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CHF – A NEW WAY OF SPECULATION

If the current global trade dispute evolves into a trade war, it has an impact on the currency markets – a classical thought is to regard the Swiss franc as a safe haven destination.

It is still not my main scenario that the American-initiated trade dispute evolves into a veritable global trade war, but it is always sensible to work with different outcomes and the respective consequences. Basically, the Swiss franc (CHF) has become less attractive as a safe haven destination than it was before the financial crisis. The short-term interest rate is minus 0.75 pct. and the economy is very similar to many other countries.

However, there is a steady surplus on trade balance, which gives a natural demand for the country's currency. Otherwise, the GDP growth fluctuates in line with the rest of the world. The housing market in Switzerland is also overheated due to the quantitative monetary policy conducted by the central bank, the Swiss National Bank (SNB).

Though precisely about monetary policy, the otherwise very sensible people in Switzerland have gone into extremes. Many factors affect a country's exchange rate, but the central bank's behaviour is of great importance. Here, SNB has changed style significantly since the financial crisis.

The quantitative monetary policy invented by the U.S. central bank (Fed) meant that Fed's balance sheet grew by what equals to 23 pct. of the total American GDP. The growth of the balance sheet was mainly due to the famous purchase of bonds. In Japan, the quantitative monetary policy was copied which increased the central bank's balance sheet by 90 pct. of Japan's GDP. In Switzerland, the balance sheet expansion equals 127 pct. of the country's GDP, which means that SNB has bought financial assets for the same amount. Effectively, SNB has created an active managed investment fund with a far broader portfolio than central banks normally have. The consequence is that SNB now has other interests aside from the usual tasks a central bank carries out.

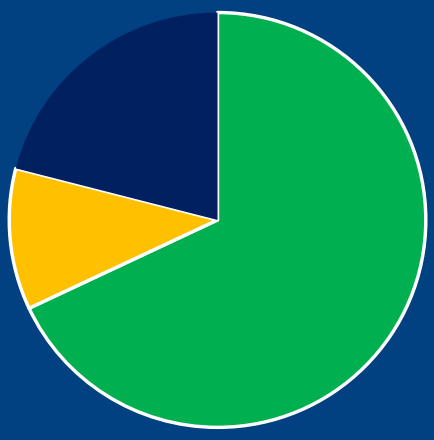
Graphic one shows the allocation of the investments by asset classes where „other bonds" and „stocks" are quite interesting, as they are largely invested in securities outside Switzerland. The central bank is not providing much information about the portfolio, but fortunately, in the United States, there are different requirements for openness.

This means that the SNB has to publish information about its investments in U.S. listed stocks. Based on this information, it appears that approximately 10 pct. of the total investment portfolio (half of the equity portfolio) is allocated to U.S. listed equities.

The largest holdings in American stocks are shown in graphic two where it also appears that one of the major single investments is in an oil producer. This is one of the segments that a growing number of investors, particularly public funds and money, are avoiding. For the investors looking out for a safe haven destination in case of a crisis, it's worth to be aware of this changed environment that surrounds the CHF

***Graphic 1*:**

SWISS NATIONAL BANK - ASSET ALLOCATION



Government bonds - 68 pct. Other bonds - 11 pct. Stocks - 21 pct.

Source: Swiss National Bank

- it is what I call speculation in a new way.

During 2017, the SNB managed to keep CHF on the weak side. It is outspoken against the euro, but even against the dollar, the Swiss franc rose just 3.5 pct. last year- where the euro went up with 14 pct. against the greenback. One could argue that this will not last, and there will come a counter reaction in the market with CHF being on the rise for a period.

Most likely yes, because it almost always happens, but the prediction about when it happens is far from obvious in this case. In addition, I am not convinced that a correction will be significant enough that it is worth to sacrifice time and risk to find the possible upwards correction in CHF.

From a general economic perspective, there is also no particular reason why CHF should be an attractive destination for the savings, but the biggest real risk could very well be to have SNB as opponent.

Like in all other countries, the government in Switzerland wants their currency to stay on the weak side. It is the usual support for the export sector, but SNB's swelling investment portfolio means that there is a particularly strong incentive to keep the CHF weak, if possible.

The return on the portfolio is positively affected by a decreasing Swiss franc. Since it is undesirable / unusual that a central bank reports negative results, the temptation to weaken the currency could be extremely high.

With its 8.4 million inhabitants Switzerland for several reasons makes up an extremely modest share of the global economy. For this reason, CHF is not the most rational currency to escape into as the limited size of the economy causes the risk of illiquidity in the currency market.

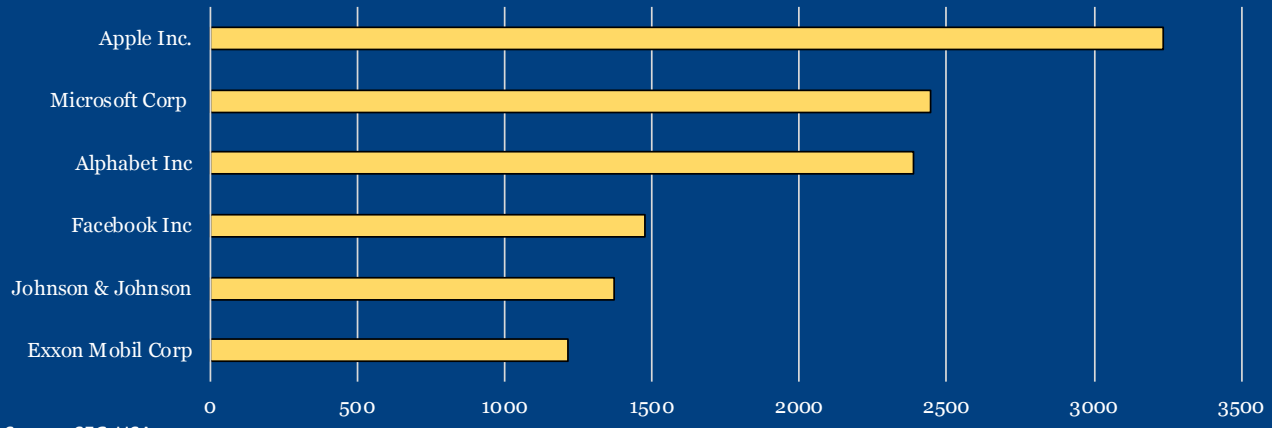
In a crisis situation, there can be good reasons for investors to flee into what I call „creditor currencies" i.e. countries with strong reserves. It could have been Germany, but the euro is a single currency for the whole Eurozone which contains all kinds of credit risks. Another obvious alternative is the Chinese yuan, but it's not free floating. Therefore, the yen is once again an obvious destination.

However, I would expect the Swiss franc to be used by some investors as safe haven. Should that happen, it becomes incredibly exciting how SNB reacts to the increase in the exchange rate. Probably the central bank's investment portfolio has a negative return in local currencies for this year.

Therefore, a rising CHF exchange rate will be extremely unwelcome for SNB as the central bank could end up with a negative result in 2018. It would also increase the focus on what kind of project the central bank in Switzerland has created. It is certainly more than unusual for a central bank, even though SNB is partly owned by private investors.

Graphic 2 **:**

SWISS NATIONAL BANK - LARGEST EQUITY HOLDINGS IN THE U.S. (MIO. USD)



Source: SEC, USA

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