# Switzerland And Europe: Convergence With A Vengeance

The concept of a safe haven is ingrained deeply in our culture. Take baseball, for instance: While you are on the base, you're safe, and untold millions will be tossed in your general direction by George Steinbrenner and those of his ilk, whatever an "ilk" really is.

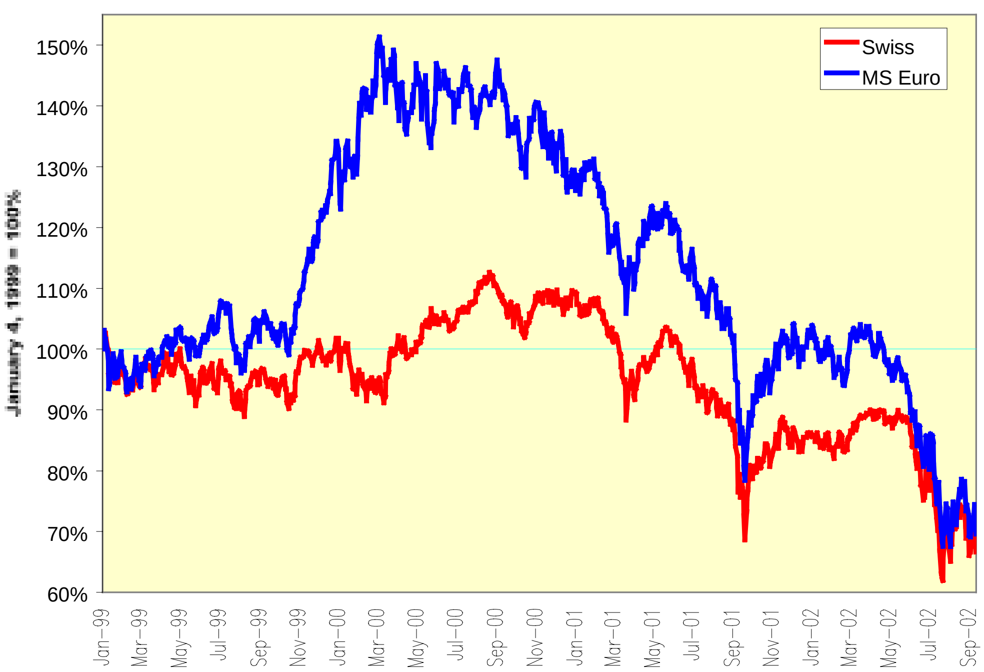
Switzerland occupies a similar role in the global conscience. While it isn't the no-questions-asked repository of ill-gotten gains it may have been, it is the first place that comes to mind for such activities; witness Treasury Secretary Paul O'Neill's ill-considered remarks about aid to Brazil possibly winding up in some Alpine retreat.

Economically, Switzerland is an island in an euro sea. Euro-bloc members France, Italy, Germany and Austria surround it. Tiny Liechtenstein, its other neighbor and a doubly landlocked offshore financial center, uses the Swiss franc (CHF) as its currency. More than half of Switzerland's GDP is based on international trade, and it is a global powerhouse in export-dependent industries as Novartis, Roche, and Ciba in pharmaceuticals and chemicals and Nestle in food products. Even minor variations in the value of the CHF, especially against the euro (EUR), have an undue impact on the Swiss economy much as changes in the Canadian dollar and Mexican peso affect our neighbors' welfare.

**Safety Is Relative**

On one level, the Swiss Market Index (SMI) has been a better bet than the rest of Europe so far in 2002, but as Bill Clinton might say, "depends on what you mean by 'better.''" The Morgan Stanley Euro index (MSER) is down 32.5% in local currency terms, while the SMI is down only 22.7%; the respective currency-adjusted figures for U.S. investors are 26.2% and 15.0%, respectively. The relative local currency performances of these two indices since the euro's advent in January 1999 are shown below.

**Relative Performance: Swiss Market Vs. Morgan Stanley Euro Index**

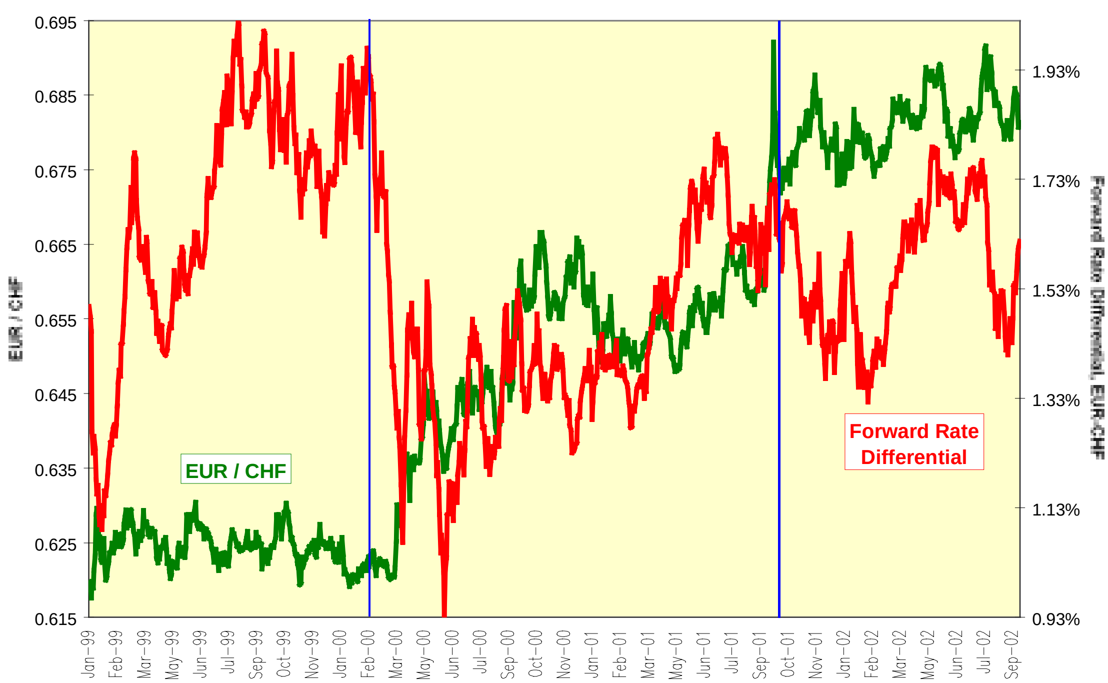



The use of percentage point comparisons for 2002 is somewhat misleading given the SMI had a much weaker rebound in the fall of 2001 than did the MSER and therefore began 2002 in a subdued state. But one aspect of the above comparison that cannot be ignored is the two markets' convergence after following very different price paths for nearly three years. Why would this be the case?

**Franc-ly My Dear...**

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 when the global bear market began in early 2000.

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




Changes in monetary policy, as so often is the case, were to blame. 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 2000. 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 twelve different countries and several potential entrants.

The role of political culture can never be ignored in Europe; every statue in every town square commemorates some bloody victory over a neighbor, and a passenger in the Chunnel from France to England will disembark at Waterloo Station. The Swiss resolve to forestall inflation - the Fed had yet to do its last 50 basis point rate hike at the time - was welcomed by investors. The SMI, which sat out the last phase of the global bubble, began to outperform the MSER. In addition, the EUR/CHF exchange rate resumed its traditional custom of moving in parallel fashion to differential interest rate expectations.

By the end of 2001, the interest rate expectation differentials between Switzerland and the euro bloc entered a trading range and the EUR ceased weakening against the CHF. Both currencies soon began strengthening against the dollar, but in a stern rebuke to those who confuse a strong currency with a strong stock market, both indices failed to outperform the U.S. market in local currency terms.

The end result has been a choice between a CHF too strong against the EUR and European stock markets that can't get out of their own way in the face of a weakening global economy. The currency trade looks uninteresting, and the different composition of the two indices makes the spread between them a poor proxy for a currency trade in disguise. Just leave both of these markets alone and add them to our growing list of global lose-lose propositions.

**Nothing To Yodel About**

In addition to the exporters noted above, the SMI is has a strong weighting in financial giants such as UBS, Credit Suisse, Swiss Reinsurance and Zurich Financial Services. These stocks sat out the technology craze, but like all global financial firms, they have been hurt by the bubble's deflation.

It perhaps is a too-telling sign of the times that the leading performer in the SMI this year, up a tidy 42.6%, has been Societe Generale de Surveillance, which provides inspection, testing and verification services worldwide. The money isn't in making things anymore, it's in seeing whether other people are being honest.

In the meantime, there's always a safe haven, right?