

MARKET INSIGHT REPORT**God Bless Latvia**

*By John R. Taylor, Jr.
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After reading the recent press about the economic and political maneuverings in and around Latvia over the past few weeks, I became very depressed. To me, the emotion expressed by Prime Minister Geir Haarde of Iceland in his speech to his citizens on October 6 seemed very appropriate. After announcing the government takeover of the three largest banks and noting a significant danger “that the Icelandic economy, in the worst case, could be sucked with the banks into the whirlpool, and the result could be national bankruptcy,” he ended his address with the jolting comment, “God bless Iceland.” For the Icelandic people the events late last year were like losing a war or watching the family home burn to the ground. At the time, the press reported that this was the first time an advanced Western democracy had ever collapsed and it surely was an outlier, resulting from the country’s flirtation with the Anglo-Saxon hedge fund mentality. Although there might be some truth in that analysis as Iceland’s financial institutions were very highly geared, the world now has Latvia going through a roughly similar crisis with several more countries lined up closely behind it. We believe there is a lot to be learned here, less so about how the crises came about, as that is already history. We are more interested in how the national authorities and international bodies, including global investors, should deal with countries that fall into this kind of hole.

There is much that is similar and many differences too, when one compares Iceland and Latvia as they went into this crisis, but the only points that seem important to us are the ownership of the banks and the currency peg of Latvia. Both countries are small with the Latvian GDP, about three times that of Iceland and its population about seven times as large. What is very interesting to the future of our global economy are the great differences in how the crises are being handled. It will be our argument in this short note that the Icelandic method, a bucket of ice-cold water over the head, is far preferable to the steady-as-she-goes direction that Latvia seems to be on. The fact that three-quarters of Latvian deposits are held by foreign banks means that most currency risk is not borne by Lat institutions but foreign ones. For the Icelandic banks (all home-owned) and the country, the devaluation of the krona generated a multi-billion dollar loss. If Latvia were to devalue there would be little currency loss among the smaller Lat banks and the risk would be borne by other countries. This situation has created perverse incentives for the borrowers. When buying a new home, would you borrow Lats at a higher rate or euros at a lower one? Being pegged to the euro, with the government policy implying no risk, it was very logical to pay less. Icelandic homeowners were more likely to be krona borrowers and only the most sophisticated borrowed foreign currencies. Three-month Lat rates are at 18% and euro rates around 1%, the penalty for doubting the government peg is tremendous. For Latvians currency risk is now compounded by very high rates, and is worse than it was in Iceland. Pegs can be a disaster.

Iceland collapsed in October, received over \$4 billion from the IMF and others, and saw their currency drop about 30%. Annual growth through the first quarter has been minus 5.4%, but the economy should be growing by year-end. Latvia has not collapsed, but it has been promised, and will spend, over \$10 billion; its currency has held firm, but the economy is down 18% over the past year and officials expect a decline of 18% for the year. The outcome could be even worse. No one bought Latvian debt at the last auction. The average Lat is either out of a job or seen his salary cut, and any small business owner has a horrific currency risk. The Icelandic “billionaires” were the big losers, but the average man has come out better than the average Lat. There the rich are insulated from the crisis, its the European way.



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CURRENCY – Commodity Currencies Long-Term View

The Commodity Currencies Have Begun a Downtrend

By Jonathan Clark

The Australian dollar made a sharp decline into Monday, and although it has regained most of its losses, we believe it has formed a significant peak and is headed lower for several months. The Australian economy has lagged behind the other major economies in entering a recession and is likely to end its recession later as well. Australian GDP surprisingly grew in the 1st quarter due to trade. Quarterly exports rose by 2.7% and imports fell by 7.0%. Household spending was relatively strong, but this is largely a function of the government's cash payment of up to A\$900 per taxpayer. Consumer spending should diminish during the remainder of the year as



unemployment climbs. The housing market will continue to weaken and there is a strong chance the RBA will cut interest rates again before the end of the year. During the next three months we expect global growth expectations to be scaled back, and this combined with a narrowing Australian interest rate advantage against the US, should cause the Australian dollar to decline. At this point it is difficult to know just how sharp the decline will prove, but it is likely to prove as aggressive as the upmove that preceded it. The currency remains overbought and the cycles are calling for commodity prices to decline in the months ahead and these factors will contribute significantly to the decline in the currency. **Exit any remaining long Australian dollar positions here.**

The commodity currencies should be headed lower for a minimum of several months. We are expecting weakness into early next week and a close below the supports at AUD/USD – .7915, NZD/USD – .6180 and USD/CAD – 1.1290 will confirm our negative outlook. They will then fall to our targets of .7500, .5900 and 1.1500 by the end of the week of June 22 before recovering for a week. The downtrend should then resume into late July and probably September before forming a major low. **Our further objectives are .7125, .5600 and 1.2200 and we cannot rule out a retest of the lows for the year.**

Only a close above the resistances at .8210, .6425 and 1.0930 means the currencies are headed higher into early August and will reach .8475, .6600 and 1.0550, but this is very unlikely.