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CHooF!

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Lorcan Roche Kelly

The Swiss must expect more euro weakness -- whether or not political solutions are found.

This Swiss National Bank this morning announced it was setting CHF1.20 as a floor for its exchange rate with the euro citing the threat posed by the strong franc to the Swiss economy. It said that it "will enforce this minimum rate with the utmost determination" and is willing to buy foreign currency -- and therefore print Swiss francs -- in "unlimited quantities."

- Before the 2008 financial crisis the Swiss franc traded in a range between CHF1.55 and 1.60 against the euro. Its gradual strengthening against the euro since then became intense during the market turmoil of the past months, with the franc coming within a hair's breadth of parity with the euro on August 8. Then the SNB cut interest rates by 50 bp, which led to weakening back towards CHF1.20. The effects of the August intervention were short-lived though, as the CHF again strengthened to CHF1.10 in recent days (see the chart below). Today, at a stroke, it is back to CHF1.20.
- But by promising "unlimited" intervention now, are the Swiss using a sledge hammer to crack a nut? The intensity of the Swiss commitment makes sense if the central bank believes that forces

Euro / Swiss franc exchange rate

Source: Bloomberg

Update to strategic view

EUROPE MACRO, EUROPE BONDS, EUROPE FINANCIAL STOCKS: The Swiss have devalued the franc, and announced a floor for the EUR/CHF exchange rate. The Swiss central bank must expect further euro weakness -- either due to more debt and banking turmoil if political solutions aren't quickly found, or to further monetary easing whether or not they are found. This a symptom of an atmosphere of intense fear, some of it rationally motivated and some of it merely panic. The stakes are so high that the risk-reward trade-off in Europe is unattractive -- yet we continue to believe that political solutions will yet be found, and that enormous risk premia will be harvested.

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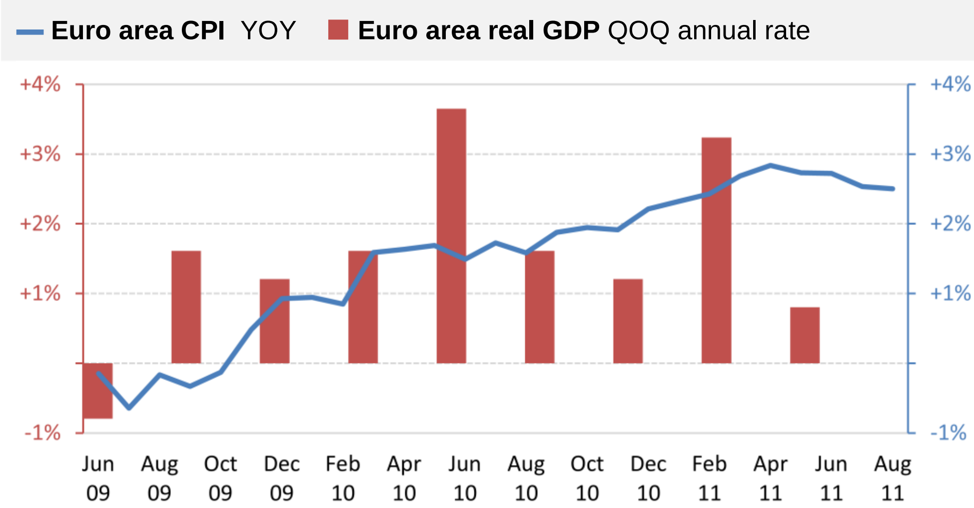
are in motion that will lead to similarly intense further pressure on the euro.

With that in mind, it is worth looking at what's ahead that has convinced the Swiss National Bank that now is the time to act.

- Tomorrow the German Federal Constitutional Court rules on the legality of Germany's participation in the European Financial Stability Facility (EFSF) bailouts. While we are certain that the court will not block Germany's participation, it now seems likely that they may curtail how automatic the EFSF can be by requiring parliamentary approval for future EFSF interventions. Anything that hamstrings the EFSF by subjecting it to political decision-making will undermine its ability to intervene quickly and decisively. Without an effective, independent EFSF to take over from an unwillingly interventionist European Central Bank, the Euro area risks losing a very important parachute.
- The ECB governing council meets on Thursday. We do not expect a rate change announcement. But Euro area growth continues to be sluggish -- Eurostat today announced quarter-on-quarter growth of 0.2%. Headline inflation is running negative over the last three months at a -1.79% annual rate (see the chart below). This is certainly going keep the current cycle of rate hikes on hold, as we expected (see "On the ECB Rate and Bond Buy Decisions" August 4, 2011). Now we will look for hints of a coming rate cut, but Jean Claude Trichet's comments on the ECB's Securities Markets Programme (SMP) will be just as important.



Source: Eurostat, TrendMacro calculations

- Friday is Greece's -- self-imposed -- deadline to get 90% acceptance for its debt swap offer. As yet, it is unclear if it will be achieved. What's worse, the unexpected abandonment of talks in Greece last Friday by the ECB/IMF/Commission "troika" over disagreements on deficit measures could mean that continued disbursements under the original Greek bailout package are at risk,

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a sentiment reflected in comments from German Finance Minister Schaeuble today.

- Friday also sees the G7 finance ministers meeting in Marseilles, and there is the possibility that there could be hints of a dovish shift in monetary policy.
- Without clear policy directions from both the ECB and the G7, European markets will continue to flail as the crisis continues to play out. The Swiss franc's safe haven status would lead to further appreciation of the currency under these conditions. On the other hand, commitments from the ECB or the G7 to loosen monetary policy would also appreciate the franc versus the euro. Either way, unlimited intervention is the only weapon left to the Swiss National Bank to counter the policy failures of others.

Meanwhile, other on-going factors continue to feed market anxiety.

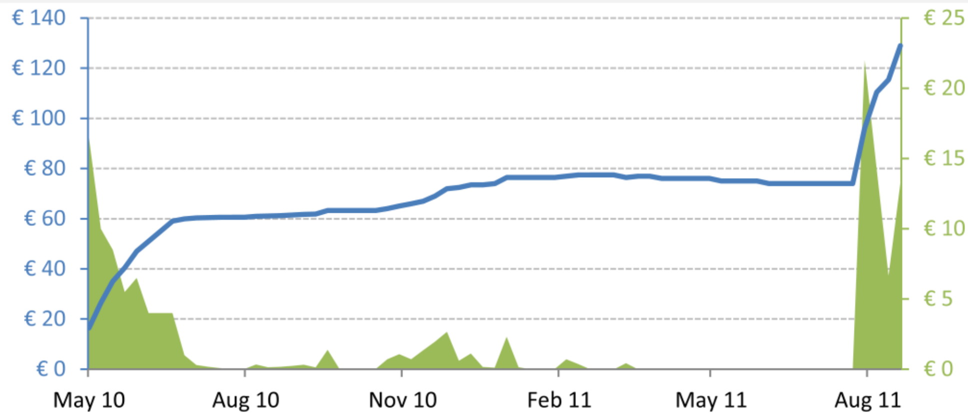
- Disagreements over the implementation of the July 21 summit proposals (see "From the Vacation to the Frying Pan" August 30, 2011) drag on. The Slovak junior coalition government party upped the ante this week, saying that they would delay implementation of the EFSF expansion package until December, far beyond the October deadline set at the summit. While we expect a political solution to be found within Slovakia to this impasse, rapid implementation of the EFSF expansion is a critical step to resolving the crisis.
- The Finnish collateral threat to the second Greek bailout still has not been dealt with. Despite European Council President Herman Van Rompuy's assertion that a solution is close, we have yet to get any details of a package that will be acceptable to other Euro area members (again, see "From the Vacation to the Frying Pan").
- Italy has managed to snatch defeat from the jaws of victory -- thanks to Prime Minister Silvio Berlusconi's chaotic policy flip-flops on austerity. The ECB had given Italy a lifeline in early August when it re-started its Securities Markets Programme, buying Italian and Spanish bonds to contain their soaring yields. Spain passed a budget cap law, in line with ECB expectations. But Italy has done little to implement an austerity package -- openly flouting the ECB's requirements for fiscal discipline. It seems that now the ECB is willing to allow a spread to develop between the two countries' yields in order to coerce Italian acquiescence (see the charts at the top of the following page).

Make no mistake about it -- the stakes are high for the Euro area.

- If Greece manages to put itself in a position where the troika cannot approve the next tranche from the *first* bailout package, then a Greek default becomes inevitable in the *near* term. If a compromise cannot be reached on the collateral deal for Finland that is acceptable for all Euro area members, and if Greece cannot get the debt-swap deal finalized -- satisfying the essential Private Sector

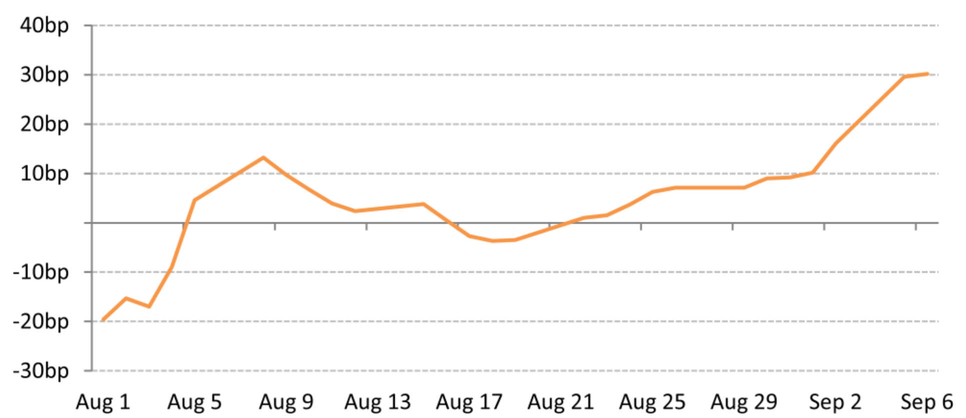
ECB Securities Markets Programme

Cumulative holdings **Weekly transactions** EUR billions



Source: ECB, TrendMacro calculations

Spread: Italy 10-year bond yield over Spain 10-yr bond yield



Source: Bloomberg, TrendMacro calculations

Involvement (PSI) clause -- then the *second* Greek bailout is at risk, too, which means a Greek default in the *medium* term.

- The bigger immediate worry is Italy. It is not certain that the Euro could survive an Italian default, and while we consider this to be an *extremely unlikely* outcome, Berlusconi is doing nothing to re-assure investors -- especially the ECB, the critical marginal buyer of Italian bonds. The debate over austerity in Italy is being played out with the same kind of reckless gamesmanship that characterized the US debt ceiling process (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011).

For all these grim realities, at the same time there is more than a whiff of irrational panic in the air -- with both real news and mere rumors interpreted in the most frightening possible way.

- The weekend's defeat of Merkel's Christian Democrats in a German regional election seems to have been reported in US as a vote against European integration by an isolationist, bailout-fatigued electorate. But the big winners in the election were the Social Democrats. If anything, the SDU is *more* pro-European integration than Merkel's CDU, so the vote cannot and should not be viewed as a direct threat to Germany's continued participation in the financial integration of Europe.
- The panic in European banking stocks was exacerbated by rumors of a pending IMF report finding that banks needed another €200 billion in capital. That figure came from a leaked draft version of the IMF's Global Financial Stability Report in which it experimented with using credit default swaps to price risk for bank holdings of sovereign debt. The report was only a draft, and does not reflect the IMF's position. Trichet took the extraordinary step of refuting the report's methods, and he's probably right -- CDS aren't a particularly good barometer of sovereign risk, and they are highly unlikely to be used in any final IMF report anyway (and besides, the IMF's analytic track record is far from stellar). Nevertheless, the leak was given great credence in a market that seems addicted to bad news.

As all this plays out, rational or irrational, European stocks continue to get hammered. In particular, financial stocks are within touching distance of their March 2009 lows, with bund yields at record lows.

- While we continue to believe that solutions will be found to this seemingly intractable thicket of political challenges, nevertheless investors are demanding extraordinary premia to hold European risk-assets. This is sensible, even if the probabilities favor our hopeful expectations. After all, a worst-case disorderly dissolution of the euro, however improbable it may be, would be economically catastrophic.
- So on a *risk-weighted probability-weighted* basis, only a fool would be long European risk-assets now. Yet on a *modal* basis -- in which one regards only the single outcome deemed to be most likely -- we have to think that risk premia are now large enough to warrant placing some bets.

Bottom line

The Swiss have devalued the franc, and announced a floor for the EUR/CHF exchange rate. The Swiss central bank must expect further euro weakness -- either due to more debt and banking turmoil if political solutions aren't quickly found, or to further monetary easing whether or not they are found. This a symptom of an atmosphere of intense fear, some of it rationally motivated and some of it merely panic. The stakes are so high that the risk-reward trade-off in Europe is unattractive -- yet we continue to believe that political solutions will yet be found, and that enormous risk premia will be harvested.