Strategy Insight
Foreign Exchange Strategy

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EURCHF: perceptions & summer quirks trump fundamentals (for now)

- A strong EUR and FX investor perceptions of the SNB have probably been key drivers of EURCHF strength
- The roles of net capital flows and SNB intervention in the recent EURCHF rally are questionable
- The CHF sell-off is detached from some fundamentals; we see a risk of FX investors becoming too CHF bearish
- We would look to reduce long EURCHF exposures ahead of the September 14 SNB rate decision

A quirky summer franc

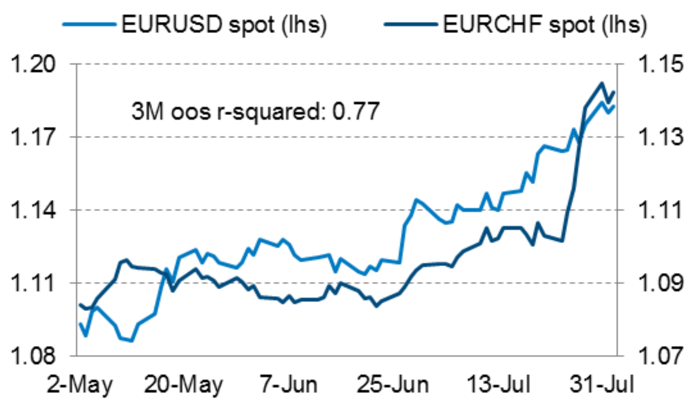
EURCHF has rallied 3.5% since the middle of July. However, a peculiar aspect of the sell-off in the CHF is that it has left the currency 1) the worst G10 performer vs the USD YTD and 2) detached from the spot returns on other major European currencies. The CHF has not only underperformed the EUR and the SEK. It has also underperformed the NOK and the GBP, which have been relatively weak for idiosyncratic reasons (i.e. weak oil and domestic political issues respectively).

EUR strength has been a key determinant of the rally in EURCHF. On a 3M basis, EURUSD has displayed an out-of-sample r-squared with EURCHF of nearly 0.80 (**Figure 1**). However, within this evidence we can see another CHF quirk. The rally in EURUSD has been based partly on improving EUR fundamentals and partly on a weaker USD. Yet the EUR has appreciated nearly 13% vs the USD YTD while the CHF has appreciated by a little over 5%. Meanwhile, there are few if any signs that the Swiss economy is performing that much worse than the Eurozone economy.

Questionable roles for net capital flows and the SNB

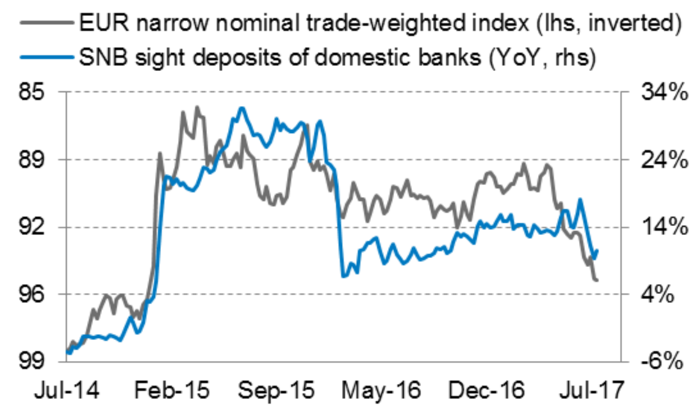
Net capital flows may have turned less CHF-supportive in Q2 & Q3, although there can be no certainty on this until Switzerland's BoP data are made available. Nevertheless, we do know that Eurozone political risks have declined, the Eurozone economy has continued to improve and the ECB has pointed investors in the direction of policy normalisation. All of these factors suggest net capital flows may have moved in favour of EURCHF during Q2 & Q3.

Figure 1. EURUSD spot vs EURCHF spot



Sources: Bloomberg, BMO FX Strategy

Figure 2. EUR narrow nominal TWI vs SNB sight deposits



Sources: Bloomberg, SNB, BMO FX Strategy

However, it's debatable whether a shift in net capital flows alone could have been responsible for the strong rally in EURCHF. By our calculations (excluding SNB intervention flow), the 4Q moving average of Switzerland's balance of payments has been in surplus during every single quarter since Q2 2014. In other words, without the help of SNB intervention, Switzerland would not generally have been able to fully recycle its current account surplus for about 3 years.

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Although net capital flows may have turned less CHF-supportive in Q2 and Q3, it's unlikely that those flows alone suddenly became large enough to more than offset the current account surplus – which has been averaging CHF17 billion per quarter – prompting EURCHF to rally by 3.5% over the span of 1-2 weeks.

This conclusion leaves the SNB as another plausible driver of the move higher in EURCHF. Data regarding domestic sight deposits of Swiss banks and FX reserves suggest steady intervention by the SNB throughout 2017, although it is also clear that the growth rate of sight deposits typically slows as the EUR appreciates (**Figure 2**).

Prior to Q2/Q3, this steady intervention by the SNB appears to have been just large enough to prevent sustained CHF appreciation, thereby keeping EURCHF in a well-defined range. Effectively, SNB intervention has allowed Switzerland's BoP to net out to around zero. With steady SNB intervention in Q2/Q3, only a small shift in Swiss net capital flows may have been necessary to send EURCHF higher. However, it is impossible to draw a firm conclusion given incomplete data.

FX investor perceptions of the SNB may have been critical to the EURCHF rally

SNB officials have been telling investors for years that the CHF is exceptionally overvalued. In the FX market, we think this rhetoric has created the perception of one-sided, asymmetric risk to the downside in the CHF. There is no doubt whatsoever that the SNB would like to prevent CHF appreciation. However, sustained CHF weakness would appear to be at odds with BoP data, given Switzerland's persistently large current account surplus. We would therefore not be surprised to see the SNB resisting CHF downside unless EUR strength reverses sharply.

Our view

Provided that the EUR doesn't reverse sharply, we would look to lighten long EURCHF exposures ahead of the September 14 SNB rate decision. Given the weak USD, we expect the CHF to realign itself with the strength in other European currencies over the coming months. As a result, we see USDCHF trading at 0.94 in 3M and 0.93 in 6M. We also expect EURCHF to retrace to 1.11 in 3M and 1.11 in 6M.

We are sceptical that the recent pace of EURCHF gains and general CHF underperformance can continue. It is not at all clear that private sector net capital outflows from the CHF into the EUR will be able to more than offset Switzerland's extremely large current account surplus (≈ 11% of GDP) on a sustained basis. Although the Eurozone economy is benefitting from a cyclical upswing, domestic and non-resident holders of CHF assets are probably aware that the structural integrity of the bloc is still far from assured.

EURCHF has recently benefitted from a surge in the EUR and thin summer trading conditions. This dynamic has probably allowed steady SNB intervention to be more effective in forcing EURCHF higher than it otherwise would have been. However, a sharp increase in SNB intervention from here would likely provoke unease from Switzerland's international trading partners, given its external surplus, and lead to an unwarranted loosening of financial conditions. We also think FX investor perceptions of an overvalued CHF are fundamentally incorrect.

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