# Fragile, not overvalued: Revisiting the Swiss franc

February 2020


## IN BRIEF

- The Swiss National Bank (SNB) continued to characterise the Swiss franc as highly valued and the situation in the foreign exchange market as fragile at its December policy meeting.
- Our analysis suggests that the currency may not be as overvalued as the SNB suggests on an inflation-adjusted basis, or when balance of payments dynamics are taken into account.
- However, we do agree with the SNB's fragile assessment of the Swiss franc, with significant recent changes in Swiss current account flows adding to the appreciation pressure on the franc, despite negative rates and continued intervention by the SNB to weaken the currency.
- With the US increasingly disapproving of the SNB's approach, and with Swiss investors increasingly hedging foreign currency risks, the franc may continue to appreciate.


## Is the Swiss franc overvalued?

Since we last wrote on the Swiss franc back in January 2019, the currency has continued to appreciate slightly in trade-weighted terms despite the resumption of small scale currency intervention from the SNB in the middle of last year. Although the SNB continues to believe the franc is overvalued, the framework we previously laid out suggests that any overvaluation may be illusory.

Although the nominal exchange rate is very strong, after adjusting for persistently low Swiss inflation the real exchange rate remains close to longer term averages. We cross-check our valuation measures by examining the balance of payments dynamics, which show that both the goods balance and overall current account position remain incredibly strong. Such readings are more consistent with an undervalued currency than with the franc being overvalued.

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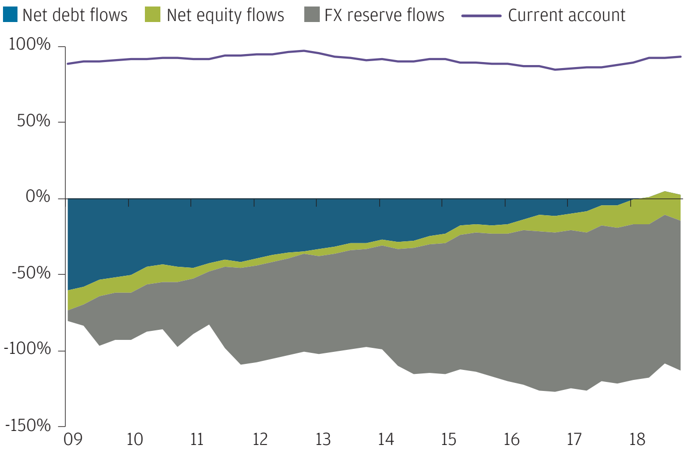
## Is the outlook for the Swiss franc fragile?

The SNB's assessment of the Swiss franc as fragile is based in part on the way the currency options market prices a far greater premium for options to protect against an appreciation in the value of the Swiss franc compared to options to protect against depreciation. Our analysis of the changing nature of financial flows out of the franc identifies a key change compared to the pre financial crisis period that we believe is related to the ongoing risks of faster franc appreciation. This change also helps explain why negative SNB policy rates have had limited success in weakening the currency.

Historically, inflows to the Swiss current account were offset by significant outflows into foreign bonds, along with moderate equity outflows. However, bond outflows from Switzerland have reversed over the last decade so that today the Swiss bond market receives net inflows. While there has been some offsetting rise in the rate of equity outflows the scale remains too small to fully offset the current account surplus. We believe that the timing of equity outflows is likely to be much more sensitive to investor risk appetite and this increases the propensity of the franc to appreciate at times of risk aversion. This experience is in sharp contrast to Sweden and the eurozone, where negative rates and domestic quantitative easing have seen bond outflows rise substantially.

TRENDS IN SWISS BALANCE OF PAYMENTS FLOWS (10-YEAR ROLLING SUM, % GDP




Source: Bloomberg; data as of 30 September 2019.

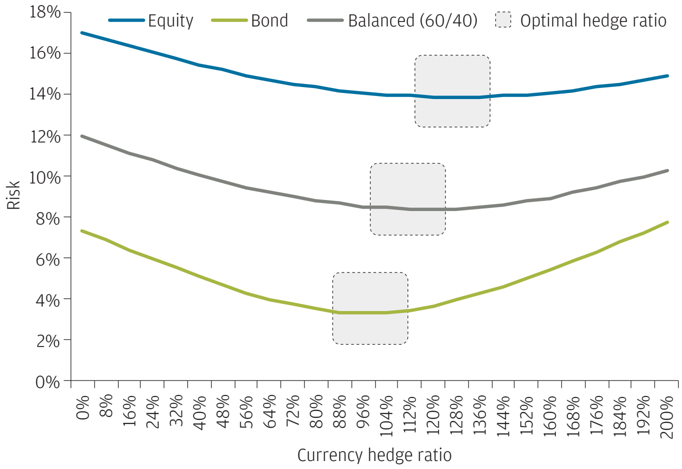
Without portfolio outflows to recycle the current account surplus, the market has instead relied on SNB currency intervention to mitigate the appreciation pressure on the franc. The costs and benefits of currency intervention may shift, however, given the growing focus of the US administration on Swiss currency policy, in part as a result of the rising Swiss trade surplus with the US. As well as adding Switzerland to the "monitoring list" of potential currency manipulators, our interpretation of the recent Treasury report was that the tone was somewhat less sympathetic to the plight of the SNB than in prior reports.

## Thinking about hedge ratios as a Swiss investor

From the perspective of the Swiss investor, the fragility of the franc and its tendency to appreciate in periods when global equity markets fall increases the attractiveness of maintaining high currency hedge ratios on foreign asset holdings due to the diversification effect.

Our analysis shows that from a theoretical perspective hedge ratios around 100% on foreign bonds, and as high as 130% on foreign equities, are optimal for reducing total portfolio risk–although in practice it is uncommon to go beyond 100%. Unfortunately for the SNB, if Swiss investors do choose to focus on hedging the majority of the currency risk associated with their foreign investments, the appreciation pressure on the franc is unlikely to fade.

HEDGE RATIO STUDY FOR SWISS INVESTORS IN MSCI GLOBAL INDICES




Source: Datastream, J.P. Morgan Asset Management: data as of 30 December 2019.

## Currency Management

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We offer a range of hedging solutions for managing currency risk as well as a tailored optimal hedge ratio analysis:

- Passive currency hedging serves to reduce the currency volatility from underlying international assets. It is a simple, low cost solution designed to achieve the correct balance between minimising tracking error, effectively controlling transaction costs and efficiently managing cash flows.
- Dynamic "intelligent" currency hedging aims to reduce currency volatility from the underlying international assets and add long-term value over the strategic benchmark. A proprietary valuation framework is used to assess whether a currency looks cheap or expensive relative to the base currency and the hedging strategy is adjusted accordingly.
- Active "alpha" currency overlay offers passive currency hedging, if required, combined with an active investment process to deliver excess returns relative to the currency benchmark. Our approach is to build a global currency portfolio combining the output of fundamental models and incorporating the qualitative views of our strategy team.



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