

Swiss National Bank's Final Bet

If I have not made it clear [before](#), let me do it now: I find Switzerland's pretension it got wealthy by accident to be more than a little off-putting. That I could link Swiss financial markets to [commodity-cash inflows](#) as recently as 2010, when Switzerland's status as a commodity producer is questionable tells us everything we need to know and for some strange reason never want to ask.

The Swiss National Bank is about to find out a second time, the first time being in 2009, what happens to those who stand on the railroad tracks to challenge the oncoming freight train: They are going to get run over, unceremoniously, by the hordes of Europeans and other holders of increasingly worthless pieces of paper who want to park their cash in Swiss francs (CHF). Their pledge to print CHF in unlimited quantities to defend this arbitrary currency peg is going to end very, very badly.

A country can fix its currency or it can fix its short-term interest rates, but it cannot fix both simultaneously. [China](#) got around this problem of yuan-peg maintenance and domestic inflation-fighting ingeniously by shipping excess capital to the U.S. and earning interest on its holdings. Otherwise, they would have needed to issue domestic bonds and pay rather than receive interest.

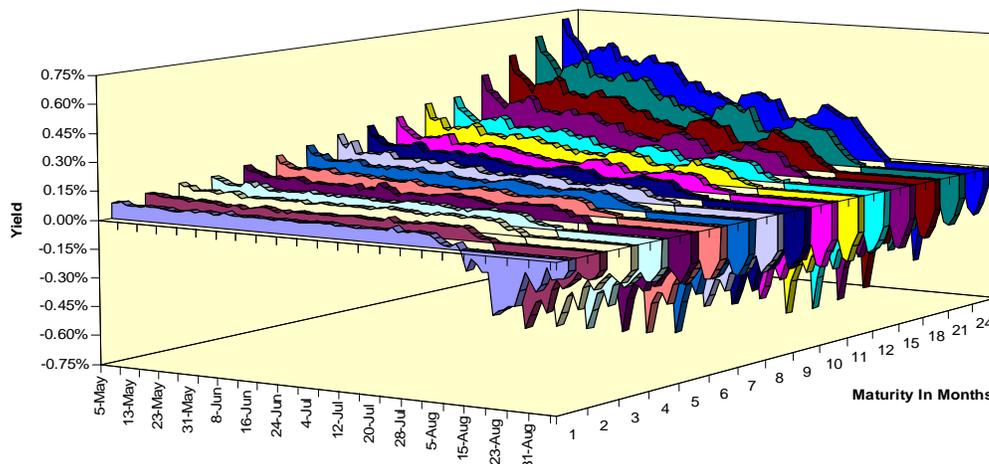
Switzerland is too small relative to the Eurozone to duplicate this trick. Moreover, while the U.S. remains a good credit, (stop laughing, please) the same cannot be said for a number of European sovereigns. Switzerland cannot buy its way out of the soaring CHF; it will try to print its way out of the bind. Yikes.

Negative Interest Rates

We live in an era where negative interest rates, the lender paying the borrower for the privilege in an act of financial masochism, have become common. You can think of this interest rate penalty as insurance against a perceived greater risk; you also can think of it as prima facie evidence of the supply of funds greatly exceeding the demand therefor. This is the situation today in Switzerland.

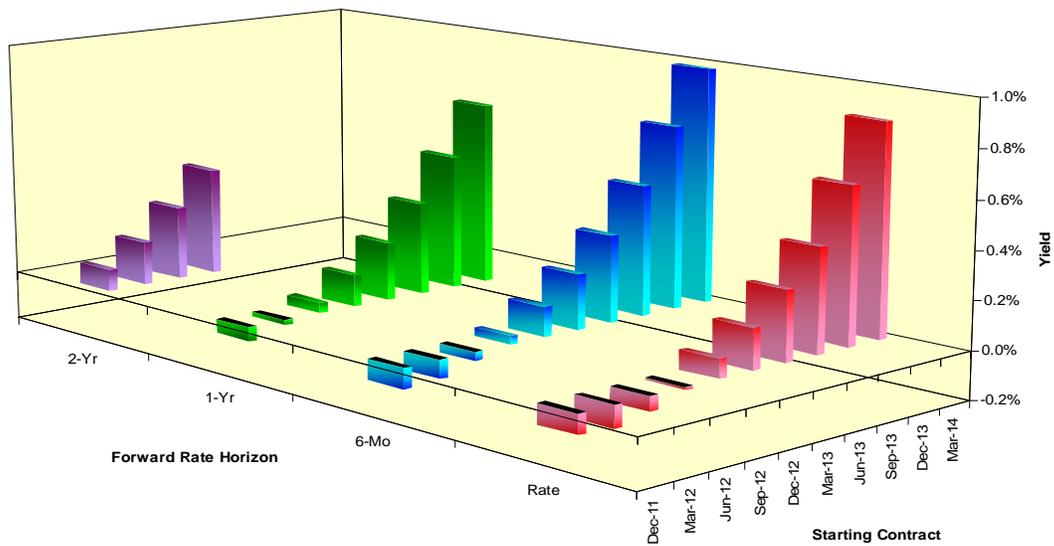
We can illustrate this with the term structure of tomorrow-next overnight indexed swap (TOIS) rates from one to 24 months since May. Please note how all of these rates have remained negative even after the franc ceiling was imposed.

TOIS Yields Remain Negative After Peg



A second illustration can be made using the synthetic forward rates derived from Euroswiss futures. The six-month rate is negative for contracts beginning out to June 2012 and the one-year rate is negative for contracts beginning out to March 2012. Restated, the interest rate market has priced in negative interest rates for the entirety of 2012.

Euroswiss Synthetic Forward Rates: September 7, 2011



These expectations imply a strong enough demand for CHF that lenders are willing to accept the interest rate penalty. All of that money is going to maintain upward demand on the CHF.

The Swiss National Bank has shot the elephant between the eyes and the elephant is charging still. Now who has the problem?