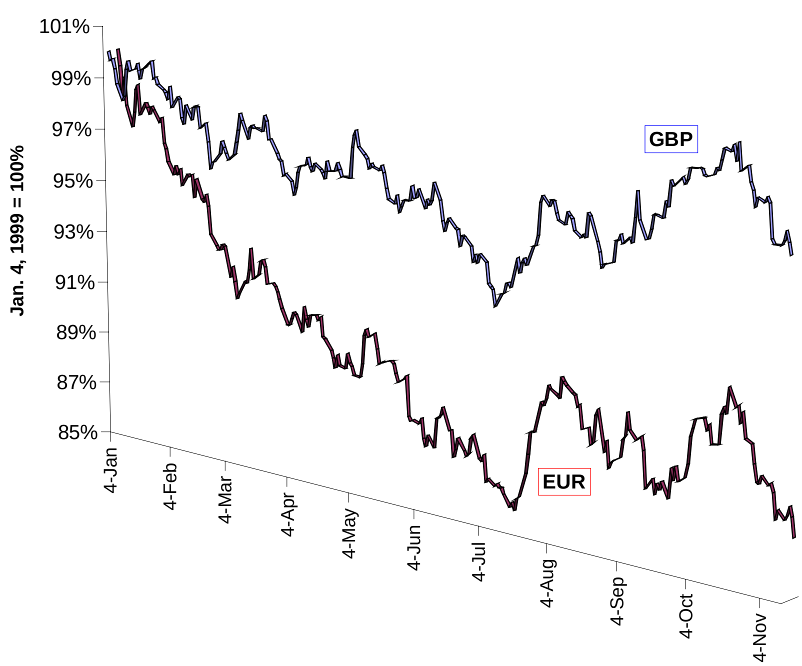
My Word Is My Bund

It was only a year ago when a friend and colleague of the European persuasion blurted out, "If they ever let you vote on changing the currency, don't do it!" I suppose he was referring to the forthcoming conversion to the euro, not to those new $20 bills of ours no one likes.

As we move into our Thanksgiving season, we should pause to reflect on what we should be grateful for in this regard. First and foremost, let's give thanks for what has *not* happened: No rank confusion, no more than mild (public) dissension between the old D-mark bloc and the old Club Med, and no more than light carping by the French that "euroland" smacked of the dreaded Franglais. Second, we should be thankful for the arrest of the euro's mid-year decline toward parity; it was the approach of this level in mid-July that led to the European Central Bank (ECB) rate hike and a threatened derailment of financial markets in a repeat of the 1998 August debacle. Third, let's give a tip of the bowler to the lads in The City for keeping both lips stiff and their tongues safely ensconced therein during this period of threatened unraveling. Finally, let's all turn our eyes upwards in thanks that somehow this disparate group of countries whose national monuments celebrate clobbering one another on the field of battle have managed to pull off the grandest currency experiment since the advent of floating exchange rates in the early 1970s with only these as hitches.

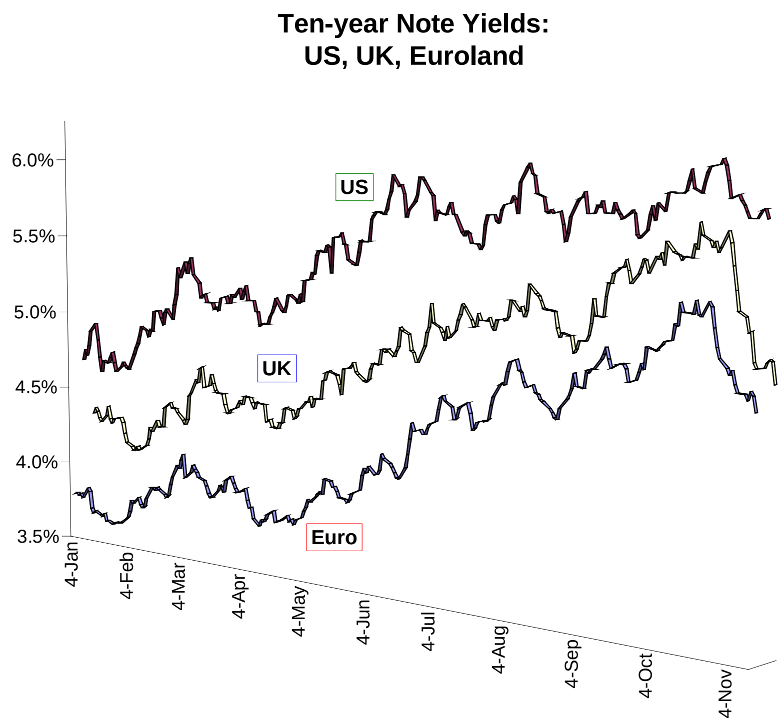
There's still no hiding the fact the euro has been weak against other major currencies. The relative movements of the British Pound (GBP) and euro (EUR) against the dollar (USD) since the euro's inception are weakly parallel, but the EUR clearly is weakening against both. A similar chart against the Japanese yen would be even more striking.

Pound & Euro Versus USD



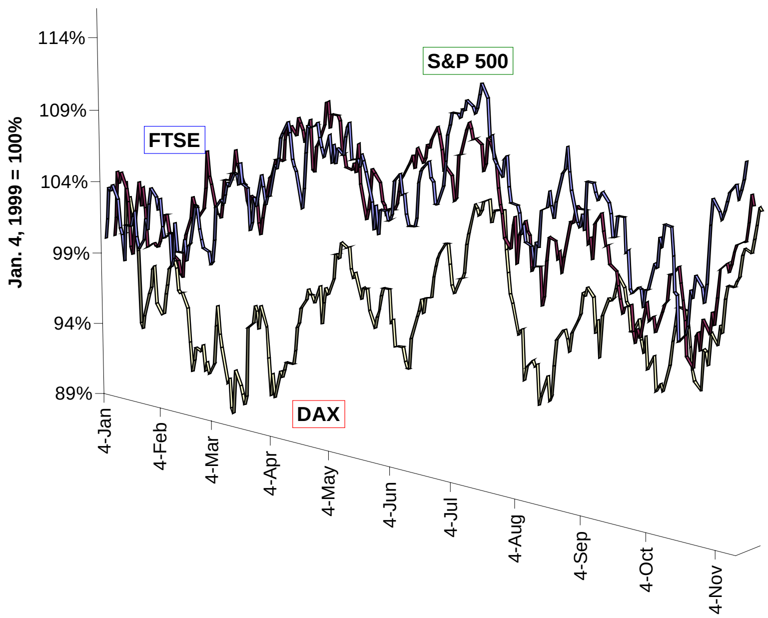
Of course, one of the more difficult concepts to accept in currency trading is that strong and weak do not equate to good and bad. Unlike the yen, which is maddeningly difficult to analyze in terms of interest rate movements, (see the Nov. 10, 1999 article "Strange Currency" on this site) the European currencies do reflect interest rate differential reasonably well.

Over the course of 1999, nominal yields in the U.S. remained well over those in both the UK and euroland. This interest rate gap at this maturity has widened in recent weeks as yields have dropped sharply in the UK, and only slightly less sharply in Euroland. The USD has strengthened accordingly.



Even though nominal note yields in Euroland have been low, the stock indices on the Continent have not been strong performers in 1999. This was especially true for the DAX during the first half of the year when the euro was sliding steadily.

S&P 500, FTSE 100, And DAX:
Local Currency Performance In 1999



Recent performance has been far more parallel for these three major indices. Given the wide interest rate gap between the US and euroland, one could conclude a drop in U.S. yields is necessary to support the euro against the dollar. Should this happen, this would be a good time to increase exposure to European equities. Will this US yield drop occur?

Recent analyses on this page have suggested:

1. The Fed needs to stay ahead of the curve on inflation;
2. U.S. financial markets can remain on track in the face of a tight Fed and higher energy prices so long as the dollar remains strong as well;
3. A strong upwards move in Canadian equities is signaling upward interest rate pressure in the U.S.;
4. The yen is in danger of a strong revaluation unless the BOJ drives interest rates much lower, even to negative levels. JASDAQ stocks should benefit; and
5. The ECB appears willing to accept a weaker euro as the price of lower interest rates.

Tough call: This is being written before the November 16, 1999 FOMC meeting. The betting here is the best way to thread the monetary policy needle is to maintain the bias toward higher rates. This will keep the dollar firm against the euro, and will probably flatten the yield curve going into 2000. As a bonus, equities should continue to do well.