

AQUILA FLASH



Aquila & Co. AG | 02 August 2017

Broad-based and synchronized acceleration in global growth

The prospect that the ECB might ratchet back its ultra-expansionary monetary policy has boosted the euro powerfully. Indeed the euro has even risen against the chronically-strong Swiss franc. An improved business cycle, reduced deflation risk and the more promising political outlook following Mr. Macron's victories in the French elections have all boosted the euro. Despite this, we still view the euro as undervalued relative to the Swiss franc.

A world-wide trend to higher yields

The data are confirming the positive outlook for the world economy which business opinion surveys were already predicting. The Eurozone should grow by around 1.9% this year. This improvement in the European economy has not escaped the notice of the ECB. Indeed statements by ECB President Mario Draghi, that the European recovery has taken root and that the risks of deflation have almost vanished, promptly triggered a world-wide increase in bond yields. At the ECB Forum in Sintra, investors have been put on notice that some ratcheting back of an ultra-expansionary monetary policy is also in prospect for the Eurozone. Yields on 10 year German government bonds have since risen almost 60 basis points, with knock-on effects on the Swiss bond market, where yields on 10 year Swiss Confederation bonds moved up to approach the zero mark. Berlin and the Bundesbank in Frankfurt are pressing the ECB to move faster towards normalizing its monetary policy and this pressure is likely to intensify. While the balance of power within the

ECB is such that these monetary policy traditionalists remain in the minority and can be outvoted, we still expect European rates to trend higher at a gradual pace. An improved political outlook, especially in France, and a further up-leg in the oil price also suggest a trend to gently rising bond yields.

Disappointing economic trends in Switzerland

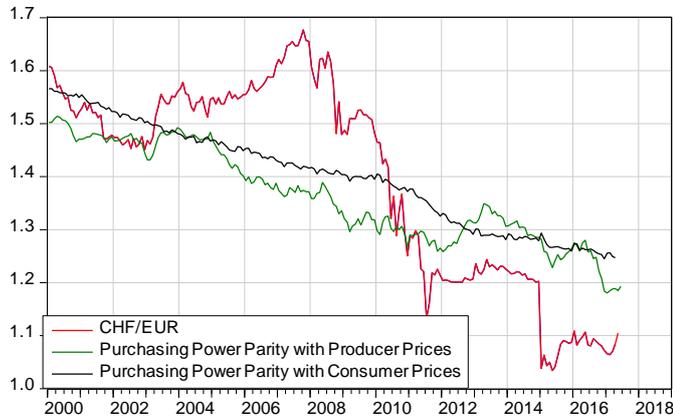
Unfortunately consumer confidence in Switzerland seems to be trending weaker in 2017 while in Euroland it has been strengthening. It seems also that the construction sector will have a reduced positive impact on the overall Swiss economy. The slowdown in immigration will also tend to dampen growth. We forecast an expansion of the Swiss economy of just 1.4% this year.

The euro has managed further gains against the Swissie

The euro has strengthened appreciably against the Swiss franc, a development that has pleased the Swiss National Bank and the tourism and export sectors.

The main factor behind the strengthening euro has to do with the recent pattern of central bank communication with the markets. A potential normalization in ECB monetary policy was indicated during the ECB Forum in Sintra and this gave the euro a powerful, if temporary, boost. Nevertheless, we believe that the Eurozone currency is still undervalued relative to the Swiss franc. The purchasing power parity estimates shown in Graph 1 support this conclusion.

Graph 1: Purchasing power parity estimates show the euro is still undervalued



Using producer price indices, we estimate that the purchasing power parity for the Swiss franc against the euro is now around 1.18. Using consumer price indices, we estimate purchasing power parity at 1.25 francs per euro.

Valuation is not the only factor which argues for a rising euro. An improving Euroland economy and the prospective trend towards a slow normalization of ECB monetary policy also speak for a strengthening euro.

What are the main risks with respect to this scenario?

- (1) Upcoming elections in Italy and Austria could bring the euro's rising trend against the franc to an abrupt end. Although the Italian elections seem to us to pose a particular risk, they are not likely to happen before early 2018 and thus may not impact the markets until much nearer the election date.
- (2) . A general trend towards investor risk aversion or a sharp stock market decline could promote a demand for safe haven assets such as Swiss francs. In such circumstances, when the investor mood shifts sharply to pessimism, a high valuation for the franc does not seem to deter investors.
- (3) An unexpected weakening of the Eurozone economy.
- (4) Some hesitation on the part of the ECB in shifting monetary policy to a more normal stance.

Much weaker than expected inflation data could, for example, cause the ECB to adjust its plans.

Investors who position themselves for a rising euro should not only consider the above-mentioned risks. They should also remember that the euro/Swiss franc exchange rate tends to correlate positively with risky assets. While there are good grounds to expect a further appreciation of the euro against the franc, one should reckon that a period of stock market weakness is likely to trigger some recovery of the franc, at least on a temporary basis.

On the other hand, the euro will tend to move up if global interest rates trend higher and we see both the euro and interest rates rising in the context of the trend to a normalization of monetary policy on a global basis.

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