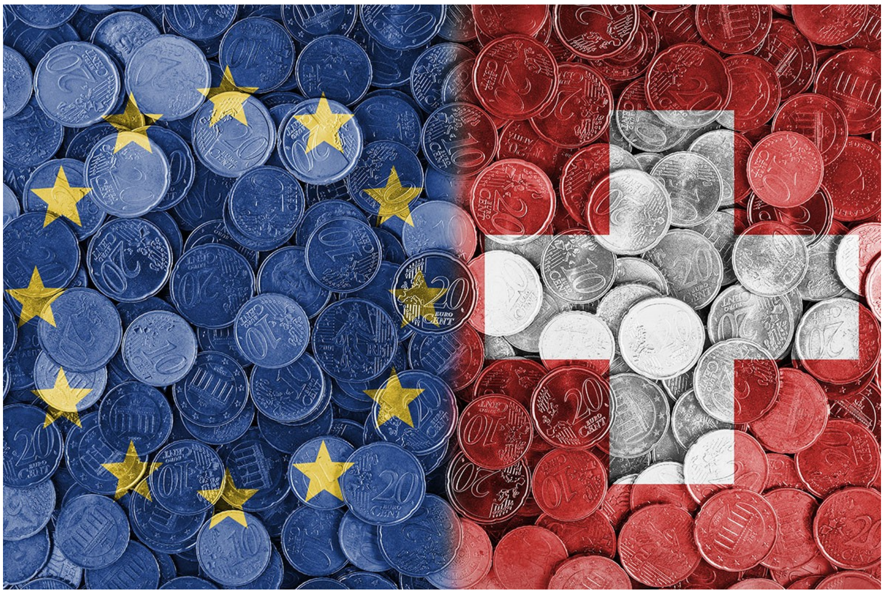
EUR/CHF: It's beginning to look a lot like 1.05

EUR/CHF is trading close to the lows of the year and it's not hard to see why. Expect the market to now question the Swiss national bank's ability to match ECB rate cuts and undertake large scale FX intervention. We can see the inflation-adjusted CHF trade-weighted index moving back to 2015 highs, which should mean EUR/CHF at 1.05



Source: Shutterstock

Rewind back five years

The ECB has turned dovish again and at the June meeting, President Mario Draghi confirmed that a fresh round of asset purchases is under discussion. Certainly, European debt markets have responded to the suggestion of ECB asset purchases, where sovereign spreads have narrowed and eligible corporate debt markets have done very well.

In the FX market, the EUR trade-weighted index has been relatively flat since June. However, this is a function of some weakness in the CNY, USD and GBP, all of which have large representation (19%, 14% and 10%) in the trade-weighted EUR.

However, we have seen EUR/CHF soften to the lows of the year – and this isn't really a surprise.

Spreads in short term interbank rates have narrowed to the lowest levels since 2015. And for many in the market, memories are still fresh (and painful) of how Switzerland's central bank abandoned the 1.20 minimum exchange rate for EUR/CHF on January 15th, 2015 – one week before the ECB announced the start of a new €60bn per month asset purchase plan.

As 2H19 progresses, and more clarity emerges on ECB rate cuts and its plans for quantitative easing, expect Switzerland's central bank policy to come under greater scrutiny

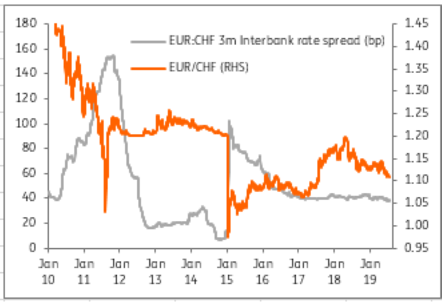
At the time and in subsequent comments the SNB admitted that the massive intervention to support the 1.20 floor was 'no longer sustainable and would require ever-larger foreign currency purchases to enforce it'. This in the face of the forthcoming tsunami of euros from the ECB.

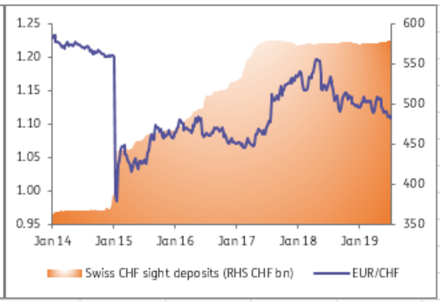
Fast forward five years to 2019 and the ECB is now considering fresh rate cuts and another round of asset purchases. Our macro team feels that next week's ECB rate meeting maybe a little too early for a deposit rate cut (but acknowledge that President Draghi tends to over-deliver). More asset purchases may be held back as ammunition in case of a disorderly Brexit – but are now squarely back on the market's radar.

Currently, there is no acute pressure on EUR/CHF. For example, CHF sight deposits have only risen CHF1bn since early June, suggesting little or no FX intervention from the SNB to limit CHF strength. Yet as 2H19 progresses and more clarity emerges on ECB rate cuts and its plans for quantitative easing, expect SNB policy to come under greater scrutiny.

In other words, to prevent the CHF becoming even more 'highly valued', can the SNB take negative rates (now -0.75%) even deeper into negative territory and could it undertake a fresh round of large-scale FX intervention?

Soft rate spreads weigh on EUR/CHF, but it doesn't seem like the SNB is intervening





Source: ING, Bloomberg

Deeper negative rates?

As our team points out, the SNB would probably try first to intervene in FX markets to hold EUR/CHF above 1.10, but failure to do so could prompt another small rate cut from the SNB. Certainly, the SNB says they haven't run out of room to take the policy rate further deeper into negative territory. However, like many central banks, negative rates are impacting banks profitability, given that retail deposit rates have not been taken below zero and margins are under pressure.

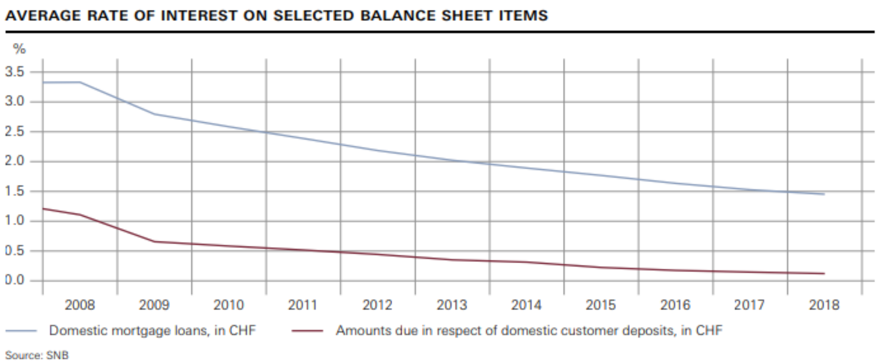
> *If the Swiss central bank were to match the near 20bp of ECB cuts priced by the end of 2019, the policy rate would be very close to -1.00%*

For reference, the average interest rates on customers deposits amongst Swiss banks in 2018 was 0.12%, while for large banks it was just 0.06%. No wonder the SNB would have to expand the current (generous) exemptions for negative rates on CHF sight deposits – were they to cut rates further. This would be especially necessary given the Swiss aversion to negative savings rates – as discussed by our colleagues in the results of our consumer finance poll last year. A separate poll of over 1000 Swiss savers showed 25% keeping cash at home if savings rates turned negative.

If the SNB is to match the near 20bp of ECB cuts priced by the end of 2019, the policy rate would be very close to -1.00% - and to match fresh ECB QE we assume the SNB's balance sheet and FX intervention would come into play.

Read ING's survey on why sub-zero deposit rates might not boost consumer spending

Swiss mortgage and deposit rates compress



Source: SNB

Limits to FX intervention?

In theory, the SNB can increase FX reserves and its balance sheet ad infinitum. In practice, there are two key limits. If FX reserves grow too large relative to GDP, huge profit and loss swings on the back of reserve revaluation can damage central bank credibility and if the central bank's FX intervention exceeds 2% of GDP over a 12 month period, it would trigger one of the US Treasury's three criteria on currency manipulation.

> *In theory, the SNB can increase FX reserves and its balance sheet*

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On the former, being forced out of the 1.20 floor cost the SNB CHF20bn in terms of FX losses in 2015 and wiped out 60% of its provisions and equity capital. The SNB's balance sheet is 50% larger today than it was in late 2014, while its provisions and equity capital are 80% larger (end May 2019 figures). While the SNB may feel it has unlimited room for FX intervention and to grow FX reserves, the sheer size of reserves, now over 100% of GDP may make the SNB a little queasy.

Perhaps a greater constraint for the SNB is the US Treasury's increased surveillance on currency markets – in an effort to reduce the US trade deficit. Recall Washington has three criteria to determine whether a trading partner is manipulating its currency for trade gains. 1) A bilateral goods trade surplus with the US in excess of US$20bn over the last 12 months. 2) A current account surplus larger than 2% of GDP and 3) FX intervention (buying FX) greater than 2% of GDP, again over the prior twelve-month period.

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In the last Treasury FX report, published on 19 May, Switzerland just about escaped the first criteria with a US$19bn bilateral surplus, blew away the second condition with a 10% current account surplus and on 3 was identified as having intervened to the tune of 0.3% of GDP in FX markets.

CHF 14 bn

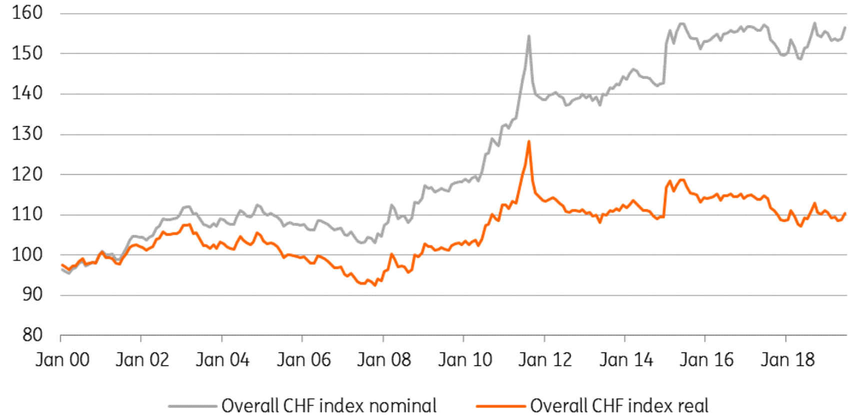
Potential ceiling on SNB FX intervention

Over the next 12 months

The third criteria could be a challenge for the SNB this year. 2% of Swiss GDP is around CHF 14bn – that is not a lot at all given Swiss FX reserves grew CHF300bn during the ECB's 2015-2018 QE campaign. Of course, there is no suggestion that the ECB will repeat a three year, EUR 2.5trn asset purchase programme, but even a programme worth one-tenth of that suggests SNB FX intervention could fall foul of the US Treasury rules.

Were Switzerland to be named a currency manipulator, it could ultimately result in tariffs – or there is even a new idea emerging that the US should undertake countervailing currency intervention, which in this case would see the US Treasury instructing the Fed to buy CHF!

Swiss franc trade weighted: Nominal TWI is on its highs, real TWI is not



Source: SNB

1.05 seems quite conservative

If we believe that conviction levels of ECB easing grow this summer, we should expect EUR/CHF to stay pressured. While the SNB's nominal trade-weighted CHF index is on its highs, the inflation-adjusted 'real' index is not.

This latter measure of the CHF is some 5% off the highs seen in summer 2015 (largely due to low inflation in Switzerland relative to trading partners) and a retest of that 2015 high would equate to EUR/CHF hitting the 1.05 area. That seems quite a conservative target for EUR/CHF this summer.

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