AQUILA

Flash

The SNB needs to reinstate some currency link to stabilize the franc

Since January 15 2015 the Swiss franc has averaged 1.0450 against the euro. Already in the first quarter, when GDP fell slightly, the Swiss economy started to feel the effects of the SNB's decision to do away with its currency floor versus the euro. This negative impact on demand will intensify in coming months. It is therefore all the more regrettable that the Swiss political process seems unable to reduce, as promised, the administrative and regulatory burdens which hamper the economy. Despite relatively calm markets, the SNB has had to spend billions of francs since mid-January buying foreign currencies in order to stem the rise of the franc. The SNB needs to establish clarity in how it deals with the markets. We believe it should peg the franc to a basket of foreign currencies before the onset of a fresh market crisis that would fuel demand for the franc. For the time being we are retaining our currency hedges. This is because the SNB is unlikely to act before violent currency fluctuations create an acute need to do so

In panic trading on January 15th, the Euro traded down to 85 rappen.

On January 15th 2015 the SNB abandoned its floor for the franc against the euro. In panic trading immediately thereafter the euro traded down to 85 rappen by 11am before rising to just below parity at the market close on that day. By mid-February the rate had risen to 1.08 but it has since fallen steadily – to about 1.03 now. The average rate since January 15th is 1.0450.

We don't share the optimistic view of others concerning the Swiss economy.

Since January 15th various economic experts have been outbidding one another with their forecasts for Swiss economic growth. The most pessimistic view now comes from the ETH's KOF group, with a projection of -0.5% for 2015. BAK in Basel on the other hand estimates growth at +1% for this year. Latest data indicate a small sequential shrinkage (-0.2%) in the economy in the first quarter. This is a worse outturn than on average predicted by the economists. Not surprisingly, exports fell. Revenues in the retail and hotel sectors also declined, with no offsetting positive impulse coming from the industrial sector. It is worth noting that industry's order books were still relatively full in the first quarter. Moreover, strategic decisions – such as relocating activities abroad – will take time to have their full negative impact on demand. Thus we are unable to share the general optimism on Swiss growth prospects – not least because forecasts tend to assume a rate for the franc against the euro around 1.10.

The promises of politicians to support the economy have come to nothing.

Generous promises from the politicians to help the economy by doing away with administrative and regulatory hurdles and through the implementation of confidence-building economic policies seem unlikely to amount to much. Berne prefers to discuss the tax privileges of domestic distillers when revising the laws governing alcohol or to vote, as happened in the Nationalrat, to do away with the Cassis de Dijon principle. Swiss politics is a tale of constantly shifting alliances, which prevent a clear majority from forming which in turn might foster consistent policy making. We don't see much chance of liberal, market-oriented support for the economy being delivered by the politicians.

Despite relatively calm markets the SNB has had to spend billions buying foreign currencies in recent months.

Since January 16th commercial bank sight deposits with the SNB have risen from CHF 402bn. to CHF454bn. Even though there isn't a one-to-one relationship between these sight deposits and SNB interventions in forex markets, we believe the sight deposit data indicate that the SNB has had to intervene significantly since mid-January in order to limit the appreciation of the Swiss franc. The ongoing disputes with Greece notwithstanding, the Eurozone has been relatively stable in recent months. Thus one might deduce that, in the event of a fourth Eurozone crisis, the Swiss franc will once again come under significant upward pressure.

The SNB should tie the franc to a basket of currencies.

According to its constitutional mandate the SNB must act in the overall interest of Switzerland. Thus it is obliged to act if a rising franc poses a severe threat to an important part of the economy. However, its scope for action is limited. For example, more negative interest rates would probably have to be combined with drastic restrictions on cash withdrawals or on cash holdings. Capital controls are difficult to implement given the complexity of today's capital markets with their countless derivative instruments. The same objection also applies to ideas such as having a two-tier franc – one relating to financial markets and a second, lower valued franc for the industrial sector. Beyond such measures there is intervention. But recent history shows SNB interventions may need to be very extensive – e.g. hundreds of millions of francs within a short time – to have even a short-term effect. Should the franc once again come under strong upward pressure, as is quite likely, then the balance sheet of the SNB will need to expand rapidly. Thus we think it desirable that, before the next crisis erupts, the SNB should act to bind the franc to foreign currencies, for example via a basket mechanism. Were this to happen the SNB's position would be strengthened in that, by presenting a clear strategy, it would be better placed to avoid being sucked into a cat and mouse game with the speculators.

We are keeping our currency hedges in place for now.

We are retaining for now the currency hedges that we put in place for Swiss franc-oriented clients on January 13th. Any future currency floor will probably not be introduced by the SNB without a strong requirement to do so. Any future currency floor is unlikely be introduced by the SNB without a strong requirement to do so, most probably in the context of a marked increase in currency volatility.

Aquila & Co. AG, 1. June 2015