Is The Euro Still Stretched?

"This game isn't over until Minnesota Fats says it's over." ... Fast Eddie Felson
"Stick with him. He's a loser."... Bert Gordon

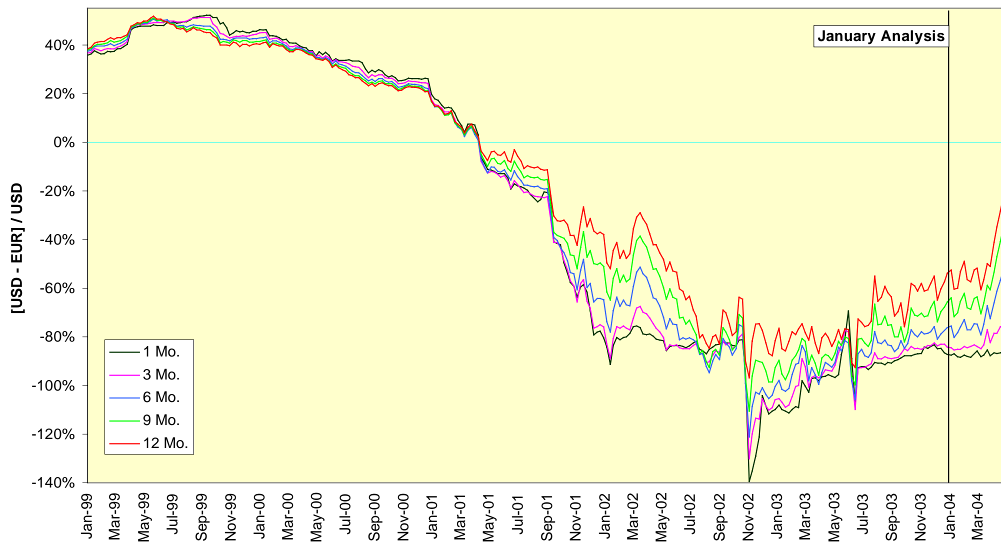
This memorable snippet of dialogue from the 1961 movie classic, *The Hustler*, comes as Paul Newman's Fast Eddie character refuses to walk away a winner. George C. Scott's Bert Gordon recognizes a gambler with a need to lose, and the rest plays out along predictable tragic lines.

Trading is subject to identical psychological pulls and tugs, and I suppose market analysis is as well. Why else revisit a topic so soon after a successful call, in this case for an impending top in the euro made in January? The answer is simple: The monetary landscape has changed tremendously in just four months, and given the importance of this exchange rate to all markets, a fresh look is necessary. Besides, it is time to close my successful bearish market calls on both the euro and the precious metals.

Currency Drivers
Too many traders view every downturn in the greenback as the inevitable and perhaps divine retribution for our wicked, wicked ways, including those ever-popular twin deficits. The U.S. has not run one single month of a merchandise trade surplus since April 1976 and only briefly ran a budgetary surplus for a few quarters during the second Clinton administration by virtue of excess Social Security tax revenues. These variables are poor explicators for the numerous periods of dollar strength during the past three decades.

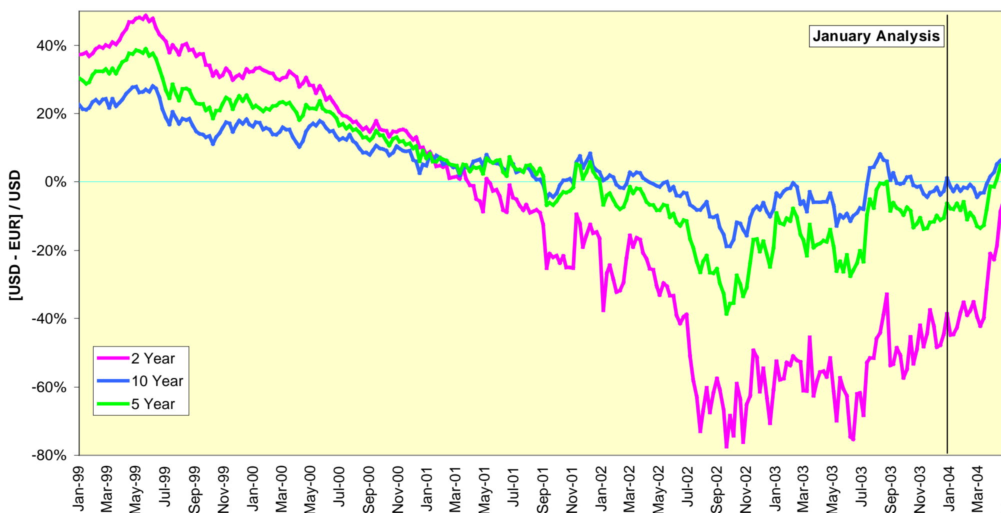
The reality for currencies is far less dramatic: You are lending in the currency you buy and borrowing in the currency you sell. According to Fisher's Law, each of the two interest rates involved can be decomposed into expected inflation and an underlying real rate; the real rate must be identical at identical maturities to preclude arbitrage. The spot exchange rate closes this interest rate relationship and - the critical *and* - reflects the market's expectations for relative asset returns in the two currencies.

Updating The Ledger
The short-term interest rate gap between the U.S. and the Eurozone ballooned in favor of the euro during 2001-2002 as the Federal Reserve cut rates aggressively and the European Central Bank hewed to a more measured approach with considerable patience. By January 2004, the rate gap at various money market maturities was narrowing, especially at the 9-month and one-year horizons. That closure has accelerated since the April release of the March employment data.



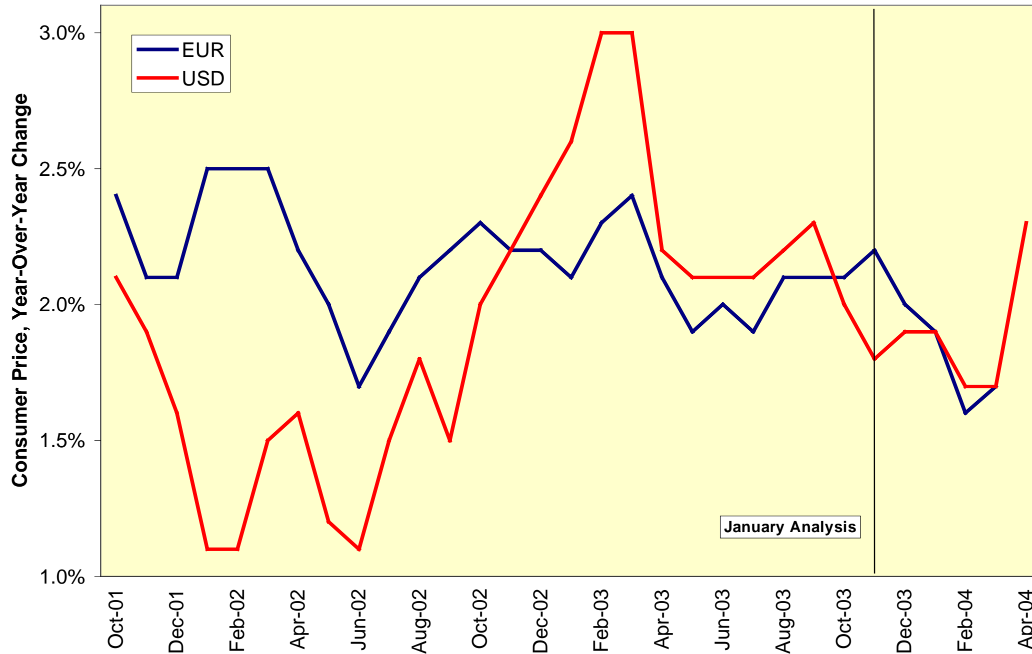
As short-term interest rate trends can be persistent and powerful, the easy course of action here would be to call a continuation of this closure, which would be bullish for the dollar. However, the Fed has spoken but it has not acted. The market, in turn, has priced in a series of rate increases beginning at the end of June and continuing for a total of 100 basis points by year's end. Presumably, the currency market has priced these rate hikes in as well. Until we see actual action or further rhetoric, we cannot regard the present short-term rate as dollar bullish. In fact, it could be a prelude to a dollar selloff if events take over and the market starts pricing out future rate hikes.

This analysis is confirmed by the move to and through interest rate parity at the various note horizons. The rate gap for the ten-year note had closed in January; it has now swung to favor the dollar at both the five- and ten-year horizons and is at virtual parity for the two-year notes.



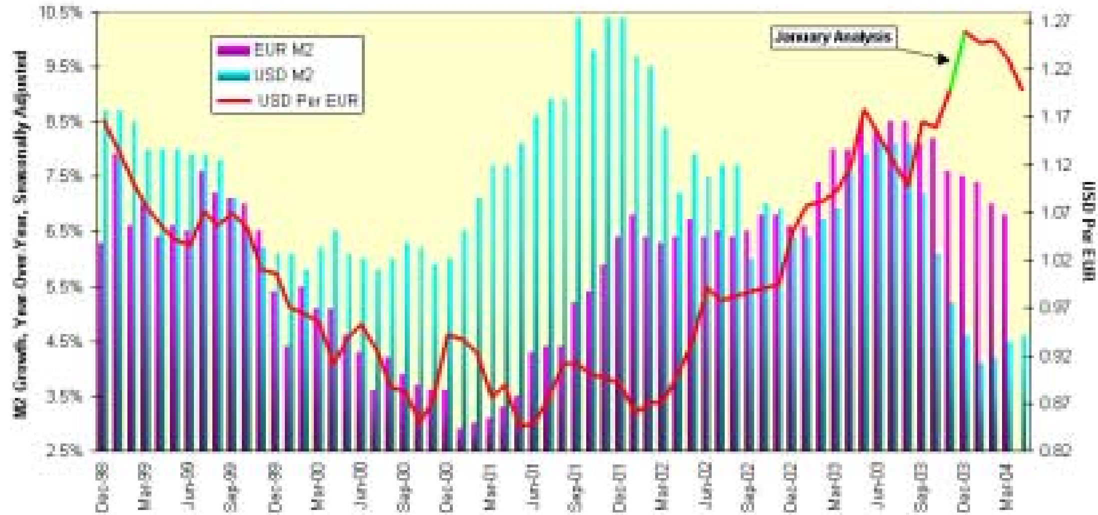
These note yields are nominal. Ideally we would compare inflation-protected notes, but there are no euro-denominated equivalents to our TIPS. *C'est la vie*, as my Spanish friends would say. If we compare the two

consumer price indices - and is there a more maligned economic datum than the CPI these days? - we can see how American inflation had started to move below its European counterpart in late 2003. The U.S. April CPI has surged higher; the European report for April is not yet available. An increase in American inflation relative to Europe is, all else held equal, a negative for the dollar.



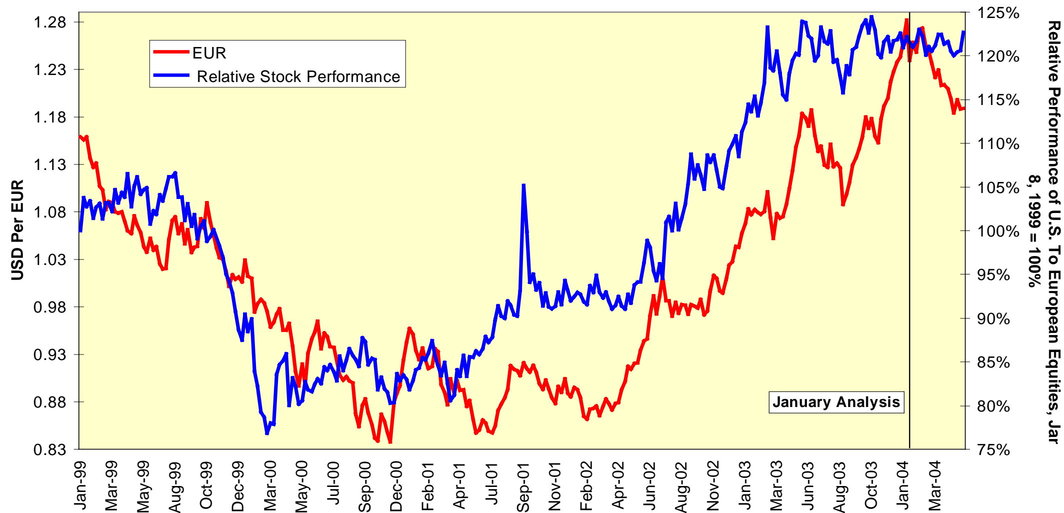
If we accept inflation to be a monetary phenomenon, and we should, we should look at the comparative rates of growth of the two money supplies; in fairness, the measurement of monetary aggregates has come under criticism as well. American M2 growth fell sharply relative to its European counterpart in late 2003, and while it is still growing more slowly, the gap started to close earlier this year. The European point for April has not been reported yet available (this is what happens when you give people six weeks of vacation). On balance, this still has to be considered as supportive for the dollar, although less so than in January.

Faster M2 Growth In Europe



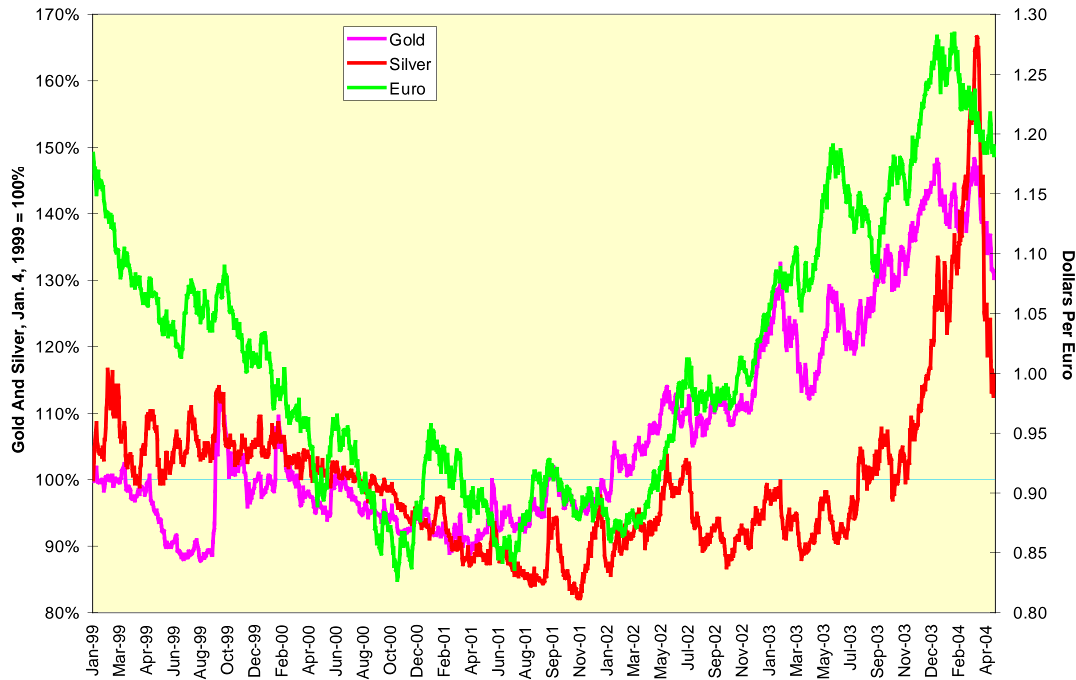
While there is no direct measure of expected relative returns on assets, the comparative performances of two broad stock indices in their local currencies, in this case the Russell 3000 and the MSCI Euro index in dollars and euros, respectively, can be used as a proxy. As noted in January, this measure has tended to lead the euro as stock markets rally in anticipation of greater liquidity and the weaker currency resulting therefrom. It has been stalled for more than a year and really cannot be considered as providing any direct clues to the exchange rate.

The Atlantic: One Side Is As Good As Another



In sum, the stretched valuation cited for the euro back in January has disappeared. A more important change from then, however, is the market now has priced in a round of higher short-term interest rate increases in the U.S. Any event that derails this expectation will lead to an abrupt decline in the dollar against the euro. It would take the opposite, the unlikely decision by the Fed to be more aggressive in its tightening schedule, to continue the dollar's rally.

Precious Metals
Gold rose more slowly than the euro during 2003 and silver rose more slowly than gold until a short-lived burst higher in February and March 2004. Both metals, silver especially, have retreated since the euro's peak. The metals' performances suggest that expected inflation has not been exceeding the short-term interest rate costs of holding the metals by a margin sufficient to outweigh any change in the dollar's absolute value.



The same calculus of risk applies to the metals as to the dollar: Should the Fed back away from the rate hikes priced into the market, expected inflation will exceed the short-term interest rate cost of carry and the metals will be able to resume their rallies.