Issue 212
25 January 2002
In its 18th year

Fullermoney

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

Stock markets are slightly oversold on a short-term basis but US and European indices are unlikely to see new recovery highs before a further correction occurs. Reserve currencies are completing consolidations against the yen before resuming their uptrends.

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Throughout financial history, every great bull market has ended in a frenzy of speculation and a shower of scandals

Identifying with Frodo - Chances are, lots of investors are identifying with Frodo Baggins right now. For anyone just reawakening from a half-century snooze, he's the ordinary Hobbit and reluctant hero of JR Tolkein's epic, "Lord of the Rings", made into a sensational film by director Peter Jackson. If you haven't seen it yet, switch off the mobile, the computer and the data provider, and get a life! The book is even better. Staying with the LOTR analogy, investors leaving their Shire for stock markets over the last two years will recall alarming hazards at every turn.

Corporate Orcs - Chief among problems have been the many Orcs running public companies. You know, the sort who took a nice, solid, cash-rich business like GEC and gave it a pseudo-Italian macaroni-like name - Marconi, while turning the balance sheet into stale pasta. Unfortunately, far worse demons are out there - such as the people who ran Enron. It might just as well have been called End-run, because that's what the executives and directors did by cashing in while hoodwinking their shareholders, including many Enron employees further down the ladder, and the company's banks. So far, only the outline details in this scam are publicly known. Apparently, Enron's management, led by the Dickensian-named Skilling and Lay, leveraged up in oil derivatives, riding the boom created by OPEC's production cuts commencing in late 1998, at least this is what a comparison of the company's price chart with crude oil from 1999 - 2001 suggests. Presumably they were most heavily long at the top, as most people are. While that could be described kindly as misadventure, management shenanigans are another matter. These insiders "materially misled the investing public", according to one lawsuit, while selling their own shares for $1.1 billion from 1999 through mid-2001. They also hid risky/loss-making activities in partnership affiliates and tried to buy influence through enormous political campaign contributions. Enron didn't just raise the bar on tax avoidance, it removed it by creating a staggering number of subsidiaries in tax havens, including 692 in the Cayman Islands, 119 in the Turks and Caicos, 43 in Mauritius and eight in Bermuda. Last August, four months before the company declared bankruptcy, senior executive Sheron Watkins wrote to Enron's Chairman, "I am incredibly nervous that we will implode in a wave of accounting scandals". She also quoted a mid-level executive as saying, "I know it would be devastating to all of us, but I wish we would get caught. We're such a crooked company." As Enron's losses inevitably surfaced and the

share price unravelled, management lobbied, according to reports, no less than the US Federal Reserve, the Commerce Secretary and the Treasury Secretary, claiming that this was a Long-term Capital Management-type predicament, presumably qualifying for a bailout. Wisely, the Government let Enron go to the wall. Meanwhile, Enron's auditors, Arthur Andersen, suicidally shredded sensitive documents. It is scams like this that create Socialists, or worse. I liked US Treasury Secretary Paul O'Neill's comment, much criticised by Democrats, "Companies come and go. Part of the genius of capitalism is people get to make good decisions or bad decisions, and they get to pay the consequences or to enjoy the fruits of their decisions. That's the way the system works." And if there is provable fraud perpetrated by Enron officials, this is a matter for the courts, because that is also how the system works.

Learning to live without the super cycle bull market- I've cited only two examples but readers have firsthand experience of all the "new paradigm" hype, tech mania, leveraging of corporate balance sheets, buybacks to boost option values, creative accounting and PR disguised as financial research. Stock markets are now in the post-"irrational exuberance", hangover, reassessment and eventual reversion to the historic mean phase, in terms of valuations and returns. There is no point in pining for "the good old days" of the 1990s. *Fugedaboutit*, as they say on Wall Street. This is a "deal with it" situation because we won't see another equity bubble of similar proportions for about 30 years, judging from past cycles. Consider this statistic from subscriber, friend and portfolio manager Peter Bennett of JM Finn & Co in London - DJIA on 31/12/1964 (874.12), and seventeen years later on 31/12/1981 (875.00). Meanwhile, life in the stock market won't be so bad if we use commonsense regarding valuations and know how to read charts. Investors who identify with Frodo will recall that he had a magic sword - Sting, given to him by his uncle Bilbo. Our stock market equivalent over the next couple of decades will be the price chart. Forget about "buy and hold", and indexed funds, because stock market indices will probably remain rangebound for many more years. Within this confine, there will be medium-term bull and bear trends, usually in line with interest rate cycles. A buy-low-sell-high approach will be the key to success. Superior investment managers/market timers will have a better chance of outperforming their benchmarks in this environment. As for those double-digit annual returns that investors learned to count on in the 1980s and 1990s, the super cycle bull will eventually return. I confidently predict that another 18-year bull market will commence around 2021. Remember, you read it first in Fullermoney.

Enron, the film - Finally, if LOTR isn't to your tastes, for some inexplicable reason, you won't have to wait long for a plethora of books on Enron, and best of all, the film, presumably to be called Pumping Enron, starring John Travolta and James Woods as Kenneth Lay and Jeffrey Skilling, plus Vinnie Jones in another swashbuckling, lovable-hood role as Enron's Treasurer. You'll also see Robert Rubin, playing himself in a cameo role as Chairman of Citigroup's Executive Committee, unwisely and unsuccessfully trying to persuade Undersecretary of the US Treasury for Domestic Finance, Peter Fisher, to phone bond-rating agencies in hope of averting a downgrade of Enron's debt. I can't wait. The film should be almost as good as the real thing.

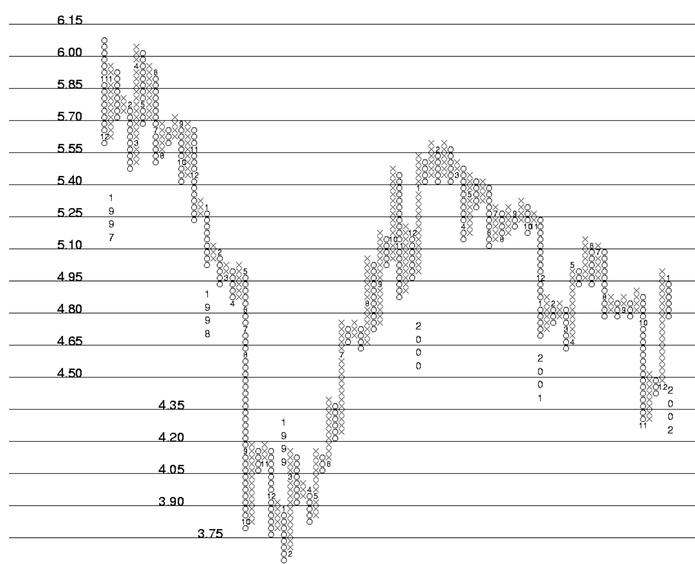
Interest Rates and Bonds

■ Weaker stock markets would increase scope for somewhat lower short-term rates, especially in Europe.

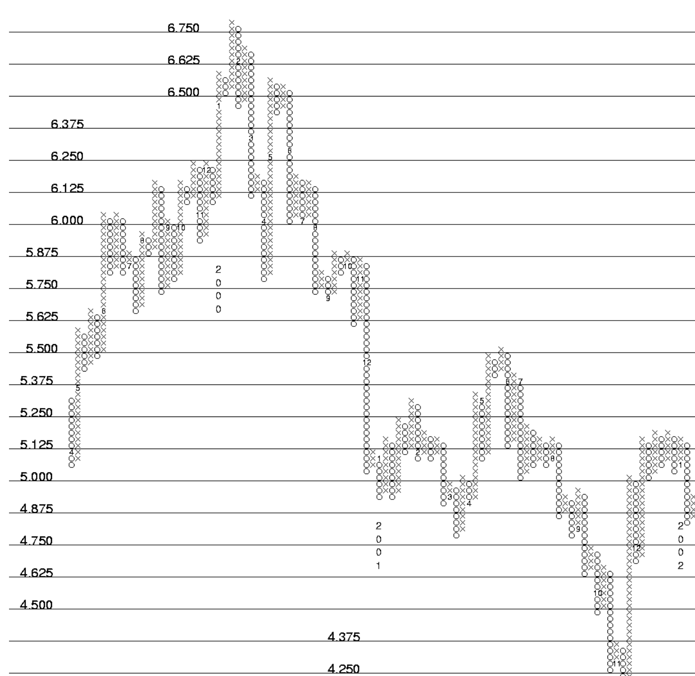
■ Was the sharp rise in long-dated government bond yields during November and December a significant overreaction, given economic prospects?

The ECB and BoE have concurred with yearend stock market-influenced predictions of economic recovery,

Euro-bund 10 Year Bond Yield (0.03)



US 10 Year Bond Yield (0.025)



judging from recent comments. On 3rd January, Wim Duisenberg said evidence of economic recovery was "better" than he had expected, implying that the ECB may not reduce short-term rates further. Sir Eddie George mentioned a rate increase if consumer spending remained robust. My guess is that both have been overly influenced by the earlier stock market rebound and upbeat yearend forecasts from brokers. If so, there could be a reassessment as equities retrace more of their rally. I believe Euroland's growth will disappoint once again, increasing pressure on the ECB to lower rates by another 25 to 50 basis points from the current level of 3.25 percent. Any weakening of UK consumer spending and house prices, which is likely, would open the door for a rate cut, especially as they remain comparatively high at 4 percent, albeit historically low. Alan Greenspan has the least cause to lower rates, which at 1.75 percent are below inflation. Moreover, the US economy shows some signs of bottoming out. Nevertheless, the Fed Chairman could cut rates again if events cause another stock market slide. However this would ensure a swift reversal of monetary policy given subsequent evidence of economic recovery by the US.

Second-guessing market trends can be hazardous but they frequently overshoot. One of the reasons we look at price charts is to avoid standing in front of the market's equivalent of a speeding train. Long-dated government bond yields soared during November and December, in a delayed reaction to the stock market rally. Some economists believe this forecast a significant economic rebound in 2002. The more perspicacious observers, in my view, said bond markets overreacted. In markets, people often do what they should have done in the previous cycle. That was in 1998, when central banks slashed interest rates to head off a financial crisis in response to the Long-Term Capital Management collapse and Russian debt default. Stock markets soared and bonds plunged, as investors switched from fixed interest to equities. Consequently long-dated government bond yields rose even more quickly than in 1998, particularly US Treasuries. Subsequently, yields have retraced more than a quarter of those gains, in what I believe is a base extension phase. The extent and length of this pullback will be strongly influenced by stock market activity, with equity weakness lowering government bond yields and vice versa.

Strategy for bonds - With conservative portfolios, I would stay with 3-month bills for safety, corporate bonds for yield and capital appreciation, avoiding high-yielding issues until GDP growth prospects appear more favourable. A temporary reweighting of portfolios, in which the percentage in shares is reduced in favour of bonds, seems appropriate while the risk of a further stock market correction is high. From a speculative perspective, bond futures should regain at least half of their November - December decline, assuming stock markets retrace more of their gains. However, charts do not suggest a retest of the highs for government long-dated bond prices. Instead, this looks like an oversold rally and top extension phase (base extension for yields).

Global Stock Markets

- **"Don't fight the Fed" failed to provide a gain for the DJIA, 12 months following the first rate cut, for the first time since 1932.**

- **For investors, it's a matter of either slow growth, or rate hikes if the US economy rebounds.**

- **Rally retracement commences - September's lows must hold to confirm the base building hypothesis.**

Stock markets' failure to rally in response to last year's rate cuts is sobering. Following publication of this table in February 2001 (FM201), I said if the DJIA is not higher 12 months after the first cut then the global economy would be in trouble. The updated version below shows a decline of 5.4 percent for the Dow, the first failure for "Don't fight the Fed" since 1932 and only the third loss over 12 months in 20 rate-cutting cycles since 1914. For most other share indices around the globe, results were considerably worse. I believe there are only three possible explanations for this poor response to rate cuts, which historically have been the best stimulus for share prices. Either the global economy is entering a deflationary depression, or stock markets were considerably overvalued prior to the rate cuts, or monetary policy no longer has a strong influence on equity cycles. I dismiss the latter possibility because it doesn't make sense. As for deflationary depression, this is certainly apparent in Argentina and Japan has been drifting in that direction. However it overstates the risk for most other major economies - at least I certainly hope so! Valuations, as we know, are a major problem and even where these are not historically high, there is little corporate pricing

Dow Jones Industrial Average

Performance One Year Following Initial Rate Cuts By the US Federal Reserve

Year	Rate*	3 Months	12 Months
1914	5.0	10.6	83.8
1921	6.5	-14.2	16.4
1924	4.0	10.9	31.5
1929	5.0	4.2	-28.3
1932	3.0	-40.2	-40.0
1933	3.0	79.2	76.3
1954	1.8	8.2	39.3
1957	3.0	0.7	29.2
1960	3.5	-7.0	6.4
1970	5.8	17.2	6.7
1971	4.8	12.7	24.0
1974	7.8	33.8	42.1
1975	6.3	6.0	28.2
1980	12.0	10.6	17.3
1981	13.0	-1.7	17.9
1984	8.5	6.5	21.7
1990	6.5	11.5	10.7
1996	5.0	3.2	26.3
1998	4.8	12.5	20.7
2001	6.0**	-7.2	-5.4
Average	**Gain**	**7.9**	**21.2**

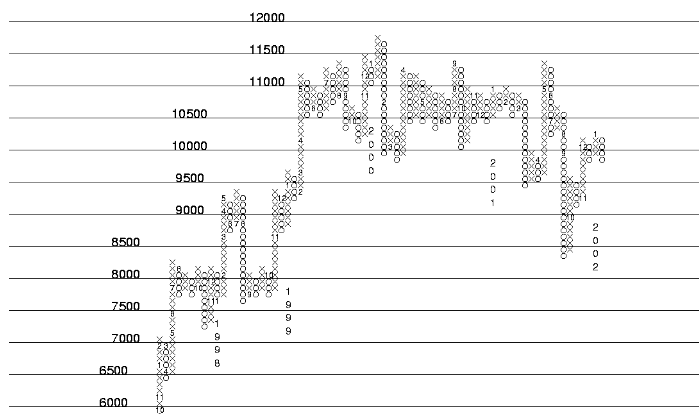
*Discount Rate, rounded to nearest decimal point.
**Federal Funds Rate from here on.

power due to deflationary pressures. I believe these two factors, together with simultaneous recessions among the world's three largest economies, are responsible for the poor performance of stock markets following last year's rate cuts.

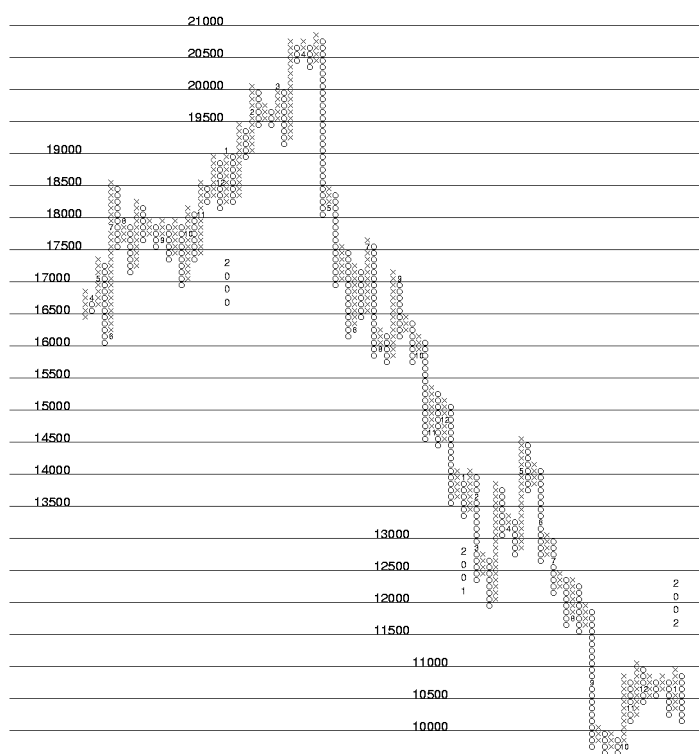
Ignore the consensus, except as a contrary indicator. The many who predict economic performance on the basis of what stock markets are doing, were of course, extremely pessimistic in September and quite upbeat in early January. The former was a behaviourist's buying opportunity and the latter a sell signal. I suspect recent optimism is being pegged back as rallies lose steam. However a minority predict a powerful economic rebound by the US this year. At the opposite extreme, a small group expect no recovery. While a weak global economy in the year ahead would increase concerns over corporate profits and equity valuations, almost certainly resulting in a challenge of September's lows, it would lead to further rate cuts, especially in Europe. Conversely, a US-led strong economic rebound would obviously be bullish, initially, but it would almost certainly cause the US Federal Reserve to raise short-term interest rates before yearend. Monetary tightening has always been bearish for stocks, capping most advances within six months of the first hike. Some of the more bullish economists are assuming that there is little chance of the Fed raising rates this year. As evidence they cite the 14-month delay between the last rate cut during the 1990/91 recession, before Greenspan tightened monetary policy. However, the Fed Chairman once raised rates only a month following the last cut, and while there is no reason for such haste this time, the US Federal Funds Rate will not stay at the historically low level of 1.75 percent for long, once there is clear evidence of a recovery. I maintain the US economy will recover this year but that Europe will lag and Japan remain in recession.

Now the base building hypothesis will be tested. My contention, since FMP155 (4th October), was that stock markets had bottomed for at least the next 3 to 6 months. As the rallies progressed, I said their strength provided evidence that the bear market had ended, Japan being the most likely exception. My script was for a V-shaped rebound, followed by a more gradual and ranging recovery, which eventually lost momentum before spilling over into a correction. I believe this pullback has commenced. If so, stock market indices should retrace at least a third of their recoveries from September's lows. Few shares would be unaffected. If I'm reading markets correctly, tech should reverse its 4Q 2001 form and lead on the downside, because it has the high beta and pricey valuations. My roadmap for the recovery rally and its eventual loss of momentum was based on observation of other instances when a selling panic following a considerable decline led to V-shaped initial rebounds. My most subjective conclusion is that the lows will hold, Japan excepted. Therefore, in terms of confidence, I cannot rate this as more than a hunch, based mainly on some technical evidence, which is certainly not conclusive, plus my view that corporate profits will rebound in 3Q and 4Q 2002, if only because of write-offs in the same period last year. Meanwhile, there is a lot for investors to worry about - poor corporate results for 4Q 2001, earnings

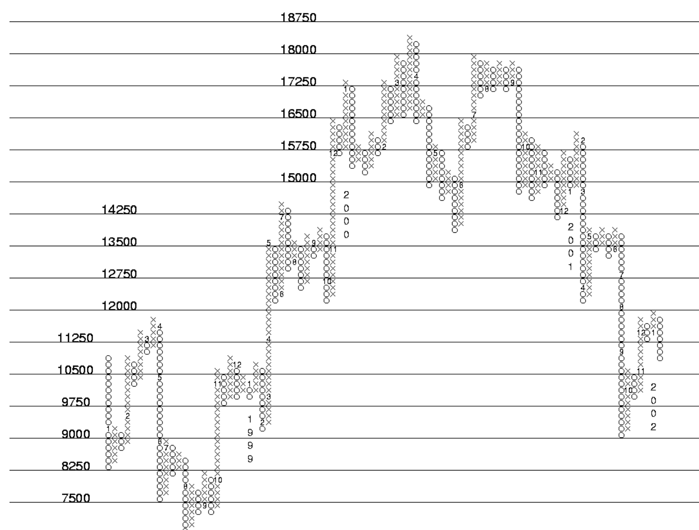
Dow Jones Industrial Average Index (100pt)



Nikkei 225 Stock Average Index (100pt)



Hong Kong Heng Seng Index (150pt)



downgrades for the next two quarters, Japan's deepening crisis and possible deflationary contagion, Argentina's economic collapse and possible political contagion, investor disillusion over portfolio losses and the Enron scam, the likelihood of further corporate bankruptcies and finally, risks associated with the very necessary war against terrorism. Therefore, wishing to take stock markets one step at a time in this environment, I'll watch this correction for a while, before concluding that it is indeed a right-hand base extension prior to some further gains by mid-year, or whatever. Finally, there is a short-term oversold condition as I complete this issue but I do not expect it to produce more than a brief rally.

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 22nd January's closes. Figures in brackets were taken a day later.*

The US's Dow Jones Industrial Average (9741) had an upside failure in early January and needs 10300 to offset a further retracement of gains seen since the September low and indicate some further test of its large top area.

The Nikkei 225 Stock Average (10041) continues to encounter resistance near 11000 and needs to break above this level to signal further recovery scope, rather than a retest of September's lows.

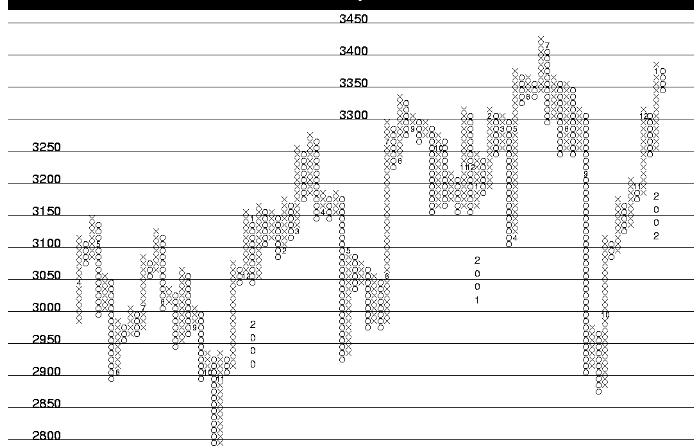
Hong Kong's Hang Seng Index (10762) saw its best rally since the May 2000 low but this has stalled. Consequently a move to 12000 is required to indicate a test of overhead supply, rather than a further retracement of gains, as suggested at present.

Australia's All Ordinaries Index (3363) has hesitated beneath its June all-time peak. While this is likely to provide formidable resistance, the orderly uptrend has not yet lost its consistency, characterised by higher highs and low and 3-column width steps. **The All Mining Index (808)** has pushed to its highest level since October 1997 and the overall pattern is a type-3 base, as taught at The Chart Seminar. The risk with these patterns, at least until the first step above the base has been completed, is that the market falls back for an additional and often lengthy extension, as last occurred following the October 1999 and January 2000 highs. Nevertheless, a decline below 750 is required for clear evidence of another upside failure.

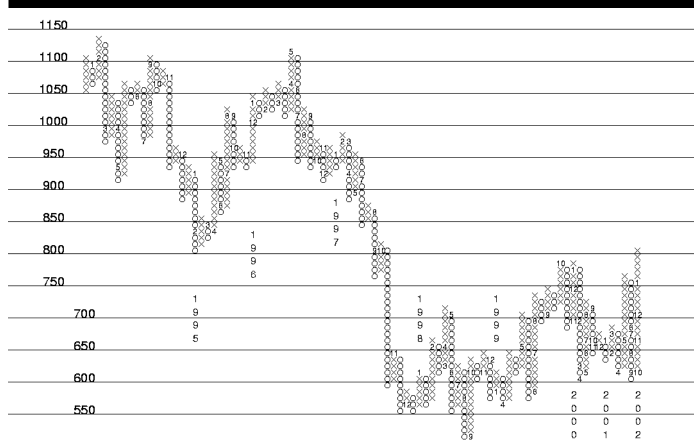
South Africa's JNB Gold Index (1940) blasted up out of its base in December and has extended the advance following a pullback. A decline below 1875 is now required to question upside scope.

The Netherlands' AEX Index (492) has seen its rally stall and a move to 512 is required to reaffirm the recovery rather than a pullback, which would resume at 472.

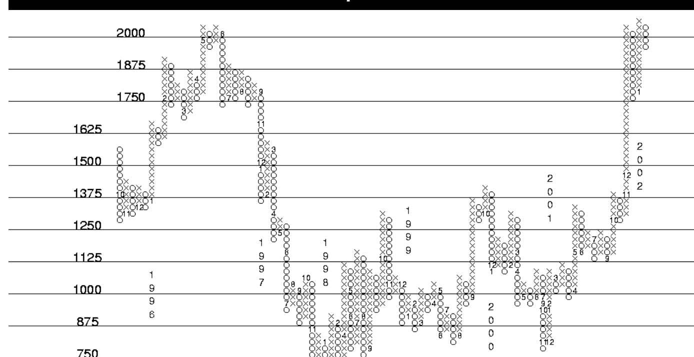
Australia All Ordinaries Index (10pt)



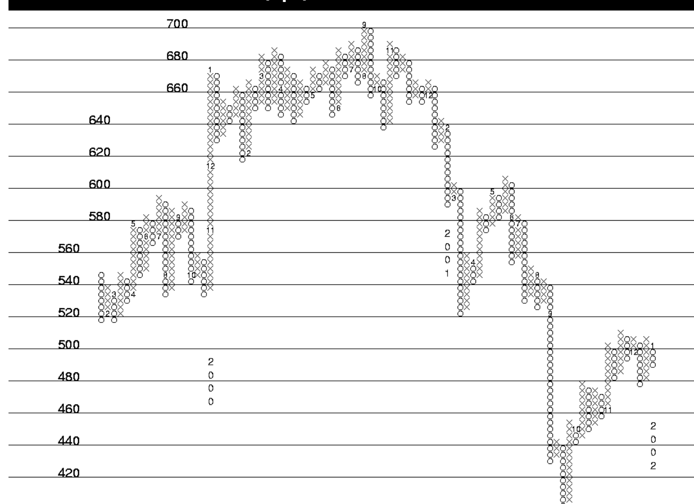
Australia All Mining Index (10pt)



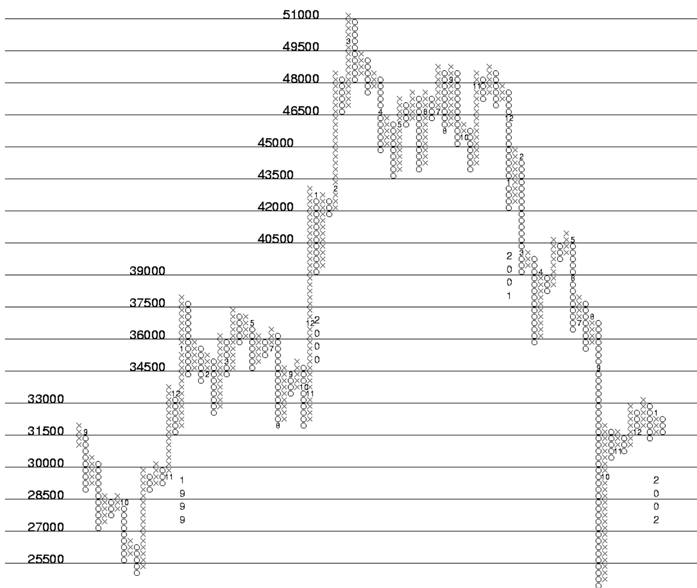
South Africa JNB Gold Index (25pt)



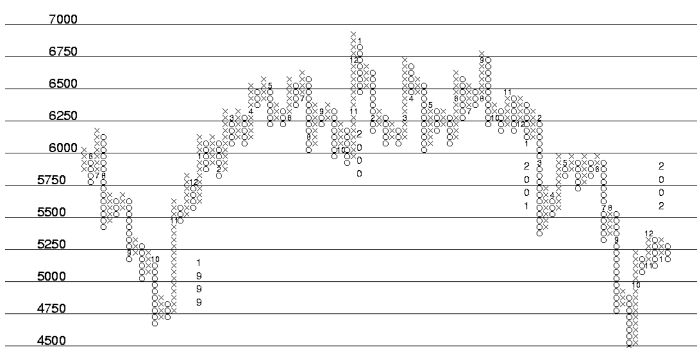
Netherlands AEX Index (4pt)



Italy SE MIB 30 Index (300pt)



United Kingdom FTSE 100 Share Index (50pt)



Italy's MIB 30 Index (31659) similarly shows a loss of momentum and 33300 is needed to offset a further pullback from current levels.

The UK's FTSE 100 Index (5180) offers yet another example of a good rally which has been checked by overhead supply. A close at 5400 remains necessary to indicate some further test of the large top area rather than a further retracement of gains seen since the September low.

Strategy for stock markets - Whenever I look at a financial channel these days, someone is recommending equities because, "investors have no other choice". Well, some may believe this, or wish that it were true, but let's read between the lines. Is this the justification of last resort because stocks have not performed for two years, are not cheap, don't yield much and the environment for equities is risky? Readers will draw their own conclusions. For captive investors, I would move quickly away from high beta and into value stocks, preferably with single figure multiples and high, covered yields. In futures, my strategy is to lightly sell US and European contracts after they have rallied for a week or two, and either cover following a similar decline or use tight trailing stops. This is in line with price activity of the last two months, characterised first by ranging with a slight upward bias, now changed to downwards. My view on other positions previously mentioned is unchanged from FM211.

Currencies

■ **Analysts are overemphasising comparative GDP growth prospects in forecasting dollar/euro over the medium term.**

■ **Argentina's problems are far from over and collateral damage would not be surprising.**

■ **Neither political pressure nor fiscal yearend repatriation will prevent the yen from falling a lot further.**

The US economy will recover before Euroland's but this has already been priced into the exchange rate. We know this, despite Alan Greenspan's caution, because every forex report from a bank, not to mention their spokesman on CNBC or BBG, cites US recovery prospects whenever the dollar firms. Comparative growth rates have been the fundamental flavour of the last few months. However, this is a movable feast. If GDP performance were all that mattered, the yen would now be on the other side of ¥200 versus the dollar, instead of just heading in that direction. Over the years we have seen the fashionable fundamental change, in no particular order, from GDP growth to inflation rates, money supply, current account figures and interest rates. Of these, interest rate differentials among major currencies are the most tangible, because for anyone with a leveraged currency position and adverse rates, the loss is immediate and compounding if not offset by trend performance. Currently, euro short-term rates are 150 basis points higher than for the dollar. This is not yet a deterrent to euro/dollar short positions because the euro is drifting within a broad range. However this pattern resembles a developing base for the single currency. Above $0.91, sentiment towards the euro among traders will start to improve. Over $0.935, everyone will be talking about base completion and upside trend potential, citing interest rate differentials, recovery prospects for the European economy and the US current account deficit among the reasons. While corporate investment flows may continue to favour the dollar, cash hoarders will inevitably exchange some greenbacks for euros, now that its notes are in circulation. Prior to January 2002, switching from marks and other European paper into dollar bills weighed on what was a virtual euro, so this flow can only favour the single currency over the next year or more. While the euro will remain vulnerable, from time to time, because of the ECB's duff mandate focusing on price stability only, plus concern over one-size-fits-all money supply and "Dim Wimery", these problems are already reflected by the market. However a new, temporary problem has been apparent recently - hedge demand for the US currency from banks faced with non-performing dollar-denominated loans to Argentina. This has pushed the greenback higher against most currencies over the last few weeks. As this technicality wanes and the euro rallies, market psychology will change causing people to rationalise its strength by citing positive changes for the single currency, whether real or imagined.

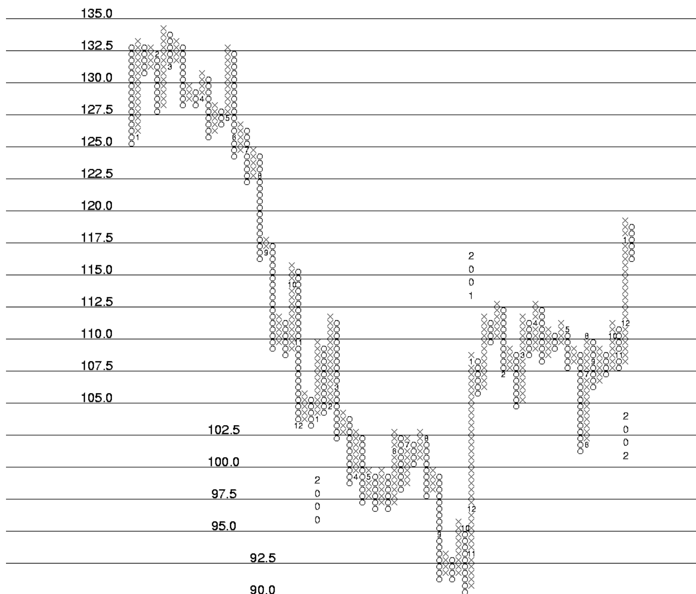
Inevitably, China and a number of other countries will shift some of their US dollar reserves into euros over time, lending further credibility. Meanwhile, the US Government would be delighted to see a firmer euro, especially as the dollar is appreciating against the yen. The ECB would be relieved to see the euro strengthen for a change. A future "shock" for the dollar will be Greenspan's retirement. The Fed Chairman will be 76 on 6th March.

A 29 percent devaluation won't be enough for Argentina. We all know that strong growth will eventually beget a strong currency. Unfortunately for Argentina, in recommending the dollar-peg some economic advisors assumed that a strong currency would beget a strong economy. The opposite will be true for a developing economy and commodity producer, which will inevitably be priced out of the market, as we have seen, with tragic consequences that are still unfolding. With social unrest, political chaos, debt default, deflationary slump and now a devaluing currency, the situation in Argentina remains unresolved and dangerous. We should not be surprised if there is financial or even political collateral damage in the year ahead. Argentina owes £141 billion, mostly to the IMF, the World Bank, other countries and institutional investors.

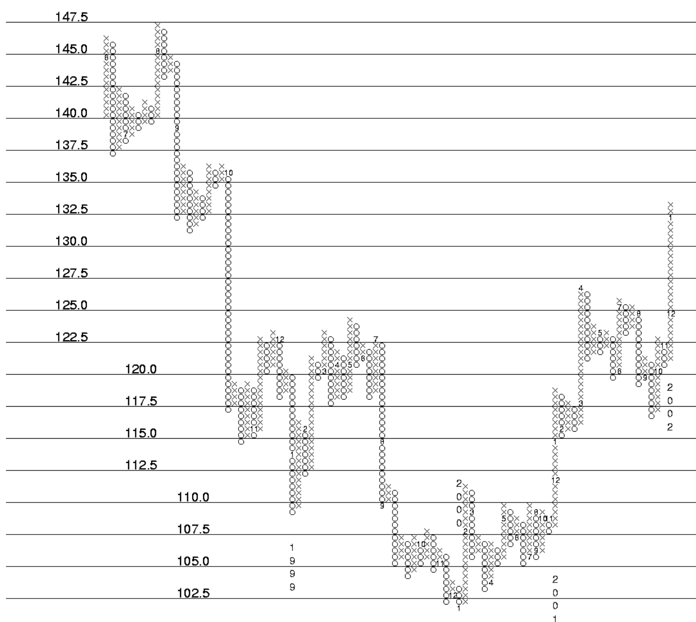
A temporary pause by the yen as it corrects a short-term oversold condition within its downtrend. Even within a clear trend prices spend most of the time ranging in steps, which punctuate the overall advance or decline. The post-breakout advance by reserve currencies against the yen gave way to one of those pauses, as the December and early-January gains were consolidated in narrow ranges. I believe this represents the first step above the base, as taught at The Chart Seminar. These pauses can sometimes be lengthy, although this is less likely following explosive breakouts from base formations similar to what we saw in December. In the "uptrends climb a wall of worry" department, currency traders are concerned about three factors - political pressure, repatriation and a repeat of last year's big correction in 1Q and 2Q. Asian countries, including China, have been protesting against what they see as a competitive devaluation by Japan. This is a matter of 'situation ethics', if you take the view that a weak Japanese economy is bad for everyone, as I do. Moreover, when I look at really long-term charts, I'm amazed that the yen has stayed so high for so long, although we know the reasons. Consequently I agree with Haruhiko Kuroda, Japan's Vice Minister for International Affairs, when he says the yen is adjusting in line with economic fundamentals. This has been described in the media, quite misleadingly in my view, as a competitive devaluation. It would be more accurate to describe the yen's former strength as an uncompetitive overvaluation, due primarily to the BoJ's misguided policies. Meanwhile, currency traders remember large pullbacks against the yen from peaks in 1998 and to a lesser extent after the March/April highs last year, in response to jawboning. Inevitably they look at what happened last time there was concern over yen weakness and many fear another ¥10 to ¥15 reaction against the dollar, with a proportionate response by other reserve currencies. Coincidentally, concern is being expressed once again about capital repatriation by beleaguered Japanese companies needing to prop up their balance sheets, prior to the fiscal yearend on 31st March. Such worries can become self-fulfilling, as traders lighten positions and/or raise stops, which are then triggered. However my hunch is that this correction, which has been too small to show up on most of the p&f charts shown, will be no more than a third to half of what is feared above and of much shorter duration, before uptrends are resumed against the yen. Protests by Japan's Asian competitors will have a very limited effect because a strong yen is not currently in Japan's economic interests and now that it is in a downtrend, jawboning to check or reverse this move would have little more than a temporary effect, as the ECB discovered in 1990/91. Also, US Treasury Secretary Paul O'Neill is unlikely to change his "let the markets decide" attitude towards exchange rates, regardless of lobbying from US manufacturing groups. Moreover, BoJ Governor and strong yen advocate Masaru Hayami has been discredited, as there is now much greater awareness of Japan's economic problems. Technically, last year's extensive and lengthy pullbacks represented a base extension phase against the yen - action that is often choppy. Now that bases have been completed, there is much more underlying support from these large patterns to cushion downside risk. Additionally, while there will be some repatriation by Japanese companies, they now have fewer trophy assets to sell and Government acceptance of a weaker yen is more likely to encouraged the exporting of capital, in search of higher returns. Finally, even if/when sentiment towards the Japanese stock market next improves, this is unlikely to support the yen more than temporarily, at least until Japan's economy is stronger relative to the US and Euroland.

Review of currency and 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*

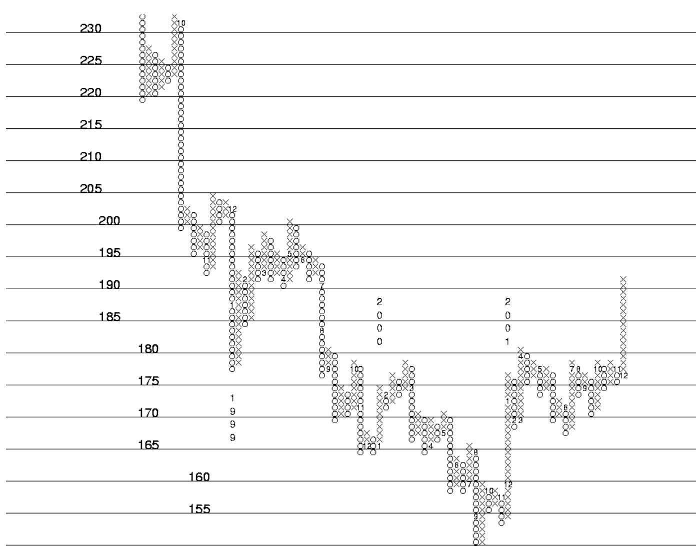
Japanese Yen per 1 Euro (0.5)



Japanese Yen per 1 US Dollar (0.5)



Japanese Yen per 1 Pound Sterling (1)



trading hours.

Euro/dollar ($0.8857) - *see previous page* - Overall, the euro shows a developing base but it has been testing the November to January range lows near $0.88 recently. Consequently a sustained move above $0.904 is required to reaffirm support above the 2000-2001 troughs and a test of this pattern's upper boundary near $0.96. Bases can take a long time to complete but this one should eventually support at least a test of parity.

Euro/yen (¥118.67) - The euro has seen the biggest reaction against the yen among reserve currencies recently but still gave up less than half of the post-breakout gains. The low for this consolidation has probably been seen and a close at ¥115.5 is needed to indicate a further pullback before the base supports a challenge of the next region of potential chart resistance evident above ¥122.5 and much higher levels over the medium to longer term.

Dollar/yen (¥133.95) - A consolidation centred on ¥131.5 has been too shallow to show on the 0.5¥ scale shown and the dollar is appreciating once again. Its large base, with H&S characteristics, extending back to January 1999 is more than capable of supporting a test of the 1998 highs up to ¥147 in coming months, and considerably more over the longer term.

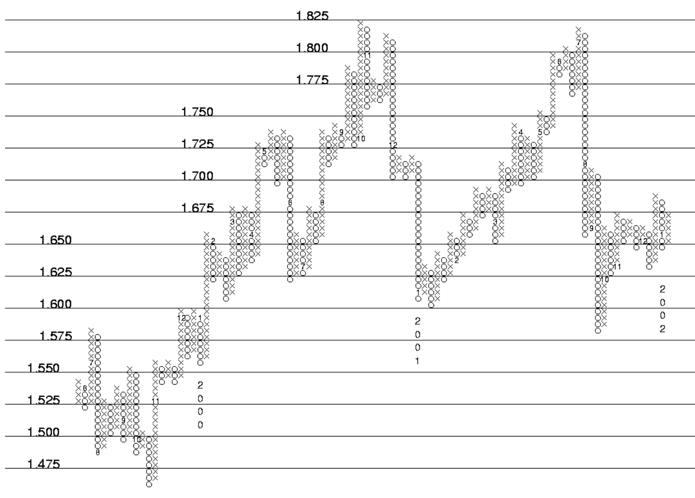
Sterling/yen (¥191.30) - Similarly, profit taking during a recent consolidation has been insufficient to show on this 1¥ scale. This pause has occurred near some minor resistance near ¥190 and there could also be a hesitation around the ¥200 level. However, the large base should eventually support at least a test of the 1998 high at ¥240.

Dollar/Swiss franc (SF1.6633) - The defining characteristic of this increasingly large 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 within what is likely to be a medium-term top formation. The greenback has been steady within the lower-middle region of this pattern recently and a move to SF1.69 would suggest some additional firming before the January and September 2001 lows between SF1.60 and SF1.158 are tested.

Sterling/dollar ($1.4286) - The most important feature of this chart is the progression of lower rally highs, which define the overall downtrend, with the most recent established in October at $1.48. However a sub-characteristic has been the tendency since December 2000 for the pound to rally more quickly than it falls. This raises a possibility that ranging since September 2000 is base building rather than a lengthy distribution beneath the overhanging top. This hypothesis would gain credibility above $1.46 but sterling is drifting at present.

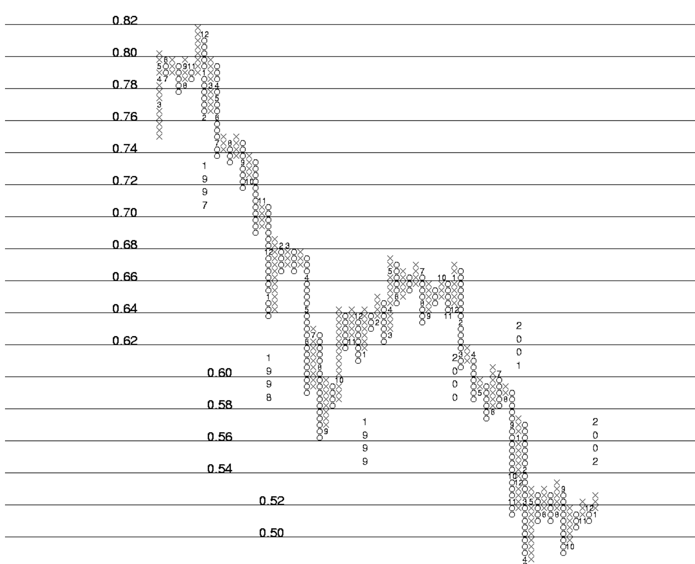
Australian dollar/US dollar ($0.5199) - Activity subsequent to the climactic low at $0.48 has looked like base development. An eventual move to $0.54 (clearing inter-day highs as well) would support this hypothesis, which

Swiss Franc per 1 US Dollar (0.005)



US Dollar per 1 Pound Sterling (0.005)

US Dollar per 1 Australian Dollar (0.004)



would be questioned by a slide back below $0.50.

Strategy for currencies - My currency strategy remains focussed on short yen, which I maintain is the speculation of the year, at least among reserve currencies. The fundamental case for a much weaker yen strikes me as overwhelming. However any forecast is only guesswork, educated at best. Needless to say, others disagree with my view, which if valid, would have also applied two years ago when the yen remained strong. The difference this time is chart action - always the critical factor. The bases are large; breakouts were decisive, and the recent pause has encountered very little selling pressure. Behaviourally, I'm delighted that so many banks expect the dollar to trade in a very narrow range against the yen this year. OK, occasionally an analyst mentions ¥160, or even ¥200 but the consensus is much lower. My conclusion is that very few people are short yen, relative to its last decline in 1998. In shorting the yen, I've confined my positions to the dollar, euro and sterling but the Swiss franc or Australian, Canadian and New Zealand dollars remain viable alternatives. For many months, until recently, my preferred tactic was to lightly purchase whichever of my three candidates was temporarily out of form against the yen, and then lighten positions on rallies. This Baby Steps tactic was particularly appropriate during the base formation stage, characterised by choppy activity. Following breakouts in early December, I completed the process of leveraging up, while limiting risk with trailing stops. As much as I like this position, I don't want to go on increasing it as the yen weakens, as that can only bring the Japanese currency closer to its eventual low. I am now using mainly trend-running tactics, augmented with a small amount of Baby Steps activity, which if successful, lowers average entry prices while also releasing cash. There are two risks one should be prepared for. Suppose sentiment changes significantly, however unlikely that may seem beforehand. Tactically, if I'm not prepared for any eventuality, I'm an idiot. Loose trailing stops are my protection against a worst-case scenario. If triggered I would lose a considerable proportion of my paper profit but not the whole shebang. Of course I could always tighten stops to protect more of the accumulating profit, and occasionally do, but that greatly increases the risk of being flipped out on a minor setback. I generally prefer loose trend-running stops as taught at The Chart Seminar, although I frequently use more than one stop. I will tighten and/or lighten positions if/when currencies accelerate higher against the yen, because such action is invariably followed by a correction, which can be sharp. Currently, I favour euro/yen and to a lesser extent sterling/yen to dollar/yen, for political rather than chart reasons. Asian countries and US manufacturers' lobbyists have already protested at the dollar/yen rate. However no one will object when euro/yen moves higher. Also, I maintain the euro is fundamentally cheap and the dollar somewhat expensive.

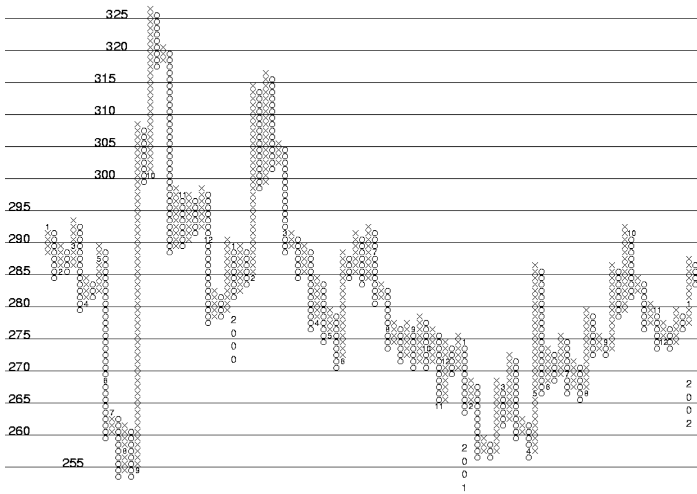
Commodities

■ **Gold is building a large base but it needs to hold near $280 to avoid another lengthy extension.**

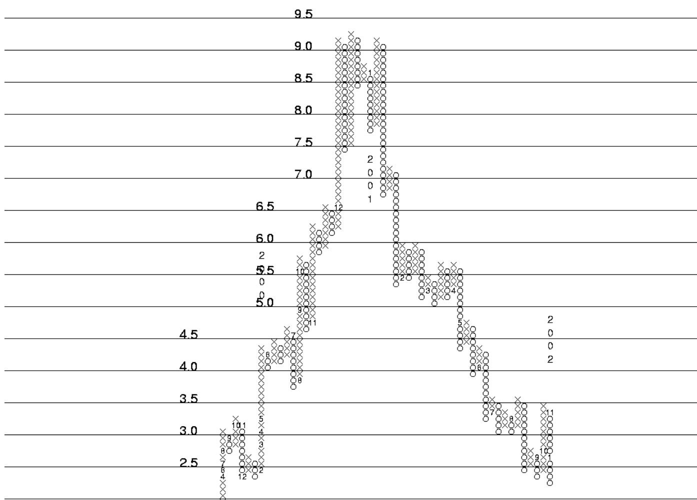
■ **OPEC will not easily regain control of the oil market.**

Gold is cheap relative to many financial assets but this was also true 4 years ago. The chart shows a portion of gold bullion's developing base, which extends back to December 1997. The low for this pattern is $251.95,

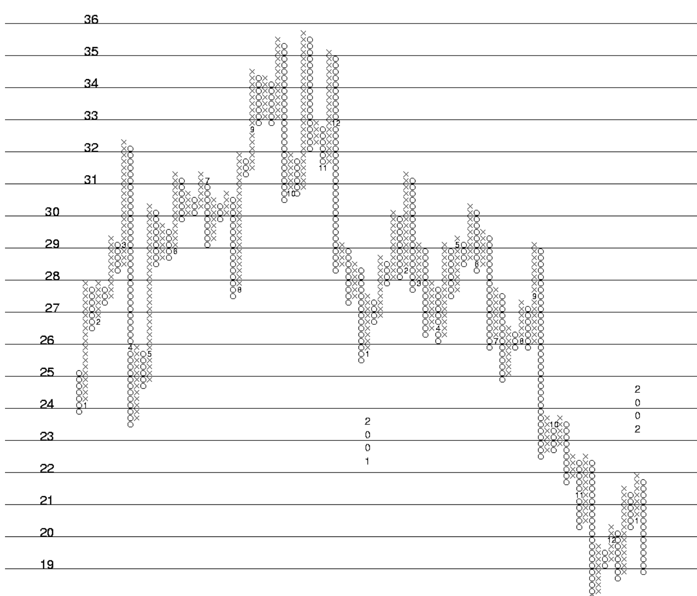
London Spot Gold (1USD)



Natural gas NYME 2nd Continuation (0.1USD)



Crude Oil NYME 2nd Month Continuation (0.2USD)



reached in August 1999. The price then spiked up to just over $340, on an inter-day basis, before falling back almost as quickly and commencing a lengthy right-hand extension, which continues today. Gold's ability to often rally more rapidly than it declines within this pattern, which we have seen again this month, is a base characteristic. The question is, when will this pattern support a significant recovery rather than 'now you see it, now you don't' flurries? Most forecasters are not bullish of gold because they see no inflation. However, logically, the gold price should be edging upwards shortly after inflation reaches its nadir. I believe many of the building blocks for a rising gold price are gradually falling into place. Deflation is now generally regarded as even more undesirable than inflation, the ECB excepted. The US Federal Reserve has been pumping up money supply, to counter deflationary pressures, for over a year and the Bank of Japan will eventually follow this lead. Short and long-term interest rates are historically low, at least in nominal terms, as are dividends. Investor confidence in stock markets has been dented following the end of a multi-year bull trend. These factors are sufficient for base development but they are unlikely to fuel a significant recovery by gold. The critical ingredients still missing are a loss of confidence in the US dollar and an inflationary psychology. These are long-term cyclical factors and my guess is that they are at least a year away from turning favourable for gold, but it could be up to ten. Meanwhile, the price chart will remain our best guide. Gold rallied above lateral trading just over $280 on 9th January but has subsequently drifted back. A move to $275 would confirm another upside failure and possible retest of the base's lower region. A rally back above $300 that held for more than a few days would certainly generate further interest. Watch gold shares as a lead indicator.

OPEC cartels always self-destruct. They only succeed, temporarily, when the world economy is strong and non-OPEC production has been deterred by low prices. However, a sharp increase in the cost of petroleum contracts, beyond a brief spike, has always triggered a global recession. OPEC persuaded producers to agree on additional cuts, commencing on 1st January, but this only produced a temporary rally. The problem, which won't go away until prices are lower, is that many producers have invested in excess capacity. Needing revenue, they are producing above their agreed quotas. Additionally, the price of natural gas, which can often be substituted for gas oil and heating oil has continued to slide. I maintain that the new trading range for OPEC's crude oil benchmark is $20 to $15, rather than an average of $25 dollars as sought by the cartel. It would now take an "event" of consequence to lift oil significantly, in which case one of the chart signals would be a move over $22 (NYME).

The Global Economy

■ **Deciphering Greenspan - was his cautious assessment of the US economy based on domestic or international considerations, or both?**

■ **On Japan's sinking ship, they aren't even shuffling the deck chairs.**

■ **Europe's economies are still weakening.**

A three and a half month stock market rally inevitably improved sentiment regarding the global economy, but concerns will resurface. Is the optimism justified or has the tail been wagging the dog? I suspect the US economy, so often the focal point of concerns among bearish analysts, is the least of Greenspan's concerns. While it is now fashionable for commentators to say he was slow in recognising the downturn, I maintain his minor error was in raising rates for too long after the tech bubble burst. Anyway, that problem which had long concerned the Fed Chairman, plus the tripling of oil prices, was always likely to cause a global recession. Greenspan moved first and most aggressively among central bankers in lowering rates last year. This was followed by a fiscal stimulus from the Bush Administration, including tax cuts, support for industries most affected by the 9/11 shock and defence spending. Consequently the US has a 'guns and butter' economy, which is certainly stimulative, as is the much lower cost of petroleum. Tentative evidence of a US economic recovery was emerging in 4Q 2001, to the surprise of most economists. Consumer spending has been resilient, despite rising unemployment and 9/11. Significantly for the consumer, house prices have not weakened sufficiently to undermine confidence. However, fallout from the tech bubble will inevitably linger. Worse still, the 18-year bull market spawned a corporate madness, which was not confined to tech. Managements from all corporate sectors embarked on a massive gamble by leveraging their balance sheets, often borrowing to finance share buybacks and using the inflated paper for questionable takeovers. Without wishing to moralise, this was none other than excessive greed. Management was evaluated on the basis of share price performance and remunerated through options. For the naïve, this looked great while the market rose and the economy boomed, but would inevitably be a double-edged sword in a downturn, as this publication frequently stated. While dotcoms were the extreme manifestation of Greenspan's "irrational exuberance", Enron typifies the full-blown corporate scandal. Company debt will remain a problem, despite lower short-term interest rates, as will pricing power in a global economic slowdown. I believe it is the synchronicity of this global recession that most concerns Greenspan. At a time when the US economy has enough problems of its own, largely due to former excesses, it is unlikely to receive any help from Europe during the first half of 2002 and possibly longer. Meanwhile, Japan's problems are increasingly alarming and a clueless government is hoping it will be saved by a US recovery. Argentina's crisis is sliding into anarchy, with the risk of political contagion. Consequently, while Greenspan can take some comfort from monetary and fiscal measures to support the US economy, he can only look on developments elsewhere with concern. Forecasting the US economy over the next two years will be even more difficult than usual, I suspect, and there is little point in trying to peer too far ahead. Nevertheless, without a significant event, which is invariably unpleasant, US GDP should rebound sufficiently in 2002 to make the IMF's latest forecast of 0.7 percent growth look silly. However, the improvement may not be easy to sustain, given the ongoing scope for higher unemployment, corporate bankruptcies, deflationary contagion from Japan, unrest in Argentina and the inevitable hazards of a very necessary war against terrorism.

Junichiro Koizumi is probably a cool guy to hang out with but he hasn't got a clue when it comes to the Japanese economy. He only understands the need for restructuring (who doesn't?) but that is best deferred until a recovery is underway, because a policy of accelerated bankruptcies and layoffs in the present environment could tip Japan into a depression. The country's immediate problems are deflation, low money supply and a national loss of confidence. The person most responsible for this crisis, in a very long parade of culpable administrators, is BoJ Governor Masaru Hayami. He is the main cause of Japan's deflation (always a monetary problem) and the absurdly low money supply growth, now back down to 3.2 percent (M2+CD). Nothing improves for the Japanese economy until deflation is checked. Meanwhile, there is a dangerous complacency that it will somehow muddle through, gaining sufficient help from a somewhat weaker currency and a US-led economic recovery later this year. Unfortunately, this is unlikely to be enough because Japan's economy is in danger of imploding in a deflationary spiral. The sane way out of this crisis, I maintain, is inflation targeting and the aggressive printing of money by the BoJ. To reverse economic decline within a year, Koizumi's Government should take this money and purchase Japanese real estate and shares, until prices are clearly appreciating. Once Japanese citizens see an end to deflation, confidence will improve, unleashing public savings and jumpstarting the economy. The transformation from nonperforming to performing corporate loans would be marked. Foreigners would reinvest in Japanese assets, adding to the property and stock market recovery. Koizumi could use profits from Japan's recovery portfolio to payback some of the Government's burgeoning debt. Will Hayami reflate sufficiently to check deflation? I hope so, but pigs could sooner fly. Should Japan's gradual economic slide accelerate (we would see it first as the Nikkei Stock Average plunged), there could be global contagion.

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Euroland's drift into recession continues. The problems are well known - too little growth before the downturn, too much unemployment, too much regulation, too much taxation, too strict a 'stability pact' for the circumstances and the ECB was too slow in cutting short-term rates. With the German engine stalled while the rest of Euroland misfires, the region is too weak to generate its own recovery. Meanwhile, it won't receive much help from the US, not to mention Japan. When will this change? Probably not in the first half of 2002 but economic prospects will become much more interesting if Bavaria's Prime Minister Edmund Stoiber, the Christian Social Union/ Christian Democratic Union Party's candidate, defeats Chancellor Gerhard Schroeder in September's election. Stoiber's strength is economic policy and Bavaria has certainly outperformed Germany's other regions. In contrast, Schroeder is a 'third way' (lost way) Clintonista type - lots of superficial charm but not much else. Stoiber would bring forward Schroeder's tax cuts - ludicrously scheduled for 2005. He should be able to lift Germany off Euroland's economic floor, which wouldn't do the euro any harm. The UK economy has been surprisingly resilient, at least to me, mainly due to strong consumer spending encouraged by previously surging property prices. The same thing happened in Ireland, only more so. When Ireland's property bubble burst last year, Euroland's best performing economy slowed markedly. The UK would be lucky to avoid a lesser version of this cycle, especially as taxes will climb again this year, to finance an overhaul of the duff rail system and to pour more money into an inefficient National Health Service.

And Finally…

The Triple Play revisited - This was first outlined in March 2001 (FM202) and described as a once in a generation opportunity for investors and speculators, courtesy of Japan's fiscal and monetary policy blunders. A crucial point to remember about The Triple Play (TTP) is that it is sequential - short yen, eventually long Nikkei and/or Japanese stocks, and finally short JGBs. My premise is that Japan's dire economic problems will necessitate a massive reflation, driving the yen much lower. This reflation will eventually be very bullish for Japanese stocks. Once Japan's economy commences a sustainable recovery, interest rates will rise, pushing up JGB yields. A year ago currencies were rallying strongly against the yen in the first stage of a recovery. This was followed by a lengthy pullback and base extension phase, leading to an additional advance in December and early January. These latest gains are now being consolidated and I believe short yen against the reserve currencies will remain the in-form portion of TTP. Arguably, Japan's economic crisis has increased overall potential, while lengthening what was always going to be a multi-year process of rotating opportunities. A year ago I thought we could eventually see ¥160 for the US dollar and euro but I now believe ¥200 is possible. As for the stock market leg of TTP, Japan is at a critical juncture, with the Nikkei and Topix near their lows, badly underperforming most share indices in other countries. I am not reassured by Prime Minister Koizumi's comment, "I won't let chaos happen that causes financial panic, no matter what", reported by Bloomberg on 17th January. I would not be surprised to see a panicky flight from Japanese financial assets over the next few months, which would do the yen shorts no harm and once the dust settled, create a buying opportunity in Japanese stocks and index futures. As for JGBs, some people believe the bear market has started because lending banks have been selling recently, to raise capital as they write-off non-performing loans. We have seen bungee-jumps like this before in recent years, providing short-term trades but JGBs then recovered because the BoJ remains a very big buyer. I think the best opportunity with this last portion of TTP will occur when investors begin to discount higher Japanese interest rates due to economic recovery.

A new website from Stockcube - www.sharestar-uk.com - Designed with the private investor in mind, this is both informative and fun. If you are interested in the UK stock market, have a look.

The Chart Seminar 2002 - One day I'll grow out of this, but not yet. TCS is returning for its 34th year, with the next venue in London on 2nd and 3rd May 2002. A feature of this workshop on Behavioural Technical Analysis is the application section, when delegates analyse the markets, often with a view to finding the most promising opportunities. I suspect a number of them have profited from short yen. Another technical conclusion was a post-New year hangover for stock markets.

The target date for FM213 is Friday 22nd February.

"Problems are only opportunities in work clothes."

Henry J. Kaiser

Best regards - David Fuller

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