Money for Nothing and Your Toblerone for Free

Summary

The Swiss Franc is the new Deutschemark and without the resurrection of the old Deutschemark, it will remain one of the most desirable currencies in Europe. The SNB does not appreciate this admiration, despite its own economy's contribution to global savings glut.

The SNB's decision to peg the Swiss Franc/€uro exchange rate backed by unlimited creation of its domestic currency is "courageous" in the truest Whitehall sense. It subordinates monetary policy to foreign exchange policy and repeats the 1978 peg in a more sophisticated manner.

The immediate success of the policy in boosting the €uro 8% has been helped by the phoney war that often follows major intervention as markets pause to reflect upon the action. The SNB has contributed by selling forward option volatility to reinforce its commitment to maintaining the peg. Theoretically this commitment is absolute because it can print unlimited amounts of its own currency.

However, there are a number of constraints upon this policy as monetary policy becomes subordinate to foreign exchange policy. In 1978, the stimulus caused inflation to accelerate from 1% to 5% within a year and eventually peak at over 7% in 1981. Global economic conditions are very different from 1978-81 and the deleveraging and deflationary environment should keep inflation in check. Nevertheless, the conservative central bank will hope its latest bazooka will work after a series of failed FX interventions.

The success of the 1978 policy lay in the recovery of the US Dollar. The flight to safety into Swiss Franc's reflects both the shortage of triple AAA assets and the crisis in Europe. The €uro is not a triple AAA currency and the continuing crisis encourages safe haven flows to the franc. The success of the 2011 policy rests on an effective resolution of the sovereign debt crisis.

This has become a war of attrition between politicians, financial markets and the ECB. We believe that it is inevitable that the SNB's commitment will be tested and that the authorities will be forced to back its commitment with negative interest rates, which in practical terms means imposing a charge on large domestic and overseas deposits.

It is reasonable to assume that the SNB will eventually prevail because the cost of failure is politically unacceptable. But every action has a reaction. Swiss intervention will be invested into triple AAA €uro government bonds, while the currency rebalancing will benefit other triple AAA rated safe havens.

Japan represents 10% of the SNB's foreign exchange portfolio and attention will undoubtedly focus on the MOF/BOJ next week after the G7 meeting at the weekend. Japan was advised to pursue a peg with unlimited currency creation in 1994. 17 years of hurt, so why are we waiting. Six prime ministers in five years and a central bank Governor who does not believe in the effectiveness of monetary policy is testament to serial policy failure. This will not change immediately, but pressures are building for effective policies to weaken the Yen.

The Swiss Franc is the new Deutschemark and without the resurrection of the old Deutschemark, it should remain one of the strongest currencies in Europe. The only way in which this might not be true would be for politicians and central bankers to create a single currency that is as strong as the old Deutschemark backed by a central bank that resembles the Bundesbank rather than a toxic sump. This is not possible in a sub-optimal currency zone, where strong, solvent countries are forced to support weaker, less competitive economies. The combined entity ceases to be triple AAA and in our opinion struggles to be AA given the likelihood of further downgrades for Italy, Spain, Belgium and France over the next twelve months. An over-collateralised CDO is no substitute for a genuine triple AAA as 2008 proved. Mercantilist Asian central banks continue to support the €uro because of its liquidity and gain competitive trade advantage against €uropean exporters, but as the appreciation of both Norwegian and Swedish Krone in the wake of the SNB peg provides further evidence of the crippling shortage of genuine triple AAA assets and demonstrates that the combined €urozone is not triple AAA nor a safe haven for domestic investors.

The SNB does not appreciate its safe haven role and after fruitless and expensive intervention last year has resorted to a currency peg against the €uro at CHF1.20 and provided an open-ended commitment to buy €uros at this level. So far so good, but the Swiss National Bank's reserves are already and controversially 45% of GDP (compared to the MPC QE, which is equivalent to 15% and Fed QE of 7% of GDP). The action

smacks of desperation. Indeed, if Sir Humphrey Appleby was still snaking through the corridors of Whitehall, he would describe the policy as "courageous". As the chart below shows, the move represents a last stand against the tide of €uropean safe haven flows. The SNB has tried repeated since 2009 to stabilise its currency, and indeed for a period in 2009, its intervention helped stabilise the currency for six months when it tried to draw a line at SF1.50. This worked for a period because the massive stimulus in spring helped to stabilise the European crisis and remarkably in the light of subsequent events there was a substantial narrowing of €uropean peripheral spreads as banks borrowed cheap funds from the ECB and bought high yielding sovereigns. However, this cunning plan failed when the new Greek Government confessed that its budget deficit was substantially higher than had previously been acknowledged. The exchange rate since this point has matched the highs and mostly lows of the €uropean sovereign debt crisis.

The SNB has intervened heavily over this period, boosting foreign exchange reserves to 45% of GDP at the end of the second quarter and they have undoubtedly risen further during the third quarter and may even exceed 50%. The SNB sustained a SF10bn mark-to-mark loss is far in 2011 on this currency portfolio, lowering its capital to SF60bn, and while the Government can easily recapitalise the bank, the duty would be embarrassing and controversial. Last month, the central bank tried quantitative easing, announcing a target of CHF200bn demand deposits to flood domestic money markets with liquidity and force three month forward money market rates into negative territory, but the effectiveness of this policy proved to be transitory because of the difficulty and cost of maintaining negative implied forward interest rates, illustrated by how quickly the SNB reached its SF200bn target. The latest policy is the cleverest policy, because it is the nuclear version of Hank Paulson's famous bazooka. The statement from the SNB noted that "the current massive over-valuation poses an acute threat to the Swiss economy and carries a risk of a deflationary development. The Swiss National Bank is therefore aiming to for a substantial and sustained weakening of the Swiss Franc. With immediate effect, it will no longer tolerate a EUR/CHF exchange rate below the minimum level of CHF1.20. The SNB will enforce this minimum rate with the maximum determination and is prepared to buy foreign currencies in unlimited quantities. Even at a rate of CHF1.20 per €uro, the Swiss Franc is still high and should continue to weaken over time. If the economic outlook and deflationary risks so require, the SNB will take further measures".

Theoretically, the central bank can print unlimited amounts of its own currency in exchange for €uros. However, in practical terms, there are political and cultural limits to the willingness of politicians and the conservative central bank to expand their FX balance sheet. The biggest limitation is inflation, the 1978 peg boosted inflation from 1% to 5% in a year, causing the peg to be suspending, and further to a peak of 7% in 1981. The current global deflationary environment is very different from 1978-1981, but memories are long and the SNB hyper-conservative. The central bank cannot simultaneously set a currency and inflation target. There has been some talk about the authorities turning foreign exchange reserves into an external sovereign wealth fund and/or suspending mark-to-mark accounting of these positions, but we believe these suggestions are straws in the wind, and the central bank will remain vulnerable to concerns over excessive reserves as a percentage of GDP, although it has some way to go before it reaches the equivalent Chinese rate of more than 80%. More importantly, there is little domestic criticism of the SNB's actions with the Economy Minister arguing that the currency is trading above purchasing power parity. As the chart shows CHF1.20 is a clever peg since it is still stronger than the start of the year, and the real effective exchange rate close to its peak. However, while inflation has been significantly weaker than expected, falling by 0.3% during July to leave the annual rate at just 0.2%, growth in the second quarter surpassed activity in the €urozone, growing by 0.4% during the period (twice the preliminary rate recorded in the €urozone), which in turn was 2.3% higher than the previous year. Likewise, while manufacturing confidence has fallen sharply over the past six months, the pace of deterioration is not markedly different from the rest of Europe, and in terms of absolute level, it remains above 51 and higher than comparable rates in the rest of Europe. The lagged impact of the massive real exchange rate appreciation will drive the economy into recession by the end of the year

More importantly, the Swiss current account surplus is still over 15% of GDP, which creates strong demand for Francs in addition to the flight to quality flows from the €urozone. The immediate success of the intervention has been driven by the easing of crisis concerns as Italy passes a modified austerity package, Greece maintains the fiction of compliance with the Troika's draconian austerity program and the German Constitutional Court paved the way for increases to the European Financial Stability Fund. However, the Constitutional Court ruling appears to preclude the next policy shift towards common Eurobonds without a painful and protracted change in the Lisbon Treaty. We continue to believe that the €uropean sovereign debt crisis will worsen further over the next twelve months. In addition, the unprecedented and deep fiscal austerity across the region will lead to double dip recessions amongst the periphery and very weak growth amongst the core economies confirming the expected sovereign credit moves. Moreover, there is a limit to EU politicians' serial forbearance of Greece unwillingness and inability to comply with the terms of its

bailouts. Ideally, the authorities would wait until Greece has achieved primary budget surplus before defaulting on its debt but as this Elysian prospect recedes further into the distance, the quarterly disbursements of EU/IMF funds become fraught with danger. Greece will provide a template for other peripheral economies to pursue the Debt Reduction Mechanism to alleviate their debt to GDP burden.

Foreign exchange markets are traditionally sceptical of intervention without fundamental change in underlying economic conditions. We believe that the next stage is to re-run its successful policy of 1978 and charge overseas residents and companies a 25bps negative interest rate charge for holding the currency. It difficult and expensive to sustain negative forward short term interest rates for a sustained period of time, without supporting the move by imposing capital controls via this charge. The 1978 policy succeeded, although the central bank's resolve was tested in the second and third quarters of 1979, because of a strong Dollar recovery between 1980 and 1985, we believe that the new peg has a reasonable chance of success, but we have no doubt that the authorities resolve will be tested by further iterations of the sovereign debt crisis and further measures will be required if the SNB is to overcome the demand created by the shortage of triple AAA assets. Switzerland is contributing to this demand through its own massive and sustained current account surplus. Creditor nations' demand for full repayment of debts by deficit nations is not sustainable in a deleveraging environment.

For every action there is a reaction. The reaction of the ECB was measured, buying helps support the currency but these purchases will be recycled into safe triple AAA €uro sovereigns contrary to the ECB's peripheral bond purchase program. According to the SNB 80% of its portfolio is invested in government bonds, of which triple AAA assets represents 93% and the remainder is double AA. There have been some Machiavellian suggestions that the SNB lowers its standards and invest in Spanish and Italian government bonds to help alleviate the crisis, support the €uro and contribute to a weaker franc. However, this addresses the symptoms of the crisis rather than the cause. The use of sovereign wealth funds to manipulate currencies has become commonplace amongst the developing economies with China a particularly adroit player, but this manipulation over the past decade has contributed significantly to the persistence global imbalances over the period and it would be sad to see developed economies aping these bad habits. In the medium term, the SNB is not expected to materially alter the share of €uros in its portfolio from the current 55%, which means that the on-going intervention will eventually be rebalanced to maintain the current diversification of 25% US Dollars, 4% in Canadian Dollars and 10% in Yen, which will exacerbate the flows to other safe havens. The global list of triple AAA sovereigns is Australia, Austria, Canada, Denmark, Finland, France, Germany Luxembourg, Netherlands, New Zealand, Norway, Singapore, Sweden, Switzerland, UK and US. We can expect insurance companies and pension funds to establish government bond benchmarks based on these rare commodities.

The rebalancing of Swiss reserves into Yen will contribute to the upward pressure on the currency. If Australia is the lucky country, then Japan must be the unlucky country. It has been cursed by six ineffectual Prime Ministers in five years and a central bank Governor who doesn't believe that monetary stimulus will have any impact on the economy. The currency peg accompanied by unlimited money creation was first recommended to the Japanese in 1994, a year before the prolonged period of deflation commenced. The BOJ does not believe that the Yen can appreciate on a sustained basis until the US economy improves and believe that its role is to offset the consequences of US monetary policy. The Fed is expected to pursue operation twist at its next meeting on September 21st, and could follow with QE3 on December 13th, which would be unlucky for the BOJ. We have no doubt that the BOJ will expand its asset purchase Vegas account, the name underlines the BOJ's disdain for the policy, and the MOF will agree additional intervention, but evidence of weaker than expected second quarter growth as well as greater constraints on the post-earthquake recovery from slowing global activity suggests that the authorities should be more active and commit to a sustained period of intervention.

The slowest moving animal is the sand dollar, the BOJ currency intervention policy has been even slower, but despite the constraints imposed by the Japanese political process and the central bank we believe that officials are moving towards action. Six prime ministers in five years reflect their abysmal approval ratings as the fail to provide economic leadership. The G7 meeting this weekend is unlikely to provide agreement on coordinated intervention, but we believe that what can't continue; won't continue and ultimately Japanese policy must become more active with a push towards negative interest rates. Consequently, we believe that the Yen will be weaker on a six and twelve month basis as the central bank is forced to stimulate its economy to deter safe haven flows in a world of excess savings.

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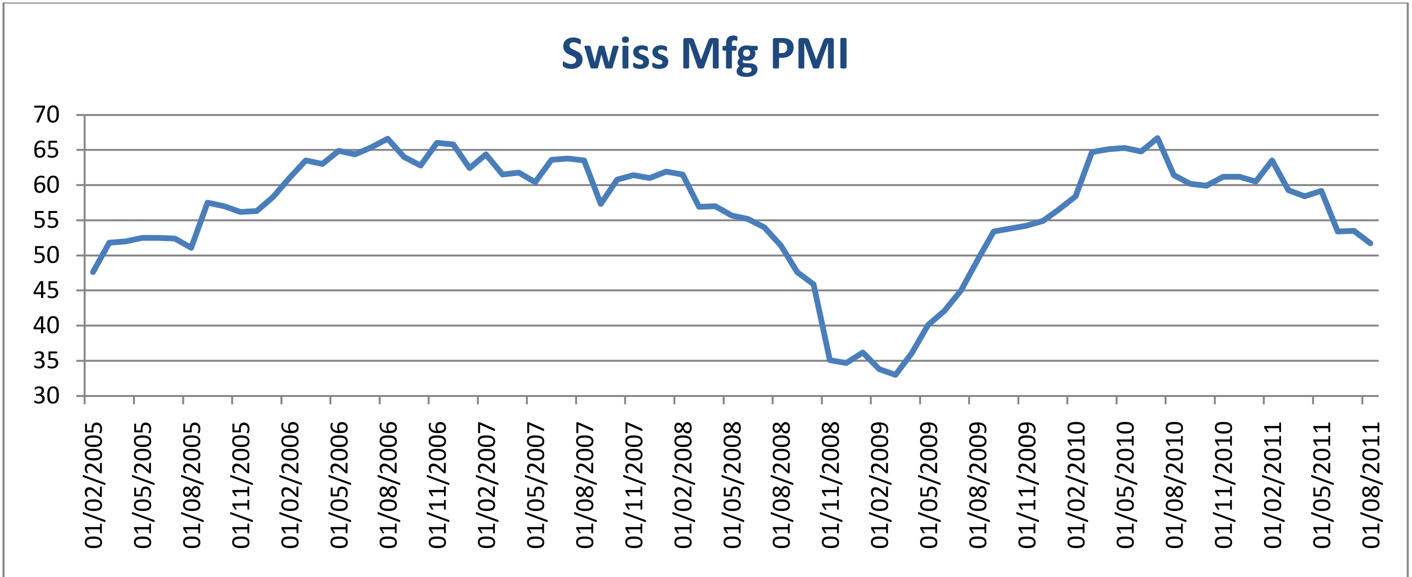

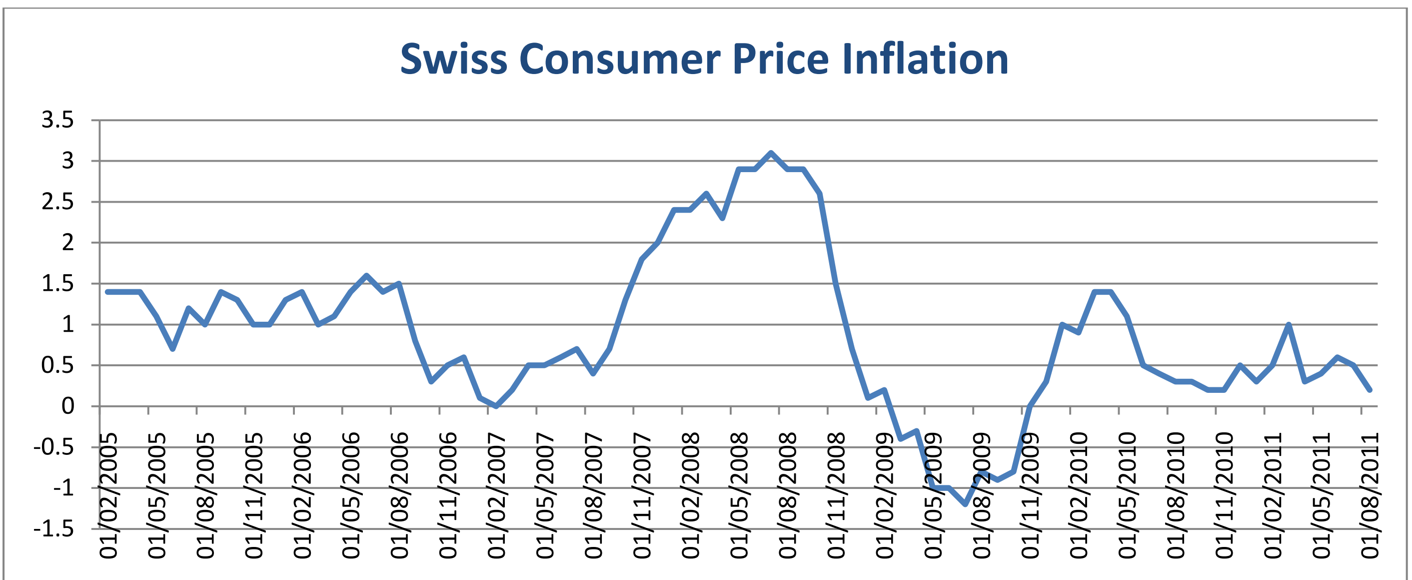

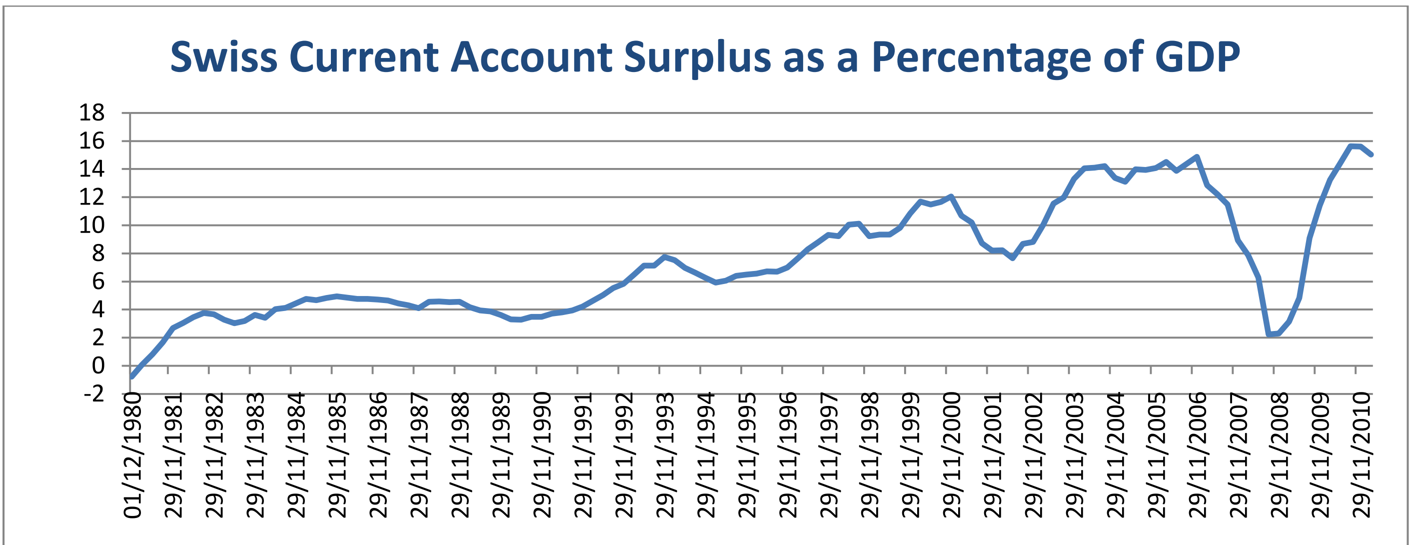

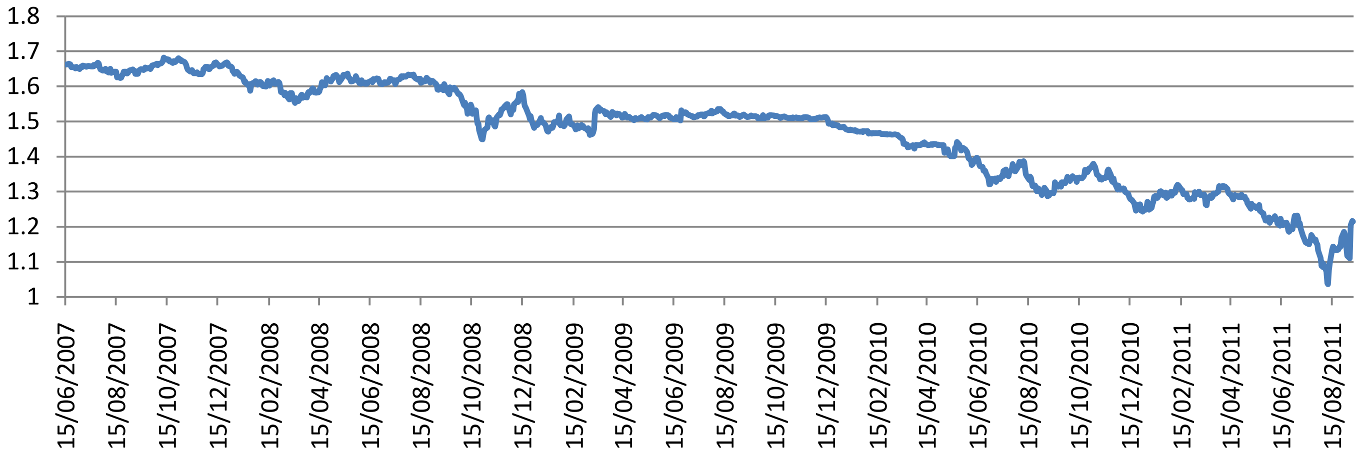
CHF/EUR Currency
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1.7
1.6
1.5
1.4
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1.2
1.1
1
15/06/2007
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15/10/2007
15/12/2007
15/02/2008
15/04/2008
15/06/2008
15/08/2008
15/10/2008
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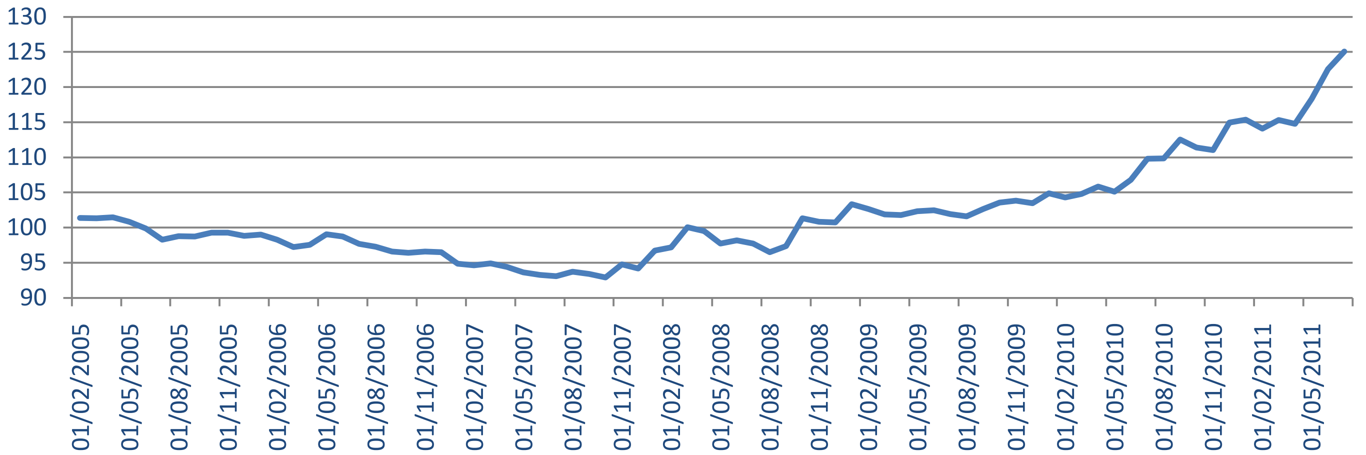
Swiss Franc Real Effective Rate
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125
120
115
110
105
100
95
90
01/02/2005
01/05/2005
01/08/2005
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01/02/2006
01/05/2006
01/08/2006
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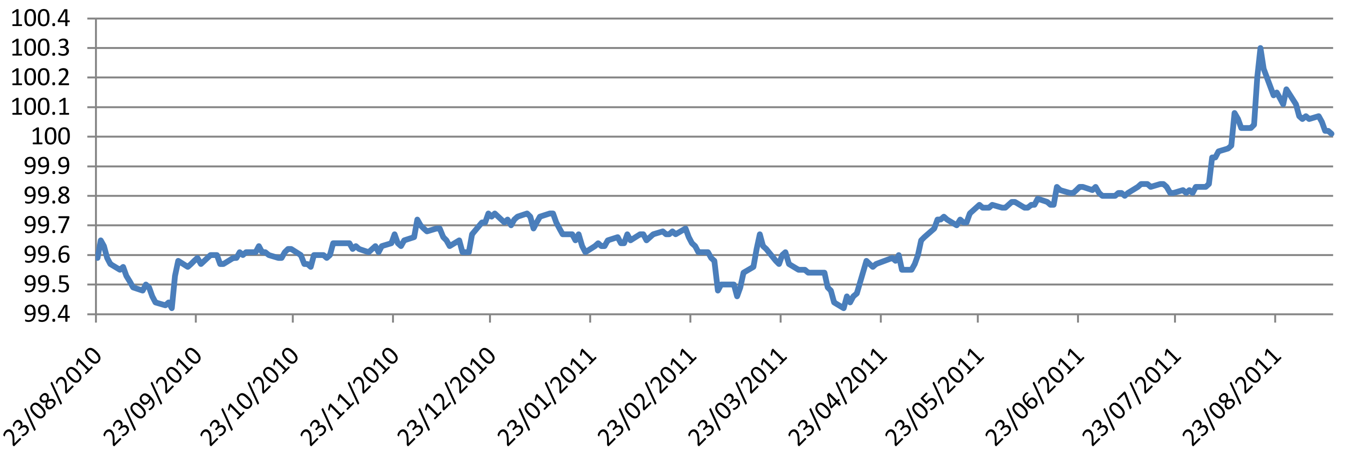
Swiss 3m Rate Future
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100.3
100.2
100.1
100
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99.7
99.6
99.5
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23/09/2010
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23/12/2010
23/01/2011
23/02/2011
23/03/2011
23/04/2011
23/05/2011
23/06/2011
23/07/2011
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