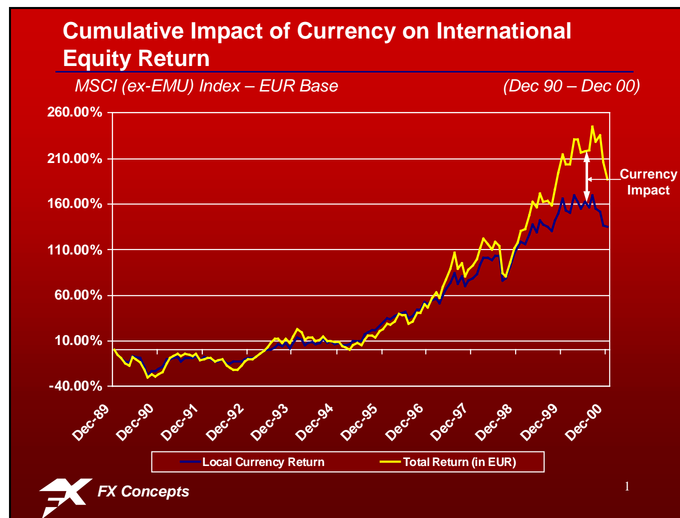
HOLDING ON TO THE CURRENCY BONANZA

By John R. Taylor, Jr.

Chairman, FX Concepts

During the last five years, global equity investors based in Europe have enjoyed a large performance bonus as the US equity market has become a larger percentage of the MSCI ex-EMU index because of the US equities' relative strength while the dollar has been rising against the rest of the currency basket as well. As the first chart illustrates, in 1999 and 2000 this bonus grew to enormous proportions as the euro dropped sharply against the MSCI currency basket.



The euro still remains depressed today and the US equity market remains stronger than its European competitors as well. Although the widely visible Nasdaq index shed more than 65% from March of 2000 to March of 2001 before recovering part of its losses, the far larger S&P Index has managed to retain most of its gains. Even looking at the tech sector alone, the Nasdaq has trounced its European counterparts. As a result, this has been a golden age of "out performance" for global equity investors in Europe, but it will not last forever. As we argue below, we believe that it has reached its end.

The benefits of the strong US equity market and weak euro were available to all continental European investors. This move did not jump into view with the hype over the internet, but built gradually over time. It began very slowly in late 1995 and then grew in power after the correction in the third quarter of 1998. It is important to note that the strengthening of all things American, currency, bonds, and equities – as measured in euros – is a trending move. Its movement was not a self-limiting or correcting one. It was not a random walk. Rather, the trend was internally reinforced by its own dynamics over a multi-year timeframe. All movements like this are compounded by human nature and overcome the mean-reverting processes, which often take a long time before they exert their influence.

Because international equity portfolios – especially those with heavy North American weightings – became the best performers in European portfolios in 1996, this helped drive more money offshore into these assets. As money increasingly chased foreign equities, they continued to rally. This portfolio flow out of Europe helped keep the European currencies under pressure, further

improving offshore performance from the European vantage point. Every investment made internationally represented a sale of euros, and eventually the euro swooned.

The technology "boom" in the US contributed to this trend in two ways. One was through the technology stocks whose profits grew sharply, driving up their corporate value and dramatically decreasing their cost of capital. This process allowed these companies to expand rapidly, causing their market value to grow exponentially. The second impact came from the investments of US firms in technology, which eventually led to large productivity gains and stronger profits. The technology mania exposed European companies as "old economy" businesses while many US companies were seen as "new economy" businesses. This concept further strengthened the flow from Europe, and foreign direct investment expanded along the same lines as many European companies bought "new economy" vigor with their euros.

After five years of dollar strength, many analysts are now arguing that the euro is weak because the investment opportunities outside of Europe are so much better than those within Europe. The quality of American investments is the reason for dollar strength, and dollar strength supports low capital costs and high equity valuations. Is there no end to this? What we have actually seen is a vicious circle where the euro's weakness brings about future euro weakness. The process is self-reinforcing and powerful, but eventually becomes unsustainable.

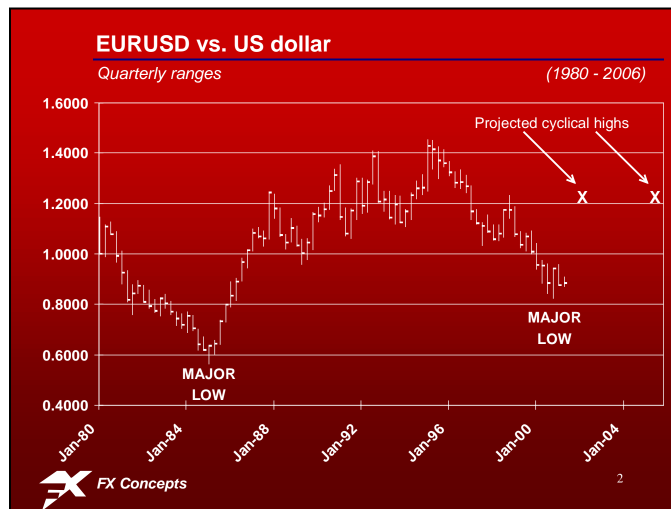
Investments in the US have become too large a percentage of the global savings pool – just like Japan in the EAFE index in the late 1980's. The rate of new inflows is unsustainable, and the market will find America's Achilles' heel just like it found Japan's. In fact, the United States is not lacking in potential problems and we believe that the market is beginning to turn against the dollar already. At this point the positive reinforcing cycle has begun to reverse. The currency market will revert to its historic trend and the dollar strength of the past five years will melt away. The dollar should lose most if not all of its gains since 1995.

From a historical perspective, the floating currency market is a relatively recent phenomenon, developing and morphing several times in the past 30 years. Its emergence as a critical economic and financial component has been closely aligned with the internationalization of global capital flows and the growth of the global funds management business. As we have seen in our review of the recent history of the euro/dollar relationship, currency movements are effected by the movements of capital and effect the movement of capital in turn. In a very general sense, major currency trends do follow the business cycle as capital is needed when economies grow and is shed – or exported – when economies shrink. As economies grow rapidly they outstrip their ability to raise funds within the country and need foreign capital. This means that capital flows toward the countries that are growing, these are also the ones with equity markets that are climbing. Currency flows go to the hot hand, whether it is Japan in the late 1980's or Thailand in the early 1990's. Capital moving into a country bids up its currency, but eventually a higher currency tightens local monetary conditions and weakens the growth engine. In this way the movements of currencies are dominated by – and help create – the cycles of economic growth. Once the stronger economy slows, the investment opportunities diminish. As a result, the flow of capital will slow and eventually reverse bringing the stronger currency down. The reversal can be – and often is – traumatic.

It is very clear that this process has been at work in the long-term relationship between the euro (German mark) and the dollar. The strong dollar has given European investors a boost, but this boost has probably reached its end. We would argue that the US equity market saw its top in March 2000 and the dollar reached its peak in October 2000. The previous trends are only now

starting their reversal. Although there are still arguments in favor of the dollar, the weight is definitely shifting against it. Our forecast is firmly with the dollar bears.

Our forecast, which is deeply rooted in the analysis of cyclical movements in the currency markets, calls for the euro to rally over the next few years, reaching a cyclical high in late 2002 and once again in 2006. Chart 2 below shows a picture of the euro (constructed from its components before 1999) against the US dollar, which represents roughly one-half of the MSCI ex-EMU currency index. We have identified the two major cyclical lows to allow a comparison of the 1985 low and the current one. The euro's decline from 1980 to 1985 is somewhat less than the one that is just ending. Although this does imply a large euro rally directly ahead, the recovery might be less impressive than the powerful one from 1985 to 1995. We can't really say. It could be a more subdued rally, considering the greater maturity of the global monetary system, but even our forecast for the end of this year is at 1.04, or a gain of 17.5% form current levels. The decline of the MSCI currencies against the euro should be more like 12% over the same period. This would be a retracement of slightly less than half of the euro's fall against this basket since the end of 1998. Even if we have overestimated this move, the odds favor a dramatic decline in value of the recent currency bonanza.

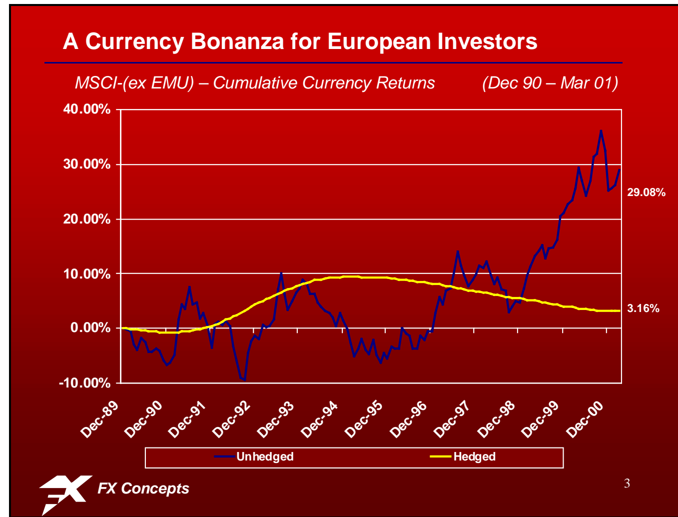


The critical questions for an investor to ask are: What should I do about this reversal? And, how should I protect myself and take advantage of this developing change?

Looking at currency levels over the very long-term as investors should, the movements will eventually balance out. One of the most accepted theoretical concepts about freely floating currencies is that long run currency movements among developed economies will cancel out over time. The ups will neutralize the downs in a classic random walk.

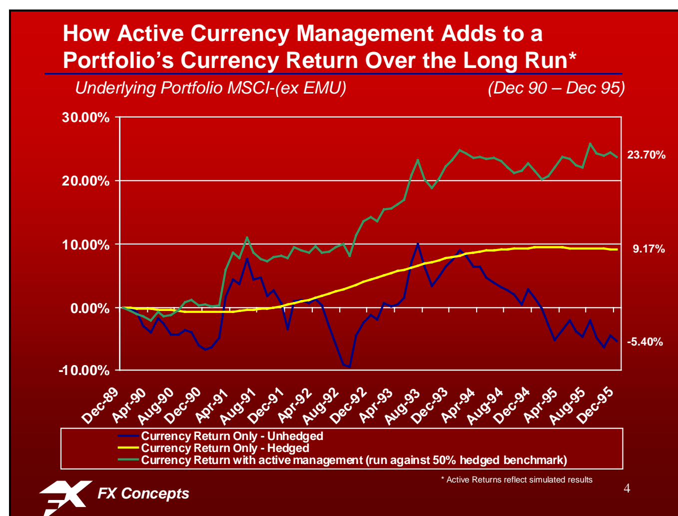
Chart 3 below shows the currency component of the MSCI ex-EMU index over the past 11¼ years, starting in January 1990. There are no equity returns in this chart, only currency returns. The jagged line is the unhedged impact of the currency over the period, while the smoothed line is the impact of the currency after it is removed by entering rolling 1 month currency hedges. The hedged line is not straight because of the interest differential between the euro and the MSCI basket. Most of the chart does illustrate the concept that long-term movements cancel each other out – it does that between the end of 1989 and the end of 1998. It also clearly points out the recent deviation that has occurred between the euro and the rest of the world. This is the currency bonanza that European investors have enjoyed. At the end of March, 2001 it was worth 25.92%. If

history repeats itself, or at least rhymes as Mark Twain once said, then this bonanza will soon dissipate.

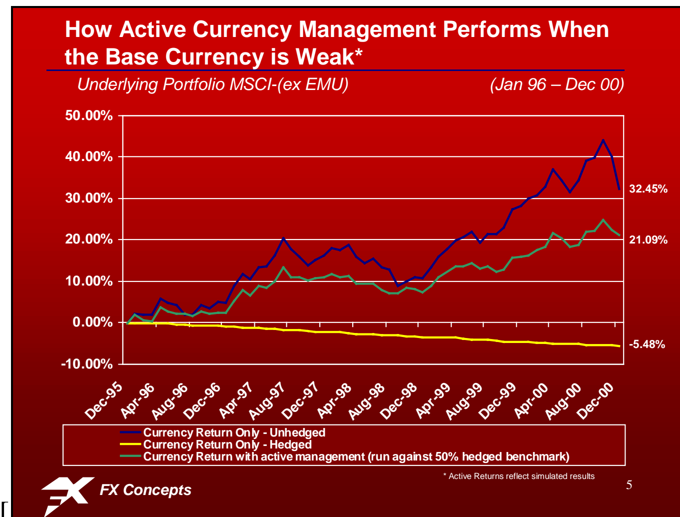


Currency overlay is the strategy investors should use to protect this gain. Currency management allows the effects of currency movements to be channeled positively. Weak currencies are hedged while strong currencies are left unhedged. The advantage of this selective hedging should be obvious as the winners are allowed to win and the losers are hedged away.

As we discussed above, most of the time, currencies do move up and down in cycles with the final effect being not too far from zero. During this normal type of market, hedging slowly outperforms both the unhedged currency alternative and the fully-hedged currency alternative. Chart 4 below shows FX Concepts pro-forma performance for an MSCI ex-EMU portfolio managed to a 50% hedged benchmark over the period from January 1990 through December 1995. During this period the unhedged currency basket dropped 5.40% while the fully hedged position gained 9.17%. The active hedging strategy outperformed the two passive alternatives by a substantial amount, returning 23.70% over the 6 years of this history. This is the kind of result one should expect from a currency management program over the long-term. An active strategy will gain value from currency while limiting any downward moves.



In chart 5 below, we have shown the same portfolio with the same currency management strategy, but in this time period the currency market is moving primarily in one direction. The euro moves down against the MSCI basket from the start of 1996 to the end of 2000 except for a short recovery period in late 1997 and 1998. The total euro decline – or currency basket gain – is 32.45% through the end of 2000. This is the currency benefit that the European investor gained over this time. In this case, if the investor were hedged, he would not perform as well. The overlay performance lags behind the streaking currency basket, but it is far ahead of the fully hedged performance. Even during this period of unusual strength, the currency overlay strategy captured 26.57% of the currency gain against the fully hedged result out of the total gain of 37.93%.



Now that the euro has been knocked down to an undervalued extreme, the odds overwhelmingly favor that the next major move will be higher. We would argue that it is almost impossible for an overlay strategy to underperform the unhedged currency basket. At this point in time, doing nothing about currency would be a terrible decision. The only way to hold on to the currency bonanza of the past few years is to take an active view by developing a hedging strategy with a professional overlay manager. Investors who continue to ignore currency will be severely handicapped in the years ahead.