Bye-Bye Miss Eurozone Pie

Some trends are so long-lasting they seem like the natural order of things. Many do not recognize them as trends at all; consider the longstanding belief residential real estate prices never go down, or the one that was thrown at me by a student way back in 1997, "Stocks go up 15% a year!"

The dollar sinking against the euro has fallen into this category, which is amazing considering how the common currency spent the first two years of its existence making one new low after another. But now the time has come to think about the unthinkable, and that is the euro's six-year uptrend may be over, at least on a trading basis.

As this outlook is based on the Federal Reserve ending its policy of negative real short-term interest rates, I must add the appropriate disclaimer to what would otherwise be a no-brainer forecast. If the Federal Reserve fails to carry through on its implicit promise to start fighting inflation, the dollar will turn south against the euro and do so with a near-Biblical vengeance.

Interest Rate Expectations

Currency movements are driven by three factors, differential short-term interest rate expectations, differential returns on assets and financial flows. Those who look at just one factor tend to lose the big picture. For example, the yen could rise during its long era of near-zero interest rates on the basis of financial flows; importers of Japanese goods eventually had to buy yen to pay their suppliers. The yen also was supported by a perpetually steep yield curve at the money market horizon; while its three-month rates were tiny, the market persisted in believing they had to rise sometime in the succeeding six months.

Special factors have operated in the euro as well. We know recognize, in retrospect, how much of the euro's weakness in 2000-2001 was the so-called "mattress trade" of various legacy currencies being swapped out of soon-to-disappear cash and into dollars in a tax avoidance scheme.

Differential interest rate expectations can be measured by taking the forward rate ratio between six and nine-month interest rates. This is the rate at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate. The more the market believes short-term interest rates will rise, the greater this ratio. If we map the differential between American and Eurozone forward rate ratios against the euro itself, we find the differential leads the currency by 31 weeks on average.

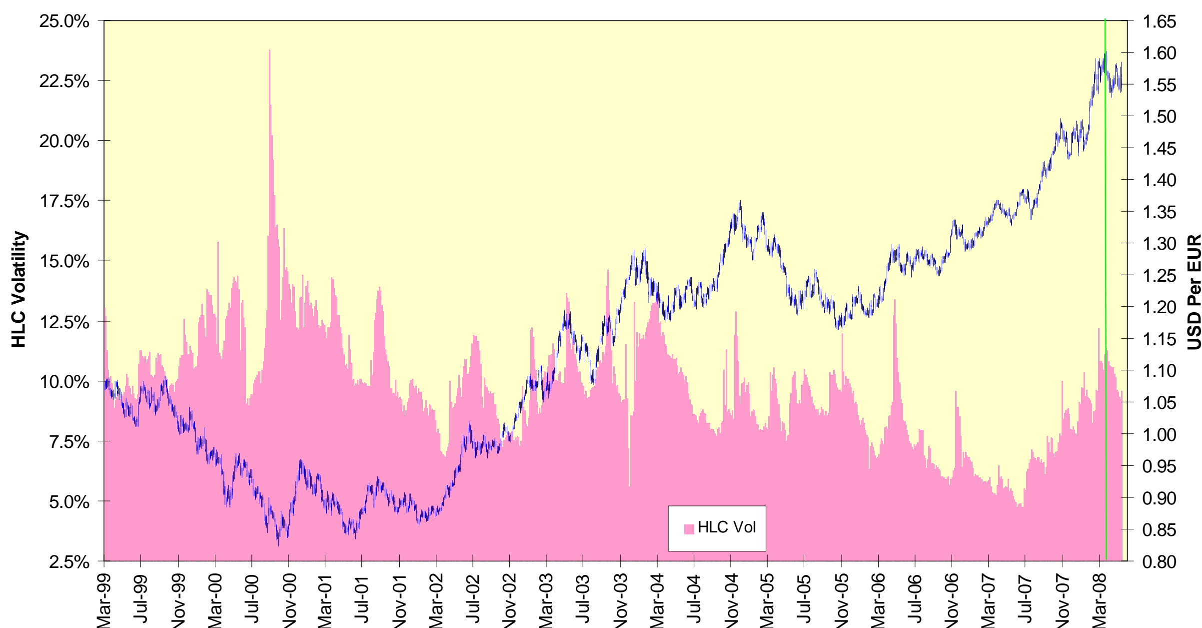
Short-Term Rate Expectations Now In Favor Of Dollar

The spread hit its low this past January, marked with the green line on the chart, and it tested this level in March. Those two periods, both of which coincided with massive injections of liquidity by the Federal Reserve and stock

market collapses, triggered the euro's run from 1.44 to just over 1.60. The differential has swung abruptly back in the dollar's favor on the belief the U.S. will start to raise interest rates.

The high-low-close volatility for the euro, a measure which incorporates intraday range as well as interday change, has been declining since the euro's late-April peak, also marked with a green line. Declining volatility signals comfort with the trend.

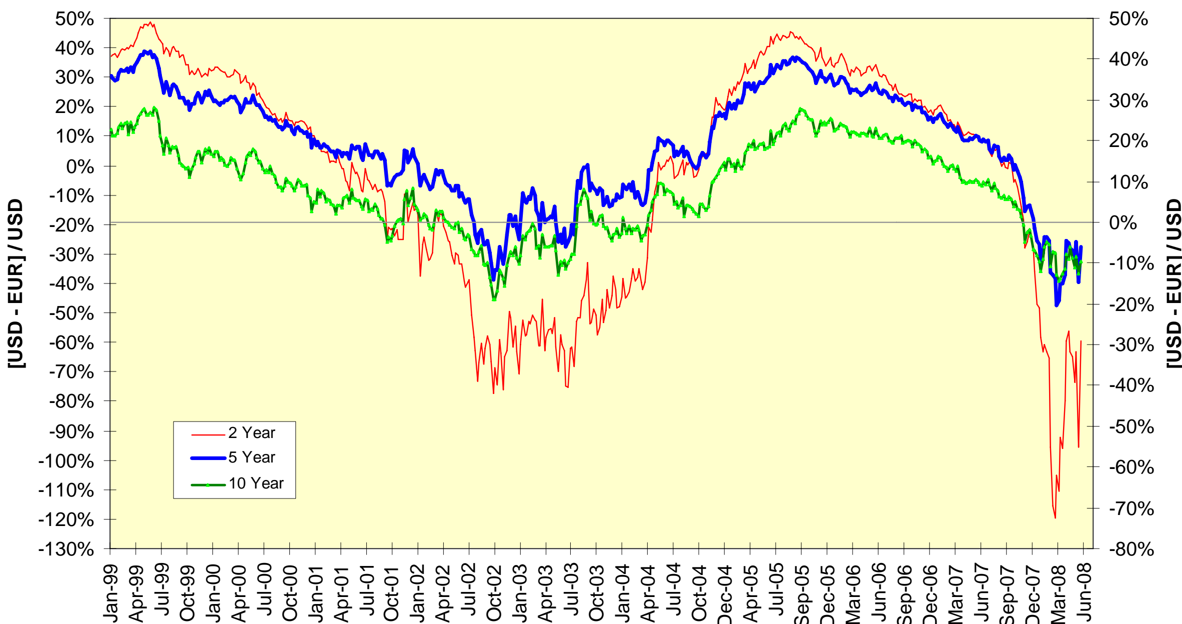
The Euro's High-Low-Close Accepting A Top



The Note Gap

One of the more striking illustrations of just how excessive U.S. monetary policy became in recent months is the normalized interest rate gap at the note horizon. If we take the spread between American and Eurozone notes divided by the American rate itself, we see how the gap at the two-year horizon was more than 100% of the yield on American notes. This gap has been closing, but is still at levels last seen during late 2002-early 2003. U.S. note rates can rise a long way before coming back into convergence with the European counterparts.

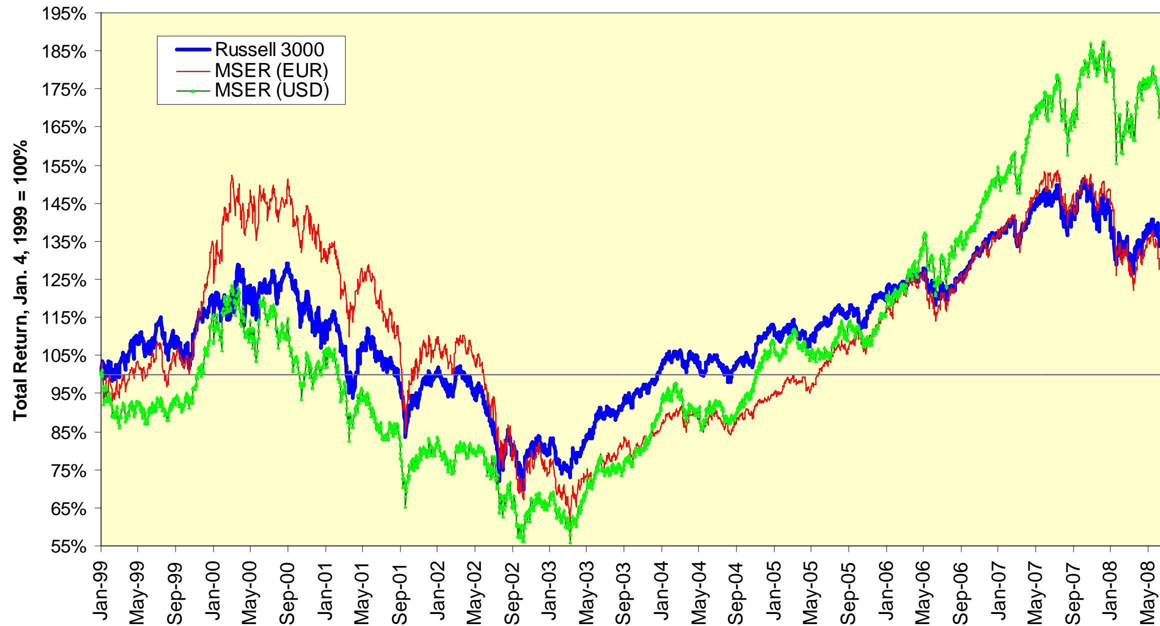
Short-Term Notes Have Plenty Of Room To Converge



Stock Market Implications

Diversification is to investing what location is to real estate. However, as world business continues to operate more globally, the domicile of the business becomes less and less significant. Returns converge in local currency terms, and the diversification benefits increasingly become a currency trade.

If we compare the total returns of the U.S. market as measured by the Russell 3000 to the Morgan Stanley Euro index both in euro and in dollar terms, all re-indexed to January 1999, we find the Russell 3000 and MSER have been the same trade in local currency terms over the past two years. A U.S. investor holding European stocks has benefited mightily from the currency translation effect; that same investor could have achieved the same returns by holding a U.S. index fund and a long position in euro futures or forwards of some kind.



If the euro has indeed topped, the implications are clear for those holding European equities: They will underperform their U.S. counterparts by virtue of the weakening euro. This includes mutual funds linked to European equities and ETFs based on Eurozone or European Monetary Union indices.

Keep in mind this is not a riskless recommendation to sell Europe. If the Federal Reserve blinks and keeps the federal funds rate at some huge discount to inflation and real growth (a Taylor Rule measure of a neutral federal funds rate is as high as 5.50%), the dollar will resume its long-term decline and it will not be pretty.