Peso Possibilities

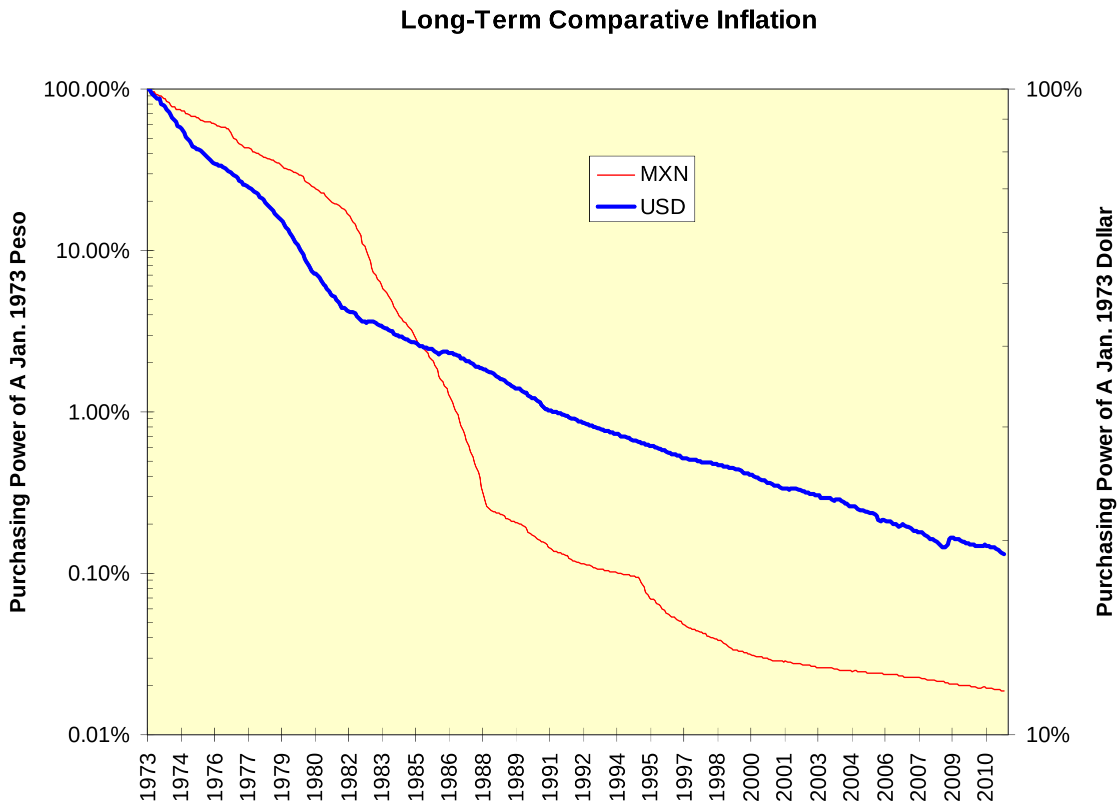
There is something about anyone's home currency that breeds cynicism. In October 2000, I had to give a couple of presentations on the Mexican peso in Mexico, mostly to an audience of outgoing PRI officials terrified of what was going to happen to them after Vicente Fox took over the presidency in early 2001. The peso was trading in the 9.5 to the dollar range back then, and I was calling for it to firm even further, which it did for the next eighteen months or so.

The reception was chilly, to say the least; several listeners were adamant the MXN was going to devalue toward 13 within months of Fox taking the reins; this level was not reached until the 2008 financial crisis. Today the MXN is trading around 11.7 and getting stronger.

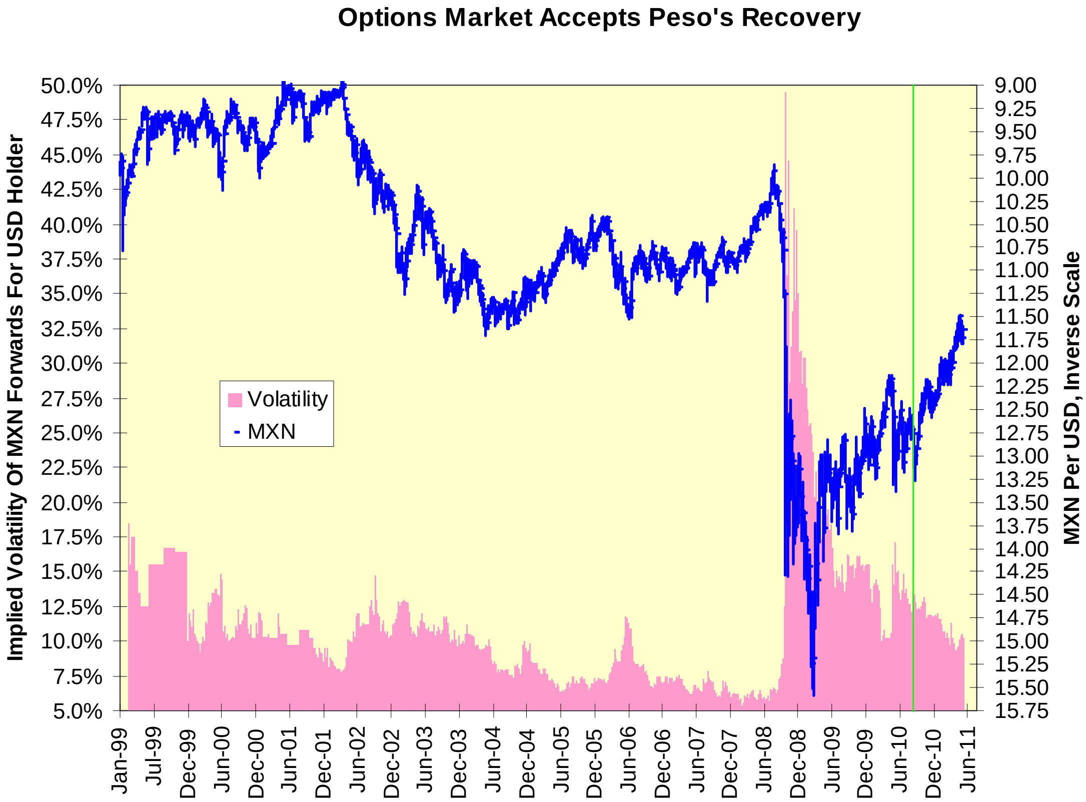
Whenever the question arises as to my opinion on "the dollar," I am careful to distinguish between the euro-dominated dollar index and various other currencies not in the index but important to U.S. trade flows and, yes, cross-border movements of labor. Mexico's two largest sources of foreign exchange are crude oil and remittances from Mexicans living and working elsewhere, primarily in the U.S.

Here Mexico faces two different problems. First, while the price of crude oil clearly increased between 2004 and 2010, Mexico's average daily production declined 23.9%, from 3.383 million barrels per day to 2.575 MMB/D. Mexico's largest field, Cantarell, is in a massive and irreversible decline. Second, remittances depend on the labor market in the U.S., and the outlook for Mexicans living in the U.S. is no better than it is for Americans living in the U.S. A modest improvement in the U.S. labor market led to a 5.5% increase in remittances in the first quarter of 2011 compared to 2010 levels, but this has been more than offset by a 10.8% increase in the peso relative to the dollar since QE2 began.

That the peso has the dollar on the run since Bernanke & Company restarted the printing press is more than embarrassing. Let's compare the official loss of purchasing power in the two currencies since the start of the floating exchange-rate era in 1973. The dollar has lost 80.97% of its purchasing power; the peso 99.98% of its purchasing power. I emphasize: These losses of purchasing power are based on official CPI readings; you are free to decide for yourself whether these are accurate assessments.



Not only has QE2 convinced the foreign exchange market the peso has been preferable to the dollar, the options market is comfortable with further peso strength. If we map the three-month volatility of MXN forwards against the MXN itself and note with a green line Bernanke's Jackson Hole speech, we see volatility has declined as the peso has increased. This condition would have struck my Mexican audience as preposterous or even worse eleven years ago.



Peso strength may be of greater interest to currency traders than to stock investors. The iShares Mexico ETF has gained 26.81% since Jackson Hole; this is actually less than the 27.98% gain seen for the iShares Russell 3000 ETF. Such an inverse relationship between currency strength and relative equity performance has not been unusual in a world where everyone thinks they can achieve prosperity via monetary debasement.