Switzerland's Commodity Connection

With apologies to Bismarck's comment regarding the Austro-Hungarian Empire, if Switzerland did not exist, would we need to invent it? Probably, but not for geopolitical reasons: The country has served as a convenient resting point for migratory capital on a flight path from somewhere, and I suppose that is a useful social service.

Its currency, the franc (CHF), has performed various useful social services, too. At the end of the 1970s Great Inflation – wait long enough and you will see everything at least twice in your life; I am convinced we are headed for a repeat on the inflation front – so much money was flowing into Switzerland to avoid inflation elsewhere the country imposed negative interest rates on foreigners' time deposits. That is right; you paid a penalty for the privilege of keeping your money in CHF.

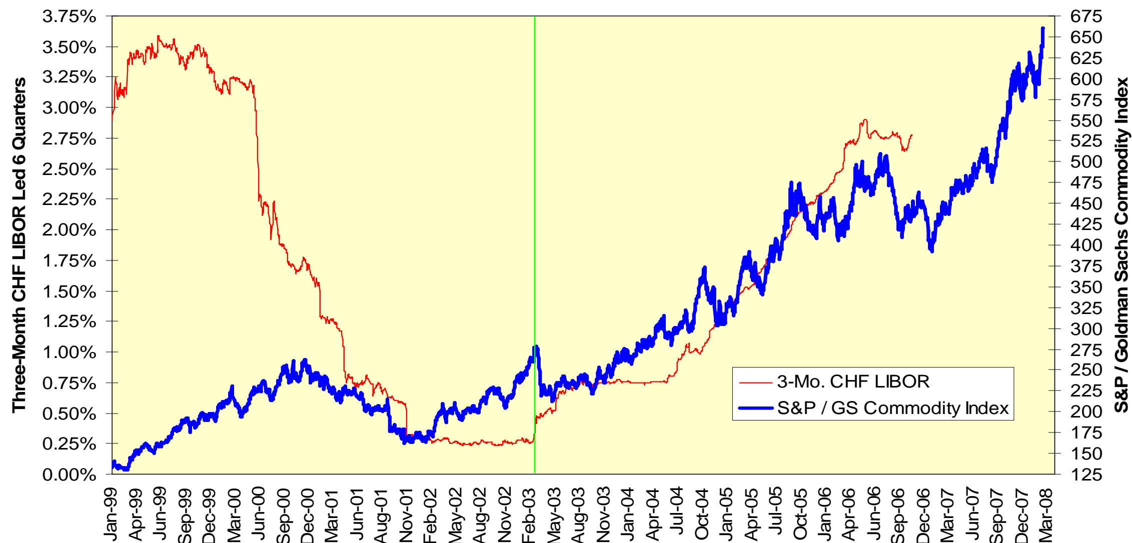
Even though Swiss interest rates are positive, they are low by global standards. The only major currency you can borrow for less in a carry trade is the Japanese yen. The U.S. dollar, as I noted last month, is fueling carry trades, too.

The Commodity Connection

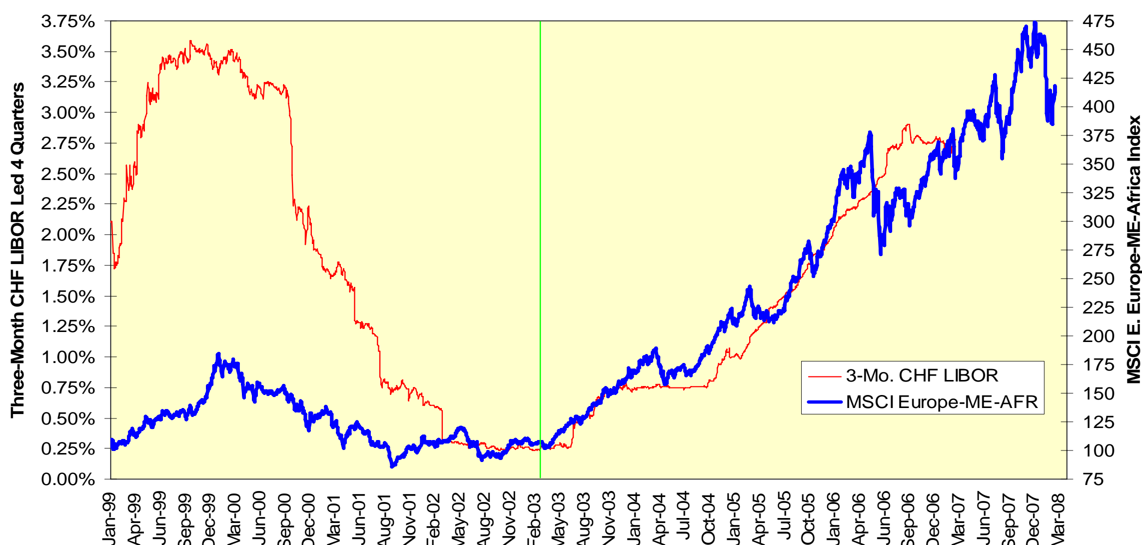
From whence is the money flowing into Switzerland coming? The answer, at least since the end of the global bear market in October 2002 and the beginning of the commodity boom that started soon thereafter, has been from the commodity producers of Russia, the Middle East and North Africa. Even more critical than the October 2002 date is March 5, 2003, which will be marked with a green vertical line in the charts to follow. This is the day when the Swiss National Bank lowered its target rate from 0.75% to 0.25%; this rate cut preceded the Federal Reserve's declaration of war on deflation on May 6, 2003 by two months.

How can we demonstrate this commodity connection? The answer is very straightforward. If we map the energy-rich S&P/Goldman Sachs Commodity index against three-month CHF LIBOR, we find commodity prices have led Swiss short-term interest rates by six quarters on average since March 2003.

Commodity Prices Affect Swiss Short-Term Rates



A second clue comes from the equity markets. The Morgan Stanley Capital International index for Emerging Europe/Middle East/Africa has been on a tear since the commodity boom got underway, and for obvious reasons. It has led three-month CHF LIBOR by four quarters on average since March 2003.

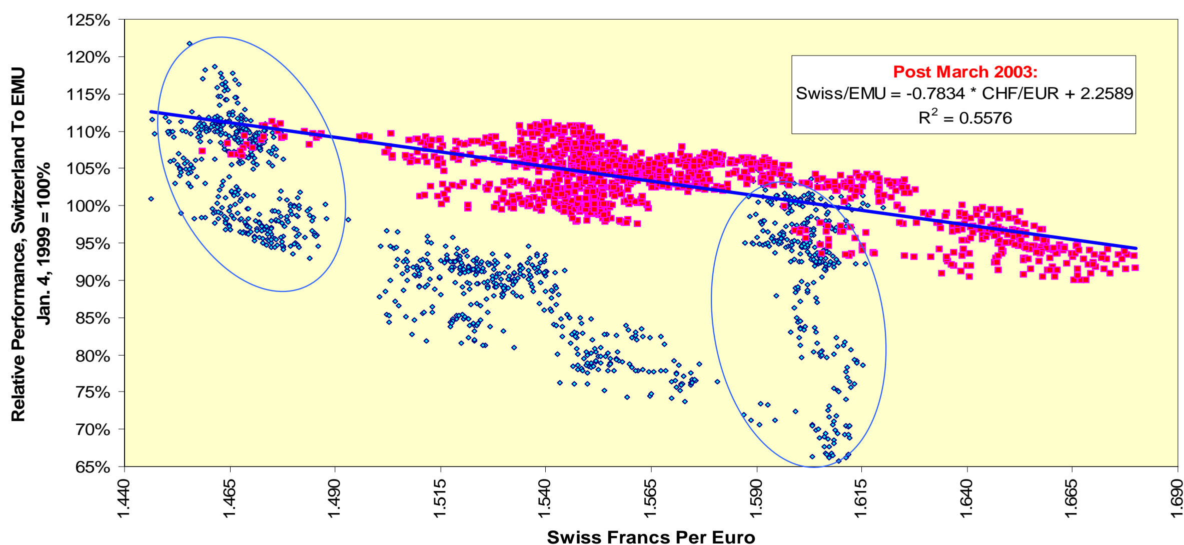


The Carry Trade And Stocks

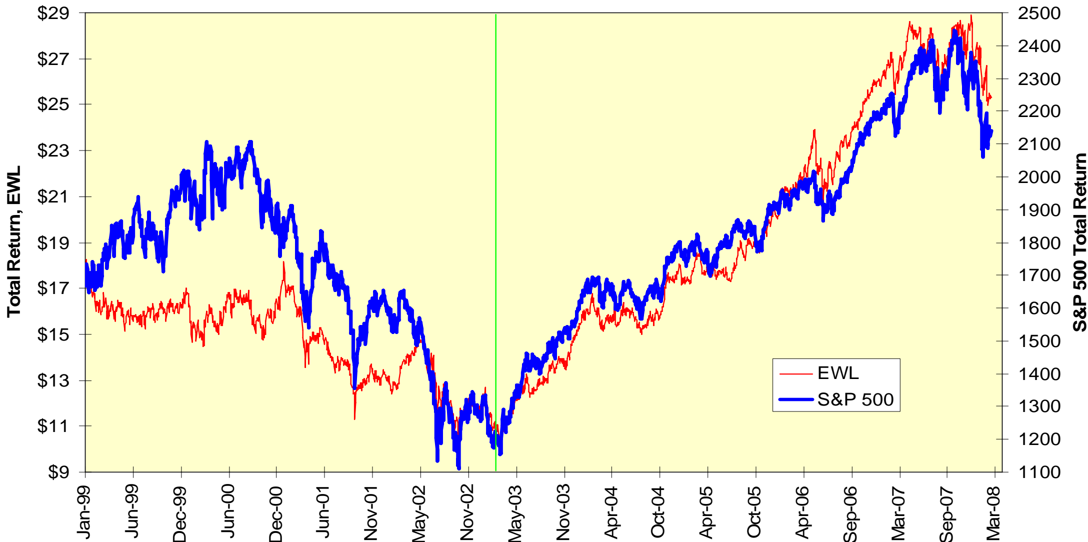
Even though CHF LIBOR has been rising as a function of the funding countries' commodity-linked economic health, it has not been rising fast enough to discourage the Swiss franc carry trade. The Swiss National Bank would have to engage in reckless tightening policies to achieve that goal, and to what point?

Moreover, any eventual downturn in commodity prices will, per the charts above, put downward pressure on CHF LIBOR and keep the Swiss franc carry trade open. If the conclusions we drew in the discussion of the dollar carry trade and a November 2007 study of comparative equity returns are correct, the country whose currency is being borrowed in a carry trade should see its equity market suffer.

We certainly can see this by comparing the total returns for Swiss stocks against the MSCI index for the European Monetary Union. Prior to March 2003, the relative performance of Swiss stocks as a function of the CHF-euro cross-rate was haphazard. Two clusters, marked in blue ovals, had a distinct non-dependence of relative performance as a function of the currency. After March 2003, the relative performance of the Swiss market became a very direct function of the currency cross-rate. If the franc continues to weaken against the euro, as seems likely, we should expect Swiss stocks to underperform EMU stocks.



What about a comparison to U.S. stocks? To no one's surprise, there is a dollar-denominated ETF on the MSCI Swiss index, which trades under the ticker EWL. How has its total return compared to that of the S&P 500?



The answer is the EWL has outperformed the S&P 500 slightly since global stocks' October 2007 high; this is encouraging only if you regard relative outperformance by a money-losing asset as a triumph of the human spirit. The EWL has lost 10.5% while the S&P 500 has lost 12.7% and an ETF representing the EMU index has lost 12.5%.

What should you do? If you are a Russian mining magnate or a Middle Eastern oil exporter, you will do what you do best, and that is continue to route your money into Switzerland. Old habits die hard. But if you are under the illusion that Switzerland will reprise its 1970s role as a haven for those seeking protection from inflation, diversification and maybe a little bit of a higher return, forget about it. And that is before we revisit 1979 and the era of double-digit inflation.

Too bad; now that we need the old Switzerland we will have to invent it. The new one is not working according to plan.