April 18, 2015

Grexit pressures the euro and momentarily strengthens the CHF

A resolution to the Greek crisis could be favorable to the euro. Possible loss in momentum for the U.S. dollar. Stabilization of the yen. A weak Swiss franc is expected.

Key Points:

- Since the discontinuing of the floor rate, the Swiss franc has only appreciated by 3.5% against the US dollar, the yen and the renminbi
- The euro is currently suffering from the uncertainty of the Greek case, which conceals the improving economic fundamentals
- The ECB injects €200 billion in just a few weeks without major consequences on the common currency
- The U.S. dollar is in the right path and benefits from growth differentials and attractive interest rates
- The momentum in the U.S. dollar could however weaken
- Probable stabilization of the yen and the euro
- A resolution to the Greek case will bring to light the improvement of economic activity in Europe
- Underperformance of the Swiss franc

Since the lifting of the minimum exchange rate, the Swiss franc only appreciated by 3.5% against the U.S. dollar, the yen and the renminbi

The SNB's decision to discontinue the minimum exchange rate on January 15 had direct and similar effects on foreign currencies. Most currencies recorded -15% to -19% fall in just a few hours.

Since that day, the seven major currencies have still picked up a positive trend against the Swiss franc, among which on top of the rebound stood a basket of three currencies: the U.S. dollar, the yen and the renminbi. These currencies are currently trading at just -3.5% below their December 31st, 2014 price.

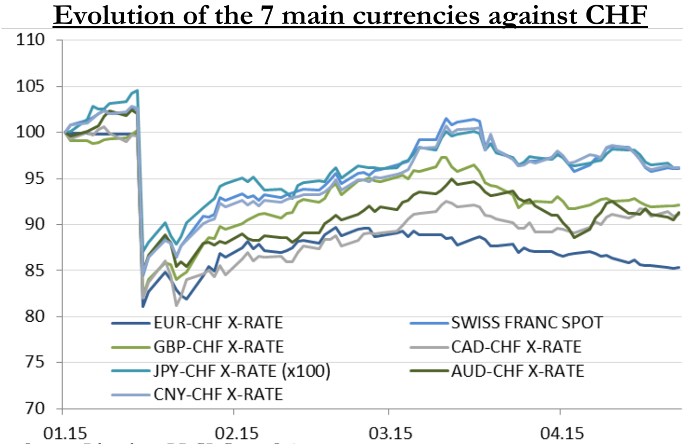
The British pound, the Australian and the Canadian dollar also rebounded by over +10% in three months and are down by approximately -7% compared to their December 31st, 2014 levels.

Despite the initial rebound, the euro is still lagging behind and appears to be struggling to regain investors' favors. The decline in the European currency remains consistent and has momentarily stabilized at 1.03-1.06, meaning 15% below the level that was initially set as the floor rate by the SNB.

The euro is probably still suffering from uncertainty related to the Grexit, which obscures the ongoing improvement in economic fundamentals. However, we believe that Europe is already benefiting from a combination of positive factors that should quickly promote an upheaval in the euro/Swiss franc rate.

That said, even if the euro were to remain weak, we still must recall that a major part of our commercial relationships are with non-EU trading partners and our trading surpluses are mainly attributed to the United States, Hong-Kong and the United Kingdom. In 2013, exports outside the euro zone to the United States (24.8%), China (8.8%) and Hong Kong (8.2%) already accounted for 41.8% of the overall volume of Swiss exports.

Evolution of the 7 main currencies against CHF



Sources: Bloomberg, BBGI Group SA

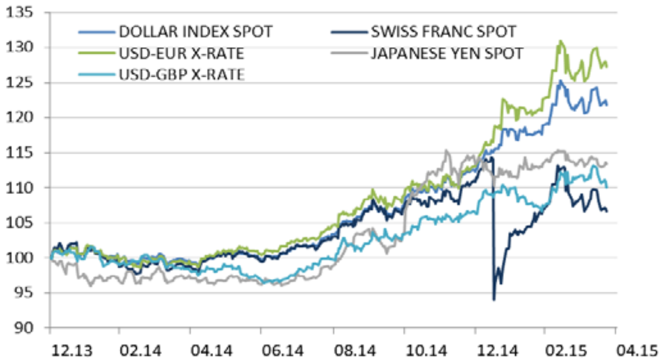
This finding tries to relativize the negative impact of the discontinuing of the floor rate on the future development of our exports and our trade balance. As Switzerland is among those countries whose foreign trade ties are a major contribution to the country's GDP, it is legitimate to worry about the effects that strong volatility could have on the exchange rate. There are still downside risks of a further decline in the euro, which could put pressure on our exports to the Eurozone, due to the loss of competitiveness of the Swiss franc. In the meantime, imports could also increase due to the growing purchasing power consequent to the appreciation of the Swiss franc.

The U.S. dollar is in the right path and benefits from growth differentials and attractive interest rates

The trade weighted US dollar index (DXY) continues its upward trend after having hit twice the 100 mark over the past two months.

The trend is clear, but the loss of momentum is also manifest, especially if we look at the euro.

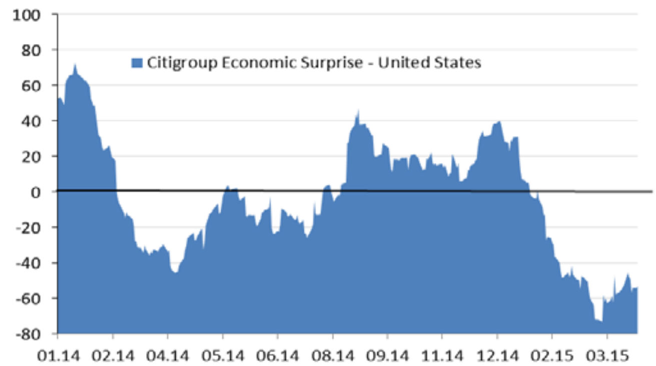
Trade weighted US dollar index and cross rates



Sources: Bloomberg, BBGI Group SA

In recent weeks, the U.S. economy has had the tendency to make investors jittery. Economic surprise indicators, as observed through the index published by Citigroup, reflect the disappointment of market observers since the beginning of the year.

Citigroup Economic Surprise index USA



Sources: Bloomberg, BBGI Group SA

The forecasts have thus proven to be overly optimistic, growth has actually subdued as it was recently pointed out by the Federal Reserve.

The U.S. economy is gradually breaking free of the Fed's support, but still does not benefit from the positive effect of the decline in crude oil prices and of the improving consumer confidence. A fairly large number of recently published data has had the tendency of being below expectations; employment data is perhaps shedding some light of the "air pocket" which is surrounding the U.S. economy in the short-term. We believe that this "air pocket" should be temporary until the U.S. economic dynamic cannot be reinitiated.

Obviously, the current economic weakness makes it highly unlikely for the Fed to change its monetary policy before September 2015.

Interest rates in U.S. dollars have also reacted to the anticipation of a stabilizing economic trend, and slipped around 40 basis points across the entire Treasury yield curve rates. The 10-year U.S. Treasury yields still offers a 1.86% interest rate and a very favorable risk premium compared to the German Bund interest rate which is close to zero for the same maturity.

The dollar continues to benefit from a favorable interest rate differential against the euro, the Swiss franc and the yen ...

We do not expect the monetary policy to change before the 4th quarter 2015, unless the current "air pocket" is followed by a subsequent economic acceleration in the United States and a rise in inflation perspectives. The most recent data shows a rise in inflation excluding food and energy at an annual rate of +1.8%. The same data over three months had an annualized increase which amounted to +2.3%. The higher prices have covered several sectors, while the University of Michigan Consumer Sentiment index for April came in with its best preliminary result in 8 years. The Federal Reserve can consider that underlying inflation is actually in the process of strengthening and is approaching the 2% target. For the time being, the drop in crude oil prices still has a negative effect on annual inflation, but the +33% rebound since mid-March from $42 to $56 could soon help strengthen the CPI on a monthly basis. The Fed has recently published a report, more commonly known as the Beige Book, on the current economic conditions indicating an improvement in its assessment of the economic situation despite a tighter employment market in March.

On a domestic level, growth should stir up in the coming months and thus favor the U.S. dollar.

However, after such an increase, we are rather expecting a stabilization phase against most major currencies. The yen is expected to remain within the 120 yen for 1 dollar range.

The economic situation, especially in Europe and Japan could disrupt bullish anticipation for the U.S. dollar against the abovementioned currencies. Following a 25% correction in the euro, a stabilization phase should take the lead for a couple of months.

Brighter prospects in Europe, still uncertainty on the Grexit weighs on the euro

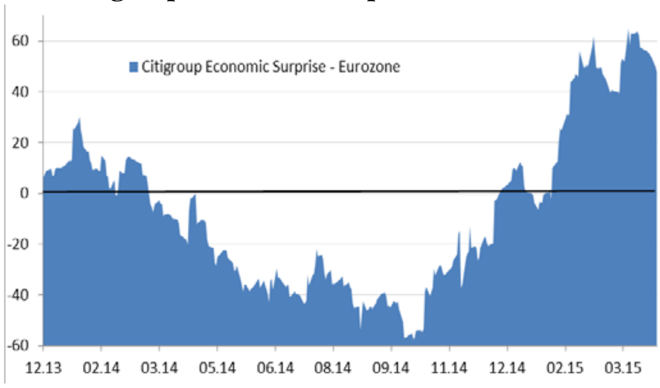
The Greek case is stealing the show and makes it difficult to observe the improvement in the European economic fundamentals.

Greece has actually promised it will repay the €450 million loan to the IMF in the next days. At the same time, it is increasing pressure in its negotiations with the Troïka by seeking to mend ties with the Kremlin and issuing political statements in favor of Russia. In 70 years, no country has ever defied the IMF by not honoring the terms debt. That said, there have nervertheless been a few cases of deferred debt. These conditions could also apply to the €9.7 billion Greece owes to the IMF. From a technical and semantical point of view, Greece could avoid default if it were allowed a deferred payment by the IMF or the ECB for instance. A Greek default could occur if the country does not honor its bond payments and commercial loans. The Greek government is threatening to withhold €2.5 billion of payments due to the IMF in May and June may just be a bargaining chip. This argument weighs less compared to the €240 billion bailout offered by the European Union and the IMF to support the Greek economy, but still speaks of the current political climate. The Greek crisis is now irritating some EU countries (Germany in particular), which now considers unreasonable to grant Greece another loan extension before the end of the month. Should Greece exit the Eurozone currency area? The President of the ECB does not seem to want to take the risk and reiterated that a solution is in the hands of the Greek government. The Prime Minister of Greece, Mr Tsipras has, to date, refused to implement the reforms to the labor market and pension system or to privatize state assets.

This climate of conflict and uncertainty continues to weigh on the euro. A resolution to the Greek political conflict is definitively favorable for the common currency, which could finally benefit from the improvement of current economic fundamentals.

Actually, Europe is better off than expected. During his last press conference, the president of the ECB revealed that borrowing conditions and consumption have improved, further strengthening hopes of economic recovery in Europe. Household credit growth remains in negative territory year-on-year (-0.8%), but displays a clear improvement since 2014.

Citigroup Economic Surprise index - Eurozone



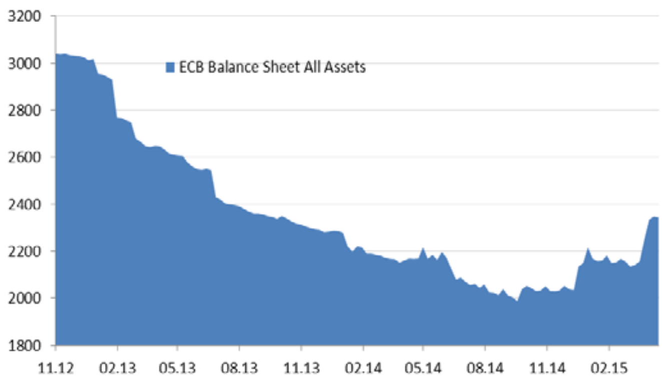
Sources: Bloomberg, BBGI Group SA

Leading economic advanced indicators point to a recovery that seems to be accelerating in Germany. Confidence is improving in Europe thanks to three main factors: Europe's improving competitiveness thanks to the 25% fall in the euro, the drop in oil prices and its impact on production costs, current accounts and purchasing power and ultimately the ECB's monetary stimulus.

Since the beginning of its monetary intervention, the ECB has earned approximately €200 billion in assets in almost 4 weeks, as its balance sheet surged by +9.7%.

The pace of the ECB's monthly purchases is substantially higher than the €60 billion per month announced back in January 2015.

ECB Balance Sheet - QE in "action" mode



Sources: Bloomberg, BBGI Group SA

The EUR/USD exchange rate has finally stabilized since mid-March along with the beginning of the implementation of the ECB's QE programme. The implementation of QE should no longer have a major downward effect on the euro. Improved fundamentals are a positive factor for the euro, but the potential dilutive effects of QE on the currency and the uncertainty of Grexit compensate for now these positive developments.

Euro/U.S. dollar Exchange Rate in stabilisation

Sources: Bloomberg, BBGI Group SA

After a 25% correction, the euro should stabilize between 1.05 and 1.10 U.S. dollars in the coming months. In our view, the negative effects of QE on the single currency have been largely anticipated, as suggested by the lack of reaction to the 200 billion euro liquidity injections of recent weeks. We do not believe that the Greek case will continue to weigh on the euro in the medium term. A political solution will keep Greece in the EU and prevent a future risk of contagion.

The euro should possibly enjoy a more favorable economic momentum and climb to 1.15-1.20 in 12 months against the U.S. dollar.

Gradual disregard in the Swiss franc

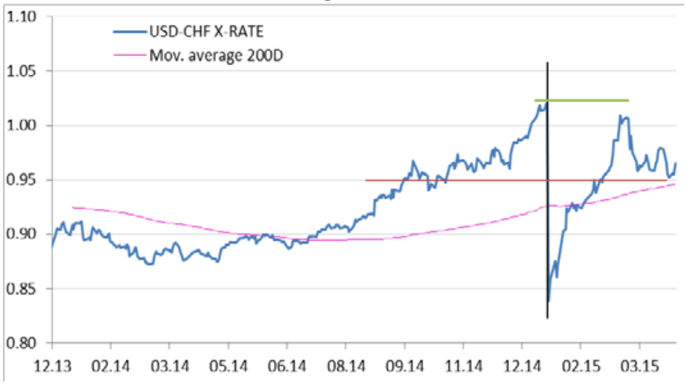
So far, the Swiss franc has been affected by the lack of European political and economic results. However, the European Union finally can count on an exceptional combination of positive factors.

These factors were not overshadowed by the Grexit. A normalization of the economic and political situation in Europe will be the key to a decrease in demand for Swiss francs. It might further enhance its effects on the exchange rate with the support of the SNB's negative rate policy.

In our view, the growth of the global economy will continue to support the weakening of the Swiss franc. The Swiss franc could lose ground against the U.S. dollar and the euro, more broadly compared to the Canadian, Australian dollar and specifically against several emerging market currencies.

Our short-term outlook for the U.S. dollar / Swiss franc exchange rate heads towards a stabilization between 0.95 and 1.02.

CHF / USD Exchange Rate in stabilisation



Sources: Bloomberg, BBGI Group SA

Regarding the euro, the upcoming weeks will definitively be crucial and will put a spotlight on the Greek problem. A negotiated solution with the Greek government should eclipse the Grexit and further emphasize the improvement of current economic fundamentals in Europe.

In this context, we believe that the EUR/CHF rate should resume an uptrend, initially pushing it back to 1.10.

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