INVESTOR ALERT

TOP DOWN INSIGHTS…BOTTOM LINE RESULTS

The Real Story on Currencies and Stocks

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Perhaps the most relevant financial story of the year so far has been the appreciation of the U.S. dollar and pronounced weakening of the euro, a trend attributed, by most observers, to over-leverage (and resulting debt woes) in the so-called "PIGS" of Southern Europe (Portugal, Italy, Greece, Spain).[1] While there's some truth to this insight, it's important for investors to recognize that *all major currencies in the world* have been losing value in *real terms* – not *only* during the past *year* but over the past *decade* too (2000-2010) – albeit at varying rates. Only superficially does it *appear* as though certain paper monies (like the U.S. dollar) are "gaining" in value; in fact they've been losing real value (which is *inflation*), and that's been quite detrimental to equity performance. In the *previous* decade (1990-2000), major currencies *appreciated* in real terms – and that proved *bullish* for equity returns.[2]

Figure One
The Value of the U.S. $ in Gold & FX
Indexed to 100 at May 2000
May 2000 - May 2010

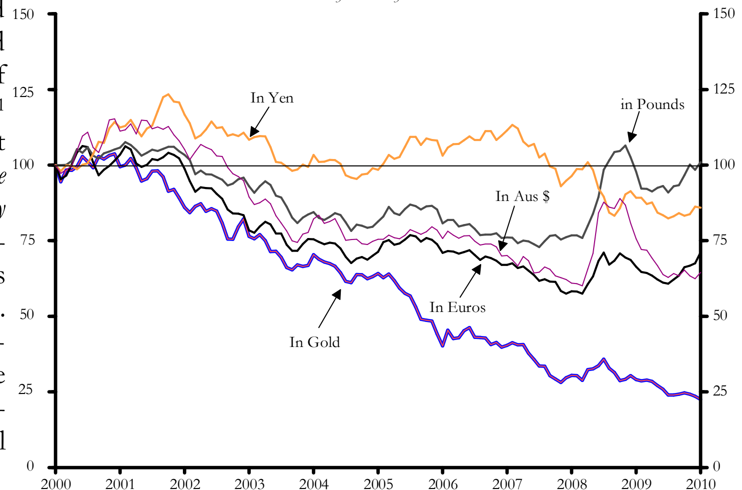
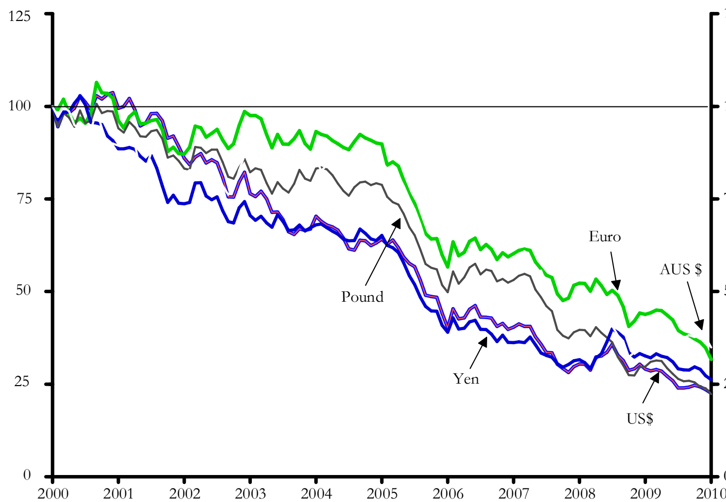


Figure Two
The Gold Content of the U.S. $ & FX
Indexed to 100 at May 2000
May 2000 - May 2010



First consider the evidence in Figure One, which plots the dollar's value in other paper currencies over the past decade and also against a real (tangible) asset: gold. We index each value to 100 a decade ago (May 2000) and trace the various moves since then. During this time the dollar has actually *gained* a bit (+1%) against the British pound, but has lost the most value (-78%) in gold content.[3] Meanwhile the greenback has lost 36% in terms of Australian dollars, 29% versus the euro and 14% in yen. Because the dollar lost *most* of its value in terms of gold, yet also lost value against other currencies, these other currencies simply didn't lose *as much* in real terms.

Figure Two shows how all the major currencies have lost considerable real value in the past decade. The

[1] So far this year, the euro has lost 15.8% against the U.S. dollar (from 1.46 to 1.23), after appreciating by 8% in 2009. The euro has also lost 14.4% against the Japanese yen (from 131.1 to 112.3), after appreciating by 6% in 2009. For our analysis of Europe's debt woes this year, see "Greece, Government Debt and All That," *Investor Alert*, April 7, 2010 and "Latest 'Crisis' is Much Ado About (Almost) Nothing," *Investor Alert*, May 21, 2010.
[2] We first documented these predictive patterns 7 ½ years ago, in "Inflation, Deflation and Investment Returns," *Investment Focus*, December 6, 2002.
[3] The "gold content of the dollar" signifies how many ounces of gold a single dollar can buy and is measured as the *reciprocal* of the more familiar gold price ($/gold). The gold price increased from an average of $271/ounce in May 2000 to an average of $1205/ounce in May 2010, so the reciprocal (or gold content of the dollar) declined from 1/271 (.00369) to 1/1205 (.00083) – that is, by -78%.

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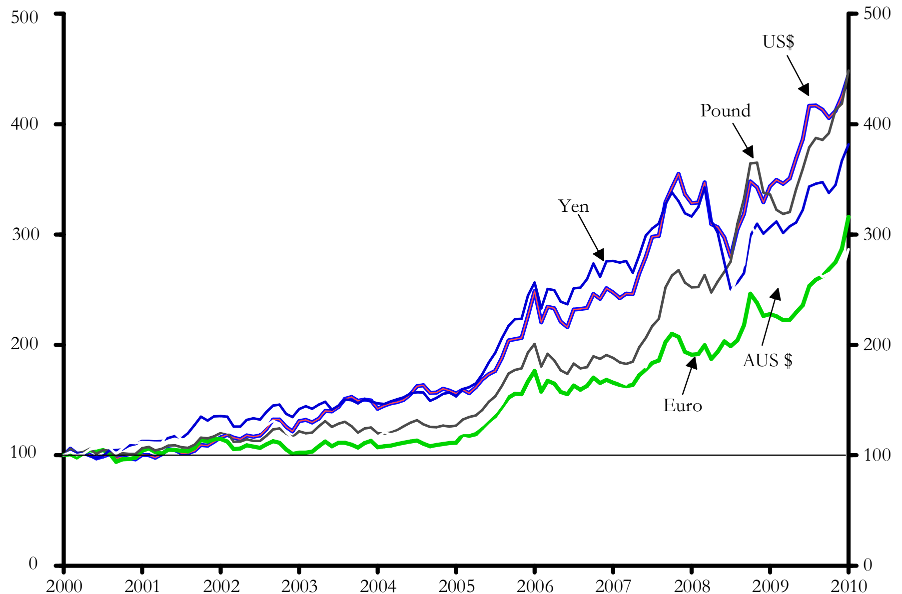
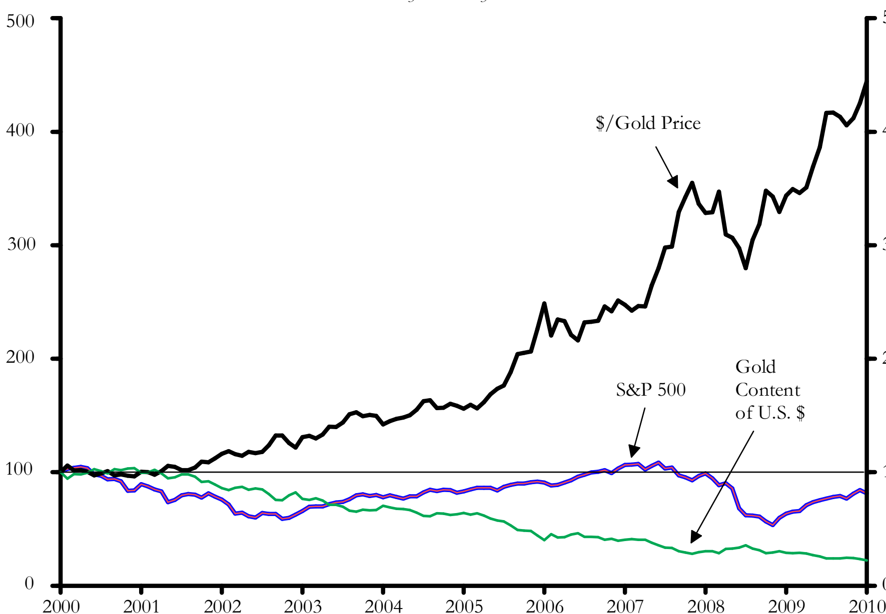
U.S. dollar has lost *the most* real value, but other currencies have lost real value too – just *not as much*. Not one currency has appreciated since 2000. All have lost real value. The "least worst" currency has been the Australian dollar, which has lost "only" 65% in real terms over the past decade.

To say the world's top currencies have depreciated in real terms over the past decade is also to say they've lost value in terms of gold (Figure Two, page 1), which also means the currency prices of a gold ounce have all *increased* during that time. Thus Figure Three illustrates how the *dollar-gold price*, the *pound-gold price*, the *euro-gold price*, the *yen-gold price* have all sky-rocketed, albeit to varying degrees, since 2000.



Now consider the deleterious effect of real currency weakness *on equities*. Figure Four shows how much the dollar-gold price has skyrocketed since 2000 (+4.5 times), corresponding to the 78% plunge in the dollar's gold content (real value). Clearly this has been *bearish* for the longer-term performance of the S&P 500, which fell 50% in 2000-2002, then rebounded a bit in 2003-2007 before dropping in 2007-2009 (-65%), such that it's now 20% *below* its initial value in 2000.



Although monetary-currency policy hasn't been the *only* bearish influence on stocks since 2000, it's been a significant one. The sequence isn't a mystery. With weaker currencies come rising inflation expectations. Central banks then hike rates, allegedly to "fight inflation." But when that policy causes inverted yield curves, it only eliminates the profitability of financial intermediation ("borrowing short, lending long"). This sabotages economic growth, profits and stocks.

The graphs reviewed so far have covered the past decade (May 2000 to May 2010), in which all the major currencies have lost material value in real terns, and the S&P 500 has been left 20% below its initial value. The *next* four graphs (Figures Five, Six, Seven and Eight, pages 3-4) undertake the same analysis, but for the *previous* decade: May 1990 to May 2000. In sharp contrast to the *past* decade, this *prior* decade entailed a sustained *rise* in the value of the dollar, not *only* against other paper monies but more importantly, in *real* terms (against gold), and that corresponded to a *sustained bullish run* in U.S. equities. Instead of the *gold price* rising more than four-fold (as oc-

curred over the past decade), in the *prior* decade the S&P 500 *itself* increased more than four-fold. This result defies the usual assumption of economists and strategists that a stronger dollar undermines equities.

Figure Five makes clear that in the 1990s the U.S. greenback *appreciated* against everything (except the yen). From beginning (May 1990) to end (May 2000) the dollar was worth 32% more in terms of gold, 30% more in terms of euros, 28% more in terms of Australian dollars, and 6% more in terms of British pounds. Only relative to Japan's yen did the U.S. dollar lose value (-30%).

Figure Five
The Value of the U.S. $ in Gold and FX
Indexed to 100 at May 1990
May 1990 - May 2000

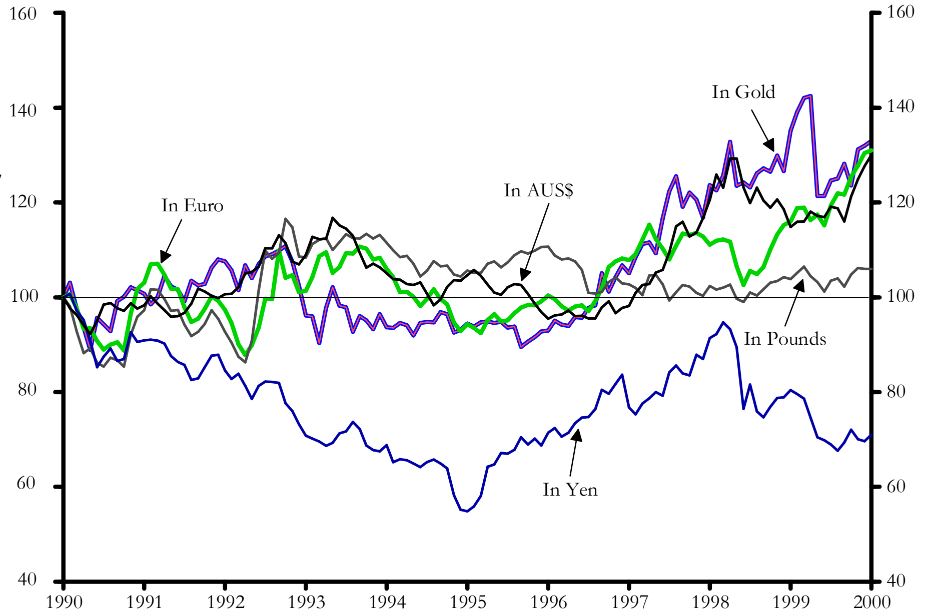
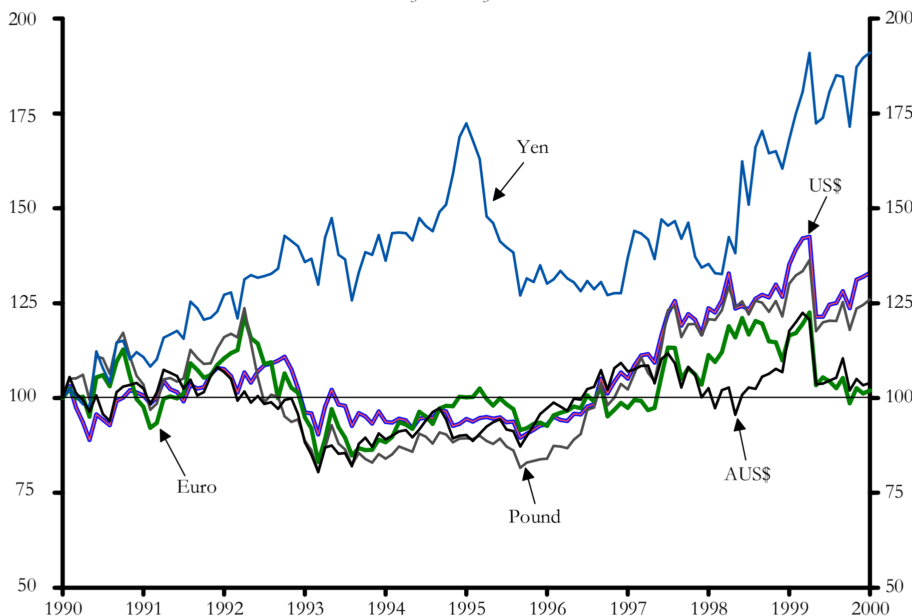


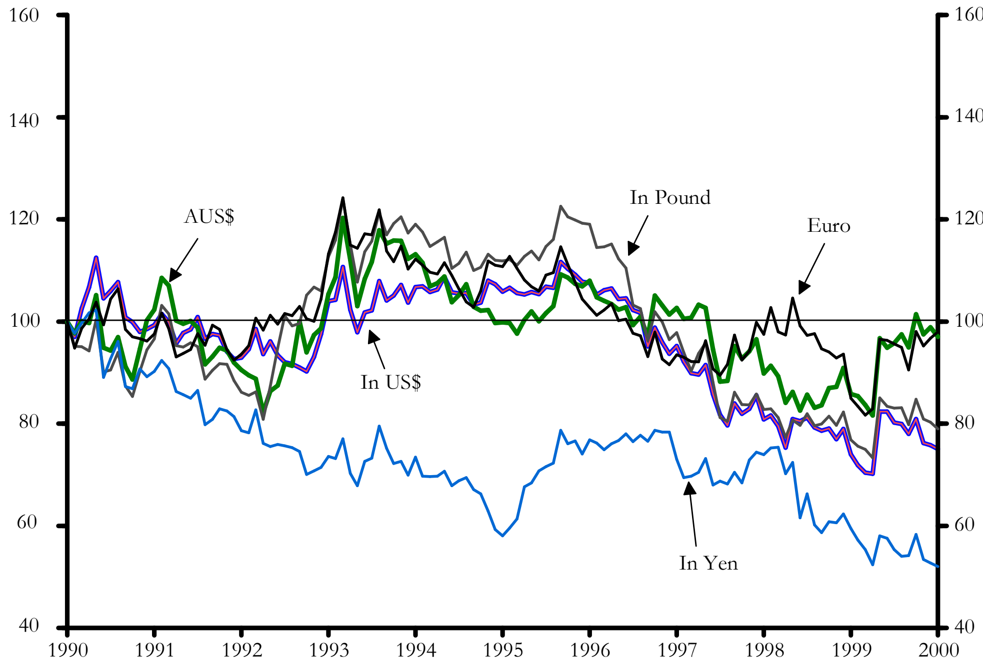
Figure Six shows how all the major currencies gained considerable real value in the 1990s – Japan's yen above all. None of the world's major currencies lost value, in terms of gold ounces, in that decade. The yen gained 90%, the dollar gained 32%, and the pound gained 25%, while the Australian dollar and euro gained 2% and 1%, respectively. As is well-known, Japan suffered a "lost decade" in the 1990s, whereby economic growth stagnated, a mild deflation took hold, government budget deficits sky-rocketed and the NIKKEI equity index remained 40% below its 1989 peak throughout the 1990s. One could argue, especially after consulting Figure Six, that a significant appreciation in the real value of a currency (in this case, the yen) is *not* bullish but in fact *bearish* for a country's equities. But Japan's equities peaked in 1989 and crashed in the few years thereafter because the yen had plunged in real value in the 1980s, and especially because the Bank of Japan then followed the rise in inflation expectations (which it called a "bubble") with *a severely inverted yield curve* in 1987-1989. Understandably, that policy dissipated the profitability of financial intermediation; most of Japan's major banks became insolvent; economic growth, profits and stocks were sabotaged.

Figure Six
The Gold Content of the U.S. $ & FX
Indexed to 100 at May 1990
May 1990 - May 2000



The economic-financial pain in Japan lasted a *full decade* (1990s) *not* because the yen appreciated too much but because Tokyo's policy-makers adopted a series of confidence-killing bank nationalizations and Keynesian "stimulus" packages which only wasted wealth.

Figure Seven
The Price of Gold in U.S. $ & FX
Indexed to 100 at May 1990
May 1990 - May 2000



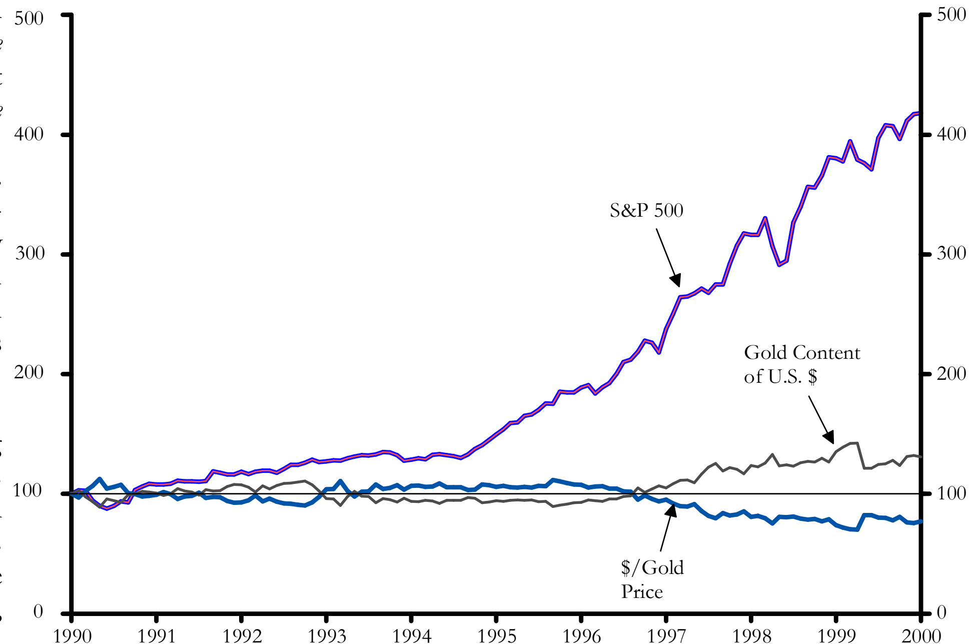
corresponding to the 32% increase in the dollar's gold content, or real value. Clearly this was *bullish* for the long-term performance of the S&P 500, which skyrocketed *more than four-fold* during the 1990s.

Again, the experience of the 1990s defies the expectations of conventional forecasting models, which assume that a stronger dollar harms stocks, while a weaker dollar boosts them. In fact, a stronger dollar fostered a *four-fold increase in U.S. stocks* in the 1990s, while in the *past* decade stocks fell 20% amid a *four-fold increase in the gold price*. The astute investor will exploit the long-term, *inverse* relationship between the gold price and stocks – that is, the *direct* relationship between a currency's *real value* (gold content) and stocks.

The fact that the world's major currencies appreciated in real terms in the 1990s means that they gained value in terms of gold (Figure Six, page 3), and that means the currency prices of gold *decreased*. Figure Seven illustrates how the *dollar-gold price declined* in the 1990s (-24%), but how, also, did the *pound-gold price* (-20%), the *euro-gold price* (-2%) and the *yen-gold price* (-47%). Again, just as a *decline* in a currency's *gold content* necessarily means a *rise* in its *gold price* (as in 2000-2010), so a *rise* in its gold content entails a *decline* in its gold price (as in 1990-2000).

We conclude by documenting the bullish effect of the dollar's real strength, in the 1990s, on equities. Figure Eight depicts how much the dollar-gold price declined in the 1990s (-24%),

Figure Eight
The S&P 500, Gold Price & Gold Content of US$
Indexed to 100 at May 1990
May 1990 - May 2000



[4] Monetary policy wasn't the only bearish public policy enacted in the past decade; see "Top Ten Policy Blunders of the Past Decade," *The Capitalist Advisor*, InterMarket Forecasting, Inc., December 31, 2009.