The Dollar Didn't Matter

One of the keys to successful trading and market analysis is the ability to remain detached emotionally from the subject at hand. This falls into the grand category of easier said than done, for an all too common human reaction is to equate self-worth with a bank balance.

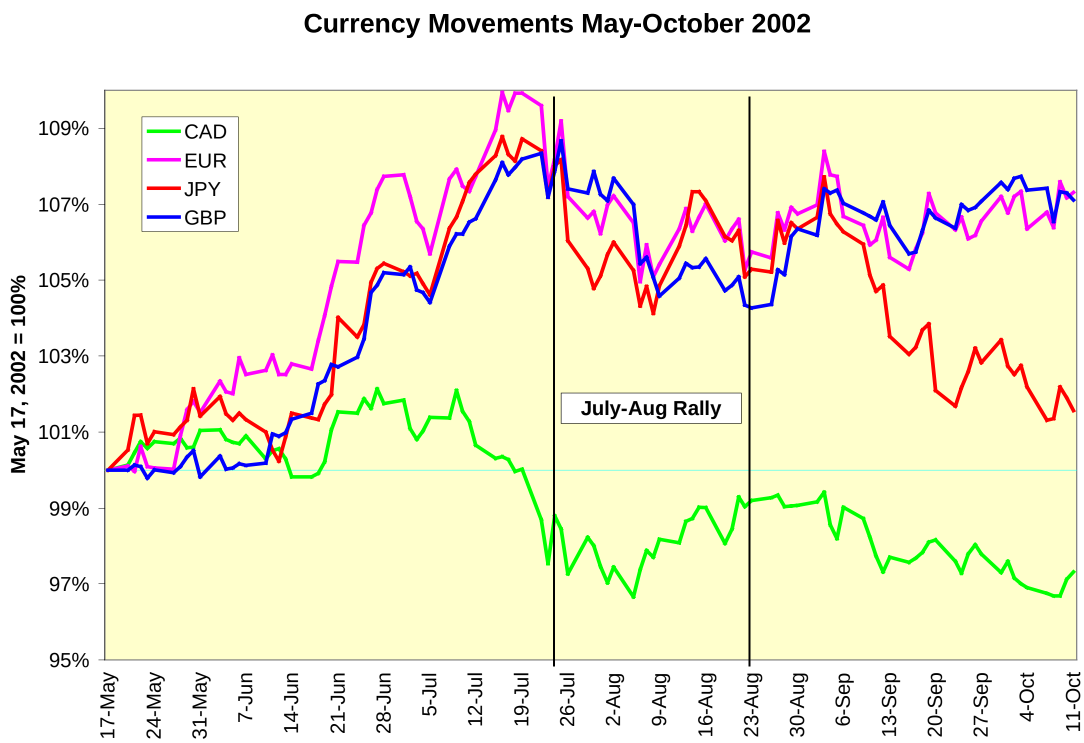
Most of us study our mistakes in a vow not to repeat them, certainly a noble sentiment well-expressed, but who amongst us has not made the same mistake at least twice? A far better impulse, and the path least-taken, is to study your good decisions as well for what may be called positive behavior reinforcement. It works in other endeavors: Does Tiger Woods practice for hours trying to duplicate his bad swings?

In that spirit, I'd like to revisit a series of article written in late May and early June of 2002, the time at which the most recent descent into Hades began. The first of this series was entitled "Stop Worrying About The Dollar," and that sums up the thesis fairly well. At the time, gold was completing its run to $330 an ounce, and the ever-woebegone euro just achieved parity with the dollar. The strongest currency at the time was the Japanese yen, of all things. The overriding fear in regard to the weakening dollar was that foreign investors would dump their American assets in favor of their own, and that U.S. interest rates would have to surge in order to keep these funds in dollars.

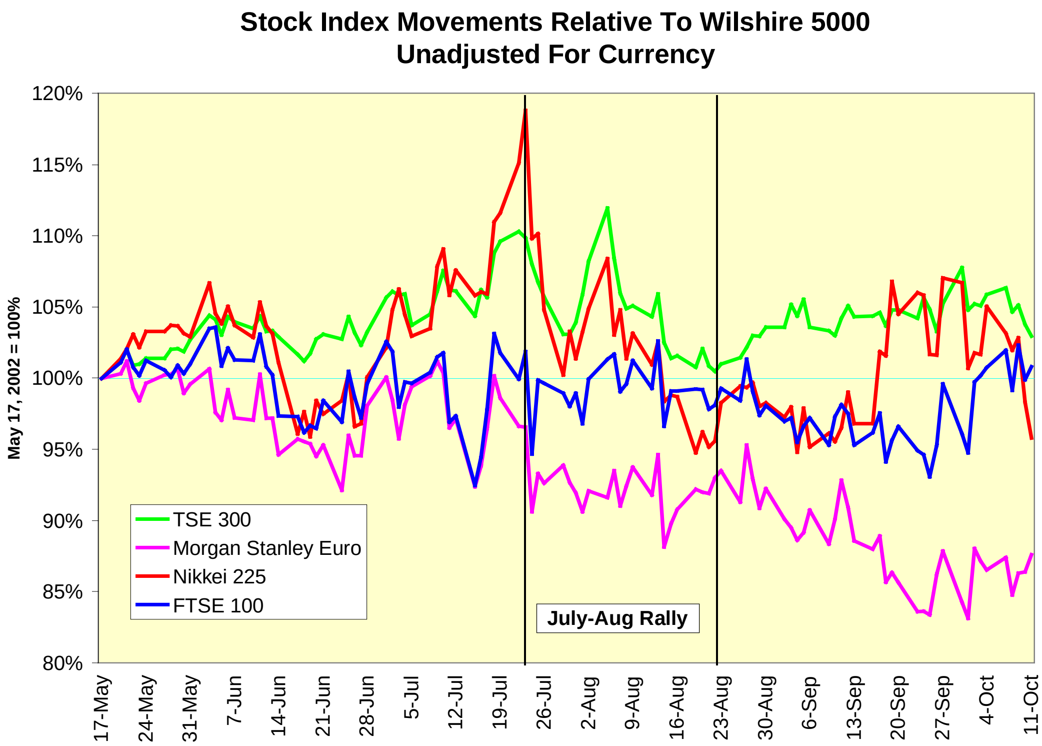
Well, stocks got shellacked from late May onwards, and bonds have headed skyward. However, neither gold nor the dollar have moved very much at all. More telling, however, is how badly European stocks have performed relative to U.S. issues since that point. Anyone who sold dollars and bought euros to buy German stocks, for example, simply went from the frying pan into the fire.

Go Your Own Way

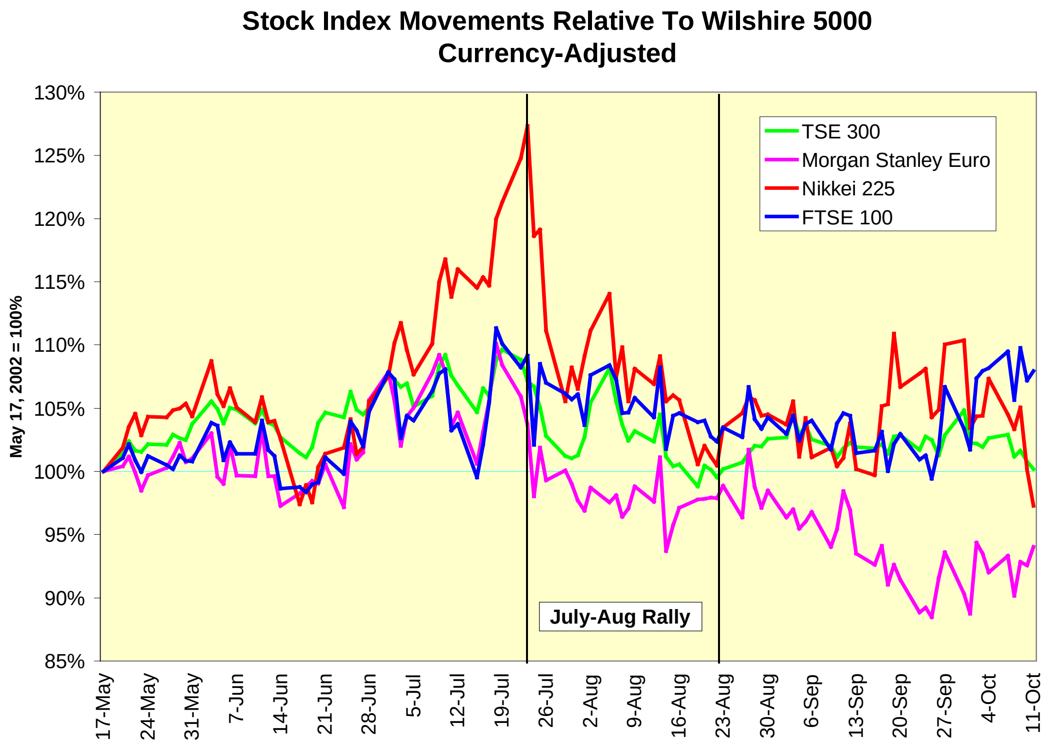
That the relative movements of key currencies against the dollar are not linked directly to their underlying stock markets can be seen below. During the May-July selloff in U.S. stocks, the yen (JPY), the British pound (GBP) and the euro (EUR) all increased smartly against the greenback; the Canadian dollar (CAD) fell, however. These relationships reversed during the July-August rally. But the return trip south from the August highs to the October lows saw virtually no movement in the GBP, EUR or CAD, and the JPY weakened.



How did the underlying stock markets perform during this period? In local currency terms, the Canadian benchmark, the Toronto Stock Exchange 300, fared the best, while the Morgan Stanley Euro index deteriorated after the July lows were hit. Neither the British FTSE nor the Japanese Nikkei changed much by period-end, although the Nikkei did do quite well relative to the Wilshire during the July selloff. Of course, since both the JPY and the Nikkei are so buffeted by Japan's political interference in the market, it is quite difficult to discern genuine movements from one-day reactions.



Now let's combine these two elements together and get the total picture for an American investor in U.S. dollar terms.



This chart has only two salient features, the Japanese spike in July and the steady deterioration of the Morgan Stanley Euro index.

The World Is Not Enough
International investing has its stomach-churning risks and rewards. In recent years the correlation between major markets has increased, lowering the diversification factor. This is forcing investors to look farther afield. Is it any comfort to you to know that $1.00 invested in Pakistan on December 31, 2001 would be worth $1.62 today? Or that the fourth-best performing index is that of Mauritius, an island nation in the southwestern Indian Ocean? Or, for that matter, that only the Brazilian Bovespa and the Argentine Merval have underperformed the Nasdaq 100, and that both of these nations had to take a sharp turn to the left politically to achieve this dubious status?

The Prague 50 index has done well in 2002, up 21.7% in dollar terms. Of course, to invest in any Czech stock like specialty steel manufacturer Zeleznicni Stavitelstvi Brno you would have to break one of my most ironclad trading rules: If you can't pronounce it, don't buy it.

You always have to look behind any set of market relationships to get the true story. Sometimes the simple answer will work: They're trashing Brazil and Argentina because these nations can't get out of their own way on a dare. Those cases are easy; just sell and don't look back. Sometimes a deteriorating currency may be the result of lower interest rates, and these lower interest rates may in turn be bullish for the stock market in question; this was the case in Mexico in recent years. It was also the case in the U.S. in markets such as late 1985 to early 1987, and again in both 1993 and 1995. Sometimes a strong currency prices a country out of its export markets and is bad for the stock market; Japan, Korea and Taiwan always keep an eye on each other's currency in this regard.

In May, investors still held out some hope for more resilient economic growth outside of the U.S. and bid the prices of those currencies up in short order. That was a mistake, and those investors have suffered accordingly on both sides of their bet, the stock side and the currency side. The current view is that nothing globally is going to get going ahead of the U.S; this is keeping the dollar strong despite everything, and that may in turn be a negative for the U.S. economy.

But the conclusion from earlier remains the same: Stop worrying about the dollar. Any level is fine so long as the market perceives that level to be natural and not the result of political machinations. Oh, and about U.S. interest rates surging: On May 17, the ten-year Treasury was yielding 5.251%. It hit a low of 3.567% on October 9. Tough trade if you were short.