Swiss Short-Term Rates In Negative Trap

Many economic policies launched with the best intentions also are launched with the least thought about how they will end. Everyone remembers how QE1 was launched in March 2009; few remember expectations were for it to be a temporary program. By mid-July 2009, Ben Bernanke found it necessary to declare it would not be short-lived; it was then and only then the bull market was saved from pulling back toward a test of the March 2009 lows.

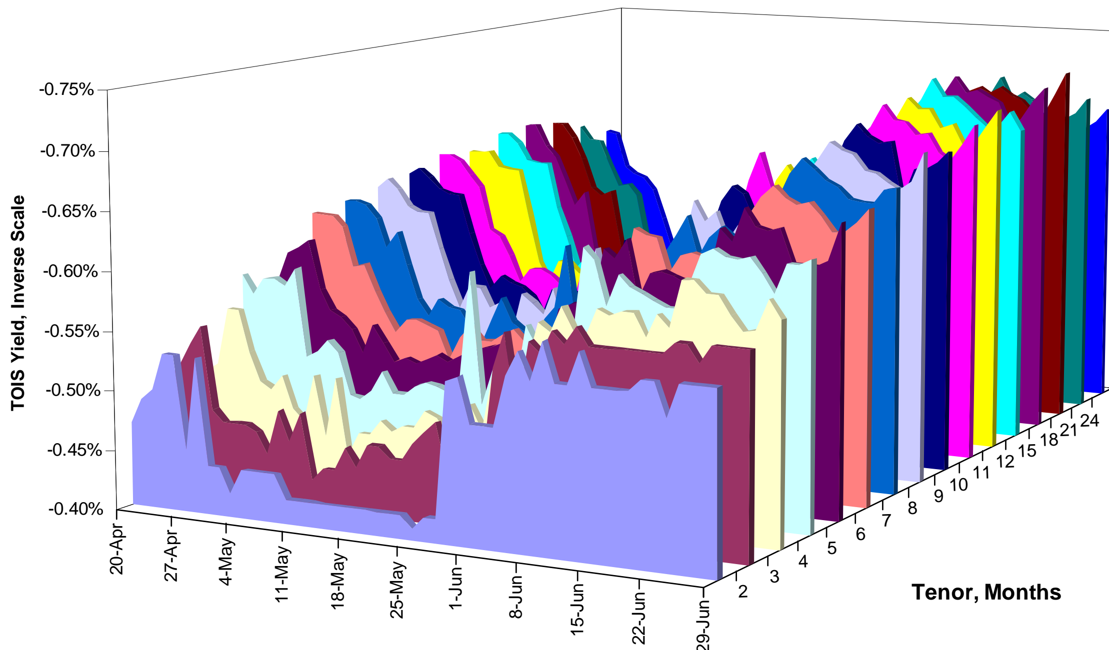
Switzerland has faced the policy "roach motel" question several times of how to handle the vast inflows from its Eurozone neighbors. The Swiss National Bank has intervened multiple times, lost tens of billions of francs in the process, imposed the 1.20 francs per euro ceiling in September 2011 and then abandoned it this past January when it concluded it could not afford to offset the inflows.

Ultimately, the only way to make a currency unattractive is negative interest rates. If Switzerland was the only country in the world that had them, they might have been more effective in arresting capital inflows, but negative interest rates are as much a part of the European landscape as are long lines at museums. Besides, the penalty of paying to lend is a form of insurance; as long as this penalty is less than the expected loss of holding on to euros people will pay it.

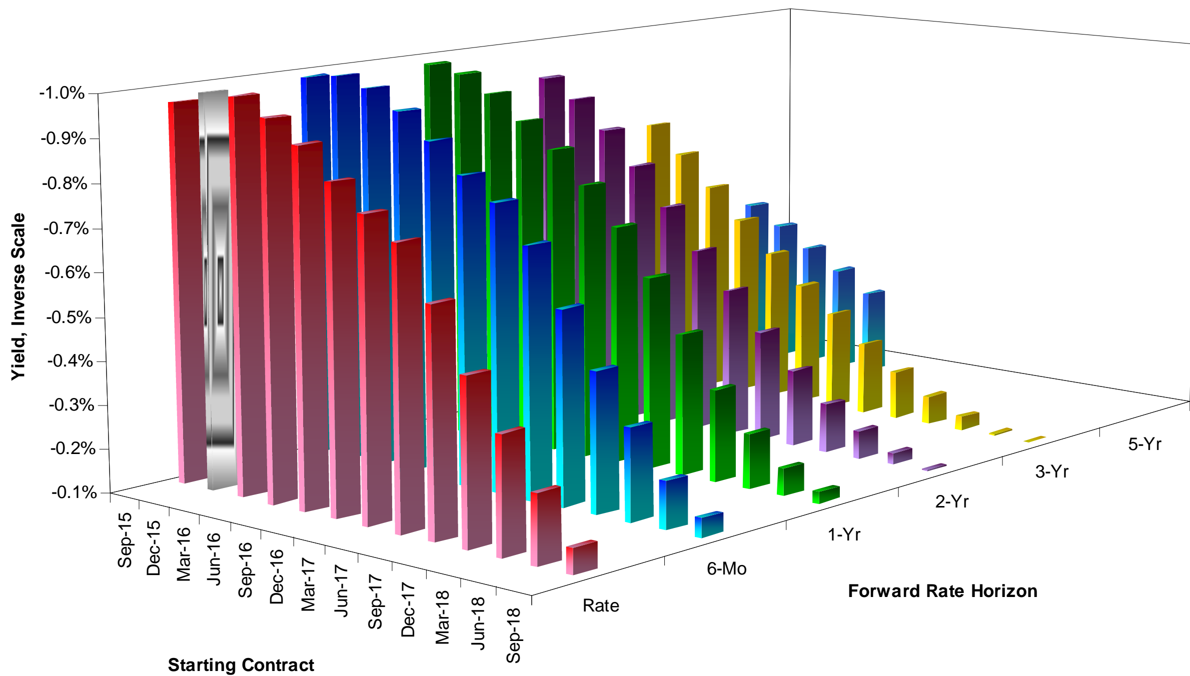
TOIS

Let's take a look at the progression of Swiss TOIS (tomorrow/overnight indexed swap) rates since the April 20, 2015 low in long-term benchmark Eurozone sovereign rates. Please note the inverse scale with the "high" at -0.40%. These rates started to decline anew at the start of June as the Greek situation came back into the headlines.

TOIS Yields Remain Persistently Negative



Another way of looking at how persistent these negative rates are is to construct a matrix of synthetic forward rates from Euroswiss futures. Once again, this is plotted inversely and once again everything is negative. A borrower could lock in a negative three-year forward rate starting with the expiration of the September 2018 three-month Euroswiss futures contract. That agreement will end more than six years from now, or as far into the future as the start of the QE era is in the past. The low rate of -0.96%, highlighted in the chart below, is for the three-month FRA starting with the expiration of the December 2015 contract.



What is doubly crazy, as if we need to get doubly crazy in this world, is non-Swiss borrowers are scared to death of borrowing the franc because of its extreme revaluation risk. Eastern European borrowers, especially those in Poland and Hungary, had lined up to take out franc mortgages in 2009 only to find out just how expensive those loans could become in zloty or forint terms.

This means Switzerland either has to maintain these negative rates indefinitely or acquiesce to a much stronger franc. Had they grasped this back in 2009, they might have been able to adjust to the stronger franc more gradually, but that opportunity is long gone. Switzerland may be famously neutral, but it certainly has found a way to fall into the trap of a war it cannot win and will not end.