Stretching The Euro

The concept of fair value is a powerful one. While buying a dollar for $1.10 can work during a bubble and selling a dollar for $0.90 can work in a panic, those trading strategies catch up to you sooner or later. If, however, the fair value of a market is indeterminable, the entire notion of buying low and selling high gets tossed out the window from a floor of your choosing.

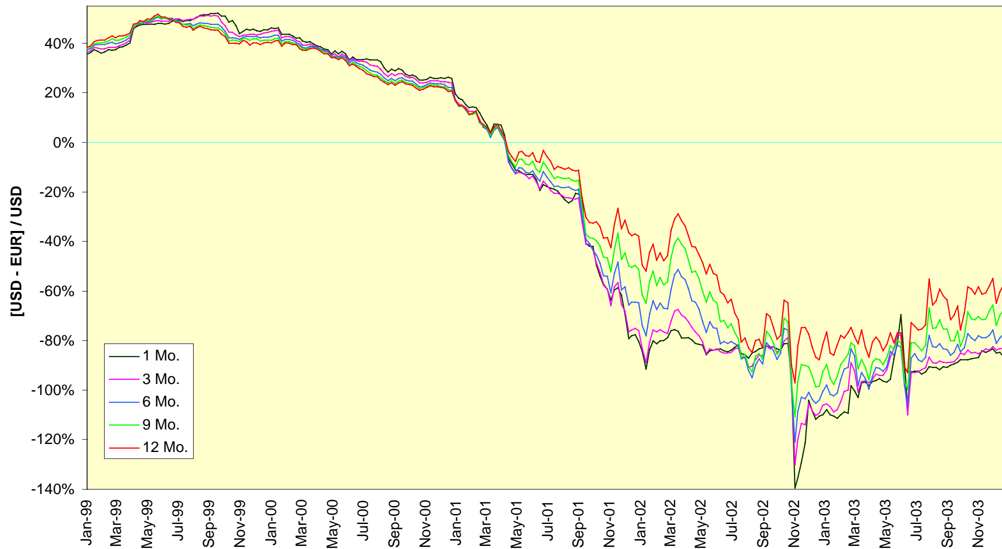
This is the case in the currency markets, especially for the dollar/euro rate, the source of so much tension and anxiety of late. The obvious runaway freight train nature of this trade is stretching the euro beyond its limits. Given the V-shaped reversals common in currency charts, those long the euro may wish to contemplate the wisdom of selling too soon.

Where Is Fair?
That currencies are impossible to value is given by the dual nature of their market. They have a role in the facilitation of actual international trade; this accounts for maybe 5% of the volume transacted daily. But to the surprise of many who view the world through an accounting lens, one wherein various forms of cash are exchanged for goods and services, very active trade in currencies can and does occur in the absence of any underlying physical flows. This is why exchange rates and the current account deficit are so unrelated over time, as I noted here in December.

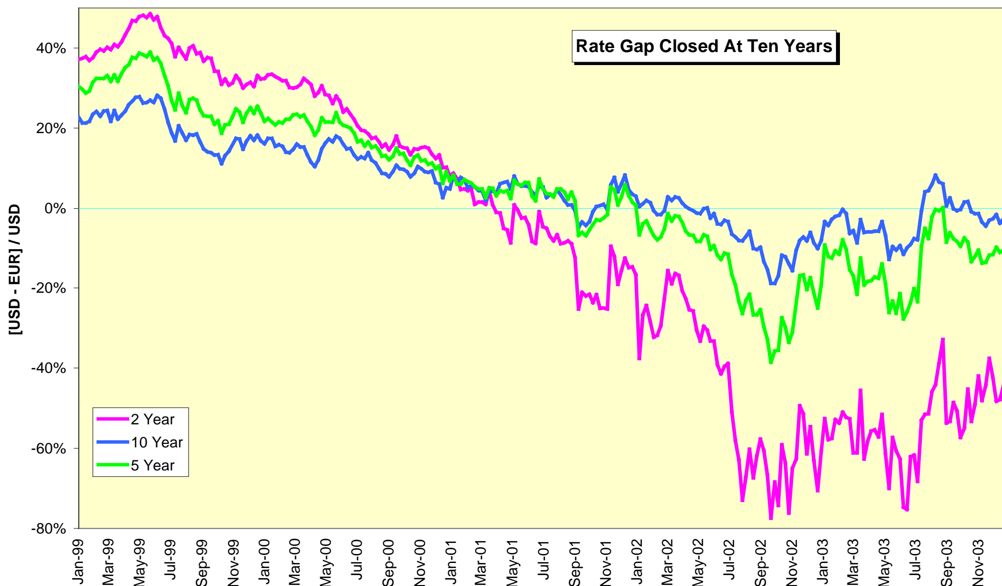
The second, and by far larger, engine of currency trading is an arbitrage between the interest rates of two economies. The central equation of this trade, known as covered interest arbitrage, contains three variables, the spot exchange rate and the two interest rates along any maturity segment of the yield curve. As we all remember fondly from our high school algebra classes, you cannot solve a single equation with more than one variable; you would need either to fix two of the variables or one of the variables and the relationship between the other two.

One consequence of the financial aspect of currency trading is that any exchange rate can take on any spot market value and still clear the market; all traders need to do is hedge themselves appropriately in the interest rate markets. If exchange rates had no other macroeconomic effects, this would be harmless child's play, but exchange rates have significant effects throughout all sectors of an economy. The recent weakness of the dollar, for example, is penalizing importers and rewarding exports and is creating greater pressures to tighten credit than would exist otherwise.

The Dollar-Euro Rate Gap
I noted last week how the euro was continuing to strengthen even as the rate gap at six months had ceased moving in its favor and even as the overnight futures markets in the two currencies were signaling expectations for higher dollar (USD) rates relative to euro (EUR) rates. The same conclusion can be reached by examining the rate gap across the money market curve.



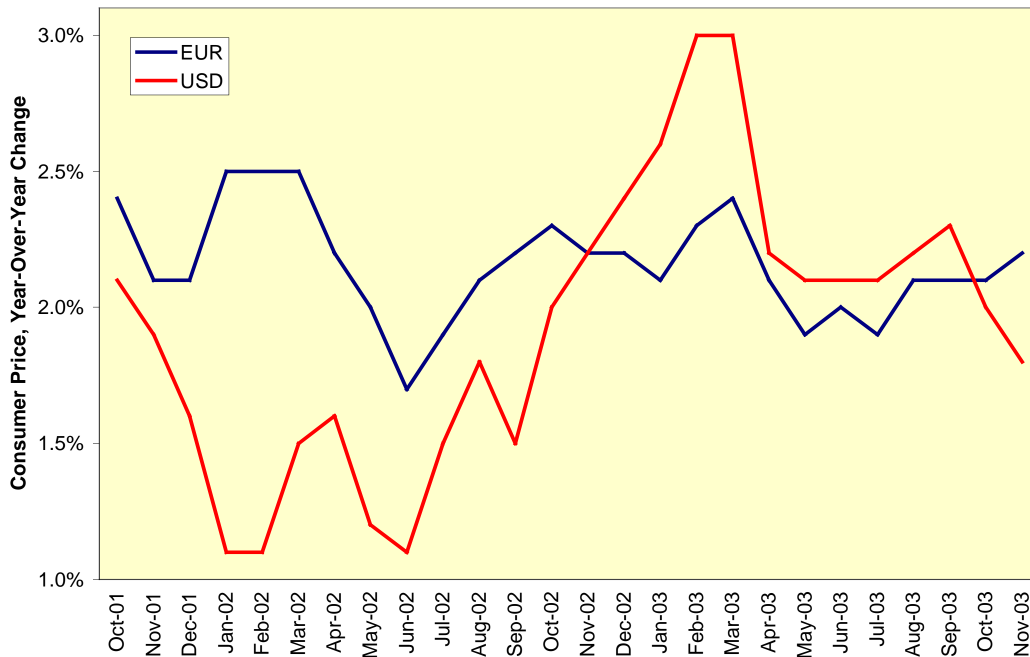
The rate gap, defined here as the absolute USD-EUR spread divided by the USD rate, was at its widest all the way back in November 2002. Not only has it been closing steadily in favor of the dollar since then, but the gap is becoming narrower at the longer maturities of the money market curve. This same pattern is continued in the bond curve to the point where ten-year USD now yields more than ten-year EUR.



Inflation Gap

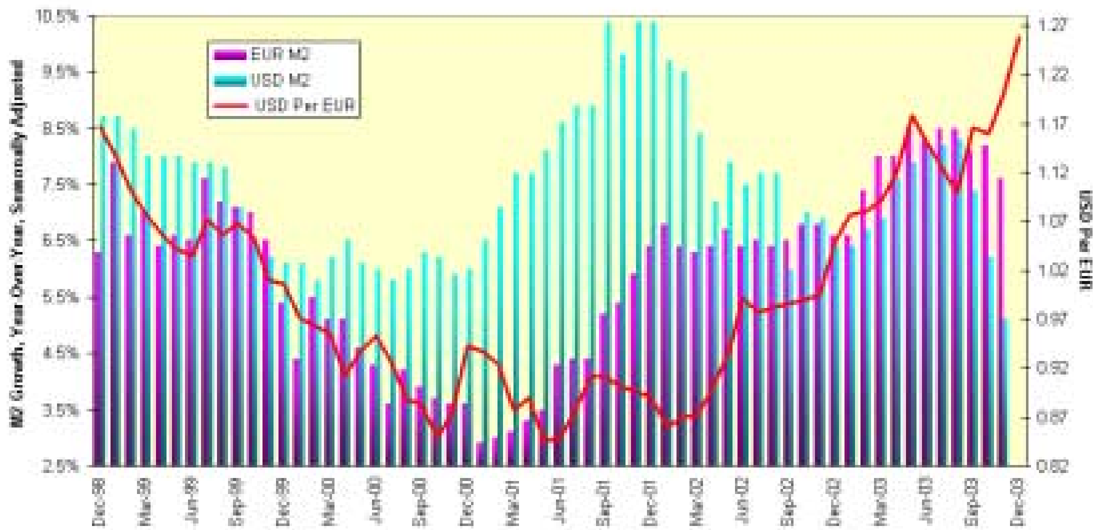
This behavior makes sense only if the market is expecting a higher rate of inflation in the U.S. than in Europe and for higher American inflation to persist over time. Restated, currency traders are bidding the dollar down to compensate for a higher inflation component within these nominal rates. While there are no euro bonds directly comparable to TIPS, we can examine some short-term clues on relative inflation. The year-over-year changes in consumer price inflation were more rapid in the U.S. than in Europe between mid-2003 and early 2003, but that trend has reversed of late.

U.S. Inflation Has Not Been Higher



Even more telling than reported inflation are relative changes in the growth of the money supply; inflation, after all, is a monetary phenomenon. Without more money chasing goods and services in the U.S. than in Europe, it is difficult to see how our inflation levels can exceed theirs in the short-term.

Does Relative Money Growth Matter?



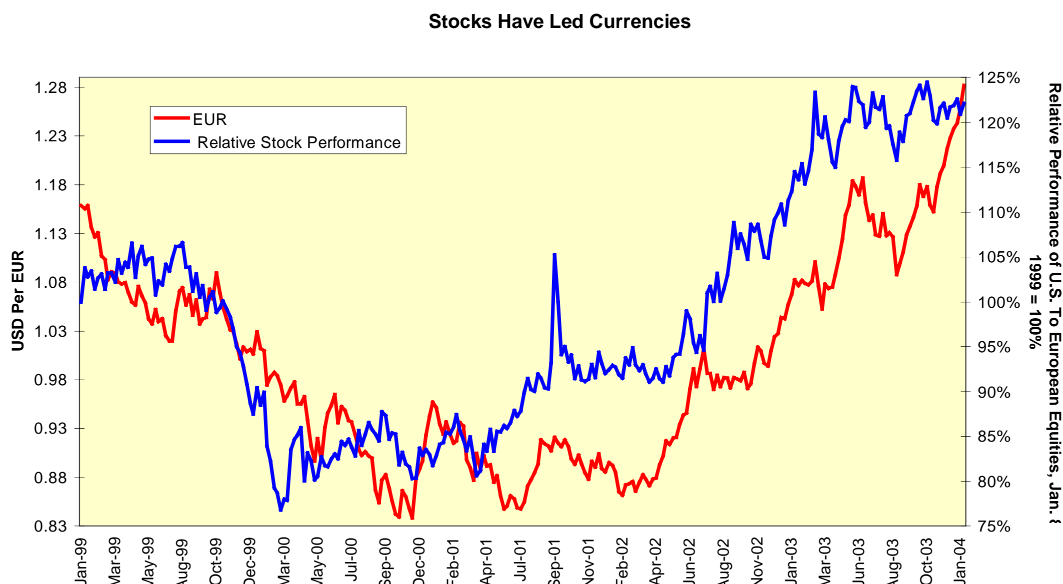
Our growth in M2 - and all of the usual caveats on measuring money discussed here in recent months apply - has been lower than comparable growth in European M2 for nearly a year. Interestingly enough, the far more rapid expansion of American M2 in 2000 and 2001 occurred during the midst of the euro's prolonged slide.

Are There Greater Returns On Euro Assets?

European growth has been far slower as of late than has American growth; the year-over-year change in real GDP in Europe through the third quarter of 2003 was an anemic 0.3%, which is quite weak in comparison to the U.S. figure of 3.6% over the same period. Unless there have been some absolutely astonishing improvements in European

productivity relative to us, there is nothing in the macroeconomic data to suggest higher returns on European assets that would make the euro more attractive.

Macroeconomic data look backward, but equity markets look forward. If we compare the relative performances of the Russell 3000 to the Morgan Stanley Euro index over the past five years, we see an odd relationship between stock markets and the exchange rate. The relative equity index performance appears to lead changes in the euro, both during the unit's decline and especially on its way higher. It is almost as if stock markets react positively to the prospect of a weaker currency.



The relative outperformance of U.S. equities ceased almost at the start of the general global rally in March 2003, and the two markets have moved higher in general parallel since then. Of course, American investors have enjoyed currency translation gains on their overseas holdings, while our European friends have been treated rudely at our hands.

Selling Too Soon

One thing we have learned in the three decades of flexible exchange rates is that official actions in the form of massive fiscal and monetary policy changes can end one-way trades. These episodes often are accompanied by large corresponding adjustments in bond markets, as is required by the mathematics of covered interest arbitrage.

Should Europe start to feel the pain of a too-strong currency, its only possible solution will be to lower its interest rates to match the policies of the U.S. That may remove the various intervention bids from the dollar and lead to an upward adjustment in U.S. interest rates, a scenario that could pose significant risks to U.S. financial markets later in the year.