EUR/CHF Crash Gets Brokers in Trouble

Is the Swiss National Bank (SNB) Discounting ECB Monetary Policy Stance?

In an unexpected move the SNB announced on the 15th of January that it will end its minimum exchange rate policy and announced a further reduction in its interest rate on sight deposit balances to -0.75 per cent down from -0.25 per cent. For many brokers the following crash had significant consequences.

» The rationale for abandoning the minimum exchange rate policy was outlined in its press release: The SNB explained that the period of "exceptional overvaluation" of the Swiss franc and of "an extremely high level of uncertainty" in financial markets was over, allowing the Swiss economy to adjust to the current environment. Moreover, it claimed that the divergences in monetary policy between major currency areas had "increased significantly" and that they would become even more pronounced.

Background

The SNB's decision to abandon the floor and cut interest rates was surprising given that inflation remains far below target, Forex intervention had not been especially large lately, and a stronger CHF introduces more downside risk to inflation projections. What the SNB is really signaling is that the ECB will indeed deliver on further quantitative easing during next week's meeting, and that it is probably going to be sizeable making it increasingly difficult to defend the EUR/CHF 1.20 level. So far, the attempt to hold

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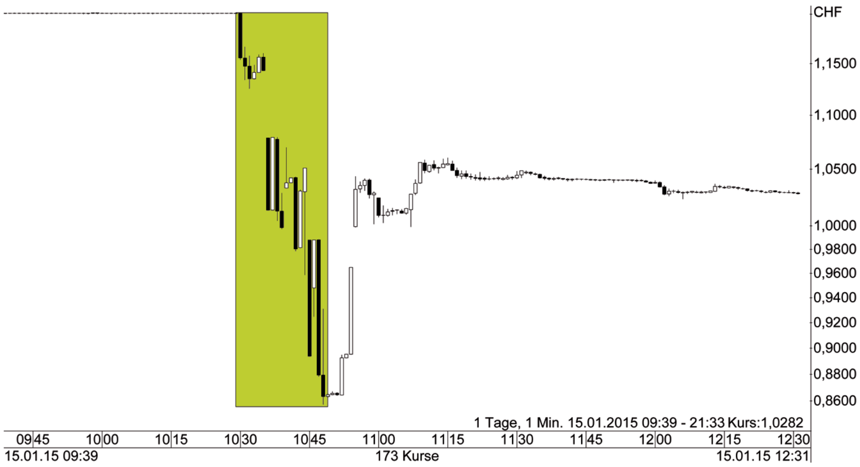
the EUR/CHF 1.20 floor has resulted in a ballooning foreign reserve stockpile at the SNB. The reserves have climbed from CHF200bn in mid-2011 to almost CHF 500bn (of which 45 per cent are in Euro), amounting to 75 per cent of GDP, the highest ratio among countries that opted for QE.

By removing the floor, the SNB is no longer compelled to intervene, a tactic that had become more politically contentious, as reflected in last year's "gold referendum". But it is questionable whether deeper negative interest rates will be able to prevent monetary conditions from tightening, given CHF's sharp rally. The SNB clearly believes that the upward pressure on the Swiss franc from inflows due to ECB policy, Greek political turmoil, and rising geopolitical tension (Ukraine crisis, etc.), will not be transitory. SNB officials probably believe that the rise in volatility in the markets experienced in the latter part of 2014 will probably intensify, and wanted to be one step ahead.

F1) EUR/CHF minute-chart



The SNB ended the minimum exchange rate policy that they have been following since 2012 on 15th January. The Swiss Franc dropped within a few minutes with a gap by 1000 pips and decreased further 3000 pips before a reversal movement started. You can see the volatility in the minute-chart with several gaps of 500 pips. The yellow chart shows that many orders were not executed because there was no liquidity and therefore imbalances appeared.

Source: Tai-Pan, www.lp-software.de

The market's reaction

The market reaction has been fierce, as the EUR/CHF settled around the 0.9755 level, representing an 18.8 per cent move since Wednesday's close; at the same time, the Swiss franc also strengthened by 17.6 per cent against the USD. SNB's argument that part of the CHF's overvaluation had decreased has practically collapsed. This short term movement could be that the market is overreacting, as it was caught by surprise, and that the rate will normalize soon by retreating to a lower level. Or, it is just a matter of a very transient market mispricing that will be corrected in the coming days.

Apart from the ECB QE related reasons, there might be a second source of potential CHF demand that makes the defense of the floor very difficult, in our view. One could argue that, in reality, there are very limited safe haven assets out there. If investors want to have exposure to a relatively riskless asset, they will continue to bid up its price. Regime shifts in volatility (upwards) bring about a phenomenon called volatility clustering (asset correlations converge). During those periods, it is extremely difficult to find uncorrelated, or even negatively correlated, assets making diversification practically impossible. The Swiss franc and gold, for example, are viewed as investments offering some diversification benefits so people want to own them, especially during periods when risk aversion is on the rise.

The SNB knows that it will probably have to continue intervening, especially when downward pressure on EUR/CHF (or/and USD/CHF) becomes extreme; however, it seems unlikely that the SNB will explicitly set another minimum exchange rate target. Its statement emphasizes that it "will continue to take account of the exchange rate

"The recent unprecedented move by the Swiss National Bank created a large amount of volatility in the Swiss franc and forex markets. Like many of our competitors, CMC Markets sustained some losses, however, the overall impact including possible bad debts has not materially impacted the Group. CMC Markets continues to have a strong balance sheet and business model. It is business as usual", **said Peter Cruddas, Chief Executive, CMC Markets**

Iron FX.com commented: "IronFX Global Limited was not affected by the events due to the Swiss National Bank's abandonment of its EURCHF floor, due to our strong risk management systems and procedures and we continue complying well with our capital regulatory requirements under all regulatory bodies with whom we are licensed. We would therefore like to inform our clients that we continue conducting business as usual. Feel free to contact our account managers around the world should you have any questions."

FxPro Group announced "that negative balances resulting from the extreme market conditions on CHF crosses have not affected the funds of our clients. All such losses were borne solely by the capital the company places as collateral with its prime broker and liquidity providers, as per our responsibility to protect our clients and comply with regulatory requirements. Our commitment to negative balance protection as outlined in our terms and conditions has been upheld. All negative balances still appearing on the terminals of our clients are in the process of being corrected. While the company has been affected by the events of what is now being called Black Thursday, FxPro remains fully operational and solidly capitalised, as always. It is business as usual: deposits, withdrawals and the entering of positions continue as on any other trading day. Our clients funds remain segregated and protected."

ActivTrades was unsurprised about the events: "Back in November 2014, ActivTrades had already anticipated the possibility of such events. Consequently, we decided at the time to increase the margin required on our CHF pairs by a multiple of 16. Thanks to this measure ActivTrades was able to protect its clients by substantially limiting their losses. Therefore by protecting our clients' interests, we protected the interests of the company as a whole. As a result, ActivTrades is proud to say we did not suffer any kind of negative impact following the SNB announcement and have preserved our name as a trusted and secure provider."

situation in formulating its monetary policy in the future. If necessary, it will therefore remain active in the foreign exchange market to influence monetary conditions." The form of intervention might be different. A number of analysts interpreted SNB's statement that CHF weakness vis-à-vis the USD has provided an opportunity for the policy to be altered, that it would probably target a CHF trade weighted index, or that their intervention will not be concentrated only in euro terms, but also in dollar terms; or that it will introduce a so-called dirty float, targeting a basket of currencies, but keeping it privy.

Future Prospects

The SNB must hope that the EUR/CHF will drift back upwards towards 1.20. A more realistic hope might be that the USD/CHF rate gets back above parity later on. In the end, the SNB will adopt a policy that is consistent with Swiss economic fundamentals and will neither risk a competitiveness "shock", as 55 per cent of its exports are to the euro zone, nor an accelerating deflation trend, especially as it comes to realize that its interest rate policy will not be as effective.

All in all, we believe that the SNB is predisposing markets that the ECB will finally embark on an extensive quantitative easing program and that economic imbalances will weigh on financial markets for quite some time. This has implications for investment choices, as we expect that short term volatility in the Forex market will increase and that there will be flows into low risk currencies, such as the Japanese Yen. «