The Swiss Emmentaler Trade: A Strategy with Holes

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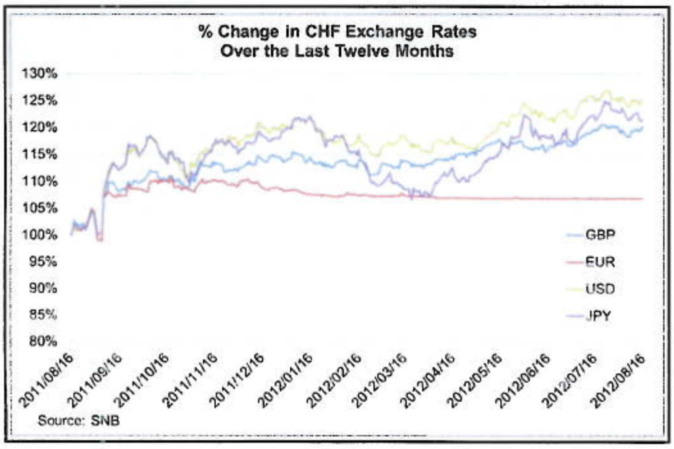
CHF One Year Into Intervention

Almost 12 months have passed since the Swiss National Bank decided to intervene in FX markets to prevent the appreciation of the Swiss franc. Guided by our experience of previous G10 currency intervention episodes, we have been skeptical about its success from the beginning. Our previous research has shown that the impact of interventions was both temporary and reversible. Once intervention ended, the currency valuation resumed its prior course.

This last intervention has lasted longer than we expected and thus far, has been successful in keeping the CHF low relative to the EUR while other G10 currencies have appreciated substantially.



% Change in CHF Exchange Rates Over the Last Twelve Months

One thing we had under-estimated was the very considerable amount of risk that the SNB was willing to take in order to achieve their aim. In our view, by sticking to their monetary policy, they now pose grave danger both to themselves and also to wider financial markets due to the enormous size of the operations performed.

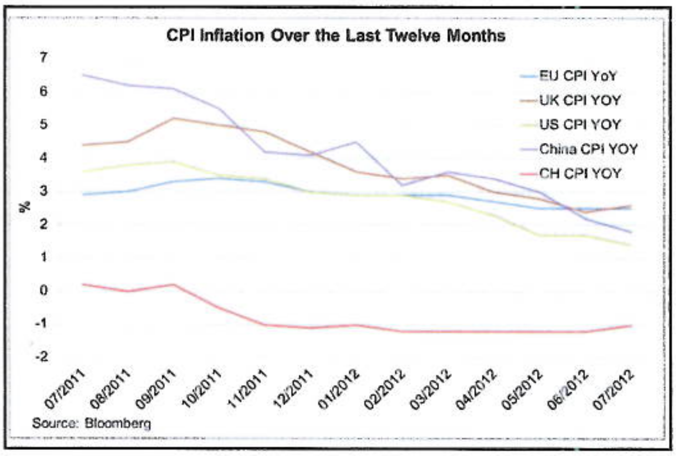
The SNB has previously intervened with the aim of keeping the CHF low. Between 2009 and 2010 it performed a terribly costly intervention. As perfect validation of our previous research, the volatility of the EUR/CHF cross was moderated during the intervention window but the appreciation of the CHF could not be reversed. The SNB incurred losses of almost CHF 35 billion for their trouble. If you think that's a large number, read on.

As the Eurozone debt crisis deepened in the summer of 2011, inbound capital flows driven by political and economic uncertainty caused an appreciation of the CHF. Between the 3rd and the 17th of August 2011, the SNB announced three sets of measures to weaken the Swiss franc: expanding banks' sight deposits at the SNB from CHF 30 billion to CHF 80 billion, expanding them further to CHF 120 billion, and expanding them finally to CHF 200 billion. As a result of all this, the Swiss franc weakened against the euro from its August peak for a few days. The move was followed by an appreciation almost to parity, which triggered the SNB's decision on 6 September to set and maintain the exchange rate at a minimum of CHF 1.20 per EUR. At the same time, the reference interest rate was set low in order to encourage capital outflows that should (in principle) mitigate the build-up in foreign currency reserves.

The SNB's decision and subsequent actions were driven by a need to meet the following objectives: to ensure price stability (by fighting the deflation driven by excessive currency appreciation), to support economic activity and to counteract a weakening GDP.

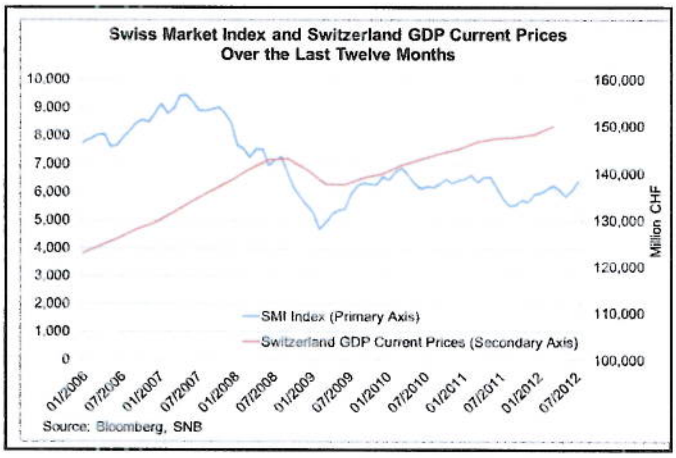
How successful has the SNB policy been?

The intervention obviously had no impact in countering deflation. Swiss CPI is still declining by about 1% p.a.



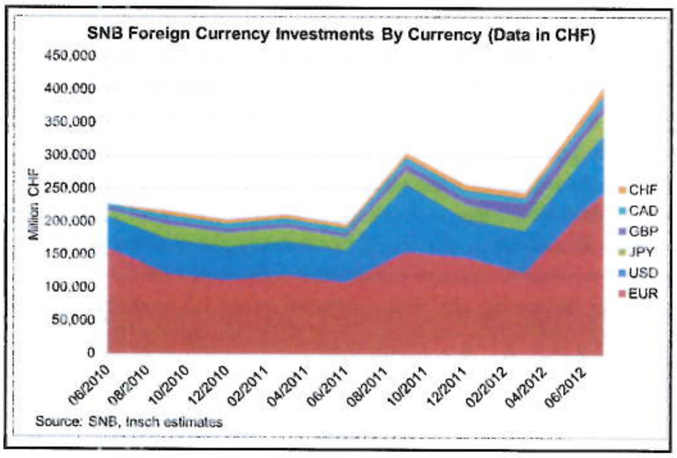
CPI Inflation Over the Last Twelve Months

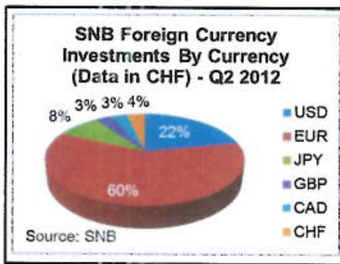
Regarding GDP growth and the performance of the Swiss Exchange, it is hard to attribute their very moderate recovery to this intervention.

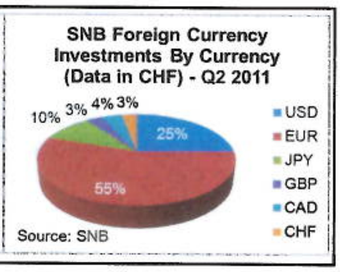


With such an accommodating CPI, quantitative easing could have been achieved through other economic channels. However, the SNB chose to proceed with an unprecedented expansion of its balance sheet. The rise in the reserve account reflects the foreign currency amounts bought to counteract market capital flows. As the Eurozone crisis has intensified further, foreign currency holdings have ballooned.

Over the last three months, the SNB has been forced to accumulate huge amounts of EUR in order to maintain the exchange rate target of 1.20.

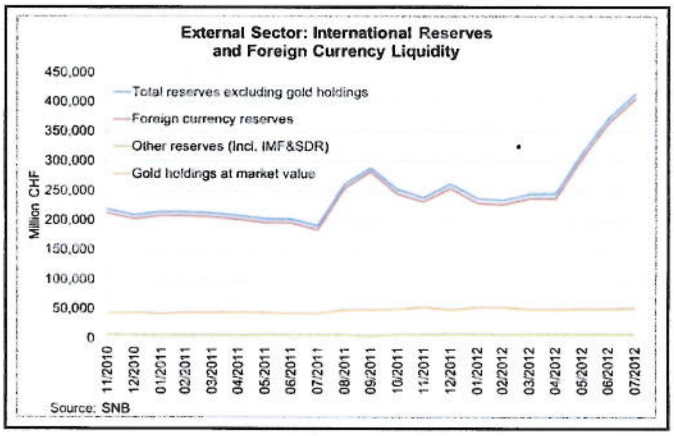






Look at the above charts: Do you know any other country holding euro reserves in this proportion? Is everyone else wrong?

We estimate that by the end of August foreign exchange reserves at the SNB will have doubled since April. The SNB has moved into dangerous territory as the Eurozone debt crisis has intensified during the second quarter of this year and demand for "safe havens" has become even more critical.



Where is the upside?

The SNB now finds itself in a position of defending its much valued credibility (being "prepared to buy foreign currency in unlimited quantities") by taking on an enormous amount of risk.

There are very substantial dangers ahead for the SNB as well as for other market players. The SNB may not be able to offload the pile of euros it has accumulated (as big as CHF 240 billion according to our estimates) without suffering huge losses.

Offloading such an immense amount of euros (€200 billion at today's prices) would assuredly have a market destabilising effect. The foreign exchange operations could send markets into uncharted turmoil and lead to a run on the euro – the very last thing the SNB would want.

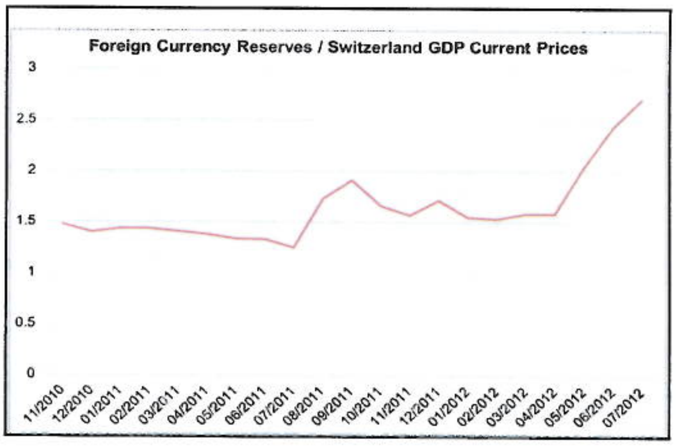
The value at risk in the SNB foreign exchange acount is as large as the whole amount held in euros. This amount is held mainly in German and French treasury bonds. In the event the Eurozone breaks up, and core economies leave the Eurozone, they would have no obligation to redenominate external debt obligations from the euro. External creditors (i.e. the SNB) would take the loss in euro valuation in full.

Furthermore, in buying highly rated euro-denominated intruments, the SNB contributes to artificially increase the spreads, thereby sending bearish signals to markets regarding the euro, in what is called a "wrong way trade" (a trade in which exposure size and the value of the asset held are negatively correlated).

This represents the downside of the SNB monetary policy.

What is the upside? Is the potentially ruinous risk worth a meager 1% additional growth in GDP?

Consider the next graph to see the extent at which this possible (but uncertain) GDP growth rate would cover the loss in the foreign currency account.



> "The Eurozone breakup is being predicted more and more frequently by various authorities in the field and the probability seems to have gained at least some acceptance by all involved parties."

Total foreign currency reserves are rapidly approaching three times GDP. The ratio has almost doubled in the last three to four months and is now eight times higher than at the end of 2007.

What has changed during the last 12 months?

Last summer, the Greek debt crisis was well under way. Slowing growth in Europe was already an issue, as was the US international debt.

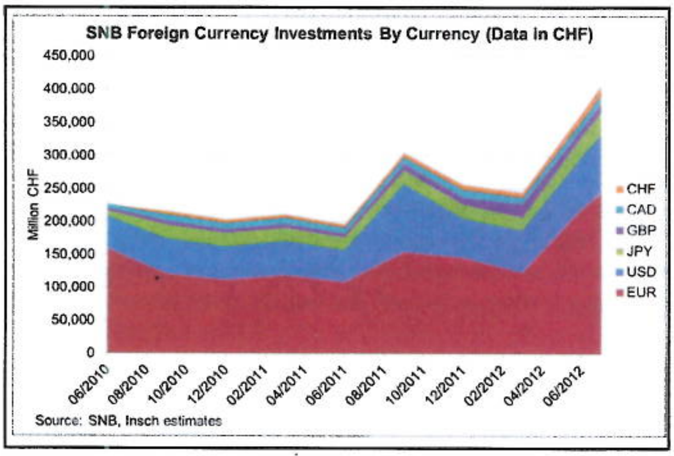
Today the situation is even worse: Traditionally safe assets have become risky (Bunds and Treasuries, yen and US dollar). Yields close to zero create skewed pay-off structures with risk concentrated in the downside. Bank lending, liquidity and trading volumes have declined.

Eurozone structural issues remain unresolved and deadlines are fast approaching – despite more and more sophisticated debt-sharing mechanisms. The Eurozone's GDP fell by 0.2% in Q2 and there is considerable divergence within the Eurozone block (Greek GDP contracted by 6.2%). In the last 12 months, Eurozone stock markets have lost value (-25% FTSEMIB, -10% CAC40, -5% DAX).

How far can this go?

Should it decide to abandon the EUR/CHF exchange rate target, the SNB risks facing major losses on its CHF 400 billion of foreign reserves. However, the SNB has pledged to maintain the intervention policy. Consequently, its balance sheet will continue to expand further in an effort to counteract the CHF appreciation driven by capital inflows.

The Eurozone crisis is far from over and the search for safe havens is as fervent as it ever was during the last 12 months. In fact, there are even fewer safe havens around. Meanwhile, the SNB is intent on relinquishing the safe haven status of the CHF by artificially pumping value into (of all things) the euro.



In the process, it distorts the valuation of other related assets. It also interferes with the ECB's bond buying plans and alters the shape of sovereign yield curves.

The composition of the SNB's euro-denominated holdings moves markets, as the SNB diversifies risk from German to French, Dutch and other sovereign bonds. The re-positioning of euro investments brings yields up in one region and down in the next. The SNB purchases are performed on an enormous scale. With currently low trading volumes, these anomalous movements are exacerbated further.

It is clear that the effect of this artificial euro pricing (imposed by the SNB) has produced severe market distortion and anomalous prices. The message that the market would usually be telling investors through the mechanism of "price discovery" has been distorted (even drowned) by their actions. The euro appears to have held its value even while Eurozone worries compound (where would the euro be trading without the SNB buying?).

Investors sell euros and buy into the safe haven of CHF and the SNB cancels out the inflows by buying euros. The price/information feedback loop is corrupted.

Conclusion

We cannot know for sure why the SNB embarked on this course or why they insist on maintaining its capriciousness, hubris, a back-room deal with the EU...), however, we do know this:

The Eurozone breakup is being predicted more and more frequently by various authorities in the field and the probability seems to have gained at least some acceptance by all involved parties. If and when the actual event takes place, there is no telling where the current imbalances will be priced.

Never before has the SNB operated in the FX markets on such a scale.

Risk is piling up at the SNB: they are holding a risky currency (euro) and sovereign issues that have lost their risk-free status.

The SNB have proclaimed themselves to be "the buyer of last resort" for the euro and appear happy to re-state it ever more forcefully. How much longer, and at what cost, can they continue to fulfill this role?

There does not appear to be any exit strategy for the SNB that would result in anything other than catastrophic losses. When, to whom and at what price does the SNB plan on selling its EUR 200 billion? Can it really print currency "in unlimited quantities" to cover the losses?

None of this is good.

The Swiss judge Emmentaler cheese by the size of the holes in it: The bigger the hole, the better the cheese. Time will tell if that also applies to their forex strategy.

"There is No Knowing What We Shall See"

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1: "Central Bank Intervention", InschQuantrend, April 2011, and "Intervention: friend or foe?", FX Invest, October 2011.