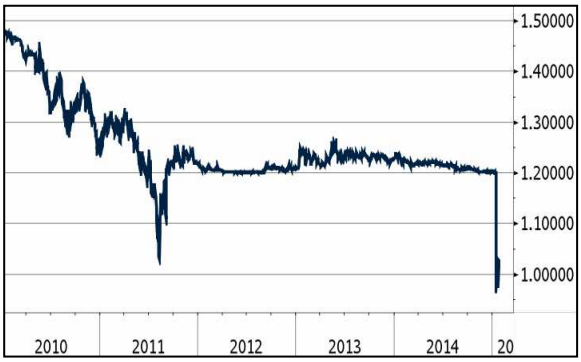
# Flash

## Swiss stocks to move with the exchange rate

**The SNB has continued to intervene in forex markets even after abandoning its 1.20 floor for the franc against the euro. In so doing, the central bank is pursuing the objectives outlined in its constitution. The course of the Swiss franc, and with it the need for, and extent of, further action by the SNB, will depend on developments in the Eurozone and the US. Following the removal of the floor the Swiss equity market is now highly dependent on the behavior of the Swiss franc. Because we believe that the franc will weaken over the medium term and also that, with now even lower interest rates, Swiss equities have the potential to be rerated by the market, we have adjusted our investment strategy and have moved exposure to Swiss equities from underweight to overweight.**

***Despite removing its floor the SNB still has a duty to act.***

**EUR-CHF since 2010**




The SNB introduced the 1.20 floor for the franc against the euro on Sep.6, 2011 and removed it on Jan 15, 2015. The market reacted violently. Within 2 days the SMI fell 14%, while the euro and the dollar lost 20% and 17% respectively against the franc. The situation has since become calmer, with the central bank helping in this process. Based on data for sight deposits of the commercial banks with the SNB, one can infer that the SNB has continued to be active in the forex markets after removing the floor. In this, the central bank is following its constitutional mandate. The bank must act to support the economy as a whole. Although price stability is its primary objective, the ultimate purpose is to promote sustained economic growth.

***What happens in Switzerland will depend on what happens in the Eurozone and the US.***

Whether the SNB needs to continue to intervene, in order to prevent irreversible damage to the economy, will depend on developments in the Eurozone and in the US. The Eurozone is beset increasingly by political forces which aim for its disintegration. Markets have not reacted dramatically to the recent Greek election result because investors think that the realities of government may force the new administration to alter some of its pre-election rhetoric. It won't be long before we discover whether this assumption is correct. The upcoming elections in Finland, the UK and Spain could also prove explosive and may lead to higher volatility in the financial markets. That said, while these political events may turn out to be stumbling blocks for the Eurozone from a political perspective, there are some positive developments on the economic front. The now weaker euro, together with lower oil prices, could boost the Eurozone, and particularly the German economy, by more than expected. This could remove some of the upward pressure on the Swiss franc. So far as the US is concerned, we believe that, if that economy grows as expected, the Fed will raise interest rates in the middle of the year, rather than waiting until year-end, as is more generally expected. A mid-year move by the Fed is therefore not the market's "best guess" and, should it happen, the dollar might rise, also removing upward pressure on the franc.

***In situations of crisis the SNB will sometimes need to make awkward compromises.***

Should the Eurozone slip into its fourth crisis since 2010 or the Fed decide that the outlook for the US economy is not robust enough to withstand a rise in interest rates, upward pressure on the Swiss franc would likely increase. The SNB could then quickly find itself in a situation similar to that on the 15th of January when it was obliged to abandon its floor. We assume that there are limits to the extent to which the SNB can amass foreign currencies on its balance sheet and therefore the central bank may have to rely on other ways to avoid an appreciation of the franc such as would cause severe damage to the Swiss economy. Much higher negative rates of interest, capital flow controls, differing exchange rates for trade and "financial" flows or even a new currency link are all possibilities. In troubled times, the SNB must be prepared to get its hands dirty and, if need be, resort like the other central banks to policies of market manipulation and financial repression.

***In spite of the uncertainties, we think the Swiss franc will decline over the medium-term.***

According to the ZKB, profits of companies represented in the SMI will be 11.5% lower than otherwise this year on an index-weighted basis as a result of the removal of the 1.20 floor. This estimate assumes average exchange rates in 2015 of 1.05 and 0.95 for the franc against the euro and the dollar respectively. On this basis, the reaction of the Swiss stock market to the impact of the SNB's move on Swiss corporate earnings has been appropriate. We have therefore decided to increase our exposure to Swiss equities back to original levels. This decision reflects the high quality of companies represented in the Swiss stock market and also the attractive dividend yields they offer. With no currency floor, the Swiss stock market should now move, at least partially, in line with the exchange rate for the franc. This is essentially good news as we believe, on several grounds, that the franc will depreciate over the medium term. Purchasing power parity with the euro is estimated in the range CHF1.10 -1.30. Moreover, the recent decline in Swiss interest rates implies that a higher risk premium is now embedded into Swiss equities. This suggests scope for higher valuations due to earnings multiple expansion.

***Within our equity exposure we now overweight Swiss equities.***

On this basis, and on the assumption that the Bilateral 1 agreement with the EU will remain in place, we have moved Swiss equities from underweight to overweight within our overall equity quota. However, we are aware that the path to above-average returns from the Swiss equity market may be bumpy, not least because of potential turbulence in the forex markets.

Aquila & Co. AG, 28. January 2015