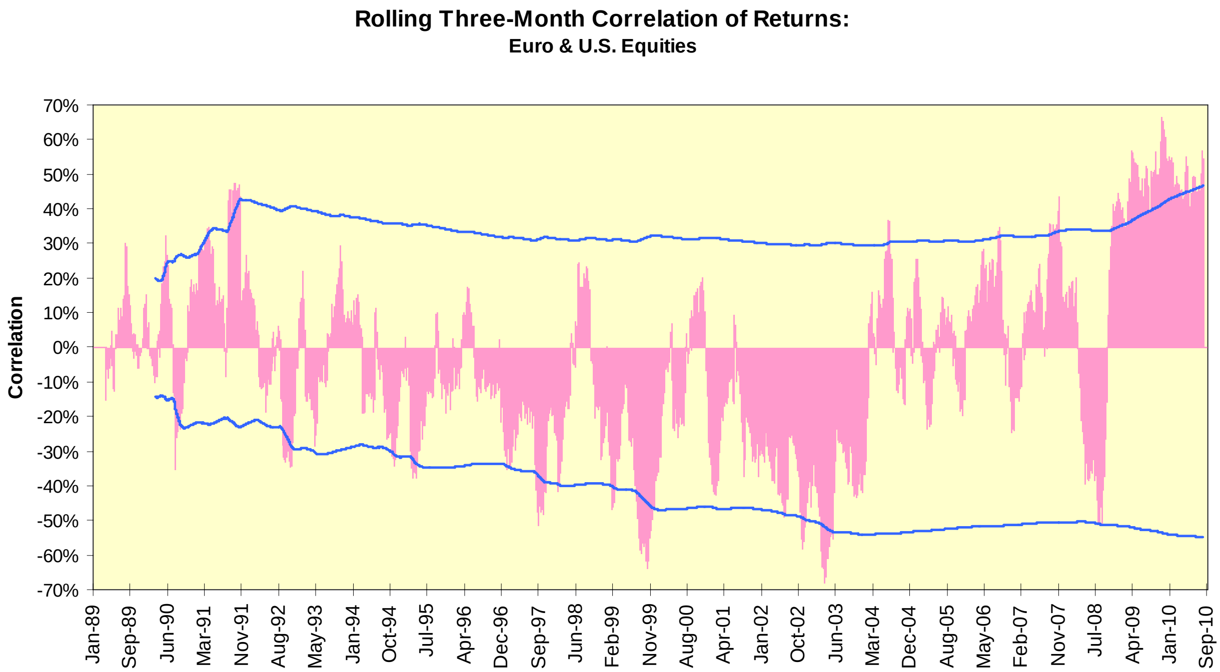
Whatever Happened To The Euro Connection?

If there is one point in market analysis that cannot be emphasized too much or repeated too often it is a relationship must work at all times and in all market conditions or there must be a valid intervening event. Otherwise, all we ever would have is a series of unrelated anecdotes pretending to be a relationship when all they really demonstrate is any two points can be connected with a line.

The 2009 global market rallies had all manner of assets we define as “risky,” as if there really are risk-free assets after taxes, inflation and holding costs are accounted for, moving in unison. One of the pairs rising and falling in unison was American equities and the euro.

Many analysts – let’s call them “slobs” in honor of their work ethic or lack thereof – compared the spot prices of the S&P 500 and of the euro, forgetting in both instances an investor is not long the spot price but rather the total return stream and that correlations should be of returns, or daily percentage changes and not of the ordinal price series themselves.

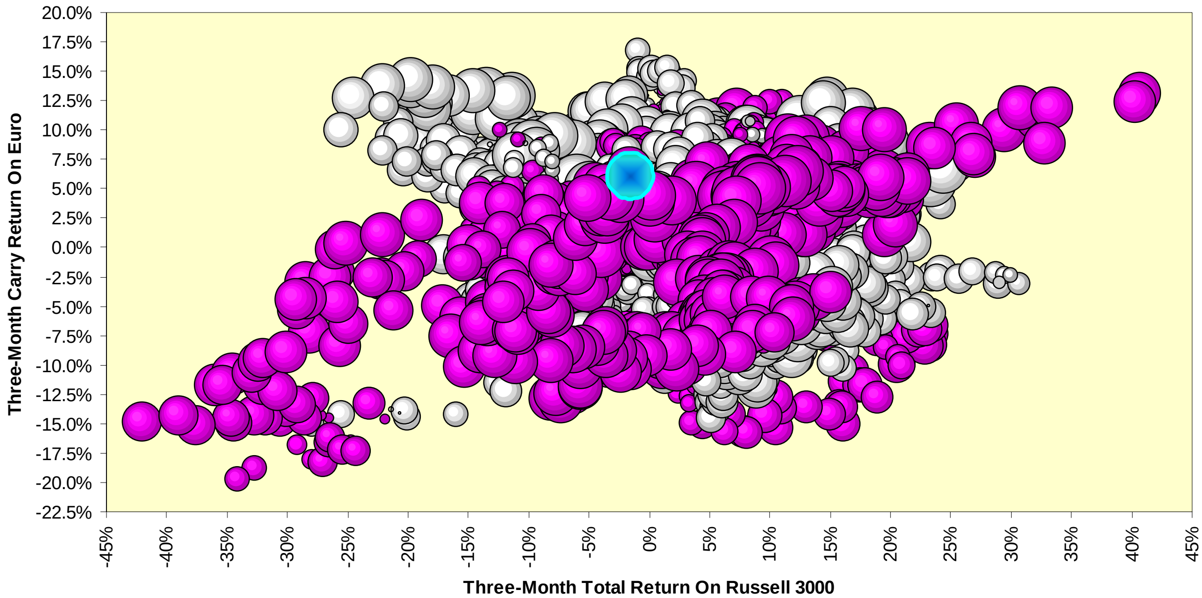
If we expand the American stock market from the S&P 500 to the Russell 3000 – where else can you get another 2,500 stocks at the stroke of a pen? – and use the total carry return from borrowing the dollar and lending the euro, we can construct the analysis properly. The chart below depicts a rolling three-month correlation of returns between these two total return series, with a continuous ±95% confidence interval starting after one year.



The rolling three-month correlation of returns has been outside of its expanding 95% confidence interval almost continuously since November 2008, a rather stunning achievement and one almost wholly attributable to the common response of both markets to near-0% short-term interest rates in the U.S.

Is this state of affairs related to the bear market that ended in March 2009, the bullish runs that peaked at the end of April 2010 or the downward-pointing trading range prevailing from May 2010 onwards? The answer seems to be no. If we map the correlation of returns as a function of three-month returns on the euro and on the Russell 3000, we see how uniformly the positive returns (magenta bubbles) are distributed. The last datum used is highlighted in blue.

Correlation Not Dependent On Stock Market Conditions



The end result of all this is if and when U.S. monetary policy ever changes, the apparently permanent strong link between the euro and U.S. stocks will end and the soundbite crowd will have to move on to something else. Until then, and we are still in the until-then state of affairs, we should continue to expect a high degree of linkage between U.S. stock market returns, accessible in thousands of ways, and returns on the euro, accessible either through the direct trading of the currency or a euro-linked ETF such as the Euro Currency Trust.

But if there is ever a situation where correlation does not imply causality, this is it. The two markets may rise and fall together as long as the money flows freely, but not because of anything the other market is doing.