

June 2012 Alvine Capital Newsletter

## **The Swiss franc cap is likely to fail—an opportunity**

**Key issue**—the euro has depreciated on a trade weighted basis by nearly 10% since the Swiss franc cap was introduced, dragging the Swissie down with it.

**Key recommendation**—the Swiss franc cap will not be sustainable and aggressive traders should see a cheap opportunity to short the euro. Portfolio investors should consider the diversification and safety of this long time refuge of value.

**‘We are convinced that maintaining the minimum exchange rate at 1.20 to the euro is absolutely necessary’** - Thomas Jordan Chairman Swiss National Bank (source CNBC.com 14/06/12)

**‘There are going to be no devaluations, no leaving the ERM. We are going to maintain sterling’s parity and we will do whatever is necessary’** - Norman Lamont Chancellor of the Exchequer, The Times 27/8/92 (source The Times archive.)

Currency caps and floors ultimately rest on the willingness of politicians, joined by central bankers, to see through **highly distorting economic policies**. While it is true that a cap, rather than a floor, does not rely on the good will of outside powers, internal politics can be just as destabilising. No such comprehensive support has ever existed in Switzerland, and with mass capital flight from the euro continuing it is likely the Swfr cap will have to be withdrawn shortly.

In September 2011, as the euro plummeted during one of its periodic crises, the franc became one of the main beneficiaries. As the euro traded alarmingly towards parity the SNB finally emerged. However, rather than repeating the piece meal intervention that had not worked in 2010 during a previous period of Swfr supremacy, on this occasion the central bank chose a bold move towards a cap. The *Swissie* would now be fixed, with a line in the sand drawn at 1.20 to the euro.

### **Philipp Hildebrand—the architect**

At 1.94m, with suave good looks and elegant suits Hildebrand was to many people a surprisingly young choice in 2010, to head the central bank. A former hedge fund trader he was to provide an activist contrast to the normal conservative, staid world of Swiss banking.



From the start Hildebrand faced a problem unlike most central bankers - how to mute the strength of the currency that was damaging Swiss business. In 2010 aggressive intervention was fought for most of the year with 147bn francs bought between February and May alone, but without support from other worldwide central banks the franc continued its upward path. At the same time the reserves bought by Hildebrand depreciated, leaving a \$25bn mark-to-market loss.

### **If you don't succeed at first...**

By the summer of 2011 the franc was moving inextricably towards parity against the euro. This time the SNB decided to move decisively catching the market unawares and imposing a strict fixed price. The new cap of 1.20 to the euro was born.

### **Controversy and enemies**

Switzerland is a unique society amongst the world's major currencies. While the living standards may be high, it is still a tiny economy with a population of 7.8mio (source World Bank). International currency flows are now so vast that these sums can distort local trade and economic flows.

With one of the world's largest private banking industries, the value and security of the franc have long been a source of pride especially in Zurich. So Hildebrand's new cap, compounded by the previous intervention losses, led to new questions. The Swiss People's party was vociferous in their condemnation.

When the Chairman's wife appeared to benefit from this policy the end was nigh. Philipp Hildebrand was forced to resign in January 2012.

### **Cap with no cheerleader**

The new chairman Thomas Jordan exceeds even his predecessor's height standing at nearly 2.0m high, but in other respects he is a return to a careerist civil servant. As an employee of the central bank since 1997, Jordan has been steadily rising through the ranks to the top job. 'The 49-year-old from Biel enjoys a solid reputation' (source Swissinfo.ch).

Upon taking over in January he was quick to affirm continuity for the bank, any other course in the immediate aftermath of the Hildebrand affair would have been impossible. But the architect was no longer in charge.

### **SNB—no ordinary central bank**

Most modern central banks are owned by their respective governments, and hence fit closely into the political process. They may have explicit monetary or regulatory mandates, but these are still subject to review by their political masters.

The Swiss central bank is a joint-stock company, registered on the Zurich exchange. Just over 54% of the shares are owned by the cantons and cantonal banks (source SNB website) with the remainder held by private Swiss citizens. **The Confederation (the Federal government) does not own any share.** In the small tight knit world of Swiss finance these local shareholders and citizens, cannot be ignored.

### **Economic effects of mass currency purchases**

If you have control of your own currency as the SNB has, then it seems a simple option to sell as much of your currency as the market wants. However, what do you then do with all the euro's that you buy?

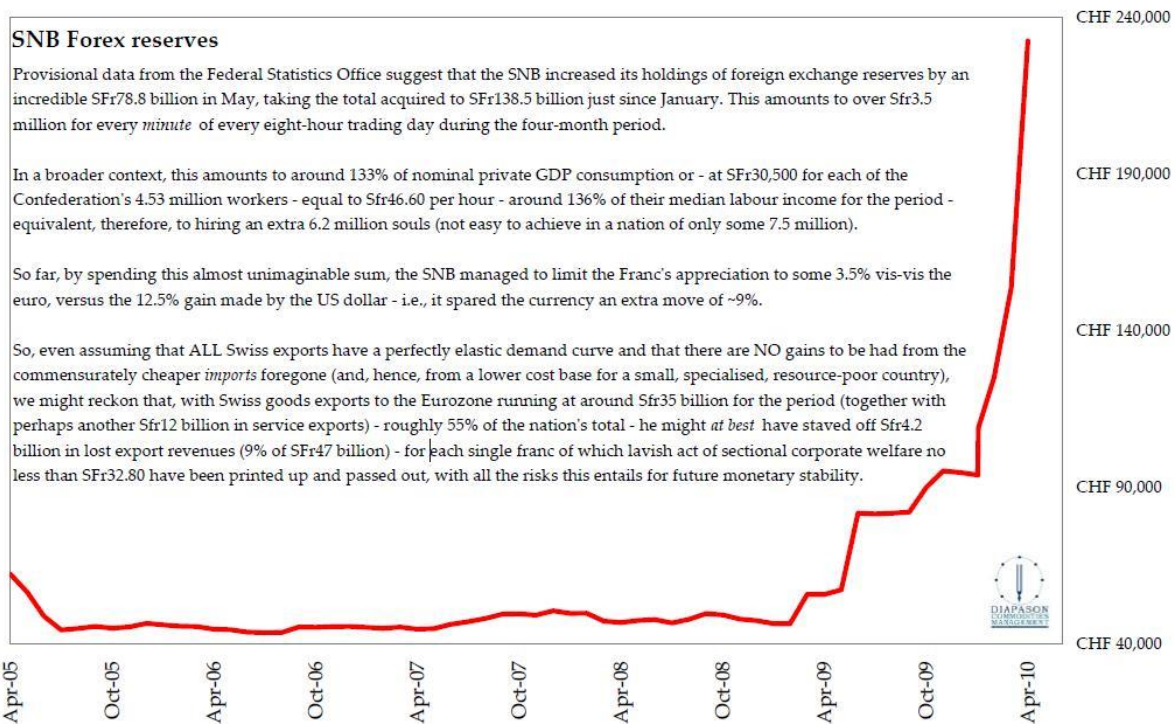
The safest way to mop up all this liquidity is for the central bank to issue a corresponding amount of local currency bonds as have been created. In this way the surplus currency is subsumed into longer dated bonds. This is called sterilised intervention.

Unsterilized intervention occurs when the bank leaves all the newly minted currency in the market. This is a direct increase in the nation's money supply, and is accordingly leaving an inflationary risk.

The SNB is aware of these risks and wants to sterilise the increasing mountain of francs. It has instigated a programme of bill issuance, together with ratcheted down interest rates well below zero. The Swiss treasury market is far too small to absorb anything like the volumes required in longer dated paper. Therefore most of this currency is flowing straight into Swiss money supply.

### History books

This is not the first time the SNB has tried to peg its currency. In October 1978 a cap was introduced against the DEM. Mass purchasing of the franc continued, with **inflation skyrocketing to 7% by 1981**.



Source FT.com/alphaville 6/9/11

The most recent bout on intervention came during 2010, albeit without a formal cap. The vast increase in reserves could not be staunched and the towel was eventually thrown in.

**The 'trilemma of international finance maintains that a country cannot simultaneously peg an exchange rate, maintain an independent monetary policy,**

and permit free cross-border financial flows’ – the Trader (source the trader.se 28/6/12)

### Politics and the timing of retreat

Thomas Jordan has gone out of his way to confirm that ‘the board stands behind all our earlier decisions’ (source FT.com 2/2/12). However, Jordan has been forced to concede that there may be political pressures further down the line. ‘There will be a special session in parliament ...there are proposals to limit the instruments which can be used by the SNB, such as limiting the size of the balance sheet or foreign exchange interventions’ (source FT.com 2/2/12).

Hardly a blank cheque when intervention in May was at a new record of \$65bn.



Euro/swiss a strange sense of calm in a long term bear market (source Bloomberg.)

While the long term criticism of intervention of back woodsmen in the Swiss People’s party has continued, mainstream debate has opened up.

Ex-CEO and veteran trader Ossie Greubel explained the concerns; ‘if we are going to defend the exchange rate with all means we are indirectly taking over part of the whole

debts of the euro bloc, which continue to rise. **I don't believe that the relative size of our economy can absorb that without considerable damage'** (source Der Sonntag website 20/5/12).

Eurozone acute pressure is flowing into other safe havens such as the Danish krone and sterling.



Sterling's appreciation as a free floating currency versus euro (source Bloomberg.)

As Swiss mainstream politicians jaw bone about the need for solidarity and trying to blame speculators, criticism has been shut down.

CTFC statistics and any lack of any trading bounce of the euro floor tend to show it is portfolio flows that are buying francs, not hedge fund shorts.





Few shorts here (source Barclays)

With few shorts to squeeze increasingly bizarre policy prescriptions are suggested including negative interest rates (although the market has already moved here) and capital controls. The problem is long term portfolios continue to see the safe haven value for the Swiss franc, and wish to diversify their considerable holdings out of the euro.

### **Euro---heading south**

Right from the early days of the currency snake, through ERM and the advent of the single currency, part of the strategy was to bring German monetary discipline to work. In fact, the French government talked about a 'franc fort', rather than relying on currency depreciation to keep the economy competitive.

This policy was also embodied as 'Merkozy', the French singing up to the German remedy of austerity to help resolve the crisis.

But with the ejection of Nicolas Sarkozy, France has also rejected this policy and combined with the southern European nations. This alliance has already been at work, and is increasingly dominant.

A weaker, southern European euro is likely to be the result.

### **Conclusion — watch this space**

Market fundamentals drive –the price of everything in free societies, especially exchange rates. Governments, and central banks, cannot staunch these flows with intervention only successful in terms of aiding and abating turning points.

The SNB's dilemma is different to central bankers who have fought currency floors. There is little doubt the Swiss political consensus was never as solid as would now be required to accept the inflationary consequences of the currency policy.

Meanwhile in planet Europe the desperate attempt to keep the 17 euro zone together continues. While we are not in the camp of euro-sceptics that believe, (hope!) that the single currency will fail, we do think that **a form of broad based debasement is underway**. In this scenario of monetisation of the debt, that scares holders of the currency. With the UK, the US and now even many EM currencies such as the Brazilian real on the same route, the attractions of the stable, strong Switzerland look good.

As **Switzerland's 'Katrina moment'** looms (Michael Casey WSJ 13/6/12) we expect a quiet retreat over a weekend sometime before year end. This is more likely to happen following a few weeks of euro short-covering rather than in the eye of the storm.

### **Model Portfolio**

After May's blow off markets have made reasonable recoveries in June. Central banks are once again moving back to garner support with the BOE already committed to a further round of QE at the next meeting.

With commodities easing some of the inflationary risks are off the table giving a broad base to support coming from EM central banks too.

Sometimes it can be a lonely place fending off the alarmist Krugman/Roubini theses. However, we continue to feel the monetary easing trends will underwrite a positive risk on strategy, and accordingly will maintain an overweight equity bias.



**This material is confidential and is intended solely for the use of the person or persons to whom it is given or sent and may not be reproduced, copied or given, in whole or in part, to any other person. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision.**

**The information and opinions presented here are for background purposes only and do not purport to be full or complete. No reliance may be placed for any purpose on the information or opinions contained in this document or their accuracy or completeness. No representation, warranty or undertaking, express or implied, is given by Alvine Capital as to the accuracy or completeness of the information or opinions contained here and no liability is accepted by Alvine Capital for the accuracy or completeness of any such information or opinions.**

**No information provided herein shall constitute, or be construed as, an offer to sell or a solicitation of an offer to acquire any security, investment product or service, nor shall any such security, product or service be offered or sold in any jurisdiction where such offer or solicitation is prohibited by law or regulation.**

**UK Residents: Alvine Capital Management Limited is regulated in the conduct of investment business by the Financial Services Authority, ("FSA").**