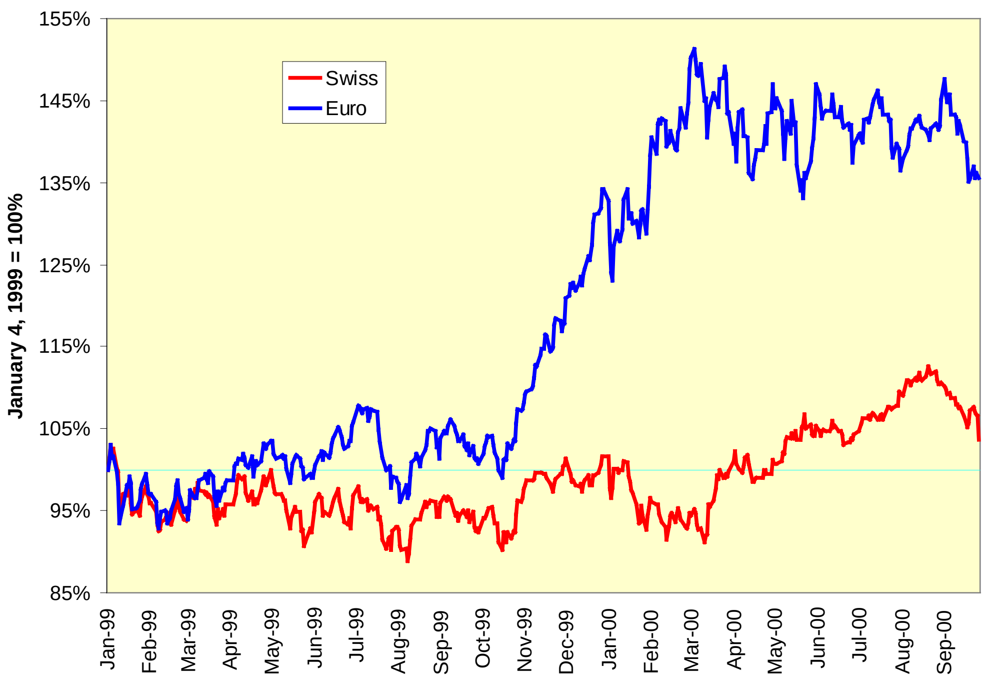
Switzerland: Troubled Island In The Euro Sea

While Switzerland has maintained its vaunted neutrality for centuries, there were never any questions as to whom the Swiss were neutral against: The well-trained and equipped army probably did not worry too much about the intentions of either France or Italy.

The alpine nation, a financial and economic powerhouse and home base to such export-dependent industries as Novartis, Roche, and Ciba in pharmaceuticals and chemicals and Nestle in food products, is surrounded entirely by members of the euro (EUR) bloc. Since exports account for almost half of Swiss GDP, the long decline of the woebegone EUR naturally has created such significant problems for both the Swiss economy and its financial markets that avoiding this market entirely may not be a bad idea.

Relative Performance: Swiss Market Vs. Morgan Stanley Euro Index



Where's The Tech?

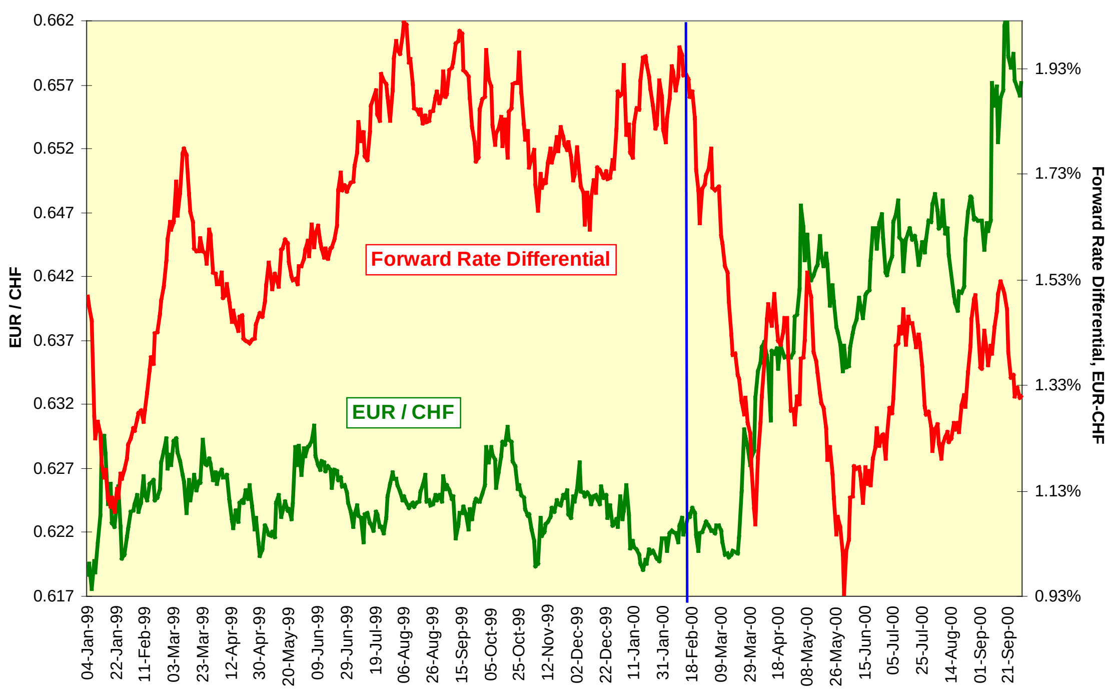
Since the euro's arrival in January 1999, the Swiss Market Index (SMI) has struggled; it has gained only 4% in Swiss franc (CHF) terms. Switzerland can be characterized as Old Economy, a term that sounds remarkably dated only months after it was bandied about incessantly. While the Morgan Stanley Euro Index (MSE) shot higher during the global technology boom of late 1999 and early 2000 on the back of such stalwarts as Nokia and Deutsche Telekom, the SMI stayed underwater. This was a difficult period for financial giants such as UBS and Credit Suisse, and for value stocks such as Nestle and engineering services giant ABB Ltd., the holding company for Asea Brown Boveri.

The SMI had no technology or telecommunications highfliers to offset weakness in other sectors; telephone company Swisscom lacks the critical mass to compete effectively in global markets. The Swiss Exchange attempted to rectify this dearth of technology by lowering admission requirements for the SMI to 0.45% of aggregate market value from 0.50%. As of October 2, 2000 the SMI will include Kudelski, a maker of pay-television systems and Unaxis Holdings, a maker of compact disk coatings. Other additions included Bank Julius Baer, pharmaceutical maker Serono, and luxury goods maker Richemont. If these don't look like the optical network and Internet portal firms you've come to know and perhaps love, it's because they're not. These industries do not yet have a significant presence in Switzerland.

As an aside, the re-balancing of the SMI shaved close to 4.5% off the index within minutes near the close on Friday, September 29, as index funds sold existing shares to make room for the new additions. So much for markets being continuously efficient.

With Neighbors Like These...
The CHF traditionally traded in a tight spread to the Deutsche mark. Both countries shared a commitment to sound monetary policies and low inflation. At first, the CHF remained in a tight relationship to the EUR, but this relationship changed abruptly during the same time frame as the global tech stock rout of March and April.

EUR/CHF Cross-Rate As A Function Of Interest Rate Expectations



If we define interest expectations as the forward rate between one and ten year horizons, Swiss interest rate expectations rose rapidly relative to Euro-zone rate expectations between mid-February and June. A more accurate description may be that the intentions of the Swiss Central Bank in fighting inflation through higher interest rates were more credible than those of the European Central Bank. After all, Switzerland can act unilaterally, while the ECB represents eleven different countries and several potential entrants.

The role of political culture cannot be ignored. A current poll published in *Die Bild Zeitung* indicates only 15% of Germans have faith in the EUR, while 51% have misgivings about the currency and its future. Denmark rejected this past week a referendum to join the common currency, and the British don't seem to be in any rush to fill in the English Channel and abandon the pound. A further round of interest rate hikes in Europe to support the EUR would be foolhardy given the slowing economies and this lack of political support. The best hope for the EUR is that an economic slowdown in the U.S. prompts the Fed into easing interest rates, a move that may have inflationary consequences.

Given this background, the appreciation of the CHF to the EUR is likely to persist and even accelerate. Just as the strong dollar has hurt the exports and repatriated earnings of U.S. exporters as diverse as Intel and Eastman Kodak, the strong CHF will squeeze margins for the major Swiss exporters.

The prospective earnings problems for Swiss exporters combined with the backwash from EUR turmoil has started to take its toll on the Swiss banks and insurance firms. Since the end of August, UBS has lost 9.7%, while Credit Suisse has retreated 11.9%. Insurance giants Swiss Re and Zurich Allied have dropped 8.1% and 10.1%, respectively, over the same period.

The good news for Switzerland is tough, if not impossible, to find. Of course, we're dealing with tough, hard-working, and resourceful people. And we all know that tough markets don't last, but tough traders do.