A Tale Of Twelve Cities

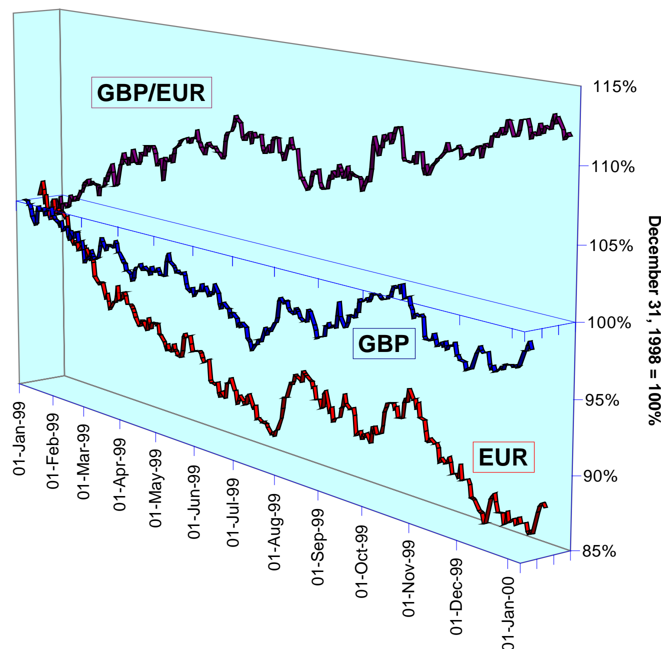
It was the best of times, it was the best of times. Really, what else can you say about 1999? We managed to get through the two largest software projects in history, Y2K conversion and the adoption of the euro as the common currency of eleven European nations. The verdict is in on the former, but the jury is still out on the latter, and will be for some time to come.

The British, still hung up on that island thing after all these years, have stayed out of the euro for the time being, even though betting men worldwide know how this game will end after 2002. Their insular intransigence has provided us with a weakly controlled experiment in how well their debt and equity markets fared relative to those of their Irish and continental cousins.

No Rust On The Iron Cross

For years, ever-witty currency traders referred to the cross rate between the British pound (GBP) and the Deutsche mark (DEM) as the iron cross. For years prior to September 1992, the Exchequer struggled with maintaining the iron cross at the expense of higher interest rates in the UK. After the September 1992 collapse of the GBP, the British decided to pursue an interest rate policy independent of Germany, and the GBP has been quite stable ever since. It has maintained this stability against the U.S. dollar (USD) since the inception of the euro (EUR), and has risen steadily on the cross against the EUR as the latter weakened.

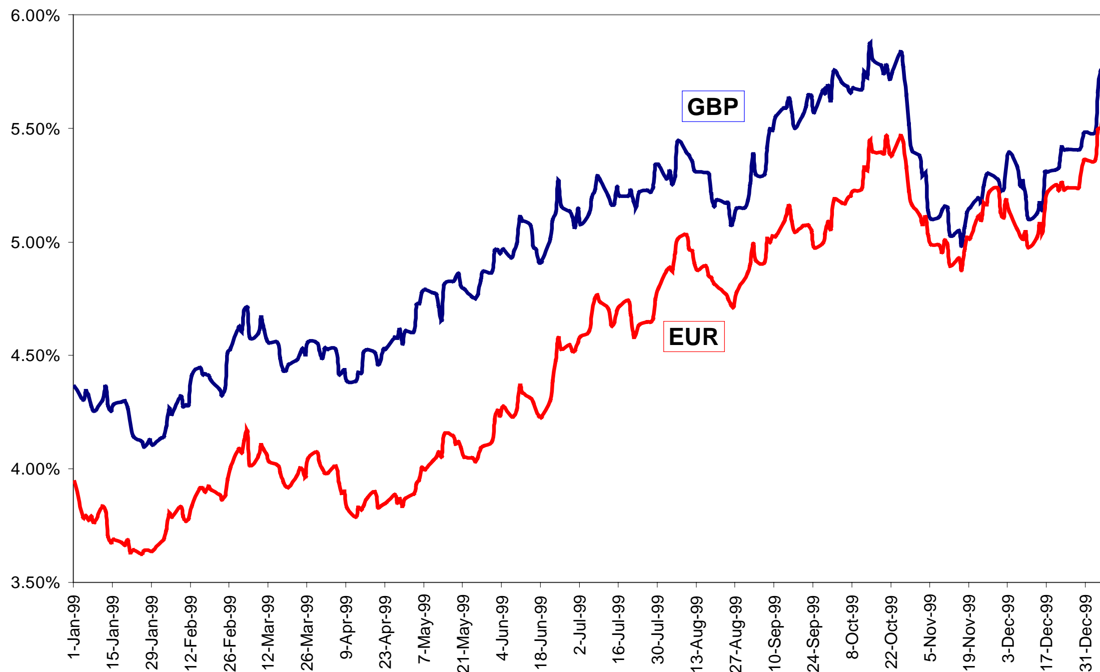
British Pound and Euro:
Relative Movement Since Euro Inception



One lesson of the post-1973 floating exchange rate era is no country can devalue its way to prosperity. It is equally true, however, that a too-strong currency can choke off a country's export growth, not a good idea for an island. Other effects of a too-strong currency include deflationary pressures, downward pressure on interest rates, and a shifting of the political balance toward importers and creditors, as opposed to exporters and debtors.

But is the GBP "too strong?" Interest rate data do not support the notion the British have engineered a strong GBP through higher interest rates so much as the European Central Bank (ECB) has kept its rates

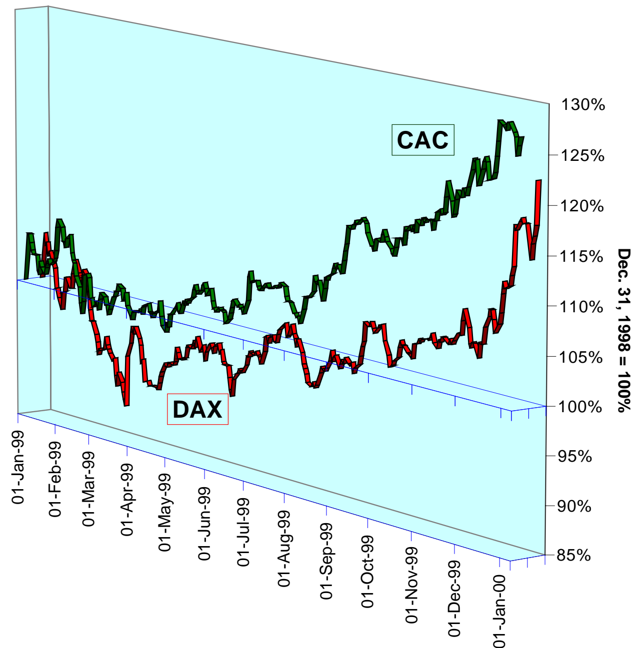
too low despite recent moves higher, leading to a relatively week EUR. The interest rate gap between the two currencies at the ten-year horizon was over 10% of the EUR rate throughout the first half of 1999. Since then, the two yields have started to converge at a higher level nearly 85 basis points lower than the U.S. ten-year note yield.



The British Are Coming

Expectations of higher interest rates to come and a strong GBP/EUR cross have punished the British Financial Times Stock Index (FTSE) relative to its principal continental counterparts, the French CAC and German DAX. This is not surprising; while the GBP/USD rate has been stable and British yields have been well below those in the U.S., the UK's principal trade and investment flows are between itself and Europe, not between itself and the U.S.

Incremental Performance:
CAC And DAX Versus FTSE



Since the introduction of the euro, the CAC and DAX have outperformed the FTSE by more than 25% and 20%, respectively. While this outperformance is not quite of the magnitude seen in the NASDAQ/S&P 500 spread, it shares the unusual attribute of occurring during a period when interest rates on the EUR were rising relative to the GBP. To those, present company included, who have extolled the values of free market capitalism, this is something of a rebuke. Both France and Germany have a far greater level of state control of the economy and levels of social welfare than does the U.K. The Jospin government in France has gone so far as to fine companies where professionals work overtime, and the Schroeder government in Germany has sided directly with Mannesmann in its defense from a takeover offer from the British telecommunications firm Vodafone. To the dot-com world of the U.S., neither country has either a work ethic or a system of shareholder protection recognizable as such.

We are setting ourselves up now for an interesting macroeconomic trade. The near-convergence of GBP and EUR interest rates should lead to a weakening of the GBP/EUR cross, especially if the ECB starts to feel political heat over the weakness of the EUR relative to the USD and Japanese yen (JPY). The FTSE was a notable no-show in the global equity rally from mid-October 1999 to the end of the year. Its relative performance to the CAC and DAX should improve, and dramatically, if and when the ECB moves to support the EUR through even-higher rates. If and when this happens, a complex trade of buying the FTSE and selling either the CAC or DAX, and selling the GBP and buying the EUR should prove successful.