The Which Blair Project

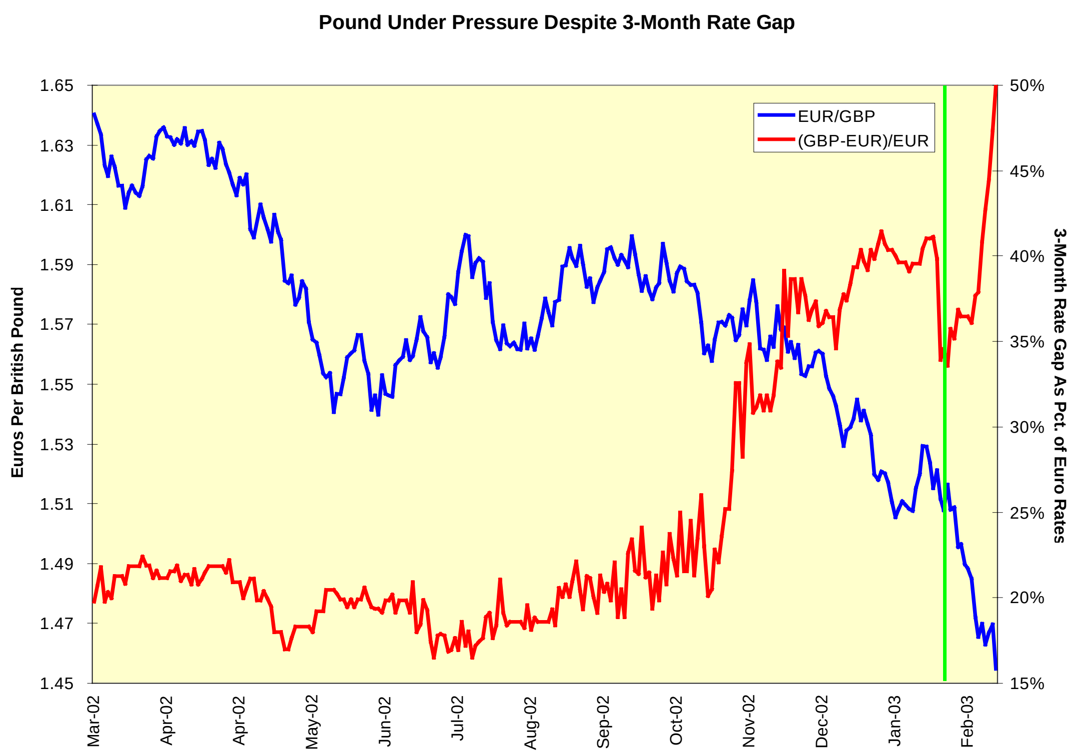
"Fog In Channel, Continent Cut Off"
-- 19th century Times of London headline

Those whose list of things to be feared includes global warming should consider the role it has played in keeping the polar icecaps in abeyance and thereby maintaining the channel between England and you-know-who laying in wait on the other side. History buffs will note that the last successful invasion of England was by William the Bastard in 1066, for which he earned the new sobriquet of William the Conqueror, a good trade in anyone's books.

No world leader has sided more with the United States in its recent foreign policy initiatives than Tony Blair, prime minister of the United Kingdom and one who not long ago was dismissed for his short-term political dexterity as nothing more than a British version of Bill Clinton. His support of the United States when it would be fashionable to do otherwise has earned him a 35% approval rating.

Markets and Central Banks Diverge. Again

The British have declared independence from the Continent in other ways, ones more in keeping with matters financial. The Bank of England lowered its base lending rate, the equivalent to our discount rate, to 3.75% on February 6, 2003. The European Central Bank, which seems determined to win some sort of award for obtuseness, has yet to match this cut. The British pound, (GBP) which had been weakening against the euro prior to the rate cut, has been getting pounded (no pun intended) ever since.



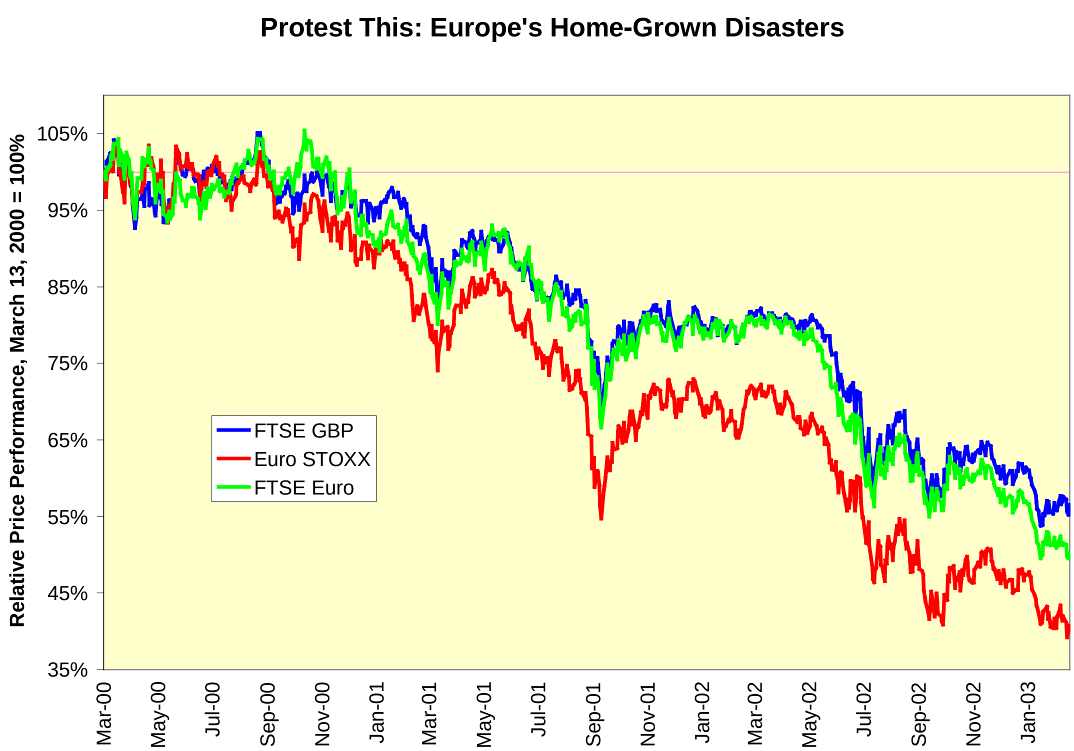
What has made life especially difficult for the pound has been the inversion of the euro's money market curve; while the overnight rate for the euro now stands at 2.80%, the one-month rate is at 2.55% and the 3-month rate is at 2.41%. This inversion is contributing to the euro's strength and to the rate gap between the pound and the euro at the 3-month horizon. The British money curve, by comparison, is nearly flat over the 3-month horizon; rates decline from 3.65% to 3.55%.

Euronext-LIFFE now has a futures contract on the European Overnight Index Average, or EONIA, similar to our federal funds futures contract. No parallel futures contract exists yet for the Sterling equivalent, or SONIA.

Central banks have had many opportunities to learn that controlling the overnight rate and controlling any other rate are two different things. That they have not chosen to learn this lesson is both inexplicable and inexcusable.

Equity Implications
International diversification in equities has given us an opportunity to lose money in different countries simultaneously and for different reasons. Gallows humor aside, this correlation of returns is sensitive to the time sample over which it is measured. The shorter the interval, the greater the correlation; all one needs to do is watch how the European bourses adjust to our economic data and market openings to sense this intuitively. As intervals expand, correlation unadjusted for currency returns falls and some measure of diversification is achieved.

Much of that diversification is derived from currency fluctuations. As we complete the Year 3 A.U., (*anno ursi*, or year of the bear) the 101-member Financial Times 100 index (FTSE, and what is so hard about having 100 stocks in an index so named?) has outperformed the Dow Jones Euro STOXX index by 18.5% on a pre-currency total return basis. If we convert the FTSE to euros, this advantage shrinks to 12%. Of course, they all lost you a bundle, so the lack of cheering is understandable.



Any Dollars From Pounds?
For those of you concerned about the dollar's various weaknesses and its effects on our financial markets, please consider that the Euro Stoxx index hit its bear market low this past week. A strong currency derived from a money market yield curve placed into inversion by a bone-headed central bank provides absolutely no support whatsoever for the associated stock market.

Not that having a weak currency is such a great thing for financial markets: The pound has lost 2.34% of its value against the dollar so far in 2003, and British bonds have negative total returns during another strong global bond rally. To be fair, investing in some of the world's strongest bond markets, which this year include Ecuador, Brazil and Nigeria, often involves impulses inconsistent with a flight to quality.

The FTSE itself has a bit of a picked-over look to it. The top performer is Safeway PLC, a grocery retailer. Sure, it is up 38.6% in 2003, but its return over the past year is a negative 4.4%, and how much of a highflier can a grocery store be? After the recent experience with Dutch retailer Ahold, can any of us be sure that all grocers are not cooking the books along with the chickens? The next best performer in the FTSE is Six Continents PLC, a hospitality and leisure chain that, amongst other ventures, operates bowling alleys. That'll be a leader in the next bull market, won't it?

We may have a large number of reasons to feel a special affinity for the British at the moment, and the British themselves may feel a special responsibility for Iraq, like Transjordan a wholly artificial country of their creation carved from the Ottoman Empire in the aftermath of World War I. However, we must not let such sentimentalities get in the way of our investment decisions. Until the ECB learns how to walk in a straight line and until a global recovery is identifiably underway, there is no need whatsoever to convert your dollars into pounds and take a flyer on anything British.