CURRENCIES: SWISS FRANC

RATE DIFFERENTIALS TO TRUMP INFLATION DIFFERENTIALS IN 2022

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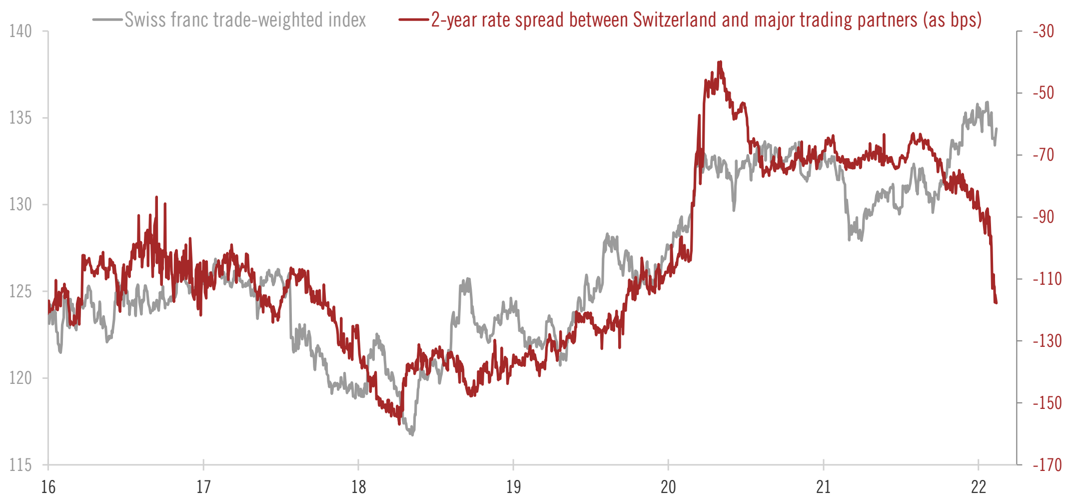
SUMMARY

- The Swiss franc has performed poorly against the euro since the hawkish shift by the European Central Bank (ECB) on 3 February.
- This weakness contrasts with a period of Swiss franc appreciation linked to a highly supportive inflation differential.
- The Swiss National Bank (SNB) has seemed willing to tolerate a stronger franc in nominal terms since the franc has been stable in real terms.
- Although inflation differentials will likely continue to support the franc (in nominal terms), our view that the SNB will prefer to allow other major central banks to normalise their monetary policies first suggests scope for further moderate decline in the franc. Our projections for the EUR/CHF rate are CHF1.05 on a three-month horizon, CHF1.06 in six months and CHF1.08 in 12 months.

Swiss franc lifted by high inflation differentials

While rising geopolitical tensions in Ukraine have offered some temporary support to the Swiss franc, the franc has generally performed poorly since the European Central Bank (ECB) adopted a more hawkish tone at its Governing Council meeting on 3 February. While the franc's underperformance against the euro (moving roughly from CHF1.04 to CHF1.06 in two days) has been most visible, the Japanese yen and the Swedish krona, which both have dovish central banks, have lost ground to the euro as well. This suggests the franc is likely to continue to be penalised by a central bank that is in no rush to normalise its monetary policy. This is because domestic inflationary pressure is consistent with the SNB's mandate (a rise in consumer prices of less than 2% per annum) but also because an unsupportive interest rate differential should help curb the franc's strength (*see chart 1*).

CHART 1: TWO-YEAR RATES DIFFERENTIAL VS. CHF NOMINAL EFFECTIVE EXCHANGE RATE



Source: PWM - AA&MR, Refinitiv, 15 February 2022

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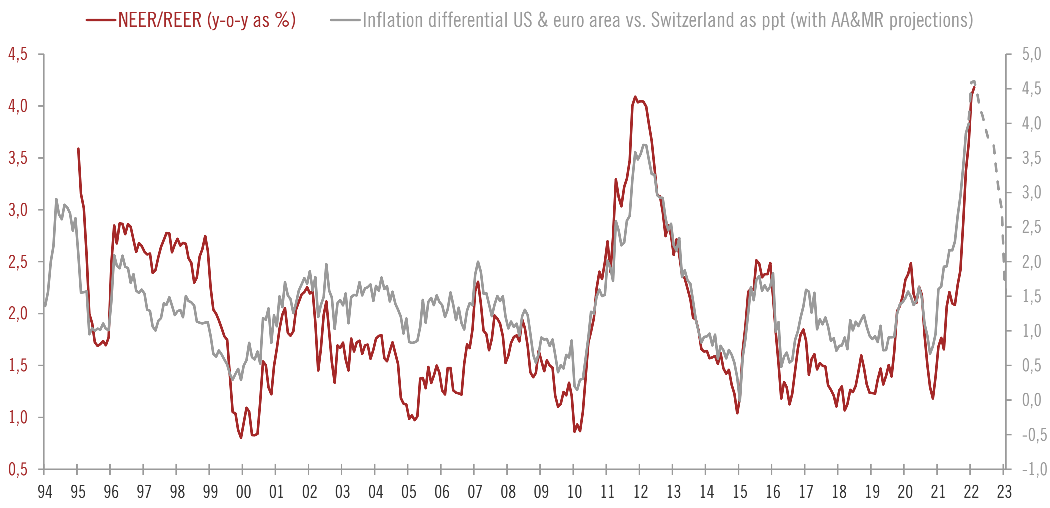
Before its recent weakness, the franc had been relatively strong, helped by the fact that inflation pressure in Switzerland has been lower than among its main trading partners. During 2021, the Swiss franc trade-weighted index strengthened much more than the index in real terms, thanks to quite benign domestic inflation (*see chart 2*). The relative stability of the real effective exchange rate has reduced the Swiss National Bank (SNB)'s concerns about the franc's nominal strength, as SNB president Thomas J. Jordan explained in a recent TV interview. Jordan highlighted that higher inflation outside Switzerland could lead the franc to appreciate in nominal terms but stay unchanged in real terms, meaning the nominal rise does not have a negative impact on the economy. This explains the lack of SNB intervention in the FX market. Indeed, using sight deposits as a proxy, the SNB does not seem to have intervened in recent months to curb franc appreciation.

We believe inflation differentials will continue to support the franc in nominal terms during 2022, although this support should decrease significantly as the year progresses since we consider inflationary pressures to be close to their peak. Therefore, the spread between the nominal exchange rate (NEER) and the real effective rate (REER) should decline, meaning the nominal value of the franc will regain in importance. As the inflation differential turns less supportive for the franc, the impact of low interest rates should have a steadily greater impact.

CHART 2: RATIO OF CHF NOMINAL & REAL EFFECTIVE EXCHANGE RATE VS. INFLATION DIFFERENTIAL



Source: PWM - AA&MR, Refinitiv, 15 February 2022

Trade flows still supportive of the franc

Beside the inflationary differential, capital flows from the balance of payments have been an important source of support for the franc. Trade flows, the main component of the current account, create structural support for the Swiss franc, especially as they are not offset by portfolio investment flows out of Switzerland (*see chart 3*).

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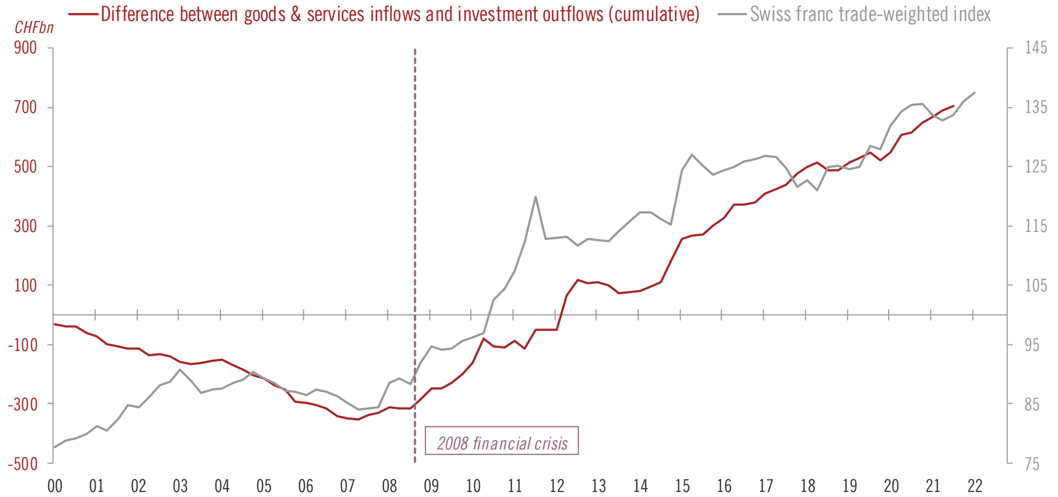
While this should remain a positive factor for the franc in the next few years, the impact of capital inflows could diminish somewhat from current levels. The increase in Switzerland's current account surplus we have witnessed since the beginning of the pandemic may not be completely sustainable. And in the longer term, the break-off of negotiations on a new framework agreement with the EU in 2021 may weigh on Swiss exports to the EU, Switzerland's main trading partner.

Regarding the financial account, investment flows into Switzerland tend to depend on political uncertainties in the euro area, as well as global risk appetite and rate differentials. Our central scenario for robust economic activity in the euro area in 2022 coupled with a rise in European yields (helped by the ECB's hawkish shift) could weigh on net portfolio investment inflows into Switzerland.

That said, while higher spreads in the euro area periphery coupled with robust economic activity there could lead to a reduction in Swiss investors' home bias, net capital outflows may not be large enough to fully offset the Swiss trade surplus over the coming quarters.

CHART 3: NET FLOWS FROM GOODS & SERVICES AND INVESTMENT VS. CHF TRADE-WEIGHTED INDEX



Source: PWM - AA&MR, Refinitiv, 15 February 2022

Seeing moderate franc depreciation

The franc may find it hard to appreciate in the months ahead based on our view that inflation differentials could turn less supportive. Also, the franc looks expensive relative to rate differentials. Indeed, notwithstanding short-term volatility linked to geopolitical tensions, the franc could depreciate over the course of the year (although moderately because of supportive capital flows). Our projections for the EUR/CHF rate are CHF1.05 on a three-month horizon, CHF1.06 on a six-month horizon and CHF1.08 on a 12-month horizon.

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