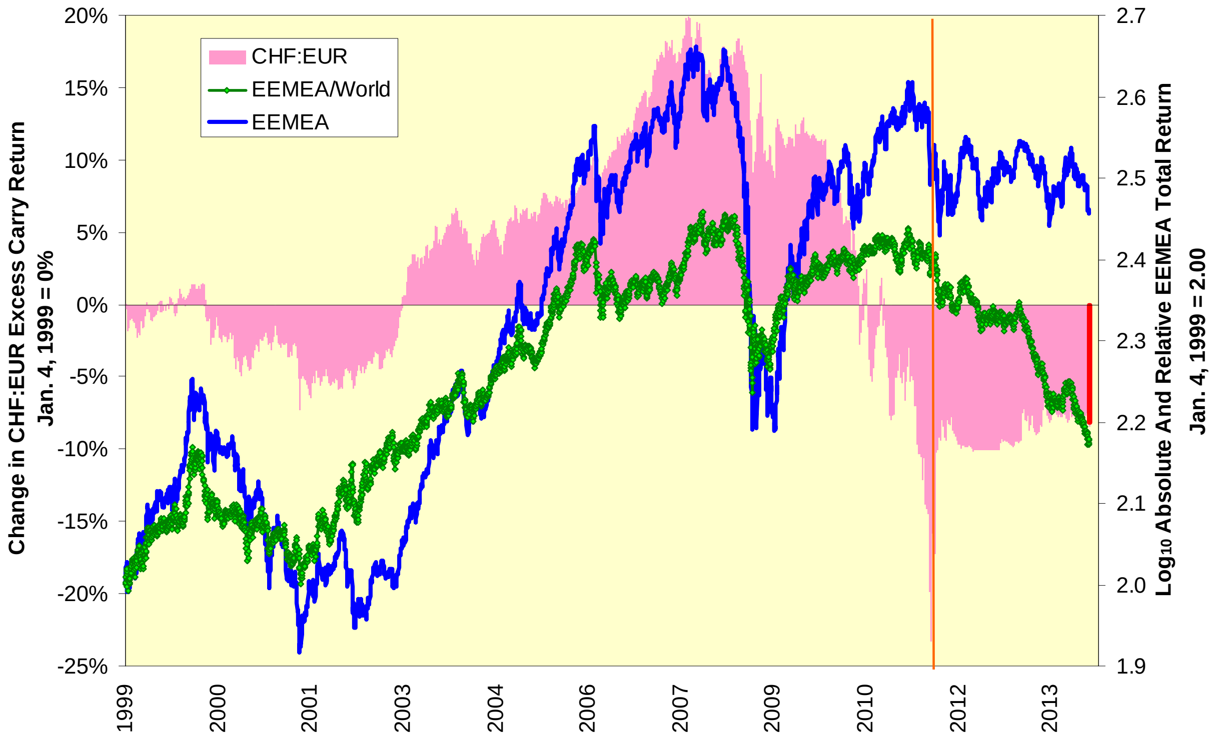
When Free Francs Were Too Expensive

The periodic financial crises that sweep through emerging markets act like a poor man's geography refresher class without intermediaries such as Apollo Education (APOL) or Career Education (CECO). While it did not take very long for troubles in Argentina or Turkey to spread to recently quiet Eastern European currencies such as the Hungarian forint, spread they did even though I had the gnawing feeling this was not "contagion" so much as the Hungarians just being sociable.

Oh, What A Feeling, Dancing On The Franc Ceiling
The Eurozone's serial sovereign credit crises of 2009-2011 led to a flow of euros into Swiss francs as a haven. That exposed a large number of Eastern European borrowers to the daunting prospects of repaying loans in increasingly expensive francs. It also scared the living daylights out of the Swiss who suddenly found their exports being priced out of global markets. They imposed a ceiling of 1.20 CHF per EUR in September 2011 and vowed to defend it with negative interest rates if necessary.

Surely this bonanza of cheap and abundant led to a borrowing feast and carry trade bubble in Eastern Europe, no? No; anything but. The MSCI Emerging Europe/Middle East/Africa index (EEMEA), which hit its post-crisis peak in April 2011, has gone sideways in absolute terms since the imposition of the franc ceiling and has declined relative to the MSCI World index.

EEMEA Relative Performance Declined After Franc Ceiling Imposed



Rational Expectations
There are several reasons this region underperformed so badly, not the least of which is the "Middle East/Africa" part. The so-called Arab Spring in 2011 led to several revolutions and ongoing civil wars; while Baron Rothschild advised buying when there is blood in the streets, global investors have said, "No, thanks" collectively. Second, much of Eastern Europe's business is based on exports to Western Europe, and growth there has been lethargic to say the least. Third, the slowdown of Russia's commodity boom meant less cash circulating through the region.

But excess liquidity has a way of papering over a lot of blemishes; why was this not the case for the EEMEA index and the Swiss franc? A borrower able to lock in negative real rates in another currency is faced with what happens if and when the funding currency revalues. It was never a given the Swiss National Bank would be able to print more francs than euro-domiciled investors would demand, and this created a massive and very expensive to hedge currency risk. Eastern European borrowers had seen already what happened to yen borrowers during the yen's July 2007 – September 2012 move higher. The Swiss literally could not give their excess francs away to these wary borrowers.

As an aside, this is one reason why QE in the U.S. has been such a poor tool of macroeconomic stimulus. Yes, you could borrow at minuscule short-term rates, but the very steep yield curve and the knowledge all interest rates would rise if and when QE stopped made borrowing at the long-term horizon riskier. The Federal Reserve's money went into paper representations of corporate assets, not into job-creating plant and equipment.

When you tell someone you are giving them a deal too good to be true, their rational response is to believe it is too good to be true. As a friend said about health care a few years ago, 'If you think it is expensive now, just wait until it is free."