AQUILA

Flash

The Swiss Franc

Since the middle of July the Swiss franc has been on a weakening trend. On September 11 it was above 1.10 to the euro for the first time since the Swiss National Bank abandoned its "floor" for the franc in the middle of January. But macro data – Switzerland's positive trade surplus and very strong current account surplus as well as Swiss inflation trends – don't point to currency weakness. Possible explanations for the weaker franc include forex purchases by the SNB, the fact that the franc still trades well above purchasing power parity, interest rate differentials and, importantly, the creeping erosion of Switzerland's advantages as a place to keep assets. As a weakening Swiss franc could be the harbinger of an even weaker euro, we are keeping our euro hedges in place. Our US dollar exposure, however, remains unhedged.

For the first time since January 15 2015 the Swiss franc trades above 1.10 to the euro.

The franc appreciated – to 97.5 rappen per euro – immediately after the SNB abandoned its floor against the euro on January 15. Thereafter the franc weakened, falling back to 1.08 against the euro by end-February. A strengthening trend then developed which lasted until mid-July since when the franc has steadily lost ground. On September 11 the franc rose above 1.10 to the euro for the first time since the SNB abandoned its floor. The current phase of weakness is remarkable because periods of stock market weakness, and the resulting heightened market volatilities, have tended to be associated with an appreciating trend for the Swiss franc.

Switzerland's healthy trade surplus rather suggests the franc should be strengthening.

Trade data are an obvious place to look if one is seeking explanations for the weaker franc. But one can note that the Swiss trade surplus, after falling slightly in the first quarter, has risen since and that the CHF 2.9bn. surplus reported for August lies well above the 10-year monthly average. Similarly, the CHF17.6 bn. current account surplus reported for the second quarter is well above the long-term average. Thus trade and current account data would suggest a strengthening franc rather than a weakening one. Swiss inflation data – which show much lower inflation pressures than in the Eurozone – also point in the same direction.

Over the last 12 weeks the SNB has continued to sell francs for foreign currencies.

The SNB's forex transactions are another potential influence on the course of the franc. The extent of these transactions can be inferred from the data for commercial sight deposits with the central bank which show a rise from CHF 456bn at the end of June to CHF 465 bn. Although this indicates forex purchases by the central bank, the scale of these purchases – just CHF 9bn. – is too small to be a significant factor driving the value of the Swiss franc.

Over the medium term the erosion of Switzerland's advantages as a place to keep assets may well lead to a weaker franc.

Swiss purchasing power parity should also be considered when analyzing the performance of the franc. Most estimates put the franc's purchasing power parity against the euro between 1.15 and 1.35. This is a wide band but one implication is clear – the franc is still probably overvalued and this might help to explain its current weakness. Interest rate differentials – which are linked to the minus 0.75% interest rate set by the SNB – also suggest a weakening franc. But over the medium term, a more important factor is probably the shift in investor sentiment

whereby Switzerland is losing its appeal as a particularly attractive place to keep assets. Our country is, indeed, losing its advantages. The political decision not to defend but to give up Swiss banking secrecy has seriously damaged Switzerland's reputation for having a stable legal system. Moreover, Switzerland lacks a strategy in its dealings with the EU. Swiss voters chose to limit immigration in a referendum 18 months ago but the implementation of the voters' decision is still vague. It seems increasingly probable that the decision of the Swiss people implies that Switzerland will have to break the terms of its Bilateral 1 agreement with the EU. Moreover, the effects of Unternehmenssteuerreform III – the Swiss response to international pressure to alter its corporate tax arrangements – are unclear at a time when new OECD rules for taxing international firms have recently been approved. Thus Switzerland finds itself in the awkward position of having to comply with rules dictated by the major economic powers. Such a position demands a strong political response and this is lacking. The market is probably right in judging that Switzerland is being forced down the path of surrendering her historic advantages. This is probably the best explanation for the Swiss franc's weakness.

A weaker Swiss franc might be the harbinger of a weaker euro.

While these considerations suggest that the franc has further to fall, this is by no means certain. Although the Eurozone looks to be in better shape than it was in 2011 and 2012, much of this perceived improvement is superficial. The real problems remain what they were three or four years ago. The current refugee crisis shows yet again how difficult it is for Brussels to coordinate an EU-wide policy response to complex issues. The result is that member states act unilaterally, sacrificing achievements such as open borders and the free movement of labor. The EU's obvious shortcomings support those who are arguing for a British exit. The upcoming UK referendum on continuing EU membership is set to increase EU tensions. Moreover, the debt dynamic in the Eurozone remains negative – i.e. public sector debts are growing as a proportion of GDP. Structural reform – especially in France – seems to be essentially cosmetic and, indeed, Germany has taken a backward step since the 2013 Federal elections, reducing the retirement age for some workers to 63. Northern Europe still resents the transfer payments it makes to the South – as the latest dispute over bank deposit insurance indicates. Although the EU has made progress in recent years, setting up a banking union and the ESM stability mechanism, we think that investors could quite quickly switch back to questioning once again the fundamental structures underpinning the euro.

We are keeping our euro hedges in place but are not hedging our US dollar exposure.

Given these considerations, we still think it appropriate to hedge euro exposure in portfolios back into Swiss francs, especially in the area of bonds. But, as we think the tendency for a weaker Swiss franc remains in place, we are keeping our US dollar exposure unhedged.

Aquila & Co. AG, 25. September 2015