



MARKET INSIGHT REPORT

After the Phoney War, Things Really Got Nasty

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By John R. Taylor, Jr.

Chief Investment Officer



Not too many traders remember 'the phoney war,' or the Sitzkrieg, as it happened 71 years ago. After Hitler invaded Poland on the first day of September 1939, Poland's European allies France and England declared war on Germany, but nothing significant happened on that front until the following May when the German Army rolled through Luxembourg, the Netherlands, and Belgium and into France. Although the horror started in Poland in the fall of 1939, for a few months, the rest of Europe was spared that horror, which eventually lasted through the next five years. Strangely, this past September (2010), the US equity market rose by about 8.8%, its best return for that month, since that same September (1939). To me the parallels are ominous. What were those people thinking back in 1939? Could a coming world war have that positive an impact on the economy and on markets? They must have been crazy – of course equities gave up their gains and were cratered in May 1940 when Germany invaded the west. But, what are we thinking of now? A war has just begun. Didn't Bernanke and the Fed announce in late August at Jackson Hole (and multiple times since then) that the US was going to enter QE2 and debase its currency setting off a currency war. Bernanke, like Hitler seven decades ago, had been warning everyone who would listen for years. On November 21, 2002 he said that he would debase the US dollar if the American economy looked as though it would go through the same lost decades that the Japanese have recently endured. Now, it is clear that he has been true to his word and the currency war has begun. Although it took Guido Mantega the Finance Minister of Brazil to state the obvious saying that "an international currency war" had broken out, the reaction at the recent IMF meetings and among analysts of all stripes make it clear that this situation is well comprehended by everyone who is paying attention. The US has thrown a rock through the world's plate glass window. This country will be severely disrupting the current global monetary system because the Federal Reserve – and not necessarily the Obama administration – believes that the status quo is not in the interest of the American people.

Right now the world is in the 'phoney war' period as the US has only just begun the process of flooding the world with excess dollars. The recent IMF meetings had and the coming G-20 meeting will see lots of venting and some skirmishes but no real attacks. Countries are complaining loudly because Bernanke's excess dollars are being sold and their own currencies are being purchased, rising as the dollar declines. As most are trying to slow that rise by buying the dollars as reserves, reserves are climbing, their money supplies are ballooning, and inflation will surely follow. With inflation and strong currencies, these countries will see their trade positions destroyed. The real war will begin as countries place restrictions on capital flows. Mantega seems as though he will make a good economic general as Brazil is one of the first to move, taxing bond inflows. Interestingly the Brazilian leaders will miss the G-20 meeting in Seoul, avoiding any direct discussion of their actions. Capital controls are likely to spring up in Asia and in other attractive economies during the next few months, but the really destructive war begins when tariffs appear. This should happen next year – maybe in May, mirroring 1940 – because by then the next recession should be in full force in both the US and in Europe, forcing many millions more out of work. The political pressure for raising tariffs in the US is intensifying and the new Tea Party supported Congressman will help tip the political scales in that direction. This war will not be fought for territory, but for markets and wealth, and when tariff walls are raised the destruction of livelihoods and property will be almost as dramatic as in the old fashioned shooting wars. With the loss of economic value, the global debt structure must collapse and entitlement promises will not survive.



CURRENCY – Asia Long-Term View

Owning Asian Currencies Isn't without Risk

By Jonathan Clark

Money is flooding into the emerging market countries because this is where global investors see the best investment opportunities. Due to inventory restocking and the surging Chinese economy, the other Asian countries are witnessing strong growth. The World Bank expects the developed East Asian countries (excluding China) to grow 8.9% this year. Since China has capital restrictions and tightly controls its currency it can raise interest rates as it did on Tuesday to slow the economy with few repercussions. However, other nations in the region are in a bind. The regional Asian central

banks are concerned about their economies overheating pushing inflation up, particularly in food prices. However, raising interest rates to slow the economy attracts more capital and causes their currencies to strengthen even further. Tensions are rising and Korea and Japan are complaining about the other intervening to hold down the value of their currency. Thailand reintroduced a 15% withholding tax on foreign investments in government debt and Indonesia has a 20% withholding tax. Korea is considering similar measures. **Exchange rates are one of the three major policy tools along with fiscal and monetary policy and some Asian countries won't allow their currencies to be hijacked.** In a struggling global economy where final demand is depressed an overvalued currency will prove very damaging to growth.



This weekend the G20 will meet in Seoul and currencies will be discussed. The US is correctly seen as attempting to devalue the dollar, while the Chinese yuan is clearly undervalued as evidenced by the dramatic rise in its currency reserves. Japan has intervened to hold down the value of the currency, so 3 of the 4 most important global currencies are manipulated. It is unlikely that any concrete measures will emerge from the meeting, but some of the emerging countries will take matters into their own hands. This means intervention, taxes, capital controls, or other measures. It is difficult to predict these political decisions, but the strongest Asian currencies since the major low in March of 2009 are the Korean won and Indonesian rupiah which have gained 39.7% and 34.7% respectively so owning them carries considerable risk. **Far safer is the Singapore dollar since the MAS hasn't expressed much concern about the strength of the currency.**