INVESTMENT RESEARCH REPORT

ABORTED LIFT OFF – THE NEVER INCREASED INTEREST RATE

”SWEDISH INFLATION AND THE RIKSBANK; BOTH SLIGHTLY DOVISH”

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SWEDISH INFLATION AND THE RIKSBANK; BOTH SLIGHTLY DOVISH

After two months of an increasingly volatile market and an October with the most negative performance since 2008, there is a demand for alternative investments to generate a return beyond the stock market. This analysis will further describe an approach to earn this return. Sweden is an archetypical open economy, and its export-oriented companies are doing well. There is no need to chase the arbitrary 2% inflation target blindly. The Central Bank Of Sweden (The Riksbank) has communicated a possible interest rate hike, either in December or in February, but there is still uncertainty regarding the rate´s development. According to the implied probability, a clear majority (78) % of the investors are optimistic and expect an increase in February. Only 7% believes in a hike in December. The prospect for the future is now more or less included in the market price. Through this, a potential strategy was created as an opportunity to gain on the incorrect market valuation. This analysis is based on several macro events and predicts that the interest rate will remain unchanged. The "already included" rate increase must be corrected, and so the bond yield should fall, the bond price increase. The ultimate execution strategy is to buy a call-option of a futures contract with the Swedish 2-year bond as the underlying asset. The profit would be the difference in the purchasing price and the selling price of the bond.

Analysts: Ofelia Aspemyr and Julia Hänström

- **October inflation disappoints, which nudges the likelihood of a rate hike a bit lower.** October CPIF inflation fell to 2.4%. The Riksbank's forecast of 2.5% has proven to be too optimistic. In a comparison between the Swedish inflation rate (SWCPYOY Index) and the Consumer Confidence Index (SWETCI Index), it is possible to see a consistent correlation between the two (see graph page 3). Higher consumer confidence often means increased consumer spending which creates inflation pressure in the economy. According to history, it is only a matter of time until the inflation decreases.

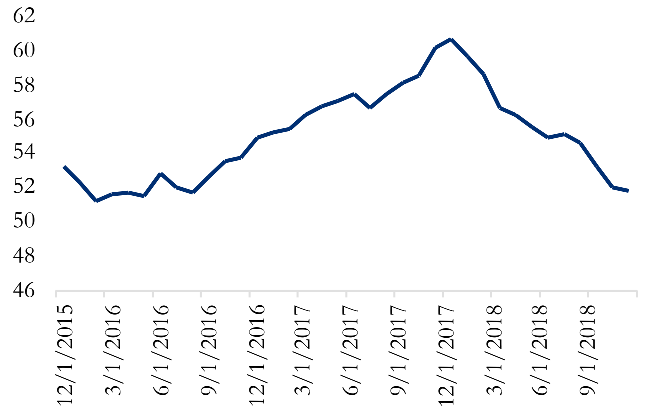
- **The Manufacturing PMI for trading partners are declining**. The Swedish economy is characterized by a knowledge-intensive and export-oriented manufacturing sector. Exports of goods and services are reported as almost 50 percent of GDP. Three-quarters of the premier trading partners exist in the Eurozone with Germany as the bigget trading partner. Therefore, Sweden is dependent on the development in Europe; a decreasing GDP could result in a reduced growth in Sweden. The purchase price index has declined in both Germany and the Eurozone since 2017 and hasn´t been this low since 5 years ago. As a result, the GDP and inflation are about to be affected. But it will also change the volumes of imports they can make. Leading to fewer exports from Sweden and accordingly to lower inflation and GDP.

- **Sweden's gross domestic product (GDP) decreased by 0.2 percent** in the third quarter, seasonally adjusted and in comparison with the second quarter of 2018. It was primarily household consumption that explained the decline. This indicates that economic growth is slowing down, which could lead to lower inflation. The krona is making Swedes poorer through damaging the purchasing power abroad, but not yet weak enough to change the game plan. A strengthen krona could hit the export-dependent Swedish economy particularly hard.

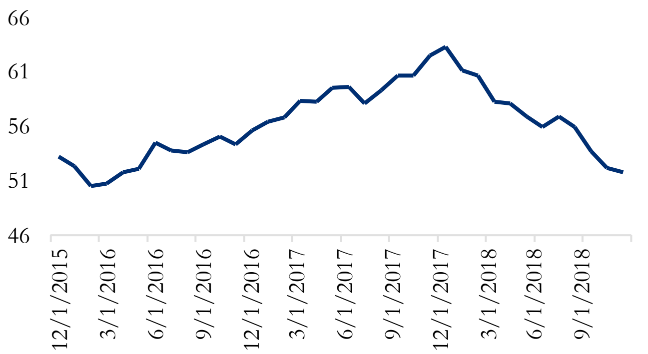
- **Household's indebtedness is sensitive to increasing interest rates**. Highly indebted households continue to poses to be a great risk for the Swedish economy. The debt itself is no reason for the Riksbank to not making the rate hike as currently planned. As private consumption has benefitted from the higher house prices the recent years, the housing market poses a risk for both growth and the inflation outlook. It can be judged as a disinflationary development and a sentiment for the unchanged rate.

SWEDEN INFLATION RATE (CPIF):

EUROZONE MANUFACTURING PMI:
(Index Value 50 = No change since previous month)



GERMANY MANUFACTURING PMI:
(Index Value 50 = No change since previous month)



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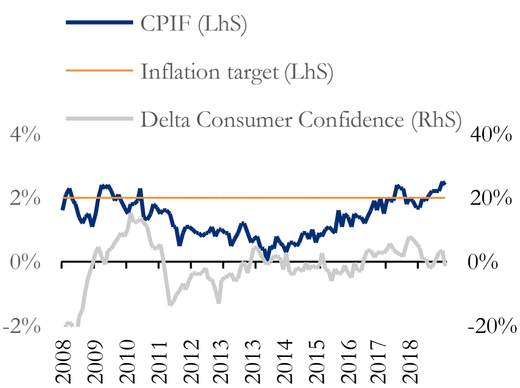
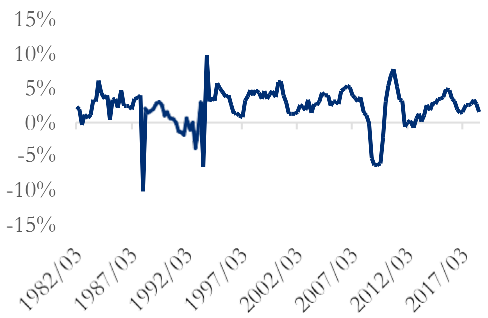
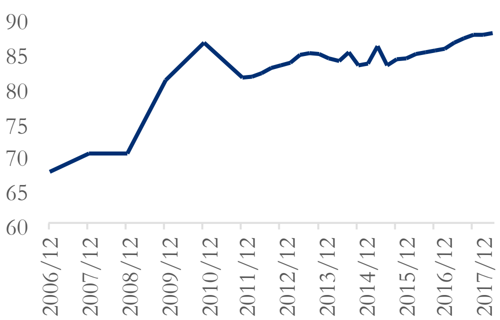
CPIF & CONSUMER CONFIDENCE INDEX:



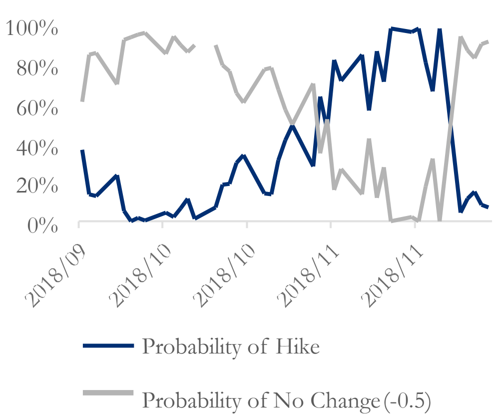
CHANGE IN GDP (%):



HOUSEHOLD DEBT/GDP (%):



MARKET'S EXPECTATION OF INTEREST RATE HIKE:



After a relatively strong September figure, Swedish inflation reverts to form. The October inflation fell below the Riksbank's target; the downside surprise is not large but continues to be weaker than expected by forecasters. This is the eight-month out of ten this year that the Riksbank's forecast turned out to be too optimistic and they have already cut their inflation forecasts several times. The inflation tends to follow the consumer confidence index with a delay. The last four years the consumer confidence index has been around the bar of the benchmark, even though the inflation continuously have increased. A consumer confidence below 100 (0 % in the graph) indicates a pessimistic attitude towards future developments. Higher consumer confidence normally means more household spending, which creates a higher inflationary pressure on the economy. As the graph shows, the consumer confidence index seems to decrease below 0 this year. However, according to history, it is only a matter of time until the inflation will decrease. A decrease in inflation leads to uncertainty among decision makers within the Central Bank that might wait to increase their interest rate – in fear of supporting an inflation below 2%. Germany is Sweden's biggest trading partner with a total trade of 46 503 million U.S. dollar, compared to the second biggest which is Denmark with 22 060 million U.S. dollar as the total trade. A decrease in Germany´s PMI will affect the country's GDP and inflation, and therefore the imports Germany can make. Sweden's exports will most certainly get affected negatively, and the GDP could decrease as well as the inflation.

Sweden's gross domestic product (GDP) decreased by 0.2 percent in the third quarter, seasonally adjusted and compared with the second quarter of 2018. It was primarily household consumption that explained the decline, but also inventories, and imports. This indicates that economic growth is slowing down, which could lead to a lower inflation. The GDP is often used to measure economic performance and is the market value of all final goods and services produced in a given period of time. A lower GDP indicates a slow economic growth and therefore a low inflation number in the future.

Household´s indebtedness is sensitive to increasing interest rates. As the graph shows, the household debt divided by GDP has increased sharply since a few years back. Household loans often have a floating rate and this rate is directly correlated with the interest rate, set by the Riksbank. Which means that it is highly affected by monetary decisions. With a larger amount of debt a possible rate hike becomes more precarious.

As a result of this analysis, based on several macro events and external factors, the Central Bank might not go through with their increase of the interest rate. The inflation could be about to decrease due to a lower consumer confidence, an unstable indebted housing market, a weak Swedish Krona and a decreasing economic growth in Europe. If the Central Bank chooses to stay with the interest rate at the current level, the expectations of a rate hike in February needs to be adjusted, which affects the 2-year Swedish Government Yield. This report suggests buying a call-option on a futures contract that has a 2-year government bond as the underlying asset, preferably with a maturity date of three months from now (March). Using a call-option decreases the downside risk of the position. The downside will be the amount paid for the premium, not the possible decrease in price in a scenario where the interest rates are increased. The upside will be the difference in the purchasing price and the selling price of the bond, less the premium payments. We have chosen the 2-year government bond, since it is short-term compared to the 10-year government bond, and therefore get affected to a higher extent by the Riksbank's monetary actions.

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