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In its 18th year

Fullermoney

Global Strategy and Investment Trends by David Fuller www.stockcube.com

Reserve currencies have completed base formations against the yen and further gains will follow. The stock market rally has run out of steam.

Japan's worsening economic crisis is a threat to the US-led economic recovery in 2002.

Who is the most hunted man on the planet? - You and I might suspect it is Osama bin Laden, but we would be wrong. Sure, just about every American wants him "dead or alive", as do many Brits and a host of responsible types elsewhere, but international support for the coalition against terrorism runs skin deep. No, the most wanted man today is a financial terrorist, now sought by every central banker, monetary official, economist, financial analyst, politician and most investors around the globe. In summary, millions and millions of people. They fear this person's poisonous sect of monetary fanaticism could export deflation around the globe, pulling stock markets lower once again and preventing an economic recovery. I am, of course, referring to Bank of Japan Governor Masaru Hayami, no less of an extremist in his own way than bin Laden. Remember, Hayami's book published in 1995 was titled, "The Day the Yen Gained Respect". Mad Masaru thought ¥80 to the dollar was a great achievement. Following his appointment as BoJ Governor in 1998, his not so secret agenda has been a strengthening yen, regardless of the consequences for Japan's shrinking economy. For Hayami, the yen is divine and all other currencies are infidels. Consequently he has persistently shown an 'over my dead body' attitude to genuine monetary reflation. When asked about yet another statistic confirming Japan's economic deterioration, Hayami's stock answer is to claim that bad news is actually "good news" because it's less bad than some had forecast! A number of analysts, both in Japan and elsewhere, now predict that Prime Minister Junichiro Koizumi will have to declare a state of emergency within the next few months, take over banks, sell off non-performing loans for whatever he can get and inject fresh capital. Perhaps, but new loans will continue to turn sour because the problem is deflation, which is always a monetary phenomenon. Nothing really changes for Japan until the deflationary spiral is broken. The situation is now so bad that radical reflation is required, namely printing money until prices are no longer falling. Hayami has resisted this, so Japan's money supply languishes at 3.2 percent (M2+CD, Nov YoY) - hopelessly low for an economy where asset values are declining across the board, along with GDP. Belatedly, the international community has woken up to this crisis. Delegations of monetary officials from the IMF, OECD, World Bank and numerous developed countries are flocking to Japan and expressing their concern. The battalions of financial analysts who write and talk about the Japanese economy are considerably less polite. However this is nothing compared to the verbal 'daisy cutters' directed at Hayami from within Japan. Pinned down within the BoJ's tunnels he probably identifies with bin

Laden and certainly shows the same disdain. Fortunately, Hayami's ability to inflict further financial damage is waning. BoJ board members are beginning to change sides like Afghan warriors, further isolating Hayami. The markets are now bringing him to justice by inflicting upside breakouts and additional gains for reserve currencies against the yen. Observing all this, I confess to ambivalence - a feeling described as similar to watching one's mother-in-law back off a cliff in one's brand new uninsured car. Hayami and his colleagues at the BoJ have made Japan's economic problems much worse, by ignoring their primary responsibility, which is to maintain price stability. This is a tragedy for the country and a threat to the global economy, but very good for those who have shorted the yen, which will fall a lot further as continuing deflation forces Japan to print money.

Interest Rates and Bonds

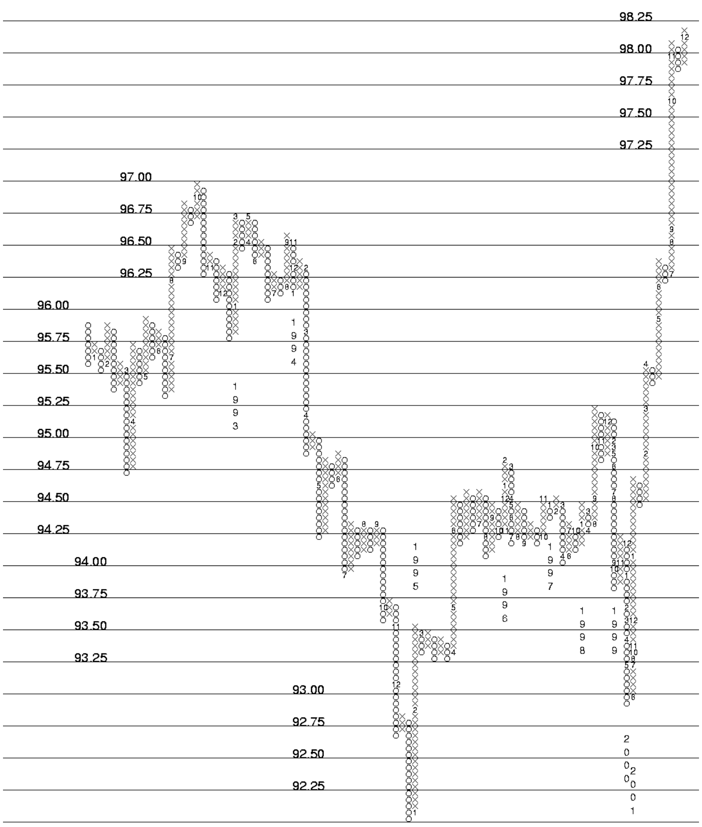
■ **The main remaining case for lower short-term rates is in Europe.**

■ **Downside scope for 10-year government bond yields appears limited to a base extension reaction above the November lows.**

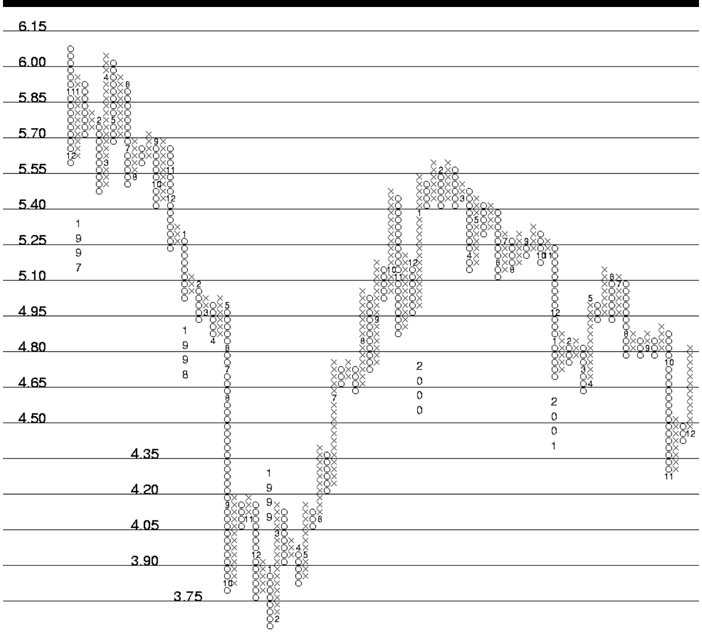
The ECB has no intelligent reason not to lower rates. One can never be sure about central banks, especially "Dim Wim"'s outfit. However with inflation tumbling and Germany in recession, with the IFO Economic Research Institute saying it won't recover before 2Q next year, at least another 50 basis point cut is needed to improve economic prospects throughout Euroland. In the UK, if retail sales do not maintain their recent buoyancy we can expect the BoE to cut as well. As for Greenspan, after 11 rate reductions this year we certainly know he won't hesitate to press the monetary accelerator again, if he thinks it is necessary. However with tentative evidence of economic improvement in the US, plus the Government's fiscal stimulus and low oil prices, I cannot envisage more than another 25 basis point cut, if that. The cycle of lower interest rates is coming to a close, at least for the US and Greenspan will be the first central banker to raise them, possibly during the second half of 2002. Looking at the 1st month continuation chart for Eurodollars, we can see acceleration in September, a slightly larger reaction in November and a loss of upward momentum, despite the new high in early December. This suggests that the topping out process may have commenced.

Initial gains by US 10-year yields have been much stronger than occurred in 1998, despite deflation

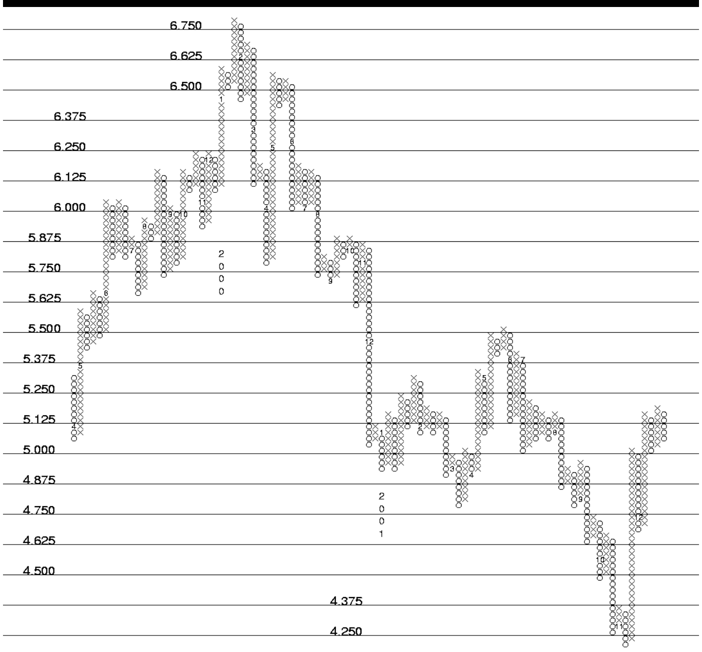
Eurodollar CME 1st Month Continuation (0.05)



Euro-bund 10 Year Bond Yield (0.03)



US 10 Year Bond Yield (0.025)



concerns. Currently, the market is backing the economic recovery hypothesis rather than deflation exported from Japan. No doubt there has been some capital flight from bonds to stocks, as we also saw in 1998. It would be surprising if US bond yields did not lead a pullback and base extension phase before long, although I do not expect the lows to be challenged during this reaction. A close at 4.975% would indicate a loss of upside momentum. This consolidation could last several months, as we also saw in late 1998 and early 1999, but I expect it to eventually support higher yields for long-dated government bonds.

Strategy for bonds - My strategy for conservative investors is unchanged from last month. Hold only 3-month bills for safety, corporate bonds for higher yield and capital appreciation, as confidence in a US-led economic recovery grows. Speculators could consider longs in futures, for a technical rally during a stock market correction, but this is now a dangerous game. I'm not tempted, although I might consider shorting bond futures if yields retrace half or more of their gains since the November low during a period of base extension.

Global Stock Markets

■ **It may only be a pantomime bull market but at least this year is ending a lot better than it started.**

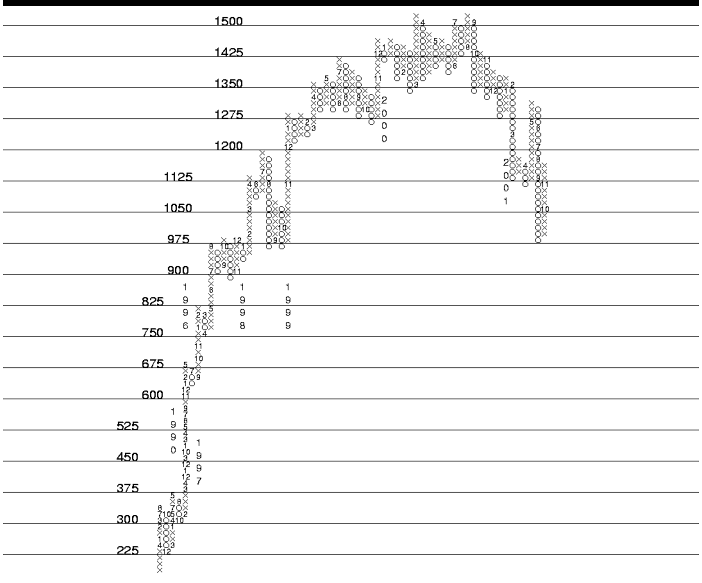
■ **Hero and goat awards for 2001.**

2001 (the real millennium) inherited all the problems of 2000. Oil prices had tripled from their 1999 lows, all but guaranteeing a global recession approximately 18 months later, just as we saw in 1974/75, 1980/82, 1990/91 and now 2001/02. The second major blow for equities was the aftermath of higher short-term interest rates as central banks clawed back all the excess liquidity in 2000, pumped due to the ludicrous Y2K paranoia, "because nobody can be sure what will happen". Rate hikes, of course, pierced the global tech bubble, which had an eighteen-month unwind. The fourth horseman of the apocalypse arrived on 9-11, courtesy of spoiled rich brat and nihilist bin Laden. Fortunately the year ended a lot better than it began. Accelerated interest rate cuts in response to a panic ended the worst bear market since 1973/74, although not for special situation Japan. Russia became the new swing-producer of oil, helping to undermine OPEC's cartel. A liquidity injection is the fuel for a bull market, which we have seen in statistical terms since 21st September, led among major national indices by the US's NASDAQ 100 and Germany's DAX, which have gained over 59 and 50 percent, respectively. Elsewhere, some of Asia's markets have actually looked tigerish, led by South Korea's KOSPI and Taiwan's TWSE Indices up 54 and a whopping 65 percent respectively. OK, they had fallen a very long way and no former high is in danger of a test. Nevertheless, a couple of months ago not many people expected September's lows to hold and some still claim we are seeing only a bear market rally. For my money, if it looks and behaves like a bull, it probably is a bull. All right, I've said the uptrends are losing momentum and pullbacks of at least a third are likely for all indices. That should be a base extension phase prior to some further gains next year, as investors discount a US-led economic recovery and generally good earnings in 3Q and 4Q 2002, if only because of write offs in the second half of this year. However those earnings may look deceptively good. The tech-led recovery has kited valuations once again. The economic recovery may be no great shakes, either because Japan exports its deflation or Greenspan starts to drain off excess liquidity. Therefore it may only be a pantomime bull market but that's a lot better than a bear.

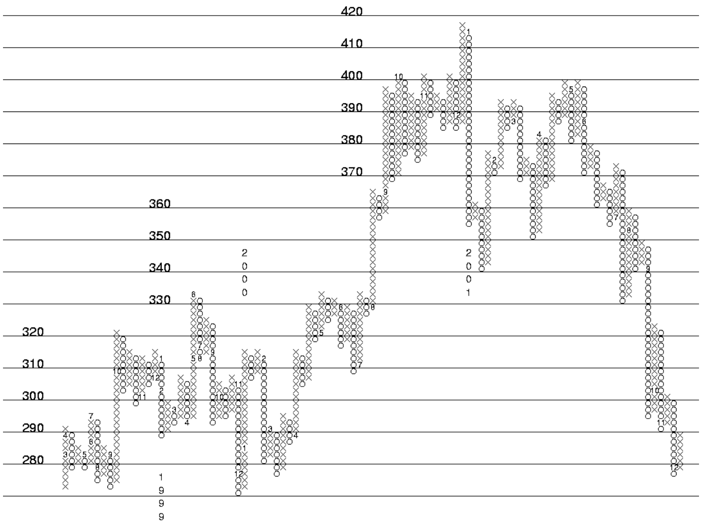
For equity investors, who are the heroes and goats of 2001? Perennial hero Alan Greenspan tops my list, for being the only central banker who realised the risks and acted both early and decisively. George W Bush, for showing a shrewdness that few expected and the best instinct for the right decision since Ronald Reagan. Vladimir Putin, for providing oil at prices low enough to assist global economic recovery and for his contribution to the war against terrorism. Donald Rumsfeld, for making the world a safer place and being the only politician totally devoid of spin. Tony Blair for being an effective and articulate spokesman in building the coalition against terrorism. As for goats, Osama bin Laden has to top any list for showing the worst of humankind. Masaru Hayami, for ensuring that Japan's economy had no chance of recovery. Wim Duisenberg for hubris and an inept performance at the ECB. Finally, a group award for all those CEOs who ruined their companies while lining their own pockets.

Chart review of topical and representative stock market indices - *The 3-box reversal point & figure charts shown are based on closing prices and taken from our website. Anyone interested in this chart service, which includes analysis and is updated daily, should register online at www.chartanalysts.com. Price levels mentioned refer to market closes. The charts were updated through 19th December's closes. Figures in brackets were taken on Thursday the 20th*

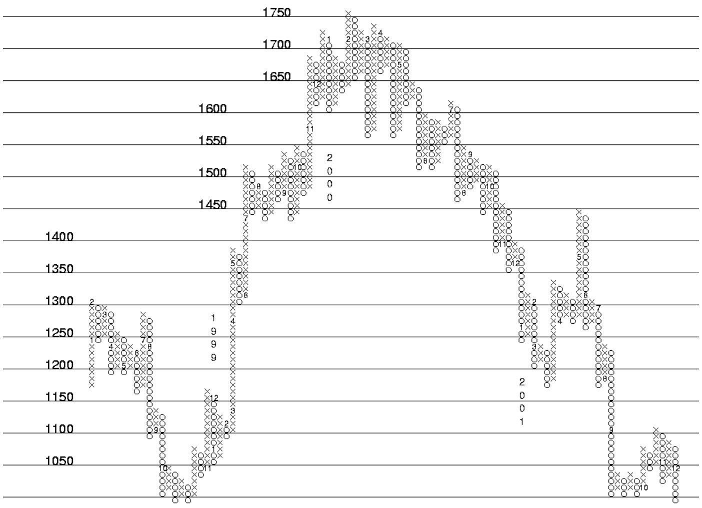
S&P 500 Composite Index (15pt)



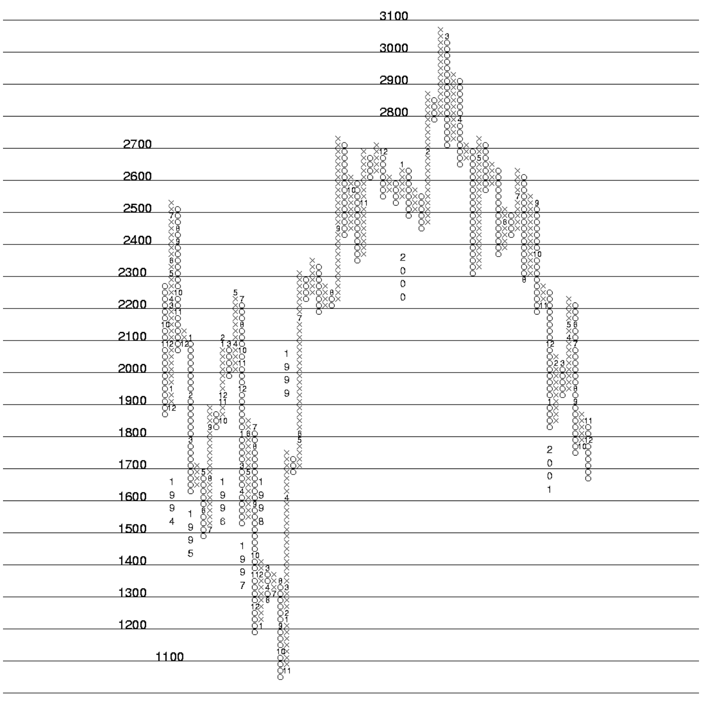
Dow Jones Utilities Index (2pt)



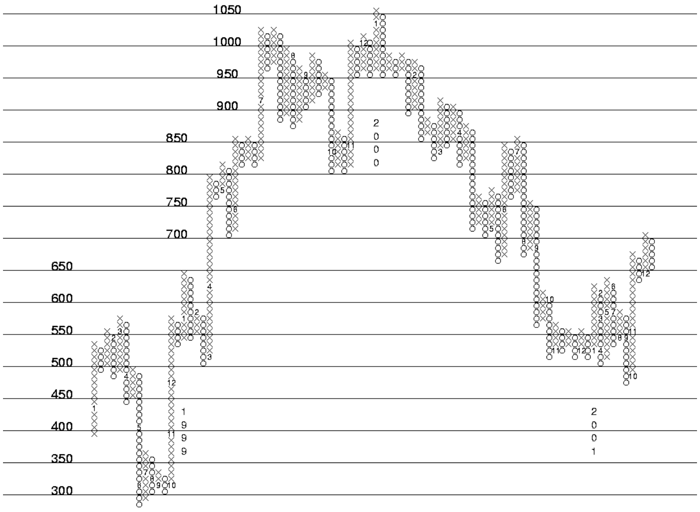
Tokyo Topix Index (10pt)



Tokyo SE TOPIX Second Section Index Index (20pt)



South Korea Composite Index (10pt)



The US's S&P 500 Composite Index (1145) - *see previous page* - has hesitated near the overall downtrend and within initial supply from the top area. A close at 1170 is required to indicate some further test of overhead trading. **The Dow Jones Utilities Index (284)** has fallen back to prior support near 270 and looks somewhat overstretched but needs a close at 302 to reaffirm this former floor and break the progression of lower rally highs established in recent months. Historically, the Utilities Index has often led directional moves on Wall Street. In recent years it has sometimes moved inversely to the NASDAQ.

Japan's Tokyo Topix Index (1012) has nudged to a new low for the year and is testing its important 1998 floor. A close at 1050 is necessary to remove pressure from here and indicate a downside failure, and 1110 to establish the September to December trading range as a base. **Tokyo Second Section Index (1648)** has resumed its downtrend and needs a close at 1880 to check momentum beyond a pause. This Index led Japan's stock market recovery in 1999.

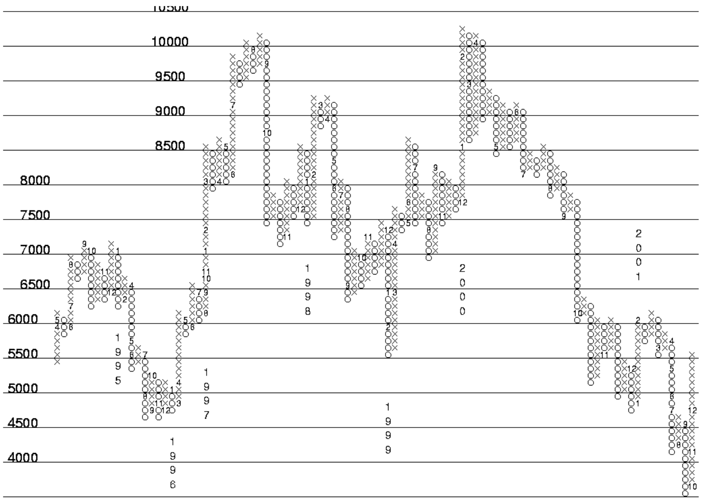
South Korea's Composite Index (664) had an important downside failure in September and the subsequent sharp rebound has established trading over the last 15 months as a developing base area. However the recent strong recovery has lost momentum and 710 is required to signal higher scope rather than a further pullback and period of base extension.

Taiwan's Weighted Price Index (5309) has been the star performer since late September. However the rally appears temporarily overextended and here also a pullback and base extension phase is likely before the next region of important resistance near 6000 is successfully challenged.

Germany's DAX Index (4951) has seen one of the best recoveries among major indices but this is now hesitating beneath overhead supply. A close at 5300 is required to indicate somewhat higher levels before a pullback and base extension phase occurs.

France's CAC 40 Index (4427) has rolled over beneath

Taiwan Weighted Price Index (15pt)



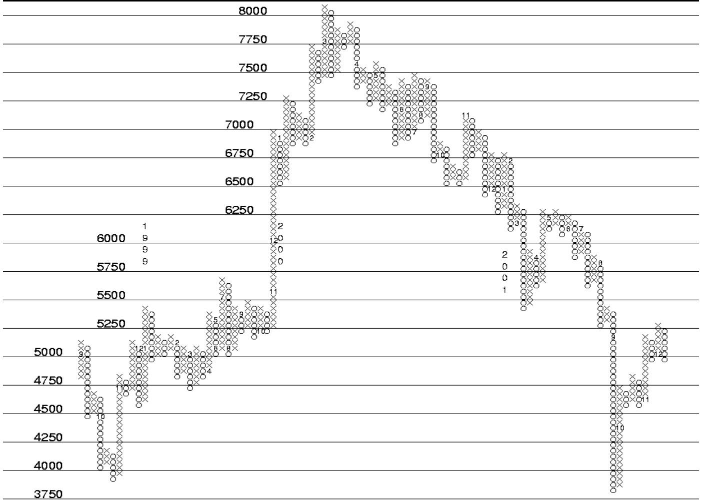
supply and broken the recent sequence of rising lows. Here also a close at 4700 is necessary to offset some further pullback and base extension before the recovery is resumed.

Switzerland's Swiss Market Index (6296) has lost uptrend consistency after encountering resistance at the underside of its broad trading range evident from 6600. A lower high and now lower low indicate that the pullback and base extension phase has commenced.

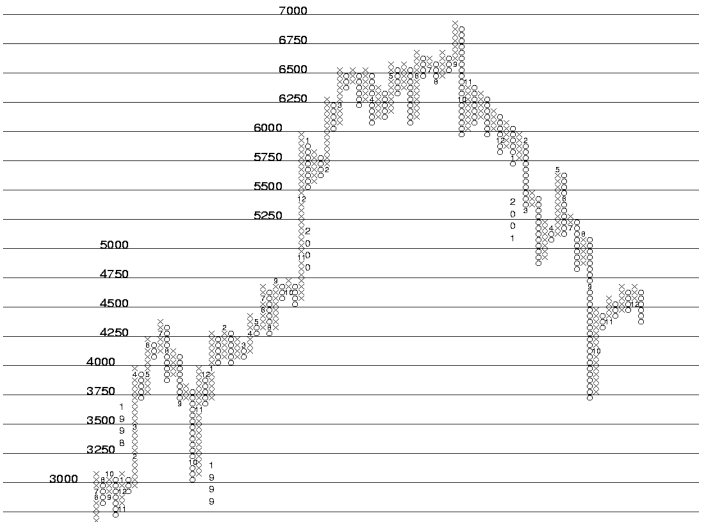
The UK's FTSE 100 Index (5080) offers yet another example of a good rally which has now been checked by overhead supply. A close at 5400 would be required to indicate a further test of the large top area rather than a further retracement and period of base extension.

Strategy for stock markets - My headline in FM208 (26th September) was "Global stock markets have seldom been more oversold". My contention from FMP155 (4th October) onwards, was that stock markets had bottomed for at least the next 3 to 6 months. As the rallies progressed, I added that their strength provided evidence that the bear market had ended, Japan being the most likely exception. This latter statement was the most subjective and cannot be proved or disproved until we see how much of the gains since 21st September are retraced during a correction. For investors, the easy part of the recovery is certainly over. Short positions are much smaller and institutional investors have considerably reduced their cash holdings. We know this because they are all confident (at least publicly) that the lows will hold during a reaction, which most feel will commence in 1Q, followed by additional gains thereafter. This makes me nervous. I am never comfortable when the consensus approaches my own view, the only difference being, I believe the reaction has already commenced. I am not recommending shares at this level. Buy and hold, whether individual stocks or tracker funds is finished as an effective money making strategy in my view. We have a trading environment which favours market timers, including hedge funds, with relative performance depending entirely on the success of individual managers rather than an index trend. For captive investors, since tech certainly dominated the rally, it should be the most vulnerable sector during a

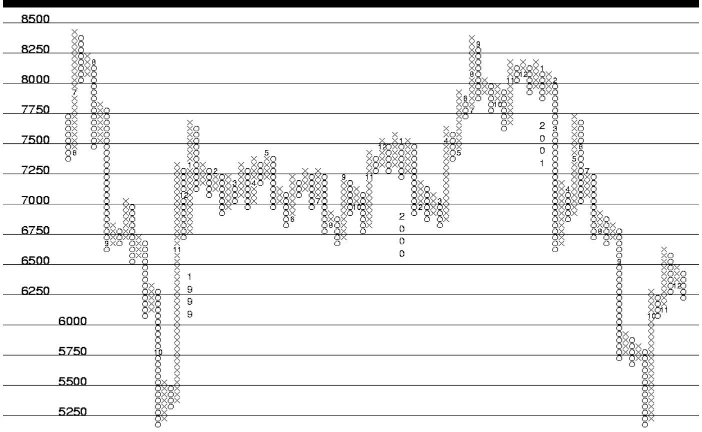
Germany DAX Index (50pt)



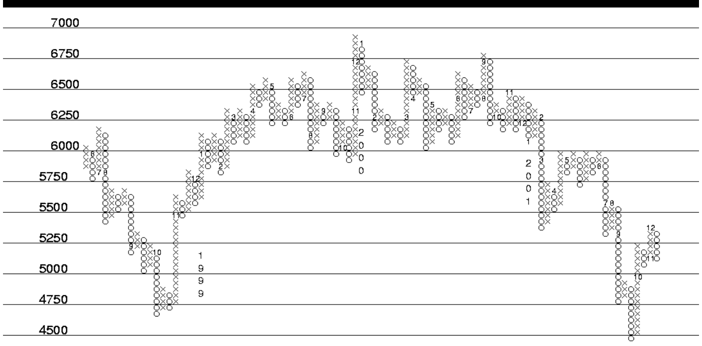
France CAC 40 Index (50pt)



Switzerland Swiss Market Index (50pt)



United Kingdom FTSE 100 Share Index (50pt)



correction. Defensive issues have been wallflowers during the last three months so they should outperform during an overall pullback. Managers will also retreat to high yielders, such as UK stocks like Boots, Northern Foods and Scottish & Newcastle, which I recommended as conservative choices a couple of months ago. Personally, I'm holding a small stake in the Atlantis Japan Growth Fund but I won't add to this until either the market takes another big tumble or shows clearer evidence of bottoming out near present levels. For long-term reassurance, I am pleased to mention that the manager, Ed Merner, recently won the Japan investment trust of the year award. In futures, I'm short the NASDAQ, looking for at least a one-third retracement.

Currencies

■ **The yen has tumbled against reserve currencies as Japan debates radical measures to tackle its deflationary spiral.**

■ **Paper currency flows, sentiment and interest rates now favour the euro over the US dollar.**

At least Japan is not short of advice. So great is the international concern over Japan's continued slide into an economic morass, that advice is being offered from all quarters. Following the IMF and World Bank, the Organization for Economic Development and Cooperation is the latest to chime in saying, "The Bank of Japan can and must ease monetary policy further". Suggesting it doesn't oppose Japan driving the yen lower to boost the economy, the OECD has called for the BoJ to buy more government bonds, including foreign issues. Better late than never, the OECD joined the fray after Japan's credit rating was lowered once again by Standard & Poors, Fitch IBCA, Duff & Phelps, and Moody's. Among foreign government critics the US has been restrained, partly because President George W Bush does not run a hectoring regime. He and Japanese Prime Minister Junichiro Koizumi have a good relationship, strengthened during the anti-terrorism effort. Moreover the US Government recognises that BoJ Governor Masaru Hayami is the main cause of Japan's worsening deflation. Recently, Glenn Hubbard, Chairman of the White House Council of Economic Advisers said the BoJ had not done enough to check the deflation wreaking havoc on Japan's economy. Similarly and with a touch of irony, US Deputy Treasury Secretary Kenneth Dam said from the US Embassy in Tokyo on 6th December, prior to a meeting with Hayami, "I'll certainly discuss the deflation issue and I'm very interested in his view on the subject". Dam also met with a number of other senior Japanese officials, including Finance Minister Masajuro Shiokawa, Financial Services Agency Minister Hakuo Yanagisawa and Fiscal Policy Minister Heizo Takenaka, and you can be sure they were not talking about US-Japan trade. Hayami may be impervious to all the external pressure, not to mention months of withering comment from Japan's more capable civil servants such as Vice Minister for International Affairs Haruhiko Kuroda, but crucially, he is now losing support within the BoJ. First Nobuyuki Nakahara, then Shin Nakahara and now Toshiro Muto are calling for the BoJ to buy foreign bonds, a strategy for Japan that is also gaining international support. This would be de facto devaluation, as Japan would be printing tonnes of yen and throwing them onto the international market by purchasing dollar and euro bonds. No wonder the Japanese currency has plummeted recently. Of course Hayami has all along taken an "over my dead body" approach to radical reflation but he is increasingly isolated and judging from recent defections within the BoJ, it won't be much longer before he is outvoted as well. That may bring forward his retirement, "to spend more time with my family", as they usually say. With Japan's monetary officials increasingly talking about exporting capital it won't take long for the Japanese public to follow suit. Similarly, Japan's corporate trend of repatriating capital will be reversed wherever possible. With the yen offering no yield and now back in a downtrend, there is no shortage of speculators willing to sell it. I would not be surprised to see gains of at least 10 to 20 percent by the euro, Swiss franc, sterling and the US dollar, from the point of breakout, before there is any significant profit taking. On a 2-year view, I maintain we could see ¥200 for both the US dollar and the euro.

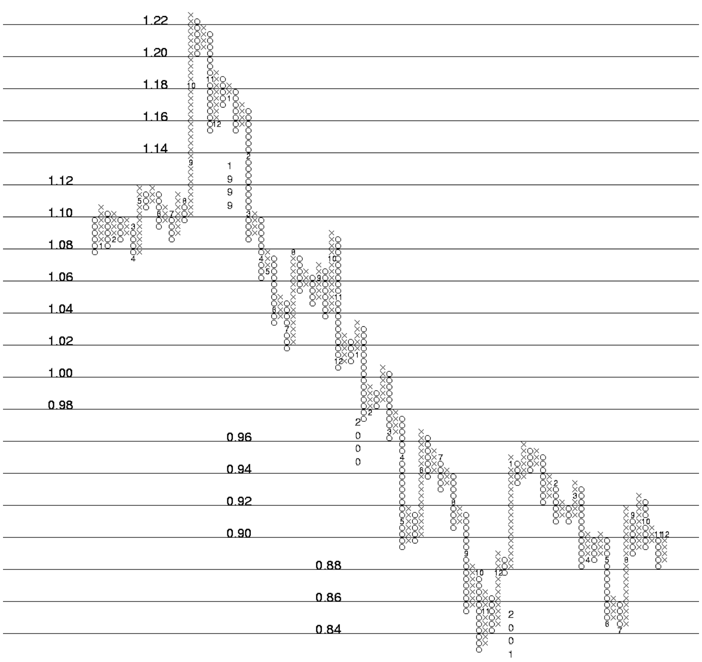
Most of the banks had been expecting the euro to retest its lows against the US dollar. That consensus in November told us that they were short, in line with the trend since September's high. However with short-term interest rate differentials now favouring euros over US dollars by 150 basis points, this becomes expensive once the trend is checked. More significantly, we can probably assume that the heavy conversion of European notes from the black economy to East European hoardings has now largely been completed. From 1st January, the flow becomes euro-paper positive, because no one will have any of the new notes and coins. Whatever the public's reaction, cash euros will temporarily enjoy collectors' status, because it is new. This factor and short-term interest rate differentials will probably outweigh the US's better growth prospects for a few months, especially because it will take time for evidence of a US-led economic recovery to emerge in 2002. Similarly, sterling should maintain its recent form against the dollar, helped by the highest interest rates among reserve currencies. However, there is no shortage of chart resistance evident above $1.55.

Review of currency point & figure charts - *These and hundreds of other 3-box reversal closing basis charts are available on our website www.chartanalysts.com and are updated daily. All comments refer to closing levels for US trading hours.*

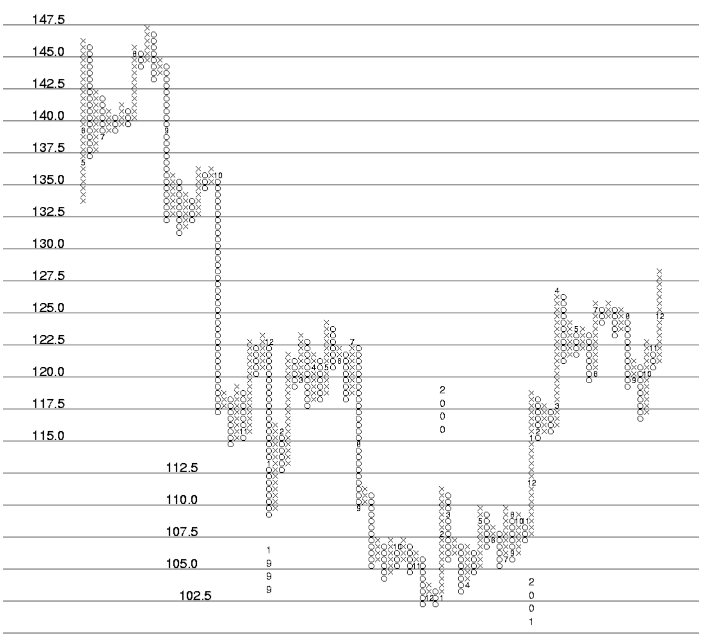
Euro/dollar ($0.8974) - Significantly, the euro encountered support just under $0.88 and has not maintained its nudge under the September-October reaction lows. A push to $0.908 will provide the next evidence of improvement and this pattern still looks like a developing base, capable of supporting a medium-term recovery.

Euro/yen (¥115.32) - A decisive breakout from the large base has occurred. Downside risk appears limited to a brief

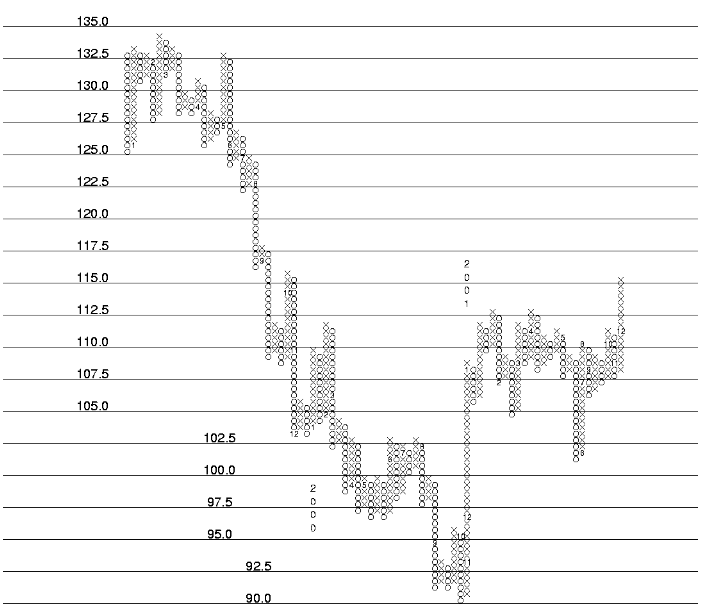
US Dollar per 1 Euro (0.004)



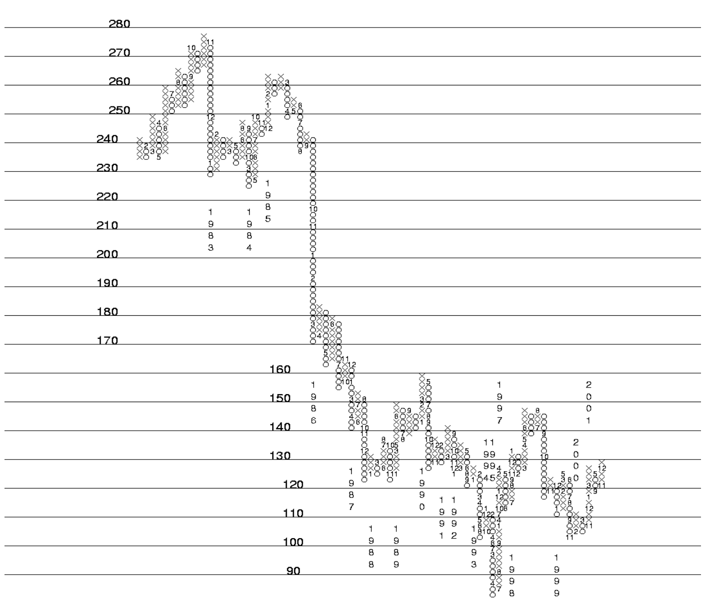
Japanese Yen per 1 US Dollar (0.5)



Japanese Yen per 1 Euro (0.5)



Japanese Yen per 1 US Dollar (2)

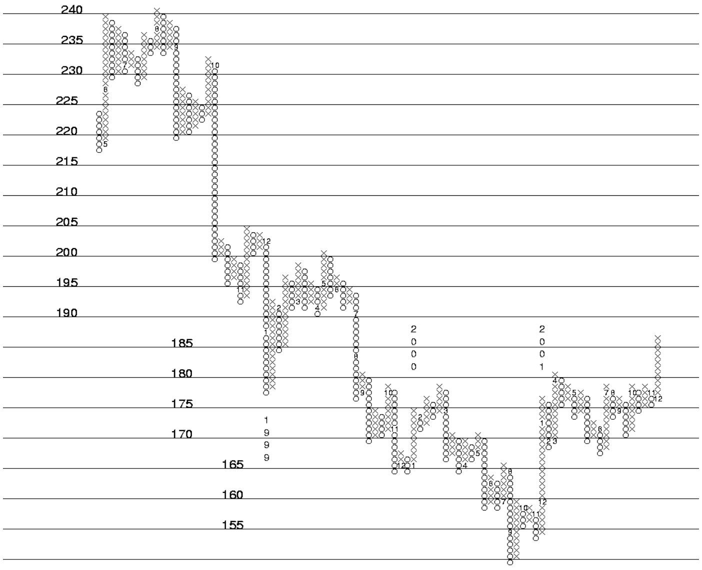


pause and consolidation of the run up from ¥107.5 and a move under ¥111 is required to suggest an upside failure. While anything in markets must be statistically possible, such a reaction appears extremely unlikely and there is very little potential chart resistance until ¥122.5.

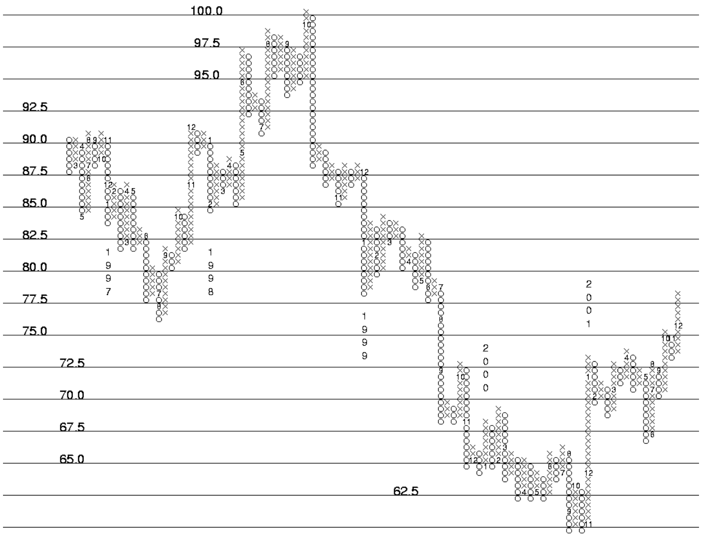
Dollar/yen (¥128.52) - The greenback has now broken up out of a large base, with H&S characteristics, extending back to January 1999. A move below ¥125 is needed to suggest an upside failure and this pattern appears well capable of supporting a test of the 1998 highs up to ¥147 in coming months, and further over the longer term. Some pundits believe the US would not allow such a large devaluation of the yen. No doubt commercial lobbyists would protest, just as they have in the past when the yen weakened. That's their job. However any tears from US manufacturers would be of the crocodile variety. The long-term (2¥ scale) chart shows that the dollar is still historically cheap. Moreover, by my reckoning the multi-year base would not be completed until ¥160. Dollar/yen was often trading above ¥250 until mid-1985. Thirty-one years ago the rate was ¥357 to the dollar. There is certainly no fundamental economic reason, that I am aware of, why the dollar and all other reserve currencies should not move considerably higher against the yen over the medium to longer term.

Sterling/yen (¥185.89) - *See overleaf* - The breakout above ¥180 has been decisive and a move back under ¥178 would now be required to suggest an upside failure, which appears very unlikely given the number of confirming moves by other currencies occurring against the yen. Last month's forecast for this pattern, which also has H&S characteristics, was for a post-breakout minimum run to the ¥190 - ¥200 region. However this large base can support significantly higher

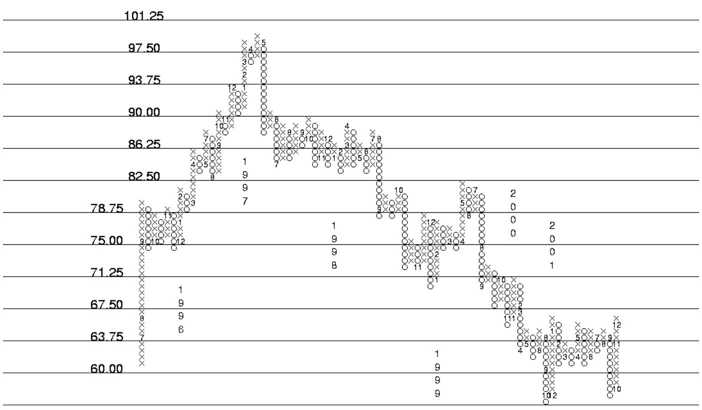
Japanese Yen per 1 Pound Sterling (1)



Japanese Yen per 1 Swiss Franc (0.5)



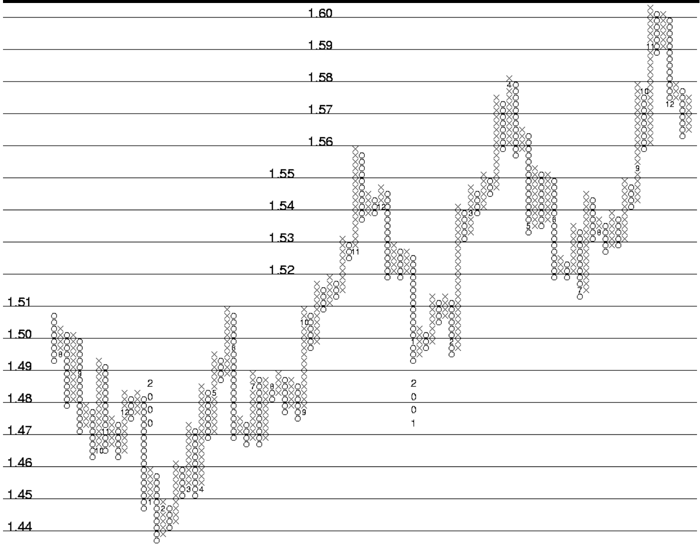
Japanese Yen per 1 Australian Dollar (0.75)



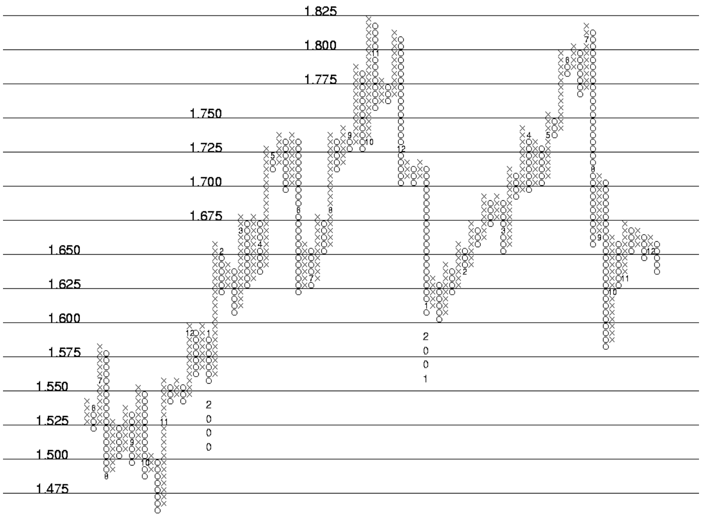
levels over the medium to longer term.

Swiss franc/yen (¥78.565) - This cross rate led base completion and the advance has now been reconfirmed by a surge over the October high at ¥75. There is potential chart resistance evident from prior trading during the first half of 1999 and earlier. However, very few people who were long Swiss franc/yen back then would still hold those positions

Canadian Dollar per 1 US Dollar (0.002)



Swiss Franc per 1 US Dollar (0.005)



today. Therefore we are talking about resistance not from supply but psychological levels such as lateral trading near ¥85 or former highs of historic consequence. Meanwhile, a decline to ¥74 is currently required to question uptrend consistency.

Australian dollar/yen (64.93) - The Australian dollar was a weak currency in September, when it retested or even exceeded former lows against the major currencies. Subsequently it has recovered somewhat, in potential base development and this pattern is particularly clear against the yen, where an upside breakout will be evident at ¥66.75.

Dollar/Canadian dollar (C$1.5779) - The US dollar did not maintain October's break above the April 2001 high and also the accelerated August 1998 peak (not shown due to insufficient room, see www.chartanalysts.com), both at C$1.58. However the dominant characteristic of primary trend activity since the January 2000 low at C$1.436 has been the higher reaction lows at C$1.466, C$1.492 and C$1.512. Moreover, during this period the main reactions have all carried below the previous high, as we have seen recently. Nevertheless, a move back above C$1.58 is required for initial evidence that another important reaction low has been established. Interest rate differentials, which can be a factor, currently favour the Canadian dollar by 75 basis points.

Dollar/Swiss franc (SF1.6372) - The defining characteristic of this pattern is the speed with which the dollar fell from its two peaks near SF1.82, relative to its rallies up to those levels. This indicates the dominance of selling pressure and a move to SF1.675 is currently needed to indicate some further recovery before the September low at SF1.58 is tested.

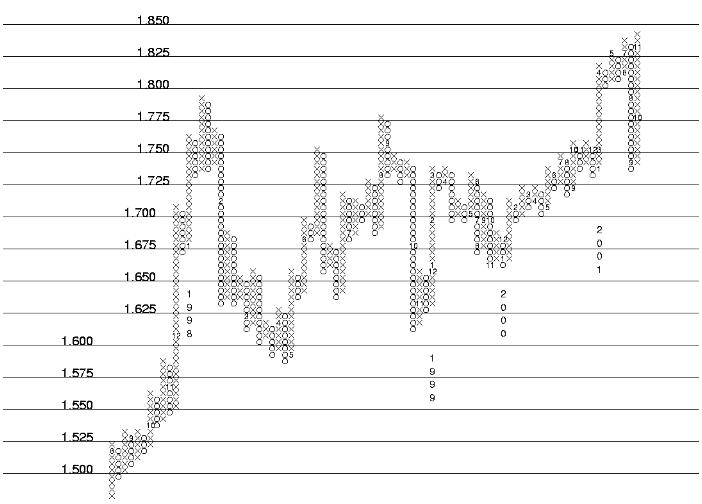
Dollar/Singapore dollar (S$1.8369) - The US dollar rallied sharply from support within the upper region of its January 1998 to March 2001 trading band versus the Singaporean currency. While some hesitation is now evident on daily charts near the former high reached in July, this is likely to be temporary. The Singapore dollar and other regional units are very unlikely to be strong currencies if the yen weakens significantly in line with the earlier charts shown.

Sterling/dollar ($1.4455) - Interestingly, sterling encountered support above its September 2000 to June 2001 lows against the dollar. However it must break the progression of lower rally highs, which define the overall downtrend, with the latest of these established in October at $1.48, to increase prospects that the current trading band is a base.

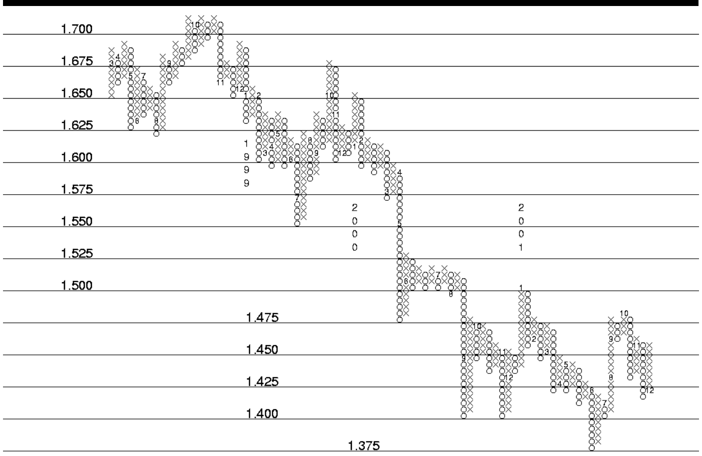
Euro/sterling (£0.6204) - The euro has been trading quietly against sterling recently but the overall characteristics of this pattern, ever since the euro's plunge to £0.5750 in May 2000, resemble base formation development. A decline below £0.61 is currently necessary to question this hypothesis, which would look increasingly likely above £0.6375.

Strategy for currencies - It's been a good month for yen bears, with the main reserve currencies completing base formations. I have leveraged up and protected all positions with trailing stops - the change in strategy following breakouts outlined in FM210 (28th November) and FMP160 (5th December). All evidence continues to suggest that short yen will be the reserve currency trade of 2002, and the move is already underway. My biggest position is in euro/yen, followed by sterling/yen, which has the best interest rate differential at 400 basis points. My dollar/yen position is smaller, in line with my preference for the euro or Swiss franc over the greenback on a medium term basis. While I feel no need to have more than three currencies against the yen, I continue to regard the Swiss franc, Canadian, Australian or New Zealand dollars as alternatives. I am still using my Baby Steps tactic, but much less so now that charts indicate a trending rather than primarily ranging environment. Consequently I buy a few more euros, sterling or dollars lightly on reactions, which have only been intra-day recently, and lighten a bit on rallies. However I won't lighten significantly and/or crowd stops unless the trends clearly accelerate as we saw last April. That's different from a base breakout, which I expect to be strong, as sentiment suddenly changes causing shorts to cover, while others increase longs and lots of new people join the action. Just before the base completions, two hedge fund managers told me that they were waiting for a clear chart signal, at which point they would jump in aggressively. I suspect many others have a similar view and far more are hoping for a pullback so they can get on board without paying new recovery high prices. If so, the technical action may resemble a textbook flag or pennant. In other words, a

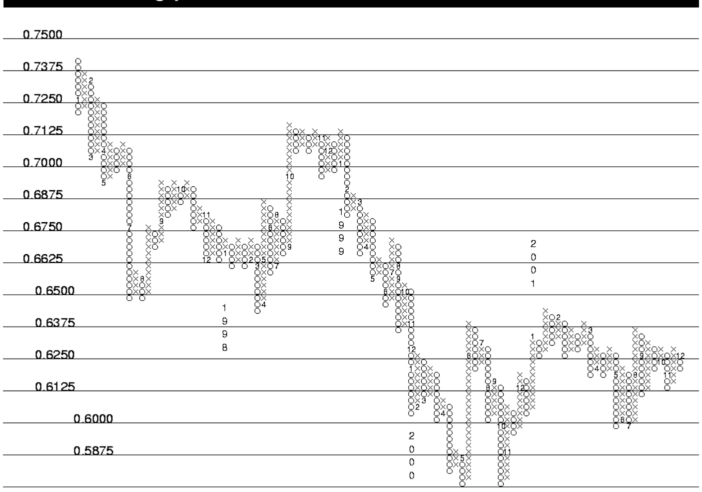
Singapore Dollar per 1 US Dollar (0.005)



US Dollar per 1 Pound Sterling (0.005)



Pound Sterling per 1 Euro (0.0025)



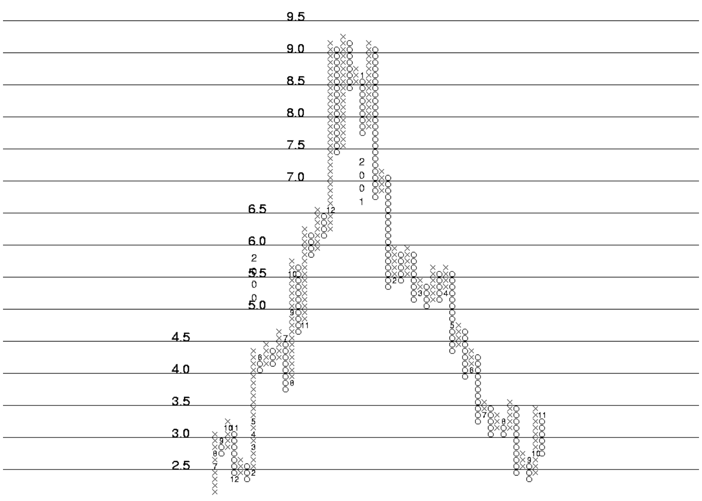
strong surge followed by a small reaction on light volume lasting for a week or two, followed by another powerful rally. I would not be surprised to see 10 to 20 percent gains before a larger correction occurs, as mentioned in FMP160. Meanwhile, the main fear, understandably, is how monetary officials in Japan, other Asian countries and the US will respond to further yen weakness. I believe this will only become a major factor when the yen plummets, as just about everyone viewed a weaker Japanese currency as both necessary and inevitable. Everyone, that is, but Hayami and his deputy, because some people never change. Over the last two years or more Hayami has triggered a number of yen rallies, albeit mostly within ranges. This caused occasional havoc, at least for me, until Hayami's opposition was factored into the trading equation as something to be harvested rather than the random cause of losses. Therefore I keep a bit of 'Hayami money' aside so that I can sell more yen when he talks it up, confident that the BoJ Governor is on the wrong side of the trend and also knowing that the Japanese Government regard him as a 'financial terrorist'. Meanwhile, Hayami says he is "watching the yen" (hopefully a "you can look but don't touch" situation) and I would be very surprised if he sanctioned the purchase of foreign bonds, as many are urging, including three of nine BoJ board members. I'll worry when one of the bright Japanese officials like Haruhiko Kuroda says the yen has fallen enough.

Commodities

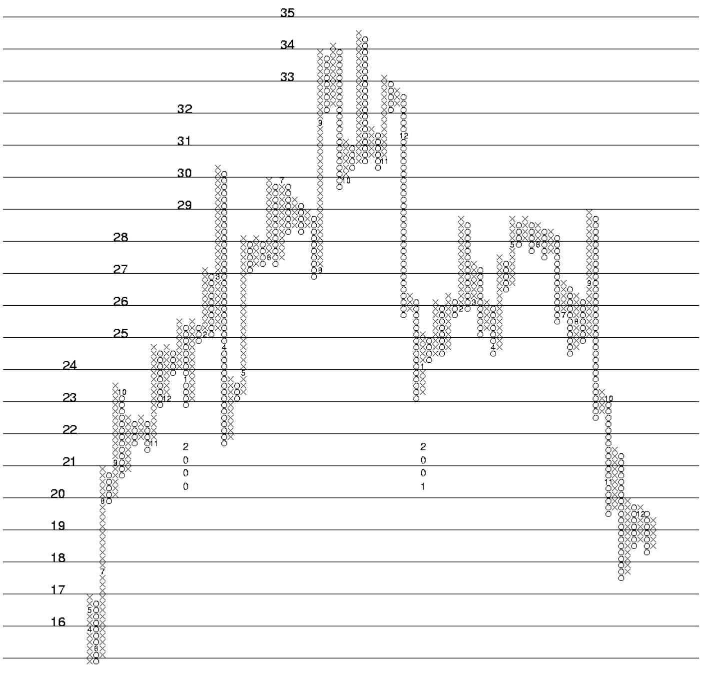
■ **Petroleum futures have steadied within their downtrends, helped by seasonal demand for heating and gas oil.**

The OPEC cartel has lost control of prices, at least until global demand is considerably stronger. Oil cartels can only succeed for 2 to 3 years, as we have seen before. High energy costs cause global recessions approximately 18 months later, as is occurring for the fourth time in the last three decades. Slowing GDP growth reduces demand for oil and encourages substitution where possible, primarily for natural gas. More significantly, high prices eventually, and inevitably, lead to increased production from countries that are not part of the cartel. This has been especially true for Russia, which has become the world's second largest exporter of crude oil over the last year. As increased supply weighs on the market OPEC members recognise that they are losing out to other petroleum exporters, so they exceed their agreed quotas as we have seen in recent months. OPEC has lobbied producers for additional cuts but no one believes that new quotas would be adhered to. Russia isn't interested because Vladimir Putin is developing a new relationship with the US, which should have considerably more benefits than somewhat higher oil prices. He can afford to pass on a temporary boost in revenue because oil accounts for only 25 percent of Russia's export revenue, against 80 percent or more for the OPEC states. I maintain that the new price band for oil, determined by economic factors rather than cartels, will be mainly in the $15 to $20 region. I'm referring to OPEC's benchmark, which is approximately $2 lower than the NYME price shown on the chart. There will be occasional supply fears next year, especially as the US carries its war against terrorism into other countries, such as Iraq. That effort will probably produce a brief spike in the oil price.

Natural gas NYME 2nd Continuation (0.1USD)



Crude Oil IPE 2nd Month Continuation (0.2USD)



The Global Economy

■ **The problems in Japan are worse than generally reported.**

■ **The US is on course for an economic recovery, commencing in the first half of 2002, which will be particularly helpful for some of Asia's smaller economies.**

■ **Danger watch - there has been progress in dealing with economic and terrorist problems but there are remaining threats, instabilities and other difficulties.**

"Lies, damned lies and statistics", Japanese style. The nineteenth century humorist Mark Twain would not have been surprised at data reported by Japan. Does anyone really believe that Japan's GDP contracted by only -0.5 percent in 3Q, as officially reported? That was greeted as good news by government boffins because "it could have been worse". No doubt it was and will be revised downwards as we have seen with 2Q's GDP, changed from -0.7 to -1.2 percent. This too surely underestimates Japan's true performance, because the daily tally of economic statistics has been unremittingly grim for many months. Moreover, we still hear that Japanese Government debt is 130 percent of GDP, a figure first cited over a year ago. According to an article in The International Bank Credit Analyst (Oct 2001, Vol 40, No 1) www.bcaresearch.com, "the Government's net liability picture is understated by between 210 percent and 250 percent of GDP", because of unfunded pensions liabilities, loan guarantees, bailouts and accounting fiddles. Meanwhile, due to deflation of approximately 2 percent, the debt to GDP ratio continues to rise even if debt is stable, which of course it isn't. Andrew Smithers of London-based Smithers & Co believes if one takes into account the effect of deflation on the value of tangible assets, the combined profits of non-financial corporations are less than a quarter of their published levels, according to an article in the Financial Times, "Japan on the brink", 14th November 2001. Japan's banks are seriously underwater due to non-performing loans (NPLs). Despite large write-offs, with the fourth and worst recession in a decade underway, the Koizumi Government estimates NPLs have reached 155 trillion yen, over 30 percent of GDP. However Goldman Sachs, according to IBCA, estimates Japan's NPLs are 237 trillion yen or 46 percent of GDP, of which 170 trillion yen or 33 percent of GDP is below bankruptcy risk. With these numbers, you do not have to be an economist to realise that Japan is in a deflationary spiral. Moreover, neither will it somehow muddle through, as the bureaucrats have long hoped, nor will the next US recovery be enough to solve Japan's crisis. Tragically for Japan, the BoJ's grossly incompetent Governor, Masaru Hayami, claims that he has done enough by lowering short-term interest rates to zero. Of course the real rate is 2 percent, due to deflation, compared to minus 1 percent in the US. Persistent deflation is always a monetary problem, as is inflation. Therefore it cannot be resolved through structural changes proposed by Koizumi's administration, although these would be a very good idea in the next economic recovery, to ensure that it is sustainable for a number of years. While Hayami can't be sacked until his term expires on 20th March 2003 and the Government has so far been reluctant to legislate against him, other BoJ policy makers are beginning to defect from the increasingly isolated Governor. It started with Nobuyuki Nakahara in October and Shin Nakahara and Toshio Miki have now joined him. This still leaves Hayami in control of the nine-man board by a vote of 6 to 3, but the trend is changing and others are now likely to join the Nakahara faction. They are calling for the BoJ to print money and buy foreign bonds. While this would increase the quantity of yen in circulation, certainly weakening the currency, it is a very non-targeted approach to reviving Japan's economy. Hayami has opposed the purchase of foreign bonds, saying it would create the impression that Japan was "selling itself". For once he is right. The BoJ will certainly have to print yen copiously, and the sooner the better. However I maintain this increased liquidity should be used by the Government to purchase Japanese property and stocks, as first detailed in FM202 (23rd March). Provided they bought sufficiently, this is the only strategy capable of halting the deflationary spiral quickly, by unlocking private savings and jumpstarting the economy as sentiment improved, while substantially reducing the quantity of NPLs held by Japanese banks. In contrast, a high-profile Government programme of printing money and using the proceeds to purchase foreign bonds would trigger a capital flight from Japan. The yen's collapse would improve operating profits for export companies but do little else for the economy until capital flowed back into Japan.

For the US, it's a 'guns and butter', stimulated by record low interest rates and increased government spending. There is no chance of the US slipping into a Japanese-style deflation, as I have often said, because Greenspan moved rapidly and decisively to provide sufficient liquidity, while government spending has increased to fund the war against terrorism and cushion the economy during a difficult period. Moreover, with Russia now the 'swing producer' of oil and Putin siding with the US rather than OPEC, economic activity is unlikely to be blighted by another sharp and sustained rise in energy costs. Consequently it would take another horrific attack by terrorists - just possible but presumably a declining risk in the post-bin Laden era - to delay a US economic recovery commencing in the first half of 2002. While V-shaped recoveries are a characteristic of oversold markets rather than major economies recovering from recession, I maintain US GDP growth in 2002 will be considerably stronger than the IMF's prediction of 0.7 percent. This will be good news for other countries since most remain dependent on the US economic engine. However, the benefits are never shared equally. Asian countries such as South Korea, Taiwan and Singapore, which manufacture and export technology products to the US, should experience strong economic recoveries. Elsewhere, Europe will lag, primarily because the ECB was too slow in lowering interest rates. Also, Euroland's unemployment rate of 8.4 percent and rising will curb consumer spending more than in other Western regions. While there is no precedent for the euro's launch on 1st January, it is more likely to create uncertainty rather than euphoria among the public, at least initially. The UK economy continues to outperform, largely due to consumer spending. However this could prove ephemeral as interest rates are higher than in most other developed economies, unemployment is likely to rise and a large tax increase to fund government spending is inevitable.

Chief among economic risks is a possibility that Japan could export deflation. Unchecked by the strategies outlined above, Japan's problems could damage confidence globally. The world's 2nd largest economy is in serious trouble and the over-challenged politicians and bureaucrats have done little more than shuffle deckchairs. Capital flight from Japan could undermine confidence in other countries, triggering a stock market slide at minimum. Among other economic concerns with at least regional implications are Argentina's default/devaluation, Venezuelan President Hugo Chavez's Castro-style Socialist experiment and Turkey's debt. The Middle East remains a dangerous region. Israelis and Palestinians are at war. Unfortunately, there is no immediate prospect of a solution, which guarantees Israel's security and the founding of a Palestinian state. The very necessary US-led war against terrorism, particularly Islamic extremism, is entering a more uncertain and potentially dangerous stage. Even if another terrorist attack of consequence is avoided, the Middle East is still a breeding ground for problems due to its undemocratic regimes and fanatical clerics. No one can satisfactorily resolve this situation other than the people themselves, and that could take a very long time if history is any guide. Meanwhile, it is only a matter of time before President Bush takes action military against other regimes that harbour and fund terrorists. Some governments will fall and national boundaries may be redrawn over the longer term. Any conflict that threatens oil supplies will be bad for the global economy. India and Pakistan, both nuclear powers, are no closer to resolving their differences over Kashmir. This list is not intended as a menu for paranoia. Circumstances are improving, at least in the West, following lower oil prices and interest rates, and the world can only be somewhat safer now that al-Qaeda-style terrorist cells are being harried and starved of funds. However there are always problems, which can affect us all. They need to be recognised and understood before they can be resolved.

And Finally…

The Chart Seminar 2002 - The show must go on, because the delegates are interesting and the markets full of opportunities. TCS is returning for its 34th year, with the next venue in London on 2nd and 3rd May 2002. For some comments on the recent seminar, read top journalist Jonathan Davis' article, "Charts can beat mumbo-jumbo", in The Independent on 15th December 2001 www.theindependent.co.uk.

The target date for FM212 is Friday 25th January.

"Intelligence is quickness in seeing things as they are."
George Santayana

Season's greetings and Happy New Year to all subscribers.

Best regards - David Fuller

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