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Currency market dilemma?

Market Comment, February 2021

With his economic stimulus plans, the new US President has paused the international currency trends that had been evident for some months. At the same time, America has been calling Switzerland a "currency manipulator". This will hardly present much of a dilemma for the Swiss National Bank (SNB), which can be expected to make further interventions in the currency markets – if it considers these to be necessary. By contrast, the spread of the coronavirus and the US President's plans raise questions about the dollar's future trend.

The US Treasury Department recently branded Switzerland a "currency manipulator". Why? Because Switzerland has a goods trade surplus with the US of more than USD 20 billion (actually USD 49 billion) and a current account surplus greater than the defined threshold of 2% (actually 8.8%), and the SNB made a number of massive interventions in the currency markets during 2020.

However, in contrast to Vietnam, which was likewise declared to be a currency manipulator, Switzerland currently has no reason to expect the US to react with specific measures such as additional tariffs. This is not because of any recent change in the US political landscape (the origins of the "currency manipulator" label date back to the last Democrat administration under Obama), but because the Swiss franc is significantly overvalued rather than undervalued against the US dollar in terms of purchasing power parity. Moreover, the SNB's currency interventions have essentially been to counter the strength of the franc against the euro rather than against the greenback. We are therefore assuming that the SNB will intervene in the currency markets – if it sees this as more necessary again following the recent phase of tranquillity in the CHF/EUR exchange rate – to mitigate the strength of the franc. Comments made by senior SNB figures are unambiguous in this regard, which means that currency intervention will remain a key instrument of monetary policy.

Where the US dollar is concerned, a pause in the previous recent trend of weakness became apparent in the first few weeks of the new year. The background to this development is the Democrats' capture of Georgia's two Senate seats last month, which – thanks to the casting vote held by Vice President Harris – gives them the single extra vote they need to get bills through Congress. This in turn increases the chances of greater US economic stimulus in the form of the coronavirus relief plan recently unveiled by President Biden. The increased growth stimuli that this will unleash in the US have prompted a resurgence in dollar yields against European currencies, particularly the euro.

> "At the moment, the key factors for future currency development are not easy to gauge."
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> Gérard Piasko, Chief Investment Officer

Despite this, almost all currency analysts of global banks are expecting a weaker US dollar in 2021, as the dollar's interest rate advantage against other currencies used to be much more pronounced than it is today. However, this market opinion is now so enshrined as a consensus that plenty has already been factored into current exchange rates – and little wonder, after the US dollar's decline by some 10% over the last year.

When viewed in historical terms, the US dollar is no longer expensive against the euro, and certainly not against the Swiss franc, when inflation-adjusted purchasing power is taken into account. By contrast, the greenback does appear somewhat overvalued against highly cyclical currencies such as the Brazilian real or the pound sterling. America's record-high trade deficit and the renewed rise of its current account deficit show that the dollar's fundamental situation is not really stable, which is why an increase in volatility should be expected.

On the other hand, depending on the magnitude of the package that could be passed by Congress in the future to stimulate the national economy, the US might see a positive knock-on effect for its economic growth relative to the Eurozone and Switzerland. In addition, the proliferation of coronavirus and attempts to combat it – and particularly the new mutations – remain hugely important for the relative growth figures on both sides of the Atlantic. But this is something that no-one can accurately predict, just as the impact of the virus on growth in the emerging markets or Japan can hardly be gauged.

Conclusion: Following surprisingly large movements in the foreign exchange markets last year – with a decline in the US dollar decline and a recovery of the euro – the situation has now become less clear following political events in the US and the plans of US President Biden. At the same time, many of the factors that will be key to the development of currency markets are not only important but are also shrouded in uncertainty. Overall, an increase in currency market volatility should be anticipated in the near future.

Gérard Piasko

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