

The New Iron Cross

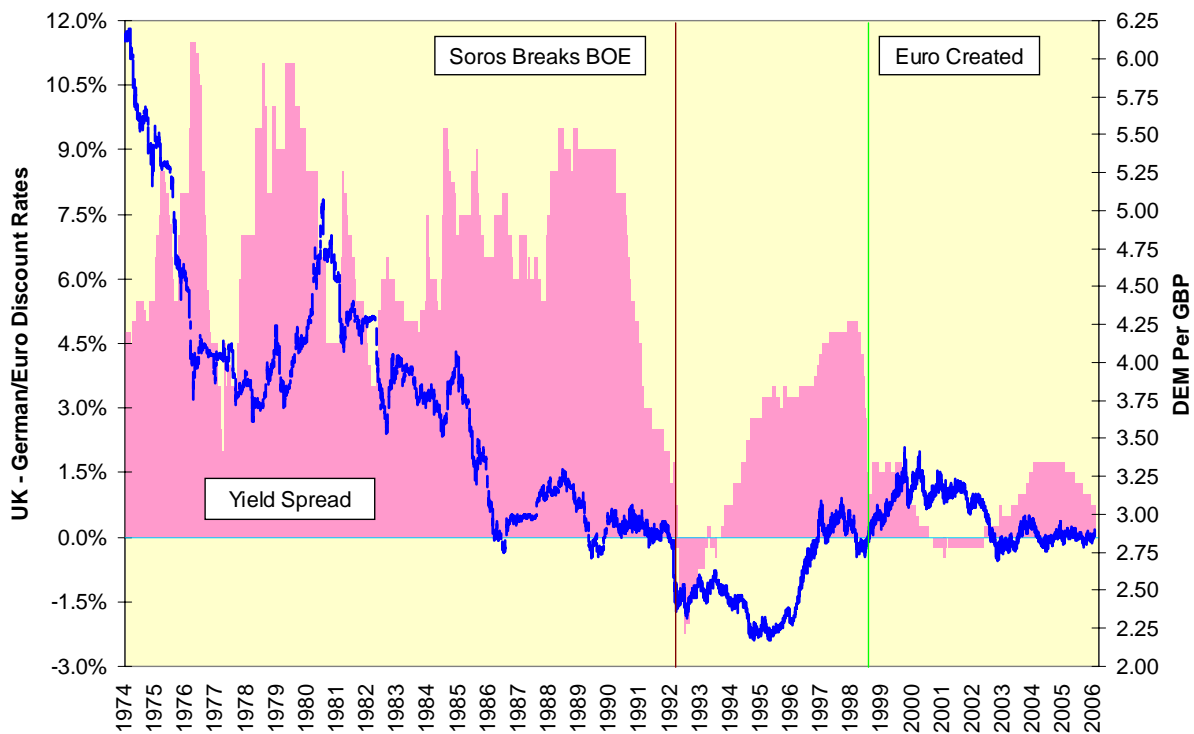
One of the downsides about being in the trading business for any length of time, and that includes the analysis of economic and financial history is the constant reminder of human foibles. Given that this author has described the entire history of currencies going back to the original barter standard as the financial version of Original Sin, we should be able to take any long-dated currency market, look back, and weep.

Another downside, as long as we are at it, is how little the world's governments care about market analysts. They change parameters constantly, re-base economic time series, add and drop data reports and, in the granddaddy of all indignities, created the euro. Not that they had much choice in the latter matter; the two decades between the adoption of flexible exchange rates at the Smithsonian Agreement in March 1973 and the adoption of the Maastricht Agreement in February 1992 were characterized by one currency crisis after another in Europe.

The problem of multiple currencies within a tightly linked economic zone with widely disparate politics and cultures was insoluble. At best, attempts to maintain currencies within a band involved wildly swinging short-term interest rates as nations sought to defend an artificial exchange rate. You can fix an exchange rate, or you can fix interest rates, but you cannot fix both simultaneously.

This history certainly is visible in the long history of the cross between the British pound (GBP) and the Deutsche mark (DEM) and later the euro (EUR). Prior to 1992, the spread between the Bank of England's base lending rate and the Deutsche Bundesbank's discount rate was volatile to say the least. It generally ranged between a 3% and 10% premium to the British side; even this was insufficient to present a long slide in the GBP relative to the DEM. The so-called Iron Cross fell from more than 6 to a target level of 3, and this target level of 3 DEM/GBP collapsed spectacularly in September 1992 when George Soros and others bet correctly the British Exchequer would be unwilling to keep interest rates high enough to maintain the exchange rate.

The Iron Cross, Past And Virtual

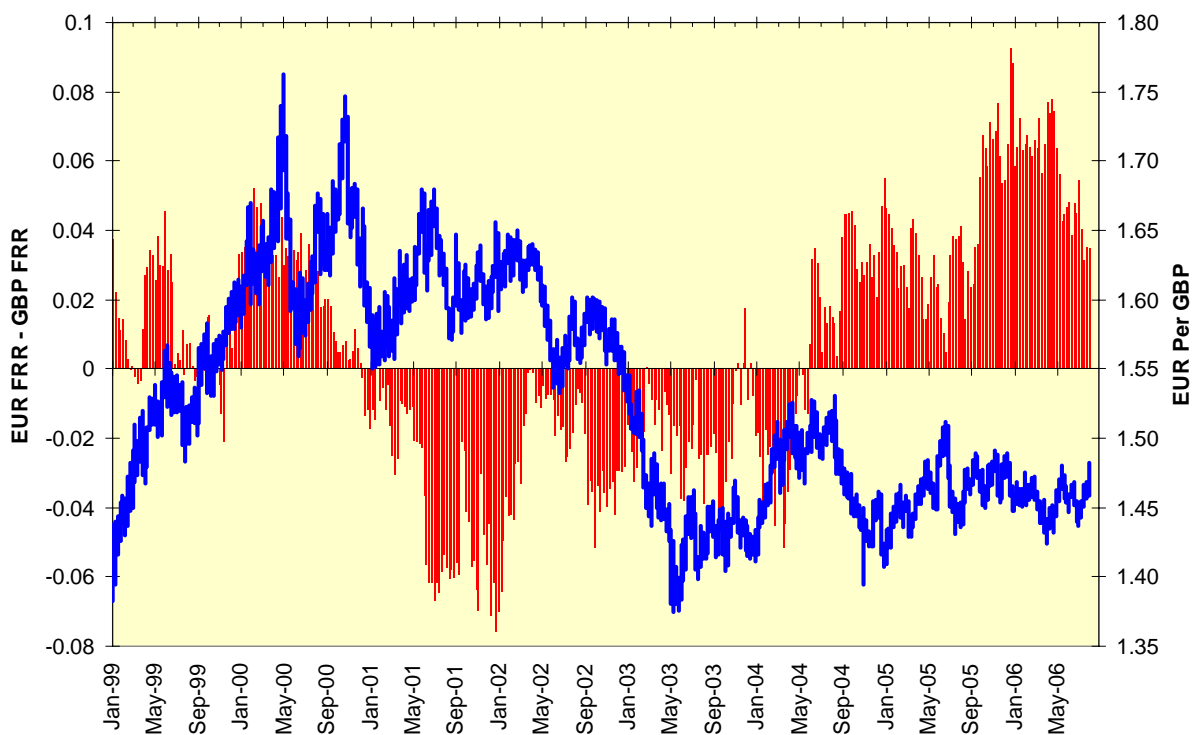


The Iron Cross eventually firmed as part of the pan-European convergence trade of the mid-1990s. Once the DEM was fixed into the EUR in January 1999, the new Iron Cross quieted into a narrow trading range of roughly 2.75 – 3.00 almost without regard to the relative movement between the U.K. base lending rate and the European marginal lending rate, the successor to the old Bundesbank discount rate.

Once the EUR came into existence, so did EURIBOR, the LIBOR rate for the common currency. We can compare the forward curve for EURIBOR with Sterling LIBOR, a parallel construct for the GBP. As we have done several times in these columns, we will use for forward rate ratio from six to nine months ($FRR_{6,9}$) as our metric for monetary policy expectations. This FRR is the rate at which we can borrow for three months starting six months from now, divided by the nine-month rate. The more this FRR exceeds 1.00, the greater the expected degree of monetary ease.

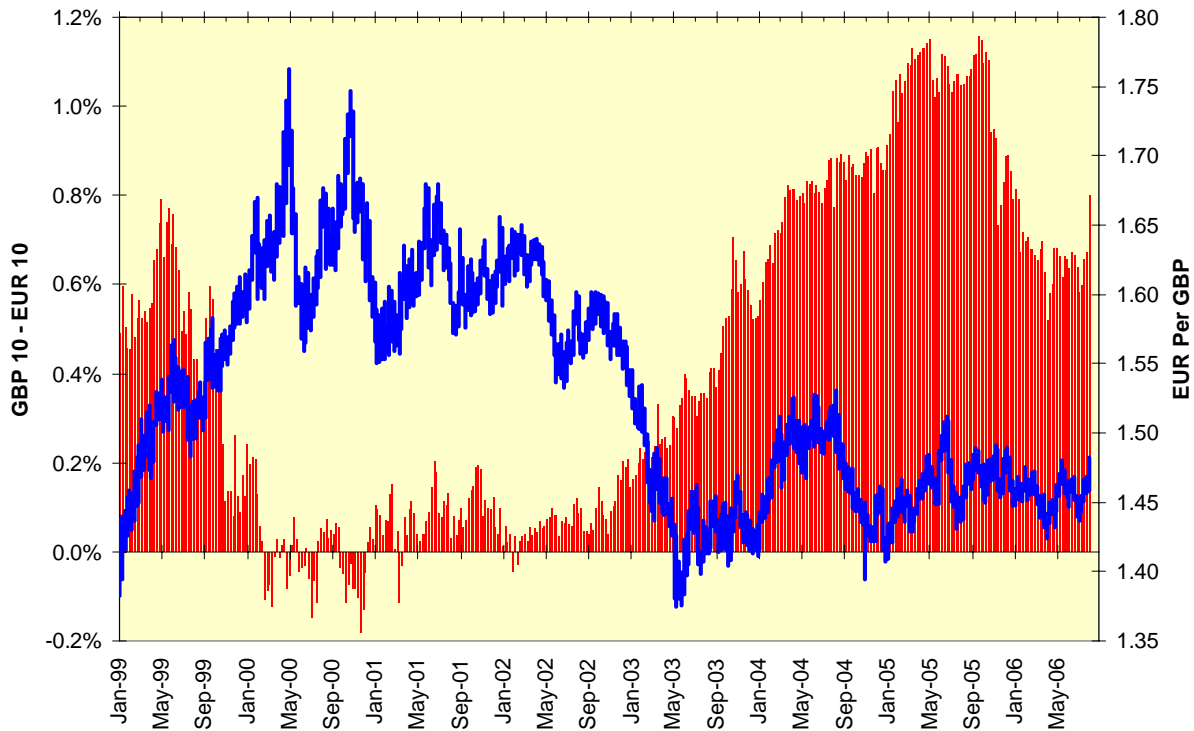
The difference between the EUR and GBP FRRs measures relative expected changes in monetary policy. If the difference is positive, as it was during 2004-2006, the market expects future tightening in British monetary policy relative to Eurozone monetary policy. This relative tightness has helped maintain the GBP-EUR cross-rate in its tight range much like the intentions of the pre-1992 BOE policies. If the opposite holds, as it did throughout 2001, the market is expecting relative ease in British monetary policy. This ease preceded a weakening in the GBP-EUR cross-rate. Markets are discounting devices: It is not the instantaneous measure that matters so much as the expected measure; no other explanation can explain the tight range of the new Iron Cross.

Relative Monetary Expectations And Pound-Euro Cross



A similar pattern can be seen at the capital market horizon. The rate spread between British and European ten-year notes was quite narrow between 2000 and 2002, the period preceding the sharp weakening of the GBP. Once Gilt yields started to rise relative to Euro bonds, the cross-rate stabilized.

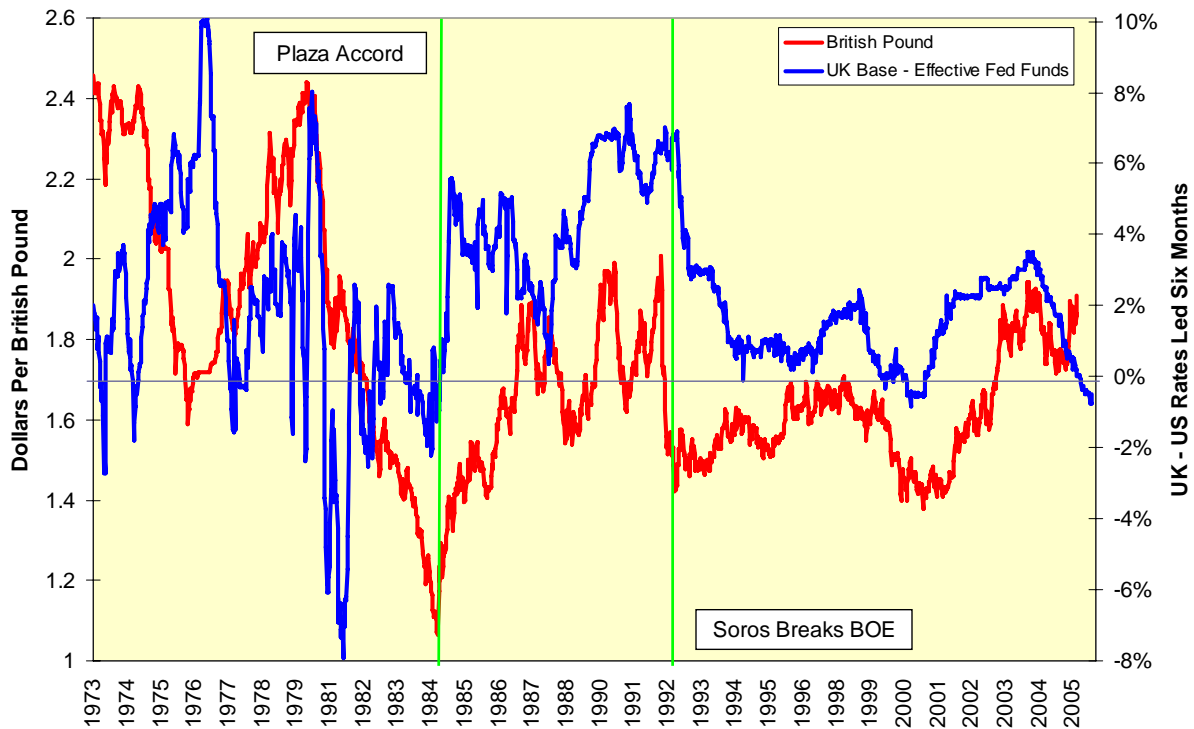
Bond Yields And Pound-Euro Cross



Not Created Equal

The extent to which the Iron Cross differs from the GBP-USD exchange rate can be seen as well in terms of the long-term interest rate history. Here the seminal event was neither the Maastricht Treaty nor the creation of the euro, but rather the 1985 Plaza Accord, a concerted agreement to weaken the USD in the vain hope such a move would correct the persistent U.S. current account balance. To say this agreement failed in this intent two decades after the fact is an understatement of the first order. It did succeed in creating violent moves in U.S. short-term interest rates and helped precipitate the 1987 stock market crash, so in fairness it did achieve some results.

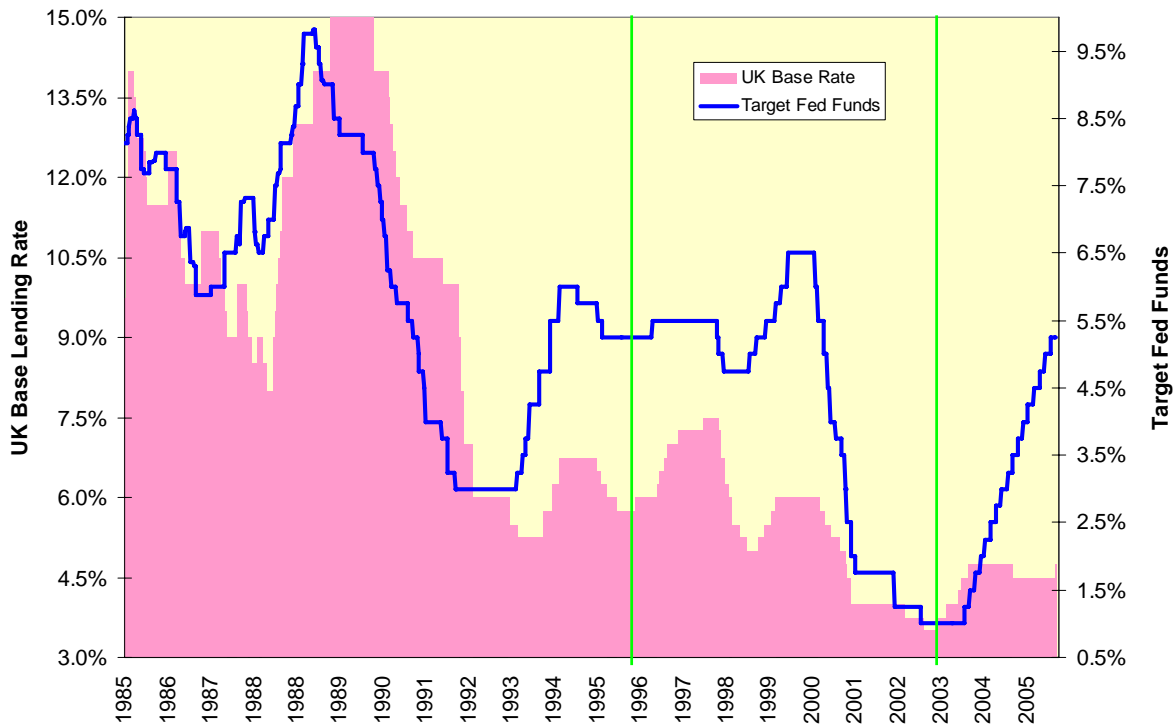
Interest Rate Differentials Had Favored Dollar



After the Plaza Accord, the GBP rose sharply against the USD, but there was no appreciable decline in relative short-term interest rate volatility as measured by the spread between the U.K. base lending rate and the effective federal funds rate in the U.S. That volatility declined only after September 1992. After this date, this interest rate spread led changes in the GBP-USD exchange rate by six months on average.

The greater volatility of the U.K. base lending rate has led many to conclude, erroneously, that the Bank of England is some sort of stalking horse for the Federal Reserve just as the Bank of Belgium often was for the Bundesbank prior to the introduction of the EUR. Only twice after the Plaza Accord, in June 1996 and again in February 2004, did a rate hike by the BOE precede one by the Federal Reserve. The opposite is not quite as strong; a prolonged move in one direction by the Federal Reserve often leads a similar directional move by the BOE. This has yet to happen after the Federal Reserve's long string of rate hikes in 2004-2006.

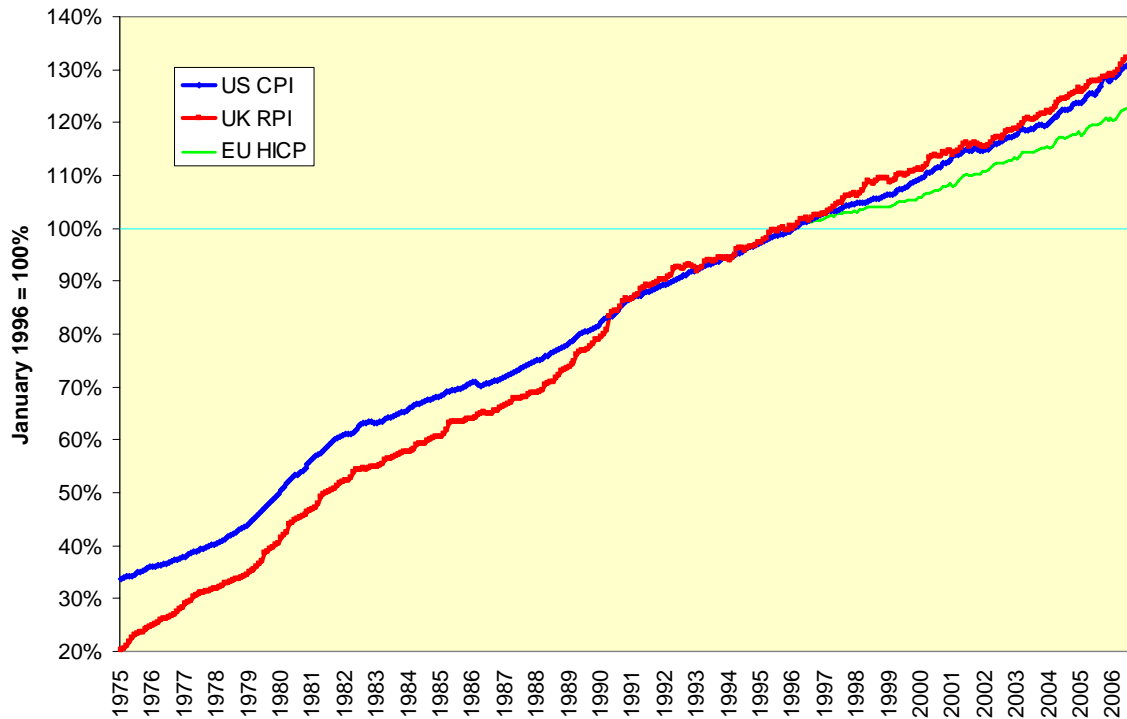
The BOE Seldom Leads The Federal Reserve



Differential Inflation

One of the reasons behind these numerous asymmetric and weak relationships between monetary policies and currency movements is different rates of inflation in the U.S., U.K and in the Eurozone. If we compare the American consumer price index, the British retail price index and the Euro harmonized index of consumer prices (can those bureaucrats in Brussels come up with catchy names, or what?) over the last three decades – just one for the HICP – we find the British have the greatest endemic problem with inflation. It has exceeded the U.S. rate since comparable data are available in 1975 and the HICP since the latter's origin in 1996. All else held equal, a higher rate of inflation should lead to both higher nominal interest rates and pressure for a weaker currency in their absence. This has been confirmed by historic experience.

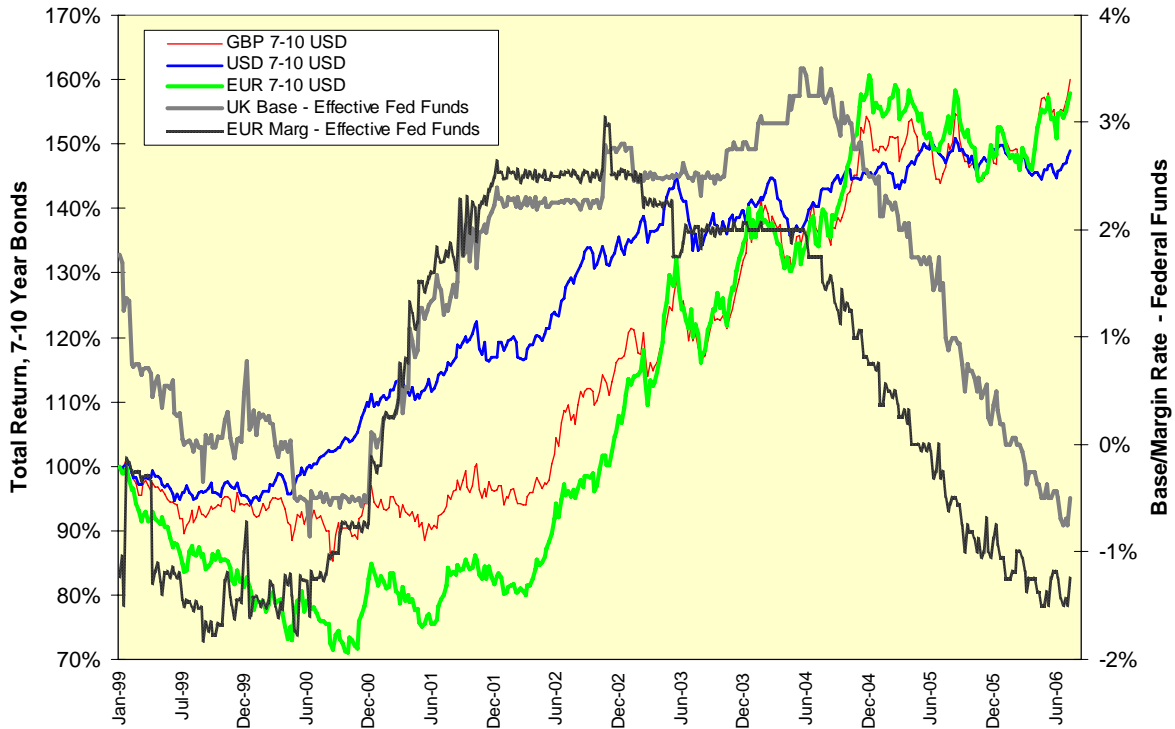
Comparative Consumer Inflation



Investors' Final Word

Markets often produce counterintuitive results. We have seen greater volatility in British monetary policy, higher British inflation and a currency seemingly dependent on higher interest rates relative to both the USD and EUR for stability. Sounds like a good place to avoid, does it not? No: If we take the total return for American, British and Euro ten-year notes translated back to USD since January 1999, we find the British bonds have the highest total return. The reinvestment at the higher short-term rates – please note in the chart below how the U.K. base lending rate remains the highest of the three central bank rates – accounts for this paradox. Which bond had the lowest total return? That would be the American ten-year Treasury; the low short-term interest rates of 2001-2005 lowered the reinvestment component.

Monetary Policy And Relative Bond Returns



This greater currency-adjusted return for the British bonds has to be some sort of odd revenge of the law of unintended consequences. We see this Law repeat itself through the study of market history. We can learn all about human foibles therefrom, but anyone who is willing to bet an understanding of the self-defeating nature of economic policy will lead decision-makers to cease, desist and abandon their hubris is likely to lose a lot of money in a short period of time.