Swiss Franc Should Not Make You Hungary For A Turkey This Thanksgiving

Neither Hungary nor Turkey can raise interest rates enough to prevent a slide in their currencies.

Too much of international finance can be conceived of as precocious nine year-old playing with a chemistry set in the basement: Even though nothing should go wrong, it always does. As an aside, I have said of various European banks involved in the never-ending sovereign debt story, “Every time there’s a fire, these guys are seen standing around with kerosene and matches.”

Of course, if carry trades such as the dearly departed yen carry trade discussed yesterday are an accident waiting to happen globally and if the U.S. has proven mortgage financing has an unexpectedly high nitroglycerine content, then mortgages taken out in someone else currency should be just as safe as an ammo dump in a fraternity house.

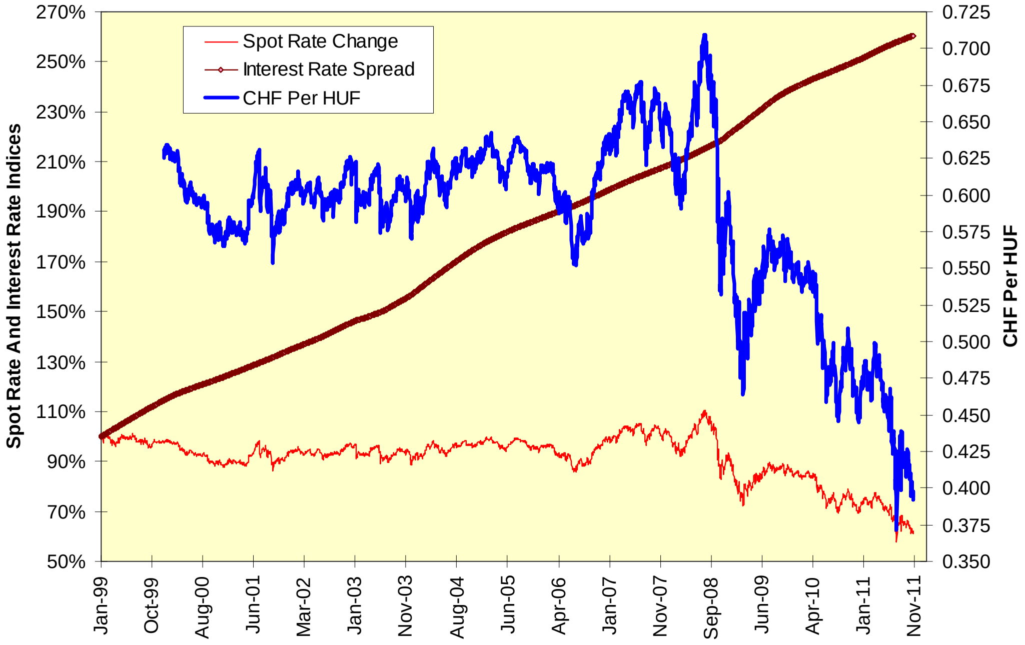
Hungary, Poland, Turkey

Switzerland was able to keep its interest rates lower than its Eurozone neighbors by virtue of its strong economy, low inflation and financial inflows from, um, diverse sources (see Switzerland’s Alpine Cash Inflows, March 2010). And as night follows day, or vice-versa, wherever there is a yield differential in the trough, the yield hogs come to feed. Billboards sprouted up in Eastern Europe encouraging homebuyers, many of whom were completely new to the process, to take out mortgages in Swiss francs. Left unsaid, I presume, was the possibility currencies such as the Polish zloty (PLN) and Hungarian forint (HUF) could tumble against the CHF and leave the borrower yodeling.

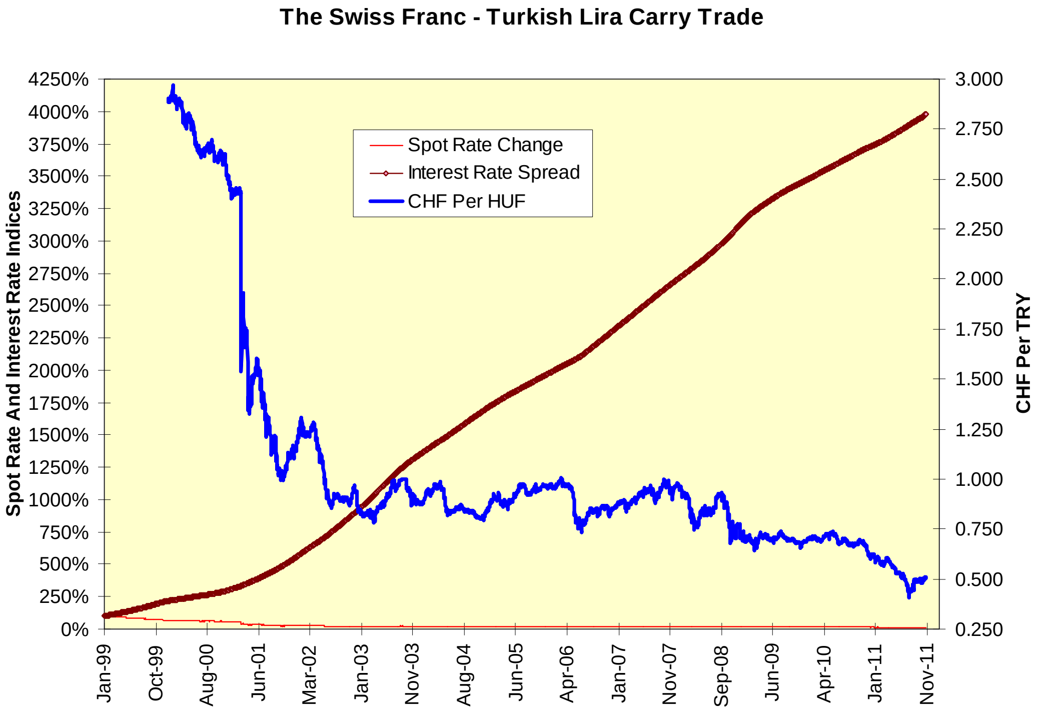
Turkey was more exposed to euro and CHF-denominated debt at the commercial level and chose to maintain the lira (TRY) as best as it could by raising interest rates. The comparative results between the HUF and TRY on their respective cross-rates against the CHF are instructive. Let’s decompose the carry trade of borrowing the CHF and lending it into the HUF and TRY into the spot rate change and interest rate spread components and map those against the currency cross-rate itself.

In the Hungarian case, the interest rate spread has grown at a 7.45% average annual rate since the January 1999 inception of the euro; the spot rate has declined at a 3.83% average annual rate. That clearly has done nothing to preserve the HUF; since July 30, 2008, the average annual carry return has declined at an average annual rate of 10.70%. Just to put this in context, the average annual excess carry return of the U.S. dollar to the Canadian dollar has been 0.25% over the same period, one that felt like the USD was on the defensive.

The Swiss Franc - Hungarian Forint Carry Trade



Now let's turn to Turkey. Here the interest rate spread has grown at a goodly 28.64% average annual clip since January 1999 while the spot rate has declined at a 16.66% pace. Has that stabilized the TRY somewhat on the excess carry return rate since the same July 2008 used above? No, it has not: The slide has been -8.95%.



The end result, based on relative interest rate expectations, all of the currencies exposed to the CHF are in massive danger. The Swiss money market yield curve is spectacularly steep; this signals along with the willingness of foreign investors to accept near-0% or even negative Swiss deposit rates that the Swiss National Bank will lose its attempt to cap the franc once short-term interest rates rise. If the PLN, HUF and TRY, amongst others are on the ropes now regardless of their chosen interest rate policies, imagine what will happen if and when things get back to normal in Switzerland.