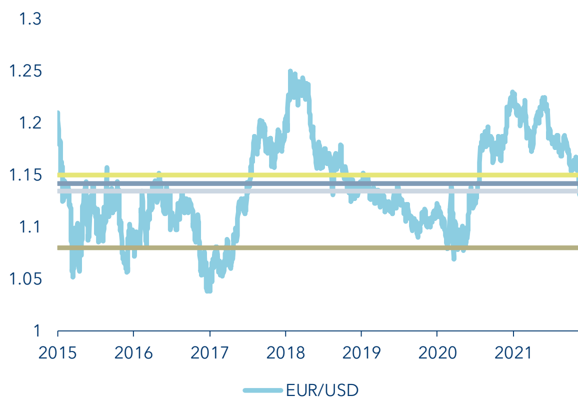
Dollar and Swiss franc flying high … for now

News from the financial markets

The US dollar and the Swiss franc have recently gained ground against the euro. The economic risks associated with today's supply-chain bottlenecks and shortage of materials are lending support to the so-called "safe haven" currencies. Once the flow of goods gets back to normal, both currencies can be expected to weaken.

The greenback has been flexing its muscles for several weeks now, with the EUR/USD cross having recently fallen below key support at 1.15. Heightened economic risks due to material shortages, a significant increase in new corona infections, rapidly rising inflation rates and the prospect of Fed rate hikes have swayed market sentiment in favour of the US currency. Add to this the fact that the European Central Bank (ECB) has yet to signal any clear departure from its ultra-expansive monetary policy.
Odds are that this situation will not change in the short term. Hence, the dollar should continue to enjoy considerable support in the weeks ahead, and further strength cannot be ruled out. From a technical perspective, the chart suggests that the EUR could even dip to 1.08 against the USD. This is by no means our base case, but it would be unwise to ignore the possibility entirely. We consider levels around 1.12 to be the greater likelihood.

EUR/USD and the relevant technical support lines

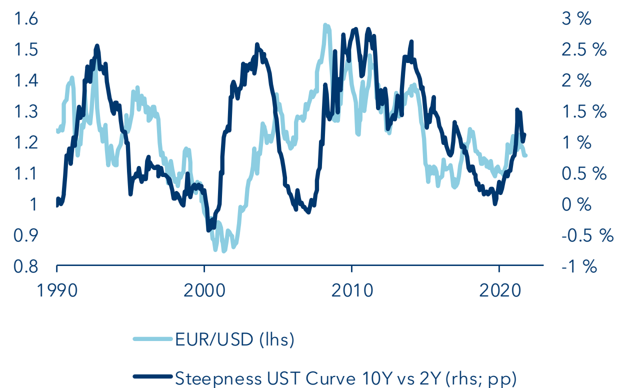


Sources: Refinitiv, VP Bank

USD is benefiting from the current environment

The COVID-19 pandemic has spawned many a phenomenon, one of which is the current shortage of key materials. Economic risks are becoming increasingly evident, with the flattening of the US yield curve being just one disturbing indicator of this. As can be seen on the following chart, the yield curve has closely tracked the movement of the USD in recent years. This is no coincidence, as the greenback in its role as a defensive currency tends to benefit in times of heightened uncertainty or phases of economic risk. At present, it appears that transient economic worries are having a stronger impact on the forex and fixed-income markets than they are on the equity markets. The latter are "looking beyond" the current difficult phase. However, the opposite applies as well: if normalcy returns to the global economy in the coming year and the uncertainties abate, the USD will be the loser – no matter what the US Federal Reserve's interest rate tactics might be.
In this regard, we draw your attention to the phase between 2004 and 2007 when the Fed sequentially raised the funds rate from 1% to 5.25%, with the greenback simultaneously plunging to record lows against the euro. By the same token, a global upswing also manifests itself in a progressively steepening US yield curve. In the fixed-income markets, 10-year Treasuries are currently falling in price more sharply than 2-year Treasuries as investors bet on higher rates down the road. Viewed this way, it should also come as no surprise that a steepening yield curve tends to be consistent with a weaker dollar. The bottom line: higher fixed-income yields in the USA do not necessarily crystallise in the form of a stronger greenback.

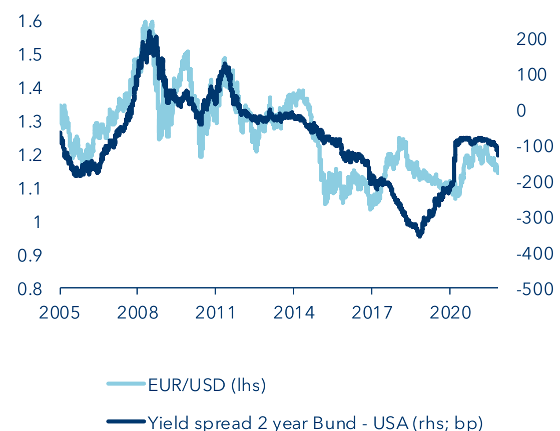
EUR/USD and steepness of the US yield curve



Sources: Refinitiv, VP Bank

The fact is, interest rate differentials can hardly be drawn on to explain the current strength in USD. There is no conspicuous disparity between the current EUR/USD exchange rate and the yield advantage of 2-year Treasuries over German Bunds (see chart).

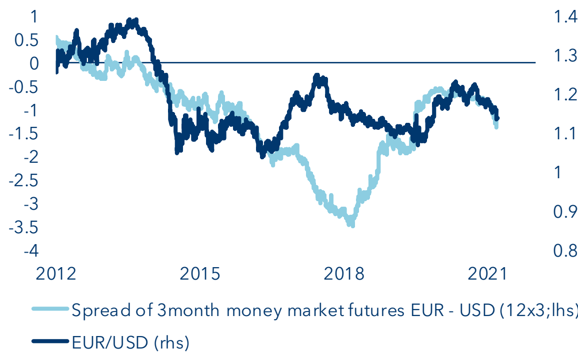
EUR/USD and yield differential on 2-year government paper



Sources: Refinitiv, VP Bank

This also applies in terms of rate expectations: the difference between 90-day EUR and USD money market futures twelve months out do not show any striking divergence at present.

EUR/USD and interest rate expectations



Sources: Bloomberg, VP Bank

This is precisely why we feel confirmed in our belief that the US dollar is being mainly driven right now by the existing economic uncertainties. Moreover, the differing stances of the Fed and the ECB on future monetary policy are likely to play at least a notional role by fanning further enthusiasm for the dollar. Nonetheless it should be borne in mind that, if the materials/supply shortages ease, the economic recovery will keep going. Manufacturers' order books are full and warehouses are empty, so when raw materials and components become available again in sufficient quantities, a surge in industrial production can be expected – at which point, at least the economic risks will wane. In such an environment, USD should tend to weaken, with a steepening US yield curve rounding out the scenario.

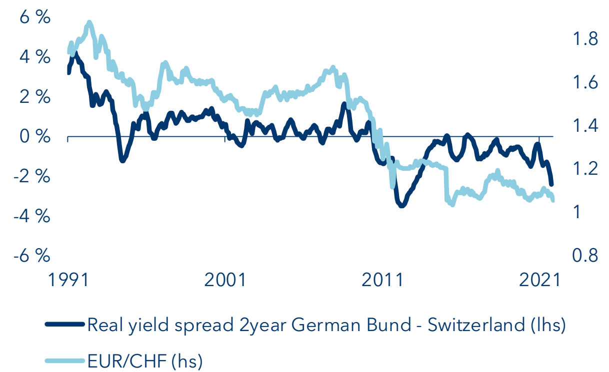
Summary: EUR/USD

US dollar strength is consistent with today's environment in which short-term economic risks are on the rise due to supply-chain bottlenecks, uncertainties abound as the result of a resurgence in Covid infections, and inflation rates at 30-year highs. This is an almost perfect setting for the dollar. However, once the flow of raw materials and components gets back to normal, the situation will reverse and likely lead to dollar weakness. So, in a nutshell: Over the short term we expect USD to remain firm in a move that could eventually take aim at key 1.08 support versus the euro. This, however, does not correspond to our base scenario. Twelve months out and beyond, we are still looking for a weaker US dollar (see our Telescope investment magazine, link).

The franc is benefiting as well

The Swiss franc is gaining favour in lockstep with the US dollar. Materials shortages, rising corona infection rates and accelerating inflation in the eurozone are giving the Swissie a boost versus the common currency. The latter factor in particular is reflected by the considerably lower inflation-adjusted negative yields within the eurozone as compared to Switzerland – yet another reason for market participants to favour CHF over EUR (see chart).

EUR/CHF and real yield differential



Sources: Bloomberg, VP Bank

It should also be noted that market players are of a mind that, in the long run, the Swiss National Bank has more leeway for rate hikes (see chart).

Anticipated rate hikes: money-market forward contracts

Sources: Bloomberg, VP Bank

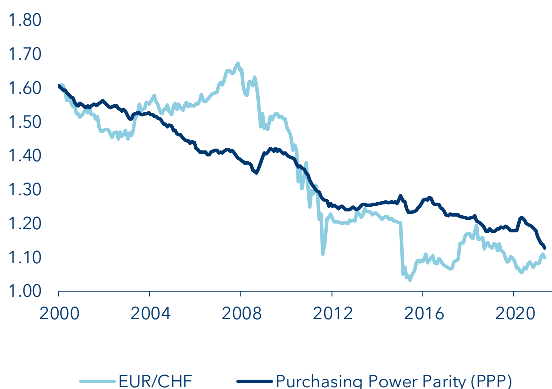
Interestingly, the financial markets believe that, even in the short term, the ECB and SNB will act in tandem rather than the Swiss monetary authorities waiting for Frankfurt to make the first move.
In response to the franc's strength, the SNB has recommenced its forex market interventions. It appears that any move below the EUR/CHF 1.05 mark will be hindered at least for the time being. However, as the recent market movement shows, even 1.05 is not considered a strict lower limit for the SNB. Since the summer months, commercial banks' sight deposits with the SNB have increased by roughly CHF 8 billion. This can be viewed as an

indicator of the extent to which the SNB has intervened in the currency market.

Structural strengths of Switzerland

There are probably two reasons why players believe that the SNB has greater scope for rate hikes in the longer run: On one hand, both the benchmark rate and the deposit rate for commercial banks in Switzerland stand at -0.75 %, compared to the ECB's main refinancing operations (MRO) rate of 0% and the deposit rate of -0.5%. The SNB therefore has farther to go on the road to normalising monetary policy than does the ECB and consequently will need to raise rates more significantly before they are back in positive territory.
On the other hand, structural aspects could also be behind the market's expectations of the SNB in terms of rate hikes. The ECB holds the monetary reins over a heterogeneous currency realm. The differing financial and economic policies of the member states require that the weakest one be taken into consideration in any move on the part of the central bank. Precisely for this reason, eurozone interest rates could be lower than those in Switzerland at some point in the not-too-distant future. The Swiss Confederation is one of the most competitive economies in the world, a factor which over the next several years could lead to higher growth rates and thus higher interest rates than in the eurozone. Since the ECB at present is increasingly and repeatedly speaking of uniform financing conditions within the currency area, this may indeed be an indication of Frankfurt's intention to act in favour of the weaker and not the strongest member states. By doing so, however, there is a risk that even in the event of persistently high inflation, the ECB will not respond adequately with a stricter interest rate policy. It is precisely this concern that could explain the franc's current strength against the euro, something that would also argue for the continued buoyancy of the Swiss currency in the longer run. Purchasing power parity (PPP) supports this notion as well (see chart).

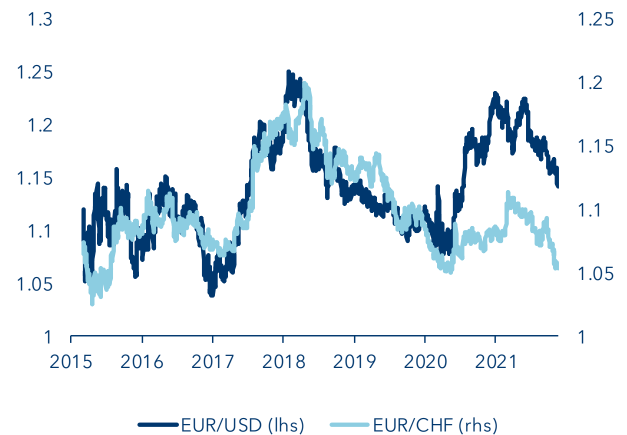
EUR/CHF and purchasing power parity



Sources: Refinitiv, VP Bank

Recently, PPP has provided a whole new dynamic to the Swiss franc. The producer price differences on which our calculation is based have moved the fair value of CHF ever closer to the actual EUR/CHF exchange rate.
Equally spoken, if and when the current supply shortages and associated economic risks subside, such a development would argue for CHF vulnerability in the shorter term, especially if the euro were to gain strength on the heels of a resurgence in global growth. Here we would draw your attention to the existing gap between the EUR/USD and EUR/CHF exchange rates.

EUR/USD and EUR/CHF



Sources: Refinitiv, VP Bank

As you can see from the chart, both currency pairs show a certain synchronicity, with the underlying cause being the general strength or weakness of the euro. It follows that, if USD were to weaken against the European common currency in response to a continued global upswing, higher prices for the EUR/CHF currency pair would also be possible. For this reason, we consider exchange rates around the 1.10 mark to be likely in the coming year.

Summary: EUR/CHF

Just like the US dollar, the Swiss franc stands to benefit further from the existing economic risks associated with today's supply-chain bottlenecks. However, the ongoing dovishness of the ECB is also spawning positive sentiment for CHF at present. If the economic outlook brightens, we would expect the franc to weaken. In the longer run, though, CHF should remain fundamentally well supported due to the purchasing power parity aspect, which is developing in the franc's favour, as well as the structural economic strengths of Switzerland.

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