

## MARKET INSIGHT REPORT

### Midsummer Night's Dream

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By John R. Taylor, Jr.

Chief Investment Officer



Here in Paris, the stores on avenue Matignon and rue du Faubourg Saint-Honoré are packed and long lines snake into the Louvre and other museums – the summer is wonderful. And in London and New York, as well as the Côte d'Azur and the Hamptons, it is just the same, as those with money and credit leave their worries behind. It's hard to believe that the world isn't in great shape. As a bear, sometimes I even feel guilty for harboring negative thoughts and raining on the triumphal parade of the ruling classes. The wealthy centers of the European and American capital cities do look better and better every year, but the business and editorial pages of the leading papers tell another story. The financial picture is deteriorating at an accelerating pace, and now even the major governments, bulwarks of the free market system, are threatening to slide into trouble. The latest phase of this has been the creation of large amounts of high powered money, issued to benefit and support crucial financial actors within the system. Finding a home for this excess liquidity has resulted in a continuing series of bubbles, large and small (one of which is the beautifully renovated monumental buildings in central Paris). Although we have not done a word content analysis for 'bubble', it is our opinion that in 2010 this word has appeared more often in the financial and general press than at any time since 1720, when the Mississippi Bubble and the South Sea Bubble topped the charts in Paris and London.

Does today really have parallels with 1720? That's what vacations are for: thinking of things like this, reading murder mysteries, romance novels and financial histories, and fantasizing. After reading *This Time Is Different* by Carmen Reinhart and Kenneth Rogoff, which we all should memorize, I wished that their analysis had gone back to the period before 1800 as it seemed to me that the most interesting financial conflagration of the last 500 years occurred in 1720. Central banks were just beginning and the big powers were struggling with monumental debts. The British had just gone through a long revolutionary period that ended in 1688, and the "Glorious Revolution" seemed to bring a new mercantilistic twist to finance, leading to the creation of the Bank of England. The large government debt was absorbed through the Bank's expanded liquidity and the economy grew rapidly, spawning many other joint stock companies. The most famous of these was the South Sea Company, founded in 1711, which, by promising to finance the government dramatically expanded liquidity, but it was never profitable, and eventually collapsed. The Bank of England and the British Treasury managed to avoid default, retiring the debt over many years but the economy suffered for decades. In France, the death of Louis XIV, a singularly expansionary and profligate monarch, caused the government to default in 1715. John Law arrived and introduced a bank, the Banque Royale, with the guarantee of the king to issue paper currency backed by the revenues of the Mississippi Company. The success of his venture led to the circulation of far too many banknotes, and the bubble collapsed in 1720. The French economy went into a long chaotic decline, never really recovering and ended in revolution by 1789.

The Bank of England was the first central bank and John Law's bank was the first to act like a modern central bank. These independent banks were there to finance the government. Although both governments needed liquidity to satisfy their debts, the banks expanded so much that the economies were stronger too. However, despite the multitude of investors attracted by the bubbles, eventually the commercial operations could not support the debts and a collapse followed. The British took a deflationary path, while the French one seemed erratic but generally inflationary. Neither brought economic relief in the next decades, but the British tactics eventually built a sounder economy.

## CURRENCY – Asia Long-Term View

### Conditions are Developing for an Aggressive Yen Rally

By Jonathan Clark

If countries with strong economies and high interest rates perform well over time, shouldn't weak economies with low interest rates perform poorly? Not if the country is Japan, which has a giant current account surplus, second only to China, a larger country. Investment opportunities within the country are limited as Japanese equities have been poor performers and 1-year Japanese government paper yields only 0.13%. This forces investors to send money offshore in search of higher yields. The Ministry of Finance reports investors bought \$88 billion of mainly 'stable' foreign bonds during the two months ending July 9. Japanese traders also aggressively attempt to capture higher offshore interest rates through currency forwards, with some brokers offering leverage of up to 400:1. Japan's Financial Services Agency woke up and announced that as of August 1 leverage would be limited to 50:1 and within two years it will be lowered further to 25:1. Nevertheless, short yen positions reached record levels this month in a very uncertain global environment. These traders are at risk.



Recent US economic data have disappointed and growth forecasts are being scaled back. In his semi-annual monetary policy report to Congress Federal Reserve Chairman Ben Bernanke said "the economic outlook remains unusually uncertain." The downward trend in US consumer and industrial prices during the past two years has raised fears of deflation. The Fed is considering additional quantitative easing and this would be negative for the US dollar. We expect global equities and global trade to decline into early next year and a worsening global investment climate is likely to cause money to return to Japan. **With the overhang of short yen positions there is the potential for an explosive rally in the currency.**

USD/JPY has been in a downtrend for nearly three months and fell to its lowest level since December of last year on Friday. Although trading could prove choppy during the next several weeks, we are expecting dollar/yen to trend lower into September when a medium term low is due and our target is the 82.50 area. The longer-term cycles call for this overall weakness to last into February or March of next year and our ambitious objective for this move is the 75.00 area, a shocking level for all involved