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## Is the Swiss National Bank (SNB) discounting ECB's monetary policy stance?

In an unexpected move the SNB announced 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% down from 0,25% and in its three-month Libor rate to a range between -1,25% and 0,25% (from -0,75% to 0,25%).

The rationale to abandon 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.

The SNB's decision to abandon the floor and cut interest rates was surprising given that inflation remains far below target, FX intervention had not been especially large lately, and that a stronger CHF introduces more downside risks 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, probably, it is going to be sizeable, making it increasingly difficult to defend the EURCHF 1,20 level[1].

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 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.

The market reaction has been fierce, as the EUR/CHF settled around the 0,9755 level, representing an 18,8% move since Wednesday's close; at the same time, the Swiss franc strengthened also against the USD by 17,6%.

[1] So far, the attempt to hold 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% are in Euro), i.e. 75% of GDP, the highest ratio among countries that opted for QE.

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 investments that offer some diversification benefits and people want to own them, especially during periods that 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 USDCHF) 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 situation in formulating its monetary policy in 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.

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.

At the end, the SNB will adopt a policy that is consistent with Swiss economic fundamentals and will neither risk a competitiveness 'shock', as 55% 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 sometime. This has implications for investment choices, as we expect that short-term volatility in the FX market will increase and that there will be flows into low risk currencies, such as the Japanese Yen.

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