

Be Careful About Trading Stocks Off Of Currencies

The question, “Who are you going to trust, me or your lying eyes?” really has only one answer when it comes to financial markets, and that is, “Neither. I will trust the numbers.” Why, then, do so many ignore this obvious answer and make sweeping generalizations based upon small and confined historic samples when a little data analysis would suffice?

One generalization sweeping the markets of late is U.S. equities and something called “the dollar” are joined at the hip, with stocks and foreign currencies rising in tandem in response to loose monetary policies. How different this association is from [five](#) or even [three years ago](#), when the worry was stocks were going to collapse as the dollar weakened.

What, exactly, is “the dollar?” Many use the dollar index (USDX) as shorthand, and while this is well and good, we have to remember the USDX is an amalgam of six different currencies whose weights have been fixed since 1973. The euro and its predecessors are the largest component at 57.6%, followed by the Japanese yen (13.6%), the British pound (11.9%), the Canadian dollar (9.1%), the Swedish krona (4.2%) and the Swiss franc (3.6%). The internal correlation of these components is anything but stationary, as recent examinations of the cross-rates between the euro and both the [British pound](#) and [Japanese yen](#) have indicated.

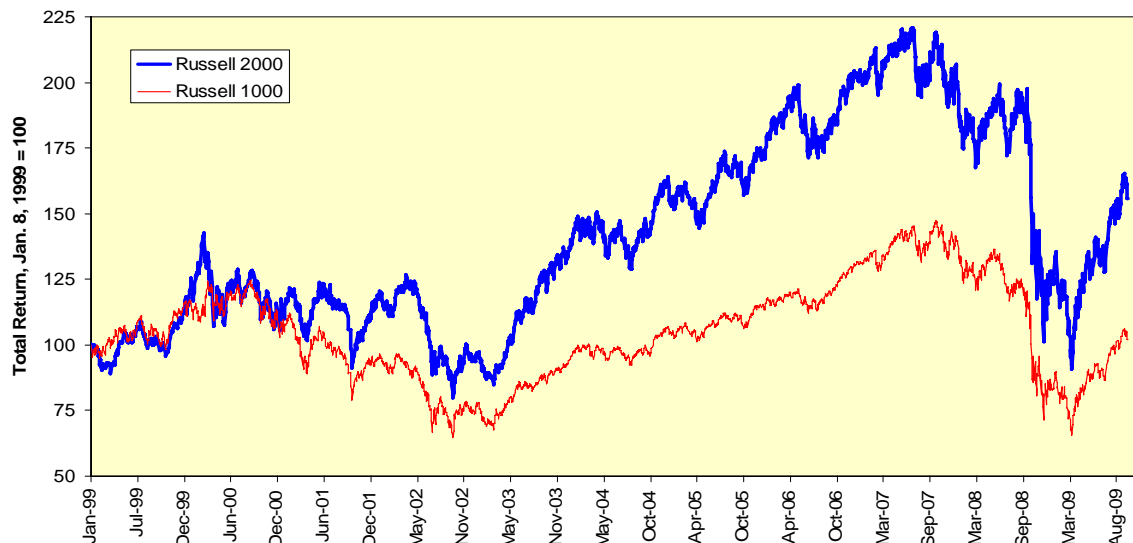
This suggests we should look at the effects of individual currencies against the U.S. equity markets as opposed to the single impact of the USDX. We will look at the euro, yen and Canadian dollar separately. In addition, as some persist in alleging a weak dollar is a boon to firms with large overseas operations, let’s split the analysis on the stock side into the large-capitalization Russell 1000 and small-capitalization Russell 2000 indices.

Both the individual currencies and the Russell indices will be examined on a total return basis, with the total return for the currencies based on a continuous short position in the dollar and a continuous long position in the currency.

The Russell Split

We last examined the spread between the Russell 1000 and 2000 indices in [August 2008](#) and concluded much of the difference in behavior was based on different sector weightings in the two indices. After the markets broke in September 2008, the Russell 2000 lost much more on a total return basis. A glance at the chart below would steer you in the direction of thinking the different currency factors would affect the large and small capitalization indices very differently, but that would be you believing your lying eyes.

Comparative Total Return Paths For Russell Indices

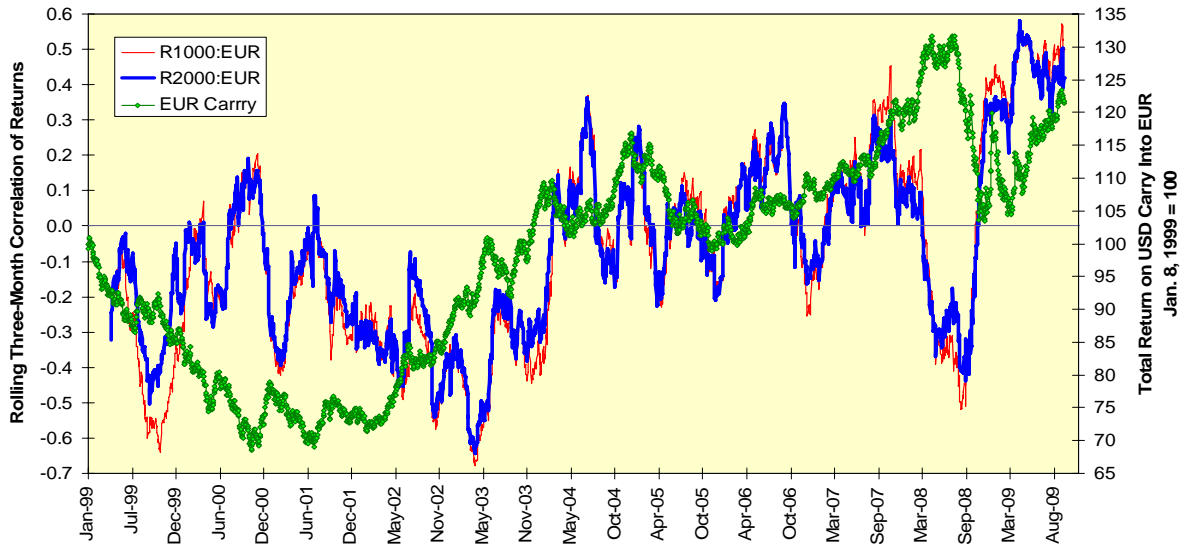


Correlation Of Returns Against Currencies

Now let’s map the rolling three-month correlation of returns for these Russell total return series against the total return for the dollar carry trade into the selected currencies. For each of the charts below the correlations for the Russell 1000 and 2000 series are in red and blue, while the currency carry trade’s return index is in green.

In the case of the euro, the correlations of returns since the financial crisis of a year ago have moved to all-time highs against both Russell indices. Nothing in the history since the advent of the euro in January 1999 even compares to it on the positive side; on the negative side, the correlation was more extreme during the latter stages of the 2001-2003 bear market.

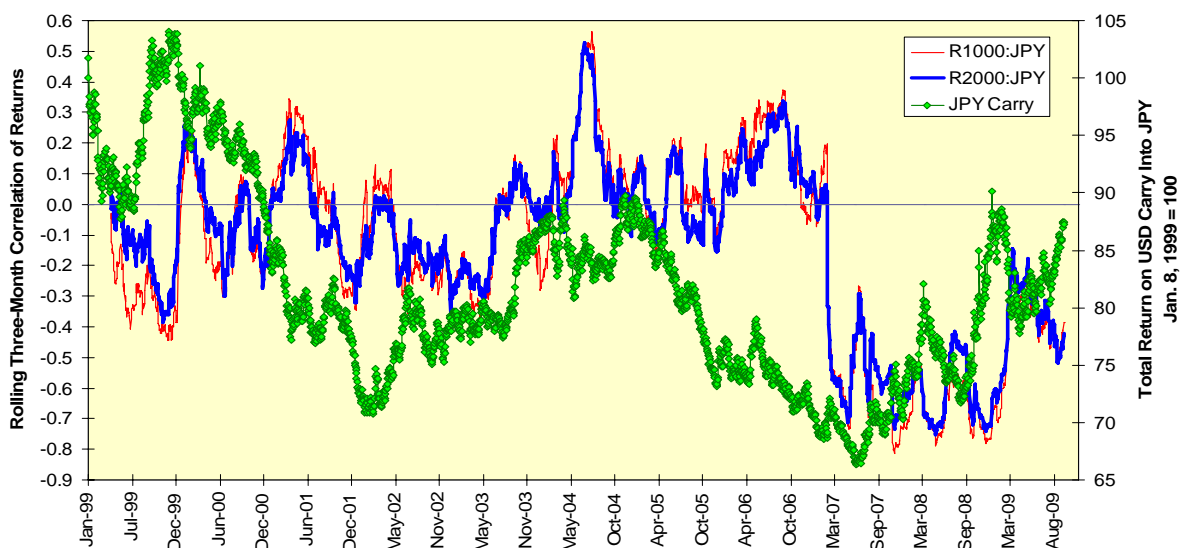
Correlation Of Returns, U.S. Equities Vs. Euro



Are there significant differences between the correlations against the two Russell indices? Surprisingly, no; the greatest difference occurs in the magnitude of correlation. The Russell 1000 index has higher highs and lower lows against the euro, but the differences appear to be minor.

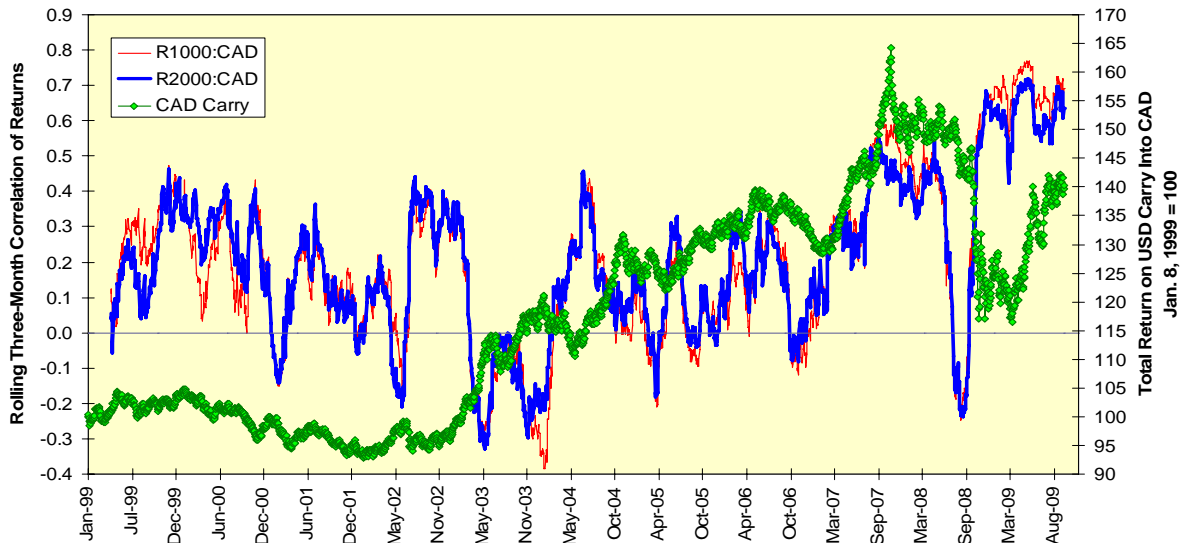
If we repeat the exercise for the yen, the correlation of returns has been negative since March 2007, the period just after the first rumblings of what was then called the “subprime crisis” were rolling across the land. As the dollar carry trade into the yen is approaching profitability in response to U.S. interest rates falling below Japanese interest rates, the response has been a negative correlation of returns by both Russell indices. The distinction between the Russell 1000 and Russell 2000 indices has been small throughout the history.

Correlation Of Returns, U.S. Equities Vs. Japanese Yen



Finally, we come to the Canadian dollar. Here years of correlation oscillating around zero were replaced by a rapid drop during the financial crisis followed by a recent ascent to a record high correlation of returns. Once again, the distinction along the dimension of market capitalization is insignificant.

Correlation Of Returns, U.S. Equities Vs. Canadian Dollar



What should you do in response to this information? The key is not to follow it blindly; the search for the one magic bullet answer to all trading questions has led to the adoption of various indicators such as the Baltic Dry Freight index or the euro/yen cross-rate in rapid succession. What is in fashion today can move out of fashion just as quickly and will fail you when needed most.

The “what” is unimportant; the “why” is critical. The reason why the link between currencies such as the euro and Canadian dollar have moved to highs has been the common impact of the dollar carry trade. The opposite has obtained for the yen as both the yen and the dollar have been haven currencies during times of increased financial risk. The unwinding of the yen carry trade and its replacement by the dollar carry trade has been unexpected, to say the least.

Finally, stay away from the quick-and-dirty answers. It is easy for someone to say a weak dollar is good for large-capitalization U.S. stocks, but it is demonstrably difficult to prove it.

Until U.S. monetary policy reverses, which does not appear likely in the immediate future, or unless another financial crisis produces an unwinding of the dollar carry trade, do not treat one market as causal to the other. They both are being affected by a common factor at the same time. Restated, you can trade currencies or you can trade equities, both as separate markets, but do not use one to trade the other.