



Market Strategy

BY TIMOTHY O'SULLIVAN

Dollar/Swiss: Still a safe-haven trade?

Historically, the dollar vs. the Swiss franc has been the purest "dollar play." Switzerland's currency is widely viewed as a safe-haven due to its high liquidity and the apolitical nature of the country. Since March of this year, dollar movement against the Swiss franc has almost directly followed the U.S. stock market's downturn. USD/CHF habitually goes in and out of being in strong correlation with the Dow Jones Industrial Average (DJIA). With recent talk of an "L-shaped" economic recovery and potential U.S. conflict with Iraq, an opportunity can be found being long USD/CHF regardless of the direction taken by the equity indexes.

Currently, the dollar appears undervalued vs. the Swiss franc and two opportunities exist for a long position in dollars. Traders are long Swiss francs in the wake of the unrest between the U.S. and Iraq. If the situation does not escalate beyond diplomatic actions such as United Nations sanctions and resolutions, the dollar

inevitably will move higher as the war risk premium abates.

For those who think diplomacy will resolve the conflict, the trade right now would be to buy USD/CHF for a test of the January 2001 highs. Conversely, a long position in the equity indexes may prove to be a mistake. The uncovering of irresponsible corporate spending and accounting procedures, the questionable potency of last year's interest rate cuts and rising concerns about the fiscal budget make the risk/reward of a bullish stock position questionable.

In the event military action materializes, the initial market reaction undoubtedly will be further buying of Swiss francs — the traditional safe-haven trade. This scenario presents an excellent opportunity to enter a long dollar position. The trade should be made no later than a week after the onset of the war. Regardless of the reasons for war, Iraq sits on top of the second largest oil reserve in the world. There is no better

way to jump start the economy than to get the price of oil down to \$15-\$20 per barrel, something a quick regime change in Iraq would work toward achieving.

The currency markets will demonstrate a volatile response to either scenario, providing a better bang for the buck vs. equities. History shows an extreme response in USD/CHF after the first air strikes of the Persian Gulf War. The dollar rose 26% from January to June 1991 after experiencing a gradual descent during the three-month build up of coalition forces. Equity markets experienced a 20% rise during the same time frame.

However, the difference is magnified by the leverage available with currency trading, as low as 2% margin in today's e-forex markets. By using full margin, the real dollar profit on the USD/CHF move in 1991 would have been 50 times the percentage move in the underlying.

As of Oct. 1, USD/CHF and the DJIA show similar behavior to events that transpired 12 years ago. Six

months before the coalition build up to the Persian Gulf War, USD/CHF dropped 17% from 1.50 down to 1.24. The DJIA followed a similar course, dropping 17% from 3000 to 2500. The accompanying six-month chart shows a similar pattern. Although the extenuating circumstances of both periods were different, a near identical pattern is evident in both products.

From this point on, we expect a rise in the dollar against the Swiss franc. A 20% move from current levels of 1.4850 (as of Oct. 3, 2002) to as high as 1.78 is realistic. The level of the rise will depend on how abruptly the war risk premium dissolves. In the end, a long USD/CHF position likely will outperform a long equity position — with less risk — over the next several months.

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OFF TO THE RACES?

USD/CHF has been in lock step with the DJIA since March 2002. However, the expectation is for a long position in USD/CHF to outperform a long position in equities in the medium term.



Source: Gain Capital