European Stocks To Depend On Euro

It was going to happen sooner or later: Free money would not be enough to propel risky assets higher but the removal of free money will be enough to cause some major distresses for the same reasons infants squall whenever they are upset. This is the sort of asymmetric, no-upside situation we should all strive to avoid.

While the statement above might seem to reference the U.S., it actually represents the Eurozone and is made as a follow-up to an August 2010 column noting European corporate bonds were quite supportive of Eurozone stocks. The conclusion was simplicity itself:

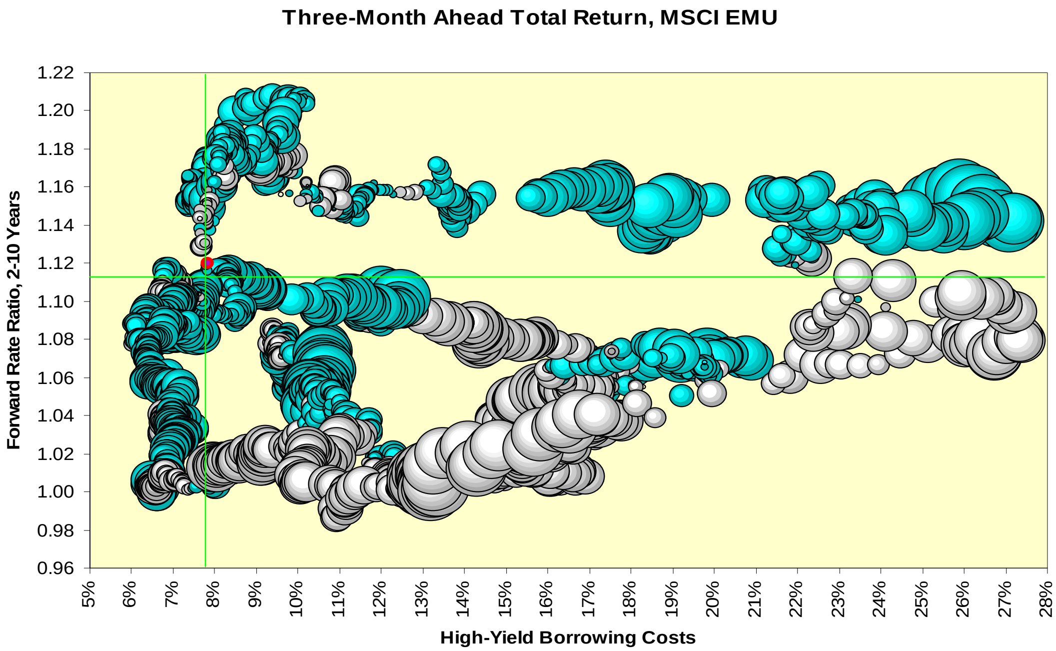
> *As the European Central Bank will not be in a hurry to withdraw the stimulus, even though all of those banks passed its rigorous stress tests, the Eurozone will find itself in the same situation we have found ourselves in more than once over the past decade: The money has to go somewhere. That "somewhere" is more likely to be in stocks than in corporate bonds given the skinny yields available.*

How did that prediction fare? Merrill Lynch's Euro High-Yield index has returned 9.71% in euro terms and 21.21% in dollar terms since that was written while the MSCI European Monetary Union index has returned 4.45% in euro terms and 15.31% in dollar terms. If we switch the bond index to 5-10 year investment-grade corporates, the returns have been 1.44% in euro terms and 12.97% in dollar terms. European high-yield bonds outperformed stocks, which in turn outperformed European investment-grade bonds.

Going Forward

Let's return to last year's analysis measuring prospective equity returns as a function of high-yield bonds and the shape of the benchmark Eurozone yield curve as measured by the forward rate ratio ($FRR_{2,10}$) between two- and ten-year benchmark notes. This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself; the more the $FRR_{2,10}$ exceeds 1.00, the steeper the yield curve is. The data sample begins in January 1999.

The charts below depict positive prospective returns in blue bubbles and negative prospective returns in white bubbles; the diameter of the bubble corresponds to the absolute magnitude of the return. The last datum used, from three months ago, is highlighted and the current environment is noted with a green bombsight.



Essentially, we are in an indeterminate zone. The Eurozone yield curve has been flattening bullishly as ten-year Bund rates have fallen there as Treasuries have fallen here, but sometimes bad news economically actually is bad news for financial markets.

If we switch the $FRR_{2,10}$ to the excess carry return for borrowing the dollar and lending the euro, a clearer image emerges. Here a stronger euro, which stresses the infamous PIIGS on the Eurozone's periphery, is would be negative for Eurozone stocks. The currency would have to weaken against the dollar, a tough task for anyone these days, for prospective equity returns to be positive.