When Elephants Dance

These must be exciting times to be a central banker. In addition to their usual heavy schedule of confusing duly elected officials and hurling verbal thunderbolts into the cowering citizenry simultaneously, the Masters of Money are starting to find themselves out of synch with each other. How will their divergent courses of action affect us as global investors? Let's just say there's reason for concern.

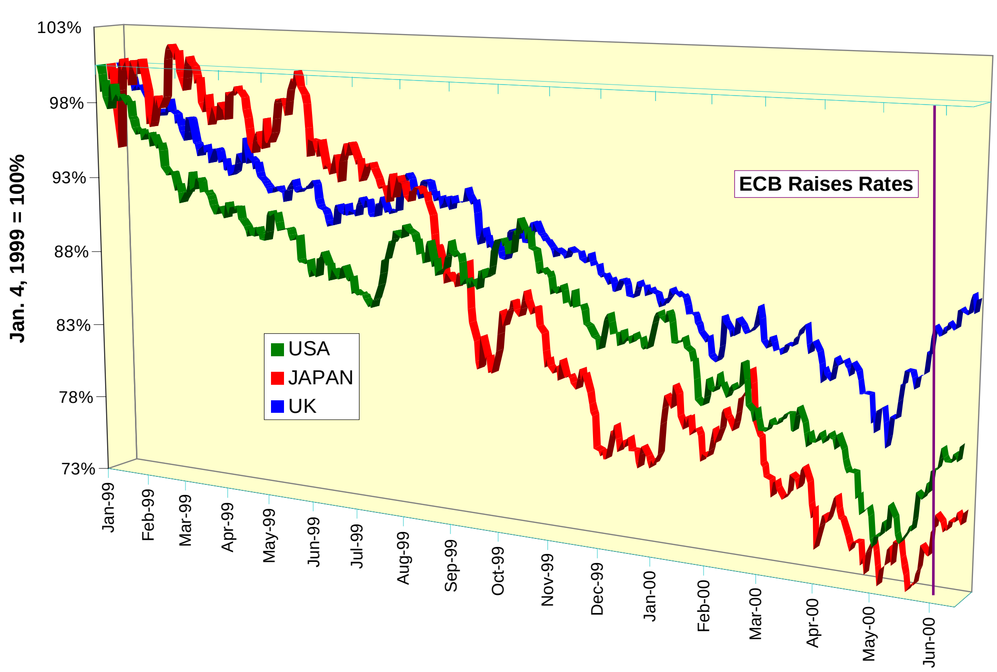
European Sophistication?

Consider first the European Central Bank (ECB), caretaker of the euro. Early in everyone's elementary education we are assigned to work on a project as part of a committee. Here we learn 1) committees are excellent accomplishment-prevention devices, and 2) the products of committee labor often address internal politics far better than they do external realities.

The ECB has been embarrassed by the euro's nearly continuous fall against other major currencies since its inception. Much of the weakness against the U.S. dollar could be explained away by the Fed's series of interest rate hikes culminating in last May's 50 basis point increase, but the weakness against currencies such as the British pound or Japanese yen was harder to explain. Well after the euro bottomed on May 18, the ECB raised raises 50 basis points on June 8 -- and then announced it did not expect to have to raise rates further.

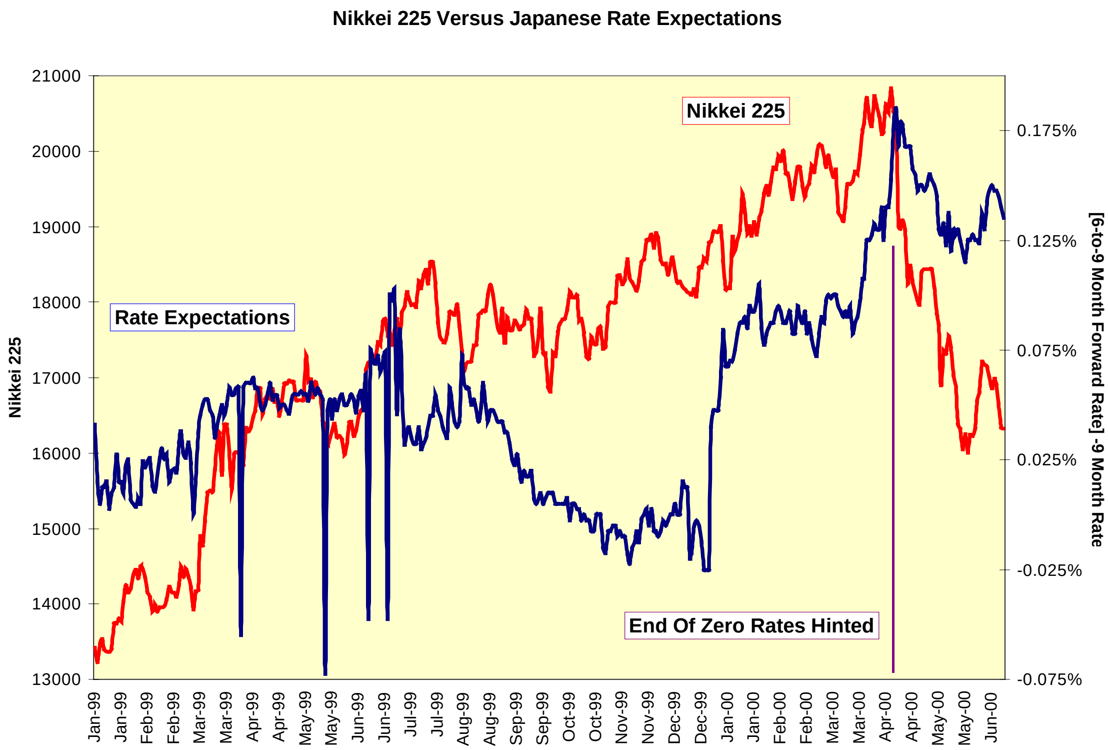
The ECB had not hinted at any rate hikes going into June 8. The forward rate structure of European money market instruments had been removing, not adding, prospective rate hikes since May 18. The problems of European inflation were not apparent on their face. European equities markets were modestly higher on the year, just 3.41% for the Bloomberg European 500 index and 9.15% for the Dow Jones Stoxx index, hardly the stuff of a runaway bull market. In light of all this, the ECB's decision must be considered a triumph of the committee process. We are all duly forewarned about this organization.

Relative Value Of Euro Versus Other Currencies



Land Of The Rising Sun And Falling Stocks
The Bank of Japan (BOJ) has been trying, with no success whatsoever, to jumpstart Japan's moribund economy through near-zero interest rates for the better part of the last ten years. Some have argued the BOJ's policies actually have been constrictive during this period: With price deflation rampant in Japan, a nominal interest rate near zero is a real interest rate equivalent to the rate of deflation, presently 1.7% as measured by the GDP deflator.

What, then, does the BOJ propose? Why, raise interest rates, of course! Their logic is based on the notion free money has allowed Japan, Inc., to conduct business as usual and avoid recognizing the structural problems of their political and economic system. While we can debate the wisdom of raising real interest rates in an economy with one of the highest levels of public debt in the world, the performance of the benchmark Nikkei 225 index during this period speaks for itself, as seen below.

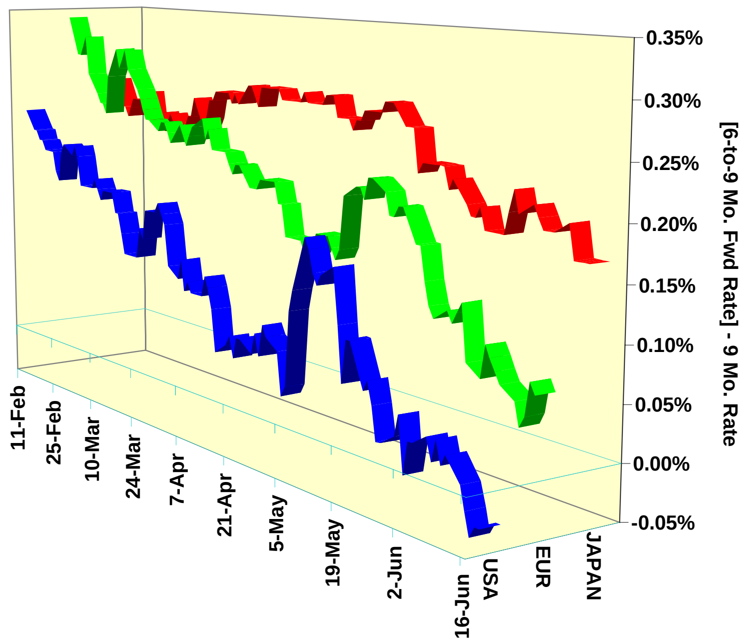


Once the BOJ hinted an end to the zero rate policy in mid-April, the Nikkei peaked and began a selloff that has pushed the index down 21.2% in two months. If the market is welcoming this apparent policy change, this is certainly an odd way of showing it.

The Fed: A Hike Too Far?
Monetary policy operates with long and variable lags, which is a fancy way of saying we don't know what's going to happen or when, but we're going to do it anyway. U.S. economic data reported over the past month has been uniformly softer than expected, and this may be incorporating only the effects of the first 50-75 basis point increase in rates from 1999. More softness may be in the pipeline and would manifest itself even if the Fed were to cut rates tomorrow.

The U.S. interest rate market is starting to price a rate cut into its forward structure. In mid-May, the market was expecting to see at least another 25 basis point hike in rates by the first quarter of 2001. This expectation has turned into a decline of 5 basis points over the same period.

Implied Interest Rate Increases At Nine-Month Horizon



The Divergence Decade Continues
This is some spectacle: The U.S. economy, which has been the strongest in the world, is slowing so rapidly the market is now expecting rate decreases. Japan, which has been the weakest major economy for years, is expecting interest increases, and these expectations are hammering the Nikkei once again. Europe is in the middle in both growth and rate expectations.

How should American investors position themselves? The Fed, like most traders, hates to admit error and take small losses, so they may be reluctant to reduce interest rates just yet. While the betting here is against an outright recession, we'll probably have to settle for slow growth at best for a while. The Japanese are taking a big risk in their impending policy reversal for both themselves and the world at large: Much of the late 1990s financial boom worldwide was financed with cheap yen. Europe may be the best alternative by default, and an American investor might be in line to gain on both the underlying asset and on a strengthening euro.