Respect The Euro's Resilience

The Common Currency Ignores Negative Indications

I do not have a top-ten list of trading rules; only one suffices and that is try to sell at a higher price than you bought regardless of the order of execution. If, however, I was to start putting forth a compendium of rules to live by, the one reading, "When a market fails to go down on negative news, it probably will go up, and vice-versa," would have to be included thereon.

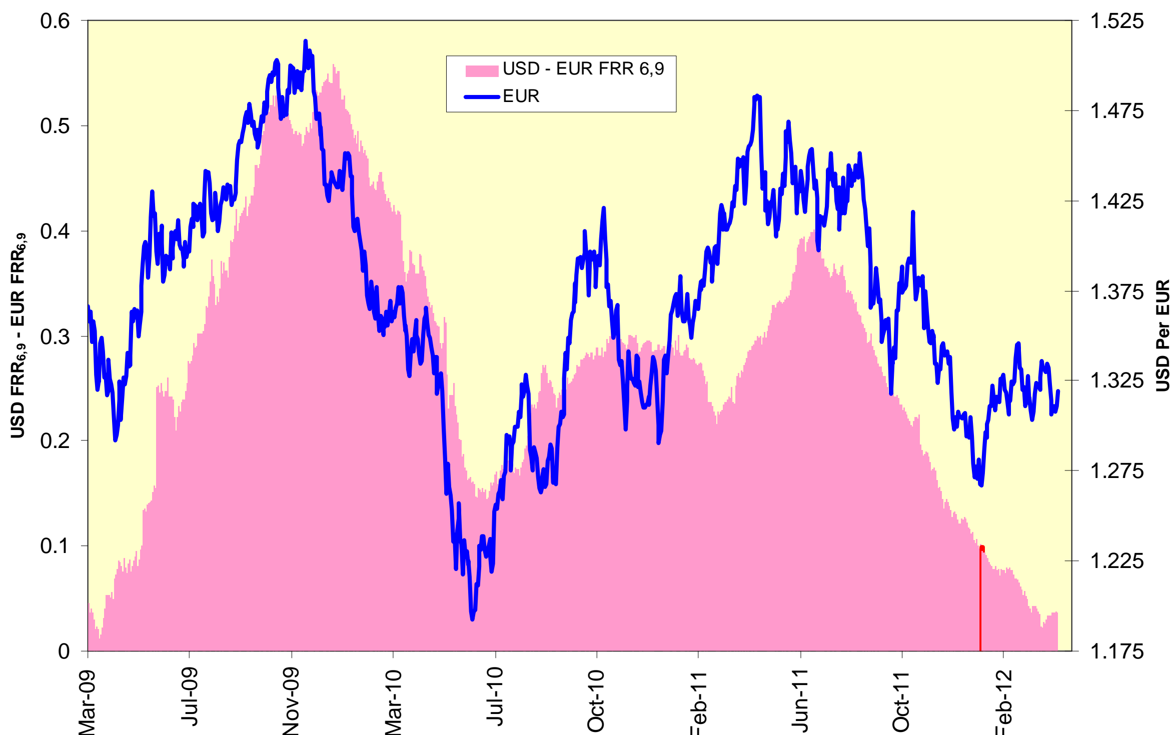
This is where we are on the euro. Oddly enough, I think one of the very difficult to quantify reasons for the currency's strength is its nature as a basket of legacy currencies and, given the waiting list for admission, of legacy currencies-in-waiting. If the whole project fails, we would be left with a small handful of strong currencies, such as the Deutsche mark, Netherlands guilder and Finnish markka. They would be fine on their own two legs and it would be amusing to hear the Germans start howling about the too-strong mark.

However, we would also be left with a group of intrinsically weaker currencies, including the Spanish peseta, Italian lira, Greek drachma, Irish punt and Portuguese escudo. These countries, all of whom have had to impose fiscal austerity, probably would have to maintain higher short-term interest rates. In a world starved of yield and populated by yield hogs – perhaps you know one or two of these – the higher interest rates just might suffice to maintain the currencies. Stranger things, such as U.S. long-term interest rates below 2% in a runaway national debt situation, have happened.

Thus if we view the intact euro as a package of currencies with reasons to stay afloat if any breakup occurred, we have a gigantic embedded option that outweighs several of the negative indicators.

Negative Indicators

The principal fundamental unrequited reason to dislike the euro here is how it has shrugged off a narrowing expected interest rate differential since mid-January. The experience since QE1 has been when the dollar's forward rate ratio between six and nine months ($FRR_{6,9}$) has been steeper than that for the euro, the euro rises, and vice-versa. As the $FRR_{6,9}$ for the EUR is steepening under a more expansive monetary policy, the euro should be weakening, and it is not.



A second major reason the euro is ignoring is relative stock market performance. Over the past year, the MSCI European Monetary Union index has returned -24.45% in USD terms while the U.S. has returned 4.21%. The pattern since the euro's inception in January 1999 is the currency with the stronger stock market performance gains under the weight of capital inflows. If this pattern held, the dollar might be under 1.10 to the euro instead of being over 1.30.

Finally, interest rate differentials at the note horizon are higher for the dollar at the two-, five- and ten-year maturities. That straight differential usually attracts a capital inflow unless it is associated with slower economic growth. As the U.S. economic outlook is better than that for the Eurozone right now, the higher dollar interest rates should be leading to a weaker euro.

Add it all up and you have a currency metaphorically laughing in the face of death. A market that should decline and does not is set to rise.