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*John R. Taylor, Jr.
Chief Investment Officer*

TEN DOLLARS A GALLON

Now that I have your attention, let's get down to when and how this will happen. These are US numbers, but everywhere on the globe, in the next five to seven years, prices will be moving dramatically. In Europe petrol should climb to roughly €3.00 a liter, and in China it should double from the current level, even while the renminbi doubles against the dollar. Last September 13, we wrote a Cyclical Perspective that argued that once oil moved over \$85 per barrel, it would eventually explode to \$300 a barrel, but we should point out that this will probably not occur before 2012 and it might not be seen until 2015. All of this is very negative for the dollar and very negative for inflation, but the odds are that none of these bad things will happen in the next year or even two.

To get a picture of the long-term flow of these things, we can look back at the last time the US and the world was in a similar situation. In the last quarter of 1973 after three years of increasing inflation and the Yom Kippur War had brought a skyrocketing price of oil and more inflation, the US was standing at the cusp of the worst recession since 1937. It was still 18 months before the loss of Saigon, but the US was losing this expensive war, fought without raising taxes, and it had lost all credence with its allies. The trade and current account deficits were out of control and the dollar had just suffered a major decline after it was cut loose from the short-lived Smithsonian Agreement in February. The only difference between now and then is that today the US is militarily and strategically much stronger but financially much weaker. Although the next twelve months were terrible for the US economy, the dollar rallied through that

recession and commodity inflation calmed dramatically, only turning up again in 1977 more than 3 years later. Looking back from today, things seemed calm from very late 1974 to early 1977 as equities rallied and the dollar recovered, but then things fell apart again. By late 1980, the CRB Index had jumped 80% and oil had exploded more than 300% while the equity market and the bond market collapsed.

Projecting forward from today, if our timing guess of late 1973 is correct, the equivalent of 1980 would be 2015. The next year or two should be mired in recession, which is likely to stop commodity inflation in its tracks if history is any guide, but it is quite possible that "headline" inflation will be a nagging problem that will bother citizens and politicians. Remember the WIN buttons – Whip Inflation Now – something that President Gerald Ford could never live down, as inflation was already dead by the time the buttons arrived in late 1974? Of course, inflation came back twice as strong when Carter took office in early 1977. The coming recession will be as hard as that one, but Wall Street will start its recovery soon. The dollar will begin to act stronger and by the end of this year, even the equity market will begin a recovery. Although the recession should drag on through much of 2009, financial markets should be more favorable as we bankers, financial engineers and money managers, gingerly begin anew, just as we did in 1975 and into 1976. However, at some point in 2010, the inflation picture should begin to worsen and the dollar will tumble once again. This is when the price of oil should begin its run toward \$300 a barrel and the CRB Index toward the 620 level, 60% higher than today.✂

CYCLICAL PERSPECTIVE

In the past few months, commodities have been in the news as they completed a 36% upward thrust that began in mid-August of last year and ended on March 17, when Bear Sterns was absorbed by JP Morgan. However, with the market's more enthusiastic view of the world since that peak the US dollar has strengthened and commodities have come down significantly. The dollar has been negatively correlated with commodities since the Bretton Woods system broke down in 1971, but the tightness of the correlation has varied significantly over the period. Different dollar pairs, like USD versus AUD or USD versus JPY, have had significantly different relations in the past but the overall picture is clear: when commodities are strong, the dollar is weak.

The chart below is a picture from 10,000 meters up, with the CRB Index in log scale plotted against an index that is roughly 50% euro and 50% yen between the start of floating

currencies and today. A Fibonacci ratio ladder set up against the CRB Index surprisingly shows that the Index traded between the 61.8% line and the 38.2% line from 1974 to late 2004, and has only dramatically broken above the top channel in the last 8 months. Our cyclical projection for the next major high in the Index calls for a peak in 2012 at a level around 620, over 60% higher than today's level. While we see commodities climbing 60%, the dollar will also decline about 60%, against the 50-50 currency basket. Using this technique, a rough target has EUR at 2.40 and JPY at 65. The cycles of shorter duration actually call for a break in this commodity rally and dollar strength over the next year or so. It is possible that the Bear Sterns reversal will be a major one, and the dollar will move higher from here, but it is more likely that the reversal is in July. 

