BLUE HORIZON
Wealth Partner AG

Turbulent start to 2015

- **On 22 January the ECB announced a quantitative easing program, which exceeded market expectations. The ECB will buy bonds – government bonds, agencies, covered bonds and ABS – worth EUR 60 bn per month, beginning in March. The purchase program will continue at least until September 2016 and until there is a sustained adjustment in the inflation path consistent with the ECB's inflation target. The fact that the program is, in principle, open ended has been the biggest surprise.**
- **On 25 January the Greek left-wing party Syriza won the national elections. Prime Minister Alexis Tsipras and his outspoken Finance Minister Yanis Varoufakis have since then used strong rhetoric to state their aim of ending the austerity policy and exiting the bailout plan agreed with the Troika. This has led to major tensions with the European Union and there does not seem to be a solution in sight, despite the fact that the tone of the Greek government has softened somewhat recently. In our view, the Greek government faces the challenging task of balancing the work to be done on structural issues with the short-term economic pain resulting from reforms. Currently, it looks as if the new government is abandoning initial structural reforms altogether.**
- **On 15 January, the Swiss National Bank (SNB) unexpectedly discontinued its exchange-rate floor of 1.20 for the EUR-CHF exchange rate, which was designed to prevent excessive Swiss franc strength. In order to make capital flows into the Swiss franc more unattractive it lowered the interest rate payable on sight deposits held with it (to -0.75% from -0.25%) and reduced the target range for three-month Swiss franc Libor to between -1.25% and -0.25% from -0.75% and 0.25% previously. This has led to a further 20% appreciation of the Swiss franc and an immediate drop in the Swiss SMI index by almost 15%.**
- **Equity markets were very mixed in January. In general, European markets performed very well, the EuroStoxx 50 index gained 6.7% and the German DAX 9.1%, while the US S&P500 index lost 3% and the Swiss SMI 6.7%. Emerging markets gained slightly, by 0.6%. Government bond yields continued to fall. The 10Y German government bond yields fell to -0.27% and the corresponding US Treasury yield fell to 1.69%.**
- **Oil prices seem to have bottomed out between 50 and 55 USD/bl for Brent. Gold prices rose to about 1,300 USD/oz on 22 January, when the ECB announced its QE program, but declined thereafter to reach about 1,240 USD/oz currently.**
- **ISIS (also known as Islamic State or IS) continued to hit the headlines when killing a number of hostages. After they burned a captured Jordanian pilot alive, King Abdullah of Jordan announced a relentless war against ISIS together with international allies.**

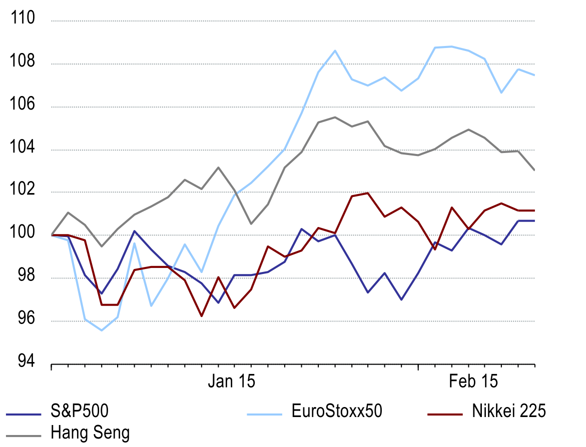
Macroeconomics and financial markets

The macro data in January were mixed. US non-farm payrolls rose by 257k, which is a reasonably strong number, but lower than the December figure of 329k. The ISM index fell to 53.5 in January from 55.1 in December. The Euro Area manufacturing PMI, however, increased to 51.0 in January from 50.6 in December 2014.

The major event for financial markets was the ECB decision to introduce an extensive quantitative easing program (QE), which was well received at least by European equity markets and by bond markets in general. Also, Gold reached a level of USD 1,300 on 22 January, the day of the ECB announcement, a level which could not be sustained.

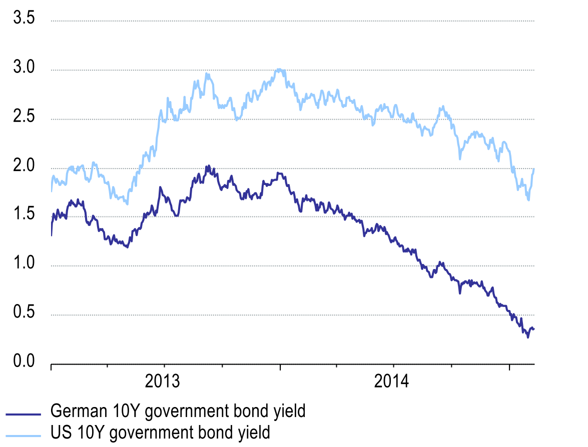
Market participants, however, have been concerned since the Greek left-wing party Syriza won the elections on 25 January. Prime Minister Alexis Tsipras and his outspoken Finance Minister Yanis Varoufakis have since then used strong rhetoric about ending the austerity policy and exiting the bailout plan agreed with the Troika (European Commission, ECB and IMF). However, since 80% of Greek debt is in the hands of other Governments or official bodies, Europe looks less vulnerable to a potential Greek default or even a possible Greek exit from the Euro area (Grexit). Mr Tsipras, in our view, is intensifying Greece's structural problems by abandoning recent reforms. His plans to rehire 12,000 public-sector workers, to abandon privatization and to bring about a big rise in the minimum wage would undo Greece's past improvements in competitiveness. In general, we think Europe should take a strong stance vis-à-vis Greece and insist on structural reforms.

Fig. 1: Major equity indices in 2014



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG

Fig 2: 10Y bond yields continue to fall



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Switzerland after the SNB abandoned the exchange rate floor

On 15 January the Swiss National Bank (SNB) unexpectedly discontinued its exchange-rate floor of 1.20 for the EUR-CHF exchange rate, which was designed to prevent excessive Swiss franc strength (see Fig. 3). In order to make capital flows into the Swiss franc more unattractive it lowered the interest rate payable on sight deposits held with it (to -0.75% from -0.25%) and reduced the target range for three-month Swiss franc Libor to between -1.25% and -0.25% from -0.75% and 0.25% previously. This has led to a further 20% appreciation of the Swiss Franc and an immediate drop in the Swiss SMI index by almost 15%. The decision led to major disruptive market turbulences. The EUR-CHF exchange rate fell from 1.20 to levels as low as 0.85 within only a couple of minutes. Many stop loss orders were triggered in a market in which there was no, or only a very limited, supply of Swiss francs (see Fig. 3).

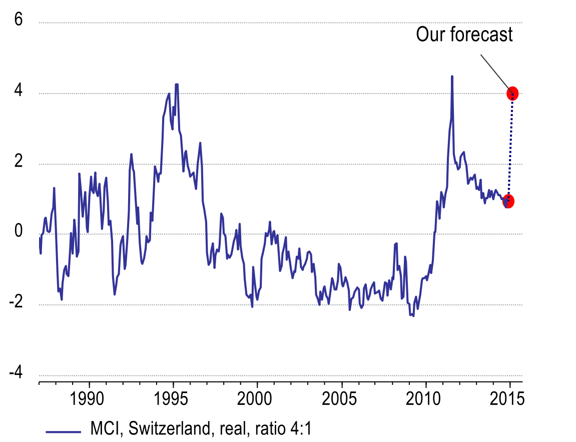
The SNB introduced the floor on 6 September 2011 when the EUR-CHF exchange rate was already at or close to parity. Just a couple of days before the SNB discontinued with the minimum exchange rate policy it publicly reiterated that this was one of the pillars of its monetary policy.

In the following we discuss the SNB policy from different angles. The first question is certainly: did such an intervention make sense at all? The Swiss economy is, whenever there are major crisis situations, exposed to excessive appreciation of its currency, which hurts the real economy since many Swiss medium-sized but also large corporations depend heavily on exports. This includes international

Fig. 3: EUR-CHF exchange rate

Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG

Fig 4: Swiss Real Monetary Conditions index



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banks with their cost base in Swiss francs and their revenues tied to foreign currencies. One of the major risks is that more and more companies will shift their cost base to other currency areas, which reduces the domestic value chain. In general, a central bank can prevent its currency from appreciation by unlimited printing of Swiss francs and buying, in this case, euro in the market. This is in contrast to a central bank which aims to prevent its currency from depreciation, since it would need to sell foreign currency reserves, which are limited by nature and will eventually be depleted. Buying foreign currency will sooner or later lead to higher inflation – which will also inevitably lead to a depreciating currency. Since Swiss inflation has been extremely low or negative in recent years this would be a desirable result. The problem for the SNB was that it was faced with mounting political pressure, especially from conservative political parties, which feared negative consequences from an ever expanding SNB balance sheet and potential hyperinflation. In our view the SNB first and foremost feared this political opposition. Obviously, every major policy intervention has distributional effects. While SNB's policy was beneficial for exporters and allowed investors to safely buy higher yielding foreign assets, importers and consumers had to accept higher prices for foreign goods and savers lower interest rates.

A second question arises around the timing and the communication of the policy change. While we absolutely agree with the SNB's statement that discontinuation of a currency target cannot be announced in advance, we find it very annoying that the SNB had chosen to use strong rhetoric to reiterate that the exchange target would be defended for the foreseeable future, and it did so until just days

Fig. 5: Swiss franc appreciation often followed by recessions

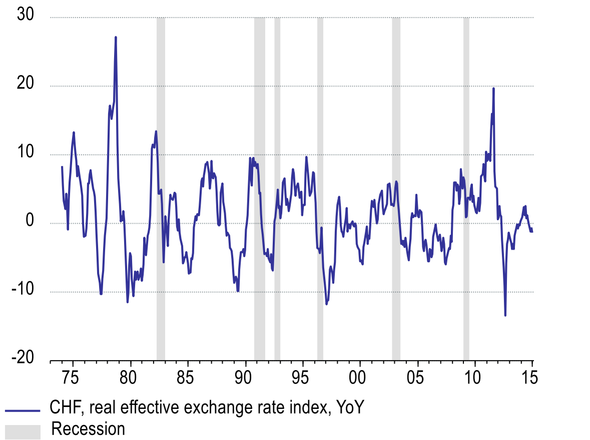

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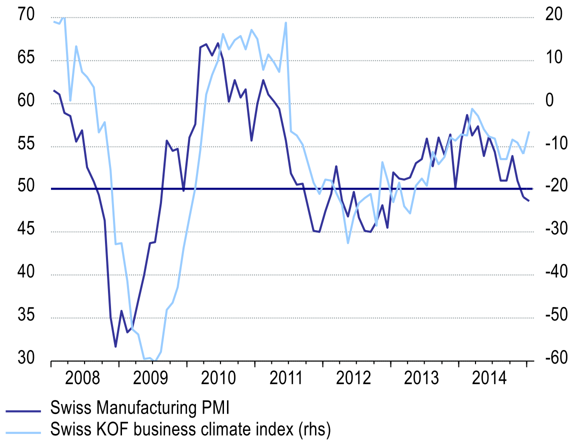
Fig 6: Swiss leading indicators



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before abandoning the exchange-rate floor. We find this misleading. In addition, the market reaction was very disruptive and many market participants suffered massive losses, with some brokers even going bust. We do not understand why the SNB did not announce the policy change over a weekend, which would have allowed market participants to prepare for the market opening and would have averted massive stop loss triggering.

The third question is concerned with the implications of the recent strengthening of the Swiss franc. Fig. 4 shows the real monetary conditions index for Switzerland. It is a measure of the deviation of the real money market rate from its long-term average combined with the relative weakness or strength of the real trade-weighted exchange rate. The index shows how loose or tight monetary conditions in an economy are. Since Switzerland is a relatively open economy, research suggests that the exchange rate should have a relatively high weight. Many analysts assume a 4:1 ratio. In other words a 4% real appreciation of the Swiss Franc is equivalent to a real interest rate increase of 1 percentage point. According to our forecast, the recent Swiss franc strengthening is equivalent to an SNB rate hike of 3 percentage points (see Fig. 4), which is a massive tightening of monetary conditions when the economy is already weak. While the recent KOF leading indicator showed little weakening so far, the Swiss PMI for January fell to 48.6 (see Fig. 6). A level below 50 indicates a shrinking economy. It is hard to make a solid assessment of Swiss growth prospects for 2015, but Fig. 5 shows that quite often the Swiss economy has fallen into recession after periods of Swiss franc strengthening. It is also worth mentioning that many corporates relied on the SNB guaranty and did not engage in currency hedging, which may lead to a much higher impact on the corporate balance sheet than necessary.

Outlook

In our view, the Swiss economy is likely to fall into a recession this year, and inflation will drop below zero. While deflation supports a currency, we think that negative economic news will lead to a weakening of the Swiss Franc in the course of 2015. We consider current levels as unsustainable.

We still remain constructive on equity markets in general. We also think that the SMI can catch up somewhat and that the 15% drop was exaggerated. A large portion of the global bond market has been pushed to negative yield levels. The US economy, despite less convincing data recently, is nearing full capacity and the earnings outlook remains positive. Therefore, we find it hard to foresee major equity market corrections. But, yes, we do need to live with higher volatility and probably with nasty sell-offs. US Treasury yields have fallen significantly since the beginning of the year, and we still believe that US yields should go up in the course of the next months. We also continue to see the USD on the strong side and think that oil prices should bottom out some time soon.

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