July 17, 2008

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A SENSE OF WHERE YOU ARE

Bill Bradley, the basketball player, Senator and candidate for President, was a classmate of mine at Princeton and he has always been a beacon of order and rationality in my life. Just after we graduated, a book on his basketball and student life at the university, *A Sense of Where You Are*, became a best seller in America. The argument behind his life and the book has always seemed very logical to me: you need to understand your current situation. Let's face it, if you don't know where you are how can you make judgments about the things around you, how can you know which way to go? Being truthful and honest with yourself is the first step to success. Although it is obvious that this applies to individuals, it would make sense that it also applies to societies and countries Unfortunately, in today's world very few of us seem to have a sense of where we are. This might be because we don't care to know the truth or because the truth is not easily discernible. Just listening to the economic and political commentators, or even the financial leaders and politicians themselves is not enough to get a realistic picture of the world around us. Basically, the people in power continually tell us things that are not wholly true or are just plain incorrect because it is easier to sugarcoat reality than tell the truth.

The distance between reality and what the non-technical, non-specialized news media tells us has reached an extreme in the past few weeks. Several of the most accurate systems that forecast recessions in the United States say that the probability of a recession in the next year is 100%, and it doesn't get any clearer than that. The housing market is in a decline that will continue for at least another year and likely two, taking house prices lower than current levels and causing many more credit losses for America's banks, bankrupting many of them. Commercial real estate is going in the same direction, and as most US banks have more than 50% of their assets in real estate risk, many will be in severe trouble or will fail. Loan growth will be very slow, so consumers will be forced to cut back on their spending, making the coming recession a long one. The financial and personal implications of these facts are significant. Now that we know where we are, we would like to take the rest of this short note to comment on the implications of this situation on the markets.

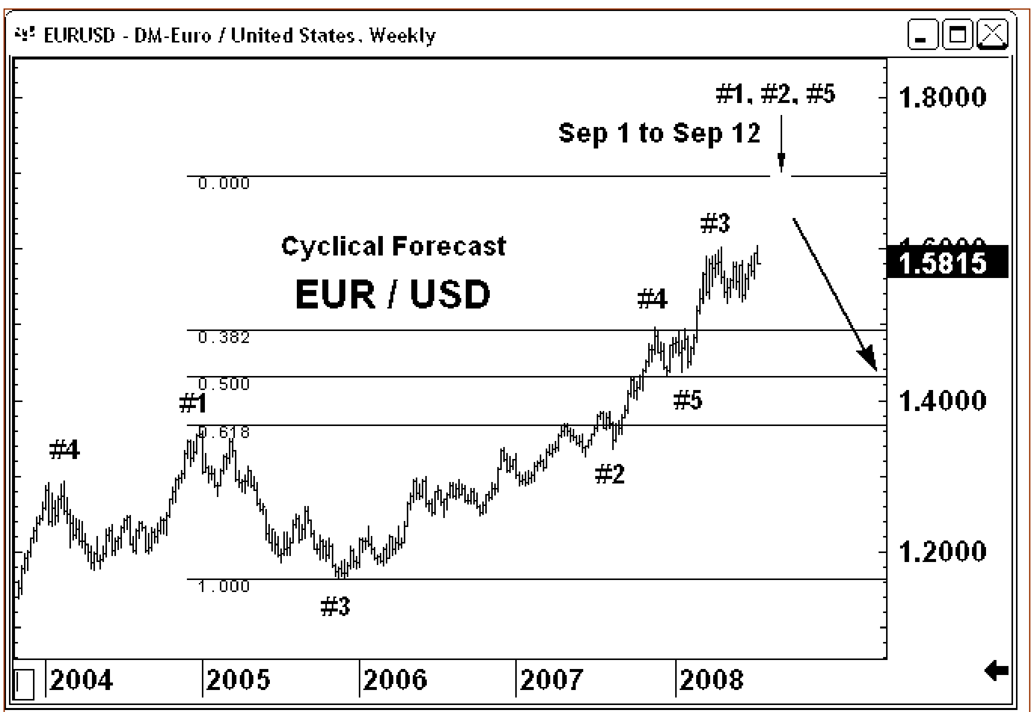
Clearly, great swathes of global companies will be facing more difficult times in the next few years and their earnings will decline, which is certain to result in weak equity markets. Wages will be under pressure everywhere as corporations attempt to maintain their margins. Because recessions will lead to lower use of natural resources and increased poverty, commodity prices will drop and inflation will follow. With banks unable to expand liquidity because of their 'bad' loan problem and diminished capital the money supply will not expand rapidly and growth will be slow to come back. It is logical to avoid equities and to favor high quality bonds. Commodities and real estate are likely to be bad bets until the banking situation hits bottom. The central banks of the world will eventually see inflation as less of a problem than financial implosion, but this probably won't happen for another six months or more – and then it will take them at least a year to be successful. When they do reliquify the world, our strategy should change dramatically because the world around us will have changed too.

CYCLICAL PERSPECTIVE

The latest moves by the US Federal Reserve and the Treasury have expanded the perceived level of dollar liquidity in the world and this has made it very likely that the dollar will see one last decline in the next seven or eight weeks. Although we do not actually believe that the Fed and Treasury activity will increase dollar liquidity, the perception is what counts in the short run and dollars should be sold aggressively in the weeks ahead.

On the chart of the EUR/USD below we have labeled various past euro lows and highs and shown how they imply certain timings for cyclical peaks. Earlier this year on January 17th in the Cyclical Perspective we commented that the dollar should see its low in "March, with a secondary low – possibly lower – in the third quarter." Thanks to the Bear Stearns' fiasco, the dollar posted an emphatic low on March 17th and then rallied for about three months. The March high (#3) matched perfectly with the low at the end of 2005 (#3), but did not match well with any of the euro highs. The high in early 2004 (#4) matched well with the high in very late 2007 (#4), but not with any lows.

The shorter cycles (#2 and #5) are targeting the first half of September as the next high and this matches well with the last euro cyclical high from the end of December 2004 (#1). Although there does not seem to be an equivalent low back in the middle of 2006 in the EUR/USD, there is a major low in the NZD and AUD at exactly the right time to match the expected EUR high in early September. The Fibonacci ratios confirm a target around the 1.6900 level. Clearly it is too early to buy the dollar.



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