BofA SECURITIES

Liquid Insight

Krone over krona

30 May 2023

Rates and Currencies Research
Global

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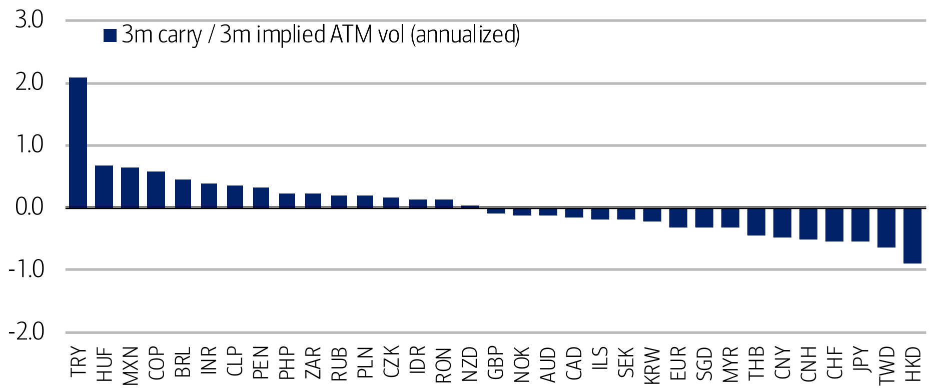
Key takeaways

- We still like NOK for the year, but remain skeptical on SEK at least through Q3. We are more bullish NOKSEK vs. consensus.
- We can justify NOK weakness from Oct until Feb but its recent weakness seems overdone. In H2 we count on...
- ...more help by risk, oil, China & Norges. We remain bearish on SEK, concerned about harder landing risks.

By Michalis Rousakis

Chart of the day: 3-month vol-adjusted carry vs USD (annualized)
The NOK carry that was



Source: BofA Global Research, Bloomberg

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We still like NOK into H2 but stay cautious on SEK

We still like NOK into H2 but stay cautious on SEK, at least through Q3 (Exhibit 1). We maintain a long NOKSEK recommendation (entry April 28 at 0.9638, current 0.9753).

NOK can count on: (1) More stable risk sentiment and a softer USD once the Fed rate cuts for this and early next year are priced out. (2) Higher oil prices and, relatedly, more help from China's reopening. (3) More help by Norges. (4) More favourable NOK flows by Norges Bank and Norway's petroleum companies *combined*. (5) Lighter positioning, especially vs. SEK and USD and for Hedge Funds.

We remain cautious on SEK on: (1) Concerns arouns the highly rate-sensitive Swedish households. (2) Risks around property markets, particularly commercial real estate. The recent 2-year wage agreement and the stable inflation expectations may buy it some time, but the Riksbank is not in an enviable position at all.

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Timestamp: 30 May 2023 12:31AM EDT

Exhibit 1: Latest Scandies FX forecasts

We continue to expect NOKSEK well above parity this year

	Jun-23	Sep-23	YE 2023	Mar-24	Jun-24	Sep-24	YE 2024
EUR/NOK	11.20	10.90	10.60	10.40	10.40	10.20	10.00
USD/NOK	10.67	10.19	9.64	9.45	9.45	8.87	8.70
EUR/SEK	11.40	11.50	11.00	10.70	10.60	10.50	10.30
USD/SEK	10.86	10.75	10.00	9.73	9.64	9.13	8.96
NOK/SEK	1.02	1.06	1.04	1.03	1.02	1.03	1.03
EUR/USD	1.05	1.07	1.10	1.10	1.10	1.15	1.15

Source: BofA Global Research

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NOK: counting on oil & Norges

NOK's recent weakness has surprised us, but we continue expecting NOK to do better in 2H, counting on higher oil prices, more stable risk sentiment, and Norges Bank.

Looking back: in line with history until Feb but recent weakness overdone

NOK's performance (trade-weighted terms) from October until February was in line with its past performance (Exhibit 2).

We would have expected a flat NOK since but, instead, it has weakened by c. 6% despite (1) the (more) modestly lower oil prices (whose demand-supply mix turned more NOK-positive), and (2) markets pricing a more hawkish relative Norges stance (Exhibit 3).

NOK's implied volatilty spread has risen notably this year (Exhibit 4)—to some extent, on spikes of oil vol—but we would still need to over-stretch its typical impact.

More likely (and not unrelatedly), NOK came under pressure by the likely unfavourable at times oil-related flows (and unrealistic expectations thereof) by Norges and petroleum companies combined.

Looking ahead: we remain constructive on NOK

We stay constructive on NOK, especially in 2H, counting on:

1) More stable risk sentiment and a softer USD once the Fed rate cuts for this and early next year have been priced out (our US economists expect no cuts until Mar-24).

(2) Higher oil prices, wth our commodities team expecting Brent at 82$/bbl in 4Q and 90$/bbl in 2024 (Money breaks oil's back 8 May 23). We also expect China's outbound ariline seats to approach 50% of their 2019 levels by 3Q (ASEAN tourism: into the final third 5 May 23) and maintain a bullish China GDP call for this year. And we find NOK to have weakened much more than its beta to China would imply (Global FX weekly: Before the X-Date 26 May 23).

(3) Norway's under-appreciated fundamentals and Norges' willingness to help avoid more and/or persistent NOK weakness. Our economists expect 1.4% mainland Norway growth this year, which compares with 0.6% for the Euro area and -0.9% for Sweden. They forecast Norges to hike once more in June but the current NOK levels (Exhibit 5) and data remaining on the hawkish side suggest risks remain firmly to the upside.

(4) More favourable oil-related NOK flows in H2 by Norges and petroleum companies *combined* given Norway's increased fiscal needs. Norway's 2023 "non-oil deficit" was revised higher by NOK44bn in May's budget revision. This would in isolation suggest Norges' FX purchases fall by c. NOK 300 million/day in the rest of the year but this assumes: (1) Norges had not factored in at all the extra fiscal needs (unlikely) and (2) Norges' forecast of petroleum tax payments and other NOK revenue is unchanged.

(5) Slightly lighter NOK positioning, particularly vs USD and SEK but not vs. EUR, driven almost entirely by Hedge Funds (Exhibit 6, Exhibit 7).

We should also flag NOKSEK performed well at the end of past Fed hiking cycles (2000-01, 2006-07, 2018-19) despite the stable oil prices (Pause and Effect: The USD at the end of hiking cycles 8 May 23).

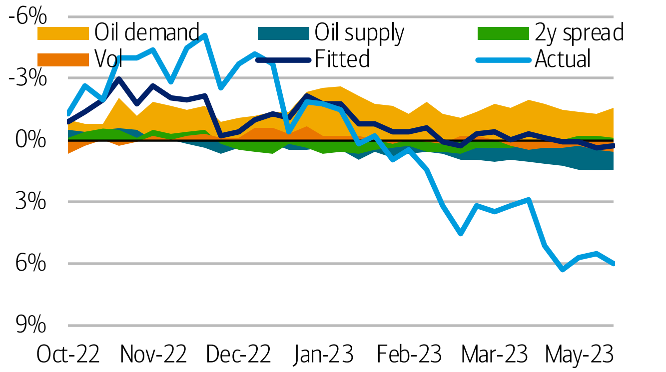
Forecasts: no changes. Risks: risk sentiment, oil & China, Norges

We continue to expect EURNOK at 10.60, USDNOK at 9.64, and NOKSEK at 1.04 by year-end, but we admit risks are NOK takes longer to get to these levels.

Key risks are around: Risk sentiment & USD, esp. until the Fed cuts for this and early next year are priced out. Oil prices. Norges' stance. Recession risks. China's reopening.

Exhibit 2: Fitted vs. actual NOK I-44 (inverted values)

NOK in line with history until late-Feb, but its recent weakness overdone



Source: BofA Global Research, Bloomberg, Federal Reserve Bank of New York, Oil Price Dynamics Report, https://www.newyorkfed.org/research/policy/oil_price_dynamics_report.html. Lower values of the import-weighted krone index (NOK I-44) show a stronger NOK. Weekly data through May 19. Regression estimates are for Jan 2018- Sep 2022. We regress changes in (log) NOK I-44 (Norges's import-weighted krone index) on: demand-driven and supply-driven changes in (log) Brent crude spot prices as per the New Fed Oil Price Dynamics Report data; changes in Norway's 2-year trade-weighted swap spread; and changes in the idiosyncratic NOK implied-vol spread.

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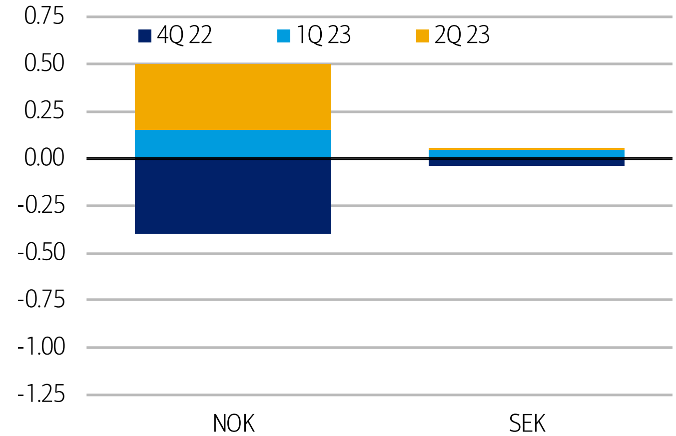
Exhibit 3: Change in 2yr trade-weighted swap spreads (percent)

Norges repriced higher this year more than making up for Q4 drop



Source: BofA Global Research, Bloomberg. Note: The 2-year NOK swap spread is with respect to Norway's 9 largest trading partners as per the, import-weighted, NOK I-44 index. The 2-year SEK Spread is with respect to Sweden's 11 largest trading partners as per the, trade-weighted, krona index ("KIX"). Data weekly through May 19.

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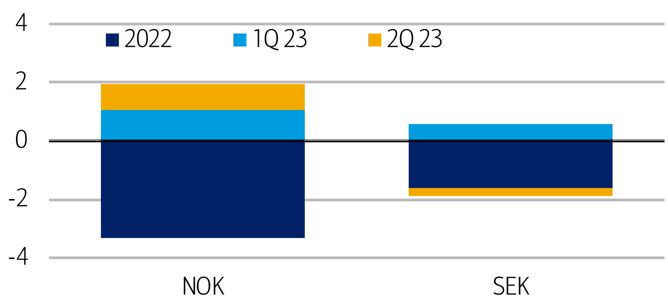
Exhibit 4: Idiosyncratic 3-month implied volatility spreads

Relative vol has likely weighed on NOK this year. SEK vol better behaved



Source: BofA Global Research, Bloomberg. Note: We define the idiosyncratic NOK (SEK) implied volatility spread as that between the equally weighted average of the 3-mth EUR/NOK and USD/NOK (EUR/SEK and USD/SEK) implied volatilities and the equally-weighted average of the 3-mth EUR/USD, USD/JPY, EUR/JPY and EUR/CHF implied volatilities. Data weekly through My 19.

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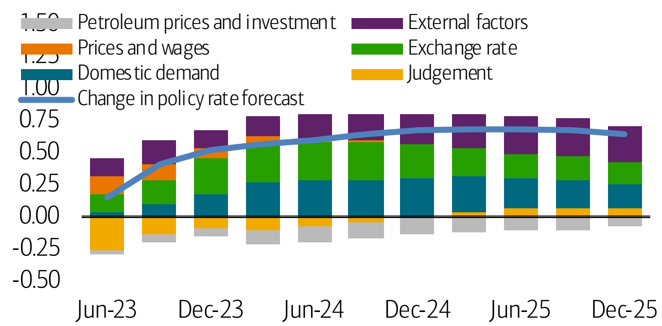
Exhibit 5: Decomposition of changes in Norges Bank's rate path

Weaker NOK was a key factor behind Norges' higher projected rate path



Source: Norges Bank, MPR 1/23, BofA Global Research. Note: Judgment is the difference (residual) between the rate-path changes and the cumulative contribution of the remaining five components.

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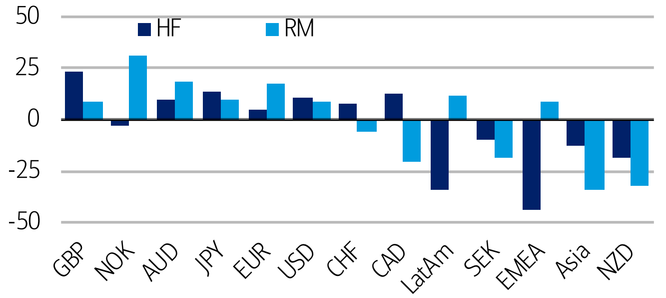
Exhibit 6: Latest BofA investor positioning level
Real Money long NOK but Hedge Funds now modestly short vs. history



Source: BofA Securities. 50 (-50) represents a max long (short) positioning level relative to history. Currencies ranked on their latest average investor positioning level (equal weights for Hedge Funds and Real Money).

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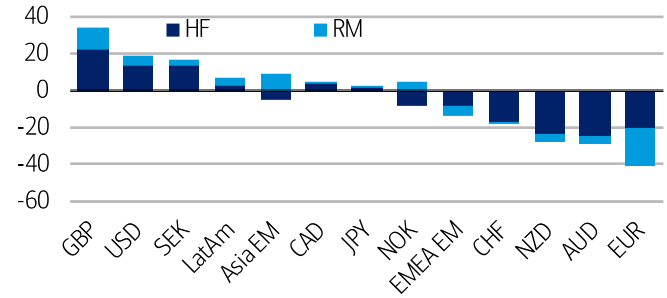
Exhibit 7: Year-to-date change in BofA investor positioning
NOK positioning lighter vs GBP, USD and SEK year-to-date but not vs EUR



Source: BofA Securities. 50 (-50) represents a max long (short) positioning level relative to history. Currencies ranked on the average investor positioning change year-to-date (equal weights for Hedge Funds and Real Money).

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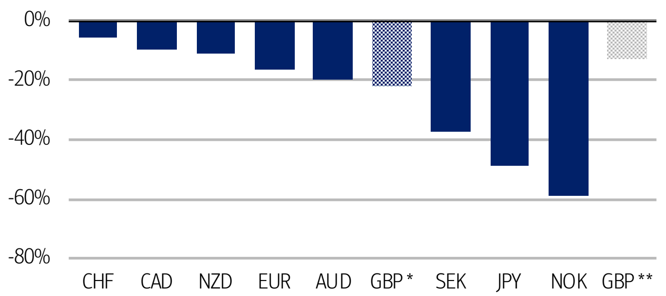
Exhibit 8: XXX/USD misalignment
Scandies and JPY most undervalued in G10, according to our estimates



Source: Bloomberg and BofA Global Research. See [Updating G10 FX equilibrium 20 Apr 23.]

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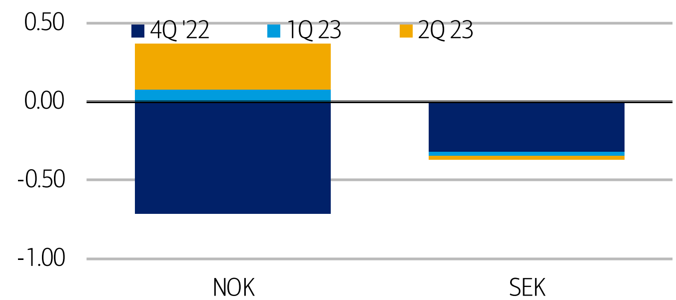
Exhibit 9: Change in 2yr swap spreads vs EUR (percent)
Norges repriced higher vs ECB year-to-date but Riksbank pricing roughly flat



Source: BofA Global Research, Bloomberg. Data weekly through May 19.

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SEK: between a rock and a hard place

We stay bearish on SEK through 3Q although we find it undervalued from a long-term perspective (Exhibit 8, Updating G10 FX equilibrium 20 Apr 23), still seeing risks for more and/or prolonged SEK weakness.

We remain worried about: (1) Highly rate-sensitive households (Exhibit 10, Exhibit 11). (2) Risks around property markets, particularly commercial real estate.

We think these, essentially "hard landing", concerns have driven:

(1) The strong divergence in SEK pricing from its own history (Exhibit 12).

(2) Relatedly, the persistent divergence between EURUSD and EURSEK (Exhibit 13) despite the relative Riksbank-ECB stance being stable this year, following the ECB's increased hawkishness in 2H last year (Exhibit 9).

Going forward: the Riksbank is not in an enviable position...

The Riksbank is not in an enviable position: On the one hand, inflation is high (and higher than in the Eurozone) and its labour market tight, with export-oriented sectors like manufacturing faring well. On the other hand, its economy is (much) more rate-sensitive and its fiscal policy tighter vs. the Eurozone, with March retail sales down c. 11% y/y (-6.5% y/y in April) vs. -3.8% for the Eurozone, and housing prices also down significantly from their peak. Meanwhile, concerns around commercial real estate keep building.

On balance, we think the above suggest risks around our 3.75% terminal-rate call are more symmetric (Riksbank April minutes: from higher to longer 9 May 23). This means SEK could come under extra pressure should the ECB turn more hawkish than markets expect (our economists expect at least another 50bp cumulatively from the ECB).

At the same time, a SEK-driven Riksbank could trigger hard landing risks, eventually weighing on SEK, in line with Deputy Governor Floden's remarks in the latest Riksbank minutes *("it is not obvious that the krona would benefit from larger rate increases if these result in a too rapid slowdown […]"*, Riksbank Minutes, April 2023)

In short, the Riksbank is between a rock and a hard place until inflation starts falling meaningfully (our economists expect headline inflation close to 2% at year-end). To this end, we have been somewhat encouraged by the recent 2-year wage agreement, the stable inflation expectations and, to some extent, the April inflation data. But we are mindful of the lags with which higher rates affect borrowers, as loan terms reset and maturities hit markets.

…and we are also cautious on risk

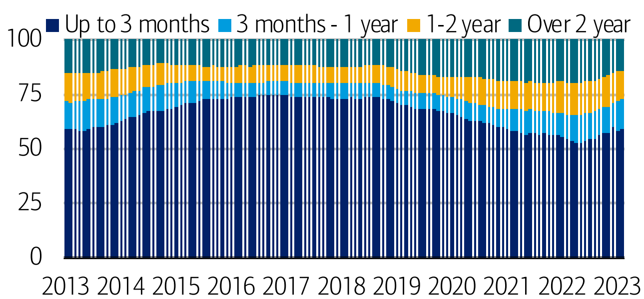
We are also cautious on risk and disagree with the Fed rate cuts priced for this and early next year. We then stay bearish on SEK through at least 3Q, hoping to get some clarity by then. Investors have reduced their SEK shorts this year (Exhibit 6, Exhibit 7), but we think it is still too early.

Forecasts: no changes. Risks: inflation stickiness, property markets, ECB

We forecast EURSEK at 11.50 in 3Q and at 11.00 by year-end. We still see risks for more /prolonged SEK weakness. We see USDSEK at 10.00 and NOKSEK at 1.04 at year-end. Risks are around the Fed & risk sentiment, the ECB, and the Swedish property markets.

Exhibit 10: Households' remaining fixed-interest periods, %

In Feb c27% of loans with 1Y+ remaining fixed-interest period and c14% 2Y+



Source: Statistics Sweden via Riksbank (Monetary policy Report, April 2023)

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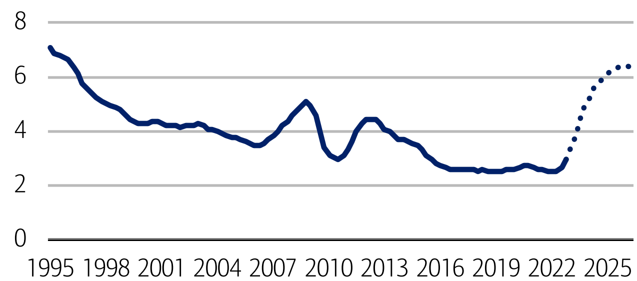
Exhibit 11: Interest-to-income ratio

Riksbank expects the Interest-to-income ratio to approach mid-90s levels



Source: Statistics Sweden and Riksbank (Monetary policy Report, April 2023). Dotted line shows Riksbank forecast.

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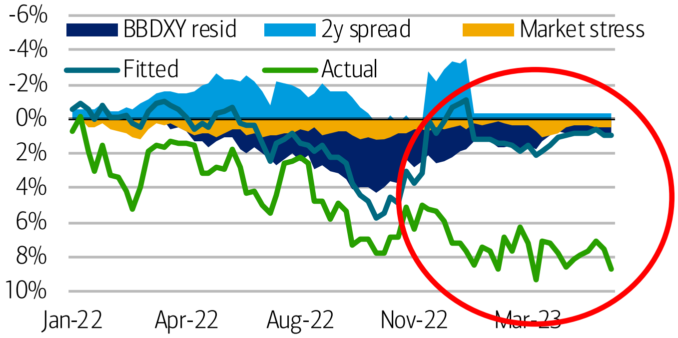
Exhibit 12: Fitted vs. actual Swedish krona index

Strong divergence likely reflects simmering property-market concerns



Source: BofA Global Research, Bloomberg, Lower values of the trade-weighted krona index (KIX) show a stronger SEK. Weekly data through May 19. Fitted values are based on regression estimates for 2018-2021. We regress changes in log KIX (trade-weighted krona index) on 1) residual changes in the (log) Bloomberg Dollar Index (see below for details); 2) changes in the trade-weighted ten-year SEK swap spreads; 3) changes in the first principal component of VIX, the MOVE Index and the US Corporate BAA 10-year spread, which we interpret as a proxy for market stress. The residual changes of the Bloomberg Dollar Index are changes in the Bloomberg Dollar Index unaccounted for by changes in market stress conditions.

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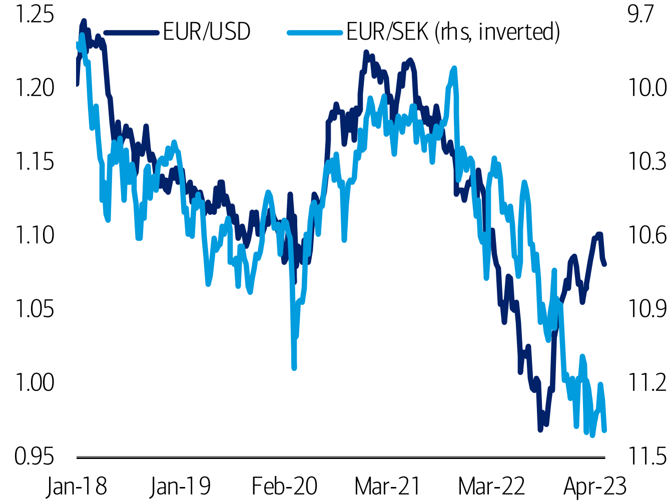
Exhibit 13: EURUSD vs EURSEK

EURUSD and EURSEK remain misaligned



Source: Bloomberg. Weekly data through May 19.

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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- Before the X-Date, **Global FX Weekly**, 26 May 2023
- X-marks the spot **Global Rates Weekly**, 26 May 2023
- China pessimism & US debt limit hopes and fears, **Liquid Cross Border Flows**, 22 May 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: Before the X-Date 26 May 2023

Global Rates Weekly: X-marks the spot 26 May 2023

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