



Compass

4th Quarter 2024

Focus on safe haven currencies

The strong Swiss franc challenges the
SNB and investors

Investment implications for Swiss
investors

The Swiss franc as a safe haven currency

The Bank of Japan's surprise interest rate hike led to the unwinding of numerous yen carry trades, causing market turbulence and a significant appreciation of the yen. Due to the low level of interest rates and the stable economy with high current account surpluses, the yen, together with the Swiss franc, is one of the typical safe haven currencies sought by investors in times of market turbulence. Thanks to a highly disciplined fiscal policy, the Swiss franc is also subject to constant appreciation pressure even in the absence of a crisis, to which the SNB can only counter to a limited extent.

This poses a challenge for Swiss investors, as low-risk, top-quality Swiss franc bonds do not offer a positive real return due to low interest rates. Equities are likely to yield significantly higher returns in the long term. For Swiss investors, however, the expected returns are lower due to the strength of the Swiss franc and because the fluctuations are higher than for euro-based investors, due to the safe haven characteristics of the franc. Even with a strong home bias, currency risks cannot be avoided, as most Swiss companies generate the majority of their sales abroad. In addition to an internationally oriented equity strategy, we rely on Swiss residential real estate funds for our Swiss franc strategies. These are regarded as good protection against inflation, they are less exposed to economic cycles and are practically immune to currency fluctuations.

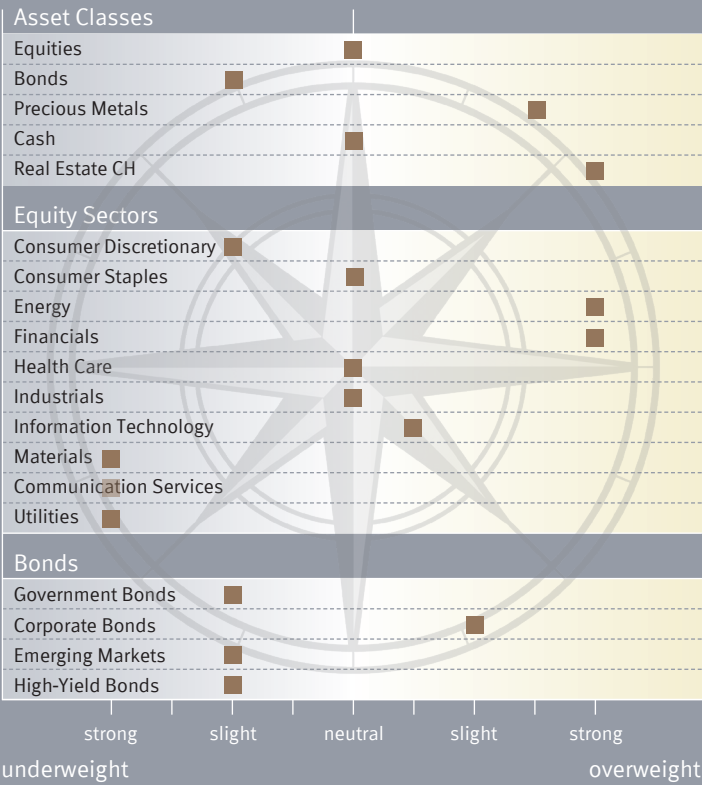
Robust growth despite weak labour market

Global economic growth is proving resilient despite recent periods of weakness, which were mainly triggered by disappointing labour market data from the US. Although the much-cited Sahm Rule signalled a recession, there are a number of signs indicating that we are not currently in a recession. Productivity has recovered and although corporate profits are falling slightly, the OECD leading indicators point to stabilisation. Positive data on GDP growth, consumption and household income support this view.

Inflation has eased in recent months, but remains above the Fed's target. This decline is mainly driven by falling unit labour costs. Consequently, interest rate cuts can be expected in the US as well as in Europe and Switzerland over the next twelve months.

Given the current macroeconomic environment, we consider our allocation to be appropriate. We therefore maintain our existing asset class and sector weightings. Our recommendation for bonds remains unchanged: careful examination of credit quality and a preference for first-class issuers remain essential.

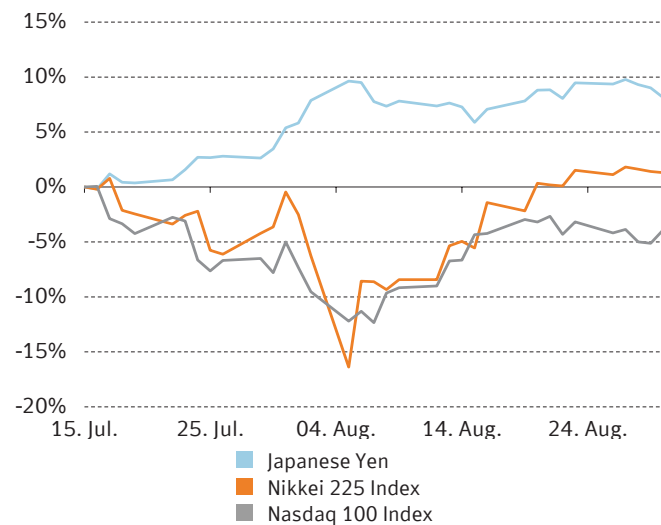
Asset allocation recommendation as of October 1st, 2024 for investors with CHF as their reference currency.



Current Topic: Focus on safe haven currencies

Current Topic 1:

Indexed performance in USD



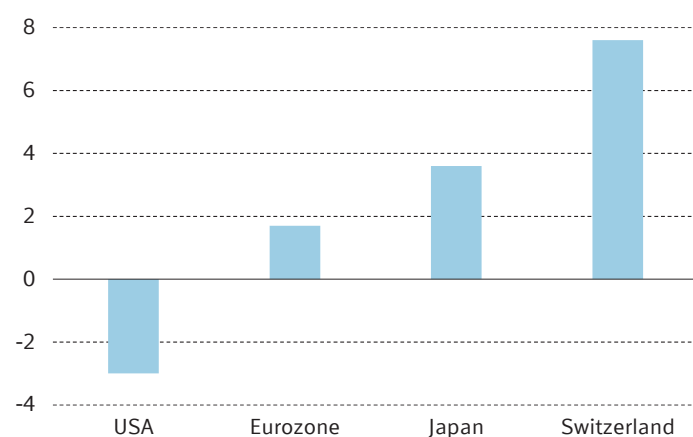
Bank of Japan shock

After a first rate hike in March, the Bank of Japan surprisingly raised its key interest rate to 0.25% at the end of July, finally ending a period of 17 years of ultra-loose monetary policy. The central bank also announced that it would reduce its monthly purchases of Japanese government bonds and equity ETFs. This led to a rapid unwinding of yen carry trades, where investors borrow in yen to invest in more profitable assets abroad. This, combined with the weak US labour market data released the same week, caused market turbulence. As a result, the yen strengthened significantly and global equities were sold off. US technology stocks and export-oriented Japanese companies were particularly hard hit.

Current Topic 2:

Source: Worldbank

Current account deficit/surplus in % of GDP



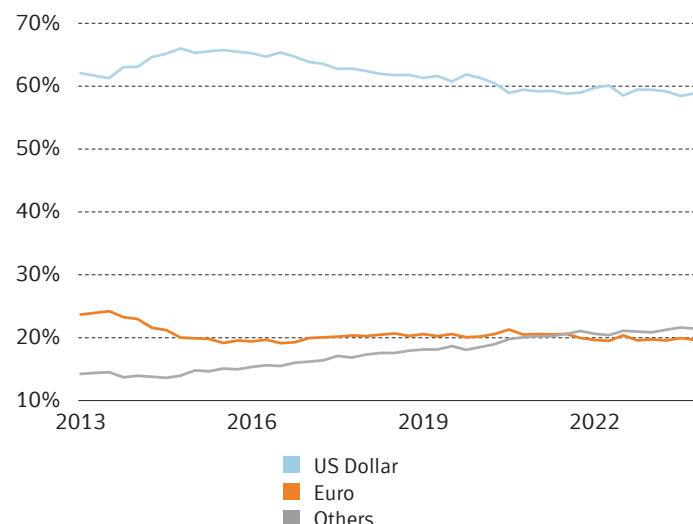
Characteristics of safe haven currencies

Safe haven currencies such as the Swiss franc and the Japanese yen are known for their stability, especially in times of global economic turmoil. These safe haven currencies are from countries with robust economies characterised by low interest rates, low inflation rates and current account surpluses. These surpluses are the result of the countries' strong export economies. Due to the low interest rates, these currencies are also popular for financing carry trades. However, as the recent example of the yen shows, there is a risk that unexpected interest rate changes can quickly unwind the leverage and lead to turbulence in the currency and equity markets.

Current Topic 3:

Source: IMF

Share of global currency reserves



Is the US dollar also a safe haven currency?

According to the Bank for International Settlements, the US dollar (USD) accounted for 88.5% of global turnover in foreign currency instruments in 2022, making it the most liquid and important trading currency. The US dollar is also the most important reserve currency, accounting for 58.9% of global foreign exchange reserves, and most debt is denominated in USD. As a result, the demand for US dollars increases in times of crisis when financial markets are deleveraging. Nevertheless, the USD is not considered a typical safe haven currency, as the US has a high level of public debt, an excessive budget deficit and, in particular, a negative current account balance as the world's largest net importer. These factors are increasingly weakening the status of the US dollar as the global reserve currency.

Basic Trend:

The strong Swiss franc challenges the SNB and investors

Basic Trend 1:

Real CHF exchange rate index

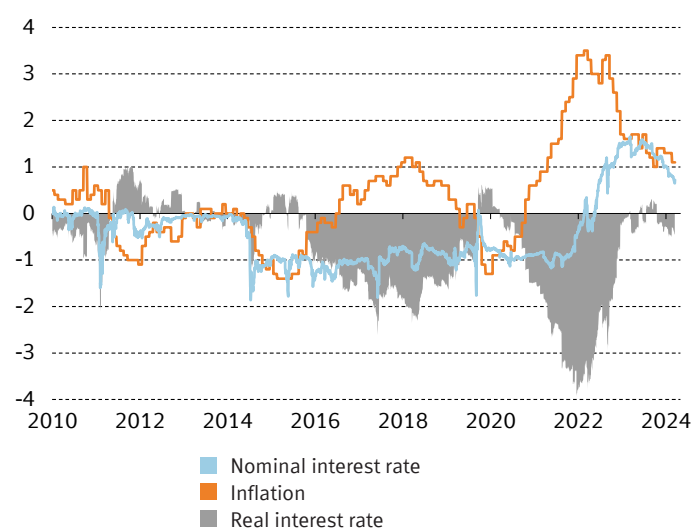


Strong Swiss franc

The Swiss franc is one of the most stable and strongest currencies, not only in times of crisis, but in general. This is because of several key factors. In addition to the reasons mentioned before, Switzerland is characterised by a disciplined fiscal policy and low government debt. The fully funded pension system and continuing immigration also contribute to the high demand for the Swiss franc. Japan, on the other hand, has high private savings but a large budget deficit as well as a high level of public debt. The unique combination in Switzerland leads to a real appreciation of the Swiss franc against most other currencies in the long term.

Basic Trend 2:

Percent

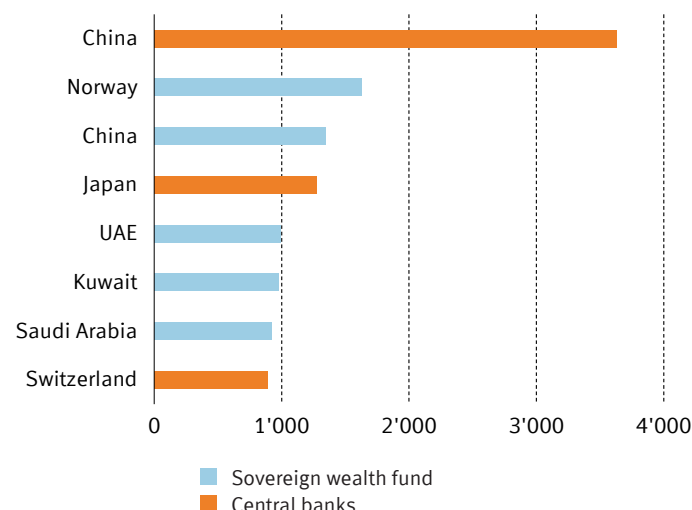


The strong franc as a challenge for investors

The appreciation of the Swiss franc has led to a steady increase in the purchasing power of the Swiss abroad. Conversely, it is a challenge for Swiss investors to maintain their purchasing power at home. As a result of the attractiveness of the Swiss franc, there is high demand for Swiss franc bonds, which leads to low nominal interest rates due to limited supply. These are even below the already very low inflation rate, resulting in negative real interest rates. It is therefore not possible to compensate for inflation with risk-free investments. In addition, the expected real returns on riskier investments such as equities are lower for Swiss investors compared to foreign investors and also riskier due to the safe haven characteristics of the domestic currency.

Basic Trend 3:

Currency reserves in USD billions



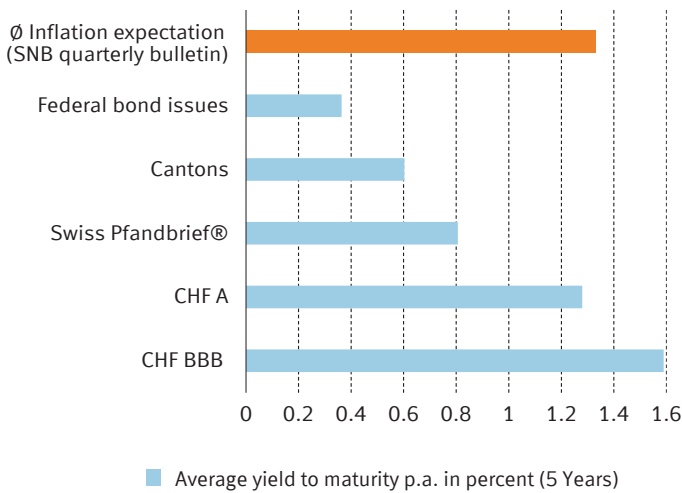
The role of the SNB

The challenge for the SNB is to manage the strong Swiss franc without jeopardising Switzerland's economic stability, while ensuring price stability at the same time. Through targeted interventions on the foreign exchange market, it tries to prevent an excessive appreciation of the Swiss franc, which could weaken the export economy. Since the major financial crisis in 2008, with the exception of a brief period of balance sheet reduction to combat inflation in 2022 and 2023, it has continuously built up foreign exchange reserves that are comparable to the sovereign wealth funds of the major oil exporting nations. As Switzerland is a small economy compared to Japan, for example, the SNB has been surprisingly efficient with its interventions in the foreign exchange markets. However, this instrument can only mitigate the long-term appreciation pressure on the Swiss franc.

Knowledge & Experience:

Investment implications for Swiss investors

Knowledge & Experience 1:

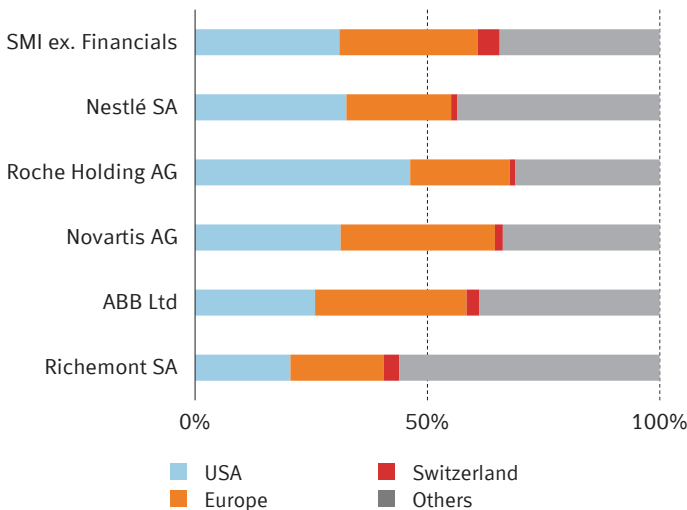


Challenging environment for CHF bonds

Bonds issued by the Swiss Confederation are among the safest assets, which is reflected in their low yields. Thanks to their multi-layer security chain, Swiss Pfandbriefe offer an almost risk-free alternative with a higher yield that is still below the inflation rate. A positive real yield can only be achieved with corporate bonds in the BBB to A segment. Foreign currency bonds do not generally offer any additional yield either, as hedging costs offset the higher interest rates in the foreign currency. In the high-yield segment, however, they can be interesting because of the larger universe of borrowers. Despite the high costs, currency hedging is recommended, as exchange rate fluctuations worsen the risk/return ratio.

Knowledge & Experience 2:

Earnings per region in CHF billions

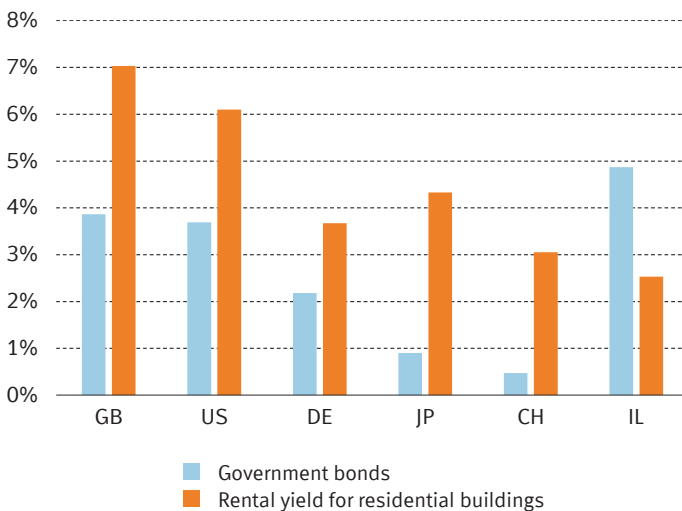


Global diversification pays off

With an earnings yield of 5%, Swiss equities should more than compensate for inflation in the long term. Of course, the risks are incomparably higher than with bonds, also in terms of currency risk, but foreign currency limits for equities, such as those implicitly prescribed by the BVG, are window dressing. The majority of companies listed on the Swiss Stock Exchange (SIX) generate most of their revenue abroad. As most of their costs are incurred in Switzerland, their profits react disproportionately to currency fluctuations. While a certain home bias is normal, the overall allocation should be internationally diversified. The advantages of a better sector diversification and a significantly larger universe for a best-in-class approach are evident.

Knowledge & Experience 3:

Yield



Attractive Swiss residential real estate

Real estate offers protection against inflation through its intrinsic value alone, while rental income less maintenance costs is added as a real return. The asset class is virtually immune to currency fluctuations. The main risk factors are interest rate fluctuations, which can be passed on to rents with a time lag, as well as political pressure to limit rents. However, this risk is lower in Switzerland than abroad, where rents are higher relative to wages. In addition, the yields in Switzerland are more attractive than those on government bonds, which is partly due to the lower inflation in this country. Given the excellent risk/return characteristics, many pension funds weight real estate assets similarly to equities. There are also tax advantages for private individuals, which is why we focus on residential real estate funds in our Swiss franc strategies.

The prices used in our analysis are end-of-period prices. The figures used for our valuation model are estimates referring to dates and therefore carry a risk. These are liable to change without notice. The usage of valuation models does not rule out the risk that fair valuations over a specific investment period cannot be attained. A complex multitude of factors influences price developments. Unforeseeable changes could, for instance, arise from technological innovations, general economic activities, exchange-rate fluctuations or changes in social values. This discussion of valuation methods makes no claim to be complete.

Dreyfus Sons & Co Ltd publishes Compass four times a year since June 2008. The publication is aimed at clients of the bank and interested parties. It describes some of the instruments and methods the bank uses to monitor everything to do with the financial markets. A description of the investment process can be obtained from your client advisers or our website. Compass provides guidance but cannot take the circumstances of an individual portfolio into account. It is for information and marketing purposes.

© Dreyfus Sons & Co Ltd, Banquiers

Editorial deadline: September 12th, 2024

Dreyfus Sons & Co Ltd, Banquiers
Aeschenvorstadt 16 | P.O. Box | 4002 Basel | Switzerland
Telephone +41 61 286 66 66

contact@dreyfusbank.ch | www.dreyfusbank.ch