

MARKET INSIGHT REPORT

Buy Latvia, Sell Club Med

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It has taken almost two decades, but with the meeting later today in Brussels, billed as an Informal Meeting of the Heads of State, the real negotiations over the meaning of the Maastricht Treaty are finally beginning. This time around the battles will be fought in public and on many political and economic levels. We forecast a long catfight because the participants are a diverse herd of cats: all Europeans, from the poorest to the most powerful, will be dealing with the true impact of the European Monetary Union. These are stubborn, historically and emotionally relevant cats as well, nation states and nationalities fighting for relevance. This will not be solved quickly and we believe the final outcome is totally unknown at this time. There is tremendous risk. Some predictions can be made, however. First, the euro and the structures supporting it will be changed dramatically, as the current structure can not work. Second, this process will eventually involve the general populace, something the entire multi-decade EU development has never done. And, third, there will be very difficult negotiations as a better understanding of the real winners and losers of the single currency structure become apparent.

Many actors will impact this developing political and economic struggle. In the original agreement, economics were brushed aside and the decisions were almost entirely political, but now the economics and, more importantly, the micro-economics, of the single currency union will be the focus. To simplify the analysis of this process, we would look at it as series of four-party games. There are two players from each of the pressured debtor countries, the local political leaders and the citizens, plus two players from the projected creditors, the individual country lender (Germany), and the Brussels bureaucracy. Historically no citizens have been involved and they are still surprisingly quiet. To illustrate how we see the future developing, we choose two countries that are currently failing to meet the Maastricht criteria and describe their positions. Although we have been quite brutal in our view of the Latvian strategy (see 'Latvia, Spain, Germany' on 25 June 2009 and 'God Bless Latvia' on 11 June 2009), we would argue that the Latvians have a much better chance of meeting the euro criteria than the Greeks do. Although the average Lat has seen his standard of living collapse – retail sales off 30.2% in December 2009 from December 2008 – he is more likely to accept this drastic fate than the average Greek. The reason for this lies on Latvia's eastern border – Russia. Latvia's centuries-long subjugation by its giant neighbor and Russia's continuing belligerent tone are so fearsome that Latvians would probably give their last lat to be tightly bound to a Europe which includes France, Germany and the UK. Furthermore, most Latvian voters remember a recent life of poverty, and life today is still better than that of the early 1990s. For the Greeks, the situation is very different; their historic enemy, Turkey, is no threat, and making sacrifices to remain in the euro is not a geo-political necessity. The most recent Greek political traumas involve Germany and Italy in World War II and Communist revolutionaries in the post-war period, and have nothing to do with today's crisis. The Greek ascent from poverty has been slow, but steady over the past 50 years and has been institutional in nature, with unions and the government leading the way. When the 'credit enforcers' – Germans and Eurocrats – set the same terms for these two countries, the governments and citizens of each country will see them differently. Latvia will agree, but the Greeks might overthrow their leaders for the same policies. Buy Latvian debt, sell Greek! As the Germans first priority is their well-being, or avoiding 'moral hazard' (the politically correct way of putting it), they would put the debtors through an internal devaluation process forcing a collapse in final demand like the Lats have seen. How independent is a country that must be bailed out? Sovereignty will be reduced, appealing to centralizing Eurocrats, but not to local politicians. In the years ahead the euro will face many critical issues with no clear answers.

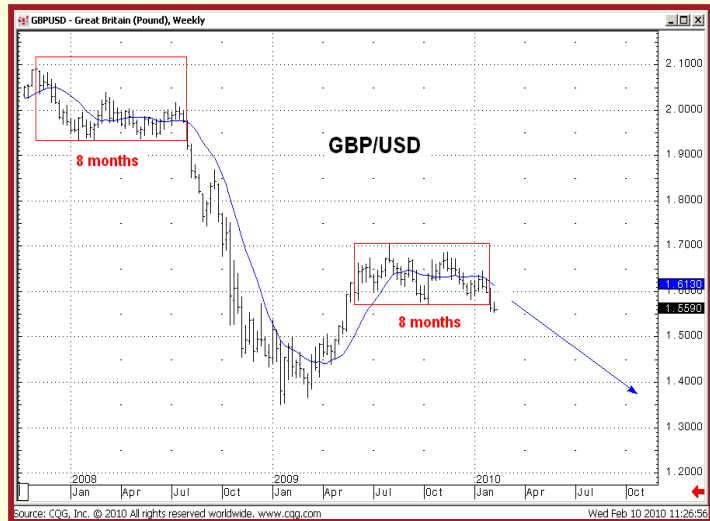


CURRENCY – Europe Long-Term View

The Pound will Show the Direction to the Other Europeans

By Jonathan Clark

For many market participants the outlook for the European currencies was darkened by the potential bailout of the weaker EU members. It will take time before the details of the first rescue program are worked out, and we can be sure that the required fiscal austerity will not be successful, even if it is accepted in the affected countries. One thing is certain: the volatility of the euro will increase in this environment as risk has increased and will stay high for years. Although we believe our negative outlook for the European currencies into the third quarter of the year is intact, the coming Greek rescue might affect its timing.



If we look to the British pound, which is somewhat isolated from the Greek turmoil in the EU, we might be able to time the next collapse of the euro. The EUR/GBP crossrate correlates with the EUR/USD, which means that the pound will be less volatile than the euro and is therefore a better indicator of overall direction. There are a number of similarities between GBP/USD's price action during the eight months between November of 2007 and August of 2008 (left red rectangle) and the eight months between June of last year and February of this year (right red rectangle). When the pound broke below the bottom of the rectangle in August of 2008 this signaled the start of a downtrend, and it held below the 13-week moving average (one calendar quarter) while the downtrend remained intact. The British pound has broken below the lower end of its more recent rectangle and this could mean it has begun a sustained downtrend into June and probably October, but it must hold below the 13-week moving average currently at 1.6132 on a closing basis if our negative outlook is correct.

There is one risk – our left hand box began at the high and if our right hand box did the same, the downside break would occur in 6 weeks. Although GBP/USD is trading at its lowest level in eight months and this increases our confidence in our negative outlook, a reversal would give us pause. A move above the resistance at 1.6100, would tell us that the European decline will begin in late March. As the next month or so is likely to witness choppy trading, the downtrend could be delayed. There is a high due late next week, a low in early March and another high in the second half of March. Eventually the pound will drop, reaching the 1.3000 area. The euro should reach 1.2000 at that time.