

FX Outlook 2018

Group Economics
Macro & Financial Markets
Research

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Norwegian krone to shine

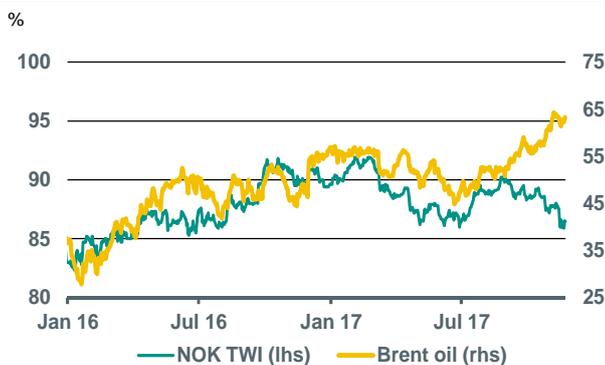
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- **A disconnect between oil prices and the krone in 2017...**
- **...because of the pricing out of rate hikes in 2018 and 2019**
- **We think that the market has overreacted and hikes in 2019 are likely**
- **Moreover, higher oil prices should support the krone...**
- **...although to a lesser extent than in the past**

The Norwegian krone has disconnected from oil prices in 2017

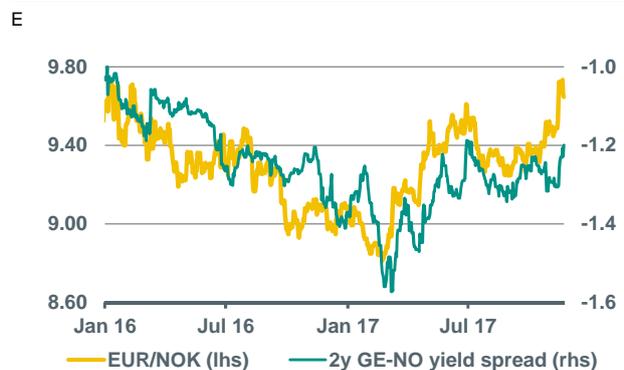
The Norwegian krone has dropped by 7% versus the euro so far this year. This despite an 11% rally in Brent oil prices. It is quite unusual that a rally in oil prices does not result in a higher krone because they have a tendency to move in tandem. There are several reasons for this. First, the euro has rallied strongly across the board because of the prospect of less accommodative monetary policy by the ECB, strong eurozone growth and lower eurozone political risks.

A disconnect between oil prices and the krone...



Source: Bloomberg, ABN AMRO Group Economics

...because of the pricing out of rate hikes in Norway



Source: Bloomberg, ABN AMRO Group Economics

Second, in recent years there has been a structural shift underway in the driving forces of the Norwegian economy. For example non-oil sectors and the housing sector have had a higher contribution. This structural shift will likely result in a lower sensitivity of the krone to oil price movements. However, a higher oil price should still be supportive for the krone but to a lesser extent than in the past. These higher oil prices have dampened the negative impact of the higher euro somewhat. In other words, the krone would have been much lower if oil prices had not risen.

Third, continued negative surprises in inflation numbers have resulted in a push out of expectations of higher official rates in Norway. In July last year CPI stood at 4.4% and CPI underlying at 3.7%, far above the Norges Bank inflation target of 2.5%. But since then inflation has dropped substantially to levels just above 1% now. Weakness in inflation is not isolated but broad-based. Because of low inflation, the Norges Bank is in no hurry to hike interest rates. Its forward guidance shows that official rates are unlikely to change in 2018.

Finally, house prices have recently dropped considerably (from a high level). This has resulted in fears that the housing bubble may have burst (as is the case for Sweden). What will 2018 and 2019 bring for the krone?

A rally of the krone in 2018 and in 2019

We expect the krone to rise in 2018 versus the euro. This is because financial markets have already pushed out their rate hike expectations for the Norges Bank to 2019. The shift in expectations has weighed on the krone in 2017. But it is unlikely that it will weigh on the krone again in 2018. We push out our expectations of Norges Bank rate hikes from 2018 to 2019. It is likely that the Norges Bank will hike interest rates before the ECB in 2019 and therefore the krone should rally in 2019.

A substantial rally in oil prices to USD 75 under our oil analyst expectation, should result in direct support for the Norwegian krone. The effect could be lower than in the past as the contribution of oil industry to Norwegian economic growth is lower. But with expectations on the monetary policy front already bearish, it is unlikely to dampen the effect of a higher oil price on the krone. In short, with the prospect of the Norges Bank hiking before the ECB and a higher oil price the krone should rally in 2018 and 2019 versus the euro.

What could spoil the party? A housing market crisis, a sharp deceleration in economic growth momentum and/or inflation remaining far below target. In these situations the Norges Bank will not start to normalise monetary policy in 2019.

Our NOK forecasts

New forecasts in red/bold

	01-Dec	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19	Q4 19
EUR/USD new	1.1913	1.18	1.17	1.16	1.15	1.18	1.20	1.23	1.25
EUR/USD old		1.15	1.17	1.20	1.30				
EUR/NOK new	9.8960	9.50	9.40	9.30	9.20	9.00	8.80	8.60	8.40
EUR/NOK old		9.00	8.75	8.50	8.50				
USD/NOK new	8.3068	8.05	8.03	8.02	8.00	7.63	7.33	6.99	6.72
USD/NOK old		7.38	7.00	6.69	6.54				

Source: ABN AMRO Group Economics

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