Market viewpoint

Election outcome could change market view on Riksbank

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A risk scenario worth pondering

In the past years, the Riksbank has cut rates by 1.75% on the back of falling inflation, weak resource utilization and a similar development in the euro-zone. This has been a very favorable tailwind for bond investors to lean against. Given the marked disinflationary trend and with Swedish inflation lower than in the euro-zone, the German 10 year yield has worked as a magnet for the risk premium a couple of years out on the Swedish curve (chart 1). With a Riksbank becoming increasingly focused on inflation alone, the market has been forced in this direction. The SEK money market curve has adopted a similar shape as the EUR and is very far from the GBP and USD (chart 2). However, according to current inflation forecasts, we should now be near the point where an almost four year long streak of lower CPIF prints is about to change, partly because of the SEK weakening. What makes this potential change particularly interesting is that it would occur at the point when front-end rates are at all-time lows and the lack of risk premium is extreme.

Chart 1 – The Bund magnet

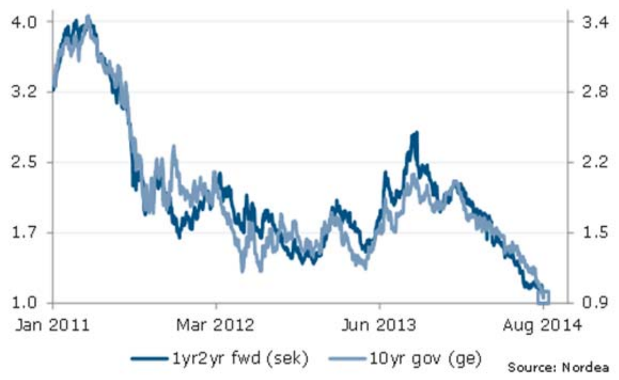
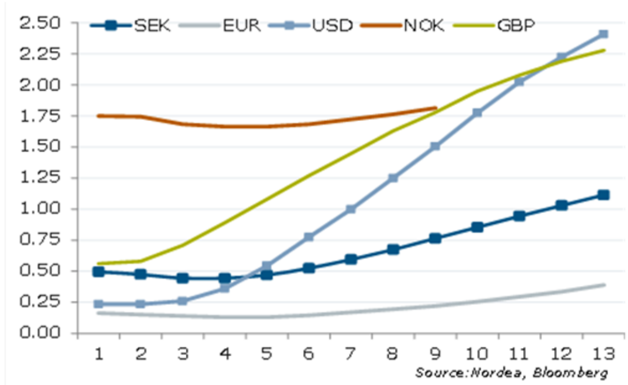


Chart 2 – Money market curves

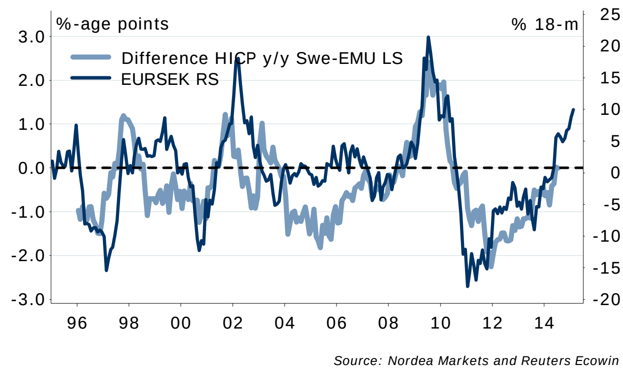


If these forecasts will prove to be broadly right, Swedish CPIF inflation will be around 1.50% already in Q1-15 (chart 3). But that's not all. Add that, depending on the election outcome, there are also non-negligible upside risks to these forecasts. If the Red-Green parties gain majority in the September 14 election, proposed tax hikes could potentially lift inflation to levels closer to the 2% target (see our Chief Analyst Torbjörn Isaksson analysis of the possible inflation effects of the election ***here***). In chart 3, the current tax proposals from the Social Democrats are included in the alternative scenario. If we also were to add the Green Party's proposed changes of environmental taxes the alternative inflation scenario would become even higher.

Swedish inflation should thus change trend and probably also rise clearly above inflation in the euro-zone for the first time since early 2010 (chart 4). This prospective scenario is of course particularly interesting to discuss when Swedish 0-5 year yields are at all-time lows and the slope of the money market curve is historically flat given the level of the repo rate. Rate hikes by Fed and/or BoE next year would moreover add dynamic to this picture. As a reference, the Riksbank kicked off the 2006-2008 tightening cycle 1.5 years after the Fed started hiking and when CPIF was 1.6%.

Chart 3 – The election matters for inflation

Chart 4 – Higher inflation in Sweden than euro-zone



How would the Riksbank tackle this?

Well, firstly it would certainly be a huge relief, given the very slippery path in 2014 and it would make the current Riksbank forecast more realistic. Some of the hawks may even sound a bit cocky again, with house prices recording new all-time highs every month and with the household credit expansion picking up pace again. One should not expect a fast change in the Riksbank's rate path, but at least, they could step away from the easing bias and more firmly stick with the view that a hike in Q4 2015 is plausible.

How would the nominal rates market tackle this?

Since inflation forecasting has been particularly problematic over the recent years, markets probably need to see things developing in the right direction in order to find the appetite to speculate on it. If such confirmation comes, we believe that the conclusion mainly will be that the Riksbank may have to tighten policy a couple of steps in 2016 (to 1.00 – 1.25%), but remain behind the curve in 2015. If the Fed and BoE will tighten in 2015, it would not be an impossible scenario that the Riksbank will out-tighten the ECB a year later. In trade-weighted terms, the currency has weakened quite a lot this year and the

Chart 5 – Riksbank already sees much stronger SEK

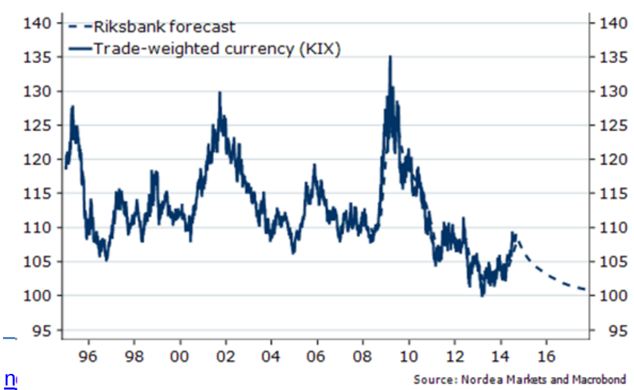
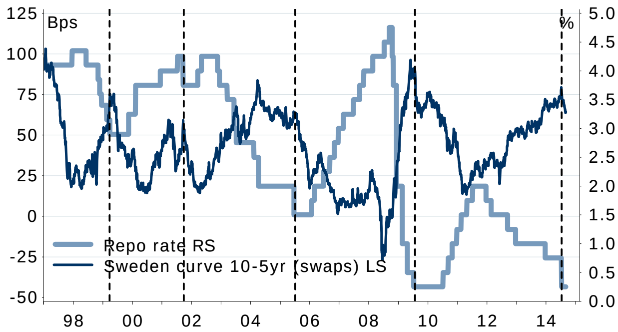


Chart 6 – The gap could start closing 2015

Riksbank is already forecasting it to strengthen notably over the coming years (chart 5). So there is room for the money market curve to steepen up and eventually even for the Riksbank to select a different path than the ECB, as long as there is an inflation argument to do so. Thus, if markets will become keen to speculate on this future development of inflation, front-end steepeners look like the trade to do (Sep’15/Sep’16 FRA) or to pay 1yr1yr fwd outright, against receiving 5yr5yr fwd against EUR (chart 6). A 5s/10s flattener in Sweden is another idea that could work both in an environment with inflation driven steepening of the money market curve and in a more negative scenario where lower long-dated euro yields drag down Swedish yields further.

Chart 7 – 5s/10s and the repo rate cycle



Source: Nordea Markets and Reuters Ecowin

Table 1 – BEI in SGBi 3107 looks attractive

			Fair-value BEI in different scenarios (market expectations of rates used, 2 % trend CPIF)			Diff BEI Ndea alt. Secnarios to main	
Bond	Maturity	BEI	Ndea CPIF	Ndea alt. (Socialdemocrats, S)	Ndea alt. (Green party, mp)	Ndea alt. (S)	Ndea alt. (mp)
SE IL 3105	2015-12-01	0.60	0.91	1.11	1.36	0.20	0.45
SE IL 3107	2017-06-01	0.95	1.51	1.64	1.72	0.13	0.21
SE IL 3102	2020-12-01	1.31	2.07	2.13	2.17	0.06	0.10
SE IL 3108	2022-06-01	1.42	2.08	2.13	2.16	0.05	0.07
SE IL 3109	2025-06-01	1.55	2.10	2.13	2.15	0.03	0.06
SE IL 3104	2028-12-01	1.64	2.13	2.16	2.17	0.03	0.05

How would the index linked market tackle this?

Swedish break-even inflation is low compared to a fair-value analysis based on reasonable inflation scenarios, even without possible tax increases, and has been so for quite some time. The reason for this is obviously the low nominal yield levels but also that the long stretch of negative inflation surprises may have spooked the market. In an environment where CPI is being pushed upward with positive contributions from possible tax increases, both nominal yields may rise and sentiment in the index-linked market may change.

When making calculations on the direct effects on BEIs from tax hikes, one can note that it is mainly SGBi 3107 that will be affected (in the range 10-20 bps, table 1). This bond may also find some support going into next year as the debt office plans to issue a new 4y index-linked in exchange for SGBi 3107 (this bond would be a buy-back bond). Also remember that a large index-extension takes place in December as SGBi 3105 becomes shorter than 1y and falls out of index. This might lead to bid for duration, which should be supportive of index-linked in general.

Buying SGBi 3107 versus SGB 1051 looks like a trade with a lot of value in it, and one could also consider switching SGB 1051 to 1052 and thus adding a curve steepener exposure to create additional beta. For the brave, buy SGBi 3107 against paying the tail on the money market curve, such as June ’17 FRA or 1yr2yr fwd.

Chart 8 – EURSEK with “inflation” risk premium

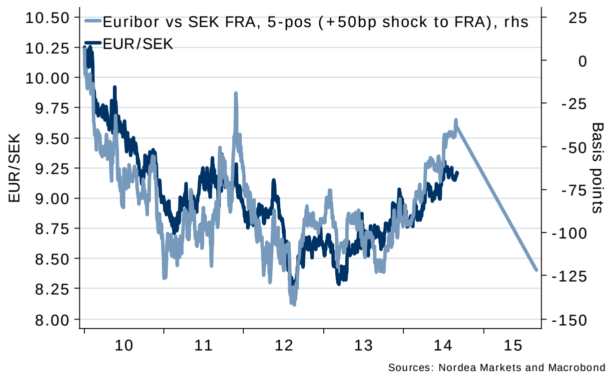
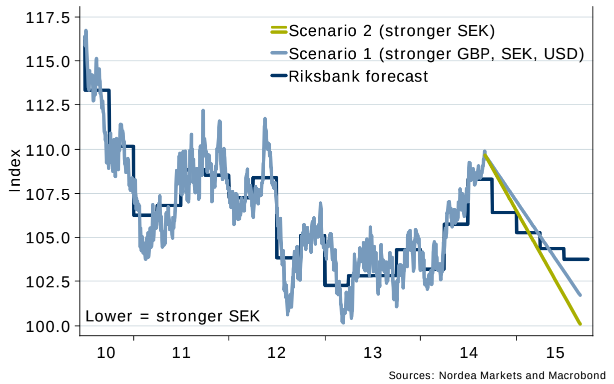


Chart 9 – KIX guesstimate vs Riksbank forecast



How would the SEK tackle this?

Assuming that the SEK continues to take its lead primarily from relative expectations on monetary policy, the SEK would of course strengthen in 2015 on this type of fixed income scenario. Particularly EURSEK could drop quite a bit. If we assume that the Sep ’16 FRA increases by 50 bps (sounds a lot today, we know…) while the corresponding Euribor contract is flat then historical patterns indicate a possibility for EURSEK to move back towards 8.50 by early autumn of 2015 (chart 8).

In trade weighted terms, which is what normally matters for the Riksbank, the move lower in EURSEK will partly be balanced by a stronger USD and a stronger GBP on the back of BOE and Fed rate hikes. In fact, such a SEK move, combined with our NOK, GBP and USD forecasts, imply a gradual strengthening of the SEK mostly in line with the Riksbank’s July 2014 KIX forecast, with an end-point 2% below its July estimate. Hence it wouldn’t be a game-changer for the Riksbank. However, assuming that all crosses but the SEK remain unchanged between now and next autumn, such a EURSEK move would hint at 4% stronger-than-expected krona (chart 9), which could have more of an effect on the Riksbank’s CPIF forecast and rate path.

Winds of change 2015?

The effect on CPIF from a Red/Green majority government is a risk scenario. We deem it more likely that we will see some sort of minority government that won’t be able to push tax hikes of these magnitudes through parliament. However, current opinion polls are tight so we could be wrong. And even if the “tax hike” scenario doesn’t play out, we feel that the inflation trend in Sweden has turned up. For markets it should be a different story having CPIF print 1.5%, especially if Fed and BoE are entering a tightening mode.