Won't Get Bucked Again

Will Rogers once said, "There's no trick to being a humorist when you have the whole government working for you." Certain financial commentators with a sarcastic bent must feel the same way with respect to the dollar. All it takes is a downturn in the greenback to bring assorted ignoramuses to the fore proclaiming this time – this time! – those perfidious foreigners who have been financing our wicked, wicked ways will self-destructively liquidate their portfolios en masse and drive us into servitude. Yea, verily, if the Good Lord leaves us standing He surely owes Sodom and Gomorrah an apology.

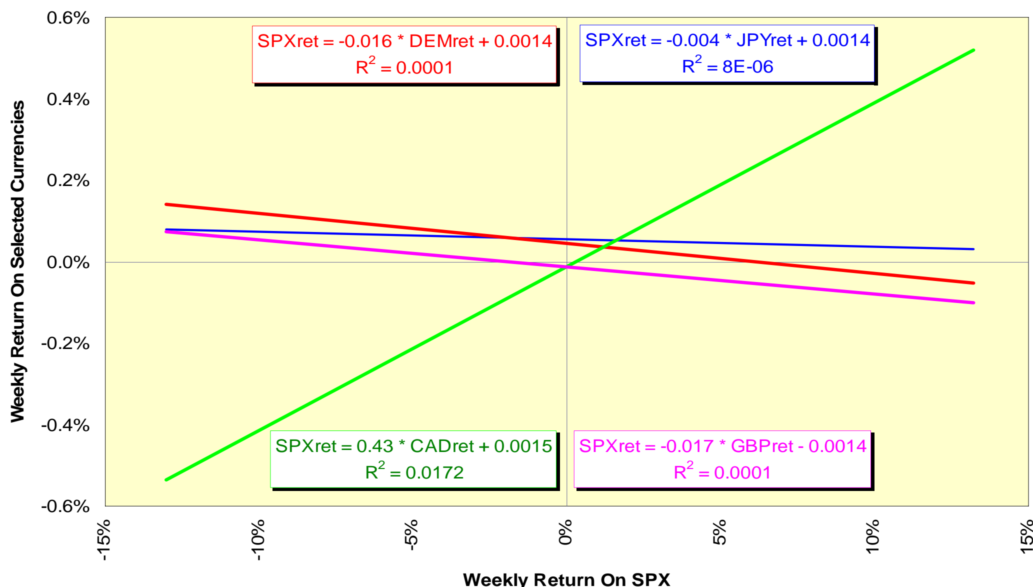
We sniff.

Even better, we sniff with 35 years of data supporting our argument.

Stocks And Currencies

Let's go back to January 1972 and take the weekly returns on the S&P 500 as a function of the weekly returns on four different major currencies, the Japanese yen, the Canadian dollar, the British pound and the Deutsche mark both as a separate currency and at its implied value within the euro. The chart below displays the just the trendlines of these relationships with the individual scatter-points suppressed for clarity. As a statistical note, even though the graph is displayed with currencies as the dependent variables, the regression equations shown were over-written manually to depict the desired relationship with the SPX as the dependent variable. This was done as a work-around to Excel's limitations regarding multiple independent-variable scatter plots (are you listening, Steve Ballmer?).

Currencies' Long-Term Relationship To S&P 500 Is Random

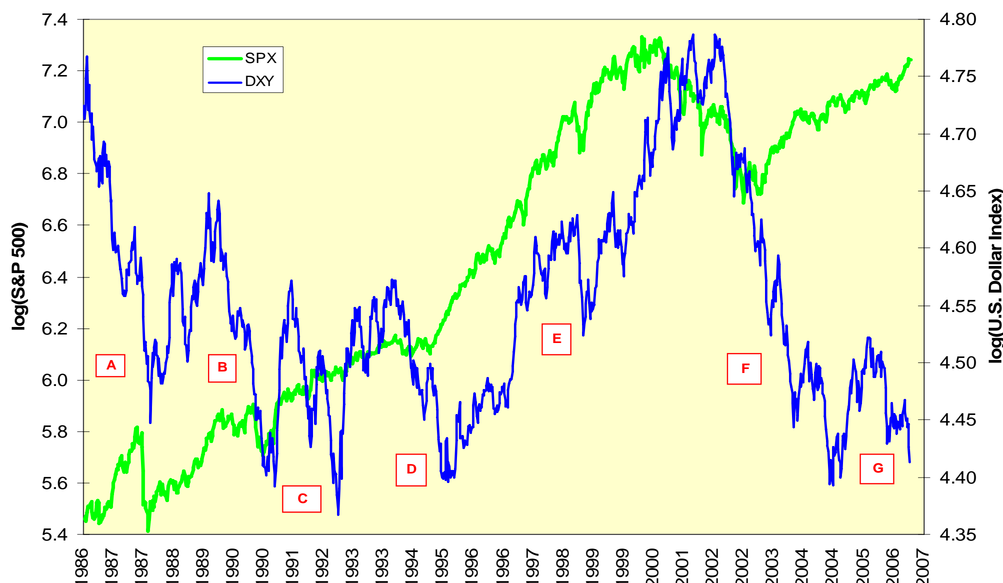


The coefficients for three currencies, the yen, the pound and the mark/euro are negative, which can be interpreted as a weaker dollar is bad for U.S. equities. However, none of these relationships is remotely statistically significant; their r-squared, or percentage of variance explained, are all below 0.01%, and that is with 1,821 weeks of data. The coefficient on the Canadian dollar is positive – a stronger CAD and stronger U.S. stocks coincide – but the r-squared here is only 1.72%.

Every Picture Tells A Story

A fair objection here would be that we have aggregated so much data that a single descriptive regression is irrelevant. Fine; let's disaggregate and compare the course of the dollar index against the SPX after the September 1985 Plaza Accord to drive the dollar lower. The scales on both the SPX and the DXY are on a logarithmic basis to work around another limitation in Excel requiring whole-cycle units for logarithmic charts (got that, Mr. Ballmer? I want you to listen before I add Vista to my collection of Windows XP, Windows 2000, Windows NT, Windows ME, Windows 95, Windows 3.0 and who knows how many iterations of Excel itself.).

A Mixed Relationship



Seven episodes of dollar weakness are noted on the chart above:

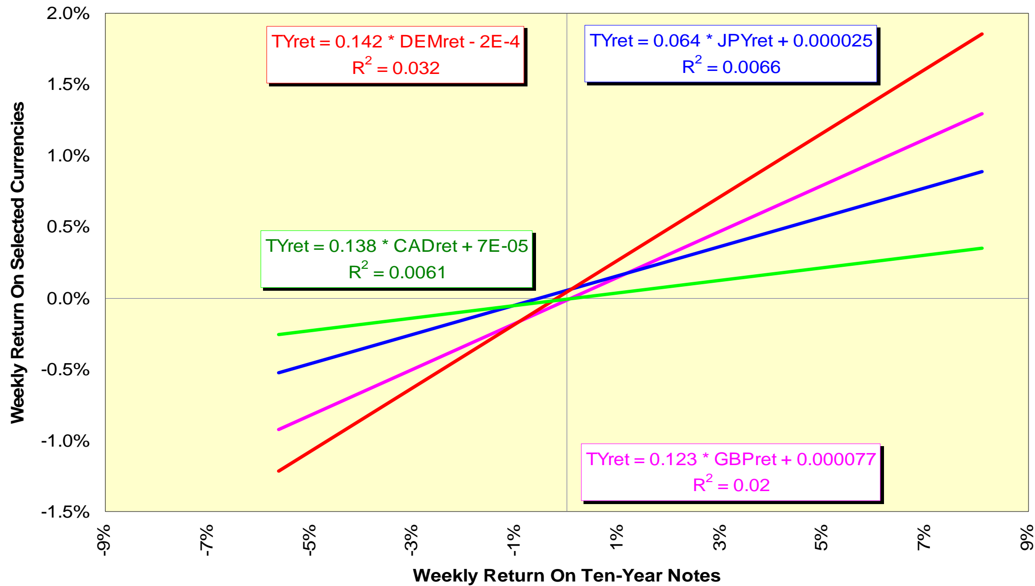
A. The 1985-1987 deliberate policy of dollar weakness produced by rapid interest rate reductions. This monetary largesse fueled the mid-1980s rally and culminated in the 1987 crash. The market at that point feared an interest rate reversal as part of a dollar defense policy;
B. The 1989-1991 weakness produced by a combination of rising European interest rates, the Japanese bubble, and the weak dollar preferences of the first Bush administration. Stocks experienced a period of slow growth;
C. The 1991-1992 weakness produced by the U.S. recession and a series of interest rate cuts in the U.S. combined with a tight monetary policy by the Bundesbank in the aftermath of German reunification. Stocks experienced a period of slow growth;
D. The 1993-1995 period of weakness produced by foreign investors' lack of confidence in Clinton administration prior to the fiscal discipline imposed by the new Republican Congress. Stocks were flat in 1994 and then began the 1ate 1990s bull market;
E. The short-lived 1998 drop associated with the Russian default and Long Term Capital Management debacle. Stocks fell sharply for a short period and then surged higher into early 2000;
F. The 2002-2004 drop associated with the Federal Reserve's aggressive cutting of short-term interest rates. Stocks bottomed five months after the dollar began its descent; and
G. The current drop associated with a sense the Federal Reserve will cut short-term rates and allow inflation to accelerate if the economy weakens. Stocks have reached their highest level since 2000.

Let's review. Stocks rallied strongly along with the dollar between 1995 and 1999. Stocks rallied strongly in the face of a weak dollar after 2002. The relationship is random on a disaggregated basis, too.

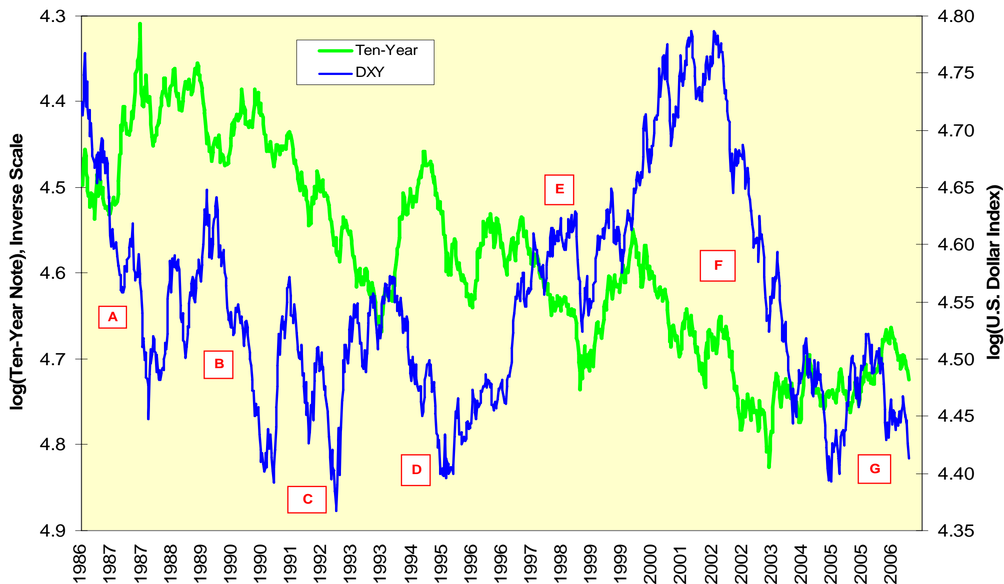
What About Bonds?

What about the persistent wail regarding the dollar and interest rates? The thinking, if we may be generous in our characterization, seems to run that as U.S. bonds get cheaper for foreign investors and their prospective currency-adjusted returns expand that they will sell their existing bond portfolios and cease financing their best customer. China, Japan, et al, cannot run a trade surplus with us without running a capital deficit. It is an accounting identity.

But this is an exercise in data analysis, not in polemics. What do the numbers say? If we create a series of returns on ten-year notes and duplicate the analysis above, we find a positive correlation between bond prices and currencies. While none of these correlations is statistically significant – we cannot say a weaker dollar leads to stronger bonds - we can reject any hypothesis that a weak dollar leads to higher interest rates.



If we compare the dollar index and ten-year notes on a logarithmic basis since 1986, we see how long-term rates (plotted inversely) have declined steadily since the 1980s with little regard to the dollar's ups and downs. The powerful bond rally between 1999 and 2003 occurred first during a rising and then during a falling dollar environment.



The weeks to come are likely to see a little more volatility than most of us desire as the market assesses growth, inflation and risk tolerance. So long as the sentiment remains the Federal Reserve will diverge from its sister central banks toward ease, the dollar is likely to remain under pressure. But whenever our financial markets have their inevitable bad-hair days, do not rush to judgment by attributing the downdrafts to the weaker dollar. Unless, of course, you have 35 years of data hidden away somewhere in support of your argument.