



Theme #5: Bern out – sell CHF versus EUR and JPY

Swiss reallocation into FX will continue to weigh on the franc this year. Stay long EUR/CHF targeting 1.25 and also sell CHF/JPY on positioning and valuation.

This year could mark the turning point for the Swiss home bias.

The Swiss private sector hasn't invested in foreign assets since the financial crisis, resulting in a structural allocation gap of around 400bn francs (Figure 1). But outflows should return this year at last, especially if bund yields approach 1% this year as expected by our rate strategists. The historically tight correlation with bunds would have EUR/CHF strengthening to 1.25. The Swiss bias for domestic equities may also diminish as the opportunity cost keeps increasing. Combining FX with equity valuations, Swiss stocks now look expensive against any other developed market (Fig 2).

Fresh outflows aside, Swiss investors' CHF demand from hedging existing foreign assets is also likely to diminish. Their foreign assets have been increasingly hedged since the crisis and especially since 2015 (Fig 3). But local appetite for FX exposure is growing again, not least because the January 2015 FX shock is dropping out of asset managers' VaR models, which typically have a 2-3 year look-back window.

The SNB will likely watch from the sidelines.

Recent rhetoric suggests the SNB still see the FX market as too "fragile", and the franc as too "highly valued", to start unwinding foreign reserves. This assessment is unlikely to change at levels below 1.20, with the SNB's assessment of fair value closer to 1.30. Unless outflows strengthen EUR/CHF materially, we believe the SNB will also be reluctant to pre-empt the first ECB rate hike, contrary to current market pricing (SNB in Q1; ECB in Q4 2019). With inflation in abeyance, the main rationale to raise rates is to reduce excess liquidity in the banking system. But sight deposits have started to fall anyway, effectively reducing the cost of negative rates to the banking system (Fig 4). While a hawkish ECB repricing may offer greater upside for EUR/CHF (see theme #1), there is still room for the first SNB hike to be pushed back.

Swiss the last funder standing

We would also sell CHF against JPY for two reasons: positioning and valuations. Given Swiss investors' structural overweight in CHF, we are not overly concerned about modest real money shorts on the IMM. Leveraged accounts in particular are not at all positioned for further CHF downside (Fig 5). Nonetheless, positioning in CHF/JPY is cleaner thanks to concentrated shorts in the yen.

The cross also stands out on valuations. As per Figure 1, the extreme valuation gap in CHF/JPY is exacerbated by the expensiveness of Swiss equities versus the Nikkei. When valuing CHF/JPY on the basis of relative P/E ratios it is about 40% overvalued (Fig 6). Just as Switzerland could see the largest outflows in 2018, Japan could therefore be a major beneficiary. The negative correlation between the Nikkei and the yen is no longer reliable, suggesting inflows could increasingly be unhedged and support the yen. Indeed, the continuation of the BoJ's 'stealth taper' at constant yields may require the anticipation of a rising yen to induce Japanese investors to repatriate unhedged foreign assets into JGBs, potentially creating a virtuous cycle for the yen. There are risk events in the first quarter that could trigger this cycle, including key BoJ appointments in March and spring wage negotiations. *Robin Winkler, London*