MACRO WRAP-UP

Macro Wrap-Up: A Haven Isn't Always Safe

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Switzerland has taken great pains to maintain its neutrality over the years. It has built a strong army and tried to avoid involvement in external conflicts. A nice stable exchange rate might also help to maintain that image. Unfortunately, precision in foreign exchange is even more difficult to achieve than it is in watchmaking. Many of us remember January 15, 2015, the day the Swiss National Bank (SNB) stopped defending its 1.20 franc cap to the euro, and the enormous appreciation in the franc that followed. Now more than three years later, the franc has depreciated back to the same level it was the day before the SNB abandoned the floor. Switzerland really is neutral.

This episode is instructive for investors and economists both in and out of small, wealthy, landlocked nations. To give you some background, during the European sovereign crisis and its aftermath, the Swiss franc appreciated on so-called safe haven flows, as investors exited euro-denominated assets. Switzerland offered political and economic stability as well as rock solid legal protection for investors, away from the uncertainty on the rest of the continent.

The appreciation made Swiss consumers richer, but it came with some costs. Switzerland became more expensive for tourists. Swiss exporters feared that their products would no longer be competitive. The SNB had been battling deflation for much of the previous decade, and its policy rate was already at zero. Capping the franc seemed like a sort of creative way to fight these problems. However, in the process of keeping the franc in line, the SNB accumulated mountains of foreign assets on its balance sheet. Unlike many other central banks, which have restrictions on what types of assets they can buy, the SNB could fill Lake Geneva with its risky securities. It may surprise investors to learn that the SNB is among the forty largest holders of many of the stocks in the Dow Jones Industrial Index.

After the SNB gave up on the cap and the franc moved to parity, pundits were blowing their alphorns with all kinds of predictions as to what would happen next. In retrospect, many of the predictions were in the right direction, if a bit exaggerated. As many predicted, the rise in the currency led to two years of deflation and lower import prices. Growth was initially weak, as was forecast, but it did recover. The big mystery has been the persistence of Switzerland’s current account surplus, which remained fairly steady at around 10% of its GDP. To put that in perspective, mercantilist China’s surplus is at less than 1.5% of GDP while Japan’s is at 4% Switzerland sells a lot more than it buys. Most economists would tell you that a rise in the currency should make imports cheaper and exports more expensive and should narrow or reverse a current account surplus. This just hasn’t happened in Switzerland. Does this mean that the economic theories have more holes than that type of cheese that has all of the holes in it?

Switzerland may be an exceptional case. Swiss exports tend to be in very highly-skilled industries and are not easily substituted. One of its biggest exports is patented pharmaceuticals. As a result, it has been able to maintain its market share and keep its exports up. Swiss companies may have chosen to keep market share at the expense of margins. The Swiss Market Index was weak in late 2015 and early 2016 in part due to weak profits, though it has recovered a bit with the recent fall in the Swiss franc.

It also seems puzzling that the Swiss franc has fallen against the euro this year. It hasn’t exactly been a great time for risky assets, yet you might think that the safe haven franc would be drawing inflows. Yet, franc investors have been clubbed by gnomes this year (figuratively). There has been some speculation that sanctions on Russia have forced repatriation, but that is hard to verify. Some analysts have been yodeling that the recent crackdown on tax evasion has made Switzerland less attractive as a tax haven, but even that doesn’t fully explain the franc’s reversal. The reality may have more to do with how we think about the franc and the kind of safety it offers investors.

The franc makes sense as a safe haven if the market’s biggest fear is a euro break-up, but that might not even make the first page of investors’ concerns this year. Trade wars, rising inflation and slowing global growth are more current. Switzerland may provide protection against inflation, but it’s not as clear how well it would do in a global slowdown. With its key policy rate at -75 bps, there is not a lot of room for monetary stimulus. It offers even less protection against a trade war. It is exposed via all of its trade linkages to the global economy, but more importantly it may be vulnerable to protectionist action by other countries. If you’re worried about a trade war, you probably don’t want to be in a country with...
one of the largest per capita trade surpluses.

The problem for the franc may not be with Switzerland or its economic policies, but rather with the whole risky/safe haven dialectic. There is no single attribute that makes a country’s assets safe and there is no perfect safe haven. Each country has its own risks and exposures, and will react differently to various events. Markets and economies are dynamic, and no securities can protect against all possibilities. Diversification applies even when looking to escape risks. Even a country with three or four national languages may not be enough.

What We Are Watching

**FOMC Meeting (Wednesday)** The Fed announced a rate hike in March, and the economic projections published after the meeting showed most participants expected two or three additional hikes over the remainder of the year. While economic data has been somewhat mixed recently, inflation readings have picked up and markets are pricing high odds of a rate hike in June, the next meeting that will feature a press conference and updated economic forecasts. With no move expected at the May meeting, market participants will be focused on the tone of the statement, particularly with respect to the characterization of recent growth and inflation numbers. If the statement downplays the significance of weaker growth data at the start of 2018, it may boost market expectations for continued rate hikes moving forward. Similarly, an emphasis on higher recent inflation figures could also be seen as a signal of a more hawkish policy outlook.

**Eurozone GDP (Wednesday) and CPI (Thursday)** Eurozone growth was quite strong in 2017, and the European Central Bank (ECB) has been signaling plans to begin winding down its stimulus program even though “measures of underlying inflation remain subdued and have yet to show convincing signs of a sustained upward trend.” [13] However, growth data for the first quarter of 2018 has been unexpectedly downbeat, raising the prospect that the eurozone economy may be losing momentum. This week, Eurostat will publish its initial estimate of first quarter GDP growth. If the data fall short of already-reduced expectations, it could shake the ECB’s confidence that growth will remain strong enough to justify less accommodative monetary policy. Preliminary inflation numbers for April could also impact the policy outlook. Core CPI, which excludes the direct impact of changes in food and energy prices, has shown a listless trend of around 1% in the eurozone in recent years. [14] If inflation numbers continue to move sideways while growth numbers decelerate, the ECB may conclude that asset purchases should be extended beyond their current scheduled end date in September.

**U.S. Employment Report (Friday)** While the key components of the U.S. employment report are volatile from month to month, recent trends have been reasonably stable. Job growth has remained strong, averaging around 200,000 additions per month.15 Unemployment has held steady at a multi-year low of 4.1% as strong job growth has been matched by an influx of new workers into the labor force. [15] The most ambiguous element of the employment reports has been wage growth. Average hourly earnings appear to have accelerated slightly, but have yet to move decisively above the weak post-recession trend. If wage numbers show a clearer pickup, market participants and policymakers would likely grow more confident that the U.S. labor market has returned to full health.

1. Also avoiding international tax lawsuits might as well.
2. The intraday chart of EUR/CHF exchange rate on January 15, 2015 had what a technician might call “the Matterhorn pattern.” The Swiss franc rallied more than 20% against the euro in a single day, one of the largest moves in any currency in history. Source: Bloomberg.
3. Investors feared what might happen if the euro split up.
5. The SNB cut its key policy rate from zero to -0.25% on December 18, 2014. When the SNB removed its franc cap against the euro, it also cut its key policy rate further to -0.75%. Source: Swiss National Bank.
6. In many ways the SNB is acting like a sovereign wealth fund.
7. Switzerland’s current account surplus as of the end of 2017 was at 9.81% of GDP. Source: Bloomberg.
8. China’s current account surplus as of the end of 2017 was at 1.33% of GDP. Source: Bloomberg.
9. Swiss cheese is mostly produced in North America. It only resembles cheese from Switzerland.
10. As of 2016, product group export data showed chemical and pharmaceutical products as the largest export group at 94 bln CHF (above precious metals and gemstones, which saw 86 bln CHF exported). Source: Switzerland Federal Customs Administration.
12. Take that, strawman.
14. Source: Eurostat
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