FX CONCEPTS

MARKET INSIGHT REPORT

John R. Taylor, Jr.
Chief Investment Officer

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ARE WE ALL TOO COCKY?

I do fear being branded as a hopeless curmudgeon, out of touch with the wonders of the modern global economy, but I cannot help but cry "wolf" at this time. The government authorities, the major banks of all types, and the newsreaders all continue to refer to the recent problems as a crisis in the "subprime mortgage market." It is nothing of the sort and has never really been an issue about a narrow segment of the US mortgage market. Even back in February, it was easy to work up a cash flow analysis, starting with the micro situation, continuing through the macro foreclosure statistics, and ending with the impact on the many billions of financial paper. To us that seemed a major problem, but we missed the valuation issue, which has made it impossible to identify the scope of the problem within individual portfolios and institutions. If you can't tell who is safe and who is not, you don't deal with anyone. This deep uncertainty has caused prime brokers to cut lines, has frozen the asset backed commercial paper market and even the overnight Fed funds market, and has severely crimped the flow of funds to all kinds of investment vehicles.

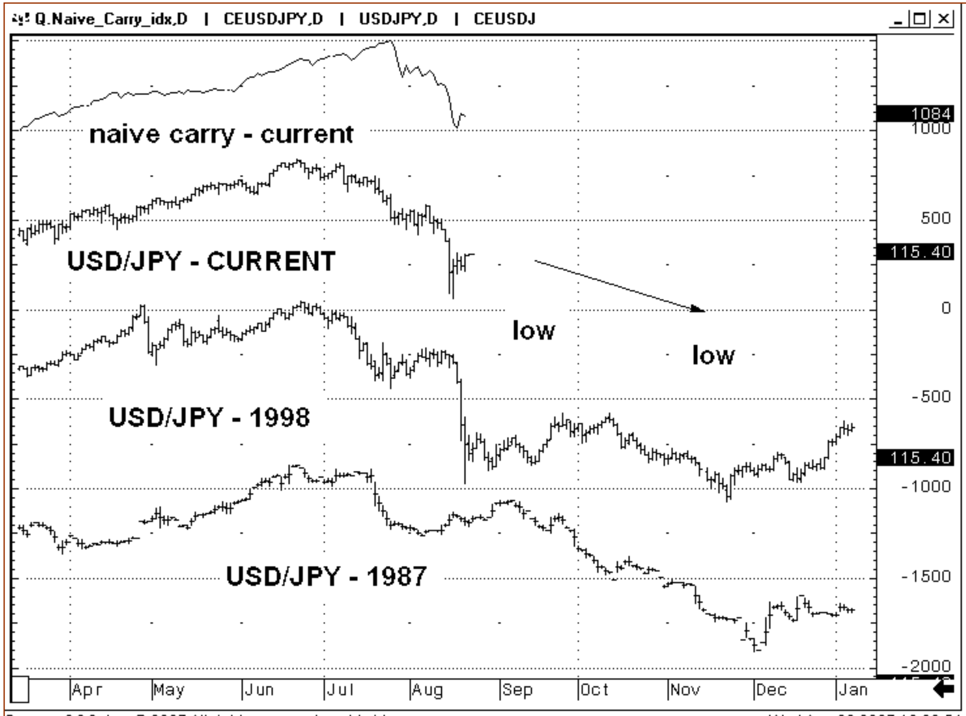
Today, many people have a pretty good understanding of the situation as it was late last week, but the really important questions involve the situation as it stands today and as it will develop in the weeks and months ahead. To get a handle on this we must first try to judge the impact of the Fed's actions, not only in reality, but also in the minds of the key market participants. The actual changes do not seem to be that significant as there have been no apparent shifts in funding patterns – although it is possible that there could be at some future time. The major shift has been in the market's mood, as the Fed's appearance has dispersed one major uncertainty – will Bernanke act? He will. But does the comforting presence of the Fed's cavalry mean that the crisis is over because the current moves are sufficient to end it or that it will be controlled because the Fed will make other moves between now and the end of the day on September 18? We believe there is a good chance that it means neither. It is far more likely that the markets are just willing to believe that everything will turn out well because that has been its recent experience. The median age of traders in the credit markets, the money markets, and the foreign exchange market is far below 40 years, and that means that their entire experience has been under Greenspan's Fed and in a period where buying a dip has always been successful.

That grim looking cash flow analysis from February has blown into a very serious storm. Experts are now forecasting at least two years of negative housing valuations in the US, a drop of around 10% is likely, something that has not occurred since the 1930's. Following the logic of the numbers leads to the conclusion that a recession is in our future and that there will be a major outbreak of delinquencies and insolvencies, which will have a dramatic impact on the American and global financial systems. Applying this to today's markets: buying this current dip will not be a successful strategy – and could be a disastrous one for some, as there should be a major continuation and deepening of the late July-early August declines. The Fed's cavalry might be standing by, but history tells us that it will be too late to head off the bloodbath. Although its actions will set the stage for the next rebound, the bottom is at least two months away and possibly much, much further than that.

CYCLICAL PERSPECTIVE

The recent movements in the crossrate between the Australian dollar and the Japanese yen are similar to those seen during the second half of 1998, but there are differences as well. In June of 1998 the Japanese yen was very weak and the Clinton administration intervened to support the yen ahead of a trip to China, but with limited impact. It was the Russian collapse and the resulting decline in risk appetites that eventually led to the LTCM crisis and an explosive yen rally that lasted for 14 months as massive short yen positions were liquidated. During this time the Australian dollar strengthened as well. The recent decline in AUD/JPY has been particularly aggressive because the Australian dollar declined at the same time the yen strengthened. There is another factor today: the last major decline in US real estate was in the early 1990's. Between August 1991 and September 1993, the yen strengthened while the Aussie fell. The similar destabilized conditions in the credit markets are analogous to the situation that seems to be developing. The divergence between the two currencies that began in June should have much further to go.

Our analysis argues the timing of the low in AUD/JPY will line up with the one in 1998, but the decline will follow a different path. The current one has already exceeded the one in 1998, but the cycles expect weakness for a minimum of another three weeks. The cross should turn down early next week and retest its previous low at 86.00 at a minimum and a further decline to the 82.00 area is likely before it bottoms, and this would be 14% below current levels. If it follows the 1991 to 1993 example the decline will not reach its final low until the second half of 2008.



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