FX CONCEPTS
MARKET INSIGHT REPORT

John R. Taylor, Jr.
Chief Investment Officer

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DIFFERENT STROKES FOR DIFFERENT FOLKS

For those of us who thought that we understood the inter-relationships among global financial markets fairly well, the last few months have been an eye opening experience. It must be even worse inside a central bank. The simple daily tasks, the erudite debate on economic data, and the scholarly articles that made up the daily bread of these organizations are now drowned out by shrill cries for quick answers to questions that no one thought about before this year. The problems that have frozen the markets in their tracks are the result of the breakdown of relationships that we – money managers, financial engineers, risk consultants, and central bankers – felt that we could handle under all conditions. We were wrong. Because the markets cannot value many complex instruments, with face values of multi-trillions, and therefore there is no price for them, the central banks have had to step in to this complex and confused scene. Although the situation is changing daily, the Fed and the ECB are following distinctly different game plans, strategies that fit their widely differing views of the markets

Jean-Claude Trichet and the ECB have not budged on their interest rate orthodoxy and speak all the time about inflation and the importance of long-term price stability. Inter-bank rates have climbed and the spreads on corporate debt have increased significantly over the past eight months as counter-parties lost trust in each other. It might seem that the ECB has turned a cold eye on the market; however, the opposite seems to be the case. The balance sheet of the ECB has expanded more than 22% at an annual rate over the past six months, and the bank has allowed unsterilized borrowing against unusual collateral. We must assume that the ECB is surreptitiously supporting many through its discount window, including the Spanish Caixas, whose position in the mortgage market makes Countrywide look good. The ECB provides the funds it feels are necessary, but within its own walls where it controls everything, not bringing the market into the solution. Rates are higher, but money is plentiful if you pay – and if the ECB wants you to have it.

The Fed has followed a more democratic, more open, course by lowering rates dramatically and bringing the investment banks publicly to the discount window. Two new facilities, the TAF and the TSLF put longer-term liquidity in banks and primary dealers hands. This is a market-based solution, where money goes to those who want it the most. Although the Fed might look like it is throwing money around, its balance sheet has grown by less than 3% annualized over the past six months. It is the tight fisted one because it sterilized all advances as best it could. The Fed has not used its balance sheet, as the ECB has, and the ECB has not used rates as the Fed has. Politics will be a growing factor as these strategies extend further, but both will have to use the techniques that the other has used, and each must develop new ways to monetize assets that have lost all fungible characteristics and to deal with questions of solvency that will arise if the current panic-level valuations prove correct. At risk is the credit system that supports the global economy. The iron rule of global prosperity is that monetary assets must expand, to have an expanding economy.

CYCLICAL PERSPECTIVE

The dollar is starting another leg down, the last major decline in this cycle that saw a dollar top in early 2006, and this move should continue into the month of July when the dollar should make a major low, and climb higher for the rest of the year. On the chart below we are showing the EUR/USD, which saw its last major peak on this roughly four-year cycle in very late December 2004. Although we have seen this move develop quite a long time ago and projected a dollar drop to EUR 1.70 and JPY 65 by the middle of this year (see the Cyclical Perspective from February 1, 2007), it is sometimes hard to remember where the major move is going while the daily market noise bounces us all around.

Recently we had been viewing the last two weeks of February or the first few days of March as a time for a major dollar low (euro high), but the medium-term cycles did not set up correctly and it now looks as though the time around February 18 was a dollar high (euro low), from which this last powerful move will begin. We now feel quite comfortable with the EUR 1.70 target, but the JPY is now more likely to move only to the 85 level by this summer, resulting in an EUR/JPY cross rate at 144.50. The perfect time for this dollar low (euro peak) should be the fourth of July, and before that there should be a first dollar low (euro high) in the first half of April and second one in the middle of May. The second half of 2008 should see the dollar strengthen against the euro and the major cycles argue that the move should continue through most of 2009. This reversal would be a function of an extended recession in the US, which had been transferred into Europe, forcing the ECB to drop rates significantly. After the July dollar low (euro peak), we expect the EUR/JPY to continue its recent decline as Asian currencies outperform.