FLIGHT PATHS (THE MONEY JUNGLE, PART FIVE)
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"The highway's jammed with broken heroes on a last chance power drive
Everybody's out on the run tonight
but there's no place left to hide". Bruce Springsteen, "Born to Run"

TAKE-OFF

Especially if noteworthy economic variables- including so-called political ones- warn of or reveal substantial financial danger or injury, many marketplace participants preach "flight to quality" doctrines. What represents a supposed "safe haven" sector varies according to viewpoint and era. Inflation often is feared. Or, how could a severe recession or deflation injure us? Political unrest and military conflict sometimes surface.

Since its arrival in 2007, the ferocious worldwide economic crisis has torn a bloody route through interest rate, equity, currency, and commodity marketplaces. This disaster offered and continues to provide marketplace dwellers frequent opportunities to assess and practice their flight to safety theories. Let's update perspectives on a few trading avenues in this context.

SWISS FRANC: ITS HEAVENLY RISE

Many gurus designate gold as a worthy store of value. We all saw it skyrocket over $1500. Clairvoyants devote much attention to government notes and bonds as an escape hatch if a dangerous downturn beckons or is underway. In terrifying recent times, those of the United States and Germany often have allured traders.

Instead, concentrate awhile on the Swiss Franc. Switzerland indeed is a rather small nation. However, this mountainous land has a very long history of and reputation for financial stability, which it battles fiercely to protect. The fluctuations of the Swiss Franc against the Euro FX are not precisely the same as its trajectories relative to the US dollar. In recent years, the major levels and trends of Switzerland's actively traded currency nevertheless reflect worldwide (particularly European and American) economic disaster fears and recovery hopes.

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The policies and problems of European nations obviously are particularly important to Switzerland and Swiss Franc trends. Note three stages for the Swiss Franc in relation to the Euro FX during the 2007 to the present period. Use the America's S+P 500 equity benchmark as an indicator for the world economy and its twists and turns.

First, the Swiss reached lows against the Euro FX at 1.685 on 10/15/07 and 1.636 on 5/16/08 (and 7/31/08), right around times of pinnacles in the S+P 500 (10/11/07 at 1576; 5/19/08 at 1440). Although the SF made an important high versus the Euro FX at 1.432 on 10/28/08, a more crucial top was that on 3/6/09 around 1.457. Why? The S+P 500 ended its meteoric fall by hitting its major bottom that day around 667.

Second, after meandering sideways for several months, the Swiss resumed its advance against the Euro FX. The Financial Times headlines: "EU hand-wringing hampers search for solutions" (6/24/11, p4). The article offers a rough "Timeline" for late 2009 to the present European debt and deficit problems, especially in regard to the allegedly peripheral territories of Greece, Ireland, and Portugal. "Autumn 2009: Concerns grow over the debt burdens of many European countries, especially Greece". From lows somewhat over 1.500 (1.535 on 8/7/09 and 1.513 on 12/16/09), the Swiss edged higher versus the Euro FX. It made a final minor low on 5/21/10 at 1.458, almost exactly its 3/6/09 high. The Swiss then raced higher, reaching peaks of 1.276 on 9/8/10 and 1.240 on 12/30/10.

But the Swiss Franc's flight relative to the Euro FX did not cease there. From its low of 1.324 on 4/6/11, the Swiss broke through the December 2010 and March 2011 (3/17/11's 1.243) resistance, exploding to new highs last week around 1.185. Note the sharp advance since 4/6/11 in the SF relative to the Euro FX alongside the recent highs of and subsequent dips in the S+P 500 (5/2/11 at 1371) and commodities (broad GSCI at 762 on 4/11/11 and 5/2/11).

The rally of the Swiss Franc versus the Euro FX since April 2011 and the very ascent to new peaks thus warns of (confirms) not only European debt and deficit problems, but also dangers to the overall worldwide recovery and global financial stability.

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Note the European Central Bank President's warning only a few days ago during European Systemic Risk Board meetings (6/22/11). In his view, the level of risk to financial stability from the Eurozone debt crisis is very high ("red", in the emerging regulatory color code system). With a highly interconnected financial system, problems could spread within and beyond the European Union. Will there be a run on some banks? The Financial Times talks of "Flight from Europe-exposed money market funds" (6/25-26/11, p11).

See also concerns voiced by the Governor of the Bank of England ("Financial Stability Report Q&A" (6/24/11; pp6-8). Regarding the European financial institution and sovereign debt crisis, he declares that the issue is one of solvency, not liquidity.

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The best yardstick of overall strength or weakness in the US dollar is the broad real trade-weighted dollar. Of course cross rates against individual currencies remain significant for marketplace study and some policy decisions.

Switzerland admittedly captures only a tiny part of the trade weight of the broad index of the dollar's foreign exchange value. Its 2011 percentage is less than two percent (around 1.80pc), around that of past years (2005's 1.39pc, 2000's 1.35, and 1995's 1.57). For 2011, compare the Euro areas 17.62pc (about 2000's 17.30pc), China's 19.87 (a leap from 7.89pc in 2000), Canada's 13.21pc, Mexico's 10.38pc, Japan's 7.48pc, and the United Kingdom's 4.23pc.

Judging from a succession of higher and higher lows made by the Swiss Franc versus the US dollar in recent years, the greenback has been a long downtrend against the Swiss. The Swiss/dollar cross rate was about 1.329 Swiss per dollar on 11/16/05, 1.277 on 10/13/06, and 1.230 on 11/21/08. Then came SF1.197 on 3/12/09 (this key interim high for the US dollar versus the SF was very close in time to the March 2009 stock marketplace major low). Then arrived the SF lows of 1.173 on 6/1/10 and 1.005 on 11/26/10.

The meteoric fall of the dollar versus the Swiss Franc during the QE2 period from its 11/26/10 high is noteworthy for flight to safety (quality) analysis. **Might there be somewhat different implications for a "very weak" dollar as opposed to just a "weak" one?** Another note in this context: since late November 2010, the dollar decisively crashed by through its 3/18/08 floor of .979. In regard to this 3/18/08 low for the dollar versus the Swiss, recall the S+P 500 high a couple of months later, in May 2008.

This dollar dive relative to the Swiss Franc beginning around the Thanksgiving holiday of November 2010 signals widespread and growing concerns regarding American fiscal, interest rate, and currency policies. **Given the parallel strength of the SF versus the Euro FX and the drops in many equity marketplaces in recent months (don't forget China in this regard), this recent decline of the dollar against the Swiss warns of fears regarding worldwide economic (financial) recovery (stability).**

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Next, review the trend of the Swiss Franc in a very broad context rather than in regard to cross rates against the Euro FX or US dollar. The Bank of England's monthly average effective exchange rate index for the Swiss Franc (hereafter, the "SFI") is a helpful guide. This index extends back to January 1975 (1990 average equals 100).

In broad brush terms, and despite wandering up and down, the SFI generally has climbed higher since the mid-1970s. On balance, it has rallied fairly steadily since a low 20 years ago in May 1992 around 92.8.

Let's look closer to the present. The SFI made an important low in October 2007 at 106.9. In that regard, keep in mind the S+P 500 peak later that month. Also, compare the pattern of a relatively weak SFI versus strong stocks seven years before that. The SFI's low was 102.7 in March 2000. The S+P 500's peak also was that month (3/24/00 at 1553; the Dow Jones Industrial Average top was a bit earlier, on 1/14/00 near 11,900).

The SFI traveled up to 119.8 by January 2009. For March 2009, the month of the S+P 500 major low, it was 119.1. Now things get interesting.

Over the next several months, even as equities rallied, the SFI fell no further than 118.3 (August 2009). Note that these 2009 levels all exceed prior SFI major tops around 116.0. Don't overlook the 116.4 high in November 1995. And especially remember the high at 116.5 in March 2003, the month of the final low in the S+P 500.

The crisis of the European periphery helped to propel the SFI decisively above 120.0 by early to mid-year 2010. With the advent of QE2 easing talk and eventual action since late summer 2010, the SFI jumped over 130.0, and then to the middle 130s. The increasing prominence of the US federal deficit nightmare has encouraged the SFI rally over recent months. These (and other) factors intertwine. In any event, the May 2011 SFI average soared to 142.3.

So now there's a very strong (all-time record) SFI for May 2011, around the same time as the early May 2011 summit in the S+P 500. This varies from the pattern of three key major marketplace turns (2000 and 2007 had somewhat weak SFI near in time to an equity peak; 2003 had a strong SFI alongside feeble stocks). **What does this 2011 SFI situation signal? Given the continued and substantial (fearsome) worldwide economic crisis, it probably indicates further falls will occur in key equity benchmarks such as the S+P 500.**

Relevant to this viewpoint is the recent level and movements of the trade-weighted US dollar (TWD). The broad real-trade weighted dollar (this is only reported as a monthly average) in recent months has achieved new all-time lows beneath long run major support around 84.0 (see the lows of April 2008, July 1995, and October 1978). May 2011's 81.3 is a new depth. This is a long distance not only from the broad real TWD major high of 112.6 in February 2002, but also even relative to the modest plateau at 96.7 in March 2009 (around the time of the S+P 500 trough).

The nominal broad real TWD did make a low on 5/2/11 at 94.05, the day of the equity (and GSCI) peaks. Thus it seems to fit the weak dollar/strong stock song (and the related hymn of strong dollar/weak stocks) of recent years. But the nominal TWD has rallied only about 1.8 percent relative to its 5/2/11 level.

Detour into the Euro FX/US dollar cross rate in this price and time context. Although the Euro FX's high versus the dollar was 5/4/11 at 1.4940, the dollar has not been very strong versus the Euro FX in the context of recent months. The Euro still hovers way above its lows at the time of QE2's dawn 1.2588 (8/24/10) and 1.2969 (11/30/10). The Euro FX is even higher relative to its 6/7/10 low against the dollar at 1.1877 (which was around time of the Swiss Franc low versus the dollar on 6/1/10 at SF1.173).

Consequently the still very weak broad real trade-weighted dollar (TWD) alongside the tremendous strength of the Swiss Franc (in SFI terms, as well as versus both the Euro FX and US Dollar) probably signifies a breakdown in the "weak US dollar means strong US stocks" relationship. The emerging (current) relationship is: "the very weak dollar means (eventually) weak US stocks". So long as the dollar remains "very weak" (use a broad real TWD level around 84.0 and below as a rough guideline), this new pattern probably will prevail.

After all, look at the current perilous worldwide economic situation from the debt and deficit standpoint. Besides, the US and the European periphery are not the only domains for these concerns. Moreover, quite a few experts have reduced some recent growth forecasts for America and elsewhere. US real estate problems are not cured. American unemployment remains high. US consumer confidence recently has slipped. What about the strategic petroleum reserve release by America and its allies this month? This action partly reflects fears regarding the durability of the economic recovery, including worries about continued fragile consumer confidence and inflationary pressures. For the US, arguably the faster return home of troops now in Afghanistan reflects economic (deficit spending) concerns

Marketplace players will not run for cover forever. Regulators and politicians surely will not be eternally fearful. The Swiss Franc will not go up forever. Not all economic landings are hard ones. **Yet the present strength in the Swiss Franc underscores its flight to quality status, and observers should watch its trends and levels closely.**

GOVERNMENT INSECURITIES

"Houston, we've had a problem here." Apollo 13 astronaut (April 1970)

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Perhaps current problems will fade into the distance. Sometimes dark skies become sunny, and remain so for extended periods. Not long after early March's 2009 stock marketplace bottom, Federal Reserve Chairman Bernanke chirped: "And I think as those green shoots begin to appear in different markets and as some confidence begins to come back that will begin the positive dynamic that brings our economy back….I do see green shoots." (60 Minutes, CBS, 3/15/09). Look at the soaring S+P 500 from its March 2009 valley until mid-spring 2009.

Unfortunately, seeds of doubt regarding the future route and extent of the United States and worldwide economic recovery increasingly have appeared in recent weeks.

So let's spend more time on the US for a moment. There has been some near-miraculous growth from titanic money printing, massive deficit spending, and sustained low policy interest rates (Federal Funds and therefore for much of the government yield curve). The weak dollar policy has tended to boost the US economy (at least until this spring). The Federal Reserve squawks that it has a fine exit strategy.

Assuming that US federal deficits remain substantial, who will fly to buy US government obligations? To what extent do US government obligations at current yields represent a durable store of value? Will US buyers be attracted by low yields? What about foreigners? How substantial will their net buying be, and what if they become net sellers?

The US Treasury note and bond constellation in recent months probably has not been as attractive a flight to quality (safety) realm as many believe. Scan the International Monetary Fund's "Fiscal Monitor Update" (6/17/11, p9). By the end of second quarter 2011, the Fed's $600 billion second round of quantitative easing (money printing) will push Fed holdings of publicly-held government debt to 15 percent. An IMF chart (Figure 5) puts Fed central bank purchases of US government securities for first half 2011 at around 75 percent of new net issuance. The Treasury International Capital Report (6/15/11) lists foreign holdings of US Treasury bills, notes, and bonds. For April 2011, the most current month available, foreign holdings were about $4.5 trillion, of which official holdings represented 71.4pc. Total foreign ownership was up merely $50 billion from end December 2010, and only around $217bb above the August 2010 level.

The US is not Greece. But what happens if big American fiscal deficits persist (picture not only the near term, but also over the long run) alongside no significant net Fed buying of Treasuries? If appetite for federal debt diminishes, what does that mean for interest rates? What if the dollar keeps falling to new lows as US yields increase?

A FINAL RUNDOWN

"Well this job I've got is just a little too hard
Running out of money, Lord, I need more pay
Gonna wake up in the morning Lord, I'm gonna pack my bags,
I'm gonna beat it on down the line." "Beat It on Down the Line", a traditional song

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In all seasons, Wall Street pilgrims dream of and diligently hunt for "good returns (yields)" from their marketplace enterprises.

Fear and hope interrelate in marketplaces, as elsewhere. Yet suppose one equates marketplace "flights to quality (safety)" with fear. Then there is a counterpart to the flight to quality outlook. Its opposite is the hopeful "flights of fancy" vision. Especially when policy interest rates are kept near rock bottom levels for extended periods (and all else equal), pursuits of profit via other paths of potential returns often become quite fervent. Suppose money printing occurs as well. All else equal, massive money printing tends to boost nominal prices of "assets", including stocks, commodities, and low-rated (junk; many emerging marketplace) bonds.

In a sluggish or fairly weak economy, many people and institutions will find it hard to borrow money. However, players with substantial net worth still probably can find leverage. In a multi-currency world, might a gleaming carry trade opportunity perhaps appear?

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Overall US after tax corporate profits have been excellent in several recent quarters through 1Q2011. Nominal quarterly after tax profits (seasonally annualized) for each of the 2010 periods as well as 1Q11 exceed the lofty height of about $1.35 trillion of full year 2006 (1Q11's were $1.45 trillion). See the Fed's "Flow of Funds", First Quarter 2011 (Table F.7, line 21). But if they do not remain elevated, what does that portend for stocks? In that regard, what happens when that money printing ceases? Or, when many buyers (especially consumers) have less money (and net worth) to inspire avid (extra) acquisition of goods and services? What if company share buyback programs become less aggressive? What if interest rates rise significantly? A widening of key credit spreads would be ominous for equities. Will people run for cover? "Record retreat from junk bond funds" notes a Financial Times headline (6/24/11, p20). "Investors withdrew a record amount of cash from US funds that buy junk bonds".