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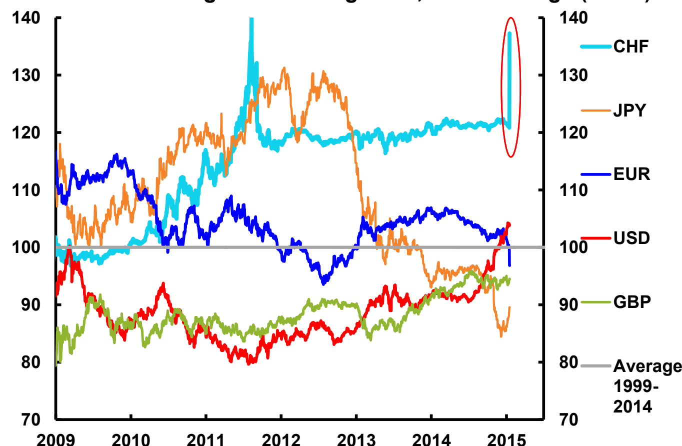
Bold action by the SNB to de-peg the Swiss franc

Yet mind the collateral damages to the Swiss economy

The Swiss National Bank (SNB) removed the ceiling to the Swiss Franc against the euro on 15 January 2015 in a move that we think anticipates the ECB QE. The SNB also cut by 50bps its target for the 3M Libor rate to -0.75% (mid-range). The Franc (CHF) appreciated sharply against the euro (EUR) and the dollar (USD) (circ. +15%). This is likely to have negative implications for the Swiss economy, dragging it into economic stagnation and endanger the country's fight against deflation. The SNB may have to enact further policy loosening and ad hoc currency intervention over the coming year. However, there are likely broader financial ramifications. The Swiss authorities have purchased large amounts of foreign sovereign bonds in recent years, but future purchases can no longer be taken for granted. There is a risk that these currency convulsions provide an unwanted shock for the financial sector and add to financial volatility.

The SNB monetary policy meeting surprised, announcing it would cease maintaining a floor to the EUR/CHF exchange rate at 1.20 and that it would lower its LIBOR range by 50bps to -1.25% to -0.25%. With the ceiling to the Swiss Franc removed, the currency appreciated sharply. The SNB said that the exchange rate floor was a transitional policy to allow the economy to adapt to an appreciating currency. We think it is more likely related to an expected "more pronounced" divergence of international policy – the impending ECB QE.

SNB decision triggered a 14% rise of the CHF



Source: Bank of England and AXA IM Research

More specifically, we think that the SNB considers that the downside risk to EUR/USD is significant, with the possibility of parity reached before year end. This would have damaged the attractiveness of Switzerland as a financial safe haven for savers from the wider dollar zone, had the CHF/EUR peg been upheld. By removing the floor, the SNB re-establishes the CHF as a hedge against FX risks for overseas savers even if it comes at a hefty, but known, price, in the form of negative deposit rates. Why would the SNB anticipate a further depreciation of the euro? In our view, SNB decision makers are anticipating that the ECB will go for a large scale quantitative strategy, that this will be announced next week and might be only the beginning of a long expansion of the ECB's balance sheet. That the opinion of the Advocate General of the European Court of Justice on Outright Monetary Transactions was unambiguously supportive of the ECB's strategy may have accelerated the SNB decision.

In other words, we believe that the SNB is considering that, while a large depreciation of the EUR against the USD might be in the interest of euro area economies, a large depreciation of the CHF would be at odds with one of the basic comparative advantage of the Swiss economy, namely its special and historical safe haven status.

For Switzerland, stagnation or recession, deflation and zero yields for bonds

The Swiss economy is an open, globally interconnected, economy and as such the sharp appreciation in the currency threatens a contraction in economic activity. The IMF had forecast growth of 1.5% for 2015 but an appreciation of the

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currency in excess of 10% is likely to turn this expected expansion into stagnation, possibly recession. This move will also deepen deflation –the current inflation rate is -0.3%- in the coming months. This further reduction of the negative interest rate also threatens to increase the pressure on Swiss commercial banks. The SNB has anticipated some of this and reduced its target LIBOR policy range by 50bps to provide some offsetting stimulus. However, we expect the SNB to have to go further with unconventional policy easing over the coming year and to undertake ad hoc FX intervention.

As for the Swiss yield curve, market action has already seen the 10Y yield falling to zero. Assuming that the SNB will anchor the 3M Libor rate at -0.75% or even lower in the next several years, we would expect 5Y yields to remain negative over the next couple of years and 10Y yields to stay close to zero this year before rising only gradually in the coming years. However, this is totally uncharted territory and there are other plausible scenarios, if negative interest rates proved more damaging than expected for the Swiss economy.

Turning to equities, the sharp appreciation of the franc will reduce the value of Swiss companies' overseas earnings and, at the margin, dent their competiveness in global markets. Large Swiss pharmaceutical companies should be particularly hurt in terms of earnings per share in CHF, which might be 10% to 20% lower than previously expected. Overall, we are keeping our 'underweight' recommendation on Swiss equities.

On the positive side, yet lower Swiss rates may attract more CHF issuance, improving the depth of the CHF credit market. Furthermore, lower all-in corporate yields may help the recapitalisation plans of Swiss banks by reducing the cost of regulatory capital issuance. Swiss corporates, while impacted by the appreciation of the Franc, should benefit from lower borrowing cost.

Broader ramifications: less capital flows into the euro area, higher volatility

Recession in the Swiss economy may have a modest direct effect on its close trade partners, not on the global economy, to which Switzerland contributes for 0.4% on a purchasing power basis. Yet, this is not good news for weak partners such as Italy, France or Austria.

The removal of FX intervention could reduce inflows into key bond markets. Based on SNB accounts, our calculations suggest SNB holdings in the order of USD125bn US Treasuries and around USD200bn of euro area government bonds (including two-thirds AAA and one-third AA). That said, SNB sight deposit data suggest the SNB undertook little intervention across 2014, and so added little to the broad appreciation in bonds across 2014. However, insofar as the SNB might previously have been expected to buy increasing numbers of government bonds in 2015 to offset the impact of an expected ECB-QE related weaker euro, this is now unlikely to be the case.

We also note that this sharp appreciation in the currency is likely to have resulted in significant financial sector losses.

As a reminder, here are our expectations for next Thursday ECB's announcements:

The ECB is likely to announce a large-scale asset purchase programme, over and above the current covered bonds and ABS programmes. We expect this programme to include government debt, supranational debt and investment grade corporate credit. It could possibly be extended to high-yield corporate debt and equities.

The size of the programme that could enable the ECB to reach its balance sheet target is USD500-600bn. But the central bank may surprise markets by deciding on a larger size, as a way to show its determination to bring inflation expectations closer to target.

As regards public debt, the most likely is for purchases to be made along the capital keys. The ECB could also set a limit in terms of the share of outstanding amounts to be purchased. A decision to let national central banks make purchases instead of the ECB itself would likely be perceived negatively by markets, especially after the positive opinion issued by the European Court of Justice's Advocate General on Wednesday 14 January.

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