Stocks Won't Get Bucked By Dollar

"Freedom's just another word for nothing left to lose." -- Kris Kristofferson

When given the choice to put up or shut up, too many elect to do neither. While this may be acceptable in certain endeavors, it is or should be inexcusable in market commentary. More than enough data exist in readily accessible formats to either substantiate or refute any claim, and while this should cut down on the nonsense it does not appear to do so.

The trigger for the present righteous indignation is the connection being made between the dollar's descent and the comeuppance being posited therefrom for U.S. stocks. Never mind that markets are discounting mechanisms and that the direction of the dollar was apparent by late September, a time when the S&P 500 was 4.6% lower than present levels. Never mind that the trade-weighted dollar index has been declining since early 2002 and that arguments were presented here in May-June 2002 that the weaker dollar should not derail either stocks or bonds.

For those of you keeping score at home, the dollar index has declined 27.5% since late May 2002. The annual average total returns on the broad Russell 3000 and the Merrill Lynch Treasury Master indices since that time have been 6.27% and 5.95%, respectively.

Does It Work Anywhere?

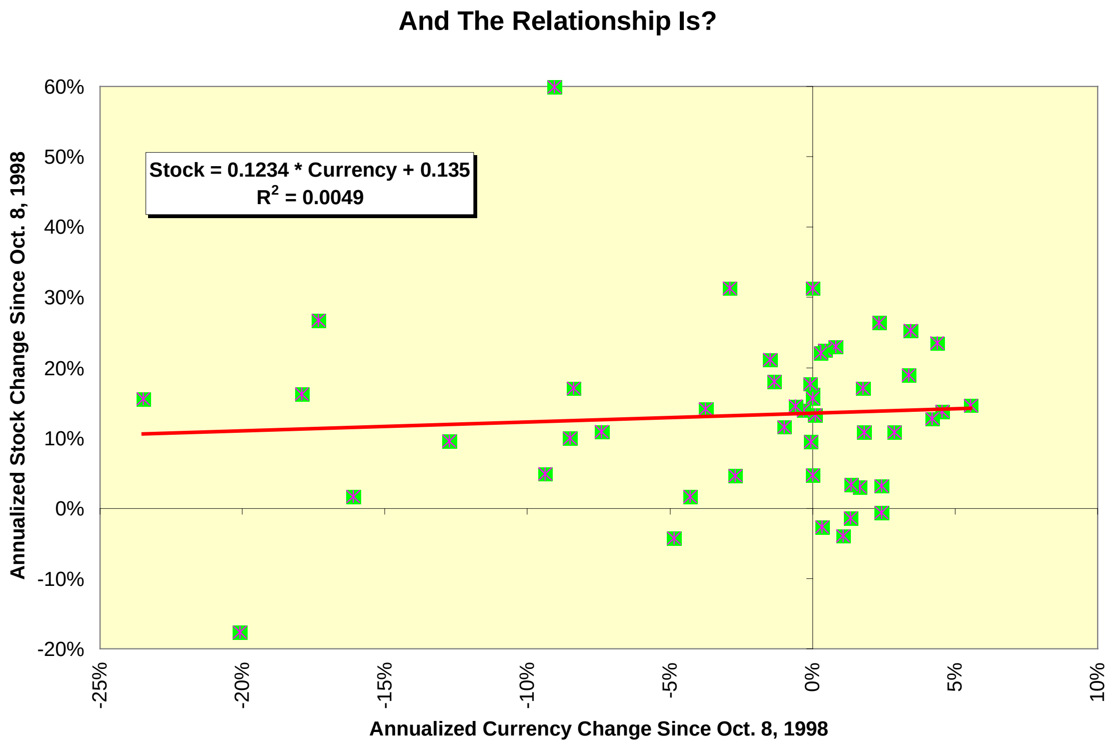
These returns are being presented, by definition, for dollar-denominated American assets. Is it possible the U.S. has been abusing its privileges and responsibilities as keeper of the world's reserve currency to sucker unsuspecting foreign investors? Is Wal-Mart nothing but a bizarre transubstantiation of a Venus flytrap, something that will attract and then ultimately devour its diligent foreign suppliers, RFID tags and all? What will happen when the rest of the world, which is composed mainly of countries whose sole purpose seems to be making me grateful to be an American, wises up and calls a halt to this tawdry exercise?

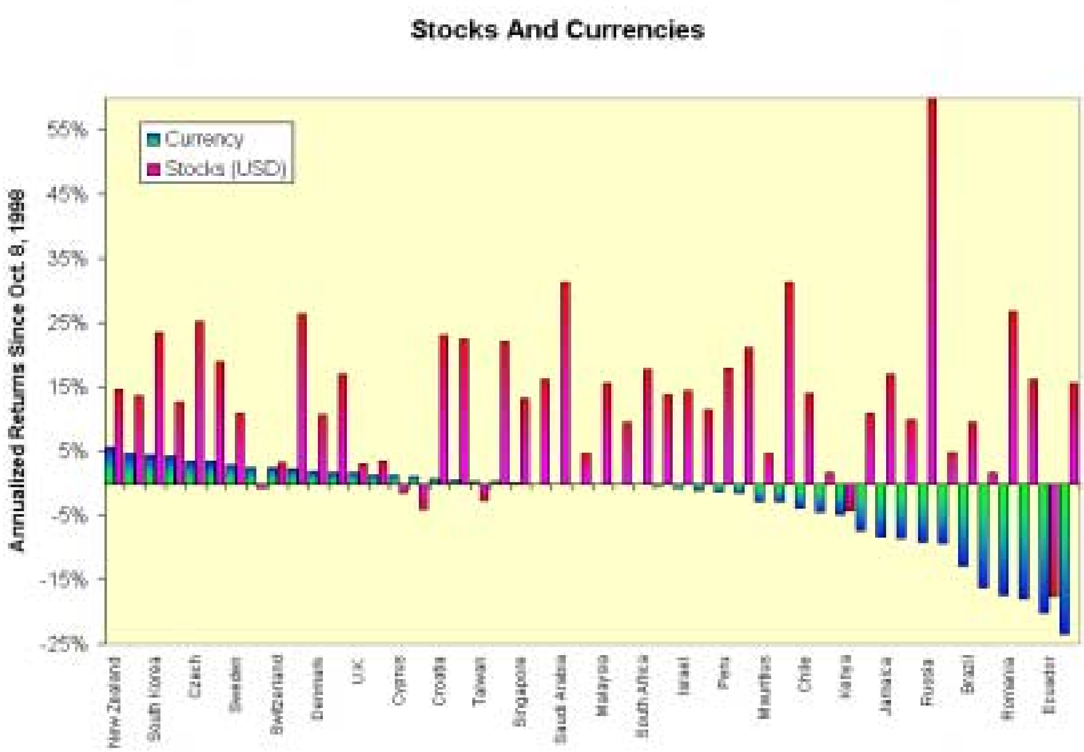
The answer here is "quite probably nothing." There does not appear to be any consistent and universal relationship between any country's currency and its stock market. I took a sample of 48 countries, their currencies' change against the U.S. dollar and their stock market returns from October 8, 1998 onwards. This start date was selected as it was the successful test of lows following the various market disruptions beginning with the July 2, 1997 devaluation of the Thai baht.

Two views of the same data are presented, a scatter diagram of stock market returns as a function of currency returns, and second, a bar chart sorted by currency returns. Neither representation suggests currency returns as a driving factor behind equity returns. The r-squared of this relationship is .49%, which means you cannot even explain one-half of one percent of stock market variance with currency variance.

The worst performing currency in the sample was the Turkish lira, which lost value to the dollar at an average annual rate of 23.49%. Its stock returned 15.55% in dollar terms to a U.S. investor; the U.S. market, by contrast, returned 4.70% over the same period.

The best performing stock market in the period was Russia, with annual dollar returns of 59.95%. The Russian ruble lost value to the dollar - and this was after their 1998 default - at an annual rate of 9.05%.

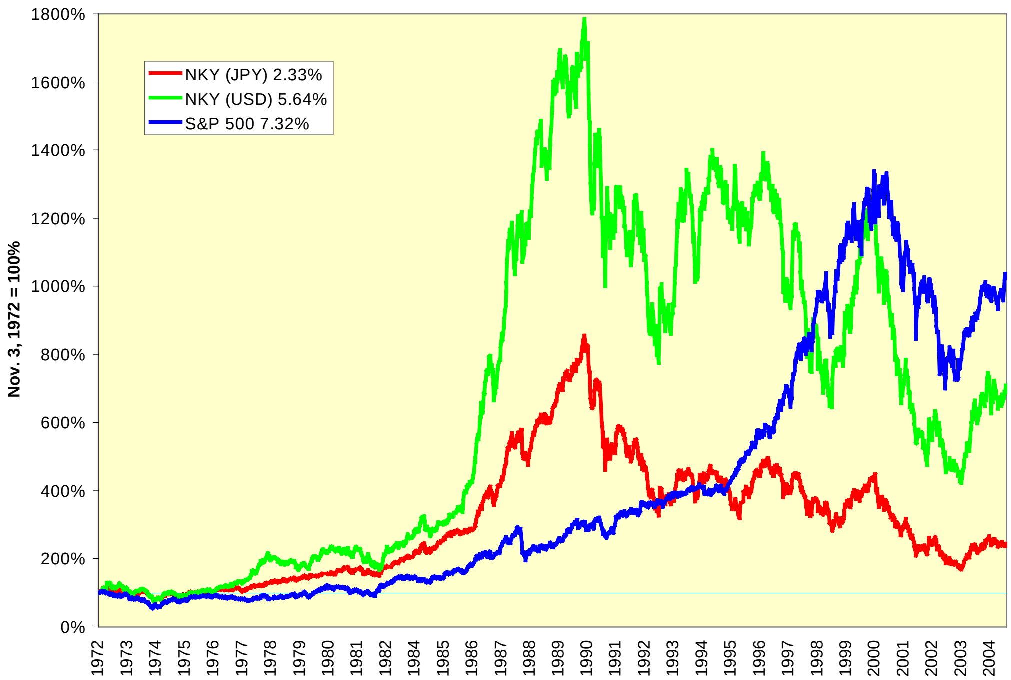




Never Worked, Never Will

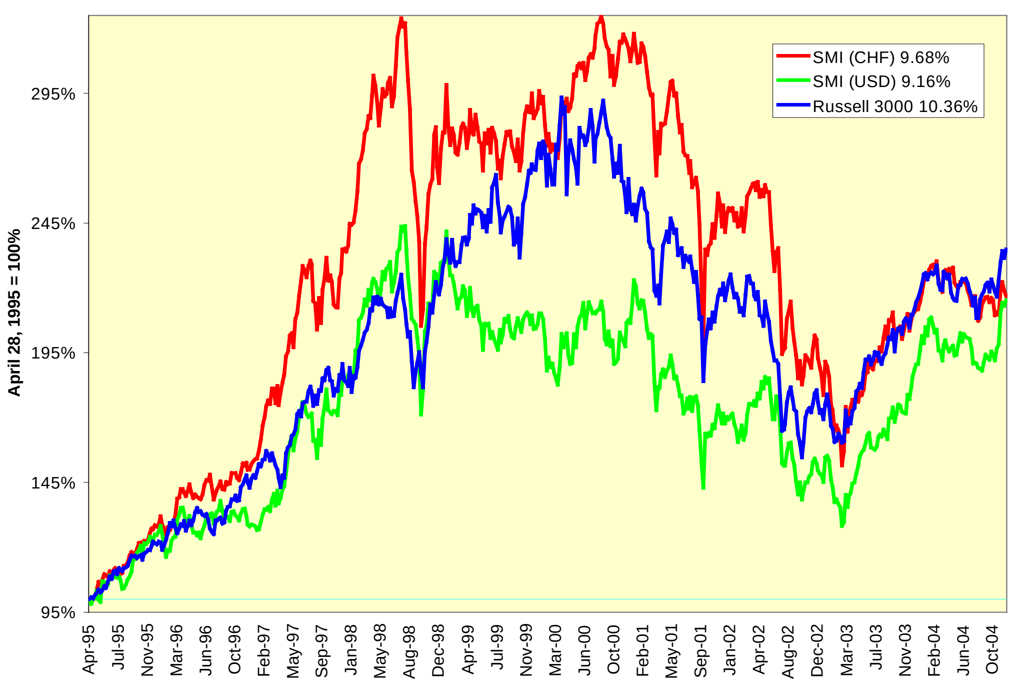
The infelicity of those who argue a connection between currencies and equities can be demonstrated further with several long-term case studies. Let's begin with Japan, a country in permanent trade surplus with the U.S. and one whose currency has appreciated by nearly 300% against the dollar since November 1972. How have the relative performances of the Nikkei 225 and the S&P 500 (this data sample predates the Russell 3000 that will be used in other examples) been over this period? Let's just say the tortoise has once again beaten the hare.

U.S. Stocks Outshine Rising Sun

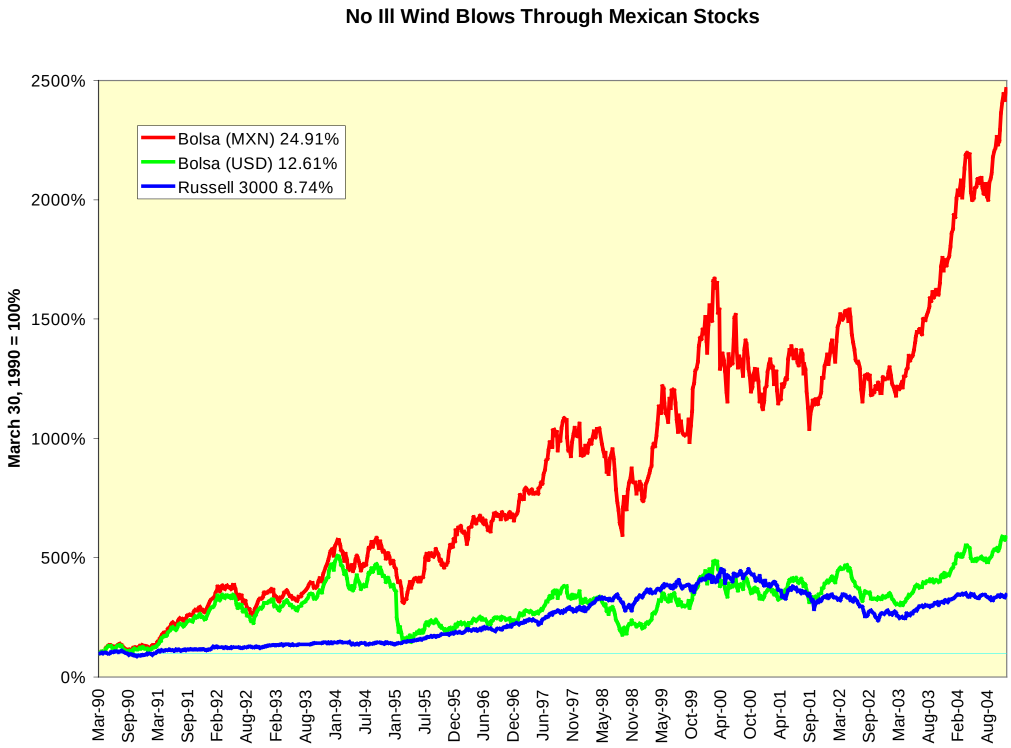


Oh, but that is Japan, you say. Bubble economy and all that. Well, the Swiss franc has been virtually unchanged since the April 1995 start of the Swiss Market Index, and the Russell 3000 has outperformed it, with the final kick higher coming during the last two months of dollar weakness.

Do Swiss Miss Weaker Franc?

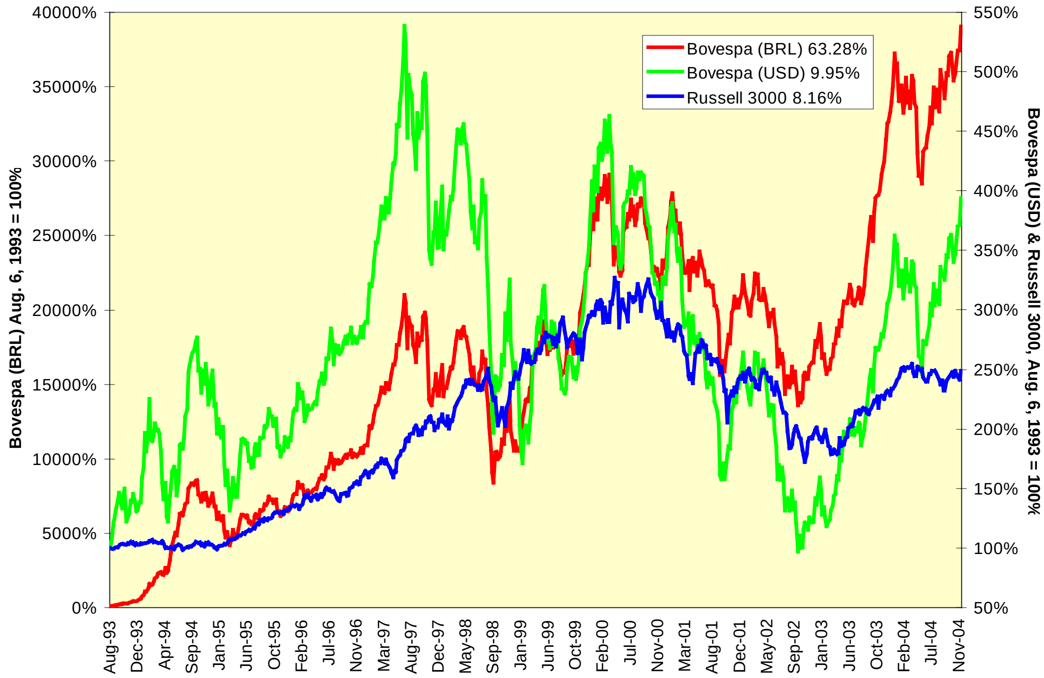


It works the other way, too. The Mexican peso has been refried and poured into a margarita blender several times in its history. In dollar-adjusted terms, though, you would have been better off keeping your money in Mexican stocks.



Ah, but Mexico has a special advantage with NAFTA, right? Who can forget Ross Perot's "giant sucking sound" as all those manufacturing jobs were going to depart to Monterrey? Never mind that the manufacturing wound up in China and the white collar outsourcing wound up in India, Ross was sure it was going to happen. Let's take Brazil, then, a country whose deliberate devaluation of the real got out of control in January 1999 and whose depreciation is such that the chart below has to have a separate scale for the BRL-denominated Bovespa index. Here, too, your dollars gained more in Sao Paulo than in New York. The scenery was better, too.

Profits Flying Back From Rio



None of this is to argue for a policy of currency devaluation to reward equity investors. Like John Snow, I would like to see a stronger dollar; it encourages price stability and provides greater certainty for investors of all origins. But as I have stated dozens of times before, markets to not prefer any specific level of any macroeconomic variable so much as whether it was derived fairly. A strong dollar created by too-high short-term interest rates will do nothing to encourage future growth or to convince foreign investors that no future large-scale depreciation will occur.

Those who continue to opine why U.S. stocks are going to suffer from the present course of the dollar have the same data available to them. Surely they can buttress opinion with facts.