



Market Views January 2015

The SNB removes the Swiss Franc Cap versus the Euro

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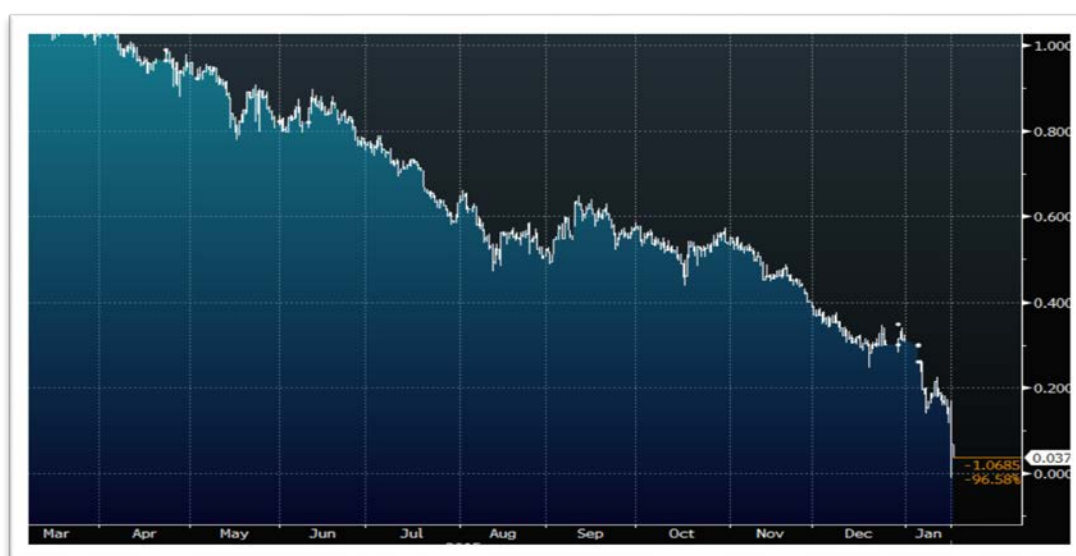
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The Swiss National Bank (SNB) this morning removed the Swiss Franc cap which it had in place since August 2011. The initial reaction was a strengthening of the Swiss franc by over 35% versus the Euro. After a few hours, the level stabilised at 15%. The SNB believes that it is no more necessary to have a fixed cap because:

- There is no longer a crisis in Europe as there was at the time the cap was initiated. The SNB therefore believes that the Swiss Franc should no longer be pressured by investors seeking a safe haven.
- The Swiss economy has had three years to adjust to the 1.20 level and has coped well.

The Swiss Franc is still overvalued and should have an exchange rate of 1.28 to the Euro under present macro economic conditions according to most economists. The SNB has stated that they will still remain active in the Foreign exchange markets and do what is necessary to fulfil their mandate of price stability.

We believe that if there is indeed no further crisis globally but especially in Europe, the Swiss Franc will gradually weaken. The SNB has implemented negative deposit rates of -0.75% to dissuade flows into Swiss Francs. The 10 year yield on the Swiss government bonds (below- source Bloomberg) has reached an historic low of 0.038% from over 1% less than one year ago. This means that after transaction costs an investor would achieve a negative rate of return every year over a period of ten



years! In an environment in which there is no crisis in the world it makes little sense for an investor to accept these terms. For periods of less than 10 years the rate of return would be even worse. For example the 5 year rate is -0.57% before costs! In our opinion these hard facts are probably going to lead people to realise that it would be quiet attractive to borrow in Swiss Francs and invest in bonds of currencies offering higher interest rates.

In the past under similar circumstances, the USD and the Japanese Yen have been used in this manner by investors as funding currencies. In 2009 during the US crisis, interest rates were rapidly decreased towards zero and the USD dollar weakened as investors and speculators borrowed in USD and invested in other higher yielding currencies like the Euro. The Yen was used for more than a

decade before the crisis as a funding currency due to its low interest rate. We believe that this is very likely to happen to the Swiss Franc over the course of the next few years. Central banks in the US, UK, Canada and Norway are considering initial rate increases this year. Bonds of all these countries already yield between 1 and 2% more than the Swiss Franc and the spreads should become more attractive as the year progresses. Additionally, due to the improved economic conditions in the US, UK, Canada and Australia, their currencies should start to appreciate versus the Swiss Franc as well. This would be a big plus for investors borrowing in CHF and investing in other currencies as they would gain on the higher interest rates and the foreign exchange appreciation. If this movement takes hold, just the fact that investors borrow in Swiss Francs and then invest in other currencies should cause the Swiss Franc to depreciate.

As far as the Euro is concerned, due to the fact that Mr. Draghi is one of the few central bankers in the process of easing monetary conditions substantially, it is expected that European growth will finally pick up this year. The weaker Euro, lower oil prices and low interest rates are a perfect combination for growth.

- The weaker Euro makes exports from the Eurozone more competitive.
- The lower oil price shrinks energy bills for companies and consumers, leaving more room for investment and spending.
- The low interest rate environment makes borrowing to invest more attractive as projects become profitable at much lower rates of return.

Therefore, we believe that during the course of this year as the general picture relating to European growth improves from very depressed levels, the Euro will also strengthen gradually. The Euro may not strengthen as much as the other currencies but we believe that some stabilisation will be achieved. The danger in the short term is that Mr. Draghi announces measures that are even more aggressive than the markets are expecting next week. The knee jerk reaction could very well be further Euro weakness. However, we do not expect this to be a long lasting downward move. If Mr. Draghi's announcements turn out to be in line with what the market is expecting and not more aggressive, then it is possible that the Euro even strengthens slightly. The Euro has fallen from 1.4 to the dollar to 1.16 at present; that is a move of over 17% in less than nine months. Many believe that this initial move has gone too far and that a reversal of about 5% is likely if Mr. Draghi does not surprise markets next week.

As all of these moves are based on announcements and emotional reactions more than any estimation of value, they are very hard to predict. In a survey late last year, every economist expected the 1.20 cap to be maintained. The SNB itself emphatically defended the cap just one month ago and has now completely changed course. This move just one month later, though it might be based on the right premises, has damaged the credibility of the SNB and this will not be easy to restore. Therefore, we believe that market forces and not interventions will have to be relied upon if the Swiss Franc is to weaken. This should turn out to be a healthier route in the medium term.

Gillian Hollenstein