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CIO Viewpoint

Fighting Swiss inflation with a strong franc

Investment Solutions

29 August 2022

High inflation has transformed monetary policy worldwide. In common with most central banks, the Swiss National Bank (SNB) is countering rising prices with higher interest rates. Unlike other policymakers, it has signalled a willingness to intervene to keep the Swiss franc strong, potentially reversing two decades of work to weaken its currency.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- The SNB is prepared to let the Swiss franc strengthen as part of its fight against inflation
- A stronger franc would benefit the SNB's balance sheet, which in terms of GDP %, is larger than other major central banks'
- We expect Swiss annualised GDP to expand by around 2.5% in 2022, in line with the eurozone
- A year from now, we see the EURCHF trading at around 0.93 and USDCHF around 0.95.

Since the great financial crisis of 2008, the Federal Reserve and European Central Bank have bought bonds to expand their balance sheets and support markets. The SNB has mainly bought assets in foreign currencies, including the euro and the dollar. Switzerland traditionally works to keep its exchange rate low because the franc affects the country's competitiveness in its export markets. A rising franc also risks deflationary effects at home as consumers put-off buying goods that may become cheaper.

In January 2015, the SNB dropped its target floor of 1.20 Swiss francs against the euro, although the central bank continued to intervene. Then in late 2021, as Swiss inflation reached its highest levels in nearly 30 years, the SNB began changing its policy. It refrained from intervening as the euro-franc fell below 1.10.

In response to prospect of higher interest rates in the eurozone, on 16 June the SNB increased its own rates. The 50 basis-point hike was its first rate rise since 2007. SNB President Thomas Jordan said that policymakers have not ruled out interventions "in both directions so that we can buy or sell foreign currency if necessary." This is a significant change for a central bank that has been selling the Swiss franc for much of the last 14 years.

A strong currency is a logical response to keeping imports as cheap as possible and containing consumer prices. Inflation in Switzerland increased 3.4% in July compared with a year earlier. While that is less than half the 7.5% rise recorded in Germany in the same month, some of that is trickling into Switzerland's small, open economy as it imports more expensive goods, including crude oil, and services from its neighbours. This means that the exchange rate is a large component of Swiss inflation.

Long-term strength

The Swiss currency's strength is not a story of a year or two but long-term appreciation. In nominal terms, the franc gained 40% against the euro since the common currency's inception in 1999, and more than 30% against the US dollar over the same period. Currency movements are by definition relative changes, and the franc has appreciated in response to demand from investors for a haven currency. More recently, the franc has strengthened in response to the eurozone's slowing economies, geopolitical exposure to the war in Ukraine and in particular, rapidly rising energy prices.

Still, while the franc has strengthened in nominal terms, it has not done so in real, inflation-adjusted terms. Compared with the highest euro-franc rates of early 2015 when the SNB abandoned its floor against the euro, or during the 2011 eurozone debt crisis, the Swiss currency has appreciated as much as 9% in nominal terms. However, when adjusted for inflation, it is about 12% weaker, and explains why the SNB can now afford to let the currency strengthen.

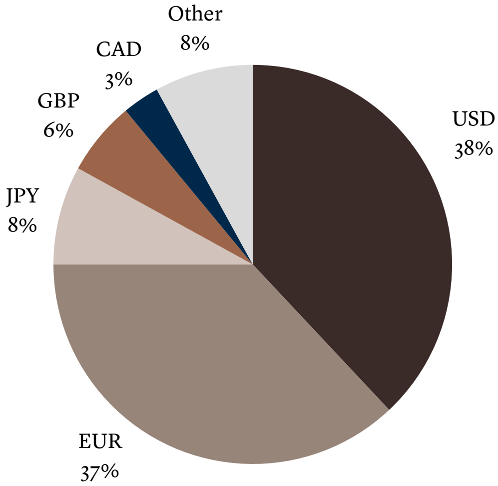
The SNB's openness to selling foreign-denominated investments to buy the Swiss franc would have the benefit of helping to reduce the central bank's balance sheet, while adding to the appreciation pressures on the franc. Total assets at 30 June 2022 were CHF 990 billion, or about 140% of Switzerland's gross domestic product (GDP). That is the highest proportion of any major central bank.

Of these total assets, around 90% are in the form of foreign currency investments, mostly denominated in US dollars and euros, with 75% invested in bonds and 25% in equities (see chart 1). The SNB's portfolio can record mark-to-market losses depending on market performance, and so the main risk is higher interest rates for bonds and stock market declines. This said, if the Swiss franc appreciates, then foreign currency investments' value in francs fall.

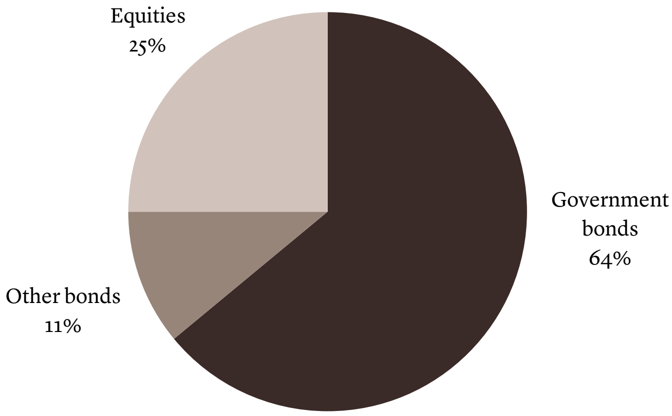
With rising interest rates in 2022, the central bank is making mark-to-market losses in their bond investments. For the first half of 2022, the SNB reported an accounting loss of CHF 95.2 billion, the equivalent of just over 8% of the balance sheet. Historically, the SNB has recorded unrealised gains and losses from its positions in response to changing currency markets. In 2021, the central bank posted a net profit of CHF 106 billion, and distributed a dividend to cantons and the Federation worth CHF 6 billion.

1. SNB foreign currency reserves

By currency



By asset class



Source: Swiss National Bank https://www.snb.ch/en/iabout/assets/id/assets_reserves

Corporate adjustments

Switzerland's corporations have had decades to adjust to a strong currency, and high costs, through innovation and efficiency improvements. That has also allowed many sectors to charge a premium for their exports. High value goods such as luxury watches and pharmaceuticals are especially unaffected by the strong franc, while sectors including industrial machinery and chemicals find it more difficult to remain competitive. Overall, we expect Swiss industries to be able to mitigate the impact of the exchange rate on their exports and pass on higher costs to customers. Since 2009, Switzerland has managed to increase its share in global goods trade from 1.4% to nearly 1.7%. Moreover, the country's trade surplus in goods has continued to grow (see chart 2).

While Switzerland's exports are relatively insulated from currency fluctuations, and less sensitive to real exchange rates, any recession in Switzerland's main export markets would inevitably impact the Swiss economy. For now, we expect the country's annualised GDP to expand by around 2.5% in 2022, in line with growth in the eurozone.

The 20-strong Swiss Market Index (SMI) of the country's most liquid stocks has declined 12.7% since the start of 2022. Measured in Swiss francs, that performance compares with a 16.5% fall in the Stoxx Europe 600 and the S&P 500's 9.5% drop. Switzerland's mid and small cap index (SPI Extra) has fallen 21.6% in 2022, as cyclical sectors such as industrials and materials suffered from higher costs and slowing demand[1].

[1] Year-to-date total return performance for all indices

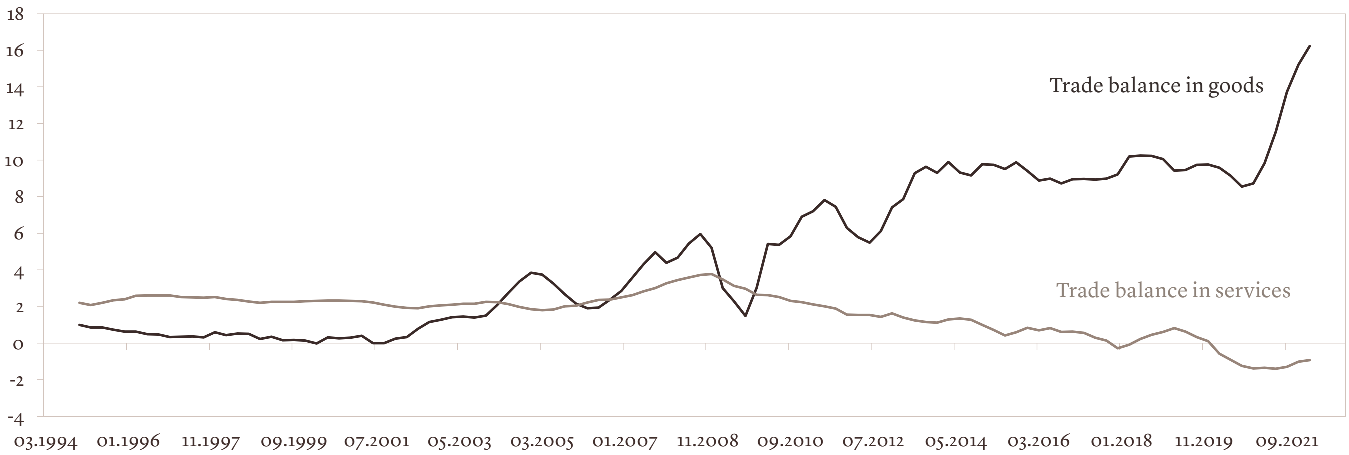
Stable earnings & caution

Swiss companies continue to warn that supply-chain pressures, rising costs, wage increases, high inflation and recession fears will affect demand. Many are necessarily more cautious about revenues for the second half of 2022 and into 2023. The healthcare sector may prove an exception as it remains more insulated from the macroeconomic environment with lower price elasticity.

Corporate earnings in the country have been stable, though slower than other regions historically. In a globally diversified portfolio, US stock markets offer higher, more expensive earnings growth. Still, the Swiss market offers an attractive way to add portfolio value. Whether investors are looking for higher, stable dividends or positions in leading industrial and technological stocks, Switzerland continues to provide bottom-up stock picking opportunities.

We have been positive on the Swiss franc and are closely watching the SNB's interventions. One year from now, we see the EURCHF currency pair trading at around 0.93 and USDCHF at around 0.95, compared with 0.96 for both pairs today. The central bank's policy change to consider selling the EURCHF may further increase our positive outlook for the Swiss currency.

2. Swiss trade balance remains healthy
Annualised % share of GDP



Sources: Bloomberg, Lombard Odier calculations

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