

MARKET INSIGHT REPORT

The Lucky Country

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There are times when just the physical location of your country is so important that it trumps every other variable – just look at Poland through the last 1000 years or Singapore during the Asian crisis. Your neighbors can ruin everything, or they can make things wonderful. Look at Australia today. To borrow a phrase from another (smaller) island: no worries mon! The Chinese development machine is covering Australia's backside, buying all the raw materials the Aussies can dig up and export through their clogged ports, while also bidding for the odd mineral company, helping push the equity market up. The average Australian consumer knows that China is there and has an optimistic outlook about the future. Why wouldn't they, as their country was just about the only developed country that avoided the last recession, with GDP up 2.7% in 2009, and the value of their houses has climbed about 30% over the past three years and 13.6% in the last year.

The situation has been so good for so long that it is getting hard to remember that things were not always like this. House prices have doubled in 10 years and the price of Australian exports has done even better. Add in the impact of Chinese growth at about 10% a year, doubling volumes as well, and it is easy to see why it is boom times down under. However, as great success breeds enthusiasm and greed, spawning excesses that become a larger and larger problem, the end is usually nasty. Predicting the timing of the end is more difficult, but it is certain that leverage will eventually do the trick. Although gearing in the consumer sector of the economy looks as though it is far worse than it is in the US; the banking system, basically an oligopoly of a few banks, has been more conservative than the American one. Nevertheless, loans are more than 120% of bank deposits and house prices are so high in Australia that the risk to the banks is huge. On top of this, to stimulate the economy early last year, the government granted first time homebuyers an AUD 21,000 subsidy, kicking the whole market higher. According to the *Demographia International Housing Affordability Survey*, the average home in Sydney costs 9.1 times the annual median income of Sydneysiders. For the entire country the number is 6.8, the highest in the world, compared to the US at 2.9 and the UK at 5.1. New York, London, and San Francisco are all around 7.0. With house prices so high, many homeowners pay more than 50% of their after-tax earnings toward their mortgage. Last year, Aussie interest rates were 3.0%, a historic low, but the Reserve Bank pushed overnight rates up to 4.0% last week and a level of about 5.0% is priced in for year-end. As mortgages are almost all floating, these hikes do hurt. For the first time in a while, buyers are worried about the level of house prices as only 42% said it was a good time to buy a house in March, compared to 53% back in December.

Although the housing subsidy has been phased out, the government has created the equivalent of a sub-prime class of homeowner who probably should not own a house in the first place. If the local economy proves strong and rates climb further, foreclosures are on the way, and if the Chinese worry about their inflation, putting a brake on their growth, Australia will slow as well, causing more problems for homeowners. Worst of all might be a double-dip recession in the US, slowing China and the world economy once again. Although Australia's economy is sound, leverage is a dangerous thing and 'excess' leverage is always a disaster in waiting. Our expectation is that the Australian economy's luck will run out this year.

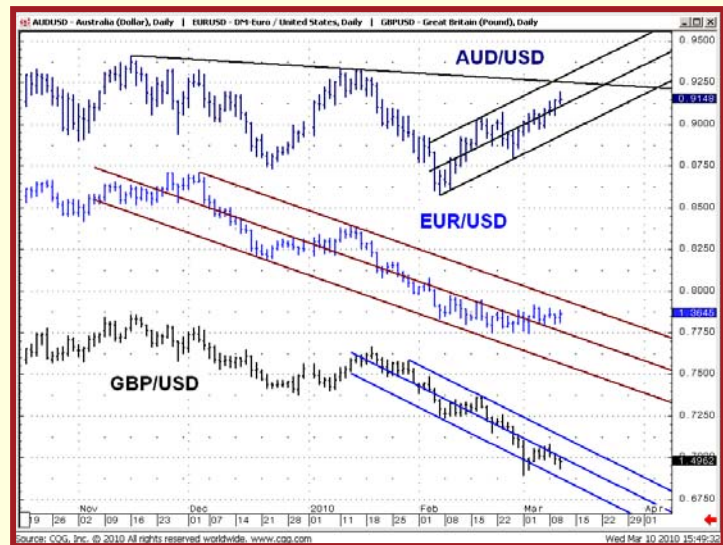


CURRENCY – Europe Long-Term View

Intractable Europe

By Jonathan Clark

Ever since the single currency was on the planning board in Europe, we worried that it might not survive its first real test - during the first big recession. It was surprising how long it took before the Eurozone experienced a real economic contraction, but growth in the region was fueled by low interest rates in some traditionally high interest rate countries and internal exports to those countries. Building booms in the new mostly Mediterranean countries, Portugal, Ireland, Greece, and Spain compounded the good times. These countries and others usually ignored the Maastricht



Treaty's upper deficit ceiling of 3% of GDP, as tax revenues were outpaced by fiscal spending. Internal imbalances and deficit spending led to the debt crisis. A consensus is building that the EU needs to create a policeman and lender of last resort similar to the IMF, but this would require 27 countries to agree to change the treaty and this isn't going to happen for years. **Everyone knows that monetary integration without free movement of labor and political integration are doomed to failure – so what's next?**

Next week the EU might announce some details of the bailout of Greece, requiring the country to raise taxes and cut spending. Although the markets have calmed down recently and European equities are strongly higher, the problems in the region are just under the rug. Greece needs to raise €15 billion by May and nearly €50 billion by the end of the year. Papandreou has promised to reduce the deficit from the current 12.7% of GDP, but the unions could be a major problem. Even if Greece passes the necessary legislation, the economy will not grow enough and the markets will be back in crisis mode. Cutting pay will cut final demand and the cycles argue the euro will decline.

Over the past few weeks, the cycles have been calling for EUR/USD strength and most other currencies have strengthened. However, the euro and the pound have only paused in their downtrend. The euro should make a further attempt to rally, and a close above 1.3690 means it is headed higher into the week March 22. Our target is the 1.4000 area. Provided this strong level holds the euro will resume its downtrend into the third quarter of the year. Our objective for the downmove is the 1.2000 to 1.2500 area. We would sell euros in two weeks.