

## Currencies And Relative Stock Market Performance: Part II

The contribution of various currencies to country-specific relative stock market performance was studied last month for Canada, the European and the Africa/Middle Eastern currencies. This month we will conclude the study for the Latin American and Asian currencies.

We concluded last month:

*Two conclusions emerge from the data analyses above. The first is national stock markets tend to have strongly positive relative performance betas to their own currencies. This flies in the face of all those who persist in believing, for example, a weak dollar benefits the U.S. stock market.*

*The second is strong currencies tend to induce negative performance effects on the U.S. stock market. Perhaps this is an artifact of the general underperformance of the larger stock markets noted at the beginning of the article. But perhaps something deeper is at work: When investors gain confidence in their own currency, they tend to hold it and invest in their own markets.*

### Methodology

To refresh, Morgan Stanley Capital International maintains a set of country-specific total return indices in both local currency and U.S. terms. Included is a global series. MSCI maintains separate European-country indices in addition to a Eurozone index; we will use the Eurozone index below.

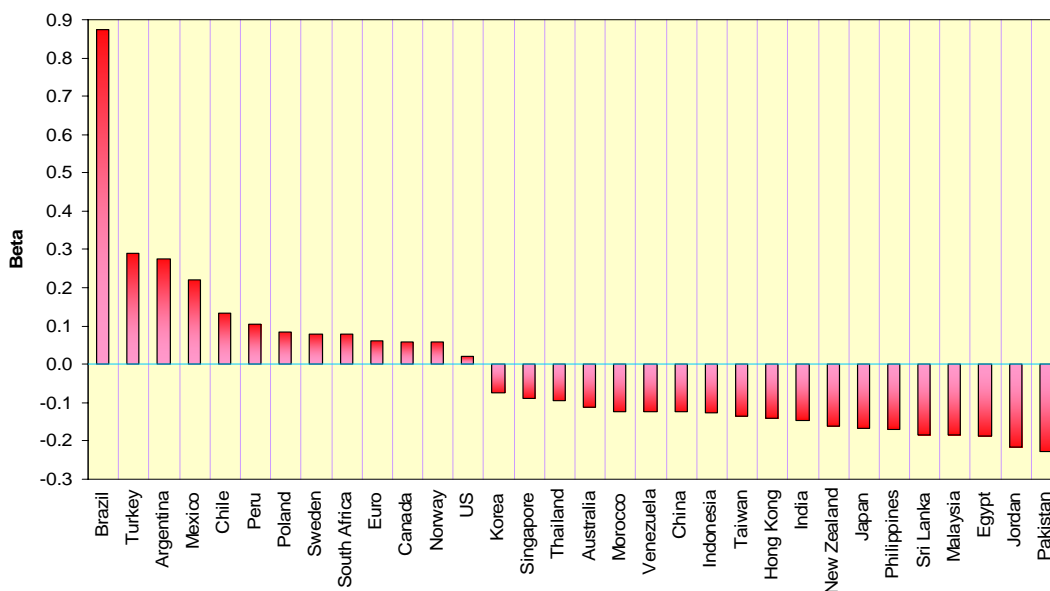
If we index each of these series' relative performance to the global series, we can test each of them against all of their underlying currencies to see which currencies have a statistically significant contribution (90 percent level) to which country-specific relative performance indices. The regression is of the returns of the country-specific index' performance against the world index as a function of the returns on each currency.

Each of the charts below depicts the statistically significant regression betas of relative performance indices against a specific currency. The more positive the beta, the stronger the degree of positive contribution; the more negative the beta, the stronger the degree of negative contribution.

### Latin America

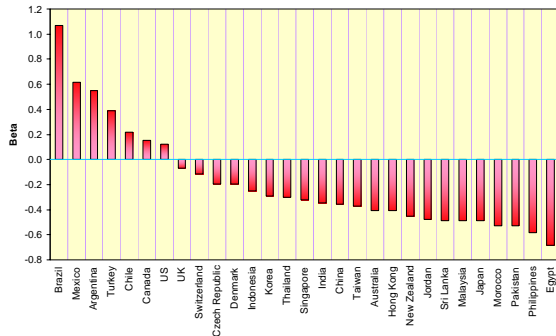
In what has to be the most surprising economic turnaround this millennium, Brazil has turned from an economic backwater to a powerhouse under the leadership of Luiz Ignacio Lula da Silva, an avowed socialist. In a pattern we saw often last month, the biggest beneficiary of a strong BRL is the Brazilian stock market itself. The other major Latin economies, such as Argentina, Mexico and Chile benefit as well, as does much weaker Peru.

**Influence of Brazilian Real On Relative Performance Betas**

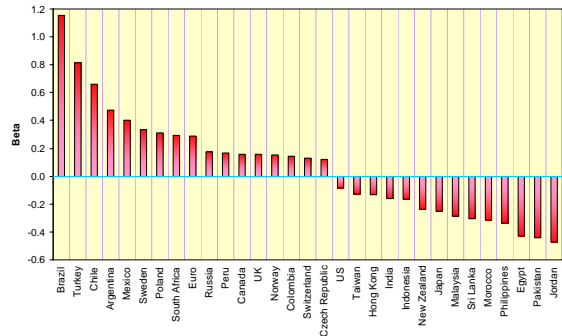


We see a similar pattern for the Mexican peso. In addition to Mexico itself, Brazil, Argentina and Chile benefit from a stronger MXN. And, just as was the case for Brazil, the relative performance betas for the Asian, European and Africa/Middle East countries are negative. Chile, which has benefited greatly from the surging price of copper, shares the pattern of positive relative performance betas for its fellow Latin countries, but a large number of European countries have a positive relative performance beta to the CLP, too. The linking variable here is industrial demand for copper pulling both the CLP and the European stock markets higher simultaneously.

Influence of Mexican Peso On Relative Performance Betas

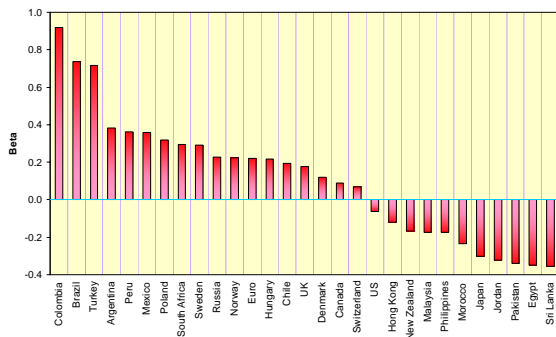


Influence of Chilean Peso On Relative Performance Betas

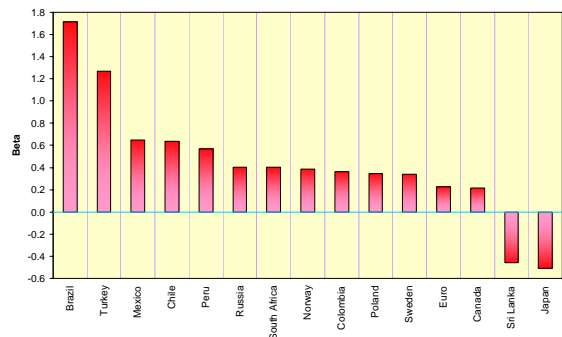


Colombia has been an interesting case in point; its stock market has led the universe of forty markets analyzed on a USD total return basis since May 2001. Colombia's economy, all jokes aside, is distorted by the massive trade in illegal drugs. Even though the country has become a major exporter of crude oil in addition to commodities such as coffee, we have to assume we are not getting the whole story. Even so, its pattern of relative betas is similar to that of Chile. The other three Latin countries in the study, Peru, Venezuela and Argentina exhibit little in the way of external influence. In fact, these three probably qualify for the admonition if you cannot say something nice, then do not say anything at all.

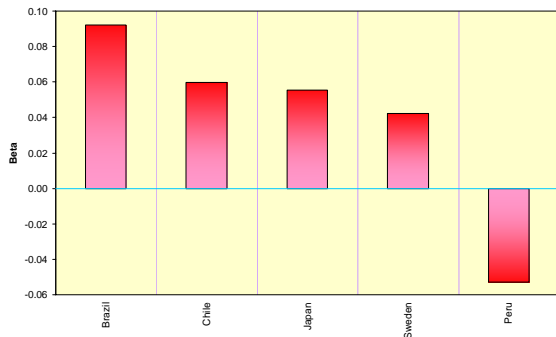
Influence of Colombian Peso On Relative Performance Betas



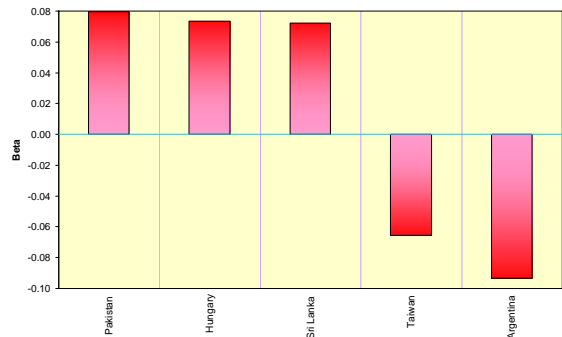
Influence of Peruvian Sol On Relative Performance Betas



Influence of Argentine Peso On Relative Performance Betas



Influence of Venezuelan Bolivar On Relative Performance Betas

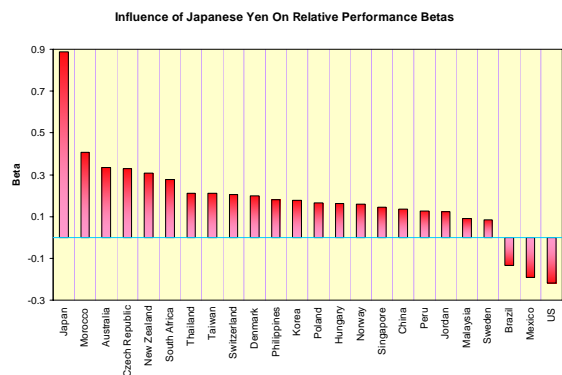
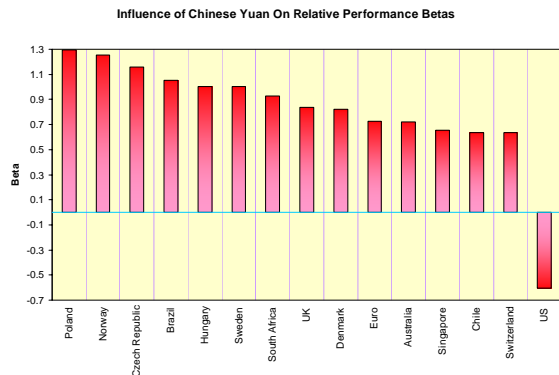


## Asia

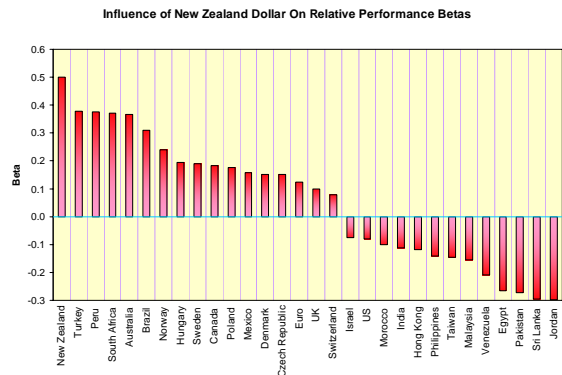
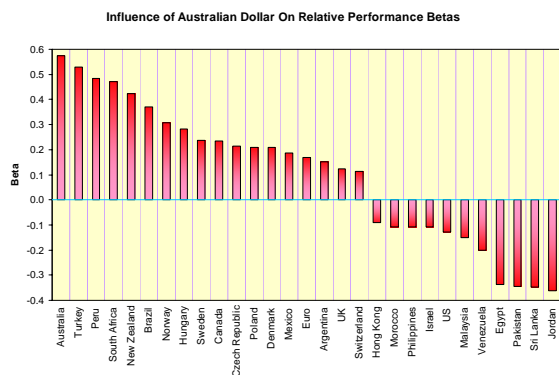
The key fact about Asian currencies is the Chinese yuan was pegged to the dollar into July 2005, and has remained conspicuously undervalued since then. Of course, China is hardly alone in the currency manipulation department; Japan has managed the yen for years. To what avail is, of course, the valid question.

The yen has negative relative performance betas against both the U.S. and Mexico, but positive performance betas elsewhere. For all of the complaining Japanese exporters do when the yen strengthens, Japanese stocks outperform when the yen rises. The yuan has a negative relative performance beta against the U.S. as well. Interestingly, it has

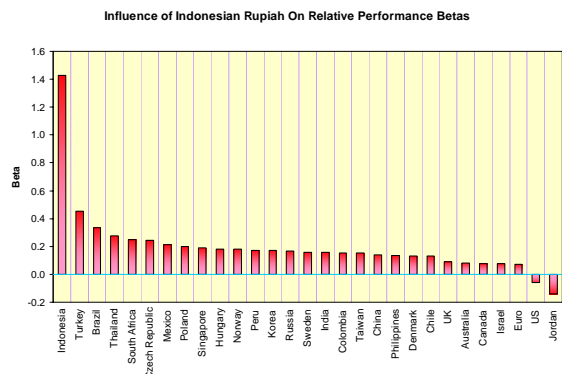
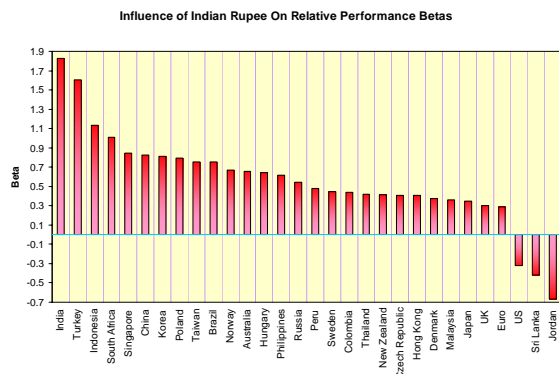
positive relative performance betas against all three Nordic countries, the U.K. and Poland, but not against any of the members of the Eurozone.



Australia's economy has a strong commodity export sector, particularly to East Asia. Fittingly, it has positive relative performance betas against fellow commodity exporters such as South Africa and Canada, but also against a large number of European countries. Both it and the New Zealand dollar have negative relative performance betas against South Asian and Middle Eastern countries.

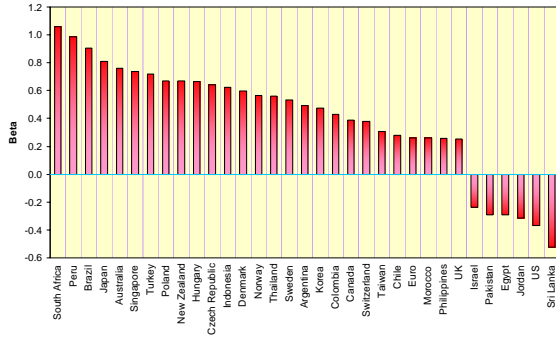


India is turning into an economic powerhouse after a half-century failed experiment with socialism. The rupee has negative relative performance betas against the U.S., Sri Lanka and Jordan, and positive relative performance betas to nearly everyone else. India, in a marked contrast to China, has decided to let the INR revalue relatively freely. In an odd twist given their highly dissimilar economies, the Indonesian rupiah has a nearly identical set of relative performance betas.

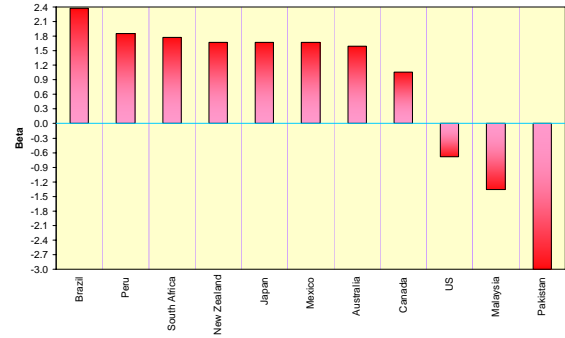


The two great Asian city-states of Singapore and Hong Kong have widely different sets of relative performance betas; the Singapore dollar trades far more freely than does the largely pegged Hong Kong dollar, and therefore has stronger statistical relationships to various equity markets. The Singapore dollar has negative relative performance betas against the U.S., and an odd mix including Sri Lanka, Jordan, Israel and Egypt. Hong Kong's small set of statistically significant relative performance betas have no identifiable patterns.

Influence of Singapore Dollar On Relative Performance Betas

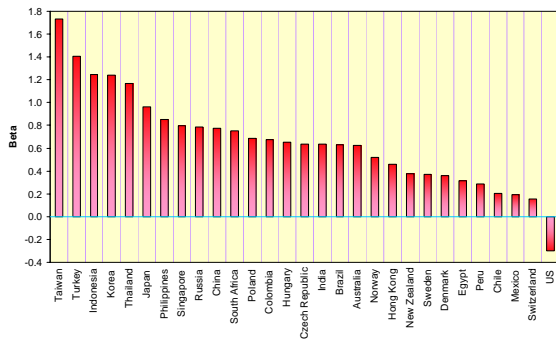


Influence of Hong Kong Dollar On Relative Performance Betas

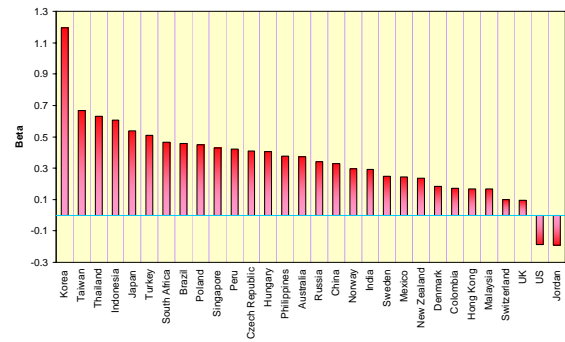


Both Taiwan and South Korea have major export sectors, largely to the same final markets. In both cases, their currency has a negative relative performance beta to the U.S. and a positive relative performance beta elsewhere. The same pattern is seen for the Thai baht, but the Malaysian ringgit has a pattern more similar to the Indian rupee and Indonesian rupiah than to these export-oriented East Asian economies.

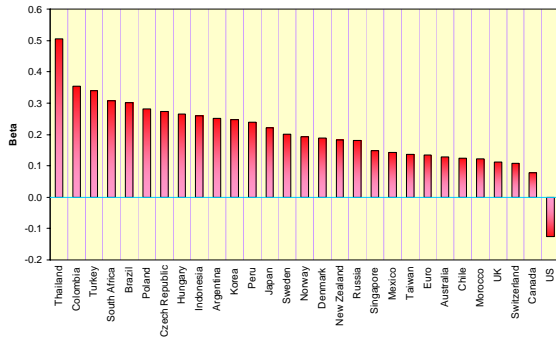
Influence of Taiwan Dollar On Relative Performance Betas



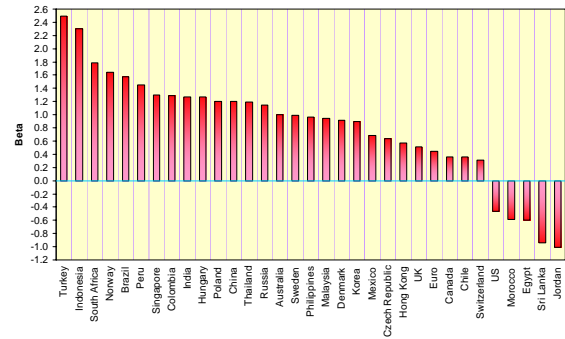
Influence of Korean Won On Relative Performance Betas



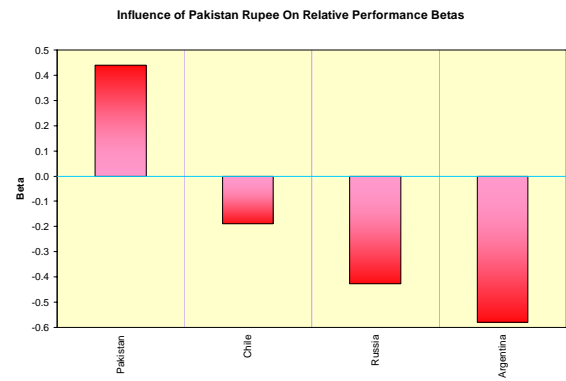
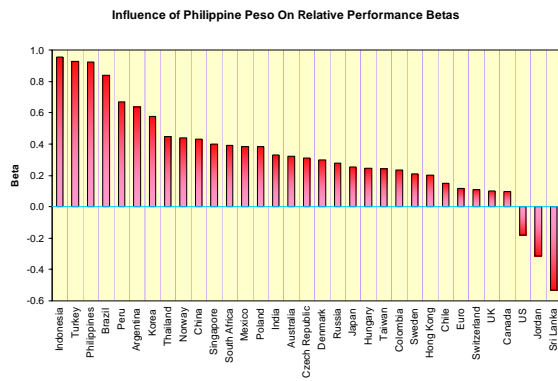
Influence of Thai Baht On Relative Performance Betas



Influence of Malaysian Ringgit On Relative Performance Betas



The Philippine peso also has a set of relative performance betas similar to the MYR, the INR and the IDR. All of these countries have large internal markets as well as a strong export orientation, so the rise and fall of their currencies tend to reflect returns on national assets and internal interest rates more than external factors. The same cannot be said for Pakistan or for Sri Lanka, the one country not accompanied by a chart as its relative performance beta extends to itself only. The Pakistan rupee has a statistically significant relationship with only four other stock markets, one of which is Argentina, a fellow economic morass.



We can reinforce the conclusions reached last month for Canada, Europe and Africa/Middle East and add a few observations. The yen carry trade has been a critical part of the international financial landscape for more than a decade, and we see a strong correlation between emerging market currencies and those emerging stock markets linked strongly to the yen carry trade such as Turkey and Argentina.

We also see a bifurcation between countries whose economies are dominated by exports and those with strong internal demand. The former tend to have negative relative performance betas only to a small number of countries, the U.S. in particular, while the latter have a wider range of relative performance betas.

But most critically we reach the same conclusion as before: Despite the perpetual temptation to competitive devaluation and export-led growth, those countries whose economies strengthen see their stock markets outperform the global index. The next time a U.S. Treasury Secretary recites the mantra a strong dollar is in the interests of the U.S. he should mean it.