The SNB will not rock the boat

The economy remains exposed and policy changes will be cautious

Our view is that the Swiss National Bank has started to normalise policy by tapering its balance sheet. As the Swiss economy remains exposed and political risk abounds globally, normalisation will be gradual. A rate hike is unlikely before 2019 and forex interventions are set to remain in the toolkit. Disruptive changes to the size or the composition of the balance sheet are unlikely, as exchange rate stability remains a key priority.

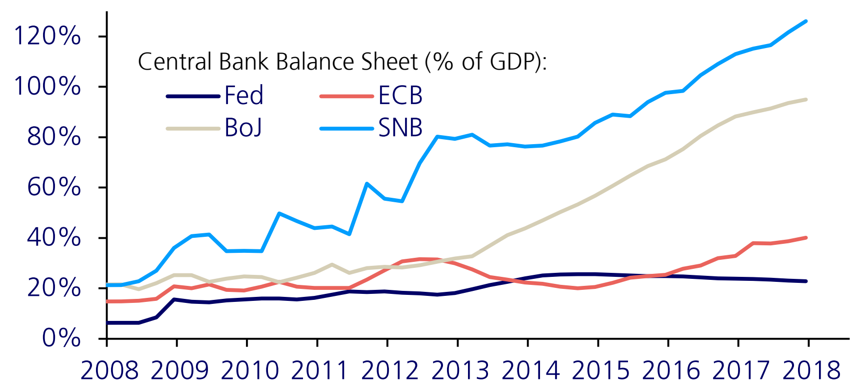
Source: iStock by Getty Images

Global expansion triggers strong demand for Swiss exports and a weaker franc

The global economy saw a synchronised expansion in 2017, with global trade and investment rebounding sharply. Risks to the outlook, which have been tilted to the downside for almost a decade, became more balanced. Last year also marked a watershed for the Eurozone, when a self-sustained recovery gained traction, with fears about a breakup of the currency union abating. While the region remains dependent on stimulus, it is no longer in emergency care. Investor demand for safe haven assets has consequently diminished.

For Switzerland, this has meant the beginning of a normalisation for the Swiss franc, which depreciated by almost 10% against the euro in 2017. Foreign demand for Swiss exports has surged and the manufacturing sector is booming. While the broader economy remains vulnerable, due to weak domestic demand and persistent structural headwinds, the economy is expanding, reducing the need for exceptional policies from the Swiss National Bank. Inflation has also recovered, turning positive after a deflationary period, as headwinds from import price deflation have waned. With this in mind, we believe that the SNB is likely to start a gradual process of policy normalisation in 2018. The way it normalises policy, however, will look very different from other central banks.

SNB measures dwarf the actions of other central banks

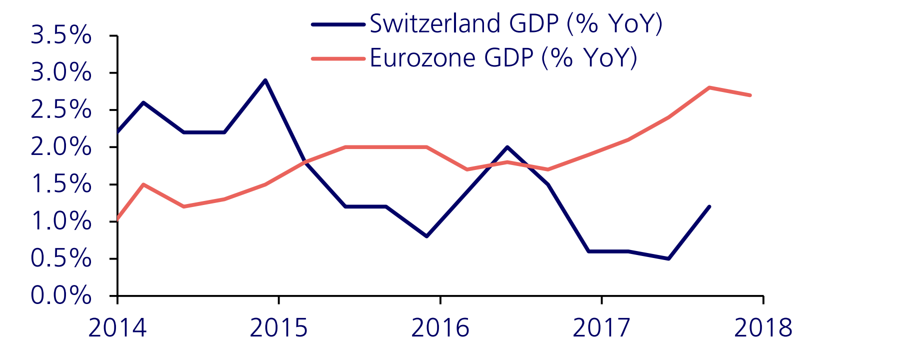


Source: National Central Banks, Bloomberg

The path to normalisation looks different for the SNB

The Swiss National Bank has expanded its balance sheet by over CHF 700bn since the beginning of the financial crisis, or close to 110% of GDP. Relative to the size of the economy, this dwarfs the actions of other central banks. The composition of the balance sheet is also different; it is now dominated by foreign currency reserves, while other central banks have accumulated domestic assets. The SNB also holds a large portfolio of risky assets – equities and non-government bonds – which most other central banks have steered away from. Because of these differences, the way that the SNB normalises policy will be different. The template that has been set by the Fed and the sequencing that the ECB has committed to following, are unlikely to apply to the SNB.

Growth in Switzerland is lagging behind



Source: SECO, Bloomberg

We do not expect the SNB to follow the steps of the Danish National Bank, which also saw a large increase in its forex reserves in 2015, but has since rapidly unwound these. The DNB is part of the European Exchange Rate mechanism and has a formal band to the euro and no independent inflation target. The SNB's policy objectives are more ambiguous making it harder, if not impossible, to rapidly cut back on the balance sheet without triggering a sharp appreciation of the franc.

Policy normalisation is expected to proceed cautiously in 2018

Our view is that the SNB has already started to taper its balance sheet opportunistically, and we anticipate this to continue in 2018. We also expect the SNB to keep forex interventions as part of its policy toolkit throughout the year. Given a focus on exchange rate stability, it would be premature for the SNB to abandon its ability to act as a seller of last resort for the Swiss franc, should safe haven demand intensify.

The SNB is set to tread more carefully with regards to rate hikes. We believe that it will lag behind the ECB, with rates on hold well into 2019. By contrast, changes to how the negative deposit rate is implemented should not be ruled out. Because of its large equity and credit portfolios, the SNB could also start the process of reducing the allocation to these riskier assets over the coming year, to reduce risk without explicitly scaling down the balance sheet.

The SNB is already tapering stimulus opportunistically

The first step in a normalisation process for the SNB is to taper forex reserves whenever the opportunity to do so arises. The SNB already appears to be doing this. Domestic banks' sight deposits, which proxy forex interventions, peaked in the middle of last year and have since fallen by CHF 32bn. This has, however, not yet been reflected in a stabilisation of the SNB's forex reserves, which have risen by close to CHF 40bn over the same period as a result of a weaker franc. This is a key difference between the SNB and other central banks; tapering asset purchases does not necessarily bring about a stabilisation of the balance sheet. Due to its sheer size, any strategy to reduce the SNB's balance sheet, while also maintaining economic momentum, must involve a stable currency.

Preventing a renewed strengthening of the franc is the top priority for the SNB

We believe that the SNB's top priority is to prevent a sharp appreciation of the franc. Apart from generating a large loss for the national bank, it would derail the recovery and trigger another deflationary episode. Despite the recent move higher, annual CPI inflation averaged only -0.3% over the past six years, putting it at par with Japan. Deflationary expectations have arguably become entrenched, with wage inflation tracking at only 0.5% YoY, compared to 2% a decade ago. At the current value of 1.15 CHF per euro, the franc also remains overvalued relative to what we would consider fair value at slightly below 1.20. Similarly, the trade-weighted franc is 10% stronger than it was in 2014 and close to 35% higher than prior to the Eurozone crisis, and current dollar weakness is putting renewed upward pressure on the trade-weighted index. This, we believe, are key reasons for why the SNB will keep its focus on the currency.

Reducing the impact of negative policy rates should be another key priority

Next in the line of priorities for the SNB should, in our view, be to begin the process of exiting from negative interest rate policies (NIRP). The negative yield environment is damaging for the financial sector and destabilising in the long run. The SNB is, however, constrained by the ECB, which is unlikely to raise rates before 2019. To avoid narrowing the policy rate differential vs the Eurozone, we believe that the SNB will postpone outright rate hikes until well into 2019.

The SNB could also reduce the negative impact of NIRP on the economy by allowing for more exceptions to the negative deposit rate. Excess reserves up to a multiple of 20 times required reserves are exempt from the 0.75% interest rate charge. In the early days of NIRP, this meant that the SNB was quite generous – banks were only charged for around 8% of their excess reserves. Subsequently, however, the policy has become increasingly more binding, and the negative deposit rate now applies to more than 30% of reserves. Arguably, this is no longer needed, given the strong global expansion and reduced demand for safe haven assets.

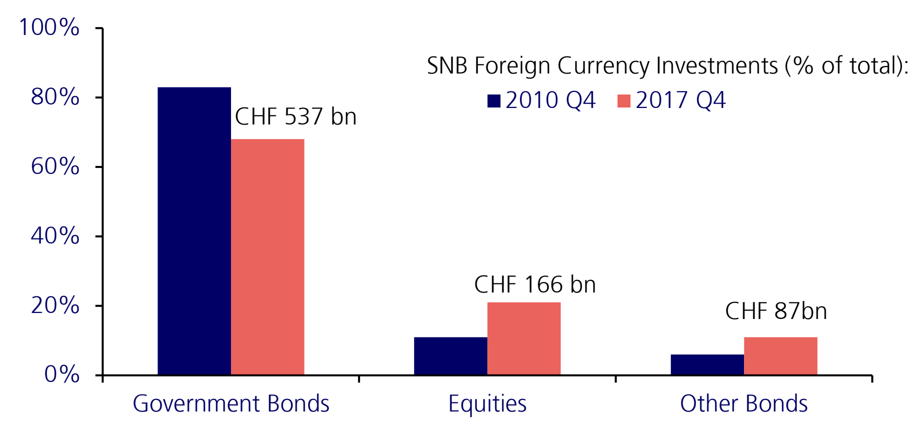
De-risking the balance sheet could be part of opportunistic tapering

The SNB's equity portfolio, valued at over CHF 160bn (2017 Q4), introduces an additional source of risk to the SNB's balance sheet. The central bank has increased its risk taking as the balance sheet has grown, doubling the share of equities from 10% in 2010 to 20%. We do not rule out that the SNB may partly reverse this at some point to reduce risk without explicitly shrinking the balance sheet. The precise timing is uncertain, but it could well begin in 2018, given valuations and the stage of the global business cycle. We do not foresee this as a global source of risk to equities and other risk assets, however, as the SNB has a strong incentive to proceed very cautiously and as the size of its equity holdings is still small compared to large global investors. The SNB is reported to hold, for example, 0.38% of the shares in Apple and 0.35% of the shares in Microsoft, while the larger investors hold well over 5% of the shares each.

The SNB is unlikely to announce a target for its balance sheet reduction

While the SNB is already reducing excess reserves, an explicit commitment to reduce the size of the balance sheet, or taper the pace of balance sheet expansion, is unlikely.

The SNB has increased its allocation to risk assets



Source: SNB

In contrast to some other central banks, the SNB's policy space is not constrained by the size of the domestic bond market. Likewise, distributional consequences, which are likely to be a constraint for the Fed, are less of a concern for the SNB. The reasons why the Fed and the ECB may want to reduce their balance sheets are therefore less relevant for the SNB.

The huge forex reserves do, however, introduce currency risk and enormous fluctuations in the SNB's profits. This worked in favour of tax payers in 2017 (with SNB annual profits estimated at CHF 54bn), but it generated a loss of 23bn in 2015, and the oversized balance sheet poses a threat to the SNB's independence. Given the vulnerability to changes in the value of the franc, however, maintaining a relatively stable currency is the most efficient way to control the balance sheet over the near term. This is an additional reason as to why we believe FX stability will remain top priority over the coming year. Over the longer run, the issue of the oversized balance sheet needs to be addressed more explicitly. This is unlikely to happen before some of the structural issues around the Eurozone, which still persist and could lead to renewed safe haven flows, are addressed.

A stronger global expansion would allow the SNB to move quicker

The biggest source of risk to our view is a significantly stronger global expansion, which could trigger accelerating capital outflows and allow the SNB to move ahead sooner than expected with a rate hike.

While activity continues to surprise on the upside both globally and in the Eurozone, inflation remains weak, with most central banks still missing target by a wide margin. In the Eurozone, core CPI is only tracking at around 1% YoY and inflation pressures are likely to remain weak over the coming year. In our view, this anchors the ECB's actions and limits the likelihood of a more rapid SNB policy normalisation.

The franc is expected be relatively stable against the euro

Our base case policy view implies a relatively stable franc against the euro. The potential for a sharp weakening of the currency is limited, as periods with downward pressure on the franc present an opportunity for the SNB to reduce excess reserves. The SNB is also likely to lean against a much stronger franc, given vulnerabilities that persist in the economy in the form of persistently low inflation and sluggish growth. The SNB is also faced with the possibility of taking a loss on the balance sheet should the franc strengthen materially. We therefore anticipate the franc to remain overvalued against the euro over the coming year, with the EURCHF below 1.20. This is manageable for the economy, in particularly given much slower consumer and producer price inflation in Switzerland compared to its major trading partners over the past years, which has helped to restore competitiveness.

The franc is expected to remain below parity to the US dollar, as a weaker franc against the euro is likely to be partly offset by a stronger euro vs the dollar. Indeed, this is what we have seen recently, when the dollar slumped against the euro and the Swiss franc.

Clear guidance from the SNB is highly unlikely

SNB policy changes have taken everyone by surprise over the past decade, and the Swiss central bank is unlikely to follow in the footsteps of the Fed and the ECB in flagging changes in advance. We would hope that the next time the SNB changes direction the world is a less risky place, with more scope for the SNB to move gradually. There are clearly risks around this though, and it has to be recognised that trying to predict the precise timing of the SNB moves is difficult. However, it is still useful to formulate a base case view on how normalisation may look like, given internal and external trade-offs and constraints.

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