

MARKET INSIGHT REPORT**The Rally Is Ending**

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

For FX Concepts, this is a big day and a very scary one as well. Because our market view is now very precise, but at odds with the accepted wisdom, we are putting ourselves out on a limb. The euro is going to be hit again and commodity currencies will come under increasing pressure. Our cyclical analysis argues that the currency markets are making a major reversal right now, today, and that this will be at least a medium term reversal in equities and credit as well. Although it is more likely that the equity and credit markets will not begin their major decline until the last week of August, the odds favor an unimpressive month ahead which means that we are at the end of the exciting part of the rally of the past two months. By the end of next month, equities will be headed lower, credit spreads will widen sharply, and government bonds will begin a rally to new all time highs. Our completely technical cyclical work implies that there will be a return to dark times in September and October, with a sharp decline driven by liquidity and solvency issues likely to set the world back on a recessionary course. Although the cyclical picture gets more uncertain the farther out we go, we believe that there will be a major cyclical low in risk during January and another one, possibly more aggressive in the third quarter of 2011.

Using this cyclical analysis as our base, we can work backward to generate a set of fundamental conditions that would allow a cyclical picture like this to occur. If the S&P 500 is going to challenge its March 2009 lows in the next year, and interest rates are going to drop sharply while credit spreads widen dramatically, what would the US economy have to do and what would the world look like? Clearly the widespread conviction that the 2008 recession is in the rear view mirror and that growth will slowly improve in the years ahead is wrong. All the forecasts of the G-20 governments are completely off base, which means that the politicians are not prepared for another downturn. We wonder what the downturn will do to the Eurozone, the US, China, and Japan, as each one is vulnerable in a different way.

The financial underpinnings of the Eurozone do not look as though they can tolerate a recession in the coming year. The recent stress test has shown that an economic decline would be disastrous for the banks. Even though the test was easy, only marking down the small fraction of sovereign debt held in the trading accounts, among other things, many of the banks still had low tier one capital ratios. If even one Eurozone government finds itself unable to roll over their debt, the whole system will come tumbling down. Our cyclical picture means that we must be negative on the outlook for the euro, and the odds favor some significant euro restructuring during this next year. A recession in the US might imply a collapse in the municipal market as many states and lesser jurisdictions will find themselves forced into bankruptcy, but the banks and the major corporations are more liquid, and therefore stronger, than their counterparts in Europe. The more aggressive write-offs in the US and the coming municipal bankruptcies are accelerating the deleveraging of the US in comparison with that in Europe. So, it is possible that the US will come out much stronger in the next few years. A slowdown in global trade similar to that in 2008 will hit the Far East countries, especially Japan and China. As the cyclical picture is projecting a decline similar to that of 2008, it is reasonable for us to assume that the credit markets will seize up as they did then and that the economies will follow roughly the same course. We will be carefully turning our positions in the direction of a stronger dollar and a stronger yen just like we did in 2008. We are bullish on government debt as well.

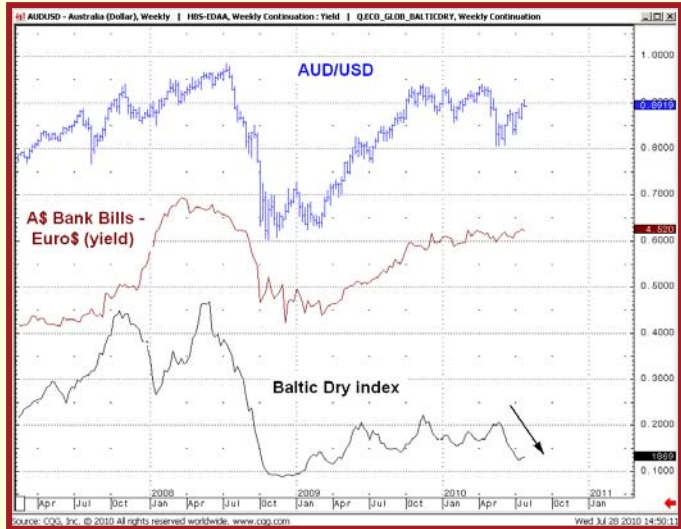


CURRENCY – Commodity Currencies Long-Term View

Aussie Should Form a Major Peak within a Month

By Jonathan Clark

Australia was well positioned for China's period of rapid growth based on resources and geography. China, the world's largest country operates with neo-mercantilist policies of encouraging exports and discouraging imports, while centralizing currency decisions. To create export-oriented industries they kept wages low and made massive investments in infrastructure including roads, railroads and ports. This created a huge demand for energy and industrial metals and Australia was able to supply many of these needs as its two largest exports are iron ore and coal. The Australian economy has benefitted greatly from an expanding export market



and this in turn allowed it to avoid recession. China's economy should slow to a 7%-8% growth rate and this will hurt Australia's export prospects. This is reflected in the Baltic Dry Index, which tracks international shipping prices of various dry bulk cargoes including coal, iron ore and grain. Although container shipping rates are rising, it reflects finished goods and the demand for Australia's main commodity exports should sag.

It is estimated that 1 in 7 taxpayers has an investment property and Australia has the highest household debt-to-disposable income ratio in the world. We've heard the arguments that there isn't a housing bubble in Australia, but we are unconvinced and expect housing to eventually become a drag on the economy. Inflation has fallen back into the 2%-3% target range for the first time since late 2007 and the financial markets are no longer expecting more interest rate increases for the remainder of the year. One of the reasons the Australian dollar has been so strong for the past 16 months is increasing interest rates in Australia versus the US. This is no longer likely to be the case and removes one of the main pillars of support for the currency. **By late August we expect the Australian dollar to begin a sustained downtrend.**

AUD/USD has just formed an intermediate peak and should decline into the middle of next week. If the uptrend remains intact as we expect then **the support between .8790 and .8815 should hold. It should then resume its uptrend into the end of the week of August 16 or the following week and our maximum objective is the .9300 area.** This high due in late August should prove significant and we then expect the Aussie to decline into December and possibly longer and our initial objective is .7700.