The Swiss Franc's Commodity Connection

People and countries, in case you have not noticed, behave differently. Yes, some representatives of both categories can be described as sanctimonious or bombastic or dysfunctional, but the parallels break quickly when you try to find examples of people who pretend they got rich by accident. To the contrary: People like to tell you how they achieved success through dint of hard work, effort, smarts or some other skill that reflects well upon them.

Some countries do pretend, however, their status amongst the world's wealthy happened by some manner of serendipity. Sweden, which had been one of the poorest countries in Europe at the start of the twentieth century, supplied both iron ore and timber to Germany during both world wars and used the profits to finance their socialist never-never land for the next half-century. Their neutrality was more a function of fortuitous geography than anything else; tucked inside the Baltic and shielded from the Allies, trade with Germany was the path of both least resistance and self-preservation.

Switzerland has a different tale to tell. Unlike lightly-armed Sweden, they remained armed to the teeth and ready to take on all comers who wanted to fight a war in the Alps. Also a poor nation prior to 1914, the Swiss had no iron ore or timber to sell, but they did have a banking system flight capital could use as a convenience. Their banks found the contents of those numbered accounts to be a cheap source of funds. Not all laundries use detergent.

It is this attribute of the Swiss economy which brings us to our tale here today, and that is the connection between the Swiss franc and the global commodity markets. The CHF, which is underlain by an economy devoid of commodity exports, is every bit as much of a "commodity currency" as the Australian and Canadian dollars (see "Of Commodities And Currencies," July 2006).

The reason behind this, and we will not mince words, is the flow of funds from commodity producers into the Swiss banking system. These funds then go into the Swiss franc carry trade (see "Franc-ly My Dear, I Don't Give A Carry," September 2008). As an aside, this is not the first time Switzerland has been deluged by flight capital outside of the context of a major war raging on its borders. By 1979, inflation-weary investors were sending so much money into Switzerland that the country imposed negative interest rates on foreigners' time deposits. Foreign investors paid a penalty for the privilege of keeping your money in CHF.

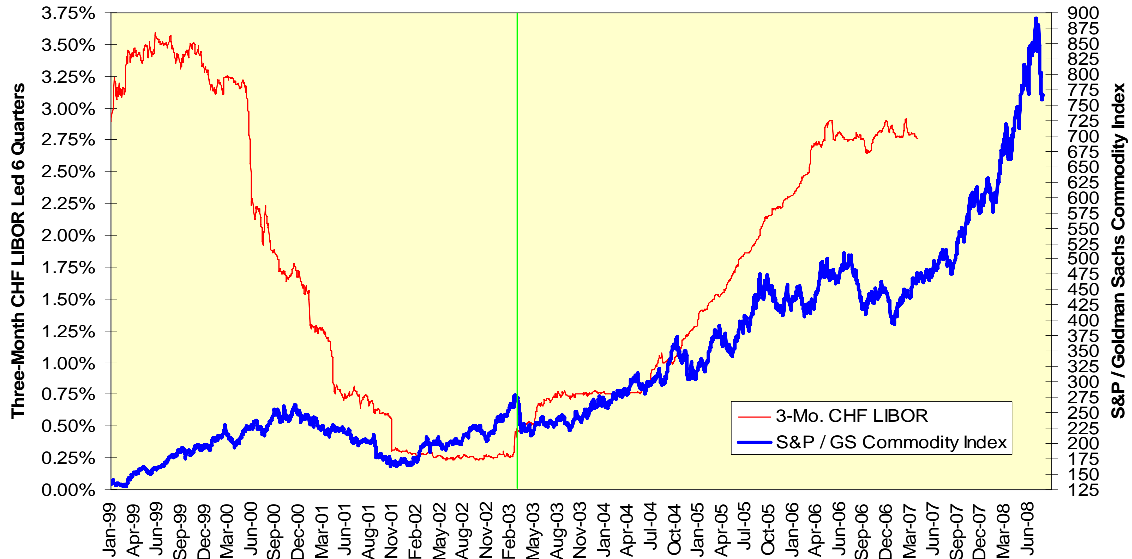
The Commodity Connection

The seeds of the global commodity boom were planted with the aggressive rate-cutting by the world's central banks in 2001-2002. Lower interest rates shift future consumption into the present; the production to satisfy those accelerated demands came increasingly from what was then the lowest-cost member of the dollar bloc, China. Chinese spending on infrastructure intersected with a decade of low investment in commodity production, and the rest, as they say, is history.

The boom accelerated with the end of the global bear market in October 2002. Interest rates remained too low for too long and the beneficiaries increasingly were not consumers but rather the commodity producers of Russia, the Middle East and North Africa. A date more critical for the CHF than October 9, 2002 is March 5, 2003; this is when the Swiss National Bank lowered its target rate to 0.75% to 0.25% (see "Comparing The Major Euro Cross Rates," March 2007). This date will be marked with a green vertical line in the charts to follow. The SNB's rate cut preceded the Federal Reserve's declaration of war on deflation on May 6, 2003 by two months.

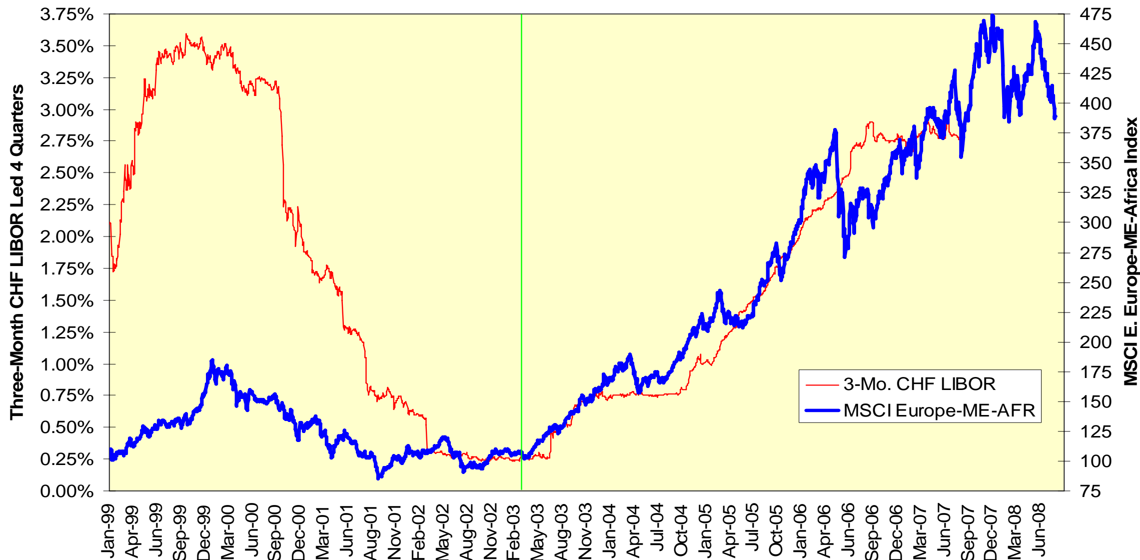
One simple way to demonstrate the CHF's commodity connection is to map three-month CHF LIBOR against the energy-rich S&P/Goldman Sachs Commodity index. The GSCI has led Swiss short-term interest rates by six quarters on average since March 2003. By the simple interest rate mechanics of currency trading, the higher CHF LIBOR linked to higher commodity prices should support the CHF against currencies without a similar link, all else held equal. This offsets some of the interest rate-induced weakness discussed last month in the context of the Swiss franc carry trade.

Commodity Prices Affect Swiss Short-Term Rates



A second link between commodity prices and the CHF can be inferred from the equity markets. While there is no global commodity-linked equity index comparable to, say, the Goldman Sachs natural resources index, Morgan Stanley Capital International has been thoughtful enough to provide us with an index for Emerging Europe/Middle East/Africa. This index has risen sharply since the commodity boom got underway as much of the wealth in these regions is extracted from the ground. This index has led three-month CHF LIBOR by four quarters on average since March 2003.

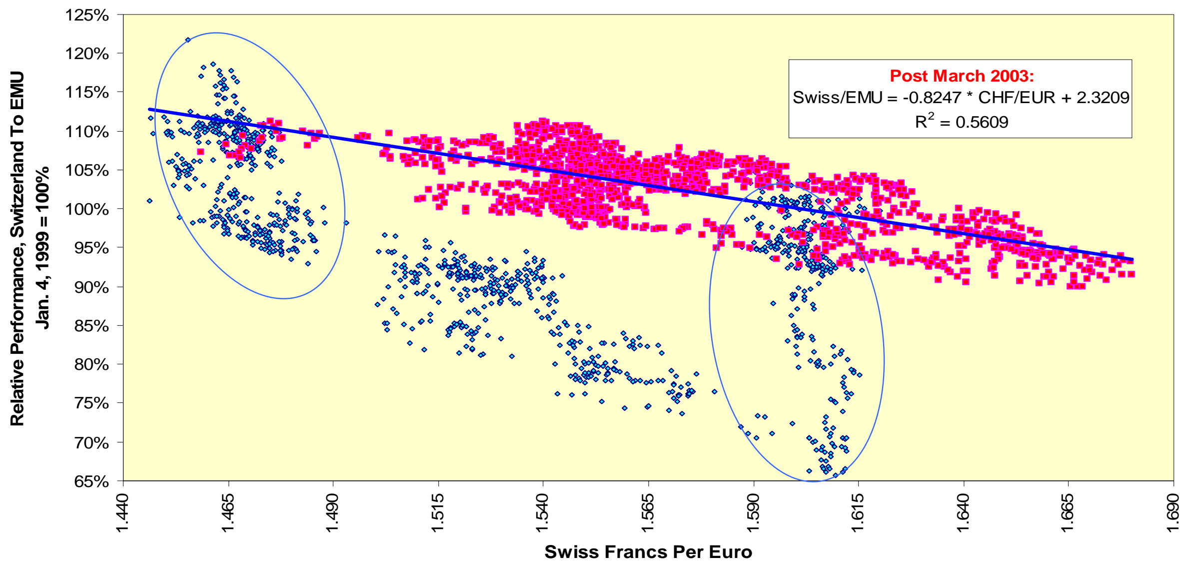
Emerging Europe/Middle East/Africa Equities Affect Swiss Short-Term Rates



The Carry Trade And Stocks

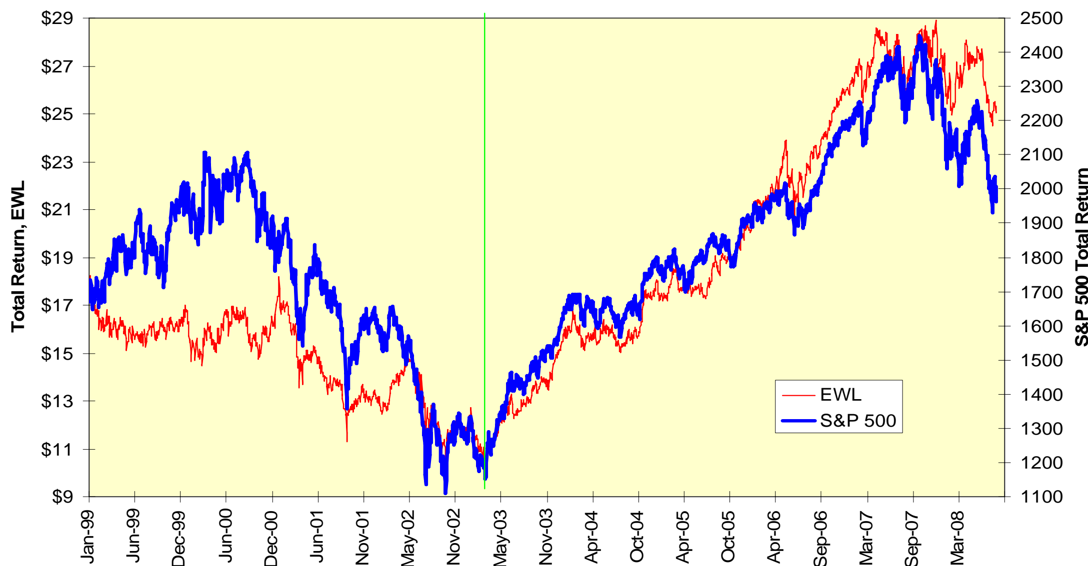
Switzerland is an island within a euro sea, if we may wax metaphoric. The CHF's cross-rate against the EUR is far more important to it than is its cross-rate against the dollar. As the stock indices behind major currencies are affected strongly by currencies (see "Currencies And Relative Stock Index Performance," April 2008) we should see whether the CHF/EUR cross-rate affected the relative performance of Swiss stocks to those of the European Monetary Union, and whether that relative performance changed around the March 5, 2003 date. The MSCI indices for both markets are used here.

The answer is strikingly clear in the chart below. Prior to March 2003, the relative performance of Swiss stocks as a function of the CHF-euro cross-rate was both random and clustered. Two of these clusters, marked in blue ovals, had a distinct non-dependence of relative performance as a function of the currency. The relationship after March 2003 became linear. If the CHF/EUR rate continues to move in favor of the EUR, Swiss stocks should continue to underperform EMU stocks, and vice-versa. If, however, the lagged effect of the late-2007 to mid-2008 commodity boom strengthens the CHF via the mechanism of higher CHF LIBOR, we should see this relationship reverse and both the CHF and the Swiss Market index should outperform their EUR-denominated counterparts.

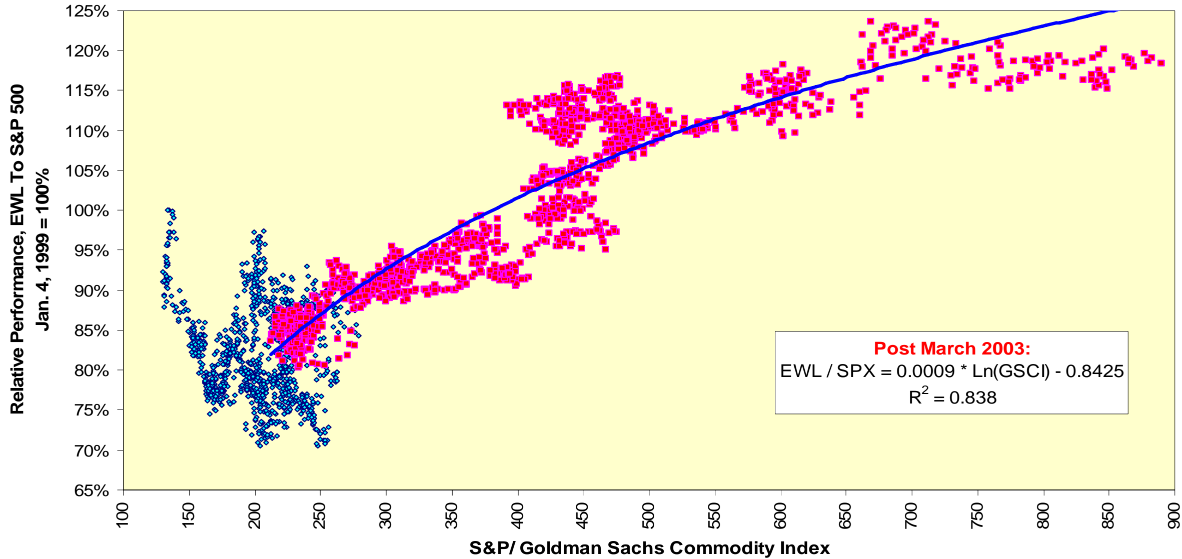


The U.S. Comparison

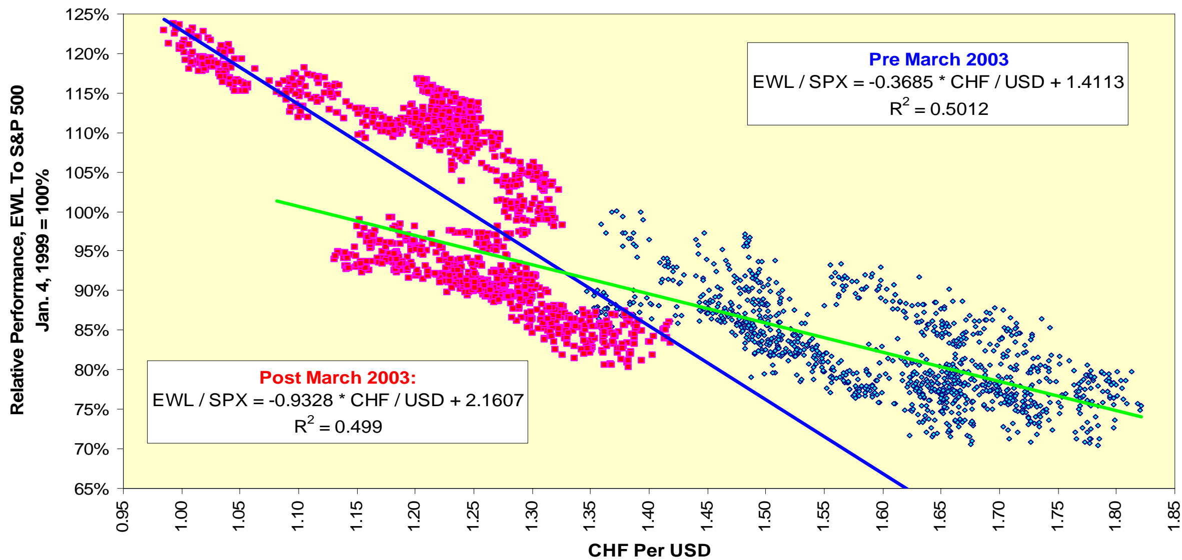
Now let's bring the U.S. stock market into the equation. There is an exchange-traded fund, the iShares MSCI Switzerland fund trading under the ticker EWL that prices the Swiss Market index in USD terms. The relative total returns of the EWL have oscillated around those for the SPX since the January 1999 advent of the EUR.



Did its relative performance change before and after March 2003 as a function of commodity prices? At first, this suggestion might seem way off-base; the U.S. market has a strong commodity connection through its energy and basic materials sectors. The data say otherwise: Once again, the relationship prior to March 2003 was a slightly negative and random one, but the relationship after March 2003 became logarithmic.



Finally, the relative performance of the EWL to the SPX has become more of a currency trade since March 2003. Prior to March 2003, the relative total return's beta to the CHF/USD rate was -.3685; after March 2003, this moved toward a near-unitary -.9328.



There we have it: The more money that comes into various Russian oligarchs' and Middle Eastern sheikhs' hands, the stronger the CHF will become. You can complain about it, or you can get on board by either going long the CHF against the EUR or going long Swiss stocks in whichever form you choose.

Is this morally ambivalent? Yes, of course it is. But the Swiss answer this question with another question: Who are we neutral against?