 16bps chance for a hike in December (17bps in the current path).

Twice a year we also ask our FX investors (corporates and financial institutions) on their expectations on the Riksbank and the SEK. It is interesting to see that in general the FX universe seems to be slightly more pessimistic on the growth outlook and slightly more dovish on the Riksbank than Fixed Income investors. In the FX survey, 74% expect the next step to be a rate hike while 26% foresee a rate cut. On average, FX investors expect the rate path in October to be lowered by 4-7bps by end-2020. Still, in line with the FI survey almost half of the FX respondents (45%) expect the Riksbank to have hiked the rate by February next year.

Potential for large market movements

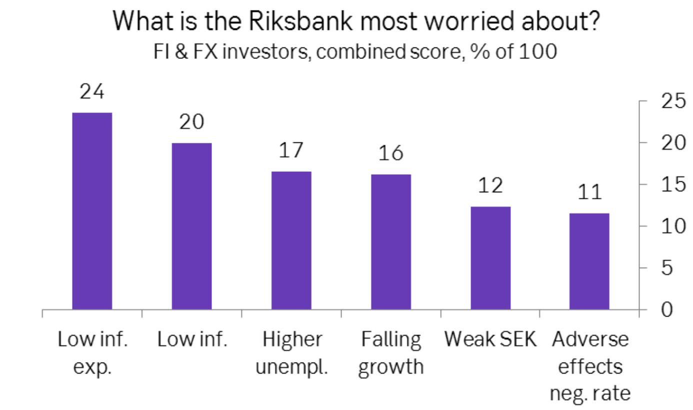
In our view, these expectations are more hawkish than what the market is currently pricing in and probably highlights a fairly low conviction among those investors expecting a rate hike. This is also indicated by the survey where the investors on average assign 43% probability of a rate hike within the next 12 months (FI investors: 48%, FX investors: 39%). Also somewhat contradictory to the expectations of a rate hike, only 25% assign the probability of a hike to be higher than 50%.

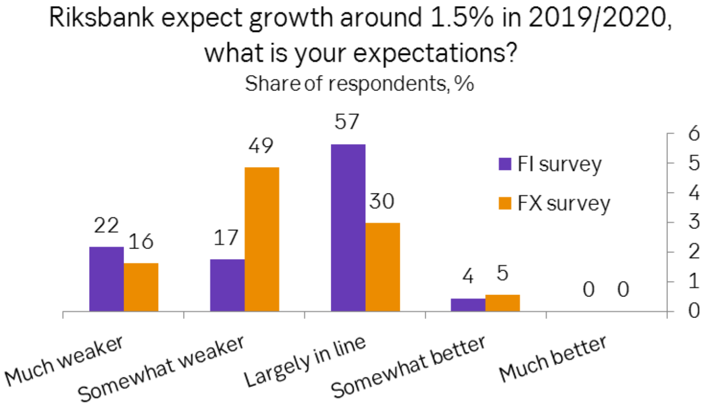
Despite being largely in line with the main scenario according to the FI survey, respondents expect large market movements if the Riksbank leaves the path unchanged in October and signal a hike most likely in December. In such a scenario the 2-year rate is expected to increase by 7bps and EUR/SEK to decline by 9 figures. These are also marginally larger expected movements than if the Riksbank would turn dovish and signal no probability of a rate hike in the coming year. In such a scenario the 2-year rate is expected to decline by 4bps and EUR/SEK to increase by 7 figures.

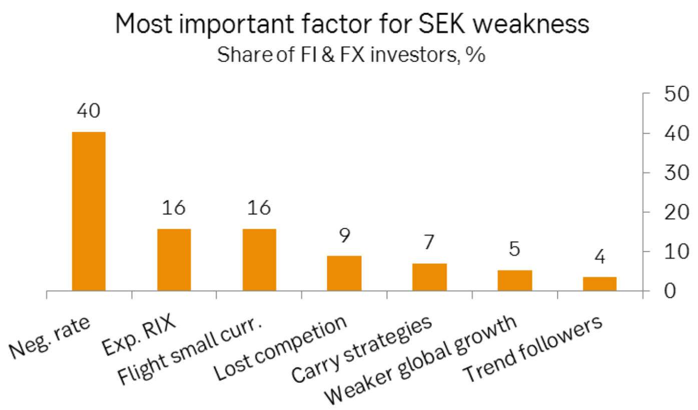
Especially the FI survey suggests more hawkish expectations than our own main scenario, which assumes that the Riksbank moves the most probable time for a hike from December to April, and we agree that movements can be large if the Riksbank leaves the path unchanged.

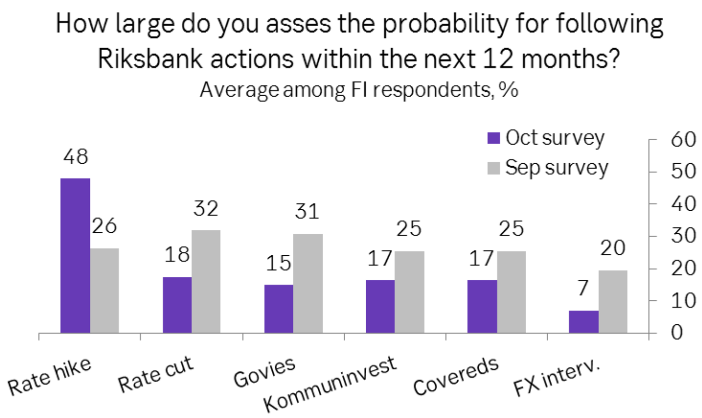
Expected market reactions to changes in the rate path

Unchanged path signal hike most likely in December	Lowered path signalling no probability for a hike in coming year
EUR/SEK: -9 figs	**EUR/SEK: +7 figs**
2y yield: +7bps	**2y yield: -4bps**









Falling inflation expectations largest worry for RIX

On the question over which factors that currently worry the Riksbank the most, falling inflation expectations receive the highest score followed by actual low inflation, weaker labour market and growth. This is not surprising but it is interesting to note that a weak SEK and adverse effects from a negative rate – the factors that could motivate a rate hike – are assessed to be less of a concern for the Riksbank. Also, when asked about their own expectations regarding inflation and growth, these do not seem to motivate a rate hike either. Especially the FX universe is quite pessimistic, with 2-year CPIF expectations at 1.5%, while 65% of respondents expect growth to be somewhat or much lower than the Riksbank forecast. Among FI investors, expectations are somewhat more upbeat with a majority (57%) foreseeing growth largely in line with the Riksbank forecast while 2-year CPIF expectations are still below the target at 1.66%.

An ongoing discussion in both Sweden and internationally is whether fiscal policy should take on a greater responsibility to offload monetary policy and stimulate the economy, but according to our surveys a majority (70%) do not expect more fiscal policy support within the next six months.

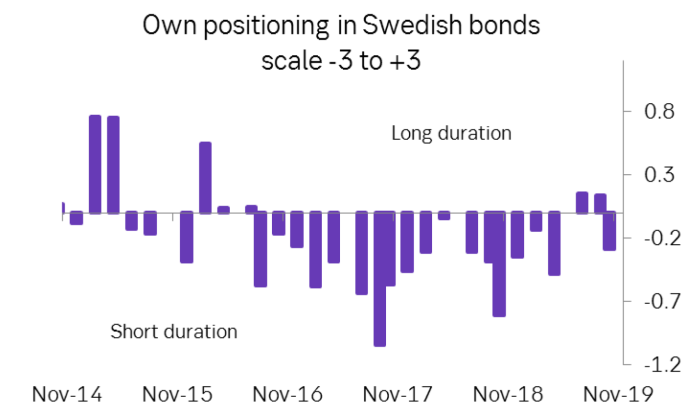
Majority of investors blame RIX for SEK weakness

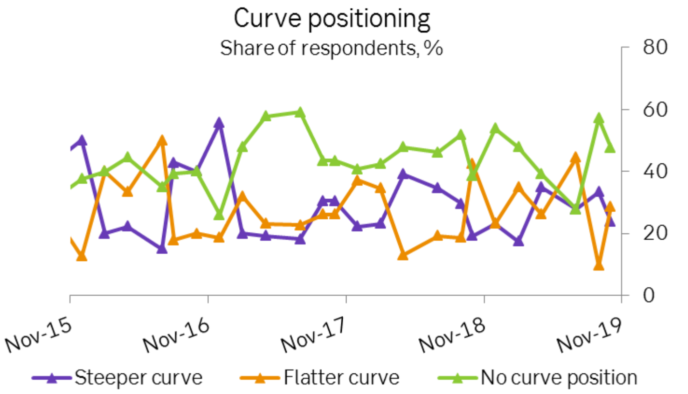
The SEK has trended higher since 2013 and last week EUR/SEK reached the weakest level since the Global Financial Crisis. For many years the Riksbank has been signalling that it does not want to see a stronger SEK, however that rhetoric has recently shifted. In recent year the board members have tried to play down the importance of the SEK to get inflation to target and have argued that SEK weakness is explained by international factors rather than the Riksbank's policy. However, investors do not agree. According to our survey, 40% sees the negative repo rate as the most important factor as to why the SEK is trading at currently weak level. Adding the 16% that instead say that expectations about the Riksbank's policy is the most important factor, a majority (56%) blame the Riksbank for the current SEK weakness. The Riksbank's explanation that a general flight from small/illiquid currencies is the most important factor is supported by only 16%. Also a few investors (9%) think that lower Swedish competitiveness is the reason for selling SEK.

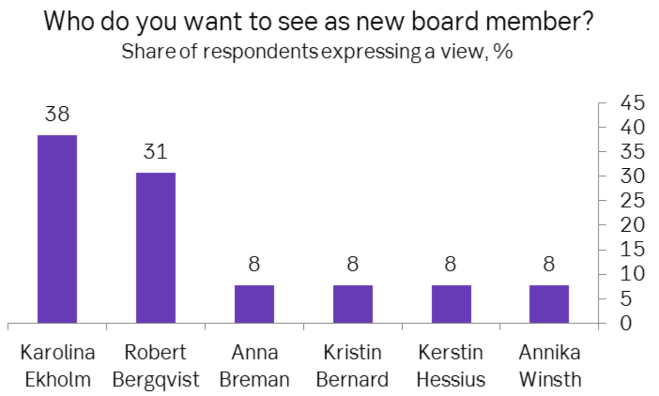
At the same time, a majority of the FX investors (56%) do not think the Riksbank has a pain threshold where it will start to signal that it wants to see a stronger SEK and among those that think there is a threshold, the average level for EUR/SEK is 11.50. This is a shift compared with our survey in April, where 56% said that a level of EUR/SEK around 10.85-10.90 could trigger some action from the Riksbank. However, the FI investors have shifted in the opposite direction since April. Now 59% say they think there is a threshold at an average level around EUR/SEK 11.20. In April 71% said there was no weakest level for the Swedish krona.

FI positioning supports expectations of higher rates

In general, we think the surveys indicate hawkish expectations for the October rate decision and the Fixed Income investors we surveyed in particular have made a large hawkish shift compared with September. The Fixed Income investors now assign less than 20% probability that policy will become more dovish over the next 12 months (not including forward guidance) while the probability of a rate hike has increased from 26% to 48%. Expectations for higher rates are also reflected in positioning where the FI investors claim to be short duration for the first time since April. However, the







investors seem more split regarding the curve, where most (48%) claim to have no curve position, while 29% are positioned for a flatter curve and 24% expect a steeper curve.

Karolina Ekholm favorite to replace af Jochnick

In October first deputy Kerstin af Jochnick left the Riksbank board for work at the ECB. Despite last week's proposed reduce the number of board members from 6 to 5, the General Council has said it plans to fill the empty seat as it will take time to implement any changes to the legal framework. The council is conducting interviews right now and plans to make a decision at its next meeting on 8 November. As there is currently only one woman on the Riksbank board, the council is looking particularly at female candidates.

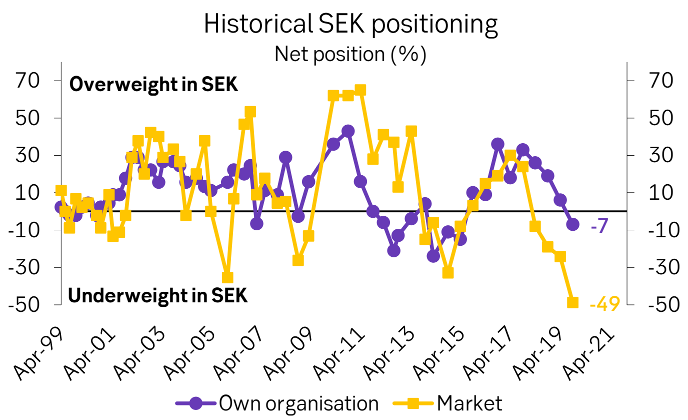
To guess the new board member has proved to be very hard. In our view, the previous board member Karolina Ekholm, which was expected by many to replace Ingves as governor in 2017 but was blocked by the centre -right- parties, remains a top candidate. However, Mrs Ekholm left a position as state secretary to finance minister Magdalena Andersson (S) returning to being a professor at the University of Stockholm only a year ago. The question is if she is ready to take a new position this soon. The council has previously argued that the profile of the new board member should be a complement the existing board. Given af Jochnick's strong focus on financial stability we think this is something the council could take into account and in such a case we think interesting names are Johanna Lybeck Lilja (previous state secretary to the Financial Markets Minister, with experience from the Riksbank and Ministry of Finance and currently at Nordea) or Ingrid Bonde (former General Director at FSA, CEO at Alecta and CFO at Vattenfall, currently member of several corporate boards).

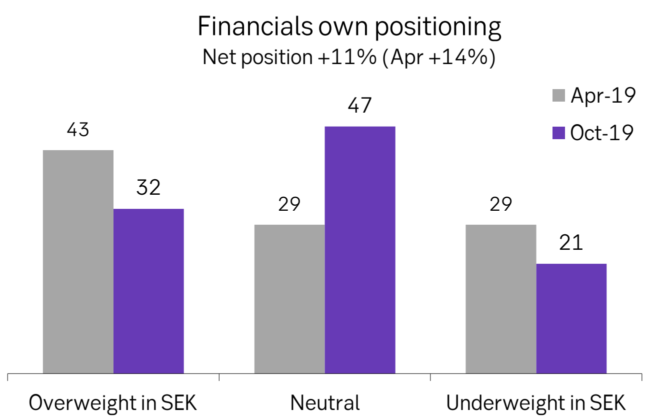
According to our Fixed Income investor survey, Karolina Ekholm is also the preferred candidate for the market. Among those expressing an opinion, 38% would like to see Ekholm as the new governor, closely followed by our own chief economist Robert Bergqvist (31%). Other names mentioned are Anna Breman (Swedbank), Kestin Hessius (AP3), Kristin Bernard and Annika Winsth (Nordea).

FX Survey

Market is record-short SEK

Our survey of leading FX trading counterparties shows that FX managers perceive the market as record-short SEK. For the first time since 2015 participants are underweighted SEK versus their benchmark. Risk appetite and liquidity are the worst drivers for the SEK whilst Fed policy is expected to be the most positive driver. 21% of survey participants say they have increased their FX exposures. Median EUR/SEK and USD/SEK forecast for June 2020 is 10.65/9.50.



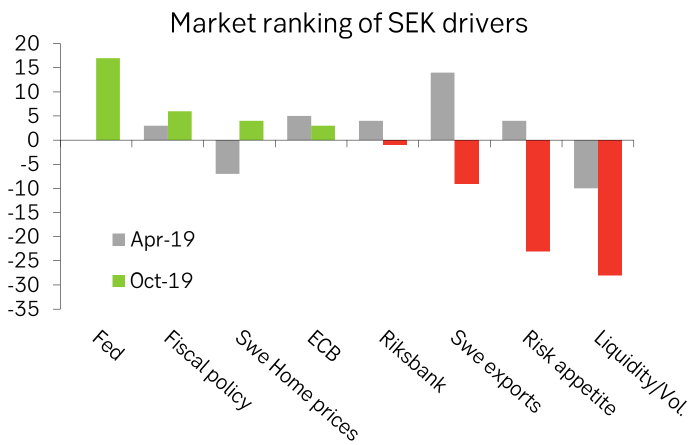


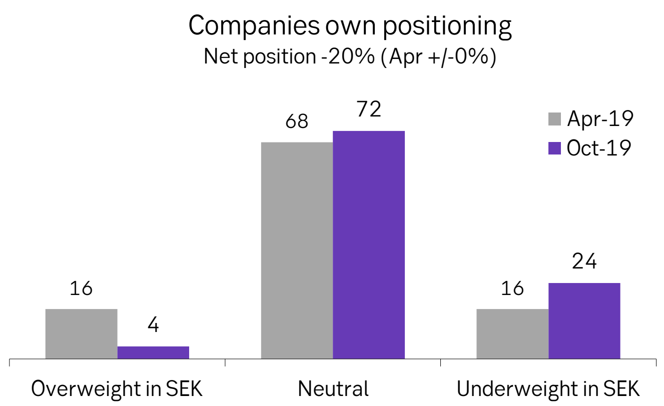
You are short SEK for the first time in four years

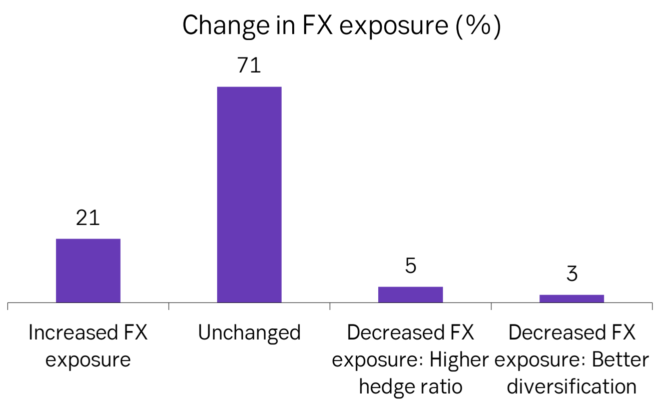
It is quite telling for the prevailing and very bearish market sentiment that survey participants are found to believe the market is holding a record-short SEK position. The ongoing trend for a weaker SEK has clearly taken its toll on market expectations and our own data supports the FX markets being short SEK. It is more interesting perhaps that participants (mostly Swedish) are short SEK for the first time in nine consecutive surveys: given the prevailing market sentiment and positioning we conclude there should be a tendency for SEK to benefit disproportionally from positive news. Hence positioning is one of few positive SEK drivers.

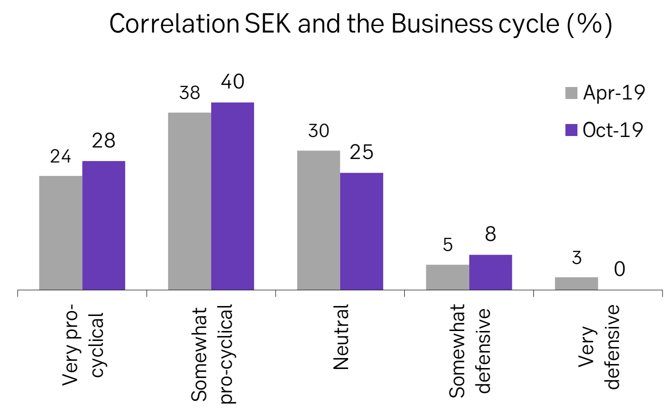
Market ranking of SEK drivers

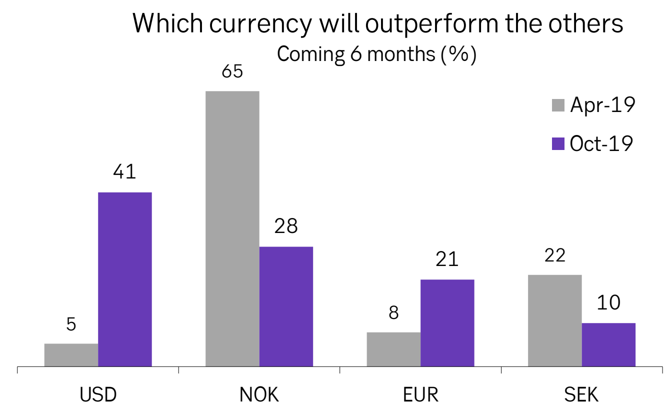
In every SEK Views survey we ask the participants to rank different krona drivers and whether they will be SEK positive or negative. As usually the SEK is expected to be affected negatively by low liquidity if market volatility rise again. Risk appetite is also expected to be pushing SEK in a weaker direction in the coming months – we have not asked how risk appetite is expected to develop but as participants remain with the predominant and historical preoccupation with the SEK as a pro-cyclical currency, we assume participants are cautious as regards risk appetite. Interestingly the survey holds the Fed to be the most positive driver for the SEK – a view we agree with as the idea is that a dovish Fed would be one of few factors contributing to a stronger SEK via a weaker USD. So far, however, the Fed remains reluctant to lower Fed funds more than what the market currently expects and FX hedging costs will remain (too costly to FX hedge USD exposures for FX managers in Sweden). Given that most people expect the Riksbank to remain on hold, Swedish monetary policy is seen as neutral for the currency.











SEK forecasts and fair values

Fair-value	EUR/SEK	USD/SEK
Average	9.90	8.55
Median	**9.93**	**8.50**
High	11.00	10.00
Low	9.00	7.00

	EUR/SEK Dec-19	EUR/SEK Jun-20	USD/SEK Dec-19	USD/SEK Jun-20
Average	10.85	10.74	9.81	9.65
Median	**10.80**	**10.65**	**9.80**	**9.50**
High	11.30	11.50	10.50	12.00
Low	10.55	10.00	9.00	8.50

Average during survey EUR/SEK 10.83, USD/SEK 9.82
Implied EUR/USD fc: 1.10 and 1.12

FX hedging is less important now?

The negative interest rates have been expected to increase FX exposures in Sweden. Indeed the cost remains around 2-2.5%/year to hedge USD assets and this cost has been assumed to be punitive for lowering overall FX exposures. In the survey a net 14% of respondents say FX exposures have increased, which partly validates our view of the effect of negative interest rates. On the duration of FX hedges, the overall periods have been shortened somewhat, again showing the same tendency (lesser incentives to hedge on long durations as it is too costly). A more open FX exposure is likely to lower SEK correlations to global risk appetite and the business cycle as companies in particular does not have the same need to cut FX hedges should orders fall abruptly.

SEK remains a pro-cyclical currency

For the past 7-8 years the SEK has not followed global growth/PMI and risk appetite developments like it used to do. Instead the SEK has had a tendency to weaken also in times of relatively strong risk appetite, something we have witnessed in the past 1-2 years. In the FX survey we again asked participants whether they agree and the answer was fairly clear: the SEK remains a pro-cyclical currency (68% of respondents) with only 8% seeing some more defensive qualities. Our own arguments for the SEK losing its pro-cyclical status are: 1) A positive net investment position with large surplus in equity investments, 2) Open FX exposures in Sweden and 3) Large accumulated FX deposits to be exchanged back once the repo rate reaches positive territory again.

NOK is out, USD comes back in

The NOK is normally the FX darling of the Swedish investor universe but has been expelled this time on behalf of the USD. It is not hard to see why the USD will remain a strong currency as the Fed is reluctant to cut rates and USD growth holds up relatively well in the context of the global economic slowdown. However, the FX forecasts that the survey participants have provided are not seeing additional USD appreciation, on the contrary participants expect a cautious but steady USD depreciation versus the Swedish krona. Looking at EUR/SEK, most participants expect EUR/SEK to have topped out during this coming quarter. Also interesting is the implied forecast for EUR/USD, i.e. based on the forecast for EUR/SEK and USD/SEK, which is more or less flat for Dec 2019 and a tad higher for June 2020. EUR/USD is thus also believed to be at a turning point.

Summary FX survey

The fact that the FX survey is short SEK for the first time in 9 surveys is perhaps not that surprising given the ongoing krona depreciation. But we have never polled a more bearish perception of the overall market positioning versus this time. This makes future price action skewed towards a stronger SEK on positive news. It is also surprising that the market is bearish SEK but not in its forecasts. Survey participants also hold very neutral views on the Riksbank but the central bank remains with a mission to hike rates according to its own repo projection. Hence the overall take-away of this survey is that the market seems less prepared for taking positive SEK news (and indeed a potential rate hike in December). We have adjusted our own SEK forecasts somewhat higher as a result of this FX survey.

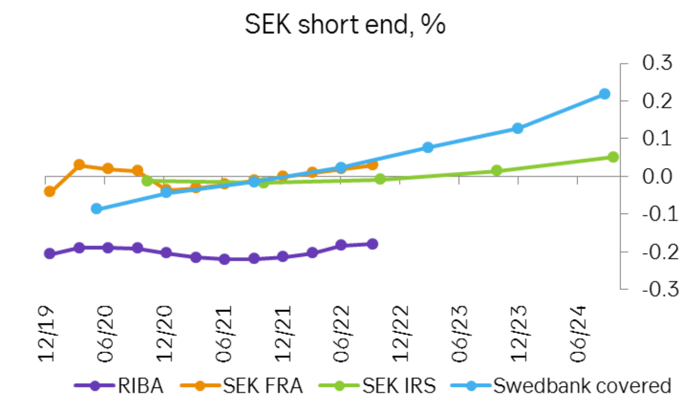
Trades

SEK at the trough but progress will be slow

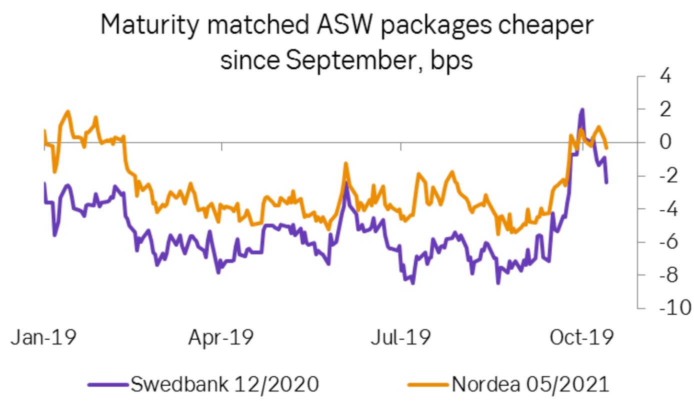
Buy Nordea 05/21 covered vs. Mar20 SEK FRA

Sell NOK/SEK as seasonality where SEK positioning is supportive

Sell EUR/SEK calls at 11.00



Sources: Bloomberg, SEB



Sources: Bloomberg, SEB

Riksbank sticking to its hawkish bias will support Dec19 and Mar20 FRA...

After a fairly strong Q3, the downside risks in growth are clearly increasing and continued declines, especially in longer inflation expectations, give support to the view that the Riksbank should drop its hiking bias and instead communicate to the public that the bank is ready to increase monetary accommodation if needed. Quite the contrary, the Riksbank seems to be sticking to its hiking bias and we suspect the biggest reason for this is the weak Swedish krona. If getting out of negative rates was important for the Riksbank per se, there have been much better opportunities to do so during the past years. Hence we think that the Riksbank acknowledges that turning dovish again along with global central banks risks further weakening the krona and therefore the bank would rather keep signalling a rate hike in the near future to avoid this. CPIF excluding energy at 1.6% in September gives some support for the Riksbank´s plan and the fact that CPIF is expected to increase towards the end of the year provides further backing. The rate path however is likely to be revised slightly lower at the October meeting to imply a hike in February/April. The bank is likely to downplay the revision in its communication and underline the hawkish bias.

...but continued economic slowdown likely to press longer FRAs lower.

The risk of a Riksbank rate hike during the coming six months is, however, non-negligible in our view and the market is unlikely to start pricing near-term rate cuts without inflation clearly surprising on the downside. The market may be sensitive to positive news and in case the upcoming data does not justify an immediate need for the Riksbank to change its plans, the market may well increase the probability of a hike in December or Februrary somewhat from the current 6bps. However, this does not mean that the market would start to price in a hiking cycle in Sweden - any positive surprise in the macro data is likely to lead to higher rates in the very short end and the longer rates are likely to lag this move, bear flattening the FRA curve. If the Riksbank were actually to hike the policy rates, the market would be unlikely to extrapolate this move but rather expect policy easing later, in line with what has happened in Norway this year. As the European macro picture is likely to deteriorate further, we think the market is more likely to move to price in rate cuts for late 2020 and 2021 again. Hence we expect the FRA curve will flatten further. SEK FRA Mar20 vs. Mar21 trades at -6bps and we see some 6-8bps further flattening potential in the coming months.

Buy Nordea 05/21 covered vs. Mar20 SEK FRA

It is worh noting that SEK covered bond curves are relatively steep at the moment, offering attractive carry and roll down in three months (see complete carry + roll-down tables here). Therefore instead of the March FRA calendar spread, buying short covered bonds vs. Mar20 FRA provides a more attractive opportunity to benefit from a curve flattening in the short end. For example Swedbank 12/2020 offers almost 4bps carry and 1.5bps roll in three months (assuming -0.2% repo). A bit longer covered bond such as Nordea 05/2021 offers 4.7bps carry and roll in three months. Both bonds have cheapened some 6-8bps versus swaps during the past month.

NOK/SEK monthly changes (%)

	Nov	Dec	Nov and Dec
2009	-0.8	0.6	-0.2
2010	-0.5	1.9	1.4
2011	-0.1	-1.6	-1.7
2012	0.9	-0.3	0.6
2013	-2.1	-0.8	-2.9
2014	-3.3	-1.2	-4.4
2015	-0.1	-5.0	-5.1
2016	-1.0	-2.7	-3.7
2017	-1.8	-1.0	-2.8
2018	-2.8	-3.4	-6.2
Average change	-1.2	-1.3	-2.5

2s5s unlikely to invert, 5s10s has room to flatten further

SEK IRS 2s5s curve has stabilised a touch above zero. We believe that the market needs to price in at least 25bps worth of rate cuts before the 2s5s curve can invert. It would require serious deflation risks to arise before the market could price in more than a 25bps rate cut amd therefore the inversion in unlikely in our view for now. The 5s10s however has room to flatten further, which could push the 2s5s10s convexity higher. We however do not see risk-reward as attractive enough to pay the belly or receive 5s10s right now.

Sell NOK/SEK as seasonality and SEK positioning is supportive.

NOK/SEK has a clear tendency to head lower in November and December. It has done so six years in a row on an aggregated level for November and December with an average of 4.2%. Also the eight of the past ten years this patterna has been seen but with a lower average of 2.5%. However, the pattern is going back as far as to 2000. It is especially strong in December and NOK/SEK has only increased in four of the last nineteen years. Besides the seasonal support the survey combined with recent data development (inflation surprising on the upside) have convinced us that SEK is bottoming out and is ready for a comeback.

Sell EUR/SEK calls at 11.00

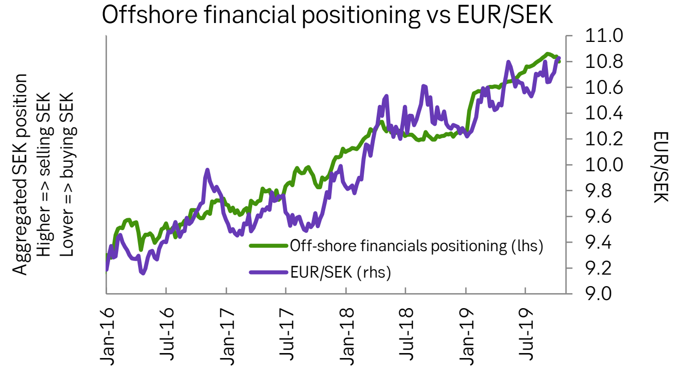
The survey together with our flows showing a tentative downscaling of long EUR/SEK positions and recent data development (inflation surprising on the upside) has convinced us that EUR/SEK is about to top out a bit earlier than we previuolsy expected. However, we also believe that preconditions for a larger turnaround towards lower levels are not yet in place (e.g. more cuts from the Fed and preferably a hike by the Riksbank). Therefore, we are not yet inclined to recommend a short EUR/SEK position but rather prefer to sell EUR/SEK calls at 11.00 at the current time.

SEK Flows

Flows are SEK supportive?

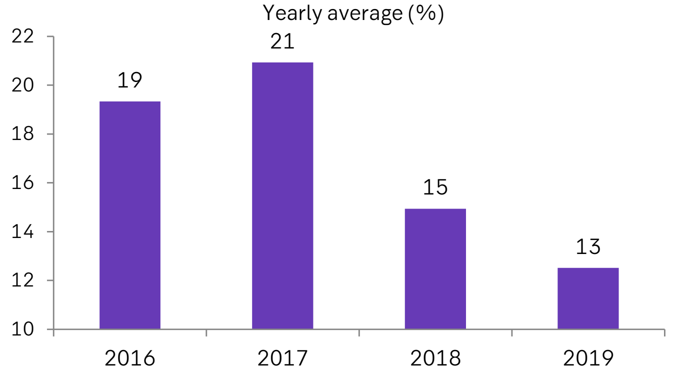
We have looked at the outlook for SEK from a strict flow perspective taking into account our internal flows, decision models for different client categories as well as the Balance of Payments/ Portfolio flow data. The findings conclude SEK is driven by carry/trend-following strategies with the international market underweighted SEK. Swedish net equity flows show defensive characteristics: positive (SEK inflows) in times of risk-off av vice versa.

Offshore financial positioning vs EUR/SEK



Weekly net SEK flow to volume

Yearly average (%)

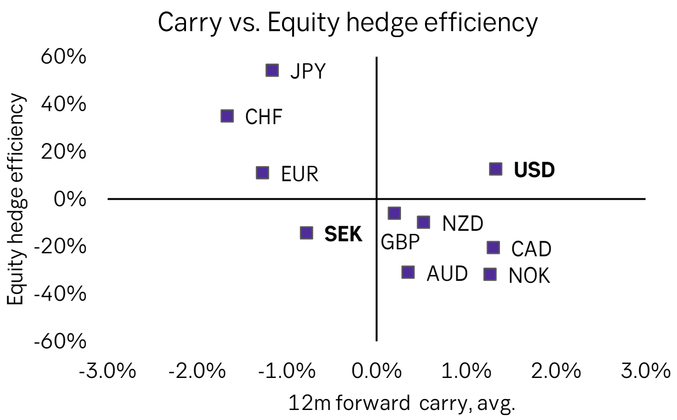


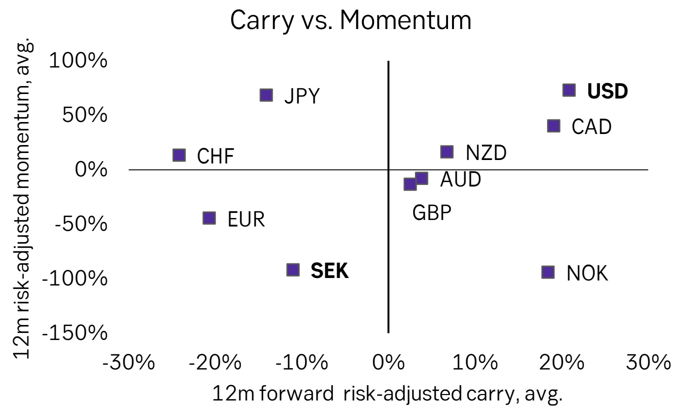
Domestic SEK flows: Less SEK buying than usual
Comparing the perceived positioning expressed in the survey (stated preference) with our own indications based on client flows (revealed preference) tend to be telling exercises. Starting with domestic corporates, our client flows seem to partly support the survey of them having switched into a slightly short position compared to their strategic targets. This as their flows since the most recent survey shows net SEK buying SEK to a smaller extent than usual. The net flow index (net flow divided by total volume) for the period is 14% which may be compared with the long-term average of 17%. In 2016 and 2017, i.e. before negative rates took hold of the markets, the average weekly net SEK buying was as high as 20% (see chart to the left). The much lower net flow index for 2018 and 2019 clearly shows that, just as we previously have been thinking; Swedish corporates are converting less of their foreign revenue into SEK due to the implementation of negative rates. Regarding financial institutions, the net flow index since April (-0.1%) indicates neutral activity, but if taking the whole year into consideration, financials seem to have sold SEK to a larger extent (-4.5% in the net flow index) than what is indicated by their perceived position according to the survey (+11%).

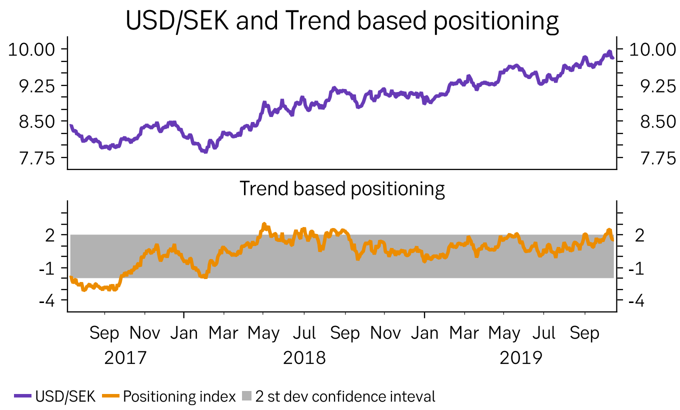
International SEK flows: Tentative downscaling of short SEK
One of the findings that really stand out in the survey is the record short (-49%) perceived market positioning in SEK. We have interpreted the market position mainly to reflect international actors and one way to measure their activity is through our international clients. Historically our broad offshore financial positioning index has been a good indicator for where EUR/SEK should be trading as corrections in EUR/SEK towards our index have been frequent following any divergences. There was one such divergence when we released the prior SEK Views survey which corrected within a few weeks. The rise in EUR/SEK the past months has been a correction towards the index which was completed last week when our index and EUR/SEK became aligned at 10.80. Without a divergence our index provides less of a directional indication. However, the index shows that international financial institutions have tentatively scaled down on long EUR/SEK in the past weeks. If this continues, it will soon exert downward pressure on EUR/SEK, but we are not there just yet.

Trend followers, carry traders, and equity hedgers
Both trend followers and carry traders received some of the blame in the survey for the weak SEK (11%). Therefore we have analyzed their behavior, and by that probable positioning in more detail assuming that when they begin to scale down (or even turnaround) their positions, it will have a large impact on the SEK. We have also taken a look at how an equity investor could have used G10 currencies to hedge their holdings (not an FX hedge but rather as protection from the global downturn in growth evident in, for example, sharply falling US ISM manufacturing since Dec 2018) which in part have added to the headwinds for the SEK.

In *Currency Strategy* (September 2019) we noted that changes in G10 currencies had been very much in line with what one should expect in times when global growth is slowing. So far in 2019 all G10 currencies but the CAD have behaved in line with how they on average have behaved on nine previous occasions (starting 1988) when the US ISM manufacturing index has fallen in a similar style as it has done since December 2018. Generally all G10 currencies weaken versus the USD during these times (on average by 7%) and the SEK tends to be one of the currencies that is most affected.







Source: Bloomberg, SEB

SEK bn	2015q3	2015q4	2015	2016	2017	2018	2019q1	2019q2
Net Portfolio flows	77,5	-117,1	-105,9	50,3	-61,4	-90,2	-13,3	42,6
Stocks and shares	-14,2	-67,5	-95,2	104,6	124,9	-42,7	15,0	35,4
Swedish shares	-10,1	-7,4	16,1	-25,7	25,0	-0,5	-5,5	17,7
Foreign shares	**-24,3**	**-74,9**	-79,1	**78,8**	**149,8**	-43,3	9,5	53,1
Debt securities	91,7	-49,6	-10,8	-54,4	-186,3	-47,3	-28,3	7,2
Swedish debt sec	**-113,7**	**55,6**	7,1	3,8	195,3	39,7	27,1	12,5
Foreign debt sec	-22	6,0	-3,8	-50,7	9,0	-7,8	-1,3	19,7

One explanation for this development may be that equity investors have been worried about the fall in global growth sentiment but reluctant to scale down on their equity portfolios as they have tended only to experience shorter periods of drawdowns. They could however have turned to the currency market to find liquid proxy hedges to their portfolios. If so which currencies should they have bought and which should they have sold? To determine this we have analyzed the G10 currencies hedge efficiency versus global stocks (inverse correlation with MSCI world). The traditional defensive currencies show up as currencies to buy (JPY, CHF, USD and EUR) while the usual pro-cyclical currencies should have been sold (NOK, AUD, SEK, NZD and GBP). The performance this year clearly reflects that notion with the defensive currencies strengthening and the offensive weakening (with the CAD fairing a bit better than usual as the only exception and GBP probably somewhat driven by Brexit developments). However, the very dramatic SEK weakness is not really explained by this analysis as the SEK is only ranked as the 4th best currency to short. But if one adds the dimension of carry, it is easier to explain why the SEK has been very weak in 2019 (top chart): the SEK is the only currency ending up in the bottom left corner of the chart, which indicates that it is the only currency an equity hedger may short as a hedge but at the same time make money on from the carry which means that one is paid to take on the hedge. In the other spectrum is the USD which is the only currency one is paid to go long and acquire an equity hedge. Thus being long USD/SEK is the best equity hedge in the G10 currency space. This should be one part of the carry trades which the survey revealed some belief to be a large part of the weak SEK.

Another part believed to have contributed relates to trend followers. This entails the same sort of analysis but where the hedge efficiency is replaced by momentum. It also shows USD/SEK at the extreme points of the analysis. It seems to be the best momentum trade among the G10 space both based on the strength of the current momentum but also as it is a trend trade that one also collects carry from – which means that one is paid to take on the trade. An interesting notion is that the other currency pair that stands out in the analysis is EUR/USD where one finds similar characteristics. This may be one explanation for EUR/USD lately heading higher when there is a risk-off mood i.e. momentum combined with carry trades being taken off.

How and when will these conditions change? These are two crucial questions whose answers may determine the time when the SEK will end its current downward spiral. Just as the survey showed, one factor is probably the Fed. One or two rate cuts will however not be enough to take the USD from the extreme square in the above analysis but should at least mitigate some of the flows. A higher Swedish rate would eventually make the SEK leave the lone lower square and if that happens a lot should change. But currently it seems remote that we will get there soon even if the majority of respondents to the survey expect their next action to be a hike. A more classical squeezed positioning analysis focusing on trend followers (chart to the left) shows that positioning based on a replicated trend strength signal is quite stressed already.

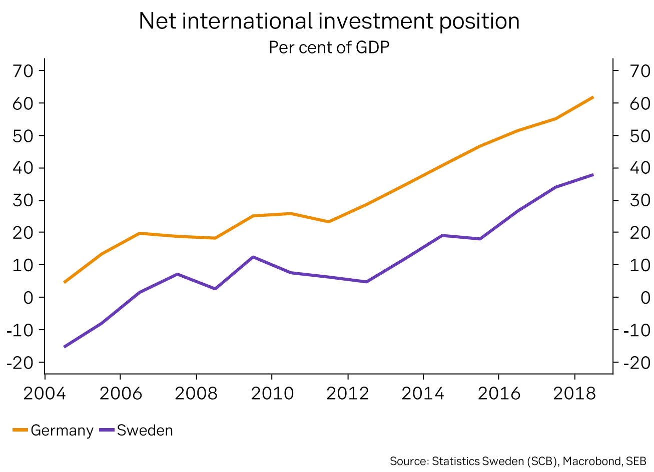
Swedish net equity flows are defensive in nature

As stated elsewhere in this report Sweden has a large positive NIIP within equities. As can be seen in the table (left) the change in foreign shares is significant. What is more intriguing is that selling foreign share coincide with periods of risk-off environment (H2 2015, 2018), whilst accumulation occurs during periods of risk-on (2016, 2017, 2019). SEK thus has defensive qualities.

The falling SEK

Government debt behind large outflows

In this article we take a look at the balance of payments (BOP) to see if the flows and positioning can contribute to the understanding of the driving forces behind the weak Swedish exchange rate. Our analysis shows that a large reduction in outstanding amounts of government debt caused large SEK outflows over the last 3-4 years. The BOP also shows that corporates are increasing deposits in foreign banks and that pension funds are increasing holdings of foreign assets.



Steady upward trend for Net International Investment Position (NIIP)

The long period with current account surplus means that Sweden's Net International Investment Position has gradually improved. Despite a declining current account surplus the upturn has accelerated over the last 3-4 years, which is likely to be explained by the weaker Swedish krona (a weak krona inflates Swedish assets abroad in SEK). As share of GDP, NIIP has increased to 40% which is a bit below Germany and far below Norway and Switzerland but net assets are increasing gradually. Swedish assets abroad are substantially higher than liabilities, which is a major shift compared with the early 1990s when the net investment position was approximately -40% of GDP.

A breakdown by sector shows that the higher NIIP is explained by increasing foreign assets among pension and investments funds but also a large reduction in the central government's foreign debt. Looking at which assets that explains the shift in the increase in net assets – a turnaround in the downward trend for the deficit for net portfolio investments explains the upturn. A further breakdown shows that the deficit in debt and loan instruments has stabilised, while the surplus in equity and funds has accelerated. We have made a detailed study of flows and balances and although BOP statistics are sometime contradictory and incomplete we below highlight our most interesting

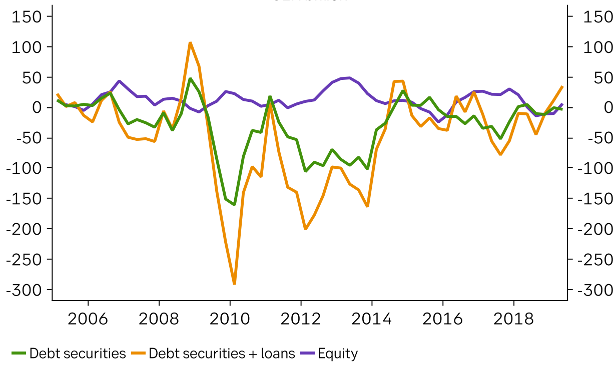
Below we highlight the most interesting findings which we believe have contributed to the weakening trend for the krona that started in the spring of 2014. A problem with the balance of payments is that it shows different agents' asset holdings, but not potential FX hedges using derivatives. Our assessment is that the statistics still are relevant to understanding exchange rate movements. Also, the balance of payments and other financial statistics used in our analysis are presented with long lags, which means that the data can help understand historical exchange rate movements but cannot be used in forward-looking indicators.

Foreign investments in debt securities have declined

The net financial inflow of debt securities has declined to on average SEK -5bn from 2014 -2019 from SEK -80bn on average between 2010-2013. The most important driver behind this shift is a major decline in foreign holdings of government debt. Over the last four years these holdings have declined by more than SEK 300bn, which is a major shift compared with 2011-2013 when these holdings increased by 300bn. The combination of a negative net supply due to central government surpluses and the Riksbank's (Swedish Central Bank) purchases have reduced SEK-denominated central government debt not held by the Riksbank to only 6-7% of GDP.

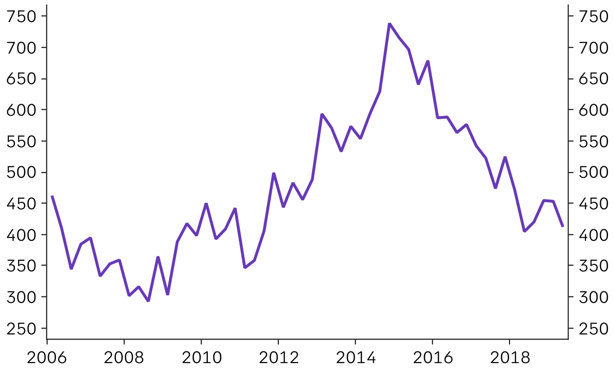
On top of the reduction in government debt, the National Debt Office has reduced its holdings of foreign currency swaps that it has held by 100bn since 2015. The combined outflow caused by the reduction of foreign government debt and the NDO's reduced holdings of FX swaps has caused a potential outflow of 25bn per year. This is a major shift compared to the preceding 3-year period when Swedish government debt was seen as a safe haven during the Euro crisis and foreign holdings of central government debt increased creating an inflow of SEK 100bn per year. The reduction of foreign holdings of government debt is caused by lower supply

Financial flows, net
SEK billion



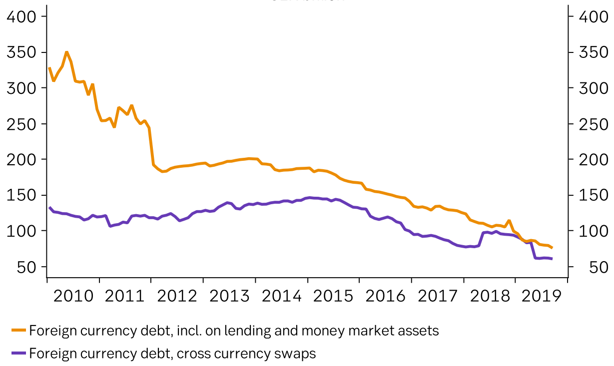
Source: Statistics Sweden (SCB), Macrobond, SEB

Foreign holdings of central government debt
SEK billion



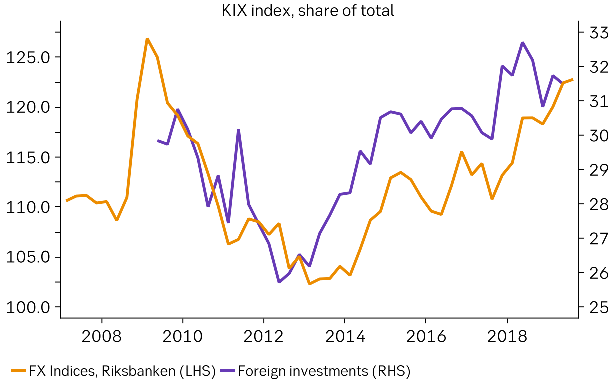
Source: SEB

Central government debt, FX swaps
SEK billion



Source: Swedish National Debt Office (Riksgälden), Macrobond, SEB

Insurance companies foreign assets, share of total
KIX index, share of total



Source: Statistics Sweden (SCB), Central Bank of Sweden (Riksbanken), Macrobond, SEB

and Riksbank purchases. Excluding Riksbank's purchases, the share of foreign holdings of Swedish central government debt has actually increased, despite the major decline in absolute terms. Outstanding government debt is still on a downward trend and the Debt Office has proposed that the reduction in FX swaps should be halted. Also, since the beginning of 2018 non-Swedes have increased their holdings of covered bonds, which means that foreign holdings of all Swedish debt is increasing slightly again.

Pension funds have continued to buy foreign assets

The high Swedish household level of savings is mainly explained by high savings in mandatory savings schemes (the savings amount to 8% of disposable income or 4% of GDP). If insurance companies are also included, the assets in these funds amount to SEK 5,000bn and the annual net inflow into the funds is around 200bn. Swedish pension funds have continued to purchase foreign assets despite that the weaker krona having an inflationary impact on valuations. This has caused the share of foreign assets held by these funds to increase by 4% points, corresponding to SEK 200bn and the annual outflow is estimated to be on average SEK 50bn per year. This flow is largely unchanged compared with 2010-2013, but a possible reduction in foreign holdings to keep the share stable has not occurred. Most likely this is explained by low supply and yields of Swedish fixed income securities while the Swedish stock market has outperformed most international markets.

Rising foreign deposits for non-financial corporations

There have been many rumours that Swedish corporates are increasing FX deposits and financial accounts confirm that this is the case. Since the repo rate was cut below zero in the beginning of 2015 non-financial corporations have increased FX deposits to SEK 100-125bn from SEK 25bn in 2014. This corresponds to an outflow of around SEK 25bn per year, and even though the level fluctuates between different quarters, the upward trend seems to be continuing.

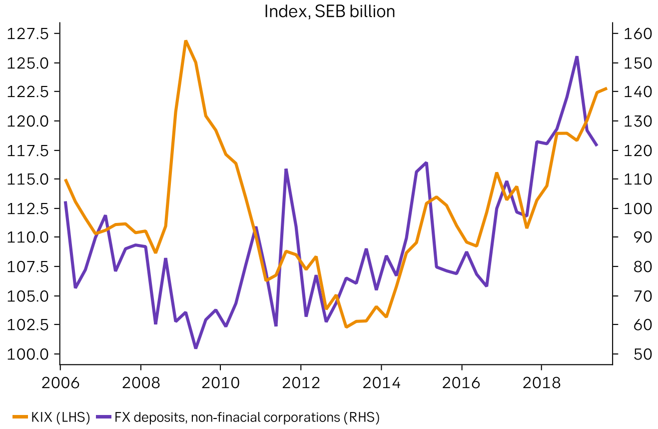
The outflows of SEK from the three sources described above amounts to totally around SEK 700bn, corresponding to almost 15% of GDP. The flows seem to have shifted in 2013-2014, i.e. approximately at the time when the krona started to weaken in early 2014 and a reasonable conclusion is that they are important contributors to the weaker exchange rate. A considerable production lag and high quarterly volatility means that the BOP statistics cannot be used as an indicator for a turning point for these flows, but we think that discussing the outlook for these flows will contribute to understanding when (and if) the krona can be expected to strengthen.

Negative rate and low supply of debt likely drivers

The negative policy rate is most likely an important driver of the outflow from decreased holdings of government interest-bearing securities and increased foreign holdings in FX accounts. We think that the repo rate will stay negative for a considerable period of time, but rate cuts from the ECB and the rate hike from the Riksbank means that European swap rates are now slightly below Swedish swap rates. Swedish government bond yields are, however, still slightly below (approximately 20bps) the average Euro area bonds, even though they are slightly higher than German yields.

Non-financial corporations and the exchange rate

Index, SEB billion



Low rates represent only one reason for the reduced foreign holdings of government debt; the combination of Riksbank purchases and budget surpluses is likely to be at least as important. According to current plans the Riksbank will purchase all of the gross issuance the National Debt Office (NDO) plans to issue. Weaker growth and possibly more expansionary fiscal policy could lead to increased supply, but the main scenario is that this is unlikely to materialise before the end of 2020. In its proposal for government debt the NDO has said that it wants to stop reducing foreign currency debt and if the government gives its approval, which is the most likely scenario, an outflow of SEK 25bn per year would be removed. The most likely scenario is that net foreign flows for government debt will be close to zero, which still would be a large shift compared with the outflow of SEK 100bn per year seen over the last four years.

Government debt outflows likely to stop

Continued negative rates and a large spread versus the US dollar mean that non-financial corporations will continue to increase their FX deposits. A possibly declining spread means that the outflow could slow slightly. Also the outflow created by the high savings in mandatory pension funds is likely to remain high. Swedish equity indices have been as strong as US indices and valuations do not stand out as attractive compared with other countries. Net savings in the pension funds are predicted to increase over the next few years and any decline in the outflows needs to come from a change in investment strategy from the pension fund community. A lack of attractive investment alternative means that large part of the pension savings are likely to be directed abroad.

Conclusion: Balance of payments indicates financial outflows of the currency, driven by high pension savings in foreign assets, declining supply of government debt and accumulation of foreign deposits. The outflow created by government debt over the last few years is likely to stop. Also, declining rate spreads to both the Euro area and the US is likely to slow the outflow to FX accounts. This supports our view that the krona will strengthen in 2020. A lot of the high Swedish household savings in pension funds are, however, likely to continue to be directed abroad, limiting the scope for a large near-term recovery for the krona.

Negative rates

The death spiral?

Declining global long yields have intensified the discussion on negative yields and their potential adverse effects on the financial system. Our view is that the recent decline can be explained by both cyclical and structural factors. Falling yields increase liabilities for pension and life funds, as well as to corporates and regulations can cause a negative spiral. Combined with a quite gloomy outlook and central banks saying they can lower rates further, we expects yields to remain under pressure.

Source: Bloomberg, Macrobond, SEB

Global decline in yields explained by both cyclical and structural factors

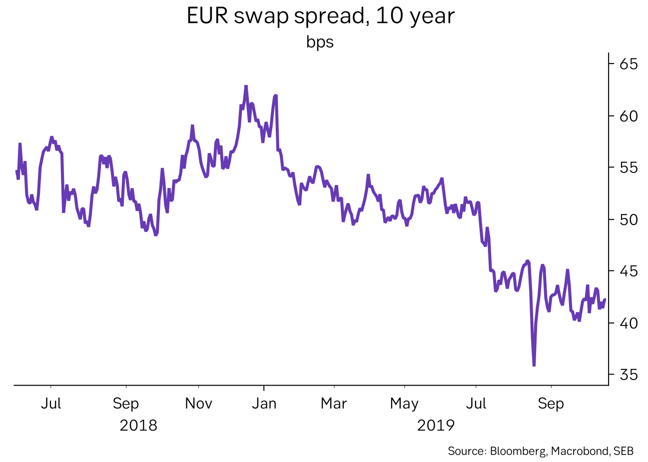
Interest rates have been trending lower for a very long time and after have declining since last autumn the drop in rates intensified during July and August this year. While there are many cyclical factors that can explain the development, such as political uncertainty, slowing growth, falling inflation expectations and monetary policy u-turns, the drastic decline in August has also raised questions about other structural drivers. In particular, the discussion has been whether the sharp drop in especially longer rates was exaggerated by pension funds and insurance companies that were forced by regulations to take positions for lower yields to offset growing pension liabilities with falling discount rates. One sign that could support this assessment is the tightening of government swap spreads during July/August. The ECB's clear indications by late July that it would restart the QE programme should probably have supported wider swap spreads. However, instead the tightening trend that started at the beginning of the year intensified during July and by mid-August a sharp drop was seen in the swap spreads. By that time, rates had declined almost every day for a month with particularly sharp drops in the long end of the curve where these types of funds are the most active.

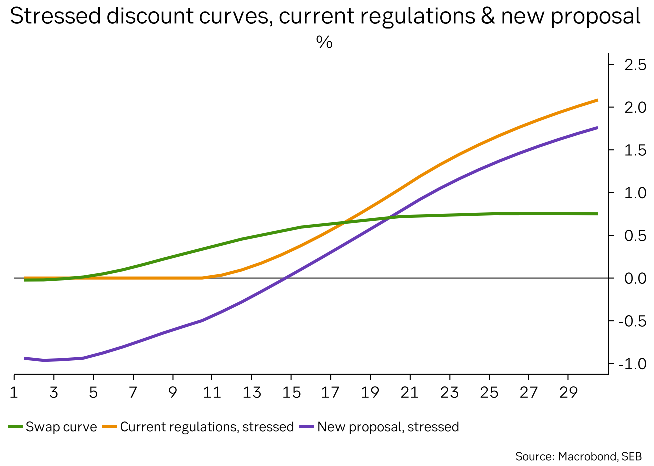
While it's hard to find data on how the funds are acting, an example of the problems in the industry was reported from some of the largest Dutch pension funds during July. The pension fund industry in Netherlands, together with Sweden, is one of the most regulated in Europe. In the wake of new rules and declining interest rates, coverage ratios had declined with decreasing solvency levels. As a consequence, the funds reported that they might have to cut pension rights in the coming years. There were also rumours about problems within some of the largest German funds. Hence, this illustrates both the problems that the pension industry has to generate required returns with low/negative yields and how regulations may force the industry to rotate further into low yielding assets as its liabilities increase with declining yields.

New regulations in Sweden

In Sweden many questions have been raised about whether the decline in rates has been driven by the new Traffic Light/IORP2 regulations that are expected to be communicated on 15 December. The final proposal (hopefully) was presented in July and contained only expected changes compared to the previous proposal. In short the new regulations regarding interest rates risk mean that the interest rate curves the pension funds use to discount their liabilities will be lowered. The previous floor for discount rates at zero will be scrapped, which means that the funds will have to discount their liabilities and be stressed to negative rates. At the same time the long-term interest rate (which applies after 20 years) will be lowered from 4.20% to 3.55% in steps (to 3.75% in 2020). In total this means that the market value of the pension funds' liabilities will increase compared with today and with no floor for negative rates, liabilities and stress levels will increase with declining rates and potentially require more capital.

It is of course unfortunate for the pension funds that the new regulations are expected to come into place at the same time as global interest rates have fallen drastically, but compared with the situation in 2008 and 2011 Swedish funds are in much better position. Sweden stands out in Europe and as the new regulations are expected to lower the solvency levels by only 2-3% in a few years' time the solvency will remain high also under the new regulations.





One reason for this is of course the strong development on the asset side, with equity markets close to all-time highs and a weak SEK, which has supported foreign assets. However, as the floor that has previously kept discount curves at zero disappears, the stressed discount curve the funds need to use when calculating their interest rate risk will be significantly lower and reduce the funds stress test surplus by around 20%. This will make the funds more sensitive to periods with falling yields or/and large downturns in the equity market, which may force funds to reallocate to safer assets. These factors are expected to increase the pension funds' hedging needs.

In summary, we think the drop we saw in Swedish rates during the summer was driven by the international development and more tactical accounts in Sweden rather than pension fund flows. However, with new regulations it will become harder for some of the funds to shorten their duration during periods with declining yields and with this in mind the funds seem to have been more reluctant to sell the long end of the curve despite the drastic decline.

Few factors argue for higher yields

As discussed above, the recent development in rates is probably an effect of both cyclical and structural factors. However, it also highlights some tensions in the financial system that risk having more serious implications in the future, which we think policy makers and regulators will have to address:

- Low/negative yields threaten to be counterproductive as they lower returns on pensions, which may make households more cautious and increase their own savings. This scenario has been highlighted by the Bank of Japan's Governor Kuroda lately and the bank has announced that it will stop buying longer-dated bonds due to the recent flattening of the yield curve.
- Falling yields and new regulations lower the discount curves used to value future liabilities. As liabilities increase and solvency declines, the funds will be forced to allocate more capital into safe assets, which will push rates even lower.
- While the BoJ has said it will not cut the rate below its current level of -0.1% and is concerned about the flat yield curve, for example both ECB and the Riksbank have lower rates and have said they can cut rates further. With apparently no bottom in rates, the question is whether it really is a Japan scenario we should be afraid of.
- Sweden looks strong and today has a high solvency compared with many other countries. However, new regulations will make the funds more sensitive to declining yields and a large drop in equity markets, which will probably make funds more reluctant to sell long-dated bonds in good times and increase hedging needs with declining yields.

With a clear slowdown in global growth and most central banks currently adding more stimulus, we expect global long-term interest rates to remain low with the German 10y yield trading around -0.70% over the coming 12 months. Political uncertainty related to the trade war, Brexit and tensions in the Middle East are risks that have the potential to affect the risk sentiment and increase the demand for safe liquid assets further. The sharp movements in August highlight some tensions in the financial system and new regulations suggest that implications may become more serious if a new decline in yields happens at the same time as a major drop in equity markets. Hence, as long as central banks hold on to their inflation strategies and keep rates low, we see a risk that the financial pressure on the system will continue to build and combined with the economic outlook suggest that rates will remain under pressure.

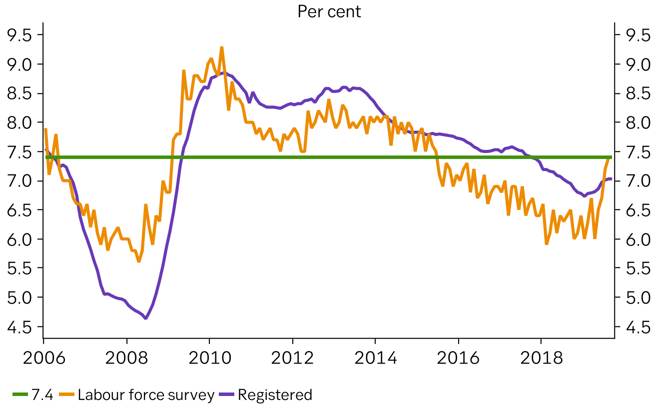
Labour market

Some recovery from summer dip

In August, the unemployment rate rose to its highest level since mid-2015. Employment has dropped by 1.5% since April. The broad picture of real economic performance and indicators doesn't suggest this kind of a marked slowdown in the labour market. But despite the additional uncertainty of summer seasonality, it is becoming more difficult to point to possibly temporary effects as drivers. Although metrics in the Labour Force Survey are always volatile, the risk of a significantly weaker labour market is clear.

Marked rise in unemployment rate

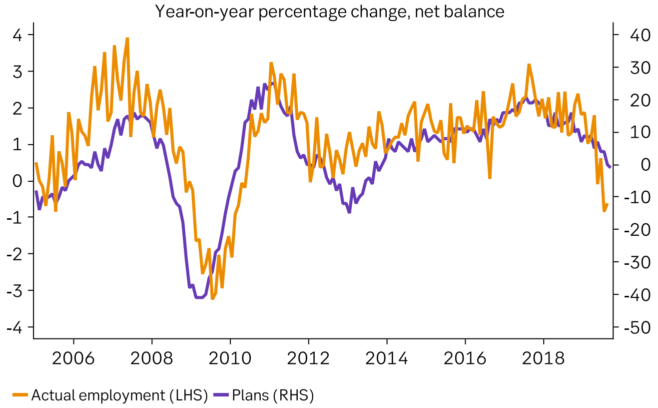
Per cent



Source: Swedish Public Employment Service, Statistics Sweden

Employment plans in the business sector

Year-on-year percentage change, net balance



Source: NIER, Statistics Sweden

Employment continued to drop in August

The August unemployment figures provided another big disappointment with unemployment continuing to rise rapidly while employment declined further from the low level in July. With labour market indicators remaining at odds with the Labour Force Survey, we will be cautious before making a more decisive revision of our assessment of the Swedish economy; however the continued labour market weakness significantly increases uncertainty.

The upturn in unemployment after the spring has been steep and both employment and unemployment resemble the developments seen during the financial crisis in 2008-09. Employment indicators, however, still do not reflect this weakness even though they too clearly signal a slowdown. Most notably the number of lay-offs, which historically has increased significantly during periods with declining employment, has risen only modestly.

Employment markedly lower

As before, employment has been the weakest for the younger age groups and an almost 10% drop in employment for ages 15-24 explains most of the decline in total employment. Employment is starting to decline also for older age groups and it should also be observed that historically the young are most sensitive to the business cycle.

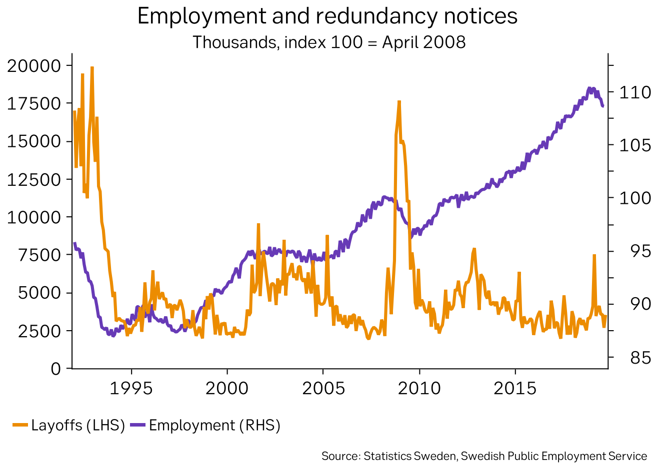
A decline in the number of persons with subsidised employment has contributed to lower employment both for persons above and below 25. The number of subsidised jobs could remain low due to large cut backs in the unemployment office's budget. This effect explains only a small part of the decline in employment, however.

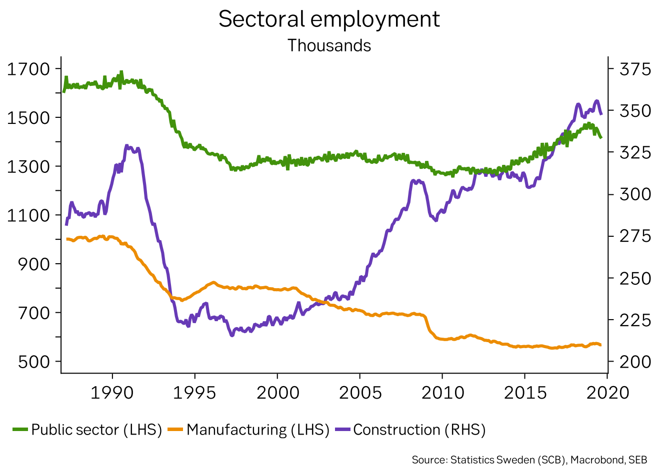
Lower number of public sector employees

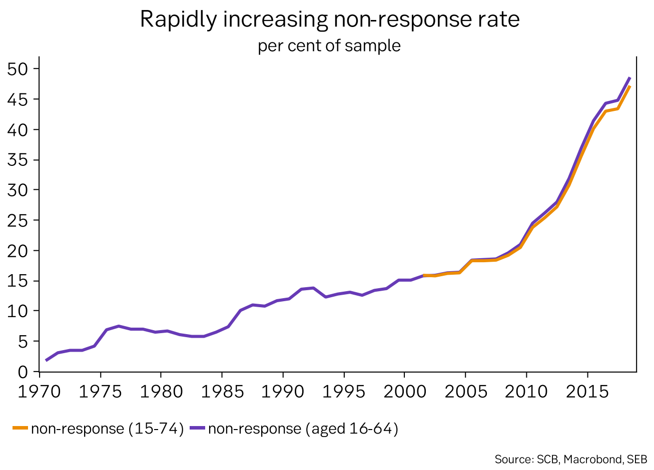
Historically construction and manufacturing have been the main drivers during periods with declining employment and employment excluding these sectors has not declined since the Swedish banking crisis in the early 1990s. That other sectors seem to be contributing to the present downturn could possibly explain why the correlation with e.g. layoffs has broken down. It also raises some questions regarding which sectors explain the downturn. Healthcare has been the weakest sector and the number of employees in the public sector has declined.

This is surprising given the high demand for public services. There are reports that some municipalities are coming under financial stress, but this has so far only concerned small municipalities in rural areas. Also, if the municipalities were reducing the number of employees quickly it should be seen in a rising number of layoffs. Possibly the decline could be explained by not replacing temporary employees and a large drop in the number of temporary employees gives some support to this idea. The decline in the number of public sector employees according to the Labour Force Survey is not reflected in the quarterly establishment survey, which also did not register the same upturn in employment in the second half of 2018.

The sector statistics in the Labour Force Survey is volatile and movements in sub sectors do not always seem to be reflected in the establishment survey, which is more reliable for sector employment. The Labour Force Survey is, however, more reliable for total employment.







Low responsive rates and weak coverage

There are a few statistical remarks that have to be addressed adding to uncertainty although it's not obvious in what way it have affected the current numbers. The overall non-response rate have gradually increased from early 1970s however the accentuated rise over past five year has been remarkable. This actually coincide with an increased survey sample. The total non-response rate has reached fifty per cent with a higher share for younger respondents, lower educated and foreign born people, in particular from outside Europe. Statistics Sweden uses several measures and methods trying to prevent this ratio from falling further. In addition, there is a well known weak coverage of immigrants depending on a large time lag from individual entry to an individual actually ending up in the statistical population. While there is a potential bias in the estimate of the trend in non-response rate the weak coverage is probably equally important for both the nominator and the denominator. Hence numbers in relations to another property (e.g. unemployed in relation to labour force) is probably relatively accurate. All in all, these statistical headwinds will add to uncertainty however we doubt it will explain the change in trend by its own.

Higher unemployment, larger uncertainty

Forecasting tends to become more difficult when the business cycle is shifting and this seems to be the case at the moment. The extremely weak labour market since April is at odds with indicators and this makes us reluctant to fully adjust our forecast to recent developments. Weakness in the public sector could partly explain why the lower employment is not reflected in the employment plans, but there are in our view question marks whether the underlying trend in the public sector is as weak as implied by the Labour Force Survey. Employment has increased significantly in the public sector over the last three to four years indicating some scope for a setback, but demand for public sector services is growing and expansion plans for education and healthcare in the municipalities are high. This suggests that parts of the decline in the public sector is a reversal of a strong upturn of (possibly) temporary employees in the second half of last year (some related to lower volumes in labour market programmes). Still, the public sector does not explain all the labour market weakness and shaky sector statistics in the Labour Force Survey mean that its importance is also uncertain.

Hence, in the near term any conclusion about the current state of the labour market should look beyond the headline LFS unemployment rate, and combine the narrative with indicators and other data sources such as the Public Employment Service. We see the LFS unemployment rate remaining at these elevated (above 7 per cent) levels for quite some time but we remain cautious about what implications this will have according to other labour market metrics.

However, it is clear that the labour market is weakening and even with some recovery in September it will again have been significantly weaker than the Riksbank's estimates. Headwinds for delivering the rate hike indicated in the latest rate path continue to grow.

Brexit and Sweden

How will the economic impact be?

The Brexit date is approaching. Questions about the impact on the Swedish economy of a potential no-deal withdrawal remain highly topical. Modelling estimates point to about a 0.5 per cent drop in Swedish GDP, but such models should be interpreted with caution. Although our trade relations with the world's fifth largest economy will be disrupted, British demand will not disappear. But the economic impact of a hard Brexit would probably be more perceptible to individual sectors, regions and companies.

"In this context, we should mention that tariff levels are not the sole force behind economic effects, but to an even greater extent general uncertainty"

Brexit from a Swedish perspective

As the probable Brexit date has approached, during our latest post-*Nordic Outlook* round of presentations we have received more and more questions about the economic consequences of Brexit, especially from the perspective of Sweden and Swedish companies. Below we provide some basic facts about existing economic model estimates, as well as the United Kingdom's trade relations with other countries and trade relations between Sweden and the UK.

For the sake of order, it should be emphasised that the economic effects described below mainly concern the overall economy. The effects on individual sectors, regions and especially individual companies may of course be very extensive.

Trade models should be interpreted with caution

Since the UK began preparations for its 2016 Brexit referendum, various effect estimates have been presented – based on trade, GDP etc. These are made primarily by major international institutions like the IMF and OECD, but also by such British authorities as the Bank of England and the Treasury. Model estimates are always approximations of something complex, and outcomes naturally vary – depending on what assumptions are made and what is fed into the model. The models are often very similar to each other, but they can still be divided into two different types. Dynamic general equilibrium models generate an alternative scenario in which factors such as certain trade flows, exchange rates and monetary policies are included. But they lack detailed information about trade relations and the effect on global value and supply chains. It is also difficult to model possible future changes in value and supply chains.

But pure trade models, which track global value and supply chains in detail, do not account for dynamic effects – that is, changes in the behaviour of economic actors. Such models are frequently based on input-output analysis (how sectors affect each other and so on), which actually only moves production values between countries and sectors, but with unchanged total demand. When the United States imposed tariffs on steel and aluminium, some model outcomes that correctly pointed to reduced production (in employment terms) of steel in Sweden, but which in response generated higher production in domestic sectors such as construction. Such an analysis thus mainly illustrates the direct effect on a particular sector.

In this context, we should also mention that tariff levels are not the sole driving force behind economic effects, but to an even greater extent general uncertainty – something that also has a major impact in the world of models. Uncertainty in one of the key components in various dynamic models. Uncertainty can be represented by various kinds of uncertainty indices, or can be expressed in yield and interest rate spreads between countries and/or price differences for various asset classes. In other words, uncertainty should be viewed both on the basis of real-economy and financial market risks. Summa summarum, the greater the uncertainty and the worse the trade relationship, the bigger the economic effect will be.

Global trade will adapt over time

It is important not to forget that countries trade with each other de facto, even when they are governed by WTO rules (which would apply in case of a hard Brexit). For example, the EU trades with the US, and in trade relations the proximity principle is usually a very strong explanatory factor. There is no indication that the UK and the EU27 would stop trading with each other in case of a hard Brexit. The economic effect would perhaps mainly be that trade would become less efficient, and that sellers and buyers would possibly seek new customers a bit further ahead.

In the most widely referenced models, the British economy would suffer a GDP decline of between 1 and 9 per cent using various medium- or long-term scenarios. A far-reaching free trade agreement would lead to a comparatively small economic effect, although that particular scenario currently appears unlikely. A more estranged relationship with the EU would have a bigger impact. If the UK should crash out of the EU (which is called a hard Brexit), the short-term impact would be comparatively large.

The UK GDP is in the longer term expected to contract between 1 and 9 per cent depending on the Brexit details ... Sweden is on average expected to lose some 0.5 per cent

If future trade relations between the UK and the EU were based on WTO rules, tariff levels would vary sharply between different categories of goods. Some tariffs would remain low, whereas others – such as vehicle parts (close to 10 per cent) and farm products (close to 35 per cent) – would climb sharply. The previous British government was planning for various temporary tariff reductions in the event of a hard Brexit. Meanwhile farm and vehicle-related products are often especially crucial in the international trade talks that are under way. Tariffs are also only one of the factors that may affect trade. Looking ahead, regulations, institutions aimed at resolving legal disputes, certification of various goods and the bureaucracy required to approve and levy charges on trade are more important than tariffs, which in many cases are rather limited. These are usually referred to as non-tariff trade barriers. Another one of the biggest negative effects is that Sweden has often had the UK as a close ally on various free trade issues. When the EU's second-largest economy (which is also not a member of the euro area) disappears from the EU, its free trade-friendly group will lose an important voice.

Since the British government opened the way for the 2016 Brexit referendum, the pound has depreciated by more than 25 per cent against the euro. If the UK should leave the EU without an agreement, we believe that the pound may decline by another 10 per cent or so from today's levels, since this scenario would generate enormous uncertainty, and there is an overwhelming likelihood of a sharp decline in British GDP. A weaker pound may partly offset the tariffs that British exporters to the EU would face if there were a no-deal withdrawal. Meanwhile the weak British pound would make imports from the EU even more costly, which would probably have an adverse impact on trade.

Swedish BNP would lose less than 1 per cent

Looking ahead, British withdrawal is expected to contribute to a decline in GDP for the EU countries of between 0.2-0.8 per cent. Ireland will probably be hardest hit, with GDP expected to shrink three times more than the EU average. There is also great uncertainty, although this is greatest in the case of British GDP. In Sweden, GDP is expected to decrease by 0.2-0.7 per cent. In order to pull down Swedish GDP by half a per cent, based only on changes in trade with the UK, this trade would need to be more than halved – a scenario that seems rather improbable. Instead, the downturn will be due to muted general demand that affects trade as well as domestic capital spending and consumption decisions. Because an important demand channel in Europe would be initially disrupted, this would spread to other economies. The strength of large models, in contrast to simple projections, is that they provide better opportunities to see the woods instead of every tree.

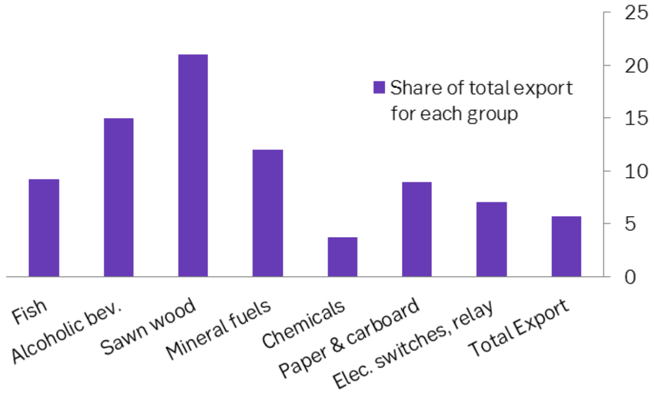
Swedish exports to the UK

Nearly half of Sweden's total merchandise export portfolio consists of a handful of product categories that each account for 6-7 per cent. In no particular order, these are forest products, iron, steel and other metals, pharmaceuticals, other chemical products, cars, automotive parts and trucks, and finally refined oil products. In 2018 the UK was Sweden's sixth largest export market for goods and its second largest for services. More than 5 per cent of Swedish merchandise exports go to the UK and a full 10 per cent of service exports. Of total exports, nearly seven per cent goes to the UK. Swedish exports to the UK consist mainly of vehicles, machinery.

In relation to how important the various categories of goods are to the economy, however, exports of machinery and pharmaceuticals to the UK are relatively small, while exports of commodities and petroleum products are relatively large. The share of exports to the UK consisting of vehicles is in line with the average, which is relatively high, but Germany has nearly twice as high a share of vehicles in its total exports to the UK. Because Sweden exports a relatively lower percentage of more processed goods and a relatively higher percentage of commodities, this suggests that Sweden – at least in relation to Germany – might be somewhat less impacted by a hard Brexit, since commodities would be affected to a lesser extent by tariffs and changed regulations.

Export shares to the United Kingdom

Export shares to the United Kingdom



Sweden's trade with the UK is important yet accounts for only a bit over five per cent of its total exports. For certain sectors, however, the UK is extremely important. This means that Brexit may have significant consequences for individual companies, even though the impact on the overall economy is manageable. The parts of the Swedish economy that have a disproportionate share of exports *vis-à-vis* total exports to the UK are food products (especially alcoholic beverages), wood and paper products and refined oil products. Total trade figures conceal the fact that individual, often small, companies may have a very large exposure to the UK, either via exports or imports.

The UK is also an economy with which Sweden has a positive trade balance, unlike the EU27, with which Sweden has a negative merchandise and service trade balance totalling SEK 250 billion per year. Sweden's current account surplus is mainly due to non-EU countries.

British alternatives determine short-term effect

The economic impact at a sectoral level is determined by how sensitive British demand is to changed prices, the increased burden of rules and/or whether there is an acceptable domestic substitute. In the short term, expanded border controls may lead to physical obstacles and delays that will probably have an adverse impact on all trade between the UK and the EU27. Trade is often governed by relatively complex processes, in which trade relations have been built up over several decades. An example of one sector in which the UK is an important export market for Swedish companies is sawn timber, accounting for about a 20 per cent share of Swedish merchandise exports, but the UK is far from capable of satisfying its domestic demand, which makes it likely that the country will buy forest products from Sweden (and Finland) even after withdrawal from the EU – regardless of a hard or soft Brexit scenario.

The UK sells a sizeable share of its crude oil to Sweden, which then sends it back in refined condition; this is also likely to continue without major changes. As for goods, the challenges to the UK seem enormous – considering that the country has a large trade deficit with the EU (equivalent to more than 4 per cent of GDP). But the UK has the upper hand in service trade. Obviously trade will be adversely affected during a transitional period, but trade usually finds new solutions.

Swedish imports from the UK

As for Swedish imports from the UK, the most important items are crude oil and vehicles/vehicle parts. Because the first-mentioned product is sent back in more refined form, as mentioned above, this trade should be impacted to a lesser extent. As for entire motor vehicles or their parts, a hard Brexit would be a bigger headache, since these products would probably face a high tariff level. In Sweden's case, the economic effects would be determined by the extent to which it is possible to find cheaper alternatives. Here, too, decisions would probably be based on the expected exchange rate trend.

Other product categories in which imports from the UK account for a large proportion of total Swedish imports are chemicals (including pharmaceuticals, perfumes and plastics), rubber, various machinery and motors, but also a large volume of office machines, photographic or optical equipment and various printed matter. Here, too, the economic impact will be determined by how unique these goods are compared to acceptable substitutes, and/or to what extent any additional costs can be passed on to the end-consumer.