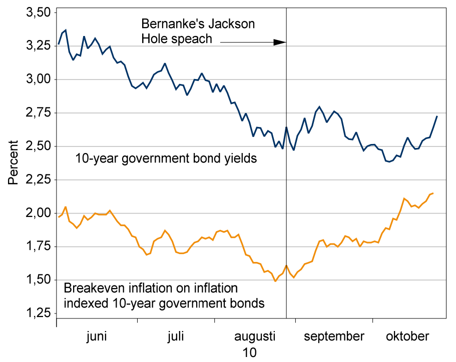
Handelsbanken Capital Markets
Macro Research | The world view from a Nordic perspective

Economic & Financial Weekly • Number 34, 28 October 2010

Sweden: Riksbank postponing hikes

Sweden: Inflation and bond yields



Source: Reuters Ecowin

Business cycle view

	3m	6-9m
US		
Core inflation	↘	↗
Growth	→	↗
FED	→	→
Eurozone		
Core inflation	↘	↘
Growth	↘	↘
ECB	→	→
Sweden		
Core inflation	↘	→
Growth	→	↘
Riksbank	↗	↗
Norway		
Core inflation	↗	→
Growth	↗	→
Norges Bank	→	→

Source: Handelsbanken Capital Markets

US: USD 500bn in asset purchases, and something more

We are convinced that the Fed will restart asset purchases as well as introduce some sort of temporary inflation target to increase the effectiveness of its purchases at the next interest rate meeting. Further quantitative easing will only work if inflation expectations rise more than nominal bond yields, lowering expected real bond yields. Thus, success depends to a large degree on how well the Fed can shape market expectations after the interest rate meeting.

Sweden: Less front-loaded Riksbank hikes now seem likely

Referring to the weak international picture and low inflationary pressures in Sweden, the Riksbank lowered its rate path notably at the October meeting. We expected only a lower trajectory beyond the one-year horizon, considering the strong and broad-based recovery in the Swedish economy. We now believe that the rate hikes will be a little less front-loaded than we previously assumed over the coming year. However, the Riksbank's repo rate peak at 3.50 percent still looks too high.

Norway: Interest rate hikes postponed until next summer

As widely expected, Norges Bank kept the interest rate unchanged at 2 percent at this week's interest rate meeting. In addition, the interest rate path was revised slightly downwards in the near term. The new path implies that the interest rate will be kept on hold until next summer.

Eastern Europe: Beneficiaries of the currency war

A global battle for market shares through currency devaluation still seems to be on the agenda. Eastern Europe is a mixed crowd in that respect. While Central Europe consists of free floaters, Russia and its neighbours further to the East still like to meddle. Against that background, the Polish zloty still stands out as a top beneficiary of the efforts to reflate in the advanced economies.

Financial forecast

	27-Oct	3 months	6 months	12 months	24 months
Base rates					
USA	0.125	0.125	0.125	0.125	1.50
EMU	1.00	1.00	1.00	1.00	1.50
Sweden	1.00	1.25	1.50	2.00	2.50
Norway	2.00	2.00	2.25	2.50	3.50
10 year government bond yields					
USA	2.73	2.50	2.75	3.25	4.00
EMU	2.58	2.50	2.55	2.75	3.30
Sweden	2.88	2.75	3.00	3.35	3.50
Norway	3.39	3.50	3.55	3.25	4.50

Source: Handelsbanken Capital Markets

	27-Oct	3 months	6 months	12 months	24 months
Versus EUR					
EURUSD	1.38	1.45	1.25	1.15	1.15
EURSEK	9.33	8.90	8.90	8.90	8.90
EURNOK	8.13	8.00	7.75	7.70	7.90
EURGBP	0.873	0.920	0.900	0.850	0.800
Versus USD					
USDSEK	6.78	6.14	7.12	7.74	7.74
USDNOK	5.91	5.52	6.20	6.70	6.87
USDGBP	1.58	1.58	1.39	1.35	1.44
USDJPY	82	79	82	85	85

Source: Handelsbanken Capital Markets

Key events

Date		Indicator	Our FC	Cons	Previous	Comment
01 Nov						
08:30	Sweden	**PMI Manufacturing, Oct**			63.3	PMI to remain at high levels
09:00	Norway	**PMI Manufacturing, Oct**	53.0		52.8	Trend still upwards
10:00	Norway	**Total domestic credit, Sep**	/5.1		/5.1	Households on hold, corporates up
		Household credit, Sep	/6.2		/6.2	
		Non-financial businesses credit, Sep	/1.8		/1.3	
11:00	Norway	**Housing prices, Oct**	-1.0/		1.6/	Last month's surge to be partly corrected
13:30	US	**Consumption, Sep**		0.4/	0.4/	To remain subdued in real terms
15:00		**ISM manufacturing, Oct**		54.0	54.4	To remain on a fairly high level
02 Nov						
	US	**Mid-term Congressional election**				Republicans to gain seats
09:58	EMU	**PMI Manufacturing, Oct**			53.7	
03 Nov						
10:00	Norway	**Unemployment rate AKU, Aug**	3.4		3.3	
		Employment AKU, Aug	2,000		4,000	
15:00	US	**ISM non-manufacturing, Oct**		53.5	53.2	To remain on a fairly high level
19:15		**FOMC rate decision**		0.25	0.25	Further quantitative easing a done deal
04 Nov						
09:58	EMU	**PMI services, Oct**			54.1	
		PMI composite, Oct			54.1	
13:00	UK	**BoE rate decision, Nov**	0.5		0.5	We expect the BoE to hold rates and not expand asset purchases.
13:45	EMU	**ECB rate decision, Nov**	1.0		1.0	
05 Nov						
09:30	Sweden	**Budget balance, Oct**			-15.4bn	
10:00	Norway	**Manufacturing production, Sep**	0.4/		-2.0/	Upbeat manufacturinig
13:30	US	**Unemployment rate, Oct**		9.6	9.6	Likely unchanged
		Non-farm payrolls, Oct		70.0k	-95.0k	Increasing again after 2010 Census
		Private non-farm payrolls, Oct		83.0k	64.0k	To increase steadily
		Government non-farm payrolls, Oct			-159.0k	State employment to decrease further

Figures are reported in percentage change month over month/year over year unless otherwise noted.
Source: Handelsbanken Capital Markets

US

USD 500bn in asset purchases, and something more

We are convinced that the Fed will restart asset purchases as well as introduce some sort of temporary inflation target to increase the effectiveness of its purchases at the next interest rate meeting. Further quantitative easing will only work if inflation expectations rise more than nominal bond yields, lowering expected real bond yields. Thus, success depends to a large degree on how well the Fed can shape market expectations after the interest rate meeting.

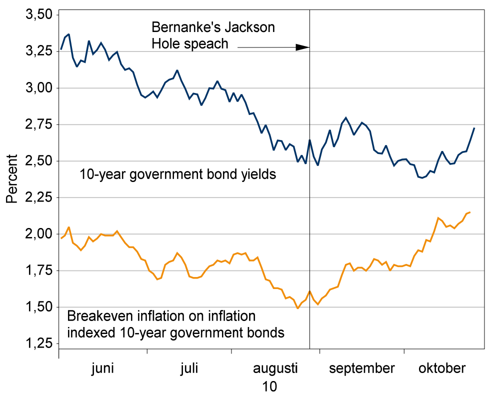
Aiming to lift inflation expectations

It would be a large shock for financial markets if the Fed did not announce a new programme of asset purchase at the next interest rate meeting on November 3. The most likely outcome is that the Fed will buy USD 500 billion in Treasury securities over the next 6 months. However, there is remaining uncertainty about what the Fed really wants to achieve by restarting asset purchases on a large scale. In our view, the only realistic aim of further quantitative easing (QE) is to lift inflation expectations more than nominal bond yields, which should lower the expected real interest rate, stimulating real economic activity.

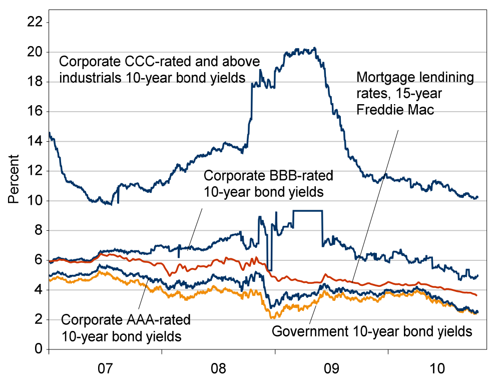
Inflation expectations have already risen

Financial markets seem to agree with us. Since Fed Chairman Ben Bernanke opened up for further asset purchases in his Jackson Hole speech to central bankers on August 27, break-even inflation on inflation-indexed 10-year government bond has increased from 1.6 percent to 2.15 percent at the present. Government 10-year bond yields, on the other hand, have moved approximately sideways during the same period, indicating that financial markets do not expect nominal bond yields to decline much further due to new asset purchases.

Inflation expectations and bond yields



Market bond yields



Source: Reuters Ecowin

Uncertain whether further QE will work…

It is uncertain whether further quantitative easing really will work. For instance, if the central bank would shock financial markets by announcing asset purchases of USD 1,000-1,500bn, inflation expectations might rise permanently, lifting nominal bond yields so much that expected real bond yields remain almost unchanged. In this case, the Fed's inflation credibility breaks down completely. Another example where quantitative easing will not work is when the Fed is able to fully maintain its inflation credibility despite further quantitative easing. In other words, if everybody is convinced that inflation will remain contained in the future, inflation expectations will not rise.

…but a temporary price level target will help

Further quantitative easing will work and lower expected real bond yields if the Fed could convince financial markets that inflation will rise temporary, but not permanently. The best method to do that is to introduce a temporary price level target above the current price level. Once the price level target is achieved, the Fed will shift back to its normal policy goal of stable prices, which currently is interpreted as a core inflation target of 2 percent.

Massive opposition against QE within the Fed

Although an explicit temporary price level target would make further quantitative easing much more effective, we are not sure that the Fed will follow that road on November 3. Hardcore hawks in the Fed believe the risk of failure is so grave that further quantitative easing ought to be ruled out all together. Most prominent are Thomas Hoenig of the Kansas City Fed and voting member of the FOMC, Richard Fisher of Dallas, Jeffrey Lacker of Richmond and Charles Plosser of Philadelphia.

Restart of asset purchases and likely something more

We are convinced that the Fed will restart asset purchases as well as introduce some sort of temporary inflation target to increase the effectiveness of its purchases at the interest rate meeting on November 3. However, we do not really know how the inflation target will be formulated. It could be a temporary price level target, but it could also be a statement in the press release allowing temporary high inflation in the next couple of years.

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SWEDEN

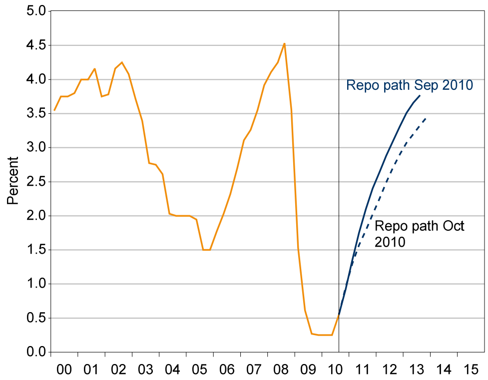
Less front-loaded Riksbank hikes now seem likely

Referring to the weak international picture and low inflationary pressures in Sweden, the Riksbank lowered its rate path notably at the October meeting. We expected only a lower trajectory beyond the one-year horizon, considering the strong and broad-based recovery in the Swedish economy. We now believe that the rate hikes will be a little less front-loaded than we previously assumed over the coming year. However, the Riksbank's repo rate peak at 3.50 percent still looks too high.

Notable downward shift in repo rate path

While the 25bp rate hike was widely expected, the notable downward shift in the repo rate path in connection with the October meeting caught both us and the market by surprise. We only expected a downward shift of the repo rate path beyond the 12-month horizon, primarily based on the board members' statements at the September 2 meeting[1]. The repo rate path now averages 2.02 percent in Q4 2011 (down from 2.40 percent at the September meeting) and 3.33 percent in Q3 2013 (down from 3.77 percent). Svensson and Ekholm entered reservations against both the rate decision and the rate path, as they preferred unchanged rates and a lower rate path that gradually rises to 2.7 percent by the end of the period (Svensson has hence augmented his preferred rate path).

Riksbank repo rate projections



Riksbank forcasts

	RB Sep	RB Oct	Risk assessment
GDP 2010	3.9	4.6	Fair
GDP 2011	3.5	3.9	Too high
GDP 2012	3.0	2.9	Fair
Unemployment 2010	8.5	8.4	Fair
Unemployment 2011	7.9	7.6	Fair
Unemployment 2012	7.6	7.2	Fair
CPIF 2010	2.0	2.0	Fair
CPIF 2011	1.3	1.3	Too high
CPIF 2012	1.7	1.5	Too high

Sources: Riksbank MPR and Reuters Ecowin

As the Swedish economy has continued to provide mostly positive surprises since the last meeting in September and as uncertainty regarding international developments has not increased further, we expected an unchanged repo rate path for the next 12 months. Indeed, the Riksbank actually raised its GDP forecasts substantially for Sweden both this year and next (see table above).

Larger rate spread and stronger krona the main motivation for downward shift

The main reasoning for the downward shift in the repo rate path was the uncertain international picture (international GDP forecasts were not changed) and that interest rates abroad now seems to be lower ahead than the Riksbank previously assumed. Lower interest rates abroad widen the rate spread and strengthen the krona. A stronger krona, in turn, decreases the need for repo rate hikes.

[1] See article in Weekly on October 21

Rate hikes to be more gradual than previously assumed

While the strong domestic economy makes us quite comfortable with our belief in continued rate hikes in December and February, we now deem it likely that the Riksbank will make a pause at one of the following meetings. By year-end we still expect the repo rate to reach 2.25 percent, primarily due to a continued tightening of the labour market.

Repo rate peak to be revised lower

However, looking at the Riksbank forecasts, we still believe its GDP forecast of 3.9 percent for 2011 is too optimistic and that its inflation forecasts for both 2011 and 2012 are on the high side. As it is also quite probable that the Riksbank will revise its view on international policy rates even lower, we think there is high probability that the repo rate peak at 3.50 percent will be revised lower. We expect a peak at between 2.50-3.0 percent.

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NORWAY

Interest rate hikes postponed until next summer

As widely expected, Norges Bank kept the interest rate unchanged at 2 percent at this week's interest rate meeting. In addition, the interest rate path was revised slightly downwards in the near term. The new path implies that the interest rate will be kept on hold until next summer.

Interest rate unchanged at 2 percent, as expected

Norges Bank has kept its key policy rate on hold at 2 percent since May 2010. The decision to keep the interest rate unchanged at this week's meeting was widely expected. The interest rate forecast in the previous Monetary Policy Report, which was published in June, implied that the next interest rate hike of 25 basis points would come in December 2010 or January 2011 and that there would be two more hikes during 2011, bringing the interest rate to 2.75 percent at the end of 2011.

New interest rate path flatter in the near term, then steeper

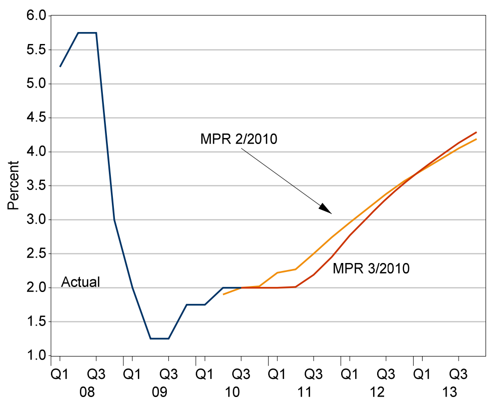
In the new Monetary Policy Report, Norges Bank revised down the interest rate path for the next year. This was in line with our expectations. The new interest rate path implies that the interest rate will be raised by 25 basis points in June or August (equal probability) with another hike of 25 basis points planned for October. Prior to the publication of the report, we had expected that the new interest rate path would be consistent with interest rate hikes in May and October. The first interest rate hike will therefore come somewhat later than we expected; however, this does not constitute a large difference in the interest rate path.

According to the new interest rate path, the interest rate will be kept at 2.0 percent for a longer period than envisaged in June. However, from the beginning of 2012, the new interest rate path is steeper, implying that the new interest rate path for longer horizons closely coincides with the interest rate path from June. The updated forecast implies that the interest rate will be 3.5 percent in the fourth quarter of 2012, increasing to 4.3 percent in the fourth quarter of 2013.

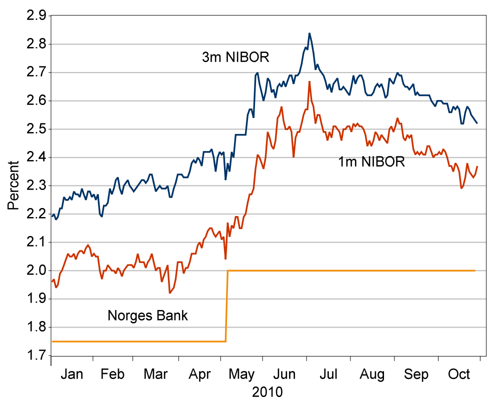
Softer inflation outlook the main reason for revision of interest rate path

As expected, the main factor behind the downward revision of the interest rate forecast for 2011 is that it looks likely inflation will be lower next year than previously envisaged. The forecast for core inflation (CPI-ATE) next year is 1¼ percent, compared to 1¾ percent in the previous report. The revision of the inflation forecast is mainly due to lower-than-expected growth in the prices for imported consumer goods. We note that the official inflation forecasts for the second and third quarter next year are slightly higher than the updated forecasts from Norges Bank's short-term statistical forecasting system (System of Averaging Models, SAM), which suggests that there might be downward risk to the inflation forecast next year. We also note that, as in the previous report, inflation is lower than the inflation target of 2.5 percent throughout the forecast period.

Policy rate, actual and trajectory



Money market rates



Source: Reuters Ecowin

The interest rate path is also pulled slightly down by the fall in expected future interest rates among Norway's trading partners since June. Towards the end of the forecast horizon, a somewhat stronger outlook for petroleum investments and net exports limit the downward revision of the interest rate path.

Norges Bank sees lower inflation, higher growth next year

Unemployment expected to peak at 3½ percent

Apart from the significant revision to the inflation forecast, there were no major surprises in the new projections. As expected, the forecasts for private consumption growth were revised downwards both for this year and the next two years. Private consumption growth is now expected to be 2¾ percent this year, compared to 3½ in the June report and 5 percent in the Monetary Policy Report from March. Unemployment is expected to increase by less than previously envisaged. The new forecast implies that the unemployment rate (LFS) will peak at 3.5 percent. This is much lower than the most recent peak in 2005. One important reason why the increase in unemployment has been so modest in this downturn is the flexibility of the labour force. When the crisis hit, labour force participation declined among the youngest age groups and net inward immigration fell. Despite lower estimates of unemployment, Norges Bank forecasts somewhat lower wage growth in the coming years than in the previous report. The forecasts of real wage growth are not much changed, however. The forecasts of private consumption growth, unemployment and wage growth are broadly in line with the forecasts in our Norwegian Macro Forecast (published earlier this week). Norges Bank's forecast for GDP growth in the mainland economy next year is 3 percent. We are slightly less optimistic and expect growth to be closer to 2½ percent. The difference in the forecasts is mainly due to the fact that we project somewhat lower growth in mainland investments than Norges Bank.

Norges Bank sees GDP-growth in the mainland economy at 3 percent in 2011

We believe the next interest rate hike will come in June next year

Risk that money market premiums remain higher than Norges Bank's forecasts

Based on the new interest rate path and the lower inflation forecasts from Norges Bank, we now believe that the first interest rate hike will come in June rather than May. Although Norges Bank has revised its forecasts of the premiums in the money market slightly upward, we still think there is a risk of premiums remaining higher than Norges Bank expects next year. We are not confident that the proposed measures from Norges Bank to improve the functioning of the money market will have the effect of lowering money market rates beyond very short maturities, at least not in the short run. If the premiums remain at today's level for the next year, as we expect, Norges Bank may have to postpone its planned interest rate hike in October. We see no reason to change our exchange rate forecasts in view of the new interest rate path.

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EASTERN EUROPE

Beneficiaries of the currency war

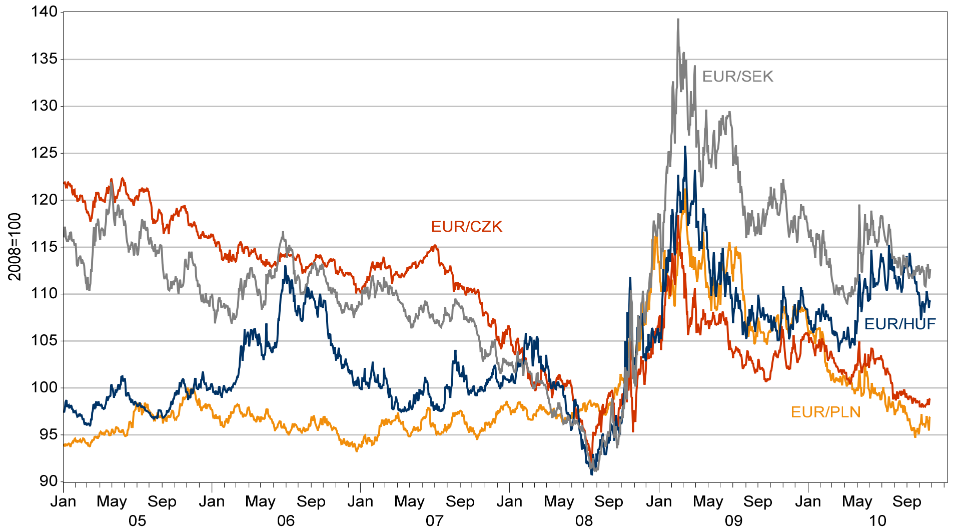
A global battle for market shares through currency devaluation still seems to be on the agenda. Eastern Europe is a mixed crowd in that respect. While Central Europe consists of free floaters, Russia and its neighbours further to the East still like to meddle. Against that background, the Polish zloty still stands out as a top beneficiary of the efforts to reflate in the advanced economies.

Advanced economy currencies to weaken against emerging ones over time

Shuffling deflationary pressures among the big three of the advanced economy universe, the US, EMU and Japan, makes no sense. None of these three regions are in good shape, and over the longer run, it is therefore reasonable to expect the dollar, euro and yen to weaken against many emerging country currencies.

China is obviously a key player in this regard. At the end of the day, we expect that the Chinese will embark on a similar journey as in 2004; the starting point for the last period with a gradual appreciation of the CNY against the USD. Regardless of the, although there are many eager participants in a potential war in the global currency market, not all countries intervene. Exposure to countries that abstain from such activity and also have the right macro backdrop is likely a profitable option.

Central Europe: Foreign exchange rates against the euro



Source: Reuters Ecowin

The PLN is our top candidate in Eastern Europe

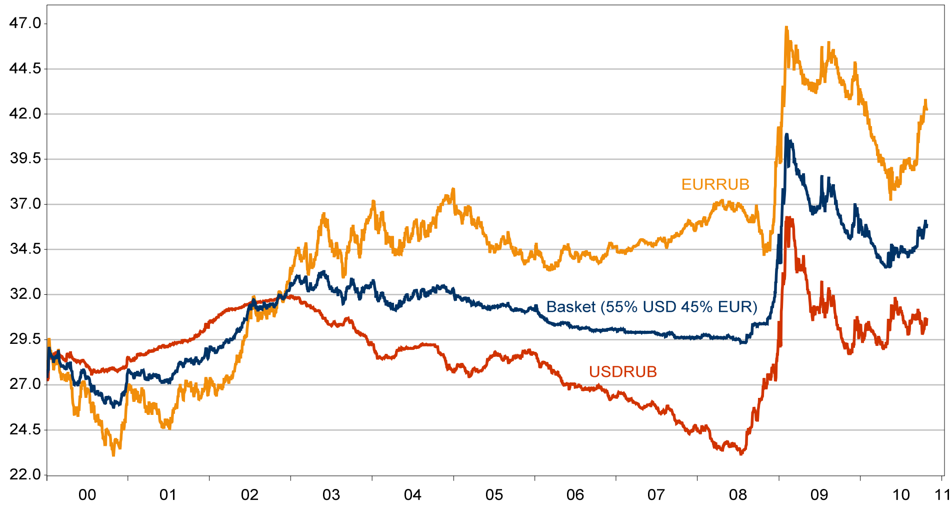
One does not have to look very far to find suitable candidates. Sweden, with its link to Germany and strong economy, is an obvious choice. It could be that the big race is already behind us but the macro outlook makes the krona appealing still. The same goes for Poland, which probably has even stronger credentials. Continued growth outperformance, limited economic slack, inflation in line with the National Bank's target, and a significant carry all speak in favour of the zloty. The PLN is free to float with the interest rate policy guided by the standard inflation targeting regime. The PLN is our top candidate.

Stay out of the HUF although the carry is high

The Czech koruna shares many of the characteristics of the PLN but is a more defensive choice. The financial crisis took a greater toll on the Czech Republic and the slack in the economy is likely more significant than in Poland. Nevertheless, despite a slightly negative carry, we think that CZK exposure is motivated over the longer term as catch-up growth continues.

The Hungarian forint is less appealing to us. Hungary is trying to manage its debt burden and cut back on its fiscal deficit. We welcome this ambition but are sceptical about the methods being used. Special ad hoc taxes on the banking, energy and telecom sectors do not send the right message to investors and risk undermining Hungary's long-term potential. Stay out of the HUF although the carry is high.

Russia: The rouble



Source: Reuters Ecowin

Russia is a different story due to the economy's structure and policy framework

Russia is in a different position, partly due to its energy-based economy and partly due to a greater propensity to intervene in the foreign exchange market. The Central Bank is looking at an indicative dollar/euro basket as a key instrument to carry out its policies. For a long period before the 2008 crisis, the rouble was rather stable, slowly appreciating against the basket. In 2008, the authorities let it weaken in a controlled way to compensate for the sharp fall in oil prices. As the global recovery got underway, the RUB was allowed to strengthen, although less than market forces left alone would have implied. The Central Bank was intervening in the market and rebuilt its currency reserve in a major way.

Due to oil prices and the dollar, the rouble is a more difficult call now

The recent move in the USD against the EUR, in combination with a levelling out of oil prices, has made the RUB a more difficult call. The authorities seem to have deliberately decided that the RUB could fall somewhat against the basket. They have scaled down their interventions, looking at foreign exchange reserves evaluated in terms of the basket. However, the bilateral move against the EUR has been much greater, which is natural given the recent weakening of the USD. In macroeconomic terms, this discourages imports, which are mostly EUR-denominated and may be mildly stimulative for the economy.

We remain sceptical about recent signals that the authorities will set the RUB free

Russian authorities have also signalled that they intend to move toward letting the RUB float freely and gradually phase out interventions. This change would be implemented over several years. However, we are, as argued before, sceptical about this idea. Russia has a long history of currency interventions and its economic structure makes the flows through the foreign exchange market more volatile to the typical industrial economy; like Poland for instance. So it remains to be seen to what extent the new signals will be implemented in practice. Having said that, the longer-term case for real appreciation remains. Barring more trouble in the global economy and a fall in oil prices, the rouble should hold up reasonably well. However, significant changes may still occur due to the basket.

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Macro indicators

US

	2008	2009f	2010f	2011f	2012f
Household consumption	-0.3	-1.2	1.5	1.9	2.0
Public spending	2.8	1.6	0.3	-0.9	1.2
Non-residential investment	0.3	-17.1	6.2	8.8	7.4
Residential investment	-24.0	-22.9	3.2	10.5	9.1
Inventory investment*	-0.5	-0.6	1.2	-0.2	0.1
Net exports*	1.1	1.1	-0.3	0.1	0.2
GDP	0.0	-2.6	2.7	2.2	3.0
Unemployment rate	5.8	9.3	9.6	9.6	9.2
Consumer prices (Core PCE)	2.4	1.6	0.9	1.0	1.3

EMU

	2008	2009	2010f	2011f	2012f
Household consumption	0.3	-1.2	-0.1	-0.1	0.3
Gross fixed investment	-0.9	-10.8	1.7	2.2	1.7
Exports	na	na	na	na	na
Imports	na	na	na	na	na
GDP	0.4	-4.1	1.7	0.7	1.2
Unemployment rate	7.6	9.4	10.0	10.2	10.3
Consumer prices	3.3	0.3	1.6	1.4	1.6

Sweden

	2008	2009	2010f	2011f	2012f
Household consumption	-0.1	-0.8	2.8	2.3	2.4
Public consumption	1.3	1.7	1.2	1.0	0.8
Gross fixed investment	1.7	-16.0	5.4	5.5	5.8
Exports	1.4	-12.4	10.0	5.1	5.8
Imports	2.9	-13.2	11.8	6.1	6.0
GDP calendar-adjusted	-0.4	-5.1	4.1	2.4	2.7
Unemployment rate	6.1	8.4	8.6	8.0	7.9
Consumer prices	3.4	-0.3	1.1	1.6	1.9
CPIF	2.7	1.9	2.0	1.3	1.6

Norway

	2008	2009	2010f	2011f	2012f
Private consumption	1.3	0.2	2.6	3.2	3.1
Public consumption	4.1	4.7	2.7	2.1	1.9
Gross fixed investments	1.4	-9.1	-3.1	5.5	4.2
Exports	0.9	-4.0	-0.6	0.0	0.8
Imports	2.2	-11.4	6.6	5.3	4.3
GDP mainland	2.2	-1.4	1.7	2.5	2.7
Unemployment rate	2.5	3.1	3.5	3.6	3.6
Consumer prices, core	2.6	2.6	1.5	1.5	2.0

Finland

	2008	2009	2010f	2011f	2012f
Private consumption	1.7	-1.9	2.6	2.4	2.3
Public consumption	2.4	1.2	0.5	0.5	0.5
Gross fixed investment	-0.4	-14.7	0.9	5.3	5.6
Exports	6.3	-20.3	11.0	5.8	6.6
Imports	6.5	-18.1	8.0	5.7	5.6
GDP	0.9	-8.0	3.4	2.7	3.0
Unemployment rate	6.4	8.2	8.2	8.0	7.6
Consumer prices	4.1	0.0	1.0	2.2	2.4

Denmark

	2008	2009	2010f	2011f	2012f
Household consumption	-0.2	-4.6	1.8	1.3	1.1
Public consumption	1.6	3.4	1.2	0.0	0.0
Gross fixed investment	-4.7	-13.0	-7.9	0.9	1.6
Exports	2.4	10.2	4.6	2.1	1.5
Imports	3.3	-13.2	3.9	2.4	1.8
GDP	-0.9	-4.7	1.1	0.9	0.9
Unemployment rate	1.8	3.5	4.4	4.8	4.7
Consumer prices	3.4	1.3	2.2	1.8	1.7

Source: Handelsbanken Capital Markets

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