PMG Fonds
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Partisan Strategie Fonds (CHF)

Strategy Meeting 3rd Quarter 2014:

Political Risks in Ukraine; Minimum Exchange Rate CHF/EUR

We have focused on the crisis in Ukraine. Discussed was also - once again – the minimum rate of CHF 1.20 per EUR and its implications for the investment strategy.

Ukraine crisis

The annexation of Crimea by Russia has ended the era after the Cold War. Practically overnight, and forecasted by virtually no one.

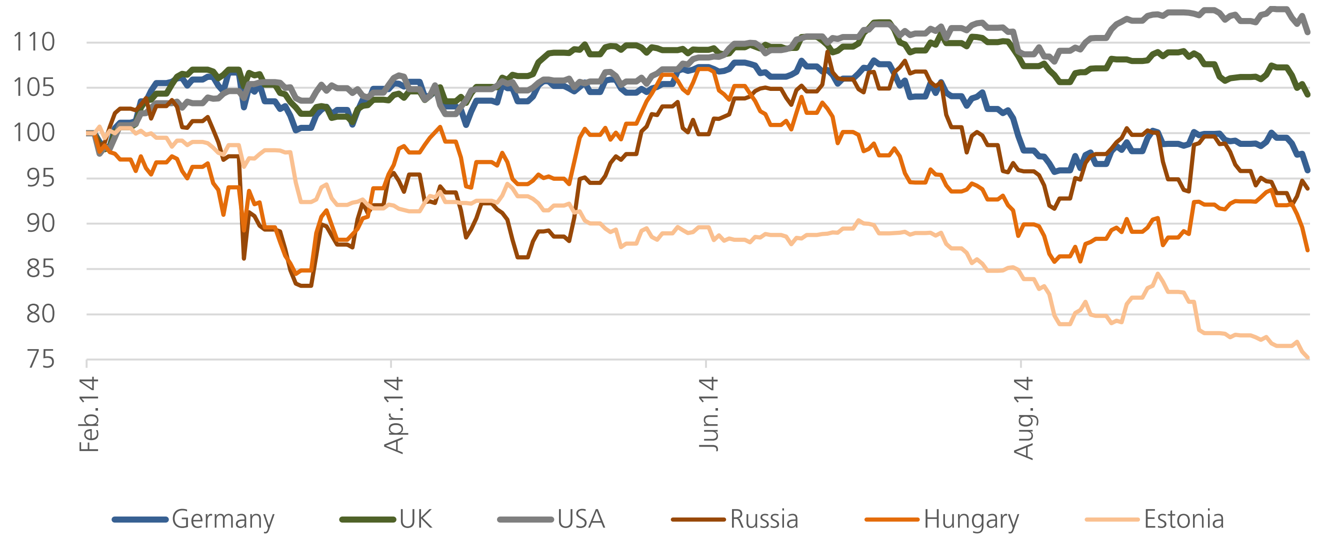
Fortunately, nuclear weapons are not part of this conflict. Nonetheless, it is indirectly a clash of great powers, Russia on the one hand, the EU and NATO on the other. A potentially dangerous situation.

How will the situation develop? Various different scenarios are possible and are discussed in the media: was the annexation of Ukraine an isolated event that will soon be forgotten? Or are we facing a renaissance of the cold war? Does Putin plan to extend the influence of Russia to other states with a large Russian population with military means, if necessary? In the focus could be the Baltics. Small states, but members of the North Atlantic Treaty Organization. How would the NATO react in such a case?

About all this we can only speculate. One thing is certain, however: the risk of further escalation is real. And this risk will not disappear anytime soon. Too much confidence has been destroyed on both sides, which cannot be rebuilt in a short time.

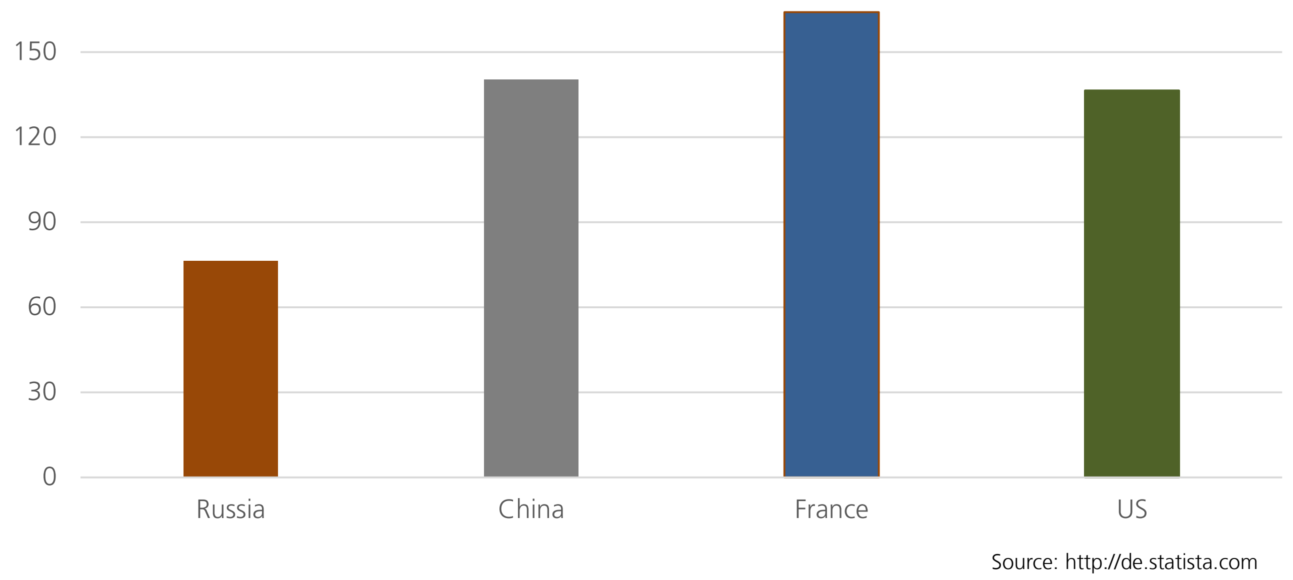
This risk of conflict should therefore be taken into account also for long-term investment decisions. What could further escalation mean in economic terms? And what can be done to protect investments?

While German stock markets suffered parallel to most Eastern European markets heavy losses, the UK was much less affected. The crisis has had little effect on American and Asian shares, at least for the time being.



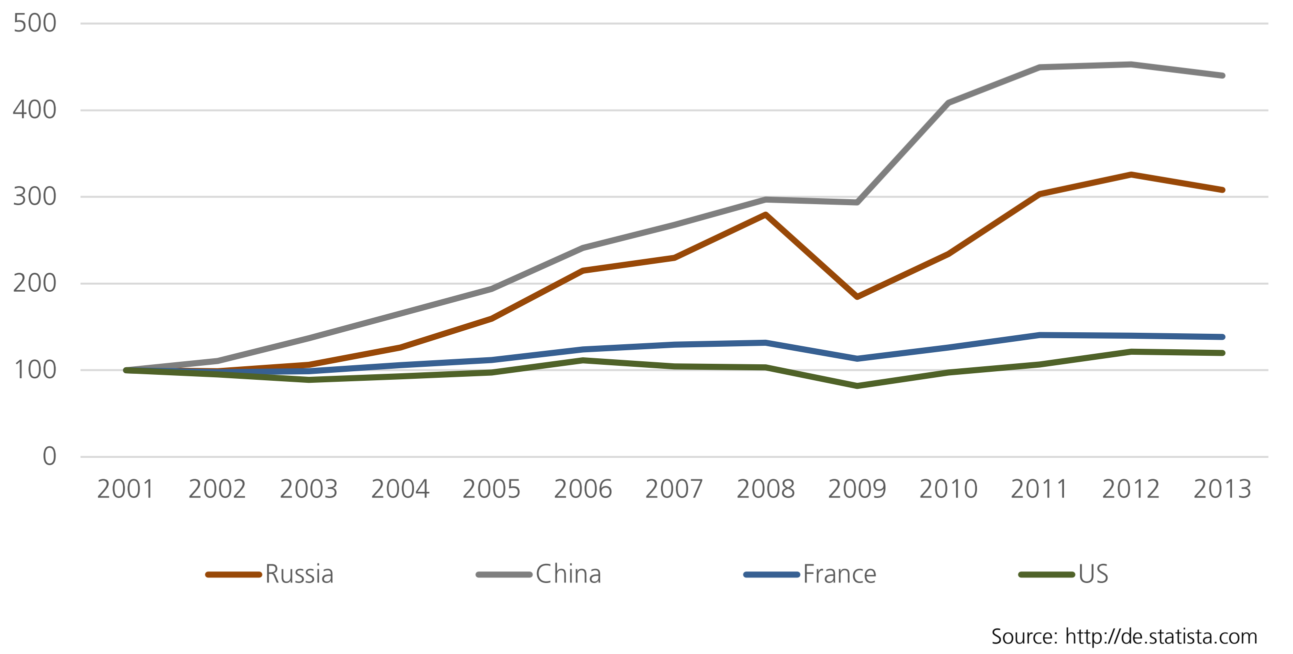
Selected equity markets (MSCI TR indices in USD) since the outbreak of the Crimean crisis in February 2014

Obviously, there is a strong connection between economic effects and geographical proximity to the crisis center, which is accompanied by a strong and rapidly growing economic interdependence. The following charts show volume and development of trade relations between Germany and some selected countries:



Imports + Exports from/to Germany, 2013 in billions of EUR

The trade volume of Germany with Russia is still relatively low. However, for the of equity markets expectations for the future development are crucial. And an extrapolation of the trade volumes over the past decade clearly suggests how important Russia could become in the foreseeable future, or which trade potential could be affected by an escalation of the conflict, respectively. For this reason, the sensitive reaction of the German stock markets comes as little surprise.



Imports + Exports from/to Germany: development since 2001

Consequences for the Partisan Investment Strategy

What is to be done? The fact that no one had foreseen this conflict, demonstrates how crucial diversification in an uncertain world is, once more. In the concrete case, people who had invested their money in Eastern and Central Europe, suffered significant losses. The one who had spread his investments over the world, had marginal losses only, at least up to now.

The increased likelihood of conflict justifies a gradual adjustment in the regional weightings of stakes in equity markets. For the scenario of a further escalation, we consider the risk of very significant losses on German shares as large. For this reason, we have moved the weight within Europe from Germany (-2%) to UK (+ 2%), away from the geographical center of the crisis.

Furthermore, we have increased the exposure towards the USD by 3%. We believe that the USD would serve as a safe haven currency in case of an escalation and thus has a certain insurance function. The shift is financed at the expense of EUR, which we justify with the current monetary policy of the Swiss National Bank.

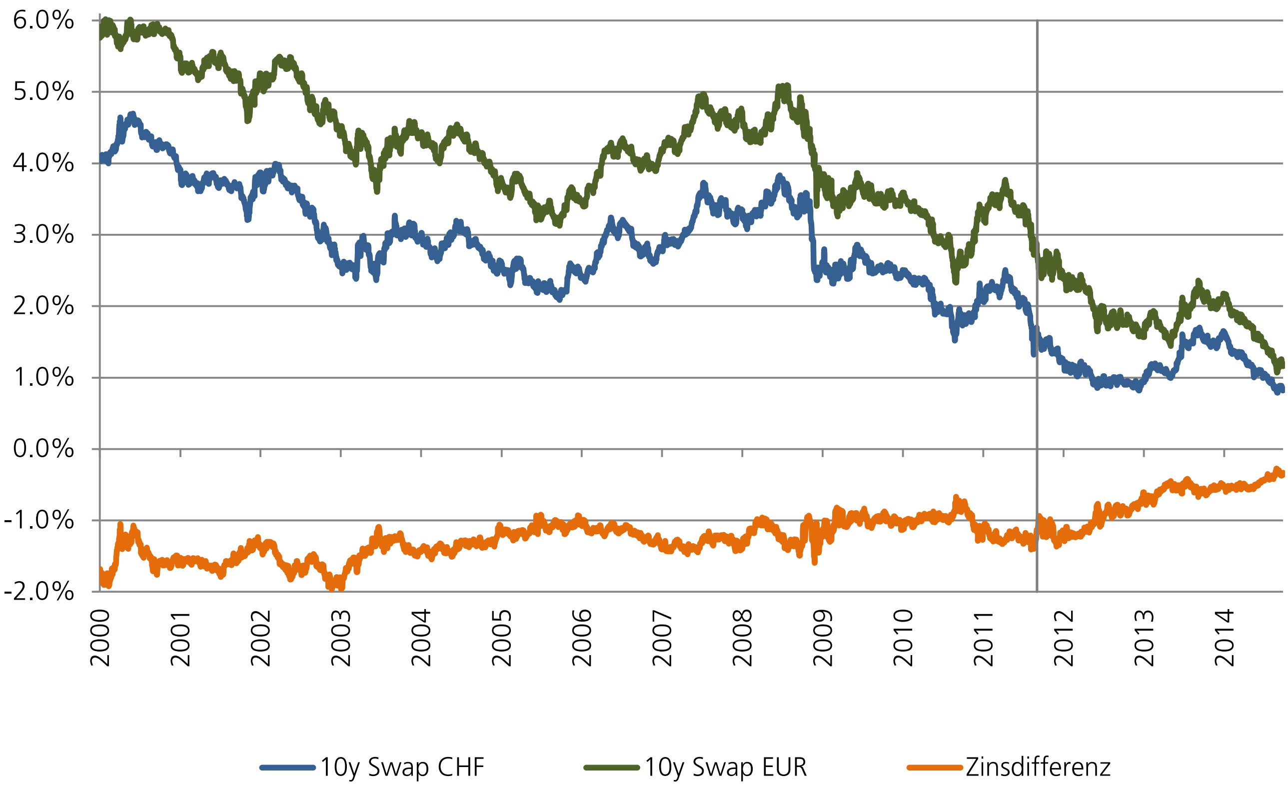
Developments on the CHF currency front

In September 2011, the Swiss National Bank has set the exchange rate against the EUR to a minimum of CHF 1.20. To enforce this the SNB "is prepared to buy foreign currency in unlimited quantities"[1]. This far-reaching measure was taken in the wake of a strong appreciation of the Swiss franc related to the crisis in the euro area, which put the Swiss export industry under pressure. The SNB was assuming a massive overvaluation of the Swiss franc at that time.

However, in the meantime, the EUR has not recovered as hoped. On the contrary, it has devalued further, in particular against the USD. In order to enforce the minimum CHF/EUR exchange rate under these circumstances, the SNB had to purchase large amounts of foreign currencies. As of August 2014, it had accumulated enormous foreign currency reserves to the equivalent of nearly 500 billion CHF. [2]

In recent months, the EUR - and thus also the CHF - significantly devalued against the USD, again. We assume that the repeal of the minimum exchange rate would result in an immediate and strong appreciation of the CHF. Not only would this mean enormous losses on the large currency reserves, but the SNB would come under high pressure from the export industry once again. We doubt that the SNB would take this decision under such circumstances. The SNB has become a prisoner of its own measures.

This is also being confirmed by capital markets, in particular by the strong convergence of long-term interest in EUR and CHF: the yield spread between 10-year Swiss and German government bonds has narrowed to only 0.4%.



Source: Telekurs

The convergence of long-term interest rates (here 10-year swap rates) since the introduction of the minimum exchange rate (vertical line) is a clear indication for the CHF approaching the EUR on a long-term basis.

[1] Press release from the Swiss National Bank on September 6, 2011

[2] Swiss National Bank: Bilanzpositionen der SNB per Ende August 2014.

The EUR has largely lost its diversification effects from the view of a Swiss based investor. And the low interest rate differential no longer compensates for the risk of a strong appreciation of the CHF due to a cancellation of the minimum exchange rate, no matter how unlikely this seems at the moment. We therefore reduce the EUR exposure to 0.

Further reading for those interested

Hoover Digest, 2014, No. 3, Summer, pages 9-35:
Some highly interesting articles regarding the crisis in Ukraine
http://de.scribd.com/doc/232009106/Hoover-Digest-2014-No-3-Summer

Notenstein Dialogue:
General Stanley McChrystal, A World out of balance?
https://www.notenstein.ch/en/news/dialogo-con-notenstein/general-mcchrystal-world-out-balance