

MARKET INSIGHT REPORT**The Coming Tequila Crisis**

July 9, 2009

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

The recent elections in Mexico are the final nail in the coffin for the Mexican economy and the peso, and could lead to the unraveling of the country's social fabric. The victory of the PRI over President Calderon's PAN party in the mid-term elections has put the lower house in the opposition's hands. We feel this will effectively paralyze the government, tying its fiscal hands, as the economic and social situation in Mexico continues to deteriorate. Although the commentaries we have seen even after the election have tended toward the positive and even the Pollyanna, our experience with Mexico over the past 36 years tells us that we all should fear for the worst.

Mexico is economically bound to the United States and, in the past, when the US came down with a mild cold, a year or two later Mexico's cold became a bad case of pneumonia. Now, the United States has pneumonia and we wonder what Mexico will get. Just in case you think that I am being melodramatic, let's take a quick tour of the history of the dollar/peso exchange rate during the post-Bretton Woods period. The Mexican peso had been fixed to the dollar for several decades when the US went into a serious recession in 1974; although the recession soon spread south of the border, the peso did not budge until late August 1976, more than a year after the US recession had ended. The reasons behind the lag are interesting. Fixed exchange rates were still ingrained in the Mexican mind and capital flows in and out of Mexico were small as there was only one international bank in Mexico, Citibank, and only one tradable market, the IMM. (It took Citibank months to hedge just a fraction of its capital position.) Because remittances from workers in the US suffer with American unemployment, which continues rising even after the recession ends, the pressure on the Mexican international position has always lagged the US recession. In 1974, the US recession saw an aggressive real estate collapse, and since many Mexicans work in construction trades this was a negative for the peso. However, the price of oil had sky-rocketed at this time and Mexico was becoming a big oil exporter and this was positive for the peso. Nevertheless the peso devalued by 45% in August 1976 and many companies went bankrupt. The next US recession began in early 1980, with the price of oil at all time highs, and it continued to the end of 1982. As oil began to decline the Mexican international position became untenable and the peso began to decline sharply in February 1982, continuing down each month thereafter, and collapsing in November as the US was beginning its recovery. The next few years were terrible ones for Mexico as the price of oil declined sharply, reaching a low in 1986. In the six years between the start of 1982 and the end of 1987, the peso had lost almost 99% of its value. As oil rallied and Mexico created a new peso out of 1000 old ones, the peso stabilized in the late 1980s. The next US recession began in 1990 and its effects dragged on to the end of 1992, but the peso did not start getting into trouble until February 1994. The crisis, dubbed the Tequila Crisis, got hot in December and the new peso went from 3.4 to over 7 per dollar by 1996 – a devaluation of slightly over 50%. The US recession of 2001 had less impact as construction activity boomed and oil prices rose, but still the peso weakened, beginning its decline in March 2002 and bottoming in May 2004.

The current American recession includes a sharp decline in construction employment and drop in imports from Mexico. The price of oil has declined from its high of last year and our cycles say it will go lower in the months ahead, and – critically – Mexico's oil exports are dropping sharply. We have seen forecasts that Mexico will be a net importer of oil within ten years. With GDP projected down at least 8% this year and the US recession far from over, dollar/peso could easily reach 25 next year.



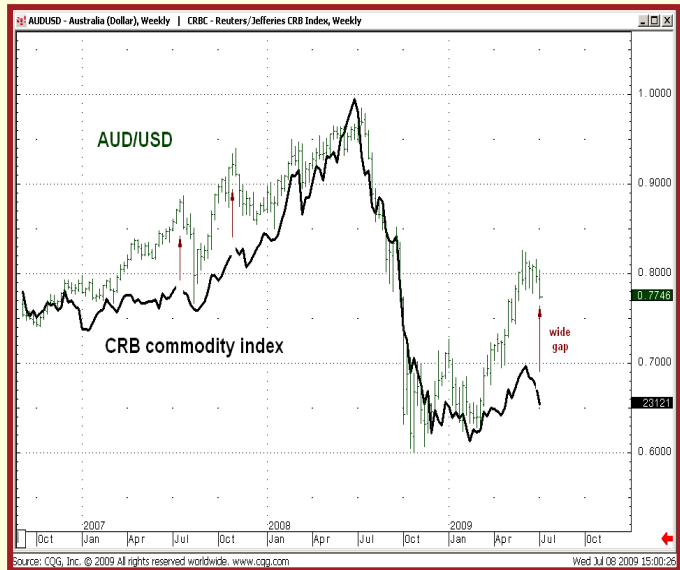
CURRENCY – Commodity Currencies Long-Term View

July 9, 2009

AUD/USD Has Begun an Aggressive Downtrend

By Jonathan Clark

We are seeing signs of a potential meltdown in the Australian dollar, and yet the financial markets remain complacent. The RBA kept rates on hold at 3% and said that growth is improving and downside risks are diminishing. Recent domestic economic data has been better than expected. Once again the growth of the Chinese economy is a major reason cited for the growth of the economy, along with an improvement in global financial conditions. By assuming that the worst is over the financial authorities are increasing systemic risk due to the lag in monetary policy. Market participants also feed off this optimism and hold long Australian dollar positions, overvaluing the currency. It was reported on Tuesday that retail long Australian dollar positions on the TFX in Japan are at a record high. Vulnerability is high as on Wednesday AUD/JPY fell nearly 5%. This is likely to trigger more selling of Aussie and Japan's Financial Services Agency is reportedly considering limiting the leverage employed by the Japanese retail currency trading community. Commodity prices have a strong impact on the economic prosperity of the AUD, and our chart shows the close relationship between the AUD and the CRB commodity index. When the currency has a significant rally that isn't accompanied by a similar upmove in commodity prices the currency level is unsustainable, as was the case in July and October of 2007. The gap is large and commodity prices are falling. The RBA's AUD commodity price index fell in June to its lowest level since December of 2007. **Now that commodity prices are headed lower again the Aussie has a long way to fall.**



The Australian dollar has fallen to its lowest level in six weeks and this should be the start of an aggressive downtrend. We strongly recommend going short the currency on even a minor recovery. There is an intermediate low due during the second half of the week of July 20 and it should reach .7450. Following this low it should recover for a week to two weeks before the downtrend resumes. There is a low due in late August and this overall weakness should last into November. Our longer-term target for this downtrend is the .7000 area. We are not expecting much strength, but the shorter cycles call for a recovery into Friday. It should hold below .7875 and only a close above .8035 means our negative longer-term outlook is wrong, but this is extremely unlikely.