

MARKET INSIGHT REPORT

The Currency Crises of 2009

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Since the start of the year, the rather modest moves in the markets, whether currency, equities, interest rates, or commodities have had a calming influence on global investors and have been a welcome change for government authorities around the world, but the realities underlying this quiet market are continuing to deteriorate at an extremely fast pace. In this letter over the next few months, we plan to outline our idea that the world is currently in the eye of this powerful financial storm and that it will rage again for many months ahead, and that the global economy is just at the beginning of a recession that will take the form of a powerful winter Nor'easter in the US like the ones of 1962 or 1978, or for Europeans like the North Sea flood of 1953. Everyone recovered from these storms, but their impact lingered for years and has been remembered for generations. The same will be true for the economic recession that is just beginning. An economic and political maelstrom like this should be an exciting time for forecasting, and it is valuable to think widely, assessing many ideas, but the risk of drawing some conclusions that turn out to be laughers is high. But without risk, there is no reward.

Global reserves climbed dramatically over the past few years, but now they are turning down sharply in some cases and the reactions to these reversals should be extremely significant. The first glaring example is in Russia, which lost about a third of its reserves in a few short weeks while the rouble was under pressure. Without dramatic regulatory changes that would severely restrict currency flows, this loss of reserves will continue in the months ahead. We expect the rouble to weaken beyond the 41.00 upper band of its basket of 45% euro and 55% US dollar and a move to the 90.00 area is possible, looking at inflation differentials and technical possibilities. The Central European currencies are also at risk of seeing dramatic currency outflows as their offshore hard currency liabilities plus their large current account deficits put them at increasing risk while the liquidity of the financial system continues to dry up. The problems in Russia and its ex-satellites will impact Western Europe. When these currencies begin to unravel, devaluations, a massive recession, and defaults will occur, and the banking systems of Austria, Switzerland, and Germany will absorb very significant losses on top of those they already have.

Chinese reserves actually fell in October and if these outflows expand this year, as we believe is likely, it would impact the value of the renminbi and all the other currencies in Asia. As the Chinese Communist Party is a party of the people and its *raison d'être* is the enhancement of the quality of life for its people, the global recession that is slowing Chinese growth and increasing employment is more than a severe embarrassment: it is a crisis. We expect that the Chinese authorities will do everything in their power to jump-start their economy, but considering that such a high percentage of their GDP is composed of net exports and capital investment, we believe that it is likely to fail and that China will experience a quarter of roughly zero growth. Not only will this lead to a sharper decline in reserves as money flows out of the country, but the government will be desperate to bring the export machine back to life. Just letting the renminbi float will solve two problems: it will drop sharply, dramatically helping the economy, and it will be a Pyrrhic victory for the US who want to see a freely floating Chinese currency. Across the Sea of Japan, the authorities are watching a collapse in their exports and a dramatic drop in industrial production as well, as the yen strengthens toward all-time highs. Japan is beginning the worst recession since World War II. A sharply declining renminbi or the USD/JPY below 80.00 would be enough to force the Japanese to intervene aggressively. The rest of Asia would follow, and competitive devaluations would drive the dollar much higher by year-end.

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CURRENCIES

Australia Is Swimming Upstream

By Jonathan Clark

The commodity currencies have been in a trading range for the past 3½ months and the Australian, New Zealand and Canadian dollars are in the lower halves of their trading bands. The longer-term cycles appear very clear to us and call for overall weakness into the third quarter of the year. What is less clear to us is when these currencies will break out of their trading ranges to the downside.

Potentially devastating news for Australia is that Chinese imports have fallen by 43% in January from a year earlier. This appears contrary to rumors China is stockpiling raw materials and is very bad news for Australia's export prospects. Since China is the locomotive for global growth, this is negative news for all export dependent Asia/Pacific countries. During the past 30 years there have been three periods of economic global trouble significantly impacting this area. The first was in the early 1980s and this was a very difficult time with two US recessions in a three-year period. The second was in 1990 with the start of the first Gulf War, which led to Australian Treasurer Paul Keating's comment that this was "the recession that Australia had to have" to solve its problems of mismanagement. The third started with the Asian crisis in 1997, followed by the Russian debt crisis, Y2K and the dot-com bubble, and ended with the recovery in late 2002. Aussie declined sharply all three times. This crisis is much worse than the others and even a new fiscal stimulus of A\$42 billion spread over four years, with lower interest rates, won't save the currency.

The cycles call for the commodity currencies to trade lower for the next two weeks. There is an initial low due early next week and they should fall to AUD/USD – .6405, NZD/USD – .5140 and USD/CAD – 1.2570 before recovering for a few days. The downmove should then resume into the week of February 23 and our initial objectives are .6275, .5035 and 1.2700. Following this low, these currencies should recover for two weeks before the downtrend resumes. The strength we are expecting during the first half of March should be unimpressive and will hold below .6710, .5400 and 1.2240. Only a close above these levels signal a rally to .6975, .5580 and 1.2025 by the middle of March, but this is unlikely. The longer-term cycles call for weakness into late July or August and our conservative objectives are .5900, .4815 and 1.3300.

