

May 1, 2008



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A LIGHT AT THE END OF THE TUNNEL?

The mood has changed in Wall Street and Washington in the past few months. Maybe it is some type of gallows humor, but the talk in the hallways of the rich and powerful is of stronger banks and ring-fences around the economic problems ahead. Although no one expects 3.0% growth in the second quarter, some brave souls actually believe that the US will avoid a recession and will see slowly increasing growth as the economy moves into 2009. As a result the Fed has signaled, in the very tentative phrasing of their post-meeting formulaic comments, that they would put the current rate cutting process on hold pending the outlook in the economy and for inflation. This act is very supportive of those who believe that the light can be seen in the end of the tunnel. This mood has won the day, until reality forces a change; and for now the hope is for the better. Whether one holds this view or not, it is apparent that the Fed has begun to slant its own view toward the one held by Fisher and Plosser for at least a few months.

What does this mean for the rest of us who earn and spend in this world economy as well as depend on its turbulent markets for a living? Surprisingly I think that most of the damage that the Fed is going to cause by holding rates here has been done already by the market's anticipation of this action, and that the largest future impact will probably be felt in the currency markets. The yield on the US two-year Note has risen by over 80 basis points since the low during the Bear Stearns affair, and from about 60 points from its average level in March and the first half of April. Ten-year rates have risen about 30 points from that

average, which will have a significant impact on the mortgage market. Financing real estate and business has become more expensive, and the slowdown in real estate transactions, mergers, and capital projects will continue if not accelerate. With the TED spread still hovering close to its high at 170 basis points, and money leaving the US equity market at a historically high rate, it is clear that fear of financial risk is still foremost in most investors minds.

The recent increase in the cost of money, especially risk money, and the continuing erosion of bank capital guarantees that total banking assets will decline, especially those that earn low returns like deposits at other banks, and, as a result, liquidity will remain tight. With the Fed signaling a tentative 'all's well,' no one should expect further liquidity gifts from that quarter either, so the dollar will be more in demand than it has been in the past nine months. As a result, it should trade better. If the Fed has the backbone to live by its recent decision, and anti-Greenspan rhetoric from leading figures like Jeremy Grantham could strengthen its resolve, then the dollar could go higher as it did in 1980, when US banks cut interbank deposits to lend the money back at home. Although Bernanke is unlikely to become a Volcker at this time, any incremental tightening in the US will support the dollar. And, at the same time, the news in Europe is reporting significant deterioration in Southern Europe, and even if Trichet turns a cold Germanic shoulder, the market will start getting the drift and the days of the super-euro will be numbered.✘

CYCLICAL PERSPECTIVE

Several times in the past few months we have noted that the EUR/USD would make a high sometime between the first half of March and the first half of July. As we are now in the middle of that timeframe, it behooves us to be continuously alert for the possibility of a reversal. We are far from certain about the dollar picture, but we do believe that we are in the general area of the low, even though some of the medium term cycles call for a dollar low right at the start of July. This might still be the case, but we are excited about the fact that the EUR/USD did reach the highest level registered in the 55-week oscillator, a long term measure which usually tops or bottoms at the extreme of multi-year moves. Its reading four weeks ago was +1633, the highest level seen since April 1995, when the dollar reached its final bottom in its long decline from February 1985. There have been very few readings at this level and every one of the previous ones led to a major

reversal. Even the one in May 2003, which fell slightly short of +1633, brought a three-month reversal.

Adding to our concern about the possible high are the long-term cyclical readings. Although the EUR/USD low at the end of 2005 and early 2006 is spread out, and therefore difficult to pinpoint, we are in the middle of the correct timing from the most likely of the lows. The USD/JPY recently passed the right time for a roughly one year cyclical low and has made a dramatic advance since that time. As the USD/JPY cycles often lead the other cycles, this is a further sign that the current dollar rally might have more staying power than we have expected. If the dollar can extend its gains into the second half of next week and then experiences only minor weakness into the end of May. Then the dollar has bottomed and will rally into September. 

