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PICTET WEALTH MANAGEMENT

Currencies: Swiss franc

Becoming less useful as a tool of monetary policy

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FLASH NOTE

SUMMARY

- A less aggressive central bank and falling inflation elsewhere should deprive the Swiss franc of some support in 2024.
- The franc could also benefit less from balance of payment flows.
- While interest rate differentials could turn more positive for the franc, the currency will continue to look expensive based on this indicator alone.
- Overall, we expect the Swiss franc to lose some of its previous strength in 2024. Our three-month forecast for the EUR/CHF rate is CHF0.95 and our 12-month forecast is CHF0.99. Based on EUR/USD projections, the implied USD/CHF rate is at CHF0.91 on a three-month horizon and at CHF0.90 on a 12-month horizon.

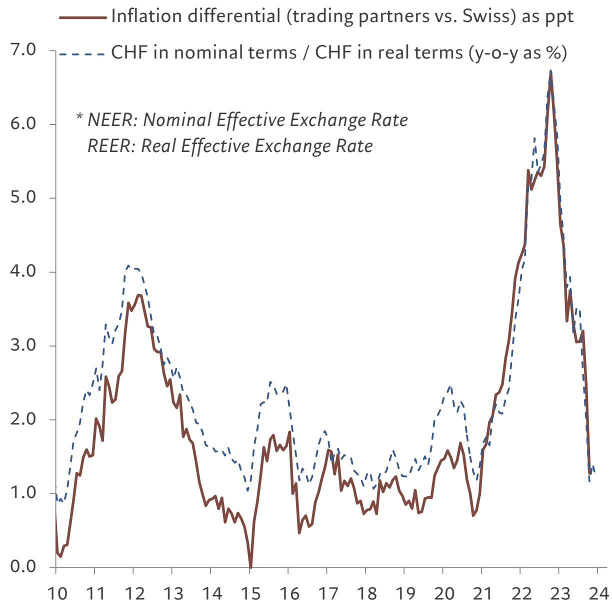
FADING TAILWINDS

Just as in 2022, the Swiss franc is likely to record one of the best spot performances of any major currency in 2023. In our view, two key elements have been supporting the franc since last year. First, inflationary pressure has been much less acute in Switzerland than in its main trading partners. The resultant erosion in the nominal value of other currencies have put strong upward pressure on the franc. Second, the Swiss National Bank (SNB) has acted decisively to support the value of the franc through FX interventions as a way of curbing imported inflation.

However, the big drop in inflation in Europe and the US in recent months means the first factor has faded. And signs that domestic inflation is replacing imported inflation as the SNB's main concern could mean the second factor supporting the franc also abates. In addition, the SNB is conscious that a strong franc could weigh on Swiss exporters, which would be especially unwelcome at a time when economic perspectives are already subdued. The SNB's decision to keep the policy rate unchanged at its September meeting (when the franc was particularly strong) despite market expectation for a hike, reinforces this view.

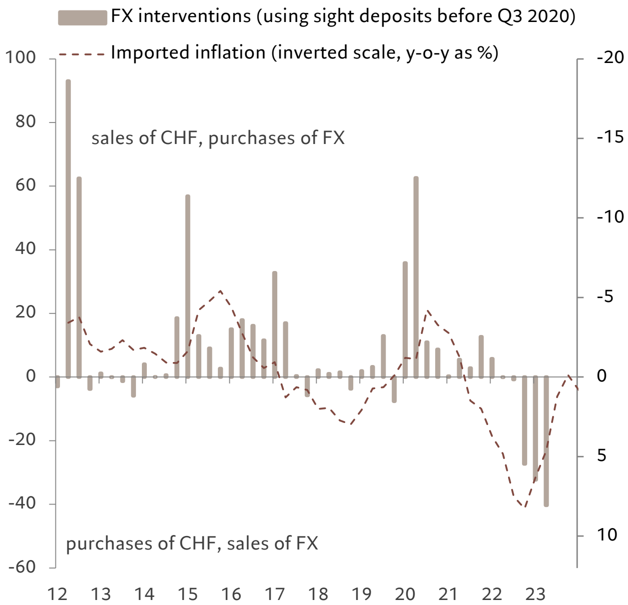
In addition, we do not believe that the SNB will actively push for 'normalisation' of its large balance sheet (equivalent to roughly 100% of Swiss GDP). In contrast to other major central banks that have moved toward reducing their balance sheets, the size of SNB's balance sheet may continue to reflect interventions in the FX market to curb unwanted moves in the Swiss franc. At the same time, given that we think Swiss headline inflation is set to remain close to the central bank's 2% target and given its substantial holdings of foreign securities, it is difficult to see the franc declining significantly.

Inflation differentials vs. ratio of NEER and REER*



Source: Pictet Wealth Management, LSEG, as of 05.12.2023

SNB's FX interventions vs. Swiss imported inflation



Source: Pictet Wealth Management, LSEG, as of 05.12.2023

SCOPE FOR SOME DETERIORATION IN BALANCE OF PAYMENTS FLOWS

Large inflows from the balance of payments have provided structural support to the franc. In other words, the currency may have benefitted lately from Switzerland's large current account surplus and the sharp upturn in portfolio investment flows since late 2022. Going forward, while balance of payments flows should remain broadly supportive of the franc, net inflows will likely decline. Since the SNB started tightening monetary policy in June 2022, there have been massive inflows into Swiss debt securities. But the volume is unlikely to be sustained. Switzerland's large current account surplus may also decline. While it has limited bearing on the Swiss trade balance, the Swiss franc's prolonged strength should at least prevent the surplus growing much further. In short, coupled with deteriorating foreign direct investment flows, balance of payment dynamics could turn somewhat less supportive of the franc.

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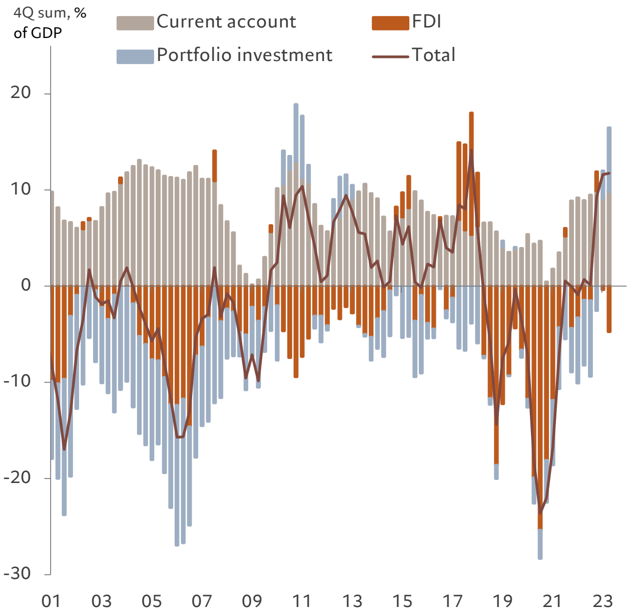
INTEREST RATE DIFFERENTIAL LIKELY TO NARROW

Our central scenario is for the SNB to be slower to ease policy than other central banks next year, with potentially no rate cuts in 2024. Interest-rate differentials could therefore turn more supportive of the franc. Downward pressure on global interest rates is usually supportive of the low-yielding franc. That said, interest rate differentials have mostly been pointing to a weaker franc since 2021, so they are not the most reliable indicator.

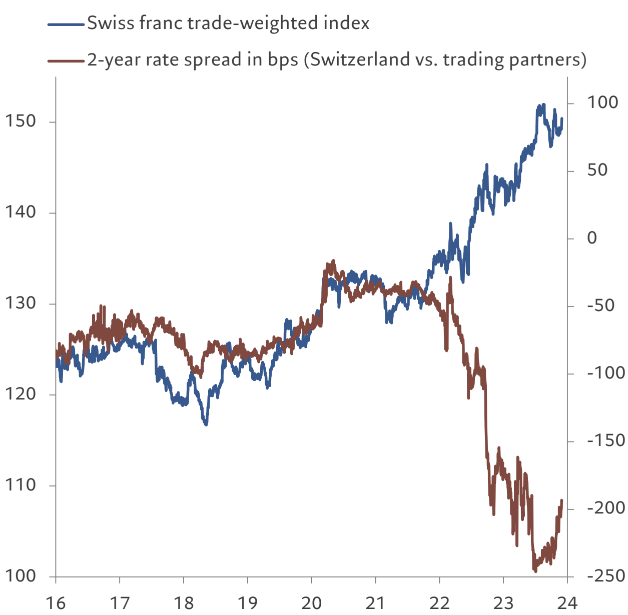
To be fair, the rise in interest rates over the past year and a half has raised concerns over the debt burdens of many other countries. By contrast, Switzerland has a very low and stable debt-to-GDP ratio. This is an important factor supporting the franc. All things considered, while we think rate differentials could turn less negative for the franc next year, they may not play a huge role in the franc's fortunes.

Current account, portfolio inv. & foreign direct inv.



Source: Pictet Wealth Management, LSEG, as of 05.12.2023

Swiss franc vs. 2-year interest rates differential



Source: Pictet Wealth Management, LSEG, as of 05.12.2023

THE FRANC MAY UNDERPERFORM OTHER MAJOR CURRENCIES IN 2024

In the round, a weak euro area economy and faltering growth in the US could keep the franc strong against the euro in the near term. However, an SNB that is less active in the forex market, less favourable balance of payments dynamics and a closing of the inflation gap between Switzerland and other countries should take away support from the franc at some stage next year. The franc could start to underperform should we see a modest economic recovery in major economies in H2 as we forecast.

Our three-month projection for the EUR/CHF rate is CHF0.95 compared with 0.9420 on 7 November. Based on our EUR/USD projections, the implied USD/CHF projections stand at CHF0.91 in three months' time and at CHF0.90 in 12 months.

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