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Institutions look for foreign equities

Higher interest rates haven't helped the dollar's parities. Even the mickeys are catching on to the crash potential.

Institutional money managers are usually the last to hear about anything. The extent to which leading New York fund managers are seriously considering portfolio diversification into British, Dutch, German, Swiss, and Japanese securities is, in itself, something of an indicator of the dollar's vulnerability to a major decline.

This interest in international diversification was evident at a seminar held by the British brokerage firm Phillips and Drew in New York on April 12 and 13. The British firm believes that the foreign portion of American institutions' holdings will double, to about 5% of the total, during the next several years.

Phillips and Drew's argument to the assembled money managers was simple: The dollar will fall, and a serious comparison of overseas equities and bonds (with an emphasis on equities) is warranted. Economist Brendan Brown presents this case with enormous reserve, arguing, "A *major* change in sentiment regarding the U.S. dollar may not become apparent until U.S. growth is slowing, concern over inflation is rising and action to cut the budget deficit is expected. It is at this point, namely the first quarter of 1985, that we believe such considerations, allied to rising interest rates in Europe, will lead to a significant fall in the value of the U.S. dollar, with the DM and some other European currencies gaining more than the yen."

Questions from the floor and private discussions among the British firm's officers indicate a growing belief the dollar's major fall may occur much sooner, particularly if the Third World debt crisis forces an easing of Federal Reserve policy in order to protect the banking system. The possibility of a general monetary crisis, and the determining role of the debt problem in the currency markets, have pushed their way into the awareness of the institutions.

The failure of the dollar to respond much to expected interest-rate increases shows the enormous potential for the dollar to fall. So does the enormous rise in the Eurodollar yield curve. The yield curve showed a 2% discrepancy between overnight money and one-year money at the end of the week of April 9, indicating that dollar holders were unwilling to commit funds for more than the shortest periods of time.

As recently as March 15, overnight Eurodollars traded at 10.0%, while six-month Eurodollars were at 10.68%. The gap has now doubled. Part of the bulge in longer-maturity rates reflects funding pressures on an interbank market overshadowed by the Latin American debt situation. European banks are writing off their Latin American exposure and determined to participate in no more such bailouts, while the Latin Americans have roped themselves together through the Argentine package of March 31.

These developments on the credit market, like the market rates paid by Texaco for its $800 million convertible Eurobond in March, reflect profound potential dollar weakness. Unless the Fed jerks rates sharply upwards, the dollar will decline during the second quarter, and the impact of any rise in rates will only be temporary.

German central bank chief Karl-Otto Pöhl stated the position of major European investors April 5. Pöhl predicted a monetary crisis should the United States fail to reduce its budget and current account deficits, saying that the financing of U.S. government deficits depended upon capital inflows, noting the fact that the United States had shut off lending to the developing sector and that American banks last year became net borrowers from the Eurodollar market for the first time in history.

This argument was restated by the International Monetary Fund staff during the April 14-15 meeting of the Fund's Interim Committee in Washington.

The West German central banker's statement is the toughest ever from that source, and Volcker's statement of American dependency on foreign capital inflows the most blatant. A "scissors" opened up in January on the financial markets, between rising interest rates and a weak dollar. The scissors
quarter, although it is difficult to tell how much of the gap will be registered respectively in the interest rate and the exchange rate.

One caveat is that Soviet military moves aimed at Western Europe might provoke flight of funds away from endangered countries, e.g., West Germany, into the dollar. This, however, can also work the other way: To the extent that leading European financial interests who believe they have a deal with the Russians perceive success on the part of the American decouplers, Kissinger, Brent Scowcroft, et al., they may determine to run the dollar down in order to drive home the message of Karl-Otto Pöhl.

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