The Euro: Always Say Never Again

When things work as they should, nobody cares. That, if we may digress, is the remarkable part of the story about Isaac Newton and the apple: Any slob would have asked why the apple fell upwards, but it took a genius for the ages to ask why if fell downwards.

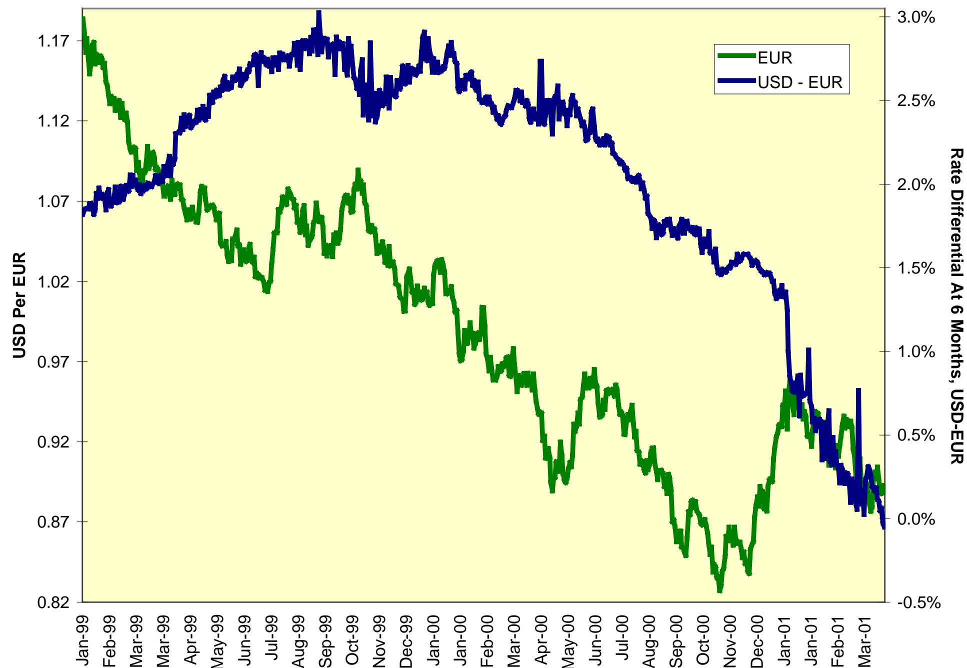
Market analysis lurches forward in much the same way. Winners go home without further ado; losers hang around the office and study what befell them. Just as George Bernard Shaw noted "The reasonable man adapts himself to the world; the unreasonable man persists in trying to adapt the world to himself. Therefore, all progress depends on the unreasonable man," market analysts learn more from the exceptions and failures than from rules and successes.

One day, but not yet, the euro/dollar exchange rate will behave predictably and cease to be interesting. Let's revisit some earlier analyses of the euro and its effects on markets on both sides of the Atlantic, and see why buying European financial assets, bonds as well as stocks, might be a good idea.

The European Central Bank Holds

The ECB's surprising decision last week to hold its refinancing rate constant underscored the euro's dilemma over its short life; if the euro were a person, it would qualify as an abused child. Until signs of an U.S. economic slowdown began to emerge in the late summer of 2000, (see "Will A Slowdown Sink The Dollar?" Sep. 5, 2000) the faster growth rate and tighter monetary policies of the U.S. created an interest rate gap between the U.S. and Europe that made U.S. assets more attractive to hold.

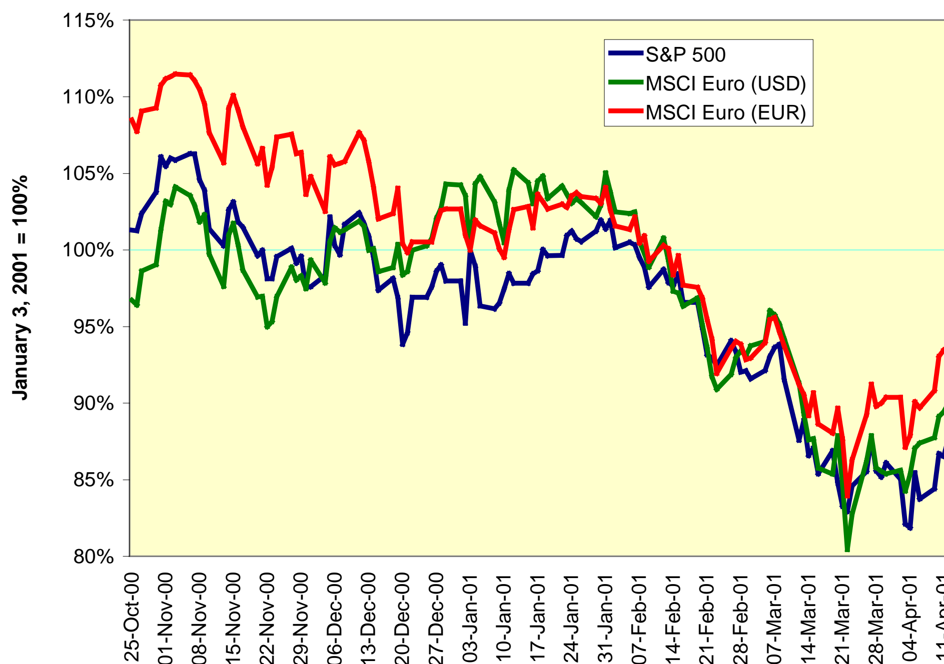
Narrowing Rate Gap Hasn't Firmed Euro



The euro began to firm in October 2000 in correct anticipation of lower interest rates in the U.S., but the rally ended and reversed in mid-January of 2001. It is the timing of this renewed downturn that is so puzzling. Not only did the Federal Reserve cut rates by another 50 basis points at the end of January and later again during March, but the returns on U.S. assets turned strongly negative as well. Moreover, interest rate markets began to price another 75 bps rate cut in March into their structure – the actual cut was only 50 bps on March 20 – and the Bank of Japan embarked on its new program of "quantitative easing," or aggressively injecting yen into the banking system.

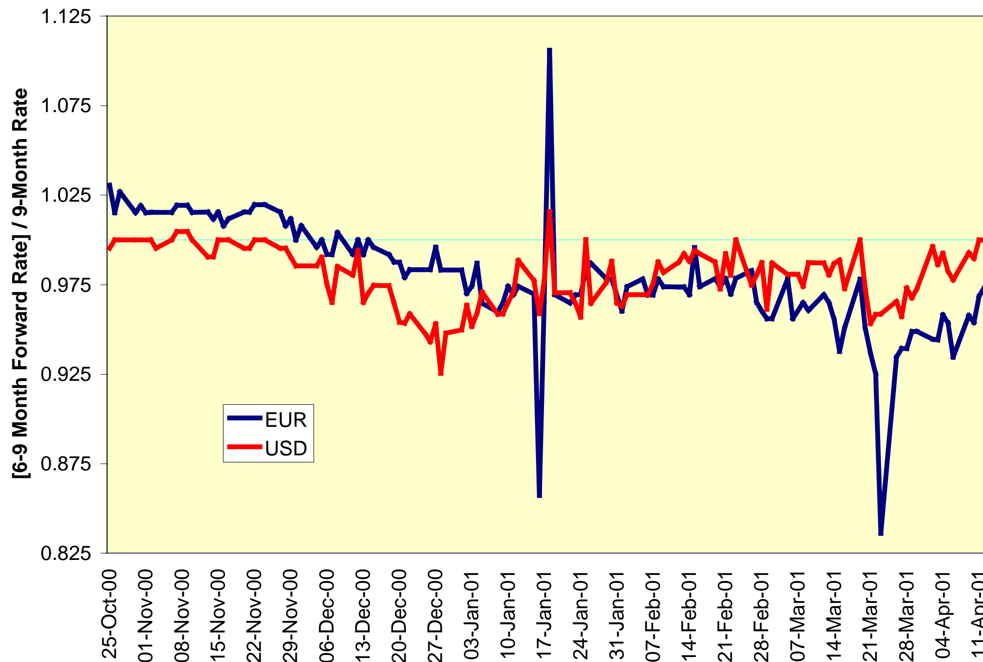
How can we interpret the euro's lack of response to the closing of the rate gap? Two possibilities present themselves. First, the markets believe the ECB's refusal to lower rates and persistent euro weakness has diminished future economic growth prospects in Europe. Second, the markets believe subsequent rate cuts in Europe are going to arrive more rapidly and be sharper than otherwise. Let's look at each possibility in turn.

European Equities Outperform
Since the October 25, 2000 low of the euro, the Morgan Stanley Capital International euro index has outperformed the S&P 500 in both euro and dollar terms. The spread trade of owning European equities against American was suggested last September as a lower risk way of trading the euro (see "Trading The Euro Through Equity Indices," September 12, 2000). This outperformance by Europe was present both before and after the Fed's surprise rate cut on January 3, 2001.



If European stocks are outperforming American issues in the face of higher relative interest rates in Europe, only two explanations are possible. First, European earnings are expected to either rise faster or fall slower than the interest rate differential is closing. Second, American stocks remain overvalued relative to European stocks, or are otherwise riskier. The P/E disparity between the U.S. and Europe is not too great, 24.7 for the S&P 500 versus 20.0 in Europe, so while the U.S. isn't cheap, it isn't grossly out of line, either. This suggests the earnings outlook in the U.S. remains relatively worse, and negates the argument that the euro remains under pressure do to the attractiveness of American financial assets.

Interest Rate Expectations
Now let's see whether the market is betting on an even larger European rate cut in the near future. A measure used here before is comparing the ratio of the forward rate between six- and nine-month deposits to the nine-month rate. A value greater than one indicates a positively sloping yield curve and rising rate expectations, while a value less than one indicates a negatively sloping yield curve and falling rate expectations. The data is sensitive to one-day outliers, but is presented below without adjustment.



The U.S. money market curve has moved into virtual neutrality regarding future rate cuts. The European markets are still biased slightly toward rate cuts, but this bias is disappearing rapidly in the face of the ECB decision to leave rates alone. Nothing here suggests any monetary surprises to wreck euro holdings.

Market technicians may recognize a classic head-and-shoulders bottom forming on the euro chart; such a technical signal provides an interesting corroboration for the quantitative case for owning European stocks and bonds presented above. Even though it's presented by a reasonable man who accepts things as they are, convincing the world to buy low and sell high still constitutes progress.