English Channel Energy Into Lower Rates

Anyone who has followed the unfortunate course of Zimbabwe over the past quarter-century should remind themselves it was once the British colony of Southern Rhodesia; Zimbabwean inflation reached the Bugs Bunnyesque level of 89.7 sextillion (10^{21}) percent this past January.

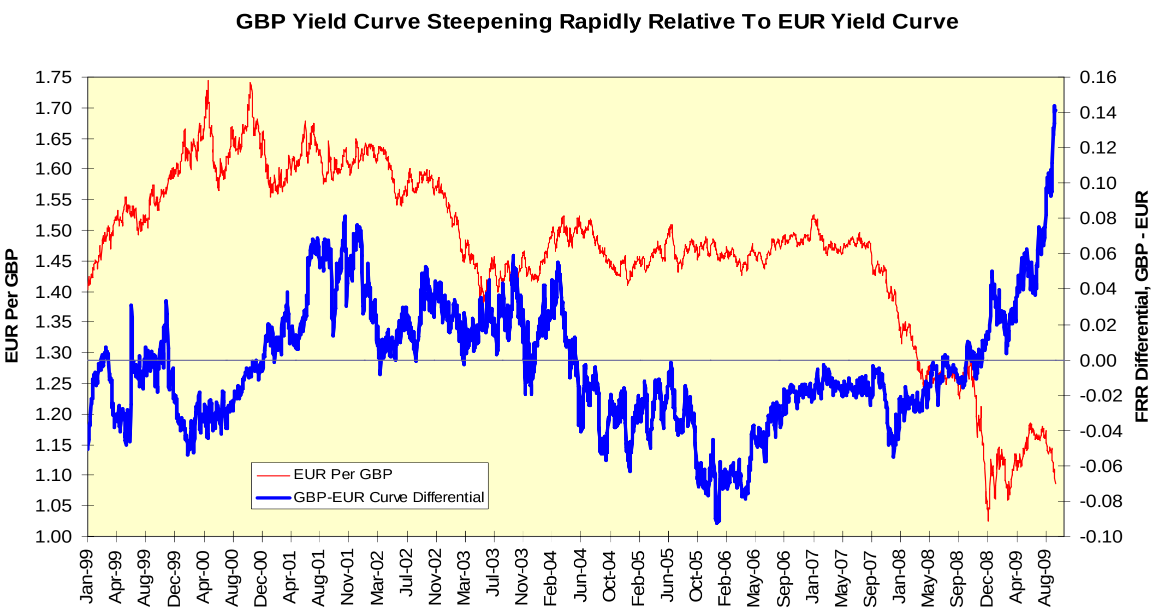
You should be careful where you step lest you leave unwelcome footprints at your next destination. The British left all sorts of calling cards from their empire's glory days strewn around the world. These included the license raj in India, a bureaucracy so maddening in Egypt people have been known to commit suicide while waiting in lines, and all manner of dingbat socialism in Africa in addition to the sorry history of Zimbabwe.

Incredibly, the British are about to eat their own cooking, a horrifying prospect in all senses of the term. Bank of England Governor Mervyn King has called the pound's weakening against the euro "helpful" in redressing the country's economic problems. As we shall see below, even the unexpected lassitude of British monetary policy has done nothing to raise the prospective valuation of British assets.

Loose As A Goose

One way to measure the extent of British monetary irresponsibility is to compare the forward rate ratios (FRR) between six and nine months of the pound and the euro. These FRR are the rates at which three-month borrowing costs can be locked in for a period starting six months from now, divided by the nine-month rate itself. The higher the FRR, the steeper the yield curve is.

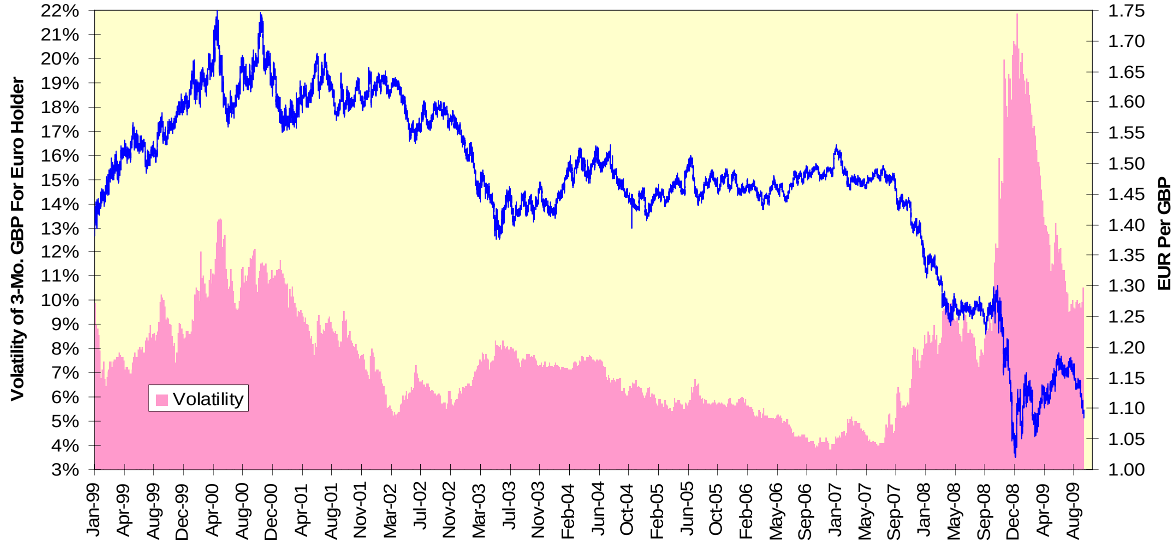
The euro FRR hit its all-time high on Friday. The spread between the British and Eurozone FRRs has been rising at a parabolic rate. As much as the Europeans try to inflate, the British are inflating faster, and the cross-rate of the pound against the euro is collapsing in response. For those of you interested in travel and geography, Zimbabwe's capital is Harare.



Not only does this collapsing exchange rate impoverish British consumers of goods priced in euros, all future global transactions between the British and the rest of the world are affected as well. Currency volatility, a phenomenon with which all of us will learn about the hard way in the months to come, raises the cost of doing business and as demonstrated in July 2003, steepens the yield curve across the capital horizon.

The volatility of three-month GBP forwards for a euro-domiciled holder has risen to levels last seen in October 2008. As anyone dealing with a British supplier or customer or who wishes to hedge British assets has to account for this higher cost of doing business, the British will suffer accordingly.

The GBP / EUR Cross-Rate And Its Volatility

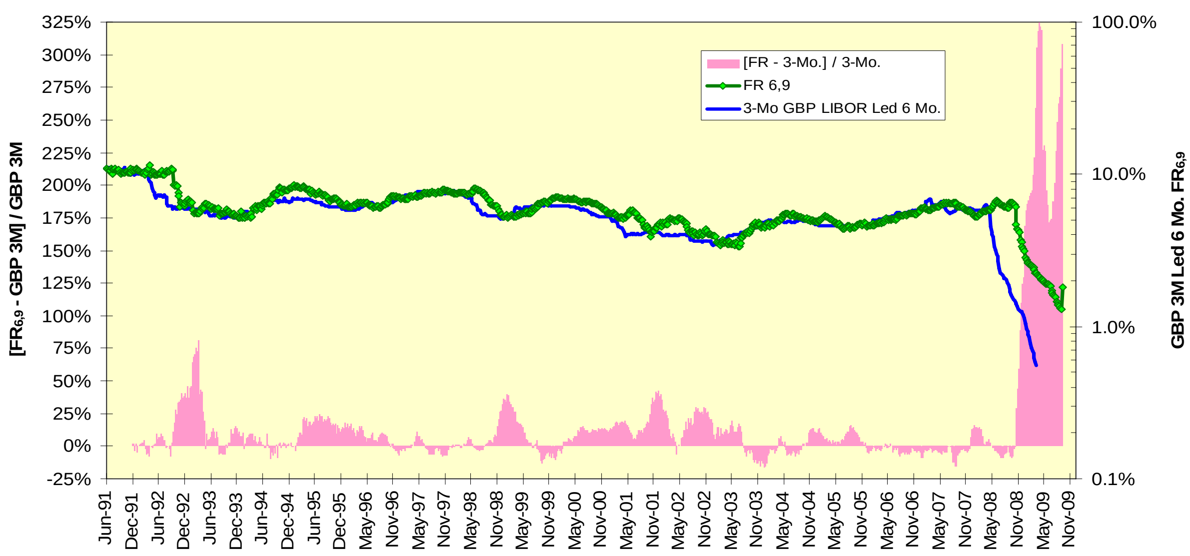


Zimbabwe's leading tourist attraction is Victoria Falls on the Zambezi River. The Limpopo River runs along the country's southern boundary. "Zambezi" and "Limpopo" are much more fun to say than "Thames" and "Potomac," but as the world is flat, expect convergence.

Surprise, Old Chap

Has the market been surprised by this drop in British rates? Let's return to an analysis introduced two weeks ago where we can compare the forward rate between six and nine months to three-month rate led six months. The higher the gap, the more the market has been surprised by the move in short-term rates. Here we have good news and bad news: No, the market has not been surprised as much as it was in either the American or Japanese cases, but yes, the market has been surprised for most of 2009 by the degree to which three-month GBP LIBOR actually has fallen.

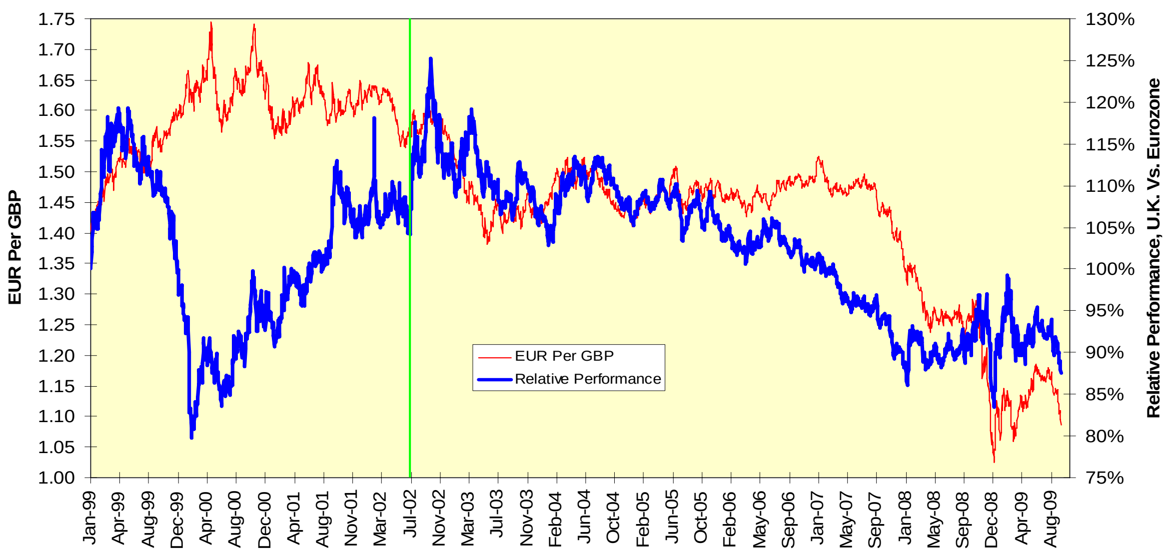
Surprisingly High British Rates Turn Surprisingly Higher



By the way, the Zimbabwean flag is both very attractive and chocked full of inspirational symbolism.

The Equity Market Response
There are some who believe debauching your home currency somehow makes assets denominated in that currency more valuable; that fallacy is rejected easily. If we compare the relative performance of the MSCI total return indices for the U.K. and the Eurozone expressed in USD, we find relative stock market performance has followed the exchange rate rather closely since mid-2002. Prior to mid-2002, the euro was unnaturally weak as vast cash caches of lira, guilders, francs, pesetas, escudos, etc, hidden from the tax collector were swapped for dollars as part of the continents oh-so-sophisticated rejection of "cowboy capitalism along the Anglo-Saxon model" was shifted into a different gear.

The Stock Trade Is A Currency Trade, Too



Each time the pound falls against the euro, the discounted stream of returns on British assets falls as well. This should surprise absolutely no one. The list of countries who have destroyed their currencies via monetary creation and have been rewarded for it is a short one.

Epilogue
There are times to mince words and there are times to say what you mean bluntly; I generally err toward the latter in any case. We can laugh at Zimbabwe's expense because it is not part of our daily life and is unlikely to become one. I have met one Zimbabwean in my life I am aware of, and that was a young lady on a plane in 1993 who was astonished I knew the capital was Harare.

I know many more people who fled parts of Europe during the 1930s with intact families and others who straggled here in the 1940s with non-intact families. Nothing led to the collapse of the social contract in 1923 Germany faster or more completely than the Weimar hyperinflation. I speak regularly with a reporter from the German edition of the *Financial Times* who tells me her grandmother used to refer to "when they took the money away."

Debauching a currency is playing with fire. You can destroy both life savings and entire societies in the process. This is a moral and ethical issue as well as a financial issue, and is there a Biblical parable where the wicked are not brought to judgment? The time to stop the madness is now.