

The European Central Bank Puts One Risk Behind Us

As Edward G. Robinson's aging gambler noted in *The Cincinnati Kid*, "... it's about making the wrong move at the right time." Nothing may explain better the European Central Bank's (ECB) surprising decision on June 8 to raise interest rates 50 basis points at a time when nobody was expecting it. The move may have been wrong by conventional standards since the normal reasons behind a rate hike, such as resurgent inflation, unsustainable economic growth, or excessive financial speculation, were not present. In addition, the ECB issued a statement indicating this was a singular event, and not the first of a series.

The timing, however, may have been spectacularly right: The ECB had been badgered for months to come to the rescue of its beleaguered currency, the euro (EUR). The EUR was already recovering from its historic lows reached on May 18 in the immediate aftermath of the Fed's 50 basis point rate increase, and thus the ECB could escape the rap it was embarking on a certain-to-lose campaign to support the EUR through higher interest rates. Its self-exculpation may have served to clear away market uncertainties; if so, the Fed should note the effects of clear statements and simple diction.

The net results of the ECB's action could be strong European stock markets and a strong EUR, a combination worthy of an American investor's attention.

What A Short, Strange Trip It's Been

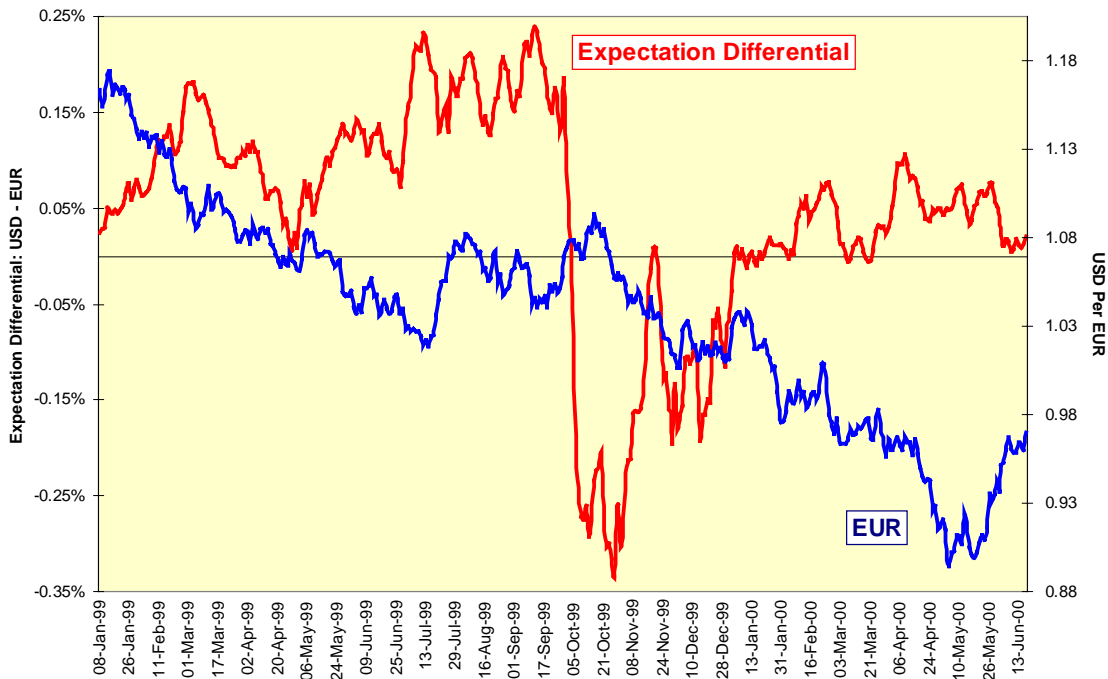
Since currency exchange rates are nothing more than relative inflationary expectations between two economies, we should be able to correlate a currency's movements with these different expectations rather closely. A five-day moving average of the three-to-six month forward rates of the EUR and the dollar (USD), defined below, proxies nicely for this concept.

$$ExpectationDifferential = .2 * \sum_{t=-4}^0 \left[\frac{(1 + R_{6_{USD_t}})^{.5}}{(1 + R_{3_{USD_t}})^{.25}} \right]^4 - \left[\frac{(1 + R_{6_{EUR_t}})^{.5}}{(1 + R_{3_{EUR_t}})^{.25}} \right]^4$$

Between the EUR's inception in January 1999 and mid-October 1999, the markets always expected forward interest rates in USD to exceed those of the EUR, and the EUR was pressured accordingly. This changed very abruptly in late-September 1999. Suddenly, global markets began to price in the notion of the ECB matching the Fed in raising interest rates. By October 15, the S&P 500 plunged to 1247.

The EUR found brief support, but by the end of October, expectations of higher interest rates in Europe dwindled, the rate expectations gap moved back in favor of the USD, and the EUR resumed the decline that would take it to its May 18, 2000 low of 0.8946.

Differential Forward Rates And EUR/USD Exchange Rate



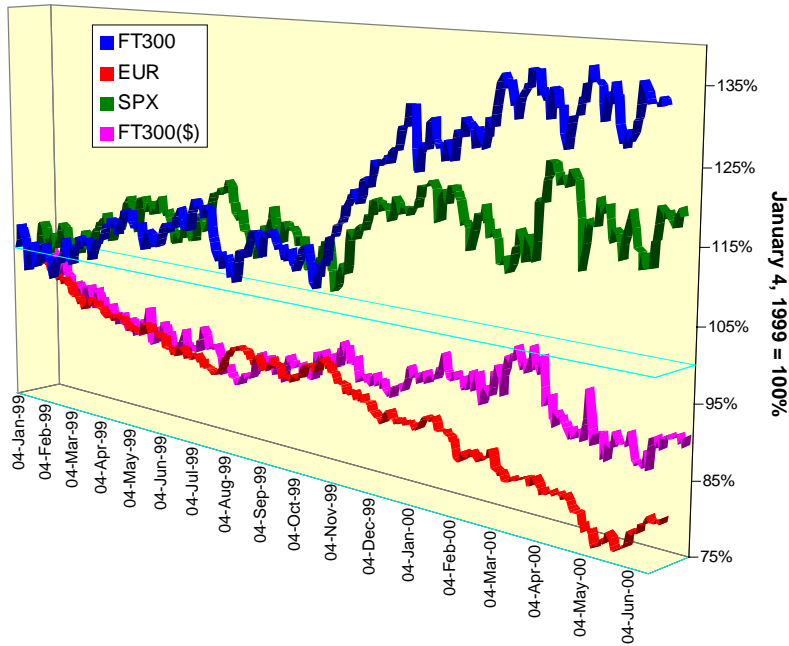
Did this sudden change have an effect on equity markets? While it is always difficult to impute causality, we can note coincidence and offer an opinion: The threat of a tightening ECB combining with a tightening Fed was removed from the market. Further monetary stimulus was supplied in conjunction with Y2K worries. The result was one of the most spectacular global equity rallies ever, especially in the technology sector.

Returning The Favor

Now that USD rate expectations are starting to decline relative to EUR, will the USD weaken under a more relaxed monetary policy? This is almost certain: During the entire history of floating European exchange rates, (1973-1998) the Deutsche mark and other key European currencies traded very tightly to the differential interest rate expectations discussed above.

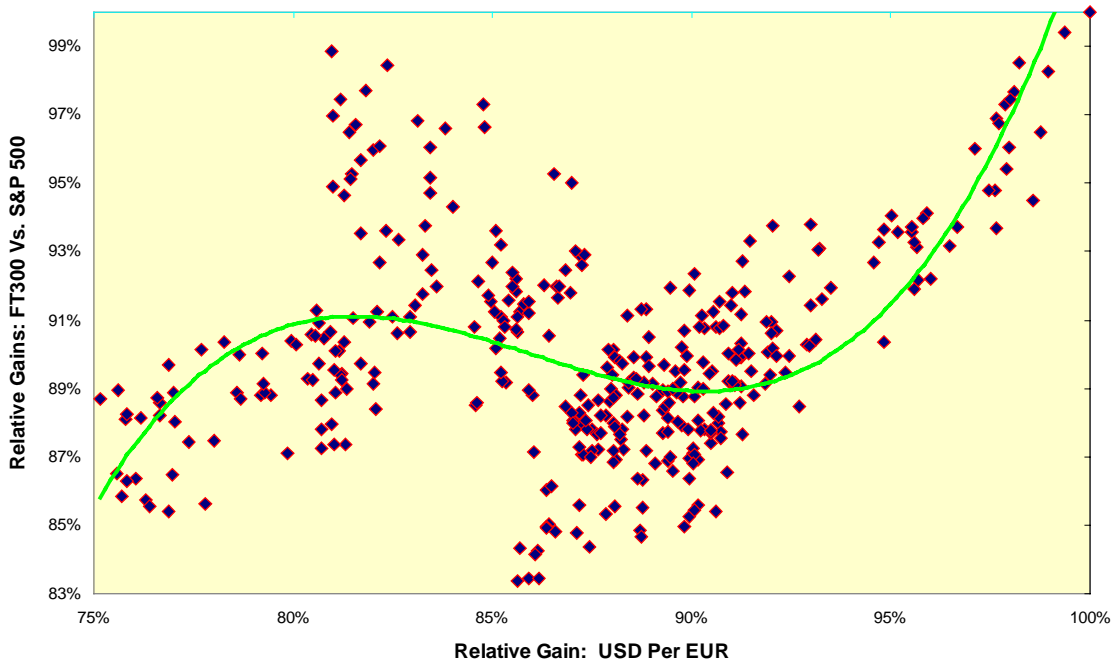
If the EUR firms, will American investors in Europe be in position to receive a double benefit, possible equity outperformance and a currency translation gain on their holdings? In USD terms, the Financial Times Eurotop 300 Index (E300) has underperformed the S&P 500 over the life of the EUR. As it outperformed the S&P 500 in EUR terms, we can attribute the loss to U.S. investors to be solely a function of currency risk. A stronger EUR should make this risk a favorable one for U.S. investors.

Relative Performance: Stock Indices And Exchange Rate



The good potential for a firming EUR to return a strong performance to American investors can be seen in a simple restatement of the data in the above chart. EUR exchange rates over 95% of the 1999 launch rate are associated with periods of strong E300 returns relative to the S&P 500.

Relative Equity Performance As A Function Of EUR Performance



Risk Management Menu

If a slowing U.S. economy leads to expectations of lower U.S. interest rates and results in a stronger EUR, this still does not translate to a winning equity investment in Europe. Clearly, a U.S. slowdown will have a profit impact in Europe. Our risk management alternatives are:

1. A foreign equity option struck in a foreign currency. These options, which can be exchange-traded, do not provide direct currency protection, and therefore need to be combined with currency options for a complete hedge;
2. A foreign equity option struck in the domestic currency. These, too, can be exchange-traded. The correlation between the equity market and the exchange rate affects these hedges. They require a combination of equity and currency instruments;
3. An equity-linked foreign exchange option. The focus of this instrument, which combines a currency option with an equity forward, is on the currency risk itself; and
4. A fixed exchange rate foreign equity, or quantity adjusting (quanto) option. A quanto is executed OTC at a fixed exchange rate.

Traders who wish to accept and manage both equity and currency risks are served best by the second choice.