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Fixed Income Research
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FX Strategist

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Sell three-month EURCHF volatility swap

- We expect the EURCHF floor at 1.20 to remain unchanged well into 2012 and possibly longer.
- Since the 1.20 floor was announced in early September, there have been no material surprises to the medium-term outlook for inflation.
- Since early September, the CHF TWI is down 17% from its peak, which together with base effects, should reverse the pre-September undershoot of inflation vis-a-vis Germany during the course of 2012.
- We recommend selling EURCHF volatility via a three-month EURCHF volatility swap currently bid at 10.25% of the EUR vega. The maximum downside is potentially unlimited if realized/ delivered volatility is higher than the pre-set level of implied vol (10.25%).

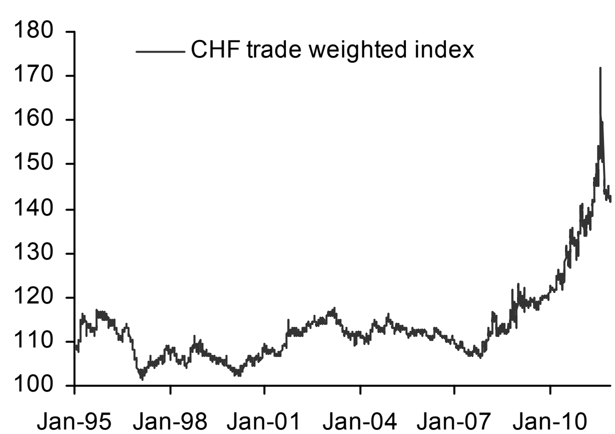
We expect the EURCHF floor at 1.20 to remain unchanged well into 2012 and possibly longer. We believe that the SNB needs to see a deeper, more prolonged fall in growth and clearer trend of deflation to justify further efforts towards franc devaluation. We expect delivered volatility on the cross to remain low.

Since the 1.20 floor was announced in early September, there have been no material surprises to the medium-term outlook for inflation. Unless this changes, we believe the SNB will not add risk to its balance sheet by changing its intervention policy. Deflation risk has emerged, but largely in line with SNB expectations. In its September monetary policy report, the SNB had predicted deflation in late Q4 2011-Q3 2012 based on the assumption of EURCHF at 1.20 at the time of forecasting and only gradually weakening over time.

Two variables seem to explain SNB behaviour. Before 2010, SNB rate changes were highly correlated with its Dynamic Factor Inflation Model, which is effectively a measure of economic slack. In the past two years, the SNB has been far more sensitive to the impact that CHF TWI moves have on spot CPI. Neither variable points to the need to change the EURCHF peg for the foreseeable future.

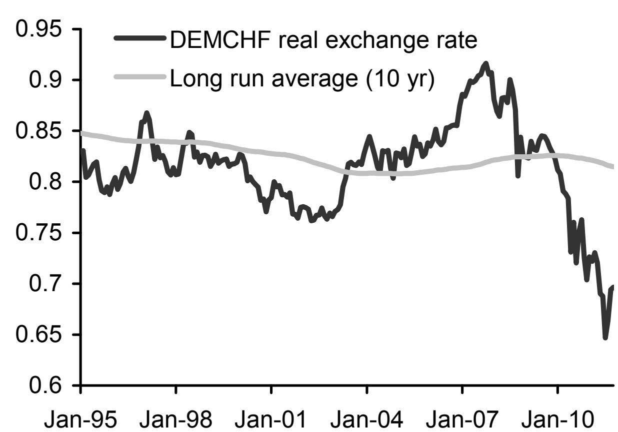
Since early September, the CHF TWI is down 17% from its peak, which together with base effects, should reverse the pre-September undershoot of inflation vis-a-vis Germany during the course of 2012. In terms of the slack variables, the PMI and KOF surveys point to modestly growing slack, but not enough to concern the SNB regarding future CPI dynamics. The Swiss seem to have coped well with the strong franc so far, as the trade surplus remains elevated and non-resident tourists arrivals have moderated only slightly.

Exhibit 1: CHF TWI has cheapened 17% from its peak...



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Exhibit 2: ... which argues for reversal of pre-Sep undershoot of inflation vis-à-vis Germany



Source: Credit Suisse

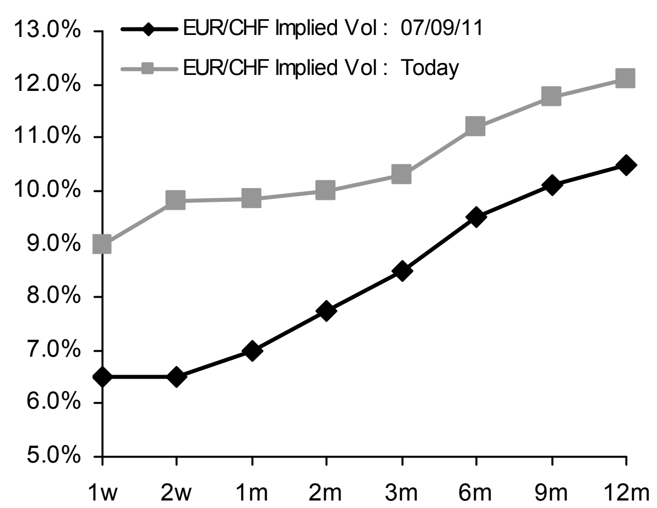
The Swiss franc remains very overvalued relative to our fair value framework, both bilaterally and on a trade-weighted basis. As such, there should be little risk of an inflation problem, a reason that prompted the SNB to withdraw its DEMCHF floor in the early 80s.

In the event of renewed safe haven buying of CHF, the SNB would rather intervene at 1.20 than 1.25 in light of how sensitive its equity buffer now is to fluctuations in the market value (but not the book value) of its very large portfolio of foreign currency holdings, in our view. We therefore look for an unchanged peg, and very low delivered volatility in EURCHF well into 2012.

Based on our expectation for the SNB to maintain the floor at 1.20 and for EURCHF to trade in a range over the next several months, we recommend selling EURCHF volatility via volatility swaps. **A three-month EURCHF volatility swap is currently bid at 10.25% of the EUR vega.** The payout to the seller of the vol swap at expiry is the difference between the pre-set implied volatility and the realized volatility (observed over the life of the swap) times the vega notional. The maximum downside is potentially unlimited if realized/ delivered volatility is higher than the pre-set implied volatility (10.25%).

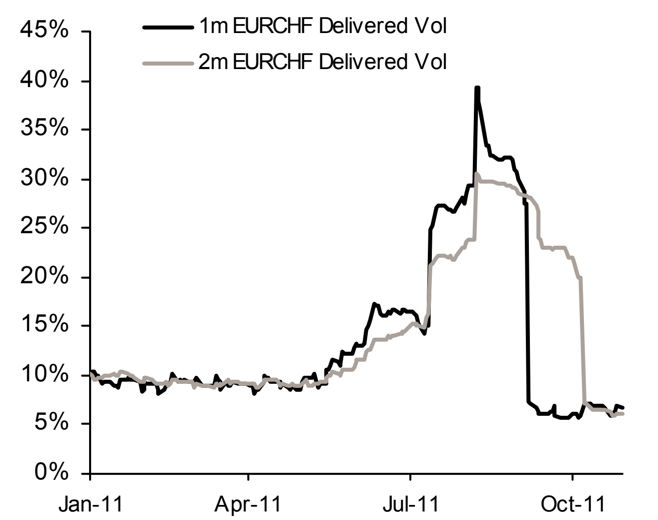
Following the SNB intervention in September, EURCHF delivered volatility has fallen significantly. However, implied vols have bounced back from the post-intervention lows in part driven by the idea of the SNB raising the EURCHF floor, in our opinion. Based on daily WMR fixes, EURCHF has delivered 6.80% and 6.20% over the past one-month and two-months respectively versus 10% implieds. See Exhibit 4.

Exhibit 3: EURCHF implieds have bounced back from Sep post-intervention lows



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Exhibit 4: EURCHF gamma has fallen post SNB floor



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