Valuation, fundamentals and safe haven qualities promote stronger Scandinavian currencies

by Carl Hammer, SEB

Scandinavian currencies (hereinafter referred to as Scandies) are increasingly hailed as a good alternative for investment diversification. We agree they are destined to continue to attract foreign flows and we furthermore see them still attractively priced.

For the last two years we have regarded the flight to fundamentally strong currencies as the main foreign exchange (FX) driver and market theme. Their countries have little debt, stabile public finances and little or no dependence on external capital (i.e., they enjoy a positive current account balance). In this 'new' world following the financial crisis of 2008, characterised by higher levels of economic and political uncertainty, increasing regulations and the decisive emergence of emerging markets as a serious, credible investment alternative, we expect this rationale to remain valid over the long term. Of particularly increasing importance are global reserve managers/sovereign wealth funds seeking to diversify current reserves from G-4 currencies into stronger peripheral alternatives – these flows represent the biggest influence on FX markets currently. Official reserve data published by the IMF Currency Composition of Official Foreign Exchange reserves (COFER) still indicate combined US dollar (USD) and euro (EUR) holdings of nearly 88% of global reserves (data obviously excluding China's holdings)! We believe the share of USD reserves will continue to decrease from currently 62% to at least 50% or even 40% based on our conversations with reserve managers. In other words, the flight to sound, fundamentally strong currencies (even if less liquid) still has a long way to run.

With regards to the G-10 currencies, Asian commodity currencies (Australian dollar (AUD) and New Zealand dollar (NZD)) have been the most obvious beneficiaries of this new financial landscape. The fundamentals theme has caused the AUD to trade well above its long-term fair-value. Our own long-term fair value model (SEBEER) agrees: AUD is currently valued at 20% above its neutral

Carl Hammer

Chief Currency Strategist / Head of FX Research

tel: +46 8 506 23128

email: carl.hammer@seb.se

web: www.sebgroup.com/merchantbanking

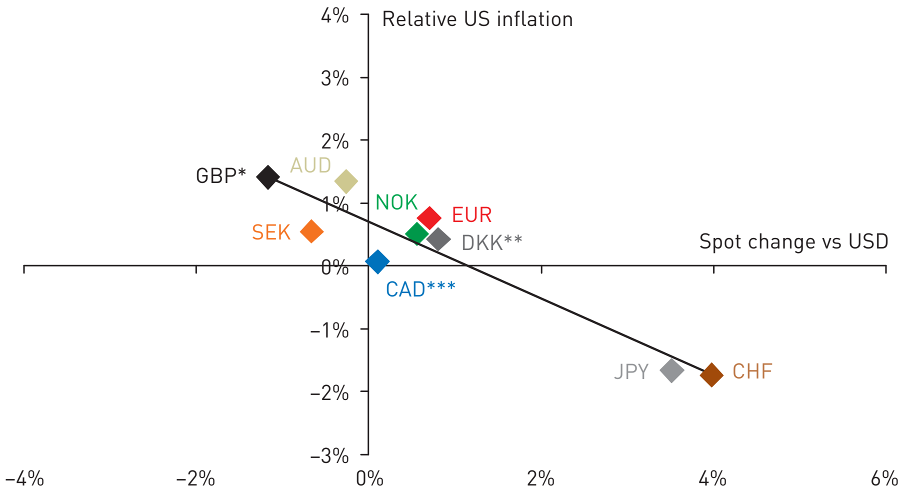
level. However, the reflationary bias of all G-4 Central Banks makes valuation less of a concern as a very relaxed monetary policy supports risk appetite/commodity currencies. Furthermore, so far the Reserve Bank of Australia (RBA) seems less concerned about the strong currency as the terms of trade support developments, while at the same time significant real economy effects on the external sector remain absent.

Repricing the Swedish krona (SEK) as a defensive currency

Scandies have lagged the performance of the (Aussie) and (Kiwi) for good reason. Their regional proximity to the European debt crisis makes the investment case for Scandies less appealing to some. Indeed many investors we have met during the past year have particularly focused on the SEK's historically cyclical behaviour. To some extent this argument is still valid. Sweden is a small and open economy with exports comprising 50% of GDP, approximately 70% of which are destined for Europe. In addition, the Swedish equity market remains a major play on global growth. However, due to its AAA-rated fundamentals the SEK is currently being repriced as a less procyclical currency: in other words we believe the normal pattern in which the SEK depreciates as Swedish export orders weaken is about to falter.

In a recently published study by our asset allocation team (*Nordic markets: the new safehaven?*), the team looks at the potential for SEK and Norwegian krone (NOK) to mirror the inflationary developments of current traditional safe havens Japanese yen (JPY) and Swiss franc (CHF). Since the break-up of the Bretton Woods, their inflation has on average been some 2% below the US level, while their exchange rates vs. the USD have appreciated by 3%-4% per annum. Over the last 20 years, the Nordic currencies have moved in the same direction, with inflation roughly 1% below the US level and USD spot rates rising 1%-2% per annum. Once currencies start moving, stronger currencies have historically continued to strengthen their

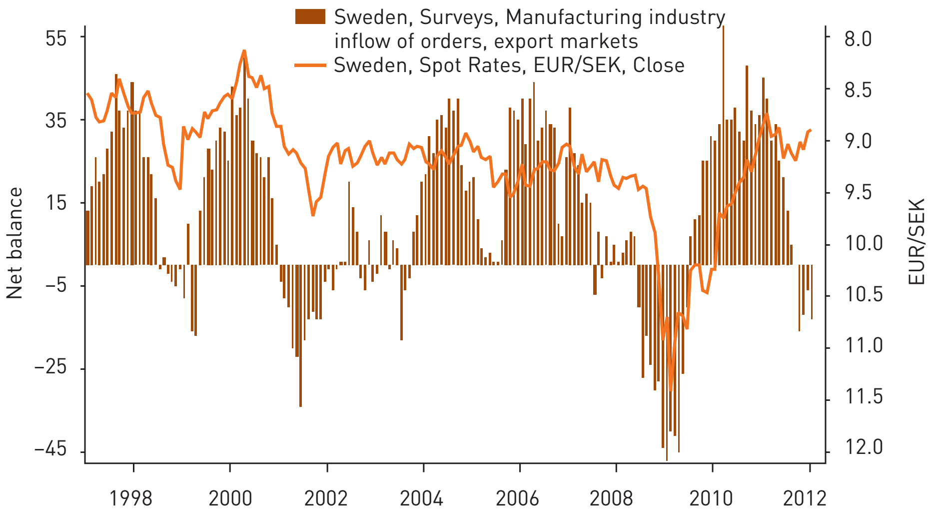
Relative US CPI and USD exchange rate, 1972-2011 **Exhibit 1**



*British pound; **Danish krone; ***Canadian dollar

Source: Ecowin and SEB X-asset

Sweden: EUR/SEK vs NIER inflow export orders **Exhibit 2**



Source: Reuters EcoWin

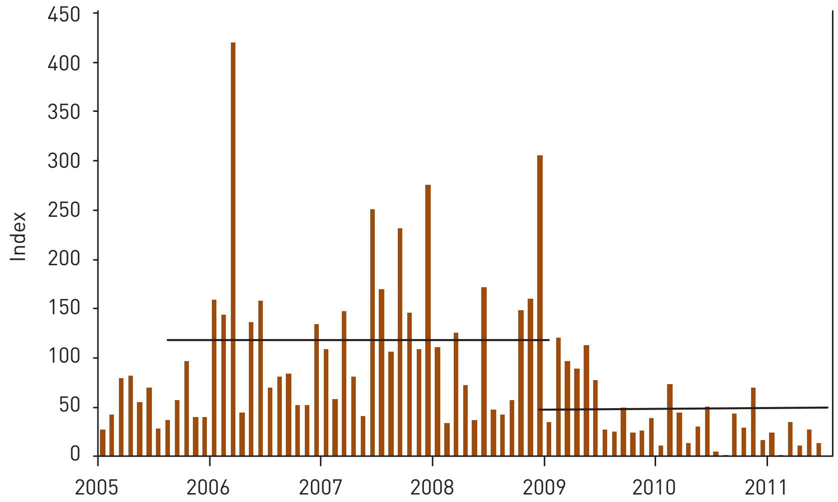
tendency towards lower inflation, so we expect the Nordics to move in the same direction as CHF and JPY.

Worth pointing out is the tendency for SEK (and NOK) in times of market stress and elevated volatility to weaken. Scandies will never develop into full safe haven currencies as the markets are simply too illiquid. Historically, leading indicators such as PMI or barometers for Swedish export order growth have proved very accurate indicators of how the trade-weighted SEK will perform over the following six-twelve months. Surprisingly precise EUR/SEK forecasts could be derived by simply considering relative interest rates and sentiment in the manufacturing index. These correlations however broke down last year consistent with the continuous revaluation of the SEK as a less procyclical currency. What are likely factors for this development?

To begin with, Swedish exporters have made significant changes to their FX hedging programmes. The substantial SEK losses that occurred in 2008/2009 were largely due to the closure of FX hedges. According to our surveys, most corporates have responded to the events of 2008 (when export orders collapsed) by cutting their hedge ratios and shortening their hedging durations.

This has obviously made profitability more sensitive to SEK fluctuations, though it also provides exporters with a greater degree of flexibility. Given more recent changes in hedging behaviour the SEK is now less vulnerable to variations in FX hedges. As Swedish exporters are multinational companies with both revenues and costs denominated in foreign currencies, the need to exchange all export receipts has lessened. This situation is also highlighted by data provided by Statistics Sweden, with Swedish non-MFIs having increased their FX deposits substantially in the last two years. In our opinion, these ‘reserves’ are causing the SEK to become more defensive – should the SEK weaken substantially FX reserves are likely to be partly repatriated into SEK. Furthermore, large institutional pension funds have also increased their FX exposure to an 11-year high (a record since the inception of the government pension funds in 2000), additional adjustments look less likely.

Lessened interest to hedge beyond six months **Exhibit 3**



Source: SEB

Exporters are competitive at current exchange rate

According to our own survey data, Swedish exporters are on aggregate surprisingly relaxed toward the potential for further SEK appreciation. Only 10%-15% of respondents say their business is affected at the current exchange rate while around 50% state that the exchange rate is not that important (taking into account all the various factors relevant to their business outlook). Despite being wary of drawing too far-reaching conclusions based on these facts alone, the position suggests some interesting factors to consider. Firstly, as already mentioned, with operations on a global scale (implying therefore both costs and revenues denominated in foreign currencies) the SEK exchange rate has become less important. Secondly, it may support our long-held view that the SEK remains undervalued and does not represent an obstacle to Swedish exports. Thirdly, on a historical basis, the level of profitability in the export sector is positively correlated with that of the SEK. Therefore, on a 20-year historical basis profits have been near highs when the trade-weighted krona (TCW) has been strongest, simply because the SEK exchange rate has been dependent on demand for Swedish export goods and not vice versa. While we argue this relationship is about to weaken it is still important to remember that companies depend on global demand rather than the exchange rate itself.

Nordic model appealing – attracts flows

Sweden's own financial crisis in the early nineties caused it to make several important changes. Obviously the 30% exchange rate depreciation in 1992/1993 helped to restore competitiveness.

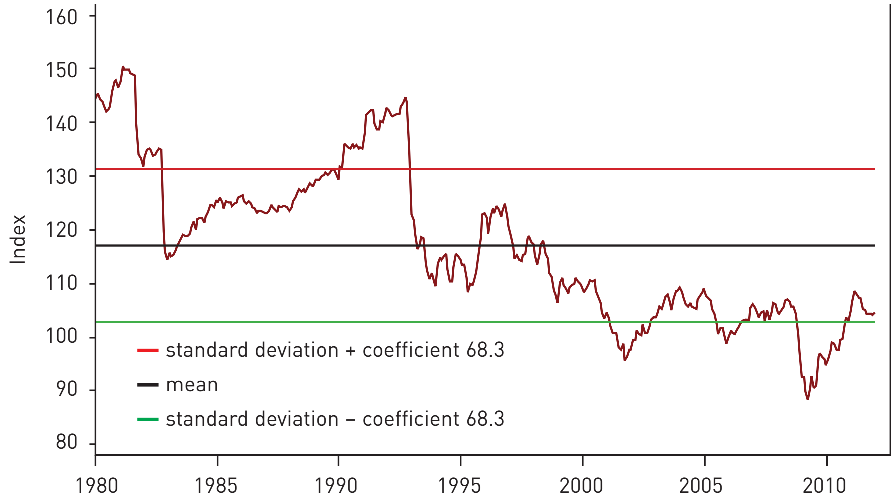
The budget rule became law, requiring the country to maintain a fiscal surplus over the business cycle. Sweden has also moved towards a much more flexible labour market. These changes have contributed to a cultural assumption that internal cost developments should be kept under control. Unit labour costs have been similar to those of Germany. The situation involving the manufacturing sector has been substantially more favourable even compared to that country. Consequently, based on disciplined public finances and sound internal cost developments Sweden has effected an internal devaluation.

SEB expects the Swedish central government debt-to-GDP ratio to decrease to and move below 30% by 2014 based on growth and a balanced budget. When ranking countries according to risk based on their debt profile, fiscal outlook and bank assets relative to GDP, Nordic countries offer investors exceptional low-risk value. In a recent report, BlackRock came to the same conclusion: it ranked Norway, Switzerland, Sweden and Finland the safest countries in which to invest. With continuous home grown debt problems in all G-4 countries interest in the Nordic model has grown. This 'third way' (an acronym first propounded by Anthony Giddens in the late nineties) may be characterised by: (i.) amongst the highest per capita wealth and greatest economic and social equality in the world; (ii.) a combination of productive capitalism and extensive welfare provision; and (iii.) an ambition to balance widespread collectivism with high levels of individual freedom. While private indebtedness has created some risks of further falls in house prices, authorities believe Sweden enjoys high levels of financial stability. The Nordic model is therefore widely regarded as creating a more sustainable society, one increasingly regarded as a safe place in which to invest.

A large current account surplus promotes attractive SEK-valuation

Foreigners are increasingly buying the attractive 'Nordic model' investment case. Regarding the balance of payments, net portfolio flows continue to be supportive for the SEK, showing a sizeable inflow (primarily fixed income) since 2009. Foreign investors now hold 45% of outstanding government bonds and recently they have increased their overall share of mortgage related bonds.

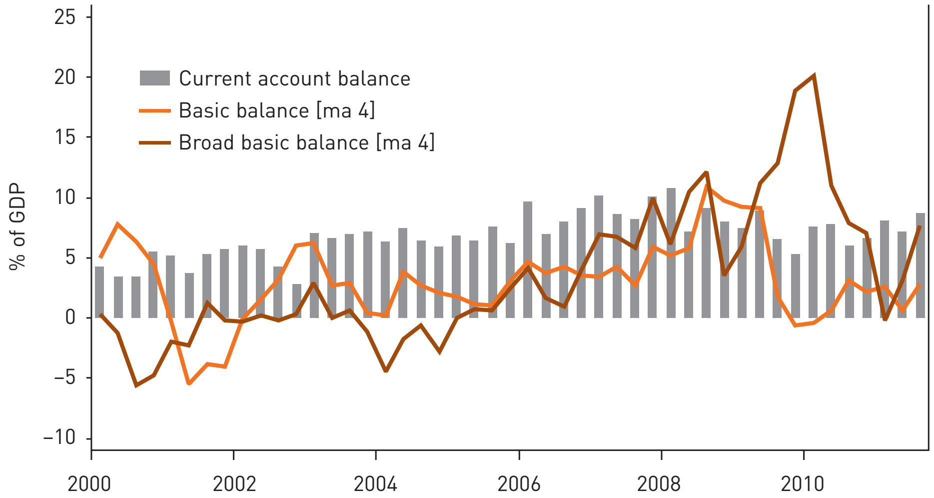
SEK, real effective exchange rate **Exhibit 4**



Source: Reuters EcoWin

Sweden, current account & portfolio flows

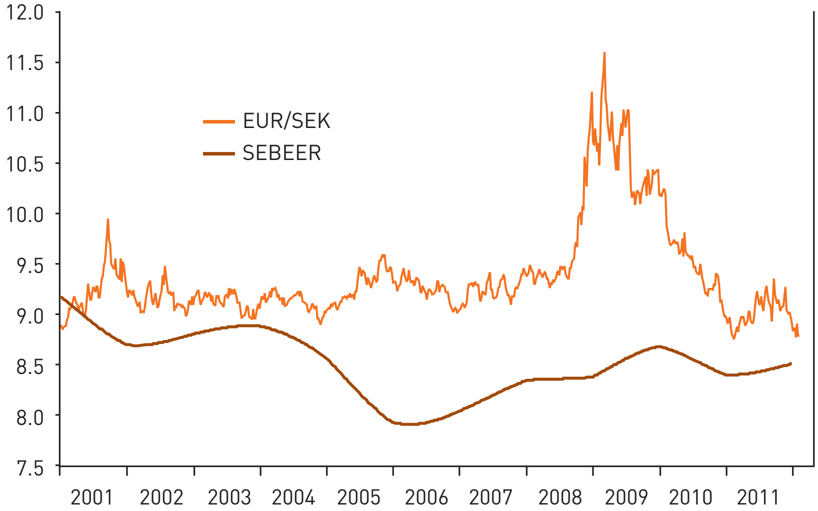
Exhibit 5



Source: SEB

EUR/SEK Fair Value (SEBEER)

Exhibit 6



Source: SEB

As regards to the equity market, foreigners own 38% of the OMX, up from 34% in 2009. In Q3 2011, the current account surplus increased to nearly 8% on an annualised basis, with the services industry accounting for 60% of the trade surplus. Slightly surprising still, official statistics still show Sweden's net international investment position as slightly negative. Over the past 17 years, Sweden has accumulated current account surpluses of close to 100% of GDP. Further, net investment income is also positive (2.5% of GDP) indicating that the country's claims on foreign assets should be positive at between 30%-70% of GDP, in line with other traditionally defensive currencies such as the JPY. This makes a case for SEK to take on more defensive characteristics as repatriation may drive the currency higher as risk sentiment deteriorates. Our long-term fair value model SEBEER puts EUR/SEK at a rate of 8.50 and USD/SEK at 7.00. We expect EUR/SEK to head toward and eventually move below our long-term fair value estimate. We do not exclude the possibility of a low towards 8.00 in the next 12 months-24 months (a level last traded in the year 2000).

Norway: NOK-appreciation despite superior fundamentals

SEB expects the Norwegian economy to continue to grow close to trend in coming years and forecasts mainland GDP growth of 2.3% in 2012 and 2.9% in 2013. While business and consumer barometers have been negatively affected by the deteriorating global growth outlook, the very strong oil sector investment cycle provides Norway with the extra demand impetus that European peers lack. Furthermore, real disposable income continues to increase substantially faster than most other Western countries (by 5.4% in 2011) although private consumption has softened somewhat in recent quarters. Consequently, the growth outlook remains very positive for the NOK.

Despite the strong outlook for (domestic) growth, Norges Bank is closely monitoring international developments including differences between its own interest rates and those of its main trading partners. Should Norwegian monetary policy deviate too much it would give rise to concerns that the NOK would appreciate more than a non-oil exporting country could tolerate. In addition and perhaps even more importantly for the Central Bank, the consequence of a strong currency will again be to create obstacles to achieving its inflation target. We regard the decision to cut borrowing costs by 50bps in December 2011 as a 'one-off'.

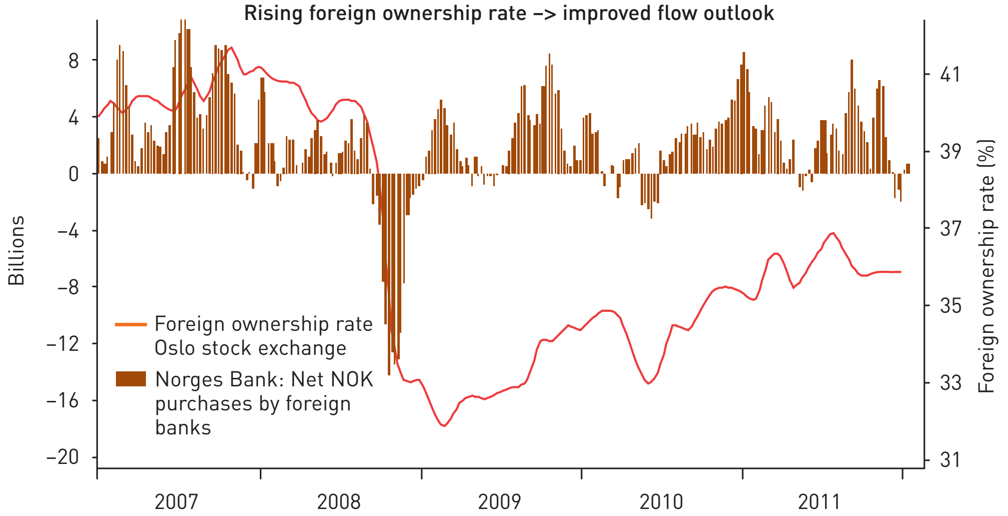
Going forward, strong domestic demand and a closed labour market gap accompanied by wage growth expected to exceed that of its competitors should encourage Norges Bank to normalise its monetary policy ahead of its counterparts. The neutral rate in Norway is 4.5%-5.0% and real interest rates well below normal, a situation unsustainable from a long-term perspective. Strong credit growth and rising house prices have also led the Central Bank to warn against domestic imbalances. Over time monetary policy will therefore provide more support for the NOK through the inevitable rising yield gap vs. the country's main trading partners.

Norway also enjoys a unique fiscal position, the envy of every other country in the Western world. The central government surplus hit NOK373bn in 2011, equal to 13.5% of GDP, more than NOK100bn above expectations at the beginning of 2011. Its 4% fiscal spending rule is another reason for Norway's superior peer-relative position; a total of 4% of the country's sovereign wealth fund (SWF) – Government Pension Fund Global (GPFG) assets under management ((AUM): NOK3055bn as of Q3 2011) – is spent every year. GPFG projections indicate AUM totaling NOK5866bn by 2020. With the fund expected to grow faster than the overall economy, *prima facie* the 4% rule would appear to have an even more expansionary effect on it. So far the rule has served to drive wage agreements for all sectors well above productivity growth and otherwise sustainable levels.

While talk of a 'Dutch disease' remains premature, the government is wary of maintaining an excessively strong currency. High unit labour cost developments have also forced Norges Bank to try to contain undue NOK appreciation with the real effective exchange rate (REER) which is expensive when deflated by related wage growth/Unit Labour Costs (ULC). Given continued strong wage inflation relative to its peers, Norway may need to

NOK: weekly FX flows and ownership rate

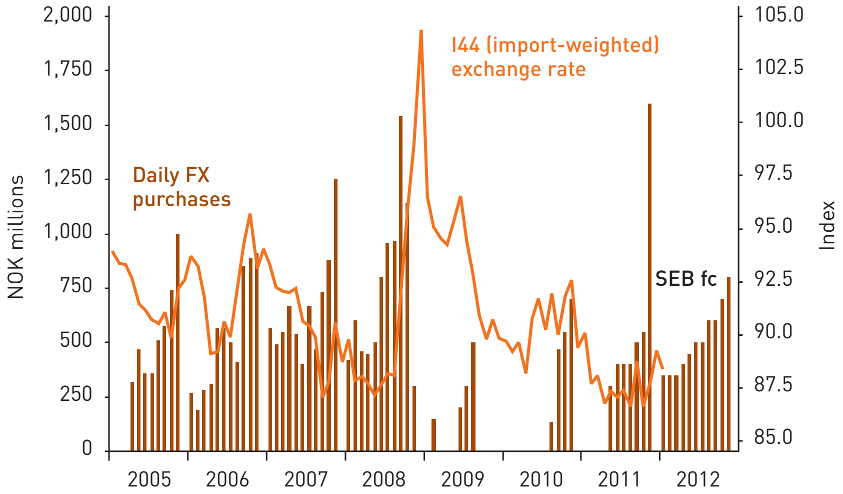
Exhibit 7



Source: SEB

GPFG and FX purchases

Exhibit 8



Source: SEB

modify or reduce its spending of oil revenues and maintain expenditure well below the 4% rule in years characterised by trend – or above-trend growth. Doing so would increase the contribution to the petroleum fund and represent a further negative flow for the NOK. Why? The set-up of the GPFG is often overlooked by foreigners – its aim is to neutralise the otherwise very positive basic balance for the NOK using petroleum revenues. In simple terms, this means that the budget surplus is transferred to the fund which then invests what it receives abroad. Consequently, the positive effect of petroleum revenues is almost neutralised as every month Norges Bank (excluding December) is selling NOK and buying FX on behalf of the GPFG. The Central Bank however first net out other FX-denominated revenues before purchasing FX. Flows are hence positive but less so than what many perceive them to be.

NOK not a true safe haven

Although Norway probably enjoys the strongest AAA-rating worldwide, its capital markets are simply too small to be an obvious large-scale destination for a major global reserve manager (1% of global FX turnover according to the Bank for International settlements (BIS)). For example, the size of the government bond market, albeit growing, is still only equivalent to 10% of mainland GDP. With no imminent solution to the eurozone debt crisis however, we expect flows to remain NOK-supportive.

In particular we expect the 'true' link between the oil price and the NOK and the foreign appetite for Norwegian (petroleum-related) equities to continue to increase from current 36.0% due to its low valuation and continued high oil price. In addition, we expect Norges Bank (on behalf of the GPFG) to sell NOK350m-NOK750m a day in 2012, well below the NOK1600m a day reported at the end of last year. Overall the flow picture concerning incoming foreign investment flows is positive for the NOK and with a trade-weighted currency still below the Central Bank's projections, EUR/NOK will continue lower in a gradual fashion over the coming year.