

# A shock from the Swiss Central Bank

Pictet Asset Management | January 2015

For professional investors only



The SNB's unexpected removal of the CHF peg to the EUR sent the CHF sharply higher; Swiss stocks plunged and bond yields fell deeper into negative territory.

The SNB acted ahead of the likely implementation of full blown QE by the ECB next week, deeming the currency cap unsustainable.

The move is negative for the Swiss economy, domestic stocks and central bank credibility; it may lead to increased volatility across financial markets.

*The Swiss National Bank scrapped its CHF/EUR currency peg on Thursday in an unexpected move that roiled financial markets. Here, we explain what may have been behind the move and its implications.*

## What did the Swiss National Bank do and what was the reaction in the financial markets?

The SNB yesterday abandoned the CHF's exchange rate peg against the EUR, which had been set at EUR1.20 since September 2011. The CHF rallied sharply in response to the move, gaining as much as 40 per cent against the EUR at one point, and hitting its highest level against the USD in three years. Such volatility is extremely rare in G-10 currencies.

On the same day, Swiss stocks lost some 10 per cent in local currency terms while Swiss bond yields fell further into negative territory. Swiss government bonds now offer negative yields right up to the 10-year segment of the curve.

The currencies of countries with private sector liabilities denominated in the CHF – such as Poland and Hungary – also fell.

## Why was the peg introduced in the first place?

The peg was introduced to prevent the currency rising to a point at which it would endanger the Swiss economy's recovery. At the time in 2011, the CHF was trading close to parity with the EUR which, by our calculations, was almost four standard deviations above its fair value.

The currency peg was also a response to the growing threat of deflation within Switzerland.

## Why did the SNB abandon it?

In explaining its decision, the SNB said it "was able to take advantage of this phase to adjust to the new situation", arguing that the CHF was no longer excessively overvalued.

Yet with Swiss inflation running at minus 0.3 per cent – well below the SNB's target – there were clearly other factors behind the policy move.

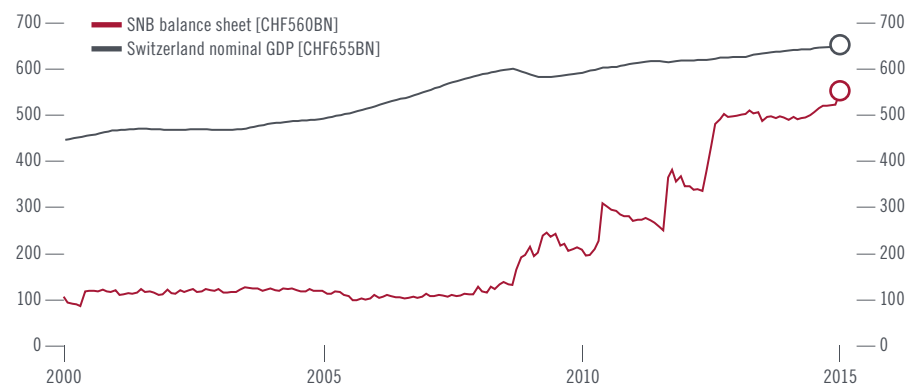
The SNB was obviously concerned that full-blown quantitative easing from the European Central Bank – likely to be announced at its January 22 meeting – would weaken the EUR further and threaten the CHF peg. This could have forced the central bank to print more money to keep the currency within its peg and consequently expand its balance sheet by far more than it was comfortable with.

Since 2011, its balance sheet has expanded by almost 250 per cent to CHF525 billion.

It is worth noting that the SNB had been buying short-dated French and German government bonds since December, having acquired around CHF27.5 billion. In purchasing at that pace and at that maturity, it would soon have run out of bonds to buy: the prospect of shifting along the yield curve and credit spectrum may

have been too unpalatable. Therefore, the SNB probably calculated that the cost and risk of maintaining a peg against the a EUR that would be in free-fall post-QE would be too great to bear.

#### THE SWISS BALANCE SHEET HAS EXPANDED TO 85% OF THE COUNTRY'S GDP



Source: Thomson Reuters Datastream, Pictet Asset Management

### What the SNB's move means for:

#### a) The Swiss economy and Swiss companies

Recession is now likely. By our calculations, a 5 per cent rise in the CHF's trade-weighted value is equivalent to a 100 basis point interest rate rise. Should the CHF hold at this higher level, we expect output in the export-dependent economy to contract by some 2 to 3 per cent this year and unemployment to climb by as much as 2 percentage points. Seen in this light, the SNB threatens to deliver a deflationary shock to the Swiss economy. Under a worst-case scenario, it is reasonable to expect to see some Swiss companies consider relocating their production facilities outside the country and others engage in a wholesale restructuring of their operations. In aggregate, companies in Switzerland's SMI Index generate almost 90 per cent of their sales outside their home country.

The SNB's move to push deposit rates further into negative territory, meanwhile, is unlikely to mitigate the negative effects of CHF strength. Because the negative 0.75 per cent rate does not apply to the country's biggest banks, lending is unlikely to grow, particularly at a time when demand for credit is weak. What is more, the policy could prompt deposit holders to shift their cash from small to large banks, which may increase systemic risks.

#### b) The outlook for monetary policy in the euro zone

The policy U-turn by the SNB suggests the ECB will implement full-blown quantitative easing at its January 22 meeting. We think the ECB is likely to buy sovereign debt in proportion to the size of the euro zone's 18 economies – to keep the QE within its mandate and legal framework. That would mean roughly 18 per cent of any money spent would go on German bunds, 14 per cent on French bonds and 12 and 8 per cent on Italian and Spanish paper. We expect the programme to commit to bond purchases at a rate of EUR40 billion per month, up to at least EUR500 billion in total. Anything smaller than that would be a major disappointment to the market.

#### c) Emerging economies with a high proportion of CHF-denominated liabilities

The Hungarian forint and Polish zloty saw sharp falls in the wake of Thursday's announcement. Both Hungary and Poland have high levels of private debt denominated in CHF; more than 40 per cent of Hungarian mortgages are

CHF-based – equivalent to 9 per cent of Hungary's GDP. In Poland, the volume of CHF mortgages is equivalent to 7.8 per cent of GDP. A higher CHF would clearly make it increasingly difficult for households to service those debts. (In Hungary's case, however, borrowers may benefit from a government programme aimed at converting mortgages into local currency).

#### **d) The credibility of central bank policy guidance**

The SNB's credibility has arguably suffered following its policy move, not least because it had vowed to defend the currency peg at all costs only days earlier. But more importantly, with deflation becoming entrenched and the CHF now back at the levels that prevailed in 2011 – our models indicate that it is trading about 17 per cent above its fair value on a trade-weighted basis – it is difficult to find an economic justification for the central bank's move.

The fact that it did not consider other options – such as a CHF peg against a basket of currencies – is an additional concern.

More broadly, the SNB's move epitomises the difficulties central banks face in the management of the unconventional policies they have established since the beginning of the 2008 debt crisis. Investors – not to mention Swiss companies – were caught off-guard by a central bank that had established a reputation for reliability. Investors may be warier of central banks' forward guidance in future.

#### **e) Equity and bond markets**

- The SNB's move will probably make investors more sceptical about central banks' interest rate guidance in future, which in turn could lead to increased volatility across financial markets; gold may be a beneficiary.
- The scrapping of the peg is unequivocally negative for Swiss stocks, which were arguably already trading at an expensive level of over 16 times 2015 earnings.
- To the extent that the policy U-turn hints at full-blown QE from the ECB, euro zone asset markets should gain.
- The JPY could strengthen if investors choose to test the Bank of Japan's resolve to end deflation. Other central banks operating currency pegs – such as the Danish central bank, which pegs the DKK to the EUR – may also find their policies put to the test by the markets.
- French and German government bonds may suffer some selling pressure given that the SNB has been purchasing such debt in high volumes since December although potential QE from the ECB may offset this.

**This material is for distribution to professional investors only.** However it is not intended for distribution to any person or entity who is a citizen or resident of any locality, state, country or other jurisdiction where such distribution, publication, or use would be contrary to law or regulation.

Information used in the preparation of this document is based upon sources believed to be reliable, but no representation or warranty is given as to the accuracy or completeness of those sources. Any opinion, estimate or forecast may be changed at any time without prior warning. Investors should read the prospectus or offering memorandum before investing in any Pictet managed funds. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Past performance is not a guide to future performance. The value of investments and the income from them can fall as well as rise and is not guaranteed. You may not get back the amount originally invested.

This document has been issued in Switzerland by Pictet Asset Management SA and in the rest of the world by Pictet Asset Management Limited, which is authorised and regulated by the Financial Conduct Authority, and may not be reproduced or distributed, either in part or in full, without their prior authorisation.

For UK investors, the Pictet and Pictet Total Return umbrellas are domiciled in Luxembourg and are recognised collective investment schemes under section 264 of the Financial Services and Markets Act 2000. Swiss Pictet funds are only registered for distribution in Switzerland under the Swiss Fund Act, they are categorised in the United Kingdom as unregulated collective investment schemes. The Pictet group manages hedge funds, funds of hedge funds and funds of private equity funds which are not registered for public distribution within the European Union and are categorised in the United Kingdom as unregulated collective investment schemes.

For Australian investors, Pictet Asset Management Limited (ARBN 121 228 957) is exempt from the requirement to hold an Australian financial services license, under the Corporations Act 2001.

For US investors, Shares sold in the United States or to US Persons will only be sold in private placements to accredited investors pursuant to exemptions from SEC registration under the Section 4(2) and Regulation D private placement exemptions under the 1933 Act and qualified clients as defined under the 1940 Act. The Shares of the Pictet funds have not been registered under the 1933 Act and may not, except in transactions which do not violate United States securities laws, be directly or indirectly offered or sold in the United States or to any US Person. The Management Fund Companies of the Pictet Group will not be registered under the 1940 Act.

© Copyright 2015 Pictet - Issued in January 2015.

**Pictet Asset Management Limited**  
Moor House  
120 London Wall  
London EC2Y 5ET

[www.pictetfunds.com](http://www.pictetfunds.com)  
[www.pictet.com](http://www.pictet.com)