

**MARKET INSIGHT REPORT****Nation Building 101**

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All students of the world economy and those who think about its future should spend a cool, wet week in the United Arab Emirates (UAE) as I have just done. No one can doubt the miraculous nature of the growth of this disjointed federation of emirates, led for more than 35 years, until the middle of the last decade, by two dominant and benevolent autocrats, Sheikh Zayed of Abu Dhabi and Sheikh Maktoum of Dubai. The two sheikhdoms share a common currency, a long border, and a zeal similar to that of their founders to create the perfect modern Islamic society. It is only natural that the two leaders, who respected each other and co-operated famously for decades, did not have the same vision. Sheikh Zayed was a man of the land, who despite his immense wealth maintained a more traditional and slow moving pace for his city and his beloved emirate. He supported agriculture, reclaiming the desert by planting trees and turning parts of it into green gardens, perhaps even ameliorating the harsh climate as the earth came alive. The Maktoum family embraced free wheeling capitalism. Despite the fact that Dubai had far fewer petroleum resources than Abu Dhabi, the Sheikh brilliantly played his few cards, expanding his small entrepot port area extensively to rival Rotterdam and Singapore in capacity. His aluminum company used local natural gas, plus raw materials from Western Australia, to revolutionize and dominate the Asian aluminum market. Dubai's airport is the dominant hub in the area, its airline is one of the world's best, its hotels are spectacular, and the city is totally cosmopolitan. Within two decades, Dubai exploded into the business, distribution, and financial center of the modern Middle East surpassing Beirut, Cairo, and Baghdad. Although the two UAE cities are both astonishing in the eyes of this poor country boy from New York, the financial underpinnings of the two are extremely different. Dubai lives on credit and Abu Dhabi lives on oil.

These two cities and five other emirates share one currency, the dirham, but their economies stand alone and apart. With the declaration of a standstill and a need to renegotiate the debt of a very large and complex government sponsored enterprise, Dubai hit a financial reef. Abu Dhabi did come to the rescue, but the problems are far from over, Dubai debt is selling at workout levels, and no one knows what is next. This sounds just like the euro. Greece is in the spot that Dubai was in at the start of December. After some difficult negotiations Abu Dhabi came to the rescue, just like Germany will, in a few weeks. But this is not the end of either crisis. Neither Dubai, nor Greece, will be able to fund themselves without big brother's guarantee – and that guarantee will not make either of the two debtors cash positive. The dirham and the euro are the same, currencies that do not work for at least one of the constituent members. Once there was another currency like this, its nickname was the Continental, and for years every American schoolchild knew the statement "as worthless as a Continental". The US dollar started as a financial federation when the country was young. Many states were in debt and the national government owed twice what the states did, but none of the debtors could call on the assets of the others, so their debt was junk and no one could borrow more. In 1790, Alexander Hamilton solved the problem by consolidating all the debt under the federal government and giving it taxing authority over the states. Virginia, very rich on its tobacco earnings, occupied a position similar to that of Germany and Abu Dhabi. Thomas Jefferson, a man of the land like Sheikh Zayed, surrendered his state's dominant position and Hamilton in return allowed the country's capital to leave New York and move to Virginia. Now Washington is the US capital. Maybe Berlin should be the capital of the EU and Abu Dhabi the capital of the UAE. Oh, that modern men were so flexible as those of old. Trouble lies ahead as neither the EU, nor the UAE, will stanch the bleeding without centralization of their finances.

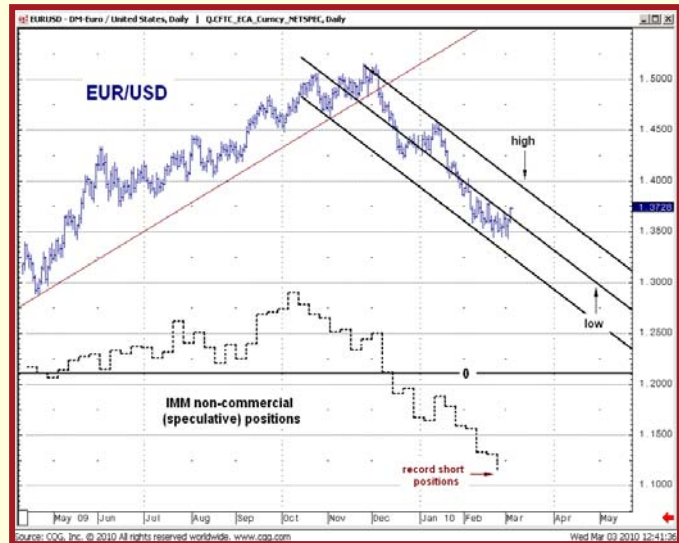


### CURRENCY – Europe Long-Term View

#### A Honeymoon Period for the Eurozone

By Jonathan Clark

In our commentary written a week ago we highlighted the extreme oversold condition of the euro based upon the Daily Sentiment Index as well as record short non-commercial (speculative) positions on the IMM. EUR/USD fell to a new low for the downtrend on Tuesday before rallying to its highest level in two weeks, confirming a medium term low has been seen. As a condition for Eurozone nations to assist if it can't repay its debts, Greece must show by March 16 it is on track to cut its deficit from 12.7% of GDP to 8.7% this year or member countries will impose on the country extra measures. The market responded favorably on Wednesday to



the latest fiscal tightening of an additional €4.8bn, or 2% of GDP, including a cut of public sector bonuses and a rise in VAT. Greek Credit Default Swap (CDS) and yield spread of Greek bonds over German Bunds narrowed. We strongly doubt that Greek politicians have the political capital to push through the necessary changes and their attempt to do so will result in social unrest. In addition, the cuts in Greek spending will worsen the recession, further reducing tax revenues and expanding the deficit, in a vicious cycle. The cycles agree and argue the recovery in European currencies is likely to last for much more than another several weeks before the major downtrend resumes. **The European currencies have just embarked on a honeymoon period and we expect a liquidation of some short positions before the major downtrend resumes.**

The next three weeks should see the euro make a recovery and this is likely to prove aggressive. This is because recoveries in a downtrend tend to be more aggressive than the downmoves that preceded them and especially when the market has excessive short positions. EUR/USD should test the strong resistance at 1.3805 late Thursday before pulling back into early next week. **The upmove should then resume into the week of March 23 and this is when our target for the recovery of the 1.4000 to 1.4040 area should be reached.** Only if this area is surpassed will the euro continue higher into the final trading days of March and reach 1.4300 before peaking, but this less likely. By the end of the month at the latest the euro should resume its downtrend into late April and the longer-term cycles are negative into September. A close below 1.3525 signals it is headed lower to the 1.2000 to 1.2500 area, but the next leg of the downmove should be postponed.