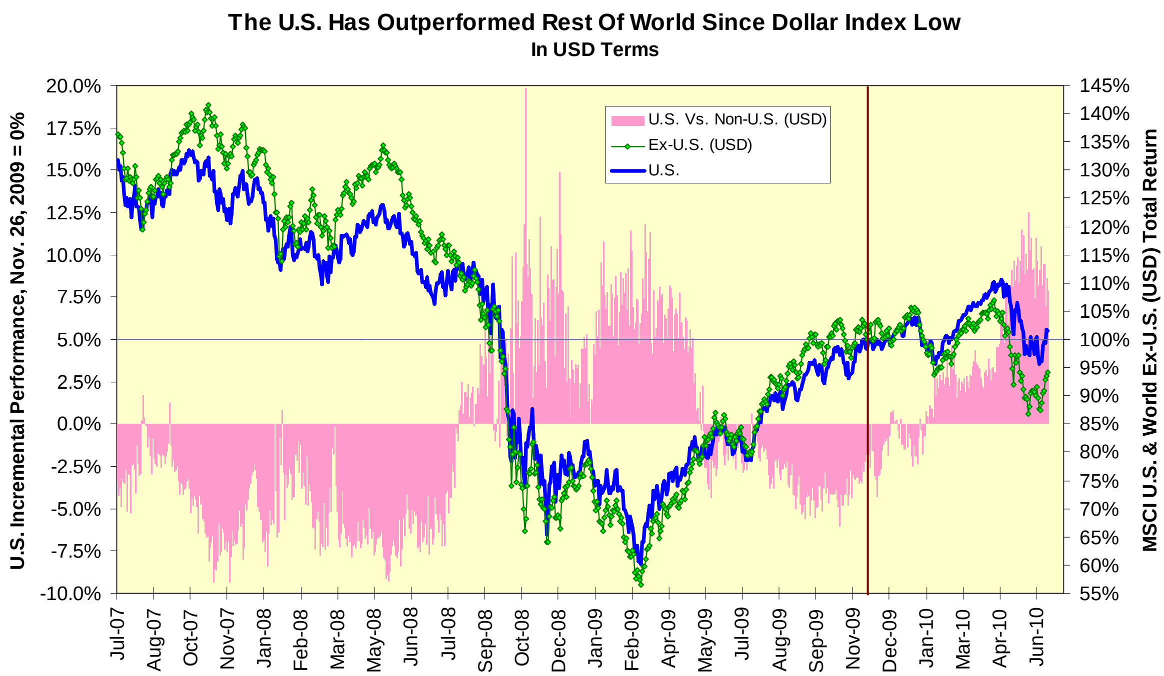
We Are All Currency Traders Now

An old Wall Street adage, the only kind, states a pattern works until it is recognized. Once a tendency is discovered, such as “The January Effect” or “Sell In April and Good Luck Finding Something That Rhymes With April,” the game is over, the easy money has been made, the tourists have been fleeced and a new truism has to be discovered.

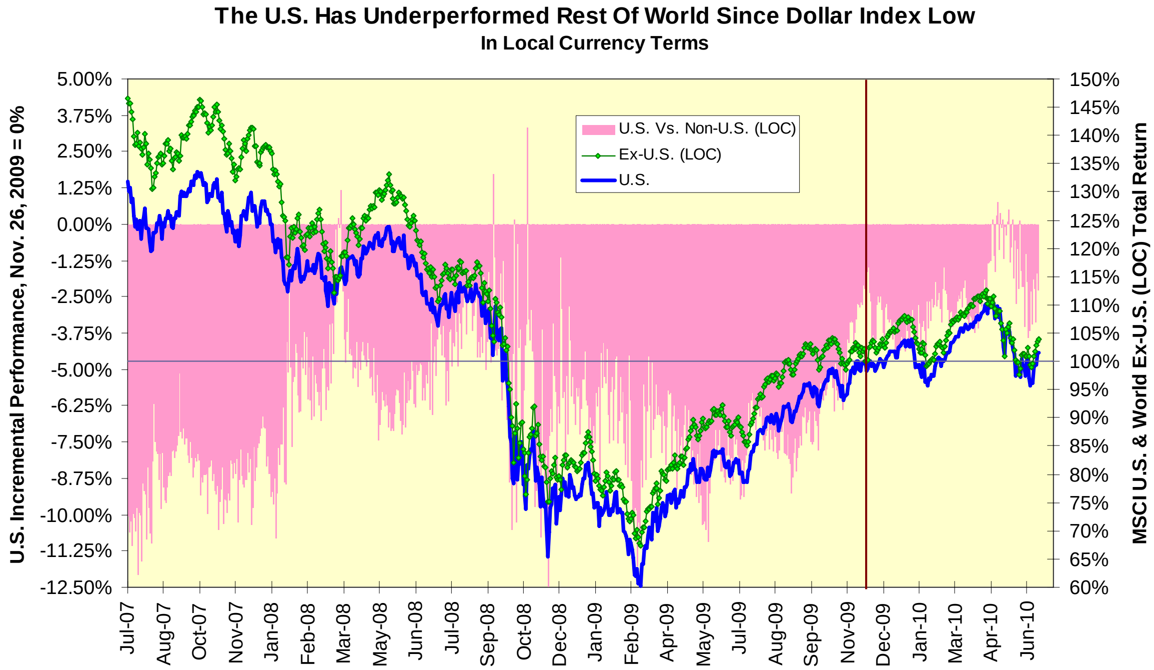
So it is with international equity diversification, at least on the national index level. Early entrants into this market were treated as if they were the financial equivalents of Indiana Jones, off to faraway and no doubt scary places to seek out investing opportunities where they sensible dare not tread and they, yes they, would bring them back to you for a management fee and a willingness to read their Chairman’s Letter in the next quarterly report.

Let’s take a case we could repeat over other times and places as the conclusion has been in place for a while. The dollar index hit its most recent low on November 26, 2009, marked with a vertical line on the charts below, as the world recoiled in disgust at American fiscal mismanagement and monetary profligacy; it has rallied since as the world recoiled in disgust at non-American fiscal mismanagement and monetary profligacy. We have not changed a thing, not unless you want to include that *Time* cover with Ben Bernanke as Person of The Year, an award sponsored no doubt by the Gutenberg Society for Excellence In Printing.

If we re-index the total returns in U.S. dollar terms for the U.S. and the World Ex-U.S. to November 26, 2009 and extend the time sample back to the start of the credit crisis in July 2007, we find the U.S. has outperformed the rest of the world handily since the dollar began its relative rise; the degree of outperformance in depicted in the roseate shading.



Now let’s replicate the analysis in local currency terms, spending only a few seconds in sympathy for the poor schlep at MSCI-Barra who has to maintain a total return index for dozens of countries in their local currencies. Here the U.S. has underperformed very slightly since November 26, 2009, which I suppose beats a long era of larger underperformance prior to the euro’s self-immolation.



The November 26, 2009 line has been a statistically significant divisor in time, both before and after for the individual indices and on the cross-sectional analysis between indices. The net result is all of the difference in performance between domestic and international investing has been, intentionally or otherwise, a bet on the dollar.

U.S. mutual fund investors have been pumping their hard-printed pieces of paper overseas more than they have been keeping them home for the past five years, with the prominent exception of late 2008. This behavior has held regardless of the trend in the dollar, which indicates a belief greater returns are to be had elsewhere. The sad truth is global equities have been homogenized by an efficient market into the current price reflecting future expectations for earnings. All that is left, then, is a currency trade and an expensive one at that.