European Viewpoint

SNB preview: steady with care

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Macro
Europe

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SNB: another 50bp

We were tempted to change our call for next week's SNB to a 75bp hike, rather than 50bp. Swiss headline inflation keeps surprising on the upside, arguably feeding concerns that higher headline inflation today will lead to higher inflation in the medium term. Core inflation has also failed to peak yet, as in the Euro area. The lower frequency of SNB meetings would also call for a more sizeable move (it only meets once per quarter), so as not to fall too far behind. Still, given recent developments, and while the dust settles from recent SNB actions that provide liquidity backstops, we think the central bank will likely opt for a 50bp hike next week with a soft signal of perhaps more to come. We are tempted to add another hike to the profile in 2Q23, but we will wait for next week's meeting and financial sector developments to reassess.

Smaller balance sheet, with caution

With a terminal rate well below that of other central banks balance sheet policy plays a crucial role here. The SNB has actively made its FX intervention policy symmetric: the option of expanding the balance sheet to fend off appreciation pressure had been topped up with the option to reduce the balance sheet to actually let (or make) the CHF appreciate. The SNB has actually started, and is likely to pursue, a policy of gradual balance sheet unwind, thereby providing tighter financial conditions through a blend of higher interest rates and a higher (nominal effective) exchange rate at the same time, as long as the real effective exchange rate does not tighten substantially at the same time.

Implications for CHF?

As the EUR response to the ECB has illustrated, the markets are likely to be conflicted in how to trade CHF on our base case: buy CHF because the SNB is showing strong commitment to fighting inflation or sell CHF as it potentially exacerbates existing Faultlines? We think the commentary on the decision will likely be the dominant driver for FX but do not think that a rate hike will weaken CHF due to its safe haven hedging properties. Staying on course has its pros and cons and there will inevitably be a lot of developments between now and the meeting. That will undoubtedly set the backdrop for how the market reacts and the tone of the accompanying comments.

Looking further ahead, we maintain a constructive view on CHF as we believe that recent events will increasingly focus SNB attention on its equity holdings which currently stand at 25% of total reserves. Our analysis has shown that the process of balance sheet tapering is under way (see: FX Watch: SNB FX Reserves: Another Decline 07 March 2023) which we think will have the most significant FX impact of any G10 central bank engaging in QT. We think SNB balance sheet tapering provides a floor for CHF as this becomes the dominant policy tool through the rest of the year.

CHF: Nothing is easy for SNB

Beware the Ides of March. Never has a phrase been so apt to describe the challenges that face the SNB at the first quarterly meeting for 2023. At the start of the month, the only question for markets was whether the SNB would hike by more than 50bps (our base case) and how far north of 2% the terminal rate would land. Within the space of 6 trading days, Swiss rates markets (using 1Y1Y OIS/forward swap rates) have fallen from 2.24% to 1.38% (Exhibit 1) as rates markets more broadly pare back expectations for the terminal rate. What we can say is that +75bps in rate hikes (where the market was gravitating towards) in March is probably now off the table. Despite the volatility in Swiss rates, CHF appreciation has been the major theme through the month and one of the relationships that has defined CHF performance in recent years, the correlation between TWI and the MOVE Index, is back in focus (Exhibit 2).

Exhibit 1: 1Y/1Y Swiss OIS
Swiss rates markets have pared back rate hike expectations.

Source: BofA Global Research, Bloomberg

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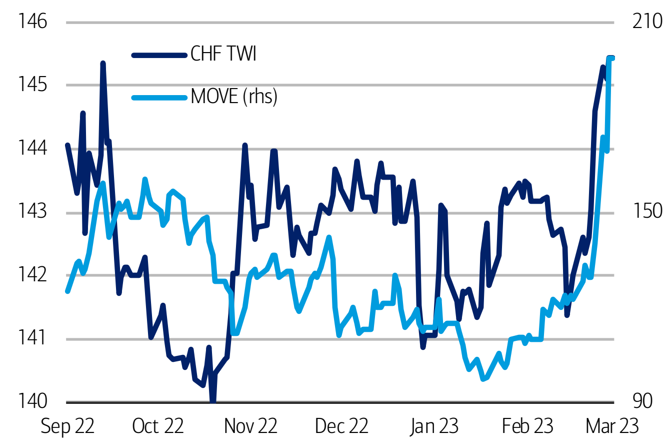
Exhibit 2: CHF versus MOVE Index
Higher Bond Vol has been supportive for CHF



Source: BofA Global Research, Bloomberg

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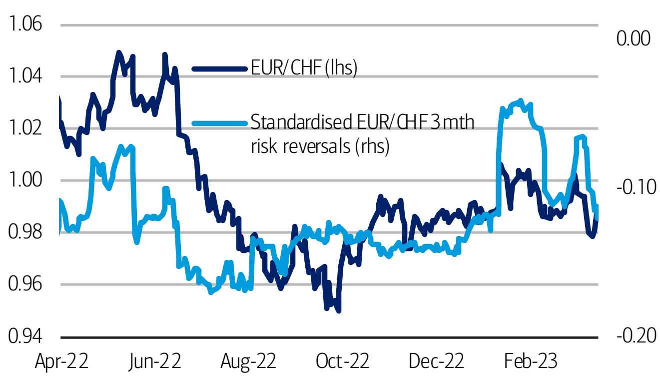
For some, there has been a perceived anomaly in CHF price action. The most common question from investors has been as follows: if the source of market stress has been Swiss banking, which is EUR/CHF lower? We have consistently maintained that CHF is the pre-eminent hedge on regional volatility. Combine this with long EUR/CHF as one the market's favoured macro long positions, then it becomes clear why EUR/CHF has succumbed to pressure.

Exhibit 3: EUR/CHF vs 3mth standardized risk reversals.
EUR/CHF calls have been a popular trade this year.



Source: BofA Global Research, Bloomberg

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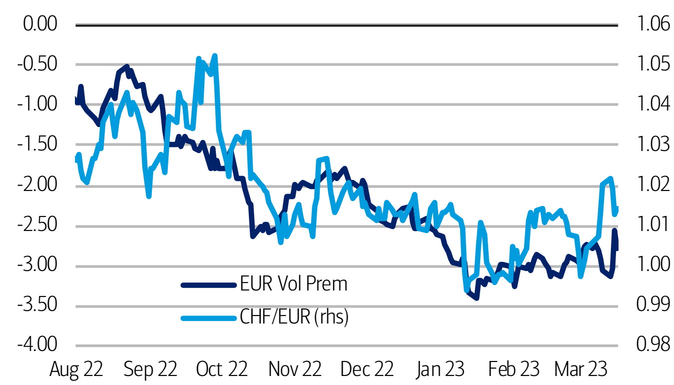
Exhibit 4: CHF/EUR vs EUR vol premium*
CHF has been sensitive to fluctuations in idiosyncratic EUR vol



Source: BofA Global Research, Bloomberg. *3mth implied EUR/USD vol vs G10/USD

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Exhibit 3 tracks 3mth standardised EUR/CHF risk reversals (vol adjusted) versus EUR/CHF. The start of the year saw a build up in bullish EUR/CHF optionality with EUR/CHF calls unusually trading in positive territory. The recent upheaval in global financial markets has seen a broader unwind of the markets favourite FX positions of which EUR/CHF has been amongst the most popular. This helps to explain why positioning has played its role in the EUR/CHF move lower. But Exhibit 4 captures the essence of the FX hierarchy in Europe and sensitivities to risk. We look at EUR/CHF versus EUR risk premium defined as 3mth implied EUR/USD volatility versus G10/USD. Though FX volatility has some moved in the same quantum as the MOVE, the relationship is clear. The issue may be a Swiss banking one, but it is larger problem for the EUR.

Against this backdrop, the SNB is facing several difficult choices. From a policy mandate standpoint, the choice is clear – inflation is reaccelerating, most rate curves in G10 have recalibrated to a higher terminal rate and some of the downside risks to growth have faded. To us, what separates the SNB from other central banks is its steadfast commitment to maintaining price stability to such an extent that it has been prepared to drop its red lines on persistent CHF overvaluation because it served a purpose. We view the SNB as amongst the most credible central banks in G10 because it has been prepared to take a do whatever it takes attitude to maintaining price stability. As with the ECB, the SNB should deliver a 50bps but the communication around the decision will be more significant. Beyond March, the market had previously priced in a higher terminal rate for the SNB than we had forecasted (1.50%). We continue to believe the risks are for further tightening in Q2, but our degree of confidence is understandably low given the lack of clarity on the end game over concerns in the banking sector.

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