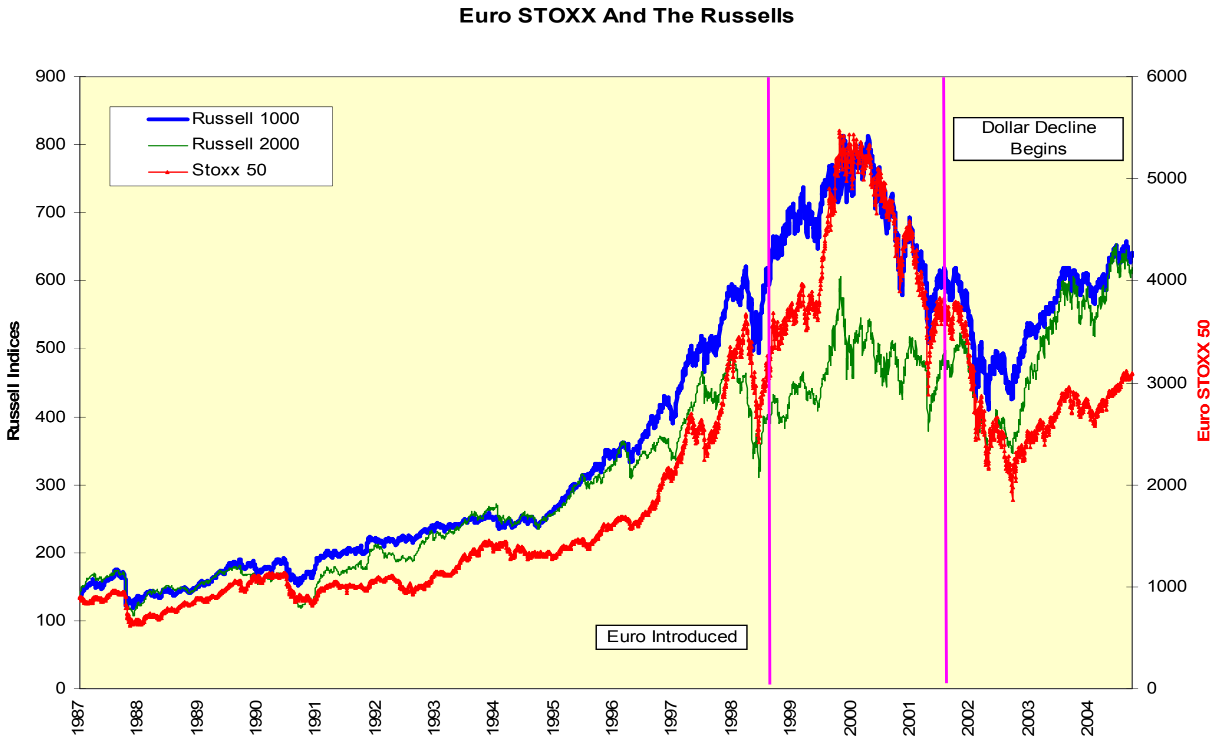
The Atlantic Is A Spreading Opportunity

The foray made here last week into the spread between the U.S. large-capitalization and small-capitalization stocks as represented by the Russell 1000 (RIY) and Russell 2000 (RTY) indices, respectively, can be extended across the Atlantic. The spread between the RIY and the Dow Jones Euro Stoxx 50 (SX5E) index embeds elements of international diversification, sector analysis and currency trading all at once.

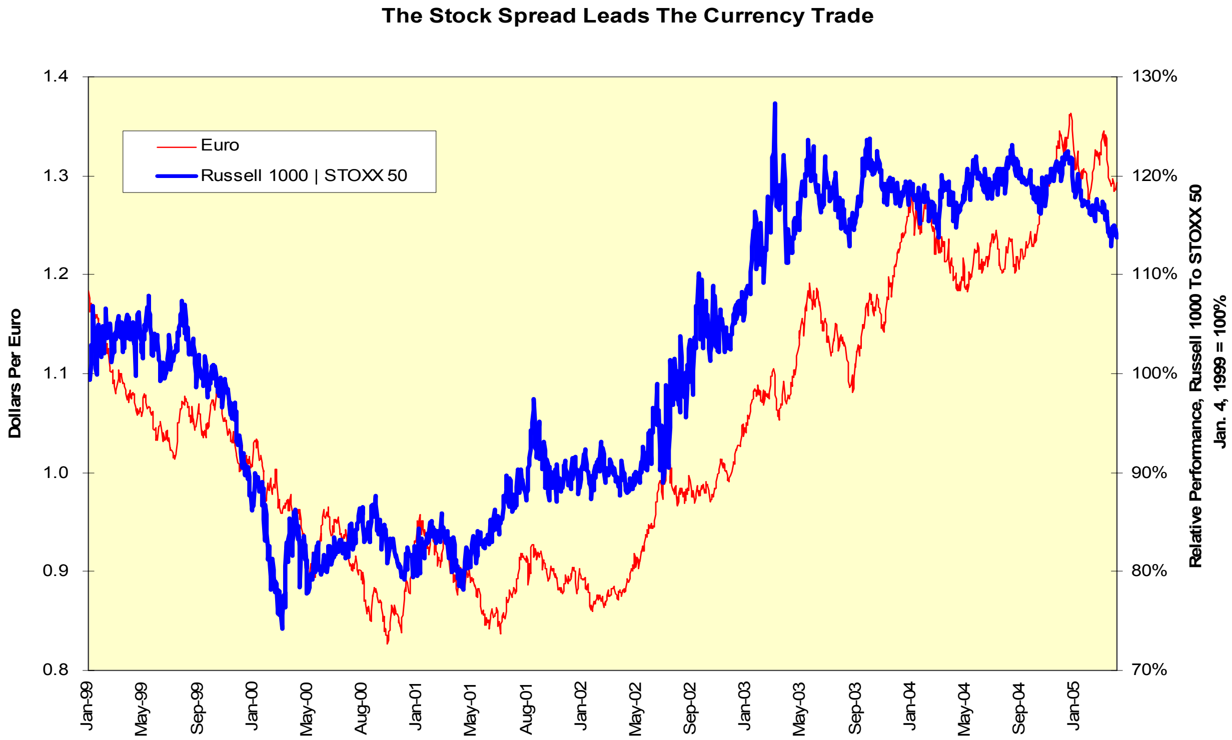
The Euro Effect

For all of the bashing of U.S. financial markets and dollar-denominated assets by those who have an apparent need for self-loathing, the American markets have done pretty well in comparison to the SX5E. During the long bull market of the 1990s - and is it just me, or does anyone else find it hard to believe that ode to excess is five years in the rearview mirror? - the RIY and the SX5E mirrored each other step for step prior to any currency adjustment. Of course, most of that was prior to the advent of the euro in January 1999. Once the multinational currency was introduced to a widespread drubbing - and is it just me, or does anyone remember when holding the euro was considered a one-way trip to oblivion? - the SX5E took off like a scared rabbit.



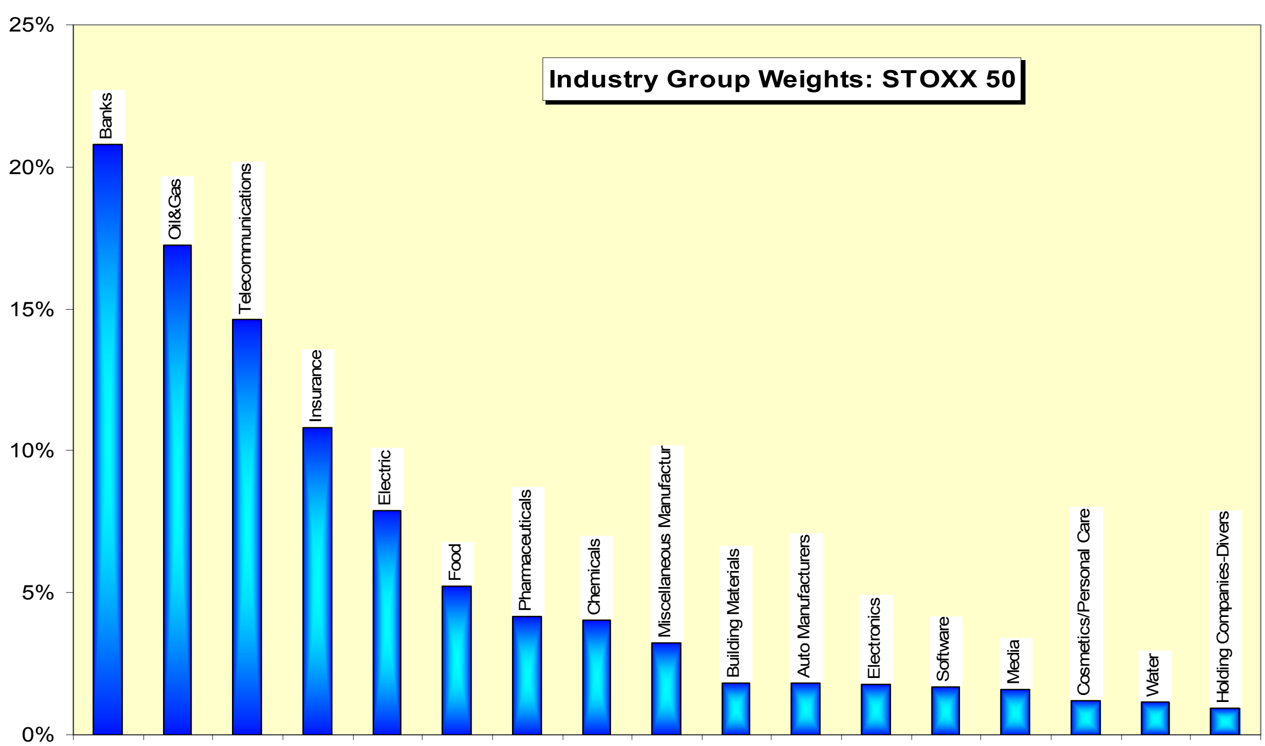
The RIY and SX5E fell apace during the ensuing bear market and really did not diverge until well after the dollar's decline began in earnest in the second quarter of 2002. This has been an odd artifact of the currency-equity relationships for the past decade: The country whose central bank is loosest generally has a weakening currency but greater financial liquidity and prospects for economic growth. Its stock market benefits, at least in nominal terms.

If we map the relative performance of the RIY to the SX5E against the euro's course, we can see just how much the American large-capitalization market rose in anticipation of a weaker currency between May 2001 and May 2003. The relative performance of the RIY to the SX5E has flat-lined for nearly two years and is now weakening. All else held equal, a very dangerous statement to make in the world of currency trading, we would have to consider this an equity market signal for emerging euro weakness. The logic is a more hostile Federal Reserve will simultaneously strengthen the U.S. currency and weaken the U.S. economy.

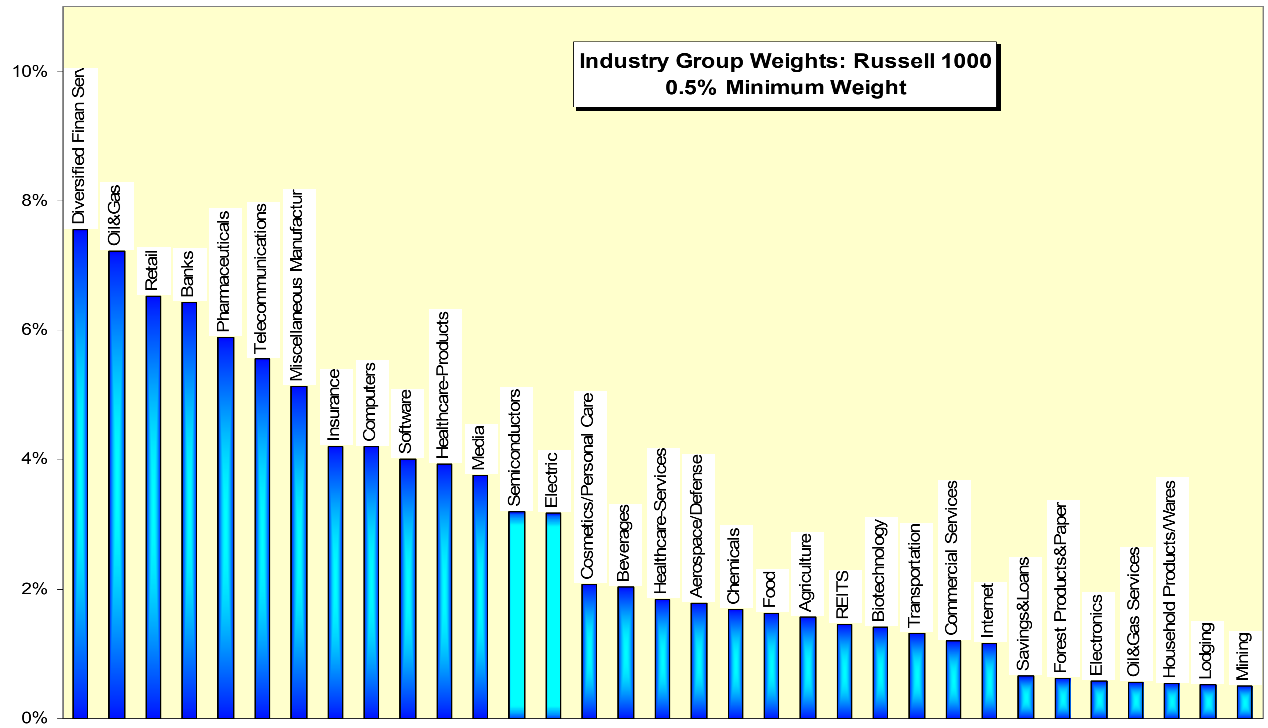


A Market of STOXX

We cannot construct as fine of a comparison between the RIY and the SX5E as we could between the RIY and the RTY. First, the index providers, Russell and Dow Jones, have their own methodologies. Second, it is much easier to slice and dice 1000 stocks into meaningful categories than it is for 50 stocks. Even so, the SX5E's group weights do contain some useful information.



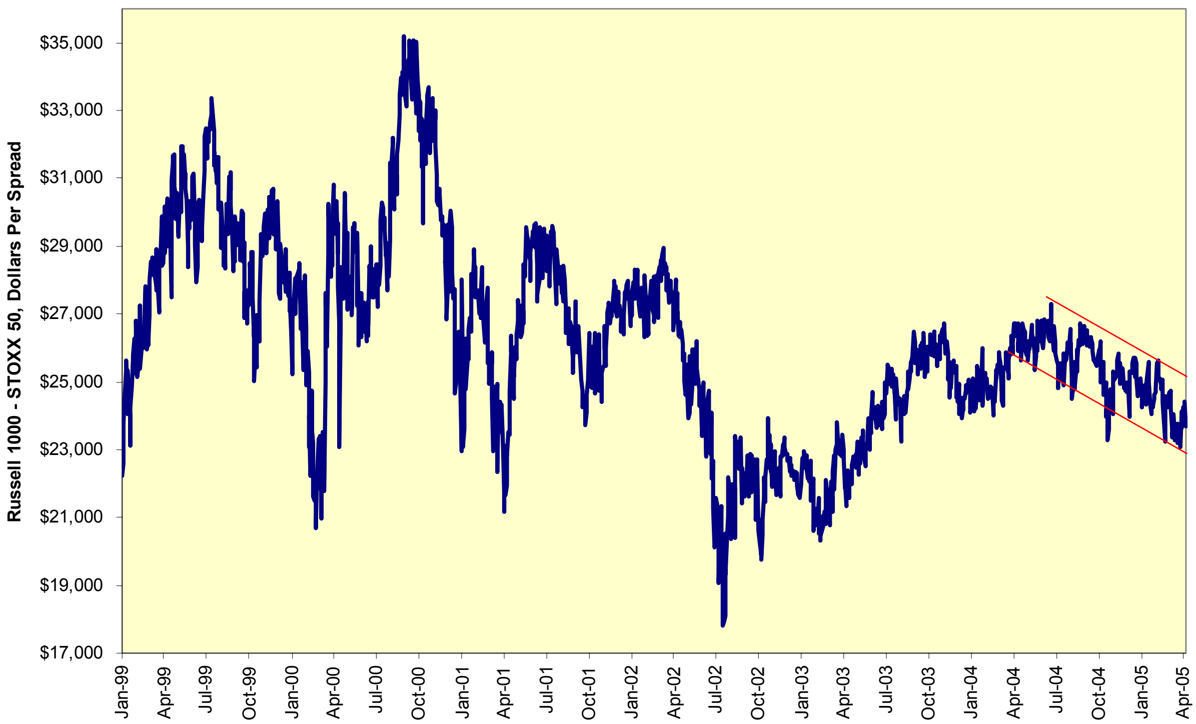
The SX5E is weighted quite heavily in its top four groups, Banks, Oil & Gas, Telecommunications and Insurance. The dependence of banks on a positively sloped yield curve is a clear and present danger in the current environment, and the risk of a sudden downturn in energy prices - and that is not a forecast - would derail the energy stocks. These are the same risk sets noted last week for the RIY, whose group composition is depicted below.



The Spread

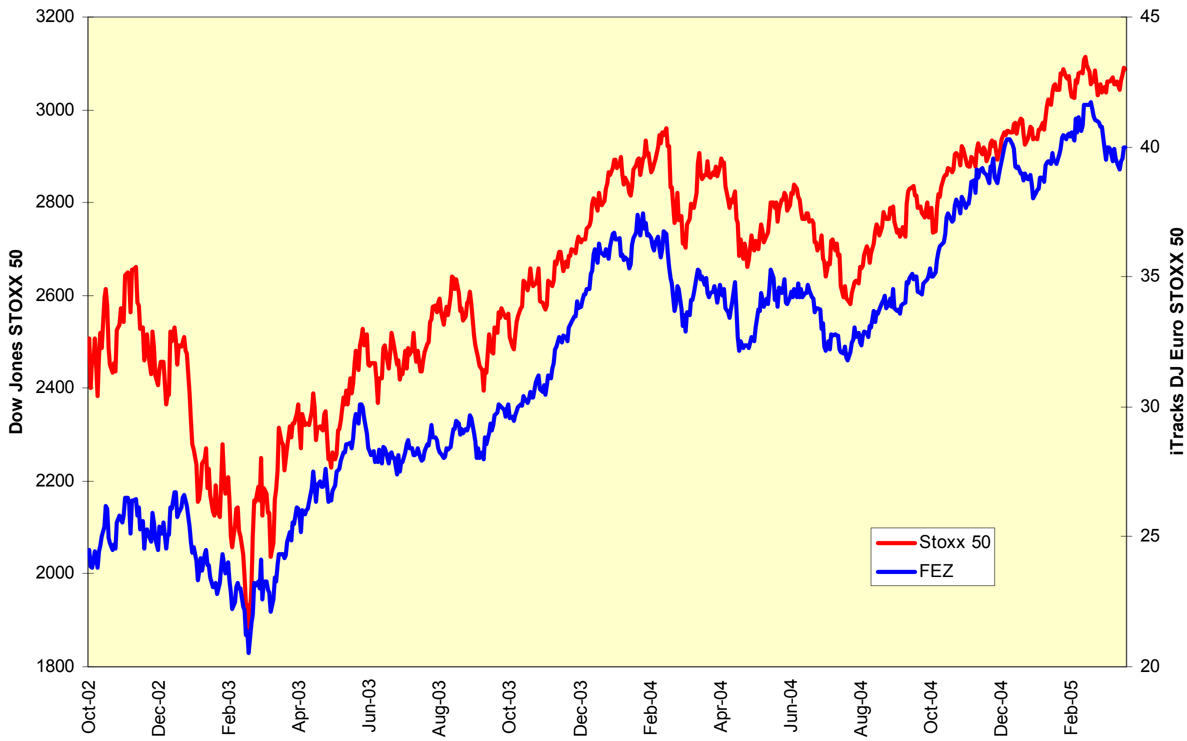
The ability of the two indices to parallel each other for long periods of time, their similar weightings and risk patterns and the impact of the dollar-euro exchange rate on the two markets should lead us to conclude we have a spread based upon a highly trendy currency rate and a package of company-specific risks. We have two ways of trading this spread. One is in the futures market; as discussed last week, a number of U.S. futures exchanges offer contracts on the RIY, and Eurex offers a contract on the SX5E. If we adjust for the different contract sizes and for the currency differential, we get a distinct picture of an emerging downtrend: The trade is sell the RIY and buy the SX5E.

Currency & Size-Adjusted Spread



A second way is to employ the ETFs. The RIY supports the IWB, and there is a dollar-denominated ETF on the SX5E traded under the ticker FEZ (no Ottoman Empire jokes, please). The advantage of the IWB-FEZ trade is it eliminates the need for a separate currency transaction. The very different behavior of the FEZ against its euro-denominated index is depicted below.

Far Off The Beaten Track



If you have always wanted to trade like a hedge fund, here is a way of doing it on the cheap. No management fees, performance fees, fund of fund fees, or any of the other folderol associated with the alternative investment business.