

The gnomes are worried

Markets slide on week as Swiss franc pegged to euro

September 9, 2011 – Maybe it all started with the gnomes of Zurich. Known for its financial probity, to say nothing of banking secrecy, Switzerland has long been a favoured safe haven in times of turmoil. The famously reticent Swiss are not members of the European Union and have thus avoided the calamity now befalling the eurozone. But last week, the Swiss gnomes sent global financial markets a message that has nothing at all to do with cuckoo clocks.

For a tiny, landlocked country, the central bank, the Swiss National Bank, has the world's eighth largest gold reserves, at 1,146.2 tons, valued at around US\$67 billion. Along with its horde of gold, Swiss financial and political stability have made it a natural home for funds seeking safety in times of trouble, especially eurozone trouble. But that's put untenable upside pressure on the franc, so much so that the SNB has warned that the strong franc is threatening economic growth, as traditional Swiss exports like precision watches, scientific instruments, optics, and pharmaceuticals are priced beyond reach.

The eurozone crisis deepened again last week with the resignation of yet another German member of the European Central Bank's executive board, combined with reports that German financial authorities were readying plans to re-capitalize German banks in the event of a Greek default got investors into a selling state of mind. Rumors of an imminent Greek default continued to swirl, although hotly (and naturally) denied by the Greek government. However, the increasing reluctance of many eurozone countries to write another cheque to the Greek government in the face of its inability to meet EU-imposed budget targets is rapidly hardening into policy. That's nowhere more evident than in Germany, where opposition parties are poised to topple Angela Merkel's ruling coalition in elections later this month. Merkel is unlikely to martyr herself and her party for the sake of keeping Greece in the eurozone. The risk of a Greek default has now ratcheted up considerably.

So when the SNB suddenly announced this past Tuesday that it will peg the Swiss franc at 1.20 to the euro, the first such peg since the 1970s, in an effort to cap its appreciation against world currencies, it may have signaled how concerned the Swiss are about developments in the eurozone.

The chairman of the SNB, Philipp Hildebrand, made no bones about it. "The current situation, therefore, acutely threatens our economy and our labour market. It carries the risk of a recession as well as deflationary developments," he said. And just so markets

wouldn't miss the point, he added, "The SNB will enforce this minimum rate with the utmost determination and is prepared to buy foreign currency in unlimited quantities." When was the last time you heard any central banker, whose universally parsimonious use of language is legendary, use the word "unlimited" in any context whatsoever?

With that little bombshell out of the way on Tuesday, markets attempted a mid-week rally in anticipation of a speech by US Federal Reserve Board Chairman Ben Bernanke, and one by US President Barack Obama to the House of Representatives. At least that was the take by the mainstream business media. And it may have contributed, as investors bid up stock prices in perhaps the last, faint hope that either of those two gentlemen are capable of influencing events in any way at all.

Against a backdrop of a gloomy economic picture painted by the Fed's so-called Beige Book, which was released on Wednesday, Mr. Bernanke actually had nothing new to say on Thursday, singing the same refrain he last warbled at the close of the meeting of the world's economic minds in Jackson Hole, Wyoming, on Aug. 26. The Fed, he said to eagerly waiting reporters will discuss tools they might use to goose an economic recovery at their next meeting on Sept. 20. The Fed, he said, is "prepared to employ these tools as appropriate to promote stronger economic recovery in the context of price stability."

Lacking anything of substance to report, analysts, pundits, and sound-biters did what they do best: speculate. So it was that something called a "twist" has entered the biz-buzzword lexicon. This is supposedly a plan by the Fed to shift, or twist, the weighting of its gigantic portfolio to long-term bonds away from shorter-dated issues. The idea is that while short-term yields would remain unchanged, longer-dated yields would fall. It might lower mortgage rates. Or it might put a fire under the stock market. It's hard to see how. What such a move would most likely do is distort the yield curve, and render it essentially useless as a barometer of growth over the longer term. Still, with quantitative easing becoming progressively less effective, the Fed's toolbag is becoming worryingly light. No wonder they want to talk about it!

President Obama urged Congress to adopt his US\$447 billion plan to cut taxes and boost spending (including extending unemployment insurance benefits) in an effort to revive the economy. The plan, with just a faint odour of desperation, got only a lukewarm reception in the House, and judging from Friday's stock market action, was either ignored or met with deep skepticism, by investors.

In Canada, there's apparently no need to do the Twist or even the Watusi. The Bank of Canada kept its benchmark lending rate at 1% last week, saying that the "global economic outlook has deteriorated in recent weeks." And while most observers concentrated on that statement, the Bank's outlook for the second half is perhaps more telling: "Largely due to temporary factors, Canadian economic growth stalled in the second quarter. The Bank continues to expect that growth will resume in the second half of this year, led by business investment and household expenditures, although lower wealth and incomes will likely moderate the pace of investment and consumption growth."

Meanwhile, US rating agency Fitch kept its AAA rating on Canadian sovereign debt, pointing to a “culture of conservative policymaking” and “strong political and social commitment to balance the budget.” It forecasts total year GDP growth of 2.3% for Canada.

And none of that mattered to stock markets by Friday’s close last week. All the big indexes fell on Friday, to post weekly losses.

Toronto’s S&P/TSX Composite Index came under selling pressure as both financials and energy retreated on Friday (exacerbated by a slight hike in Canada’s unemployment rate to 7.4% in August from 7.3% in July, and a worrisome decline in job creation for the month, contrary to the consensus estimates of job gains). The S&P/TSX Composite consequently posted a 1.7% decline on the week.

Similarly New York’s Dow Jones Industrial Average dropped 2.2% on the week, while the S&P 500 Composite Index lost 1.7% week over week.

The gnomes of Zurich are worried. So are the bankers in Berlin. The CBOE Volatility Index (VIX), also known as the “fear gauge,” spiked to 38 on Friday. Notwithstanding the slightly more positive longer-term outlook, now might be a good time to do some short-term hedging.■

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