

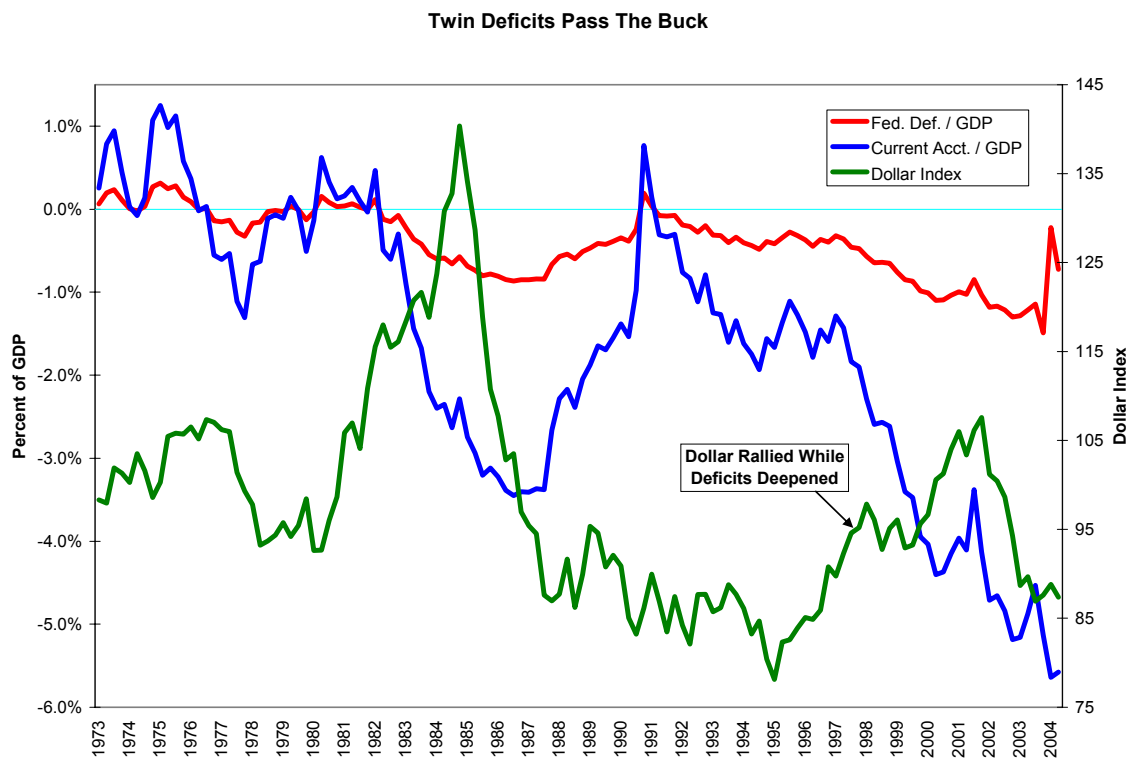
The Euro And The Logic Of Money

It has been fifteen years since the fall of the Berlin Wall and the collapse of communism in Eastern Europe. One memorable image of that era was the reopening of a bridge between Romania and the largely ethnically Romanian Soviet Republic of Moldova. Crowds were poised on either side of the bridge, and for one tense moment no one could bet against a mutual attempt to flee to the other side.

Some aspects of global currency trading have a similar feel, especially in the largest bilateral market of all, the dollar/euro cross. The euro spent its first three years on the run, only to be replaced by the greenback as an object of scorn and derision.

Crossing The Bridge

What prompts such powerful and enduring trends? One set of simple answers seized on by those who like to view economics as some sort of morality play, lies either with something dubbed "Eurosclerosis" or with American economic excesses. The shorthand for the latter has been subsumed in the phrase "twin deficits," in honor of our persistent merchandise trade and federal budget red ink. But financial markets are not futures contracts on macroeconomic variables (see "It's Not The Economy, Stupid," March 2004). The attribution of dollar strength or weakness to either deficit is a nice theory, but it is totally bereft of any sort of empirical evidence on its behalf.



Currency trading actually is far less dramatic. It is simply borrowing in the country whose currency you are selling and lending in the country whose currency you are buying. These two interest rates are of necessity nominal rates, which include both a real rate of interest and an expected rate of inflation. The two real rates must be identical at identical maturities and at identical credit risk to preclude arbitrage.

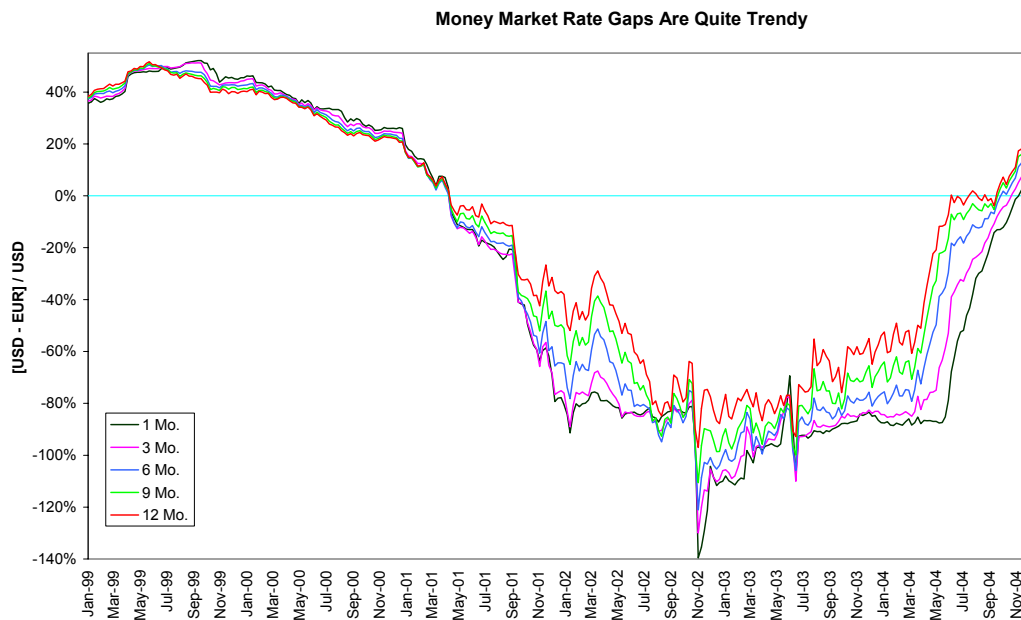
The spot exchange rate both closes this interest rate relationship and reflects the market's expectations for relative asset returns. Other factors can enter the equation as well, and not just the obvious ones of political interference and country credit risk. The Japanese yen, for example, could rise through periods of both near-

zero nominal interest rates and poor asset returns because importers eventually had to buy yen to pay their Japanese exporters.

Interest Rate Trends

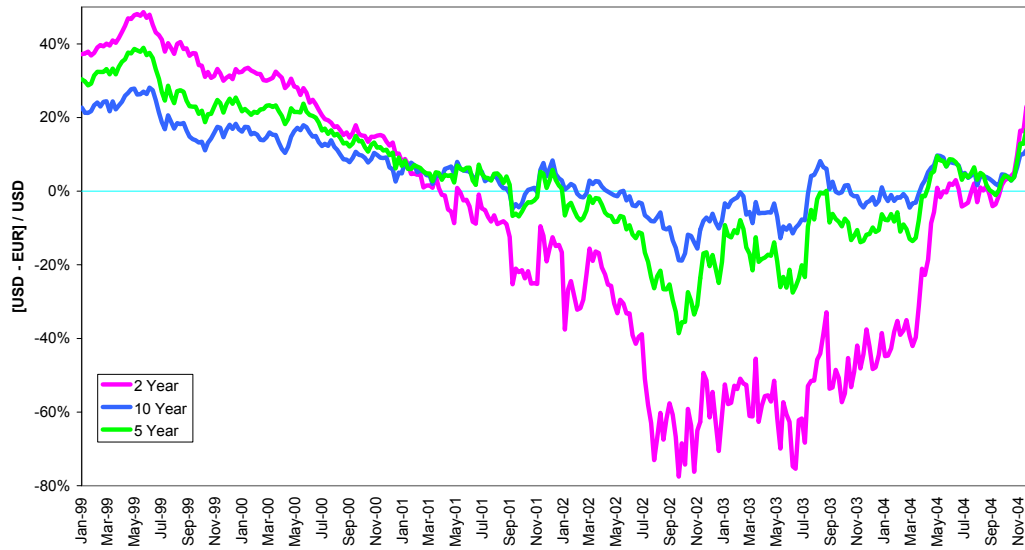
The euro could pull a V-shape reversal because the underlying short-term rates pulled a V-shaped reversal in late 2002. Over the entire money market horizon U.S. rates exceeded their European counterparts until the Federal Reserve already had cut interest rates by 200 basis points. This rate cutting led many investors to believe in an impending economic rebound and therefore greater returns on dollar-denominated assets. By 2002, hoped ceased to spring eternal and the euro's rebound began.

The Fed's enthusiasm for rate cuts into 2003 produced the opposite effect; the yawning rate gap raised the specter of higher American inflation, and the euro strengthened accordingly. Even though the gap began to close by late 2003, it was not until the release of March 2004 employment data that investors began to take the prospects of American interest rate increases seriously. The gap closed fastest at the nine-month and one-year horizons; by the end of September 2004, U.S. rates exceeded European rates even as the perception of U.S. monetary excess persisted.



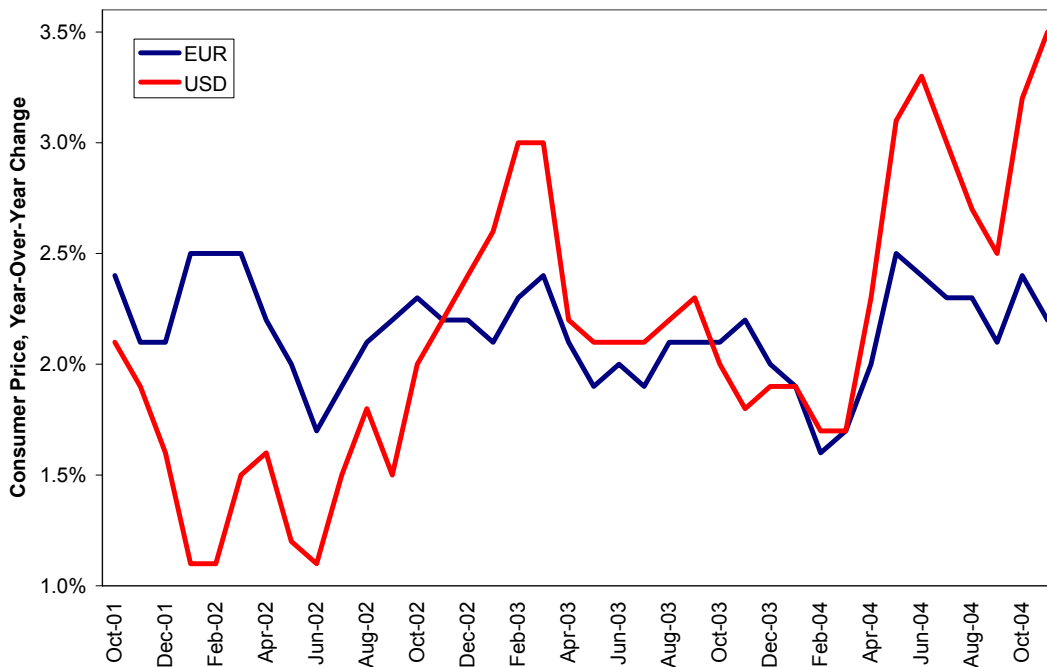
The longer-term notes tell a similar story. The rate gap at five and ten years never got as extreme as the two-year notes' gap as the market discounted the Fed's policy as short-lived. By the fourth quarter of 2004, a time when the dollar sank steadily against the euro, the yield advantage at the note horizon favored the dollar quite strongly.

Longer-Term Rate Gaps Are Less Trendy

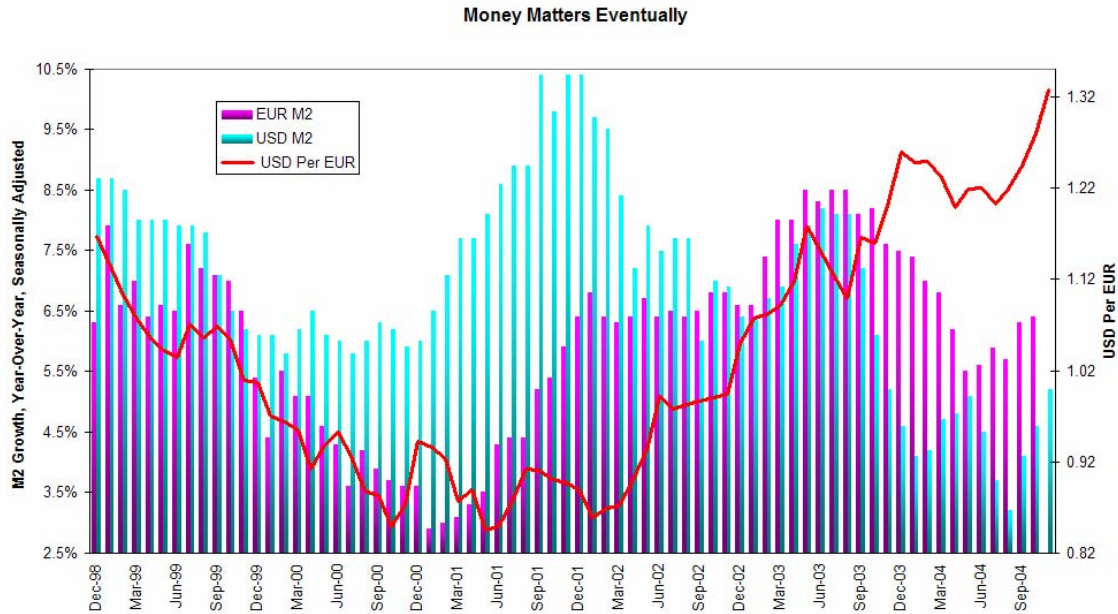


These note yields are nominal. Ideally we would compare inflation-protected notes, but there are no euro-denominated equivalents to our TIPS. And, it is important to keep in mind that simply adding the CPI to the TIPS yield will create something quite different from the nominal note yield (see "Can The CPI Catch Your Eye," April 2004). If we compare the two consumer price indices, we can see how American inflation had started to move below its European counterpart in late 2003, but then rose steadily in comparison throughout 2004. An increase in American inflation relative to European inflation is all else held equal a negative for the dollar.

Inflation Differential: Can You Trust The Data?



If we accept inflation to be a monetary phenomenon, and we should, we should look at the comparative rates of growth of the two money supplies. American M2 growth fell sharply relative to its European counterpart in late 2003, and that trend continued throughout 2004. Money supply growth famously operates with long and variable lags, and we can see just how far in advance the surge in American M2, which peaked in 2001, led the decline in the dollar. The more rapid European money supply growth eventually will cap the euro if nothing else will.

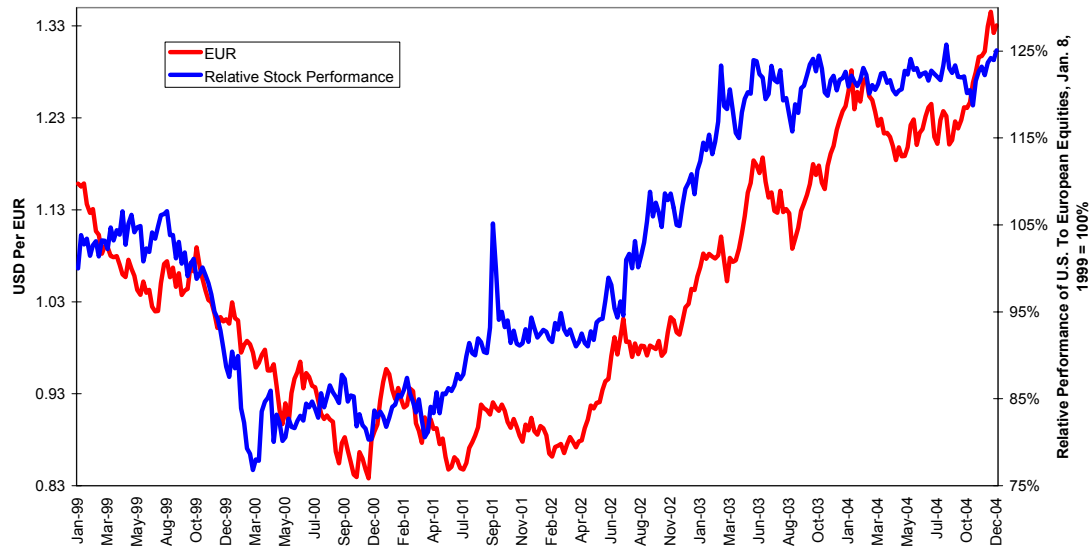


Clues From Stocks

There is no single direct measure of expected relative returns on assets. However, stock prices are alleged to capture the discounted expected dividend stream of the underlying companies. The comparative performances of two broad stock indices in their local currencies, in this case the Russell 3000 and the Morgan Stanley Capital International Euro index in dollars and euros, respectively, can be used as a proxy, however imperfect, for expected returns on assets.

The relative returns have tended to lead the euro. This is consistent with the notion that stock markets rally in anticipation of greater liquidity and the weaker currency resulting therefrom. This relative performance measure can be quite trendy; the U.S. market in dollars led the European market in euros for nearly two years during the 2001-2003 period. And, like all trends, it ends: A trading range began in early 2003. This stable performance coincided with the onset of the interest rate gap closure.

Do Stocks Prefer Weaker Currencies?

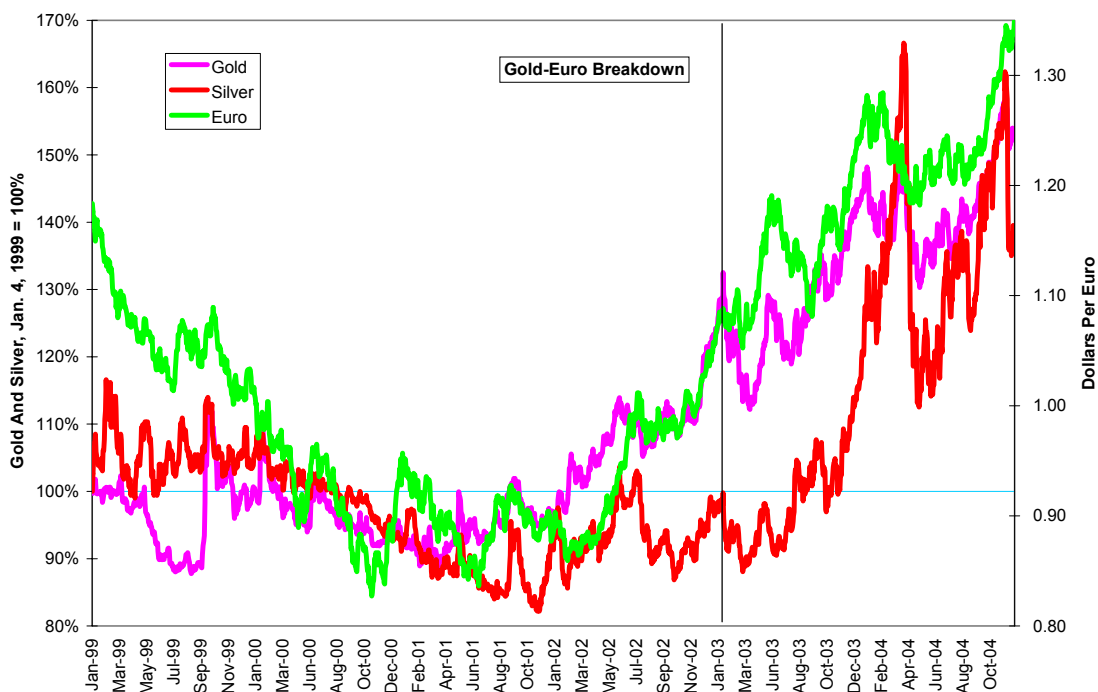


Precious Metals

Gold more than any other market is linked to the value of the dollar (see "Precious And Few," November 2003). The linkage between the dollar and silver is less strong on a fundamental basis but just as strong on a psychological basis.

Gold rose more slowly than did the euro during 2003, and silver rose more slowly than gold until a short-lived burst higher in February and March 2004 and again in November 2004. The metals' performances during this period suggest that expected inflation did not exceed the short-term interest rate costs of holding them by a margin sufficient to outweigh any change in the dollar's absolute value. Perhaps this is attributable to the then-extant talk of deflation, perhaps it was simple hesitation to speculate aggressively in the metals - note how rapidly silver fell from its March and December 2004 peaks - but regardless of cause, the metals should have risen more rapidly than they did.

Precious Metals Trail The Euro



Financial markets can never be viewed in splendid isolation from each other. The fashions of intermarket analysis may change over time, but certain truths remain constant, none more so than the relative behaviors of economies and central banks drive stocks, metals, interest rates and currencies in one giant system. It may look messy, but it is quite logical, just as was the ultimate decision of the Moldovans to flee into Romania.