CHF: Keep the hedging cost low

- **Expect SNB to out-dove the ECB in order to widen hedging costs, since SNB notes that Swiss pension funds have been increasingly hedging offshore investment**
- **SNB might face some challenges in the form of better Swiss activity – yet low Swiss CPI should provide cover for the SNB**
- **Left-field risks exists that Switzerland falls foul of US Treasury currency manipulation laws. Goods surplus of US$20bn with US sees all 3 criteria met**

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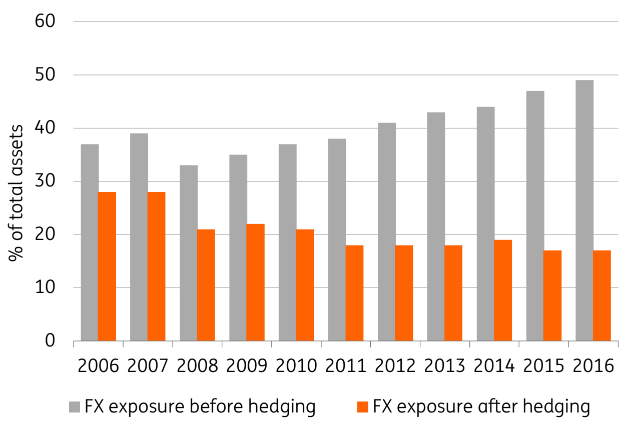
The Swiss National Bank welcomed last year's depreciation of the Swiss Franc and even downgraded its description to being 'highly' instead of 'significantly' overvalued. With Swiss inflation persistently below that of its key trading partners, plus some nominal depreciation, the real CHF trade-weighted index has now corrected back to levels seen in summer 2014. A little lower would see a return to levels, seen before the Greek crisis.

But the SNB want more. The SNB forecasts CPI not to return to 2% until the final quarter of its forecast horizon (3Q20). We very much doubt the SNB will have a 'Sintra moment' in 2018 by declaring deflationary fears are dead. Instead, the SNB will likely keep the 3m policy rate at -0.75% right through 2018 – hoping that the ECB normalisation will generate some very welcome widening in rate spreads. The desire for wide(r) rate spreads with key trading partners is a common theme in SNB literature. This looks particularly relevant for the SNB since it feels that the FX hedging activity of large Swiss pension funds may be preventing the CHF from weakening further.

Here the SNB notes that while Swiss pension funds are increasingly putting assets to work offshore, the FX exposure after hedging is actually declining. Thus Switzerland is struggling to recycle its current account surplus since overseas asset purchases are hedged. What to do? Presumably, the SNB will do their utmost to widen rate spreads and increase the cost of hedging FX risk back into CHF.

Swiss pension funds: foreign currency exposure



Source: SNB

SNB's CHF exchange rate index

Source: SNB

Given our positive EUR story in 2018, we're looking for EUR/CHF to head back to 1.25. That is not a big move and would take the real CHF trade-weighted index back towards levels that existed prior to the start of the Eurozone crisis in 2009/10.

There are probably three risks to our 1.25 call for 2018.

1) We are under-estimating Eurozone political risk, be it from Italy or Germany.

2) The Swiss economy looks set to bounce back to 2% in 2018 from 0.9% in 2017. Strong growth may start to question SNB's super-loose policy.

3) If the US grows more quickly and sucks in imports – increasing the annual US goods deficit with Switzerland to US$20bn, it would hit all three of Washington's criteria for currency manipulation – deterring SNB FX intervention to limit any CHF strength.

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