Eastern Europe's Swiss Miss

I am not an authority on Jeff Foxworthy's oeuvre, but I definitely am in tune with the concept of someone's last words being, "Hey, watch this!" It would seem as if any region funding itself with a carry trade, such as borrowing cheap U.S. dollars or Japanese yen and investing them elsewhere will soon find its next of kin posing for pictures with Ricky Bobby outside of the Talladega Speedway.

This certainly has been the case with Eastern Europe and the Swiss franc carry trade. Our Alpine friends' banks had been flooded with commodity-derived export earnings from Russia and the Middle East, not to mention funds from Americans interested in managing tax liabilities, and this helped drive Swiss interest rates lower.

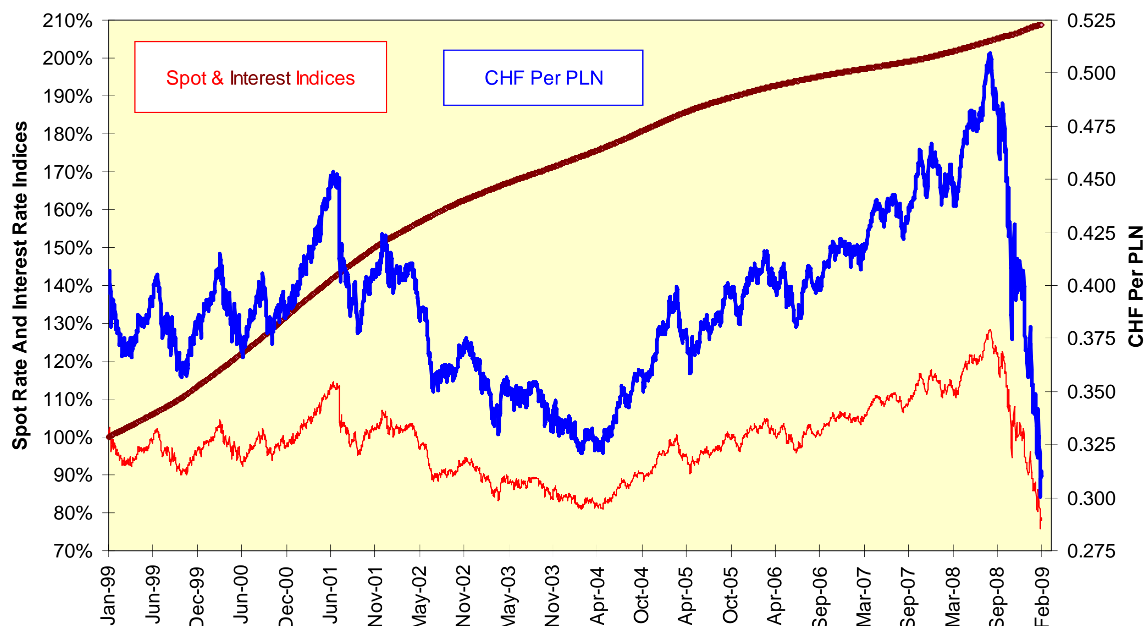
Small wonder, then, mortgage borrowers in Poland, Hungary, the Czech Republic and elsewhere found loans denominated in Swiss francs irresistible. Did they understand the risk they were taking, that one day their forints, zlotys, koruna, etc, would plunge vis-à-vis the franc and increase their mortgage liability? Yes, of course they did; as much as Americans taking out teaser rate ARMs and other financial exploding cigars understood their risks.

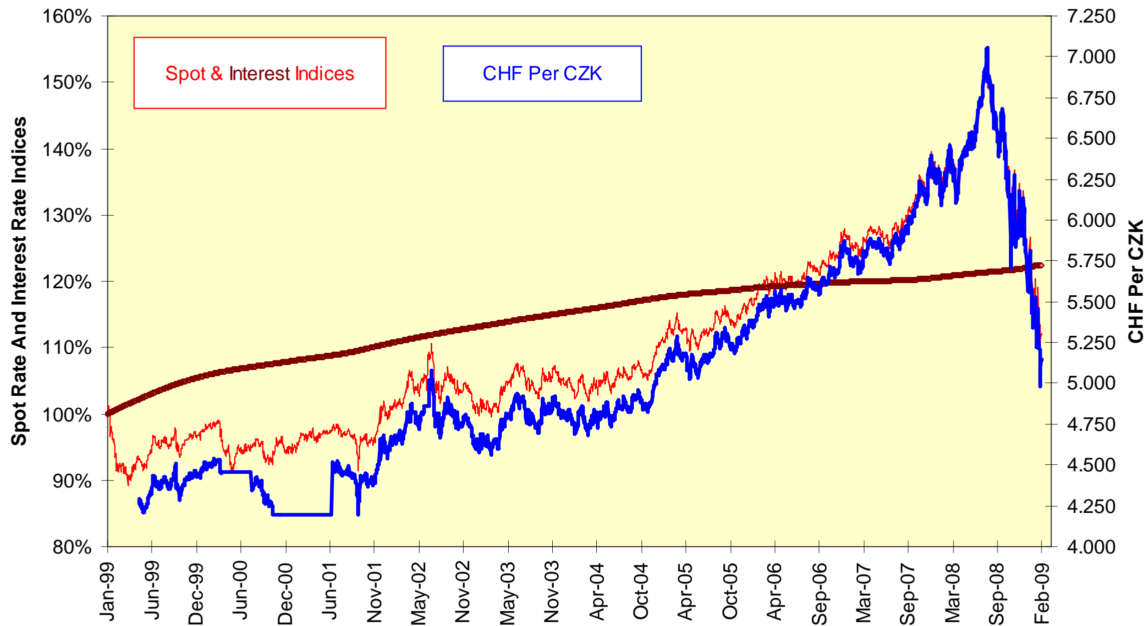
The Carry Trades

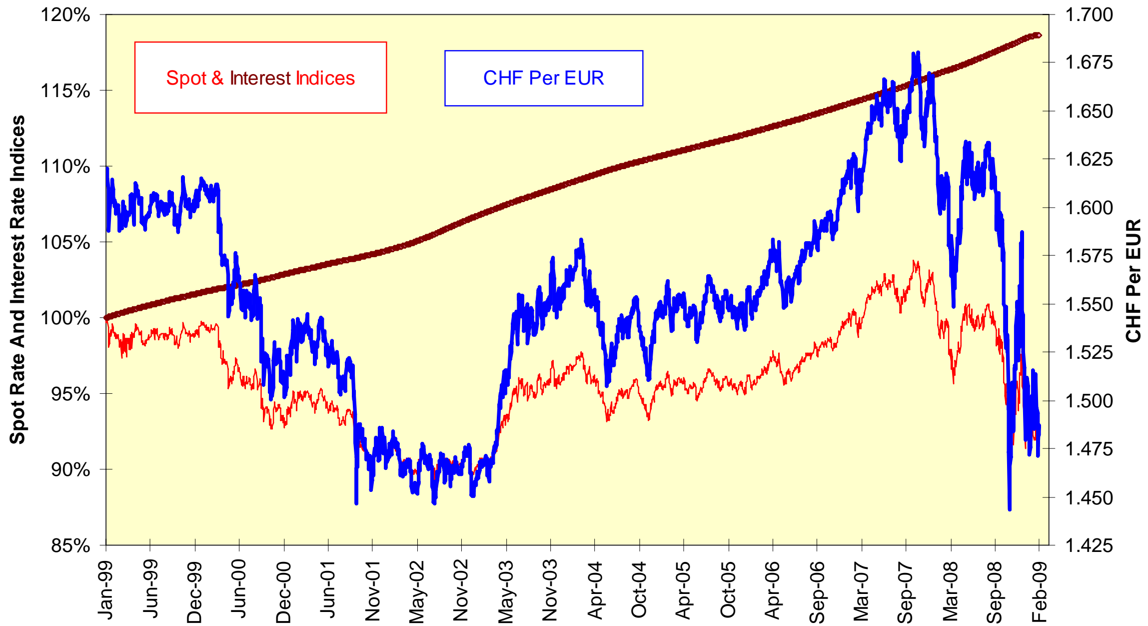
You can decompose any carry trade into two components, the interest rate spread and the change in the spot currency rate. This is one reason why governments seeking to "defend" their currency often raise short-term interest rates; the hope is the interest rate differential can offset the losses on the spot rate. More often than not, the interest rate differential destroys the domestic economy in the weak currency's country, but that is a story for many other days.

Let's illustrate this decomposition of the Swiss franc carry trade against two explicitly Eastern European currencies, the Polish zloty and the Czech koruna, and against the euro itself. Many of the Eastern European currencies are pegged in one form or another to the still-common currency.

In all three cases, the interest rate spread continues to advance in favor of the Eastern European currency. This is unsurprising; three-month Swiss interbank rates are a mere 44.25 basis points. The collapse of the respective carry trades, then, must be a function of the changes in the spot rate component of the trade. This is quite visible in the currency cross-rate for each currency.





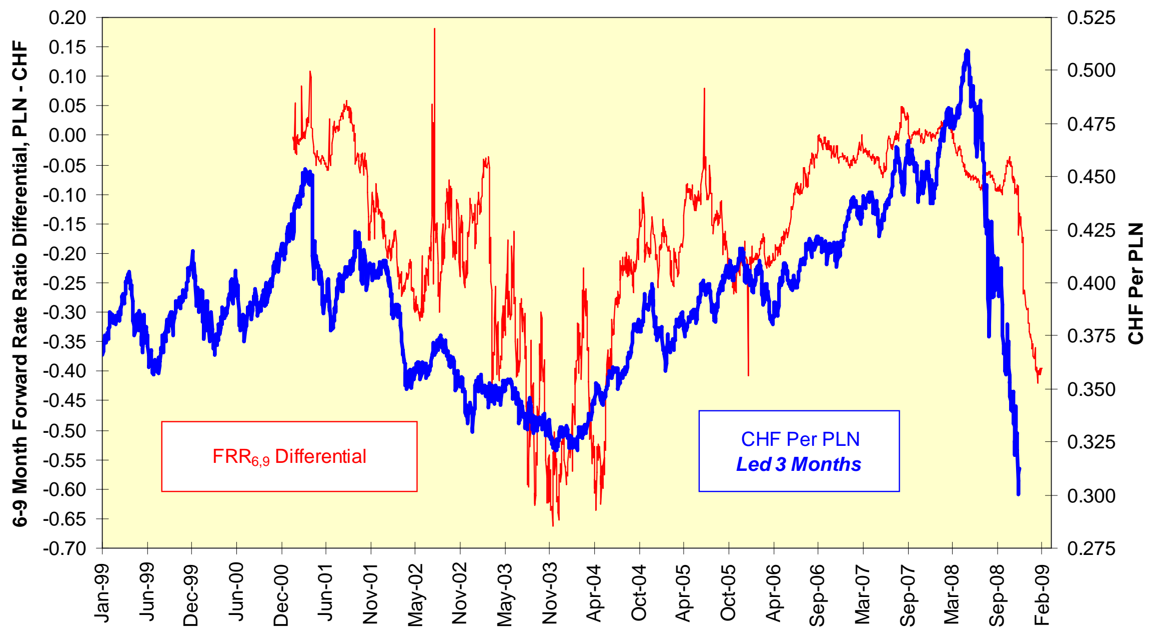


Prospects For Change
As we should all know by now, proclaiming something will change and realizing specific changes for the better are two different things. Talk, like three-month Swiss francs, is cheap. Is there a leading indicator we can use to predict when the various cross-rates against the Swiss franc will reverse?

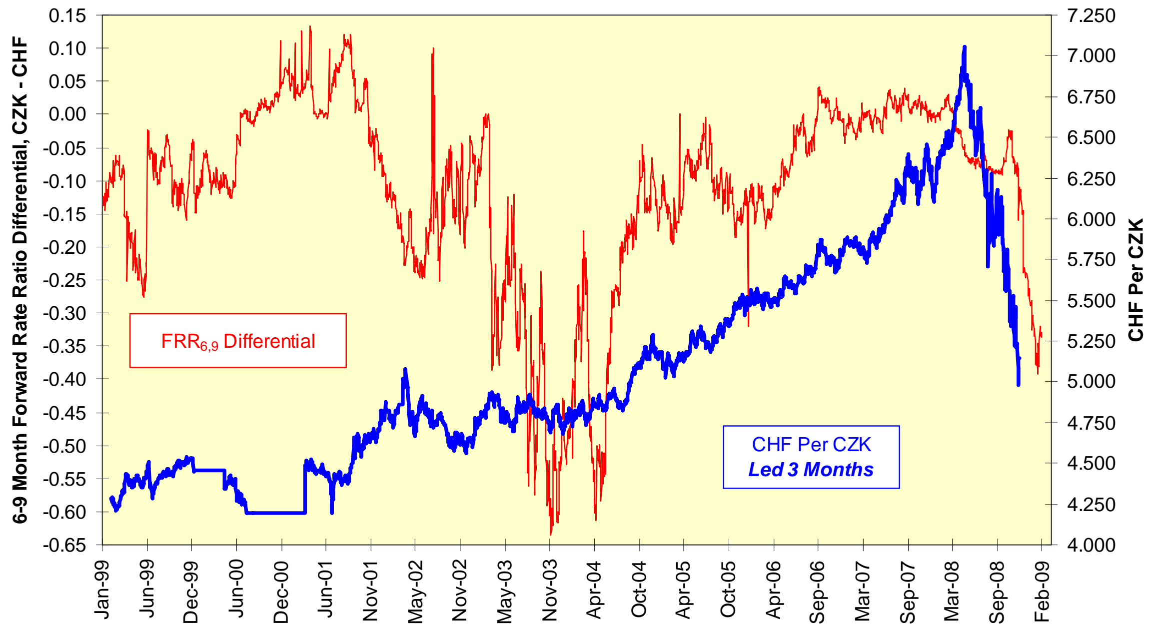
Yes; we can use the relative slopes of the respective interbank money market curves between six and nine months. As we have done before, we can calculate the forward rate between six and nine months, the rate at which we can lock in borrowing for three months starting six months from now, and divide it by the nine-month rate itself. The forward rate ratios (FRR) can be compared to one another to see which currency's interest rates are expected to rise the most. These FRR differentials lead the cross-rates by three months.

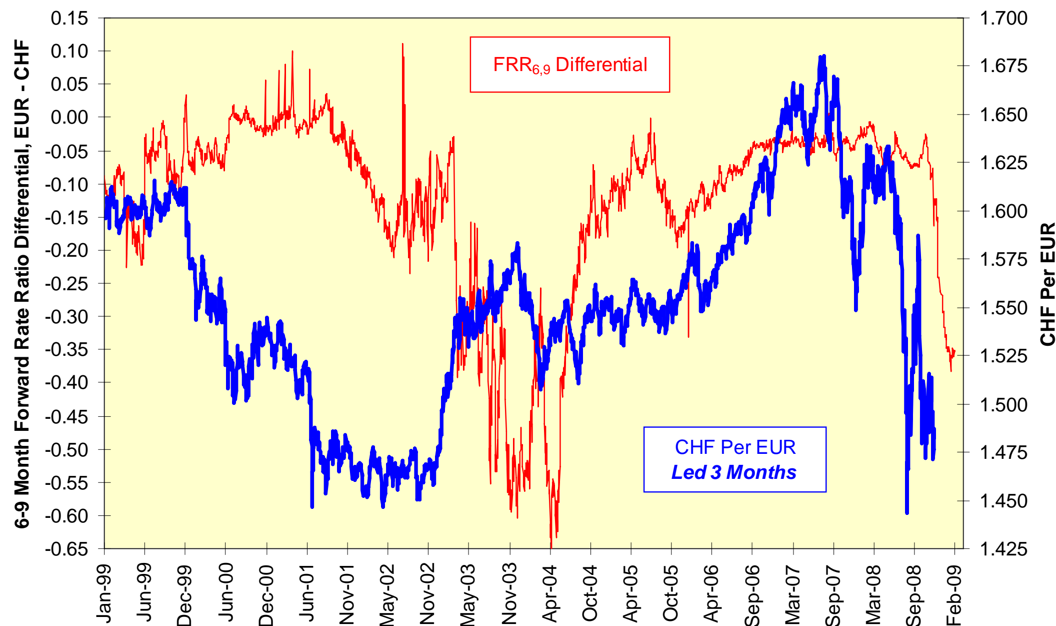
Here the pictures diverge somewhat. In the case of the zloty, the relative interest rate differentials point toward continued weakness relative to the franc. The koruna shows some signs of trying to firm against the franc, but the euro remains under relative pressure.

Relative Interest Rate Expectations Favor Swiss Franc



Relative Interest Rate Expectations Stabilizing



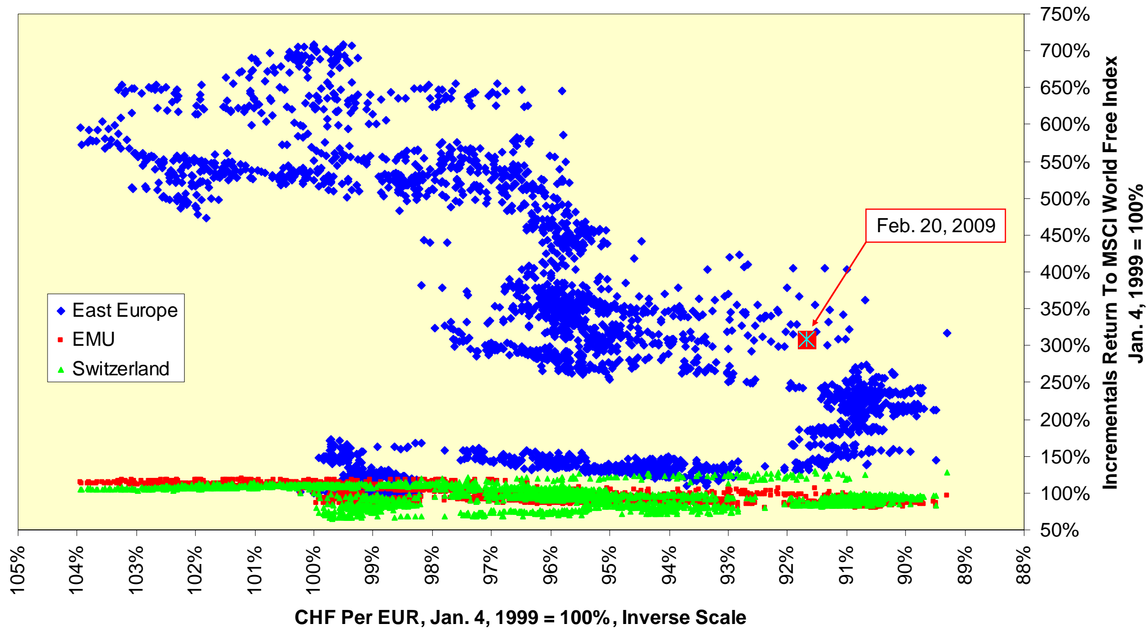


The key takeaway, however, is nothing in the picture above suggests any of the Eastern European currencies are about to pull out of their nosedive. The illustrations above are for the cross-rates against the Swiss franc; the real macroeconomic problem is occurring with the cross-rates against the euro as banks in both Germany and Austria are as exposed to Eastern Europe as banks in the U.S. were to San Bernardino and Las Vegas. It is not a pretty picture, and I do not expect a revival of Hohenzollern or Habsburg imperialism on behalf of the banks. These losses may be beyond a bailout.

The Stock Market Effect

Finally, let's ask the question whether these currency issues affect equities. The answer is a strong, "Yes" for Eastern European markets. If we map the incremental return on the MSCI total return indices for Eastern Europe, the European Monetary Union and Switzerland to the MSCI World Free index, we see a striking pattern for Eastern Europe. The weaker the franc is relative to the euro; that is, the more the carry trade is in operation, the stronger the total return for Eastern Europe. The effect is non-existent for both the EMU and Switzerland.

Eastern European Equities Very Sensitive To Franc-Euro Cross-Rate



This suggests American investors should avoid Eastern European equities for the foreseeable future. Those would include a handful of open-end funds such as the Morgan Stanley Eastern Europe Fund, the Vontobel Eastern European Equity Fund and the U.S. Global Investors Eastern European Fund. There is an iShares MSCI Emerging Markets Eastern Europe ETF pending listing; wait until it lists and then avoid it.

Much of the tragic history of the twentieth century started in Eastern Europe, the land between hostile German and Russian powers. The lines on the map have been redrawn, but the geography remains the same and so does Eastern Europe's unfortunate geography. They had a great run over the past decade, and perhaps they will again. Do not let your inner Foxworthy emerge in a "Hey, watch this!" moment.