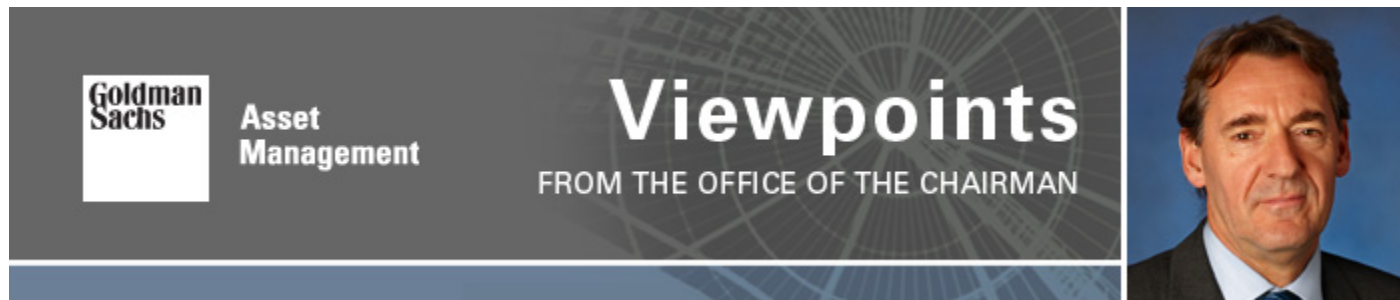


**From:** O'Neill, Jim [IMD]  
**Sent:** 03 September 2011 19:16  
**Subject:** SWISSY NEVER LIES.



### SWISSY NEVER LIES.

In the context of the ongoing challenges in the US, the Euro Area and elsewhere, this week I have chosen to focus on the Swiss Franc currency. Throughout the market mayhem of August, and its subsequent carry over into the start of September, the Swiss Franc has been sharing in the roller coaster rides of global markets. As any old bold foreign exchange trader will tell you, "Swissy never lies," i.e., there is belief amongst some international market participants that the Swiss currency's movements have some mystical powers that shadow all the world's ups and downs. The Franc does well when the world is a mess, and vice versa. Because the strengthening of the Franc in the summer of 2011 has been so dramatic, it is arguably the number one economic and business issue in Switzerland. As a result, Swiss policymakers have become eager to reverse the Franc's strength. For a few days in late August it looked as though they had succeeded. But as last week saw more bad news in the US and the Euro Area, the Franc came roaring back. Can the Swiss do anything about their currency given the turmoil elsewhere, especially in the Euro Area? And if they succeed, does this, oddly, herald a better fortune for the rest of the world?

Having spent a large part of my career in the foreign exchange market and also quite a bit of it employed in a Swiss bank, I am most fond of all matters Swiss, including the much fabled belief that "Swissy never lies." Switzerland is a small, very open economy. If exchange rates ever matter for the relative performance of an economy, you can be sure Switzerland would be amongst the top candidates. So, in a period of extreme movements, you can expect strong economic consequences for Switzerland and occasionally, dramatic efforts by its policymakers to do something to reverse the currency move. In virtually all cases because of Switzerland's history of economic stability, low inflation, neutrality, safety and calm, the currency issue is one of excessive strength. This is often because in times of great uncertainty, the Franc is immediately attractive to nervous wealth holders in some part of the world. In the period since 2008, and especially in the past 12 months, the Franc has been perceived as a haven from an increasing variety of hazards: the financial chaos of 2008-2009, the rising troubles and revolts in the Middle East, the fears about the standing of the US in the world, and especially, the increasing fears about Europe.

Switzerland is landlocked and surrounded by members of the European Monetary Union (EMU). It is bordered, for the most part by the three largest EMU constituents: France, Germany and Italy. These three countries are also Switzerland's largest export markets along with the US – although as with many other countries, export growth to the BRICs and other Growth Markets is large. The scale of the recent acceleration of the Franc is best seen in the context of a chart showing its 25-year performance against the Euro (assuming the Euro would have existed before 1999). The chart shows the Franc against the Euro and its 200-day moving average. As you can see, for a large part the Franc traded within a 1.50-1.70 range. Looking at such a chart, you can understand more easily stories of mass shopping trips from citizens of Swiss borderline towns into Germany, France and Italy. If the Swiss authorities can't reverse a lot more of the Franc's recent strength, Swiss retail outlets will struggle to survive – never mind some of their international companies.

I shall return to the Swissy-specific issue later, but let me now bring in the latest developments from around the world this past week.

### THE US. SOFT BUT NOT OUT.

Last week was another one of "those" weeks for the US. Much of the evidence continued to suggest signs of a modest improvement in the US economy in the third quarter only for a vital statistic to significantly disappoint. For it to be the jobs data again ahead of the Labour Day weekend is more than a touch ironic, but the numbers reverberated all over the world and create the impression that the US is really struggling to stay out of recession. More fiscal and perhaps

monetary action now seems pretty inevitable, and markets partially adjusted for this Friday. Next week's now eagerly awaited address from President Obama is likely to be the next key focus.

Historically, even before the Euro was introduced, the Swiss Franc typically shared in the periods of excess Dollar movement. It often strengthened more than the DM when the Dollar fell and weakened more when the Dollar rose. In this context, part of the Swiss Franc's strength since 2009 is clearly because of the US economy's struggle and the aggressive bias to US monetary policy. To some degree, the Franc's recent behaviour is no different than the historic norm. The important exception is that the other major currencies are deemed less attractive, especially now that there is no Deutschmark.

While many people are now positioned for an "inevitable" slip back into recession and/or a multi-year period of Japan-style weak growth in the US, this is still far from inevitable in my view. I would expect repeated efforts by US policymakers to stimulate the economy. I continue to believe that, if carefully thought out, more targeted, specific fiscal measures, or measures targeted towards especially weak sectors like housing, might have some effect. News (not given much media attention) that the US fiscal balance in 2011 is likely to be considerably less bad than originally thought by the Congressional Budget Office adds to the potential scope of such measures.

#### CHINA NOT SENDING ANY EASING SIGNALS – YET.

Following on from the central bank's decision the week before to broaden the application of reserve requirements, any ideas of an early reversal of caution in Beijing were (for now) further laid to rest this past week. The all important NDRC, the National Development Research Council, talked about continued inflation challenges and the President stated that controlling inflation remained the number one policy priority. We await the August CPI release, probably the week after next, with great anticipation.

In my view, a reversal of Chinese inflation and anti-inflation policies remains absolutely key to resurrecting a bull market in global equities (and this week's moves by the Brazilians show that these things can happen pretty quickly).

#### EURO AREA TROUBLES GET WORSE.

When it seemed it would be impossible for the August mess to get any worse in the Euro Area, the start of September brings evidence that indeed it can. In addition to the complex political environment in Germany, Greece appears to be descending into further economic and policy turmoil with lots of suggestions that there is little progress on reform. But most importantly, within two weeks of supposedly agreeing to implement a tough new budget, the Italian government appears to be in some disarray as it has backtracked on some of the more unpopular measures. Many European policymakers appear to be in a state of shock about this particular twist. This is not surprising given the intensity of debate about ECB actions to support the beleaguered Italian bond market.

In addition to all of this, the Euro Area economic data has continued to take a distinct turn for the worse and IMF Head Lagarde stated publicly what so many investors believe: that much of Europe's banking system is undercapitalized.

All the above would be a nightmare for the Swiss authorities alone, but coming on top of the weak US payroll data and its implication for more expansive monetary actions, you can see how the Franc started to re-accelerate so much at the end of this week.

#### WHAT CAN THE SWISS (AND G20) DO?

The Swiss authorities face a huge challenge. If they are serious about trying to prevent the devastating damage that could result from the Franc's strength, they will have to intervene even more and pursue the idea of a direct policy target – temporarily – for the Franc against the Euro. This would make it clear that Switzerland would offer no "safe haven" in the current environment.

What intrigues me more about the Franc over the next week or so, is what it will symbolize about the state of the world if the Swiss authorities decide to do more, or if they don't. Since mid-August I have wondered repeatedly if it is perhaps (and increasingly) inevitable that we see some kind of co-ordinated G20 policies to support the world economy and markets. Seen within the context of other G20 actions, Swiss policy on the Franc might not only be successful, but herald a better period for markets.

In my view, the policy responses that are now needed include:

1. Clear, credible, targeted action from President Obama and Congress to create US jobs and stimulate domestic investment.
2. If not more QE from the Fed, an ongoing clarity about their bias.
3. A quick resurrection of a credible budget in Italy.
4. A move towards an interest rate cut from the ECB. There is no inflation problem and the Euro Area economy has weakened a lot.
5. Some indication by German Chancellor Merkel that as part of a more fiscally coherent EMU, Germany would accept the principle of Euro Bonds.

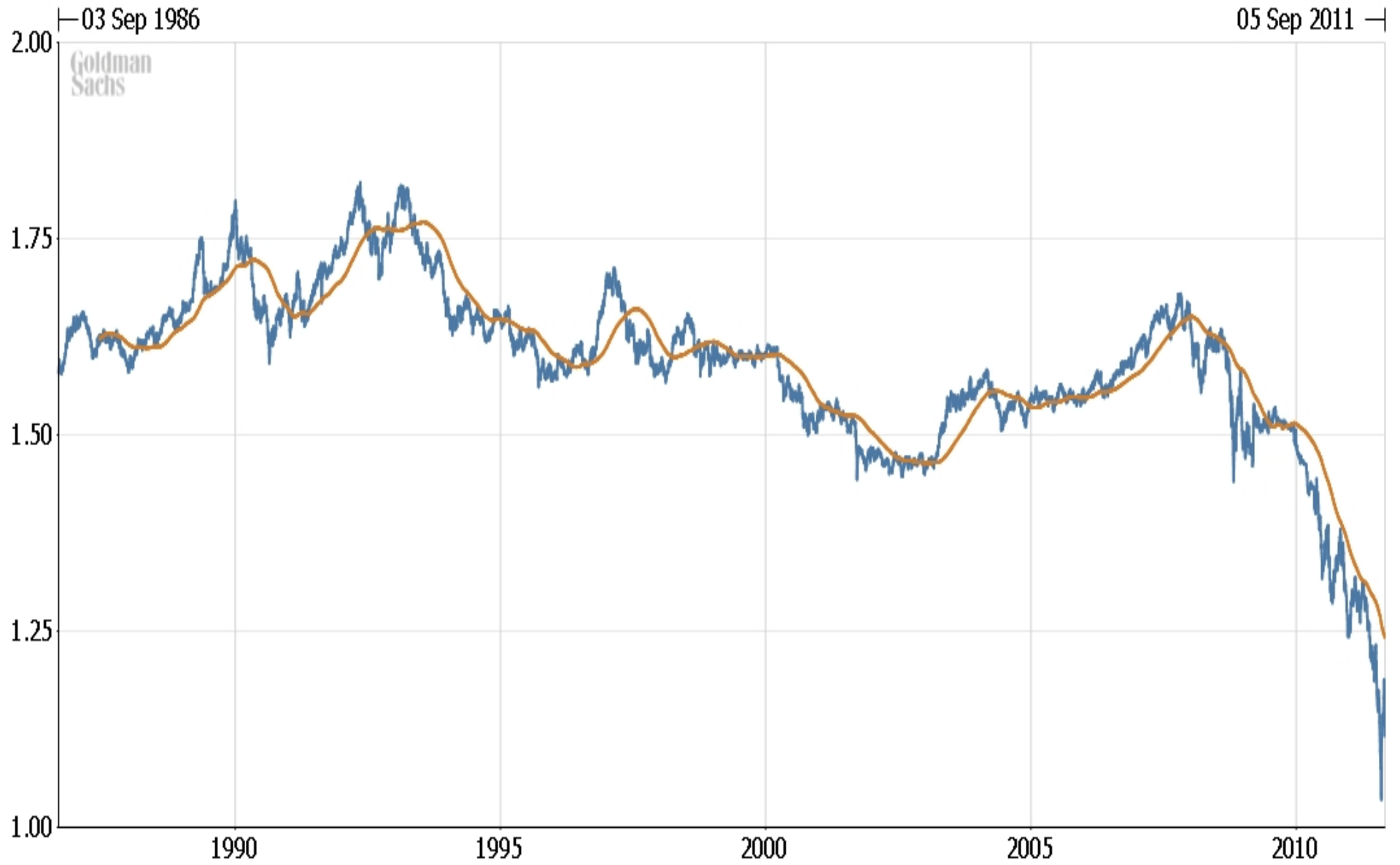
6. A clear signal from Beijing that once inflation has peaked, monetary tightening is finished.

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Series	Min	Max	First	Last	Mean	StdDev	No Data
CHF/EUR	1.0358	1.8219	1.5789	1.1169	1.5902	0.1074	No data
avg(m1,200)	1.2425	1.7718	1.6230	1.2425	1.5958	0.0940	No data

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