EMU Relative Performance Currency-Driven

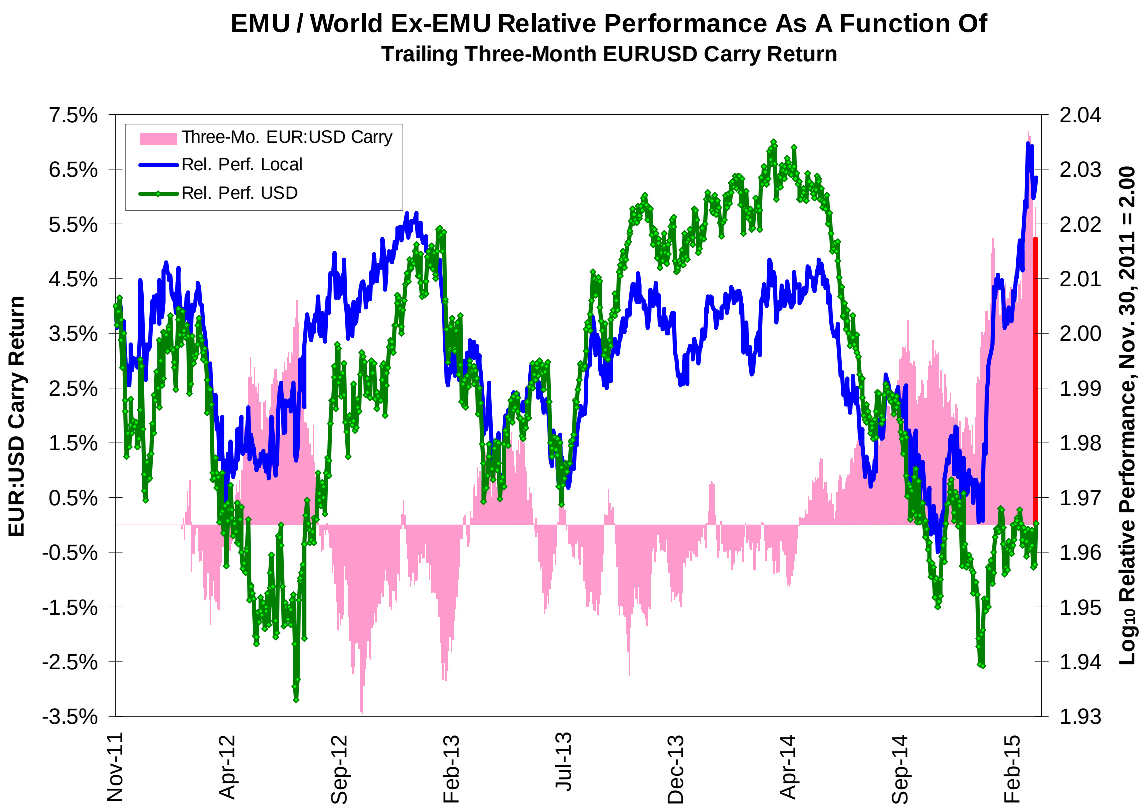
Yogi Berra said, “You can observe a lot just by watching.” Just to prove all these years of staring at screens have not been a total waste, let me share some observations on how our various Euro-friends, assuming there are some left, have handled the horror show of having to pay their governments to lend to them all while watching their euros lose purchasing power on world markets.

To summarize succinctly, they are willing to take on additional market risk, but they are drawing the line at currency risk when it comes to equities. I noted [last week](#) how the euro carry trade into emerging markets was a bond market affair. Now let’s focus the analysis on the relative performance of European Monetary Union (EMU, no relation to a certain flightless bird) equities versus the World Ex-EMU in both local currency and USD terms.

The EMU/World Ex-EMU relative performance measure can be measured as a function of two variables. The first is the carry return from borrowing the euro and lending into the dollar (EUR:USD), a trade some would have considered prima facie evidence of insanity at various times over the past fifteen years. The second is the three-month implied volatility of USD forwards for a EUR-domiciled investor.

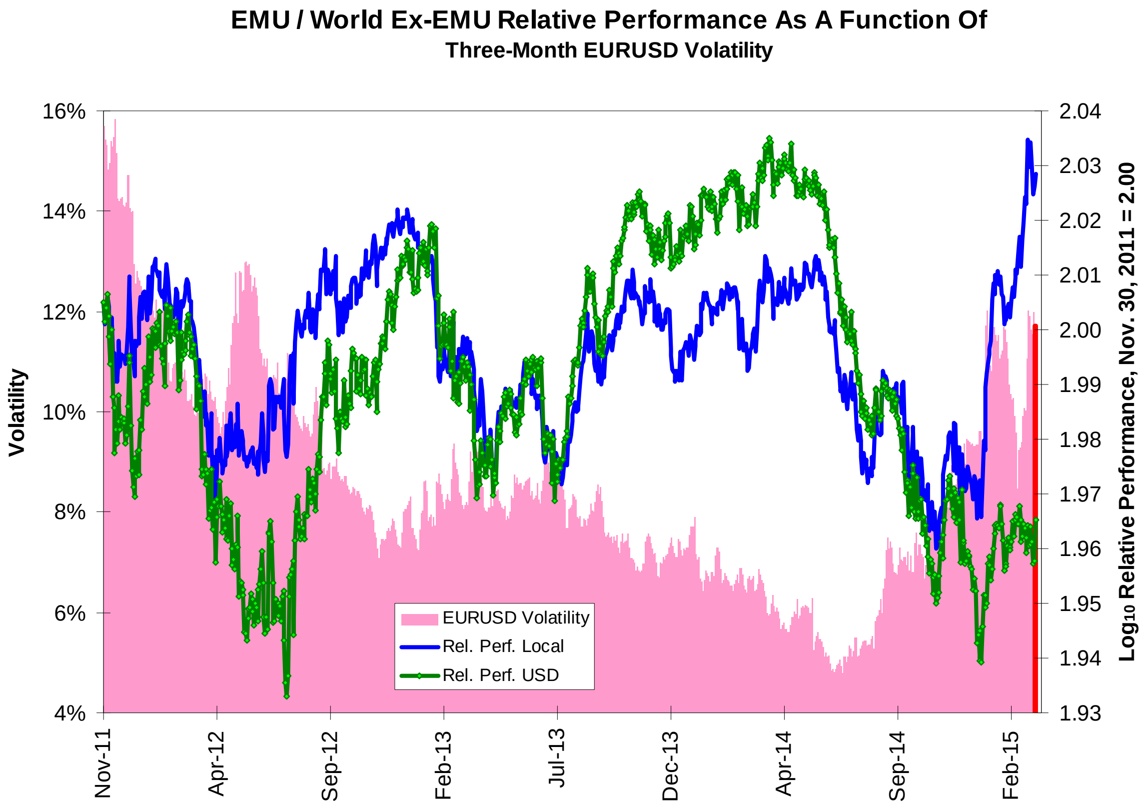
Carry Return

EMU relative performance in local currency terms increases markedly when mapped against rising three-month trailing EUR:USD carry returns and vice-versa. Between January 7 and March 20, 2015, relative performance increased 6.215% in local currency terms versus 2.57% in USD terms. The EUR:USD carry return was 3.94% over this period. As an important aside, EMU outperformance in USD terms in the face of a weaker EUR is a sign of intrinsic strength for EMU equities.



Volatility

Now let’s replace the EUR:USD carry return with three-month implied volatility. This measure showed a pronounced increase in mid-January, but this is a function of the massive dislocation associated with the lifting of the Swiss franc ceiling. Implied volatility had been rising since the first strong hint in August 2014 direct QE might be coming in the Eurozone. If we measure from August 22, 2014, we see volatility rising by 6.43 percentage points, the EUR:USD carry return expanding by 8.84% and the EMU outperforming the World Ex-EMU by 5.36% in local currency terms while it underperformed by 1.57% in USD terms. This is consistent with the notion rising currency volatility encouraged EMU equity investors to focus domestically, but it is not demonstrative proof thereof.



Where do we go from here? EUR-domiciled investors have been hesitant to swap the currency for USD for fear they would be buying the high of the greenback and would lose whatever they earned on a yield pickup on the currency downturn. All it takes is a couple of days like last Wednesday and Friday to reinforce that fear. This suggests the combination of a weaker EUR and rising currency hedge costs will encourage EUR-domiciled investors to keep on diving into their own equities. This beats paying to lend to their governments and it sidesteps the currency risk.