

MARKET INSIGHT REPORT**The Dalai Lama and the Dollar**

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The Chinese authorities are flexing their new-found monetary muscles in a sharp reaction to the Obama administration's sale of military equipment to Taiwan and its recent welcome of the Dalai Lama in the White House. In its effort to intimidate the naïve youngsters in Washington and to influence the financial market's perception of the dollar as a reserve currency, the Chinese are bringing out the big guns, whose words intimate that the dollar, the US economy, and even the world economy are dependent upon their good will. After Washington's latest signs of independence, that is in short supply. China has threatened to impose sanctions on the US firms that take part in the \$6.4 billion military sale to Taiwan, a major threat to Boeing's sale of commercial aircraft in the Chinese market, the world's largest. Recent records show the Chinese government sold \$34 billion in US bonds in December and rumors in the market have hinted at further sales this year. Government newspapers and spokesmen have praised this sale, arguing that the Obama administration's financial policies were in severe disrepair. Not only is the US in China's gun-sights, but the whole developed world is as the Chinese single handedly torpedoed the Copenhagen Climate Change Conference late last year and have ignored WTO regulations since the day they joined the organization. With the world's largest population, the fastest growing economy, and a fast growing bankroll of \$2.4 trillion, will the Chinese be able to dictate world monetary and economic policy in the years ahead?

Does China really hold the world in its economic thrall? Or is the opposite closer to reality? Many have written that the relationship between China and the US is one of mutual assured destruction, much like the US and the USSR, with their missiles pointed towards each other. The idea is that China desperately needs the US consumers to continue to buy their goods and employ their rapidly modernizing workforce, while the US needs the dollars that the Chinese have to fuel their consumption-oriented social structure. This situation would imply a rebirth, or continuation, of the Bretton Woods II, and a fixed or semi-fixed exchange rate between the two supported by open trade relations. If the US were to upset China by throwing up tariff walls, cutting Chinese growth and employment, Beijing would sell their bonds and drive up interest rates. The problem is this is not the way it would happen. The mutual destruction part only applies to China and serious collateral damage would go to Europe and the rest of the world, except the US, which would escape scot free. China's trillions actually give them no power. In this poker game, the winning cards belong to the US. They just have to play them.

What can the Chinese do with their bonds? They can exchange them for other currencies (as they did in December), driving up the value of the euro (the only bond market big enough to deal in). Or, they can sell them for renminbi and drive up the value of their own currency. In both cases, the dollar declines, a bonus for the US authorities in today's deflating world. The first would terrorize the Europeans as the euro would climb even higher, a plus for US exporters, and the second would drive up the renminbi, a disaster for the Chinese and a plus for the US and China's competitors. If the Europeans were sharp, they would buy some of the US bonds, printing more euros and driving their currency down as well, leaving the renminbi the only strong currency and playing the same trick as the Chinese under Bretton Woods II, by tying the euro to the declining dollar. History has shown that while inflation remains low, interest rates will not rise but the currency will decline, so the major Chinese threat, that US real estate will be harmed by high mortgage rates, has no teeth. The harder the bonds are to sell, the further the dollar will fall and the more the Chinese and the Europeans will suffer.

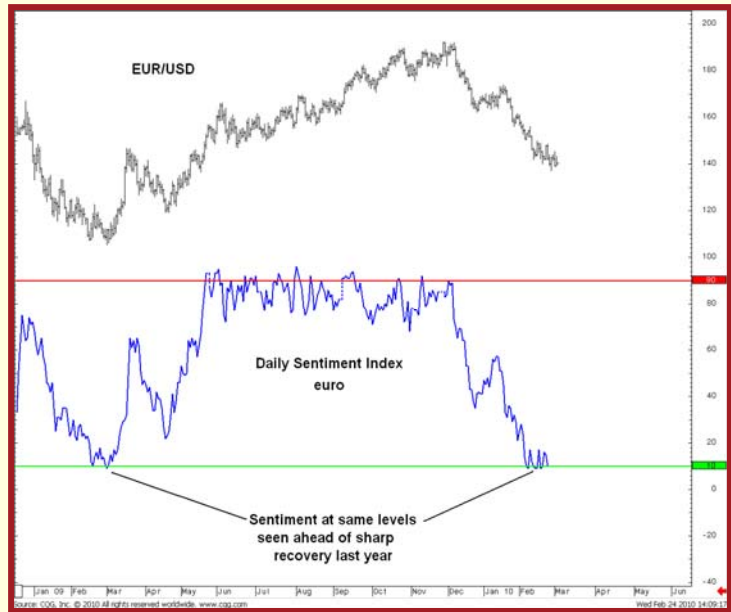


CURRENCY – Europe Long-Term View

Euro Sentiment & Positioning At Extremes

By Kristian A. Kerr

After last week's pledge by EU finance ministers to support the periphery, equity markets have recovered and CDS premiums have come down. The euro, however, has not really benefitted from this newfound optimism, and on Tuesday it closed at its lowest level in over nine months. Not surprisingly, the extent of this decline has seen positive sentiment towards the single currency drop to almost single digit levels. In the past, when sentiment has gotten so dire, the euro has had a tendency to rally fairly aggressively in the proceeding few weeks. For instance, last March during the height of the financial crisis, positive sentiment towards the euro fell to 9 just two days before the pair commenced an 8% recovery over the next few weeks. Coincidentally that was the low for the year. Given how poor sentiment currently is towards the euro, we think conditions are once again ripe for a multi week recovery. It doesn't hurt either that the speculative community is still betting heavily on further EUR/USD weakness as measured by the record number of short positions on the IMM.



The cycles are generally positive towards the euro into the middle of next month, but trading is expected to be choppy. The shorter cycles call for strength into the end of the week, and the resistance at 1.3700 would be a good bet. EUR/USD will then pull back for a couple of days before making another move higher into late next week toward 1.3840. It will then be the right time for an intermediate-term top and the euro should come under modest pressure for a week before making a final move higher into the week of March 15. Our maximum target is the 1.4000 area, but the longer term view is not positive as it was last year and we expect the euro to embark on a decline into May.

The support at 1.3440 should hold while the EUR/USD moves higher and only a close below this level would warn us that our positive view is wrong. In this case the euro is headed directly lower into late next month to 1.3000. This weakness should be delayed for quite a few weeks if our reading of the cycles and other tea leaves is correct.