The Swiss Franc Carry Trade

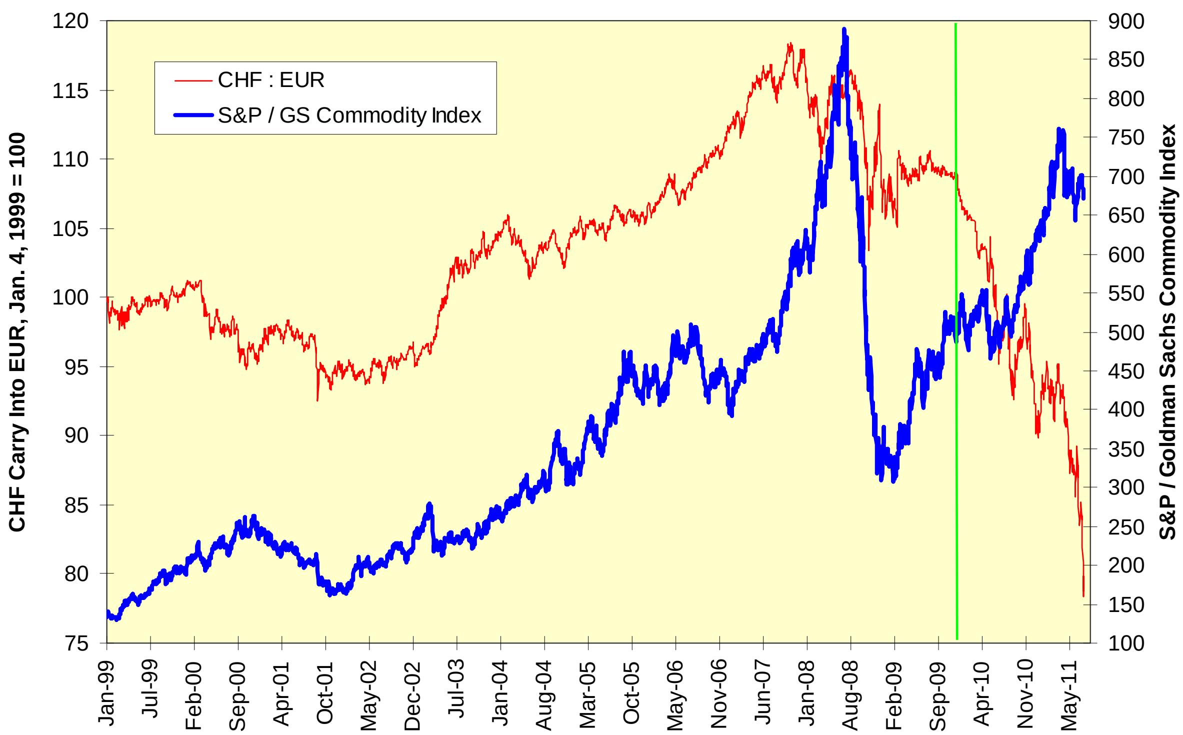
If Russia can be characterized by that enigma-riddle thingy, as some U.S. politicians might say, Switzerland can be characterized by the inherent contradiction of running what amounts to the world's largest hot-money depot with some of the world's coldest characters.

To wit: I was on a dinner cruise on Lake Zurich a number of years back. My host was a New York lawyer on an expatriate assignment. The cruise was scheduled to last until 10:00 PM. As we pulled in toward the dock, he said, "Look at your watch." I did, and responded, "10:00 PM on the dot." He said, "This really gets to you after a while."

Hot Commodities

I had observed prior to the unpleasantness of 2008 how the carry trade between the Swiss franc and the euro (CHF : EUR) was moving parallel with the S&P / GSCI commodity index and theorized hot money might be flowing into Switzerland from Russia and Middle Eastern oil exporters. Those funds depressed the franc and opened up the carry trade into Eastern Europe. A little laundry without Procter & Gamble being in the room, we might say.

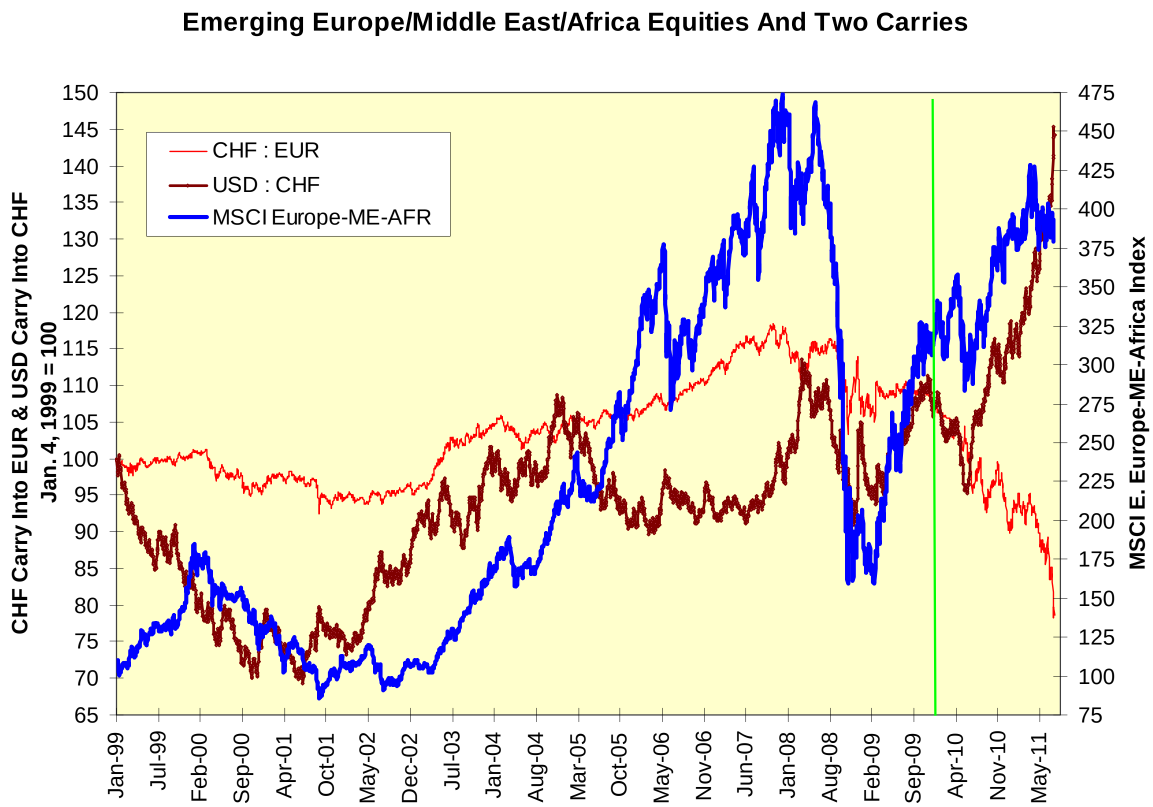
Commodity Prices And The CHF Carry Into The EUR



After the 2008-2009 bust, the lending into Eastern Europe dried up, the Eurozone's sovereign credit issues began to emerge and the CHF began to strengthen against the EUR. The Swiss National Bank intervened and intervened mightily at enormous cost to the Swiss taxpayer before stopping the interventions, marked on the charts with a green vertical line.

Cheap Dollars To The (Sort Of) Rescue

The surge of the CHF on its cross-rate to the EUR coincided with a massive increase in the carry trade between the U.S. dollar and the franc (USD : CHF). That carry trade helped maintain the returns for the MSCI-Barra Emerging Europe/Middle East/Africa index. A euro-dominated or linked borrower did not have to worry about the franc becoming more expensive so long as there was a flood of dollars coming into the region. Ironically, much of that flood of dollars went into Swiss banks as search of safety, an odd choice given the Swiss National Bank's demonstrated ineptitude in currency management and the Eastern European loan exposure of banks such as UBS.



That wash of dollars has allowed the MSCI Barra index to tread water to-date in 2011, although experience has shown if the global selloff continues or gets worse, these smaller markets will get hurt. However, as long as money flows into Switzerland at this pace, it will create a massive carry trade incentive and will need to be invested somewhere.

Here is a little tidbit you might want to consider: A search on *Bloomberg* for "Eastern European funds" domiciled in the U.S. turned up ten entries. Four of the ten have "formerly known as…" in their description line. Another one has "Bear Stearns" in its name. One vehicle you might want to consider is the Templeton Developing Markets Trust; it has been around for almost twenty years, which is longer than several of the countries involved.