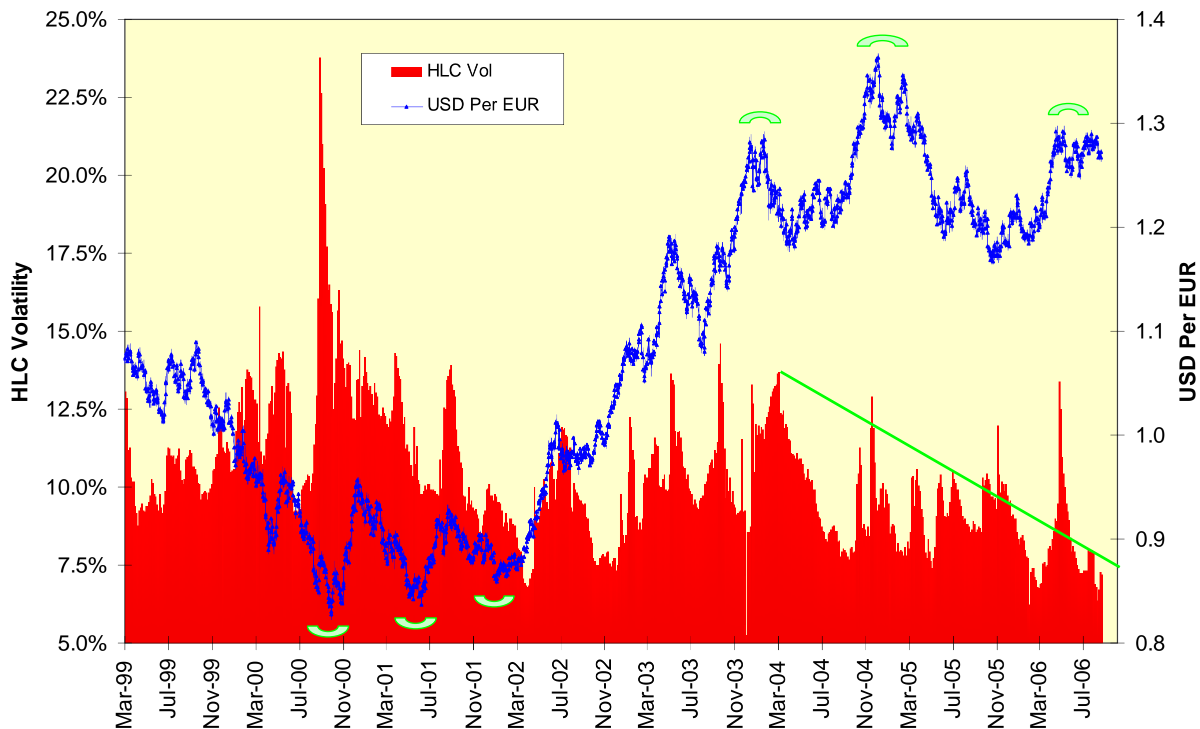
All Quiet On The Euro Front

For all of the attention devoted to the Federal Reserve's next move, the dollar's exchange rate against the euro is arguably more important. We saw how it took a year and one-half of rate cuts, between January 2001 and May 2002, for long-term interest rates to respond to cuts in the federal funds rate, and we saw how the yield curve's inversion throughout 2005 and into this year trumped the Federal Reserve's intention of using monetary policy to slow the economy.

The exchange rate can operate nearly instantaneously. Not only does it operate through intermarket arbitrages such as the spread between bond yields at various maturities, but it affects all manner of costs at the macroeconomic level. Much of the returns generated by hedge funds and other risk-seeking vehicles are produced first and foremost by currency volatility. This is why the long trading range of the euro against the dollar has led to a prolonged period of mediocre returns in financial markets.

Head And Shoulders

Some market developments are invisible from the inside. How many of us realized in late 2003 that the euro, which was to put in both a strong rally in 2004 and a subsequent decline in 2005, was embarked on a multi-year trading range characterized by a massive head-and-shoulders top, marked by the three arcs on the chart? I use the H&S reference with some trepidation as all newcomers to technical analysis find this chart formation everywhere. The opposite is true as well: How many of us could define the rising triple-bottom on the charts between late 2000 and early 2002?

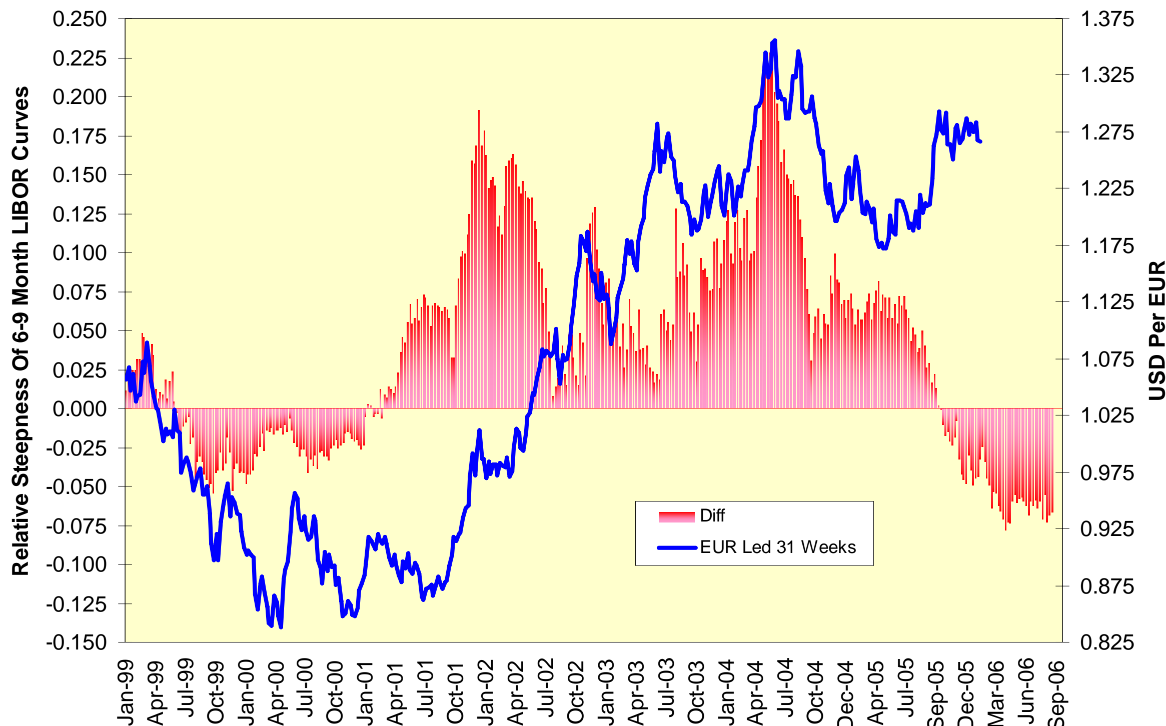


A major consequence of this post-2003 trading range has been a decline in realized high-low-close volatility. This measure takes intraday price range as well as interday price change into account. It has been trending lower since the market realized in April 2004 the Federal Reserve would have to start raising interest rates.

Nothing Lasts Forever

Just because a market has remained in a trading range for two and one-half years does not mean it will remain in that range. Something will need to keep it confined. That something is relative monetary policy expectations between the U.S. and Europe as measured by the forward rate ratios between six and nine months. These are the rates at

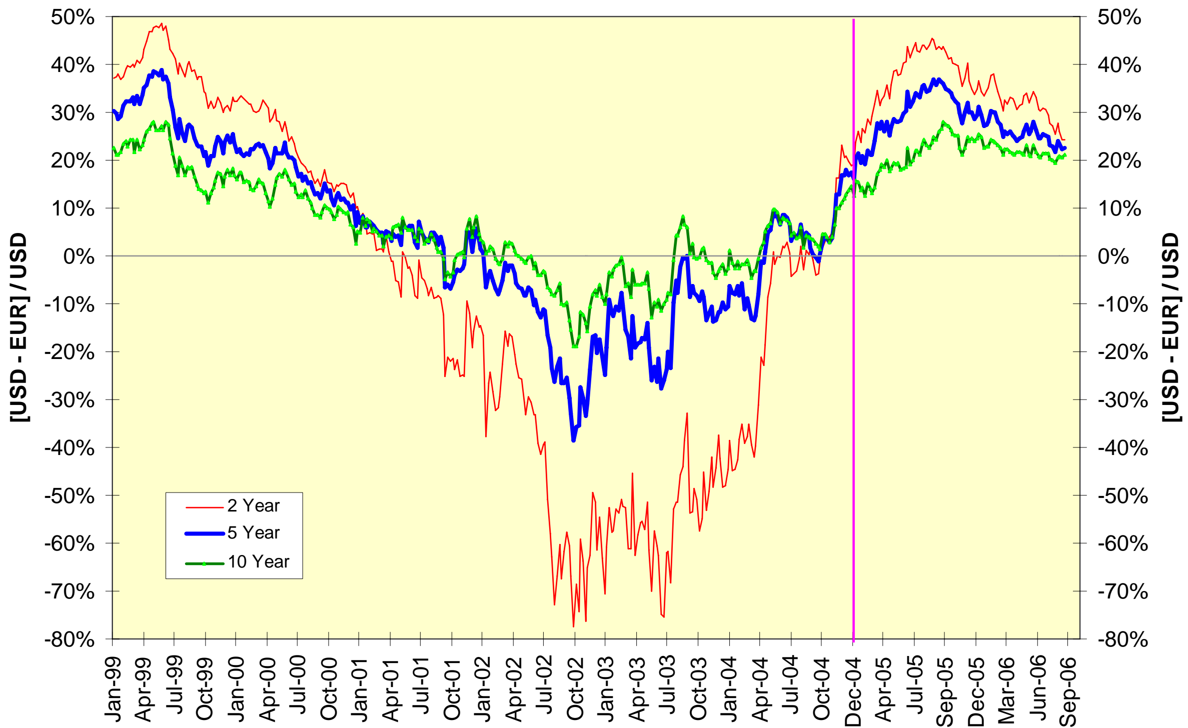
which you can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself. The more this ratio exceeds 1.00, the steeper the money market curve and presumably to looser the monetary policy. If we subtract the FRR for the euro from that of the dollar, we see this difference has remained quite stable since March 2006. As it leads the movements in the euro by 31 weeks on average, we can project at least two more calendar quarters of the euro-dollar exchange rate remaining confined in its present trading range.



Implications For Relative Returns

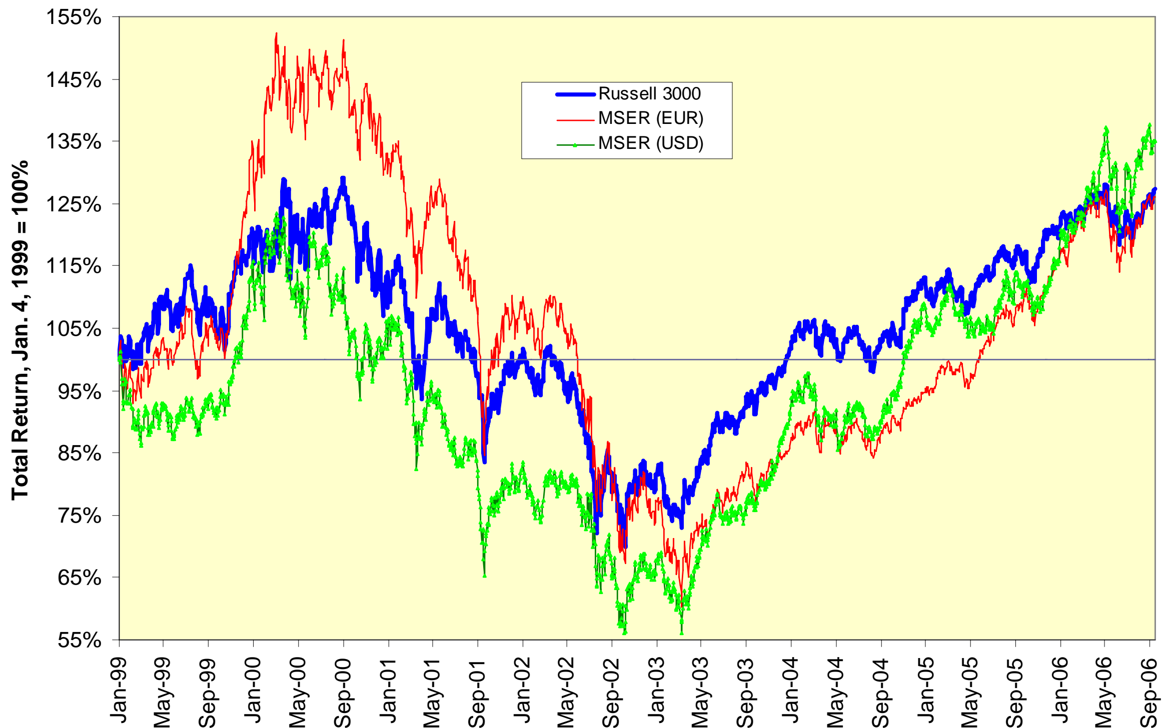
If the dollar-euro exchange rate is stagnant, it should have implications for relative returns on both stocks and bonds. If we compare the yield gap between U.S. and European notes at the two-, five- and ten-year horizons expressed as a percentage of the U.S. rate, we see how this rate gap stabilized very quickly after the euro's December 2004 peak. This forces a convergence of both the nominal returns on these bonds and the currency-adjusted returns. So long as the euro remains in its range, investors will become indifferent as to whose bonds they will buy, and that will constrict trading opportunities further.

Note Horizon Rate Gaps Converged After Euro's Top



The same mechanism is operating in equities. If we compare the total returns for the Russell 3000 index and the Morgan Stanley Euro index both in dollar and in euro terms, we see a complete convergence of returns between the Russell 3000 and the MSER index in euro terms. Restated, the entire difference between the two markets has devolved into a currency trade.

Benefits Of International Diversification?



While the implications for international diversification are negative, none of us should be surprised at these convergences of returns. In an economy with nearly complete mobility of capital and information, why should one set of firms be able to seize and maintain a competitive advantage solely on the basis of their domicile?

Implicit in this conclusion is what has been passing for international investing and diversification is little more than a currency trade in disguise. However, no one walks into their investment policy committee and argues that an international fund should stay with its domestic indices and simply dabble around with currency overlays. That would be considered style drift, rank speculation, deviation from the investment charter, blah, blah, blah. Chances are overwhelming conventional investment mangers will continue with the pretense of real diversification.

Alternative fund managers, including those self-styled buccaneers of the hedge fund world, will continue to struggle in what they will whine about as a low-return environment. The simple fact is most of their return came from currency volatility, which in turn came from differentials in trans-Atlantic monetary policy. That was the wind, and these pirates with their 2-and-20 fee structures could not learn to tack into it or sail on calm seas.