

MARKET INSIGHT REPORT

Cognitive Dissonance

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The current worldview of economists and those who project markets is divided into two irreconcilable camps, just like US politics with its blue states and red states. In the US, the Democrats in the blue states might point out that the sky is falling, while the Republicans in the red states would retort that, no, it is the best of times. Every intelligent American, who by definition listens to the news, must suffer from an extreme case of cognitive dissonance as it is clear that whichever camp one adheres to, at least some of the incoming information is dissonant with the listener's view of things. Psychologists point out that cognitive dissonance can lead to irrational justifications and actions. The dissonance in market outlooks is absolutely jarring and makes life very difficult for money managers.

The forecasts for 2010 are of two sorts: one says that the US economy will grow at an above average rate and that the world economy will do even better, with Asia in the lead and Europe trailing, while the other argues for the end of the current recovery and the start of a new global recession. At first glance, one could argue that these two outlooks vary only in degree with one group more optimistic about the growth of trade and final demand and one more conservative, but that would be wrong. The two views are nearly incompatible. Although I place myself firmly in the negative camp, the positive view is by far the more widely proselytized and fits in much better with the economic history of the past 65 years. Two basic arguments behind the positive growth and market outlooks for 2010 are monetary conditions, which centers on the steepness of the yield curve and the extreme liquidity that exists throughout the world. This is backed up by historical consumption analysis which implies a strong rebound in final sales after a recessionary slowdown like the one just seen. The American consumer has always stepped up at this point in the business cycle to push the economy to new highs. The positive view also argues correctly that the decline in bank lending seen over the past few months is the normal situation and that it would usually move higher only later in the cycle. The optimistic view is widespread: 58 out of 58 economists called for growth with a mean of 2.73% for the US economy and the *Wall Street Journal's* panel of 56 was unanimous as well. Of these, only one called for growth below 1.0%, so we feel safe in saying that this is the widely held, 'blue ribbon,' view.

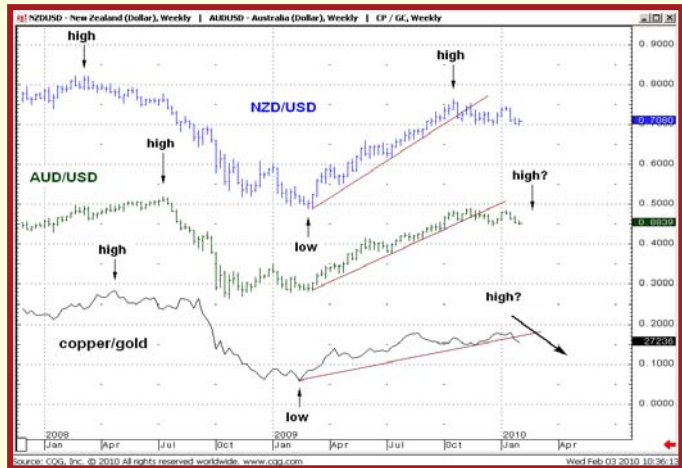
The other view, held by far more people than the above numbers imply, is that the economy will crumple under the pressure of debt liquidation, taking the equity and commodity markets down and widening credit spreads dramatically. Basically, the argument is that the global liquidity crisis has been solved but the global solvency crisis is just arriving. Although this problem is focused primarily in the United States and Western Europe, it is those economies that overwhelmingly dominate the banking and financial sector, which means that the rest of the world will be impacted, even though they have not sinned. Basically this view posits that the world will be following the Japanese example, but the ride ahead should be rougher than the Japanese one has been. This is because the US and Europe are much bigger than Japan, because the Western world does not have the savings that the Japanese began with, and because there are no export markets, which acted as the Japanese pressure relief valve. This world view is widely held by independent economists, hedge fund managers, and some independent think tanks, but is extremely unpopular with major commercial banks, the sell side of the market, and the government, all for obvious reasons. In the many decades I have been in the market, I have never observed this wide a discrepancy in market views, but every money manager must cope with this extreme divergence in outlook and place his or her bets accordingly. Good luck.

CURRENCY – Commodity Currencies Long-Term View

The NZD has Already Peaked and the AUD will Quickly Follow

By Jonathan Clark

Although Australia and New Zealand tend to be grouped together by market participants, the movements in their currencies can vary significantly at times. The Kiwi formed a significant peak in March of 2008 and the Aussie formed its peak four months later. Once again these currencies are diverging. The NZD formed a clear high in October of last year, and in a few weeks it will be four months from this peak. **The cycles argue that the Kiwi has begun its downtrend into late June or July, and we expect the Aussie to turn sharply lower within the next few weeks and follow the Kiwi to a similar low.**



The Australian and New Zealand dollars share are like two peas in a pod even though the two major trading centers of Sydney and Wellington are 2,200 kilometers apart. Both are considered 'commodity' currencies, due to the significant proportion of raw commodities in their exports, as well as 'pro-cyclical' currencies, as world growth always drives them up. These characteristics make them very sensitive to expectations about economic growth. The ratio of the industrial metal Copper to the precious metal Gold is an excellent short-hand measure of the strength of the global economy. When the global economy is expanding or is expected to expand Copper outperforms Gold, and when the global economy is slowing or expected to slow Gold outperforms Copper. The Copper/Gold ratio peaked in April of 2008 and the date was bracketed by the highs in the NZD and AUD. The ratio declined into a low in February of last year, which was within a few weeks of the Kiwi bottom and a secondary low in the Aussie. The longer-term cycles argue that the uptrend in the Copper/Gold ratio, which began last February, is over and has begun a significant decline. The ratio should now head lower into the middle of the year. **This argues that the outlook for the global economy will deteriorate, dragging the Australian and New Zealand dollars lower.**

AUD/USD has been in a broad trading range for the past four months and we consider this period as an extended topping process that should quickly end. The currency can strengthen for a week or two, but it is unlikely to reach new highs and the resistance at .9075 could possibly hold. Our maximum target for this recovery is .9300. Following this peak, AUD/USD should turn down and close below the support .8735. This will signal it has begun a downtrend lasting to the first half of April for an initial low of .8350 and this overall weakness will continue into July and our long-term objective is the .7700 area.