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In its 18th year

Fullermoney

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

The prospect of stock markets remaining rangebound for a very long time will cause investors to consider alternatives, such as gold.

Stock market valuations are undergoing a gradual reversion to the historic mean.

This process is brutal for the unwary. Inevitably, it involves a long, drawn out reversal of the euphoria evident at significant market peaks. This is a cyclical phenomenon, taking approximately a generation to inflate a super-cycle bubble, another generation to unwind it and another to reflate a new bubble. I began my analytical career in the mid-1960s, just as a super-cycle bull market was ending. Consequently, most of the mistakes I made occurred when I remained bullish after a good rally by stock market indices. The next great bull market commenced in 1983, and the mistakes were usually in not being bullish enough, 1987 excepted. My hunch is that the danger for equity investors until approximately 2020 will be in buying too high and holding on too long after rallies. If markets maintain their remarkably consistent super-cycles seen for well over a century, another long-term bull market should be commencing around 2021, give or take a year or two, although few will recognise it until much later. As investors and traders, we certainly don't need to wait until then before we can profit, but we had better accept the new norm and adjust tactics accordingly.

Forget "buy and hold" and "buy the dips", unless it is a very big dip, perhaps better defined as a rout. Remember "Dow Jones 36000" - the best selling book that made a fortune for its author and rendered down many more personal "fortunes" for its readers? I'd put it away for a couple of decades. Reversion to the historic mean does not occur in a single trend for the market, as we saw with 4Q 2001's powerful rally and will probably see during many more medium-term recoveries. Moreover, stocks don't just gravitate back to some consensus level of fair value. Instead, they eventually overshoot on the downside, often testing historic lows for multiples and highs for dividends.

In the last great unwind for equities, lows for valuations and indices were reached halfway through the cycle, in December 1974. The bell-ringing refrain was, "I'll never buy stocks again!" We will probably hear this at least once more, in the next decade or so. Following the 1974 low, stock markets soared in their best medium-term bull run of the cycle but the DJIA did not break decisively clear of its upper boundary near 1025 for another 8 years. It is impossible to tell when we will see the lows in the present super-cycle unwind, because this will be determined by events currently unknown, but it will probably occur following a period of rising short-term interest rates.

The clear and present danger concerns valuations,

typified by the S&P 500 Index's current P/E Multiple of 31.8 and a dividend yield of 1.2 percent. This multiple should at least halve over the next decade, for two reasons. Share prices will move lower from time to time. Also, GDP growth will lift profits for many companies over the longer term, but investors will pay less for those earnings than during the bubble years. Subscriber/friend Jeff Fisher reminds me that reversion to the mean equals a 4 percent yield for the DJIA, compared to 1.1 percent today. Remember the accepted wisdom of the 1990s, "Dividends are an inefficient use of capital"? Sure, if we are living in a bubble environment. Looking ahead, investors are much more likely to say, "Show me the money". Jeff points out that reversion to a 4 percent yield equals DJIA 2650, which neither he nor I expect. However I do believe that DJIA 11750, reached in January 2000, will be the upper boundary for a very long time, and that we will see more bungee jumps from current levels.

Could Wall Street revert to its historic mean much more quickly than you suggest? Yes, and most investors hope so but I don't think they would like the route. This would require a massive sell off from current levels, inevitably affecting all stock markets. It would cause enormous economic damage on a global scale, delaying recovery in a replay of the 1930s. Fortunately, this is unlikely because Alan Greenspan moved quickly and aggressively in lowering short-term interest rates last year. The comparatively painless, albeit time-consuming, path for reversion to the mean is via GDP growth. However it is strewn with obstacles, because corporate excesses in the 1990s considerably outstripped those of the 1960s. Too many companies leveraged their balance sheets, often to finance share buybacks, and Enron is not the only company with off-balance sheet debt. Inevitably, the weight of debt lowers corporate profits in anything other than boom times, and reduces the ability of companies to increase dividends. Investors can expect a wave of secondary offerings whenever the stock market rises, as companies seek to pay down debt and replace it with equity financing. Moreover, demand for equities from pension funds and private investors is likely to be lower than we saw in the 1990s, for at least a decade or two. As 'baby boomers' reach retirement age, they are likely to become more conservative, often opting for fixed income. Capital flows away from stocks during a post-bubble reversion to the mean.

A period of dissolution is part of the process. Psychologically, Enron represents a terror attack of the mind (as opposed to a terrorist attack), which will affect sentiment far longer than 9/11, as I mentioned in FMP168. Since management at what was once the US's seventh largest company engaged in a 'get rich quick' conspiracy at the expense of all other shareholders, right under the nose of its once highly regarded auditors, it's no surprise that investors now question the financial probity of other firms. Suspicion lingers and some other companies will be found wanting, albeit hopefully not on the scale of Enron. Among shares, comparative safety is likely to be found in companies already trading at low multiples and offering high, covered yields, wherever they may be listed. Low valuations are the key, rather than geographic diversification per se, even though European indices, for example, often trade at lower multiples than their US equivalent. The historic norm has been for markets of lesser capitalisation to perform like high beta versions of the US.

This is no cause for despondency. In markets, adversity can always be turned into opportunity. Our challenge is to recognise the reality markets provide, and adjust tactics accordingly. We should see a number of medium-term bull and bear markets over the next couple of decades, usually in line with the lowering and raising of short-term interest rates by central banks. However, sell offs will probably be more pronounced than rallies, until we have passed beyond the low point during reversion to the mean. Market-neutral funds will siphon some investors away from their index tracker brethren. We are in a buy-low-sell-high environment. Investors have as many opportunities to sell short as to buy, including index futures. Hedge funds are also trading spreads - simultaneously buying one share while shorting another in the same sector, usually on the basis of technical criteria. Many high beta stocks will perform well during the rallies following sharp declines, as we saw during 4Q 2001. All this can be monitored on price charts, which are never more useful for timing than when strong rallies are followed by equally significant declines.

Interest Rates and Bonds

■ **Central banks may not cut rates further without another stock market slide.**

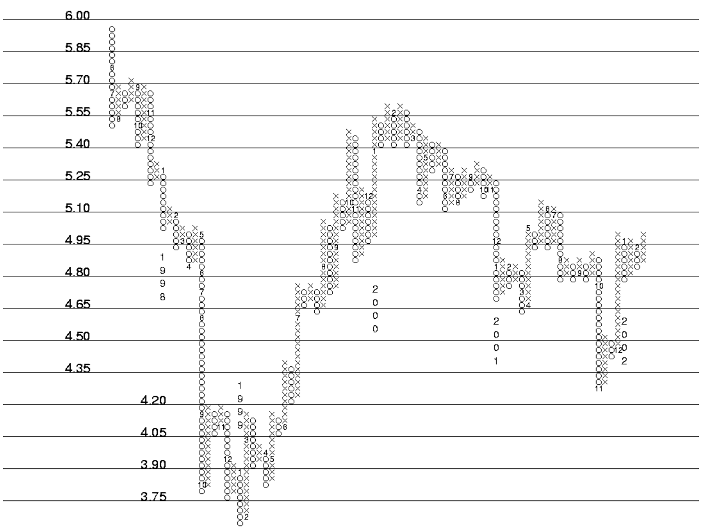
■ **US and European long-dated government bond yields have diverged recently but the former are probably leading.**

Central banks hope they have done enough to encourage recovery. US economic data justifies Greenspan's cautious optimism. The ECB and BoJ appear to be banking on the US to lead them out of recession. With UK fiscal spending going through the roof, Chancellor Brown is just hoping. All will continue to be influenced by stock markets. If these rally above the year's earlier highs, we can assume there will be no further rate cuts. Conversely, if share indices approach let alone retest their September lows, the ECB and BoE will be under pressure to lower short-term interest rates once again.

Further base extension by yields appears likely. Second-guessing market trends can be hazardous but they frequently overshoot. I maintain that many managers dumped government bonds in November and December because they remember how rapidly yields rose in October and November 1998, following the Russian debt default and Long-Term Capital Management bailout. People often do in this cycle what they wish they had done in the last cycle. US long-dated yields are now ranging lower, despite evidence of economic recovery and a generally easier stock market following the yearend rally. Investors expect inflation pressures to remain low and they have reservations about the extent and sustainability of economic recovery. They are probably right. Technically the US yield chart looks like a classic partial retracement and base extension phase, which could be lengthy. Euro-bund yields now exceed their US 10-year equivalent. This doesn't make sense to me and I expect them to follow the US lead and ease lower in base extensions before long. As for day-to-day moves, bond prices often take their cue from stock markets, moving inversely.

Strategy for bonds - Little change 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 and debt concerns abate. Investors could also buy quality long-dated government issues for the short to medium-term, during the yield pullback and base extension phase. From a speculative perspective, bond futures should regain at least half of their November-December decline, assuming stock markets do not rally strongly. 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.

Euro-bund 10 Year Bond Yield (0.03)



US 10 Year Bond Yield (0.025)

Global Stock Markets

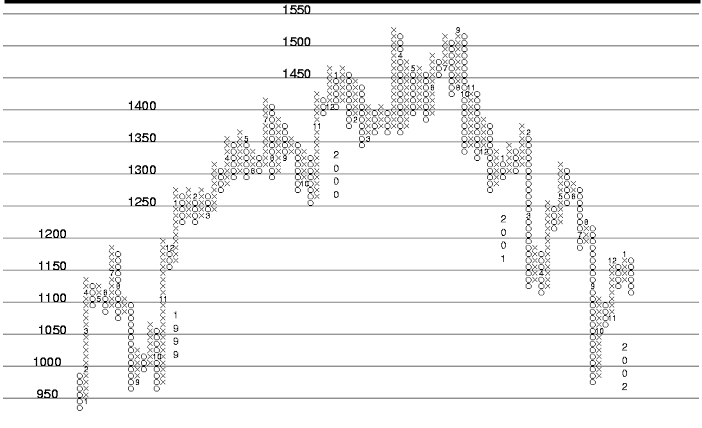
■ **There are plenty of concerns for investors in shares but chart patterns could be forming bases above the September lows.**

■ **Will Japan support its stock market?**

Most stock market indices have retraced more of their yearend 2001 rally as investors worry about corporate profits and accounting procedures. "Don't fight the Fed" failed to provide a gain for the DJIA 12 months following the initial rate cut, for the first time since 1932 - see table in FM212. This sobering result gives investors much to ponder, especially concerning equity valuations. Moreover, the Enron scam has further undermined investor confidence. How many more companies have used accountancy tricks to artificially lift earnings and hide debt? No one knows but the worries will persist. Debt was already a problem following the fashion for leveraging balance sheets in the 1990s. Companies will try to convert this to equity financing, capping stock market rallies with secondary offerings. US equities remain historically expensive at a P/E of 31.8 and yield of 1.2 percent for the S&P 500 Index, and Wall Street is certainly the most influential market. Valuations always revert to their historic mean following every super-cycle bull market. Deflationary pressures, including limited pricing power, weigh on corporate profits. Japan's economic crisis threatens to export more deflation. Many economies remain in recession, although this is at least partially discounted. There is also some good news. The oil price and short-term interest rates are low. The US economy is recovering. Corporate profits should rebound in 3Q and 4Q 2002, if only because of write-offs in the same period last year. Looking at chart patterns for indices, rallies back to this year's highs are required to reaffirm support from the September lows. This would be in line with my earlier hypothesis, first mentioned in late September, that we would probably see V-bottom with right-hand extension base formations, prior to some additional gains, before markets ran into trouble again due to either rising interest rates and/or concern over GDP growth and corporate profits. This script called for at least a one-third retracement of the 4Q 2001 rally, which we have now seen, and markets are rallying as I complete this issue. However, failure to break the medium-term downtrends over the next few weeks and retests of the September lows would obviously lessen the likelihood that bases were forming. The charts will show us.

A rebound reflects hopes that Japan will support its

S&P 500 Composite Index (10pt)



ailing stock market to help banks, which are struggling to meet capital adequacy requirements. Given the many hints of policy changes from Japan, few of which have been realised, is it likely to be different this time? Certainly the buying of Japanese equities and property, as part of a radical reflation, is something I have long advocated. Perhaps significantly, Koizumi is now talking about action to stem deflation. However, given the Government's inaction to date and its differences with the Bank of Japan, it would be a pleasant surprise if they could now agree on a policy and implement it. A major support programme for the stock market would certainly boost Japanese equities. Conversely, if such expectations prove to be the triumph of hope over experience once again, new lows for Japan's share indices will soon follow.

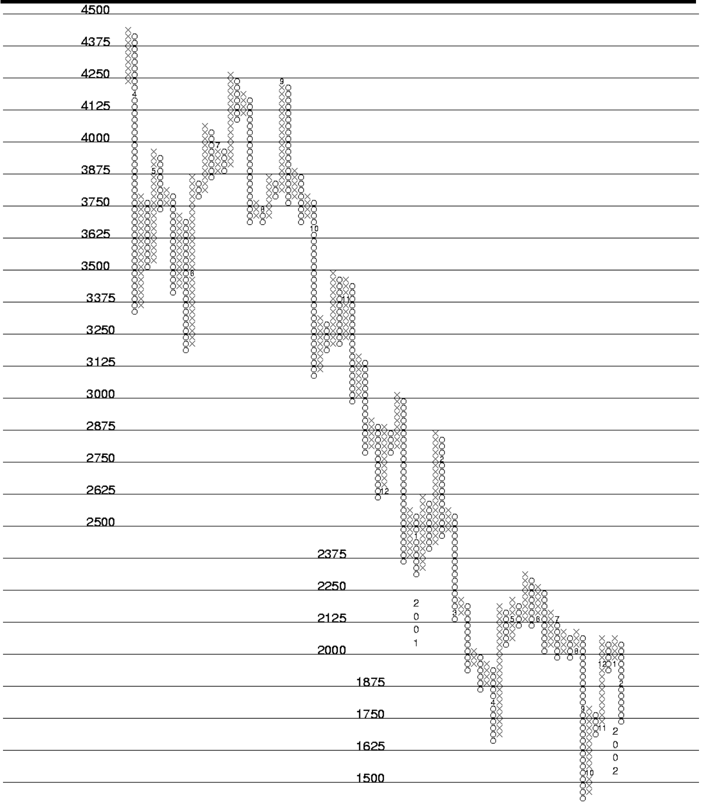
Chart review of topical and representative stock market indices - *The 3-box reversal point & figure charts shown are based on closing prices and taken from our website. Anyone interested in this chart service, which includes analysis and is updated daily, should register online at www.chartanalysts.com.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

The US's S&P 500 Composite Index (1116) has rolled over within its overall downtrend and requires 1180 to offset a further retracement of gains seen after the September low. **The NASDAQ Composite Index (1783)** has retraced nearly half of its yearend rally and 2075 is needed to check this drift and reinstate the base building hypothesis. **The Dow Jones Utilities Index (278)**, which often leads, is testing its December low and a rally to 290 is required to break the progression of lower rally highs and demonstrate further support from the 1998 to 2000 reaction lows.

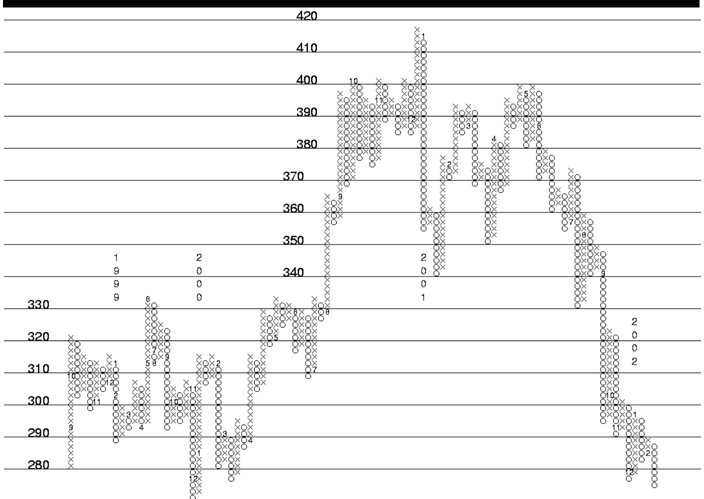
Japan's Tokyo Topix Index (1007) has pushed up into the lower side of its September 2001 and late-January 2002 range lows, which are also near the 1998 floor. A move to 1050 would provide further evidence of a downside failure.

Singapore's Straits Times Index (1702) has seen a powerful rally since the September low but this has encountered resistance beneath the April 1999 to March 2001 band and lost upward momentum, evidenced by a break in the progression of rising lows. Consequently, 1800 is now needed to reinstate the uptrend and offset current

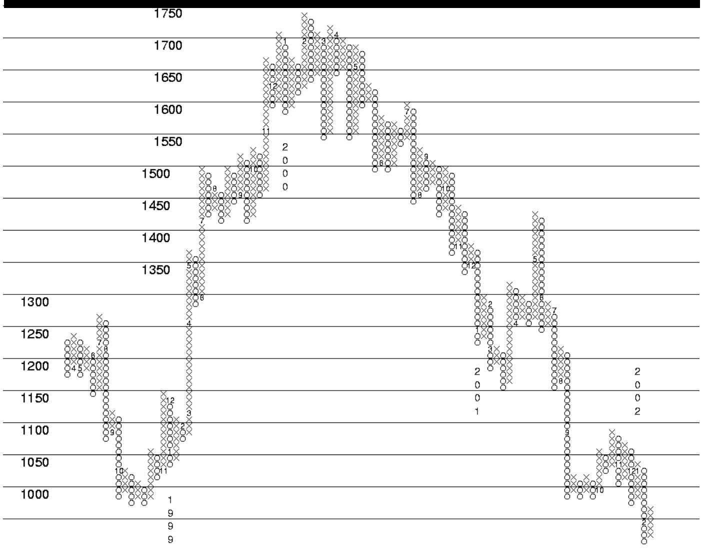
Nasdaq Composite Index (25pt)



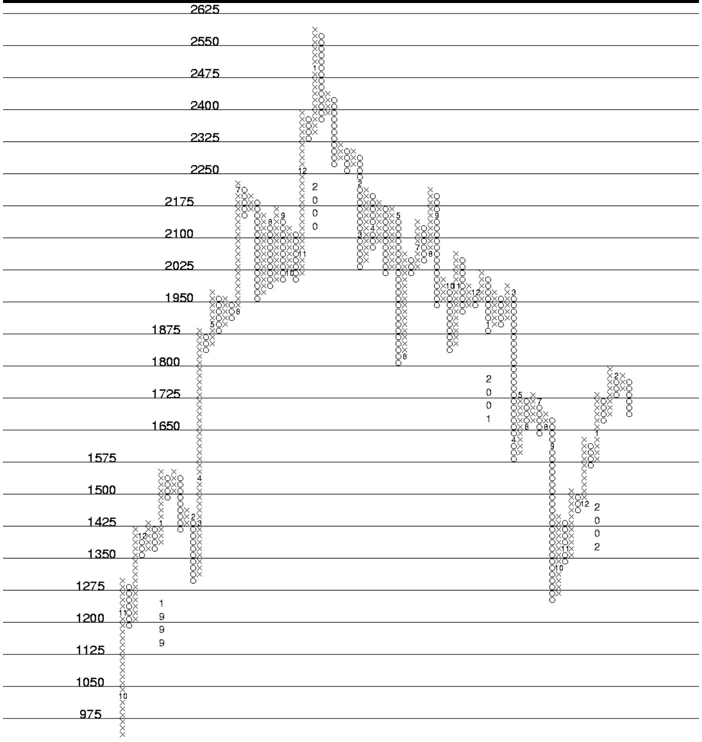
Dow Jones Utilities Index (2pt)



Tokyo Topix Index (10pt)



Singapore Straits Times Index (15pt)



scope for a further retracement of gains.

Taiwan's Weighted Price Index (5696) saw one of the best recoveries among world stock markets, following the September low. However it too has lost momentum recently and a move to 6050 is needed to reinstate the upward trend and check current potential for a further pullback.

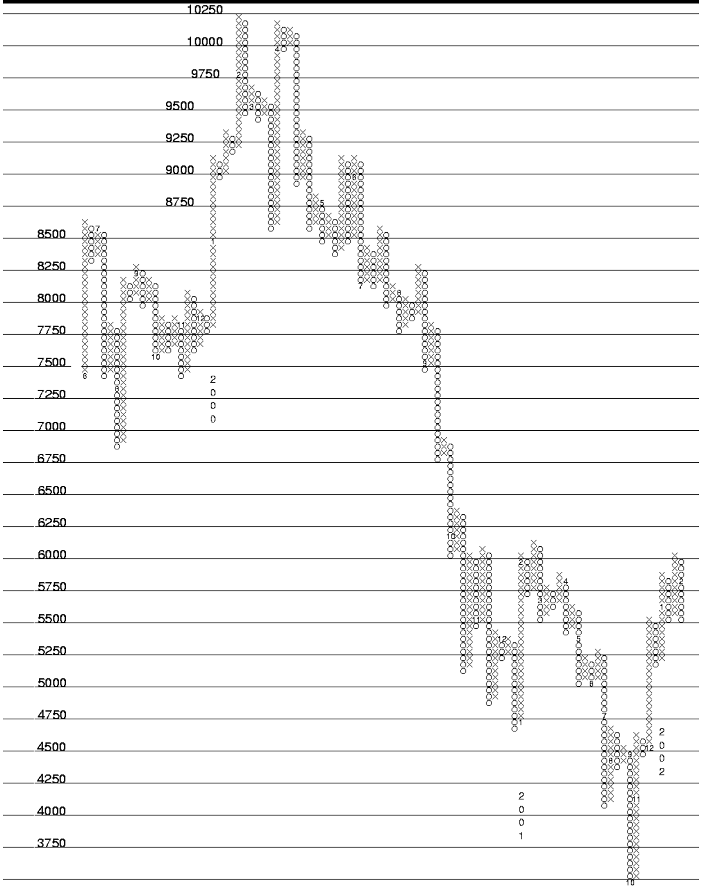
Australia's All Ordinaries Index (3380) has shown amazing resilience in testing its June 2001 all-time closing high near 3420. However it shows a loss of momentum and broadening pattern although the all-important sequence of higher reactions lows is still intact, albeit just. A close at 3430 is needed to question the probability of a correction. **The All Mining Index (845)** is consolidating after a surge up out of its base. A move to 750 is now required to indicate an upside failure, which seems unlikely and 920 would open the door to further gains.

South Africa's JNB Gold Index (2447) - *See overleaf* - has spilled over into a correction following explosive gains on completion of the base in November. Some further reaction and consolidation appears likely, given the extent of recent gains.

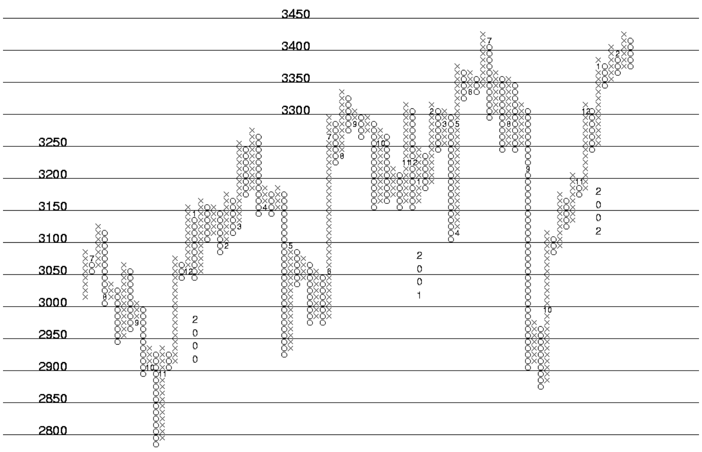
France's CAC 40 Index (4387) - *See overleaf* - has rolled over and a move above 4500 is needed to question current scope for a further retracement of yearend gains and revive the base building hypothesis.

Germany's DAX Index (4954) - *See overleaf* - saw the best 4Q 2001 rebound among Europe's national indices but has rolled over recently. A push back over 5000 is the minimum required to suggest a downside failure and question scope for additional easing towards the September low.

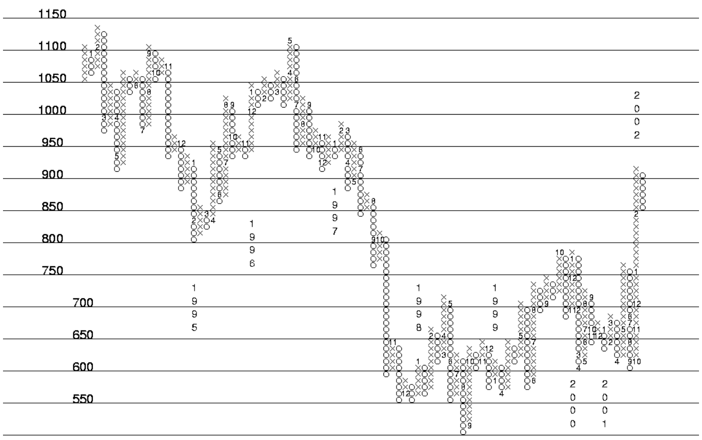
Taiwan Weighted Price Index (50pt)



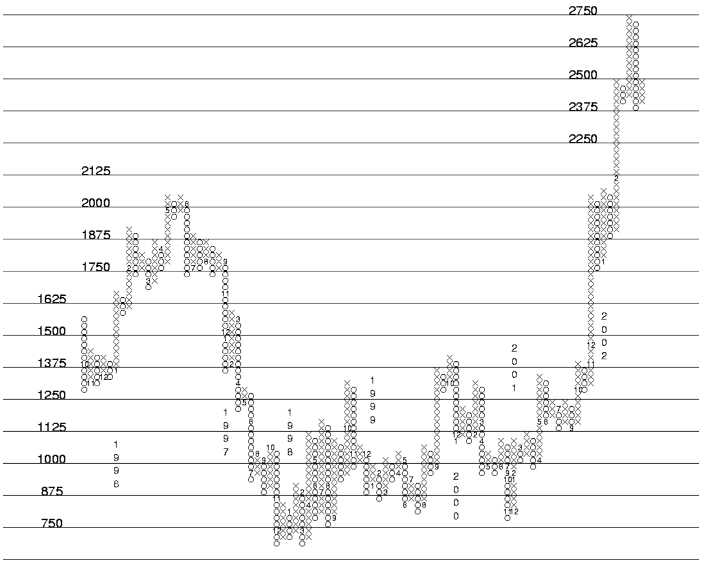
Australia All Ordinaries Index (10pt)



Australia All Mining Index (10pt)

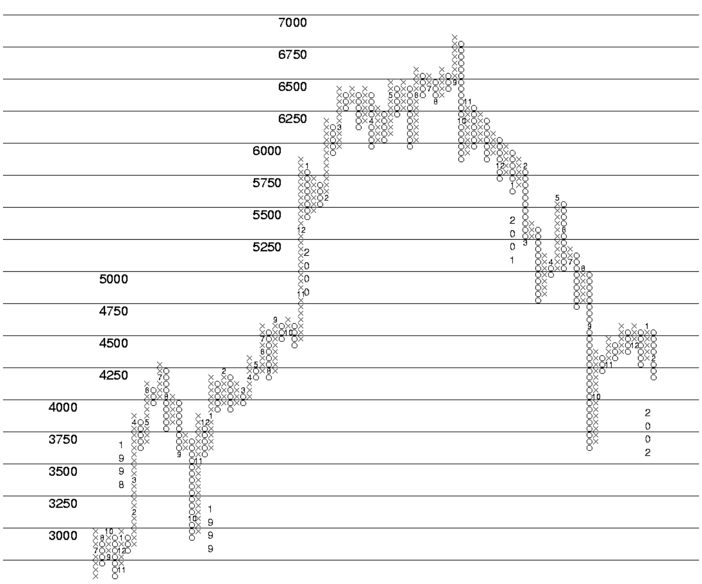


South Africa JNB Gold Index (25pt)

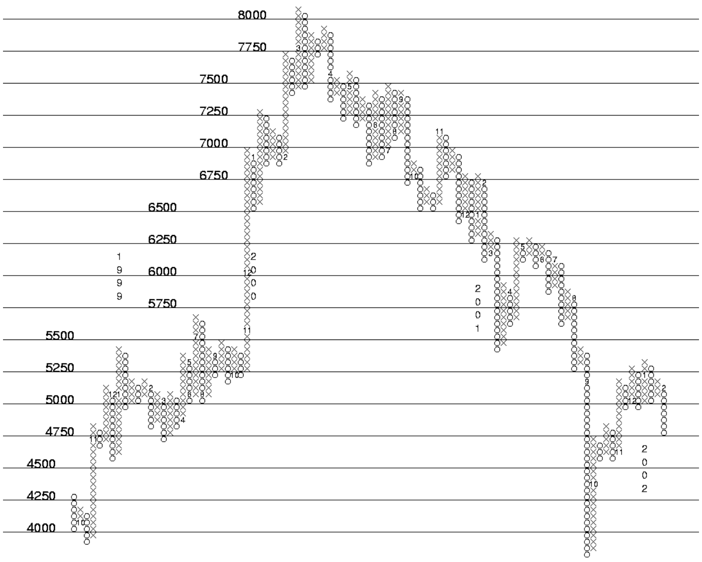


South Africa JNB Gold Index (25pt)

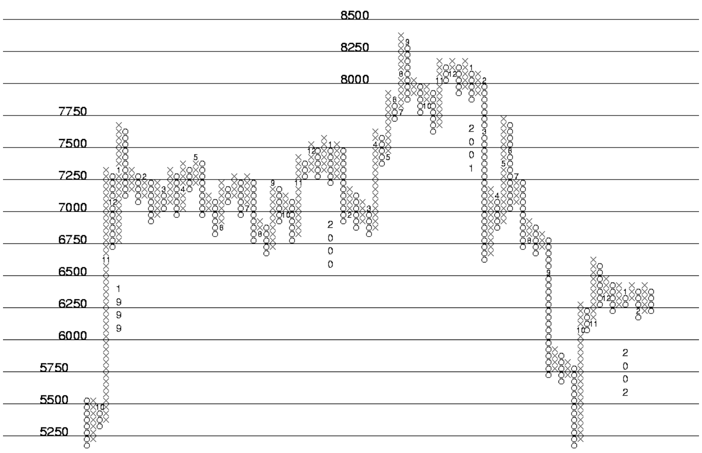
French CAC 40 Index (50pt)



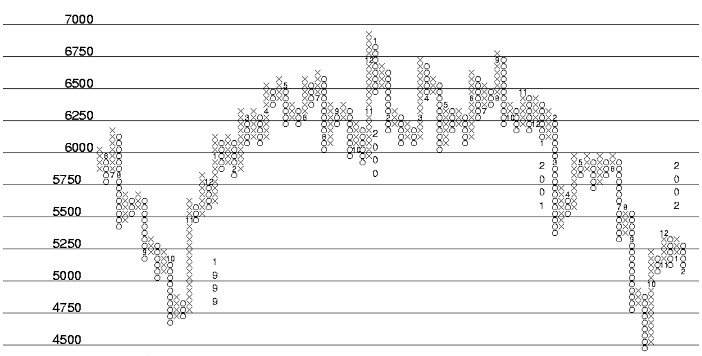
German Dax Index (50pt)



Switzerland Swiss Market Index (50pt)



United Kingdom FTSE 100 Share Index (50pt)



Switzerland's SMI Index (6303) is ranging beneath extensive supply and has recently backed away from 6400 once again. A close at 6450 is necessary to offset scope for a further retracement of the 4Q 2001 gains.

The UK's FTSE 100 Index (5182) is yet another example of a yearend rally that has been checked by overhead supply. A rally to 5250 is currently required to question current scope for a further retracement of those gains.

Strategy for stock markets - I maintain that concern over valuations and mistrust following the Enron scam will linger for a while longer. Consequently my approach to stocks remains cautious. For captive investors, I would stay with value stocks, preferably with single figure multiples and high, covered yields. However, should markets fall sharply for any reason, thereafter the better recovery candidates, at least initially, would be in high beta stocks as we saw during 4Q 2001. In futures, my strategy in recent weeks has been to lightly sell US and European contracts after they have rallied for a week or two. Once they start to move in my favour, I usually introduce a breakeven stop for money control, particularly as I may be selling other contracts, and cover when these begin to show a loss of downside momentum, especially if this is near former support levels. Consequently I'm now looking to open a few shorts, but am feeling a little more cautious following Japan's downside failure and the DJIA's test of its January high. I may defer, at least until or unless the current rally stalls, and if the medium-term downtrends are broken I will be much less inclined to short. My view on other positions previously mentioned is unchanged from FM211.

Currencies

■ **Japan has no sane option for breaking out of its deflation other than to print money - lots of it. Hayami resists but it is just a matter of time.**

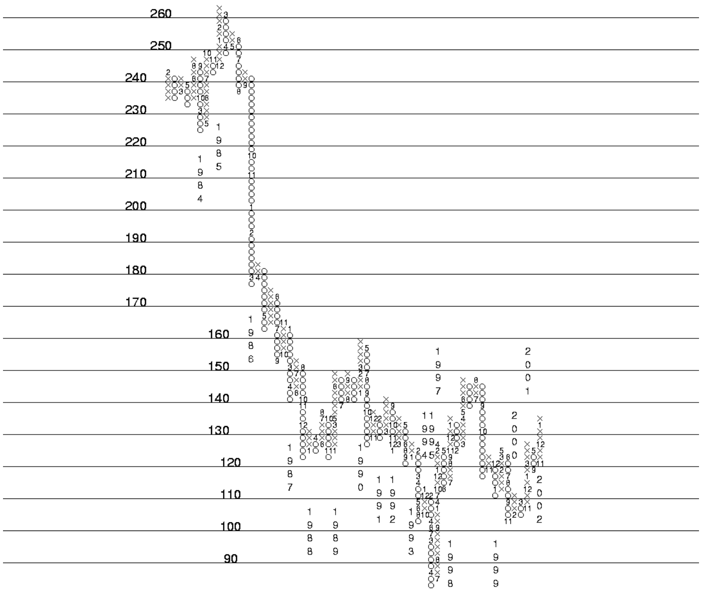
■ **Currency traders shun the euro but is the ECB quietly buying it?**

■ **Sterling has gradually metamorphosed from being a US dollar proxy to an alternative for the euro.**

Japan's economy is in a deflationary spiral and radical inflation is inevitable. Officially, Japan's government debt is approaching 140 percent of GDP. This is 35 percent higher then the next most indebted G7 government, Italy, and higher than any other OECD country. Add unfunded pension liabilities for Japan's ageing population and Japan's public debt could be 300 percent of GDP, according to some estimates. As for the banking sector, non-performing loans amount to at least 30 percent of GDP. Moreover, this total is rising faster than it can be written off, because the economy is still contracting. Hayami wants the Government to address this problem. Well, if it forced banks to write off these bad loans, the economy would collapse into depression and unemployment soar, similar to the US in the 1930s. Alternatively, to bail out banks with public money, the Government would have to issue another avalanche of bonds, piling up debt and burying Koizumi's promise of fiscal responsibility. We can assume that Japan will not allow its technically bankrupt lending sector to fail, because that would wipe out public savings and developed countries no longer do that. The Government may have to nationalise a number of banks. Alternatively, or additionally, it could start to buy Japanese stocks, lifting valuations sufficiently for banks to meet their capital adequacy requirements. There has been talk of this recently, although that guarantees nothing. Ministers have a habit of floating ideas, creating the illusion of being in control, without actually taking any action. I can only assume that this is due to incompetence, indecision and feuding factions within the ruling LDP, which make it difficult to implement policies. Whatever, something has got to give because Japan's deflation is moving beyond the point where the country can somehow continue to muddle through. I suspect the currency is about to crack, as Japan's prodigious savers take fright and move out of yen deposits and/or BoJ Governor Hayami resorts to the printing presses. This would be a bitter pill for Hayami, who joined the BoJ in 1947 and authored "The Day the Yen Gained Respect" in 1995, after it had surged to ¥80 to the dollar, compounding another of Japan's deflationary recessions. However, he cannot go on pretending that the economy is about to recover and that the BoJ is not responsible for Japan's deflation. Chart formations suggest that currencies are within weeks of completing what I describe as the first step (trading range) above the base at The Chart Seminar. These patterns can support significant additional gains against the yen.

It would make sense for the ECB to convert some of its dollar reserves into euros. It would also be a good idea to do this clandestinely, because a high-profile intervention would only risk further criticism of a central bank that has yet to find many admirers. The ECB has huge dollar reserves through its member state subsidiary central banks. Duisenberg and Euroland's finance ministers would be considerably embarrassed if the euro fell for a fourth consecutive year, a development that could exacerbate capital flight. Confidence in the single currency is now more important than any additional competitive advantage for exporters, should it weaken further. I suspect the ECB has been quietly buying euros under $0.87, and a break above $0.88 would begin to squeeze the many euro bears. I have been expecting a decent rally by the euro against the dollar this year, partly on demand for the new paper and central bank diversification. With little sign of this during the first two months of 2002, the missing ingredient is an event that changes sentiment.

US Dollar per 1 Japanese Yen (2)

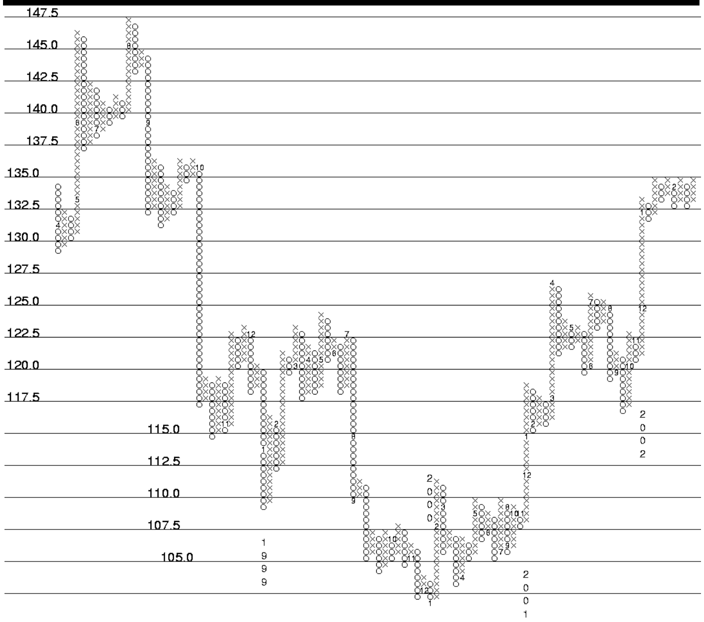


From 1988 to early 2000 sterling was a US dollar proxy, albeit with a slight overall downward bias, reflecting growth differentials. Thereafter it metamorphosed into a euro proxy, albeit generally slightly steadier due to interest rate differentials and the UK's marginally better growth rate. The reason for this change is UK Prime Minister Tony Blair's wish to join the euro. Consequently the pound is now tethered loosely to the single currency. The euro's base formation characteristics evident on long-term charts against sterling suggest that it should appreciate somewhat over the next year or more, although the reasons for this are not yet apparent.

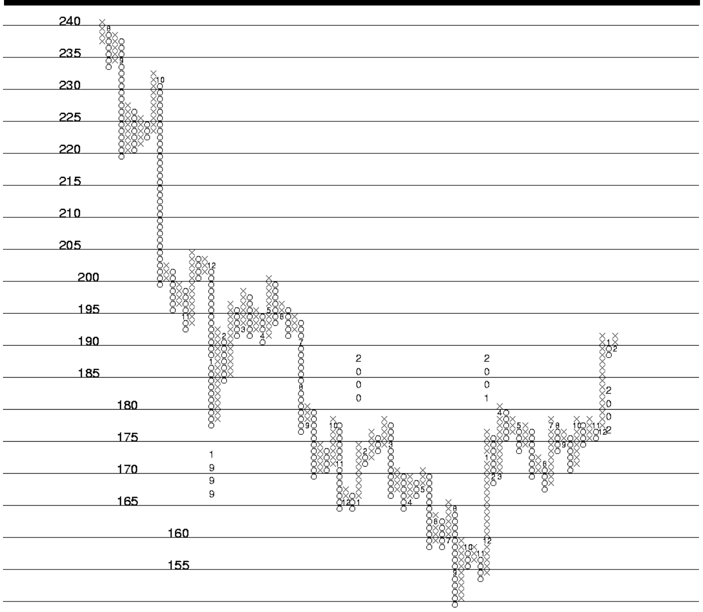
Review of currency and point & figure charts - *These and hundreds of other 3-box reversal closing basis charts are available on our website www.chartanalysts.com and are updated daily. All comments refer to closing levels for US trading hours.*

Dollar/yen (¥133.74) - I've shown two p&f charts, the first being on a very condensed ¥2 scale, for the back history. At a glance, it shows that the dollar has actually seen very little

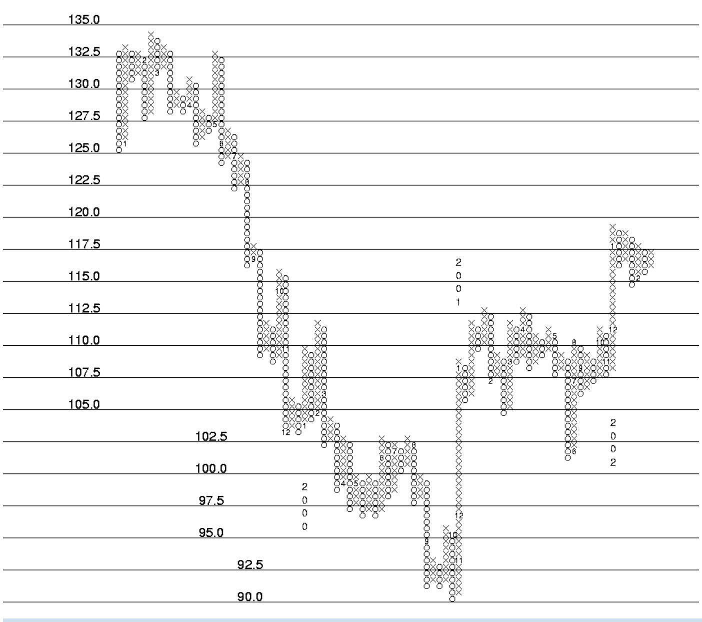
Japanese Yen per 1 US Dollar (0.5)



Japanese Yen per 1 Pound Sterling (1)



Japanese Yen per 1 Euro (0.5)



overall appreciation against the yen, despite Japan's many years of poor economic performance. And remember, there were ¥357 yen to the dollar just over 30 years ago, shortly before Nixon ended the Bretton Woods fixed exchange rate system. This price history makes nonsense of charges that Japan is engaged in competitive devaluation. I maintain it is much more accurate to say that Hayami is responsible for the yen's long and uncompetitive overvaluation. Could the many years of ranging on either side of ¥122 actually be a large base? I believe so. After all, the dollar was in a long-term downtrend against the yen from 1971 to 1995, significantly interrupted only by a rally from ¥180 to ¥278, between 4Q 1978 and 4Q 1982 - *not shown*. The ¥0.5 scale chart clearly shows the dollar's base with H&S characteristics, dating back to January 1999. A consolidation since mid-January, which has been too shallow to show on this chart, indicates very little selling pressure despite some jawboning by Japanese officials to prevent the yen from falling too quickly and much talk of capital repatriation prior to Japan's fiscal yearend on 31st March. The dollar's base remains 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 (¥189.50) - The pound remains generally steady within its consolidation and could test minor resistance near the psychological ¥200 level within the next few weeks. Moreover, the large base should eventually support at least a challenge of the 1998 high at ¥240.

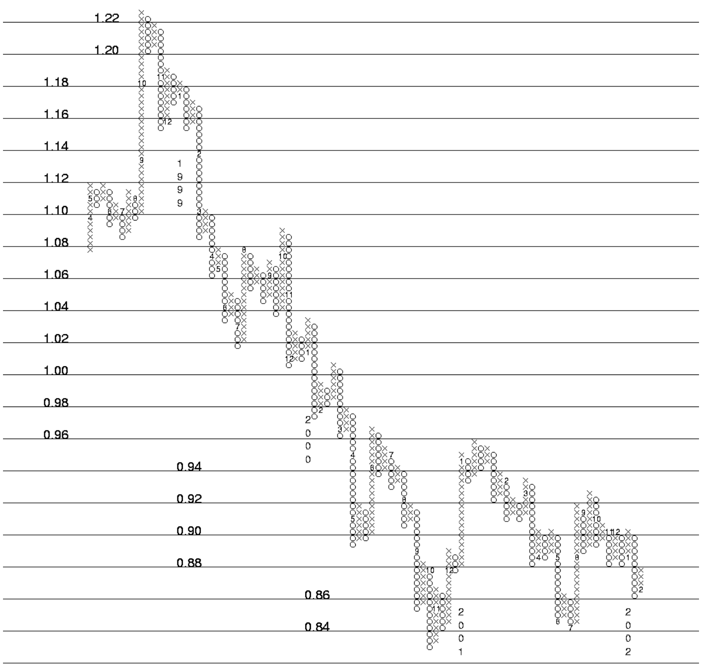
Euro/yen (¥115.82) - The euro's first consolidation above the base is more clearly visible because of the somewhat deeper correction that has occurred. Nevertheless this has not retraced to the breakout point at ¥112 and we have probably seen the reaction low at ¥114.5. As this pattern is completed, traders are likely to look at prior history in estimating targets such as ¥125, ¥135, etc. However the base formation can support much higher levels over the medium to longer term.

Euro/dollar ($0.8656) - The euro's weakness questions the base building hypothesis and a sustained move above $0.904 remains necessary to reaffirm support above the 2000-2001 troughs. I still believe this is a medium-term base but generally bearish sentiment towards the euro will not wane until it can push up into the $0.90s region.

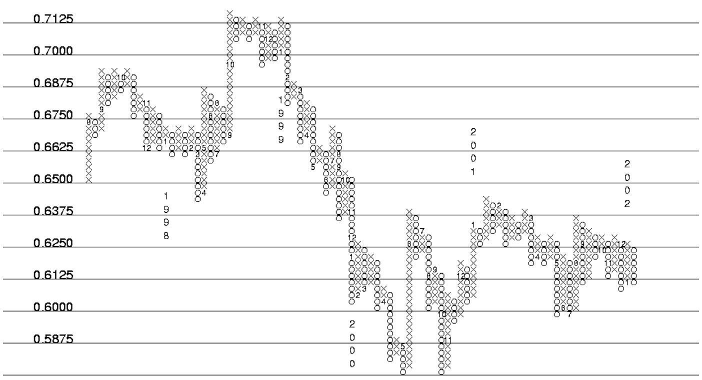
Euro/sterling (£0.6103) - Although the euro has been drifting recently, this pattern also looks like a base, particularly if the May-July 2001 reaction low at £0.5975 holds. The first upside improvement would occur at £0.6275, breaking the gradually declining rally highs since last August. At £0.6375, the euro should be nearing completion of this pattern.

Sterling/dollar ($1.4166) - 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. The hypothesis

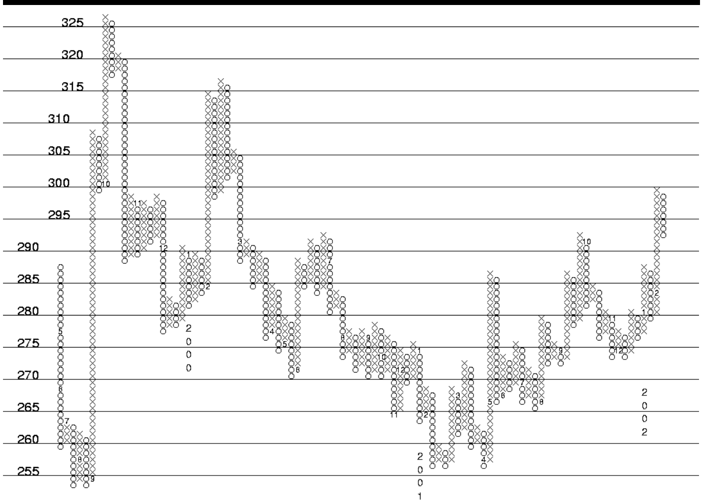
US Dollar per 1 Euro (0.004)



Euro per 1 Pound Sterling (0.0025)



London Spot Gold (1USD)



would gain credibility above $1.46.

Dollar/Swiss franc (SF1.7059) - 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. Meanwhile, the greenback has been ranging gradually higher within this pattern in recent months and a move to SF1.720 would suggest some additional firming before the January and September 2001 lows between SF1.60 and SF1.58 are tested.

Strategy for currencies - My currency activity remains focussed on short yen, which I maintain is the speculation of the year, at least among reserve currencies. The yen has now fallen for six consecutive months and I maintain that the fundamental case for a much weaker Japanese currency over the next year or two has only improved. Needless to say, others disagree with my view and many of the fundamental reasons cited would have been relevant two years ago, when the yen remained strong. The difference this time, other than Japan's further economic deterioration, 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 of the banks' foreign exchange spokesmen expect the dollar and other reserve currencies to trade in very narrow ranges against the yen this year. OK, occasionally an analyst mentions ¥160, or even ¥200 but the consensus is much lower. My conclusion is that today very few people are short yen, relative to its last decline in 1998, which ended when many were blown out by joint US/Japan central bank intervention. Today, any intervention to support the yen is extremely unlikely and would be a disaster for Japan's economy. 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. My strategy at this stage of the cycle is to use mainly trend-running tactics, such as generally loose stops, augmented with a small amount of Baby Steps buy-low-sell-high trading within the ranges, which if successful, lowers average entry prices while also releasing cash. Recently, there has been very little to do because of the narrow trading ranges. This can become stressful, if we have unrealistic expectations about the timing of the next advance against the yen. Some find the ranging tedious but with positive interest rate differentials and a leveraged position, one is being paid just to play the game. Currently, I favour euro/yen and sterling/yen over dollar/yen, for their better interest rate differentials and because no one will object when euro/yen moves higher. However, dollar/yen has maintained the firmer pattern recently.

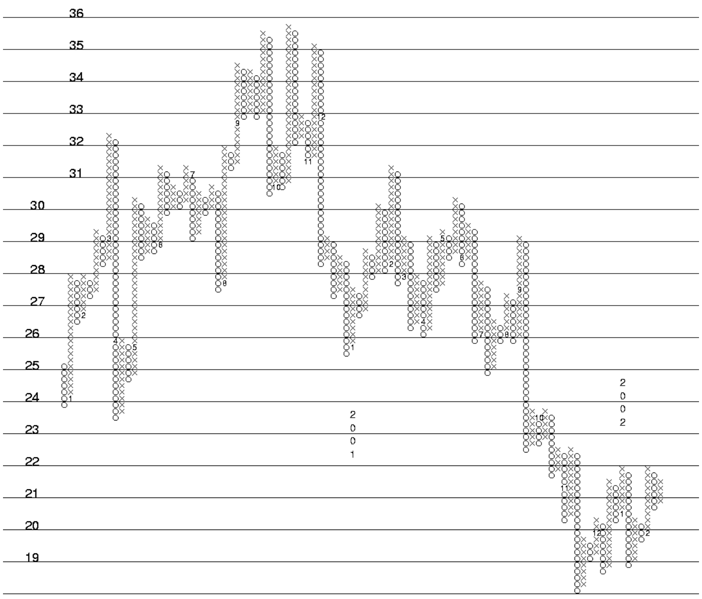
Commodities

■ **Gold is consolidating gains within a large, developing base formation.**

■ **Limited upside scope for crude oil but watch out for the Iraq factor.**

Gold's base is already massive and will eventually support a significant advance. The question is when? No one knows but the charts will show us. Interestingly, lows have been rising since the 1999 trough was successfully tested in April 2001, with the exception of the October-November reaction. February's rally broke above lateral resistance at $292 on this chart based on closing prices.

Crude Oil NYME 2nd Month Continuation (0.2USD)



If gold can find support near $292 during the present consolidation, we can expect a close above $300 before long. Conversely, a close below $280 would probably suggest another lengthy base extension. The next question is why should gold move higher, especially as many believe we live in a deflationary environment? The short answer is because gold has always been a safe store of value in times of uncertainty. Now that stock markets are no longer regarded as the answer to all our monetary aspirations, a trickle of money is flowing to gold. Consider beleaguered Japanese savers, disillusioned with their stock market, economy, government, banking system, currency, and the low yields in domestic deposit accounts and bonds. Just suppose they decided to put 2 or 3 percent of their prodigious savings into gold. The price would easily double. I don't own gold yet, preferring gold share funds at this stage of the cycle, such as the UK-quoted Merrill Lynch Gold & General Fund (a unit trust) and particularly the ML World Mining Trust (an investment trust), even though the latter is not a pure gold play. I continue to nibble at silver futures on setbacks, because the grey metal usually tracks gold but with a high beta - *see also FMP 166 (1st Feb).*

Crude oil has seen a modest technical rally following its climactic sell off from September to November. Overhead supply from the large top area should make any further gains difficult to sustain. Moreover, the gradual nature of the rally does not suggest a dynamic reversal. Therefore the November low will be tested and perhaps broken later this year. However, the Iraq factor is very likely to produce another temporary rally at some point, because the Bush Administration is going to topple Saddam Hussein, one way or another. A major military build-up would worry the oil market, causing short covering and some precautionary hedge buying. Once Saddam and his sons are no longer in control of Iraq, another sell off by petroleum contracts is likely.

The Global Economy

■ **Policy stirrings in Japan but it may be another instance of too-little-too-late, even if they surprise us by taking appropriate measures.**

■ **Europe's economies will not receive much help from the US rebound as politicians hope.**

■ **A 'guns and butter' economy will strengthen the US…for a while.**

Unfortunately for Japan, the three people most responsible for economic policy - Prime Minister Koizumi, Finance Minister Shiokawa and Bank of Japan Governor Hayami, do not inspire confidence. Apparently they meet frequently, issue reassuring press releases, while actually doing very little. The danger, I maintain, is complacency. Because Japan appears to have more or less muddled through over the last decade, many people assume that either the situation is under control or that it is only a matter of time before the economy rebounds. This is the psychological trap, because the consequences of economic implosion - like a high-tech version of Argentina - are too appalling for most Japanese to contemplate. The country has reached a crisis point because a succession of governments have procrastinated on real reform, preferring to prop up a deteriorating economy with pork barrel budgets, which have piled up debt to third-world proportions. According to official estimates, which few believe, Japan's government debt remains at 130 percent of GDP. This would be bad enough but the reality is certainly much worse. As for Japan's banking sector, bad debts are piling up faster than they can be written off. According to sources at the G-7 meeting on 9th and 10th February, Japanese banks hold an estimated 151 trillion yen ($1.13 trillion) in loans that are not being repaid, although only a quarter of these were officially categorised as bad debts, as of 30th September 2001. No wonder people are beginning to ask if Japan is a gigantic Enron. Technically bankrupt, the lending institutions cannot meet capital adequacy requirements. The Government may provide over 10 trillion yen ($74 billion) to the nation's banks and require them to cut support to their weakest borrowers by next September, according to the business daily, Nihon Keizai. Or it may not, as Koizumi suggested on 13th February. Shiokawa recently said he plans to provide 2 trillion yen of public funds to buy stocks owned by banks, or he might not, because Japanese officials float numerous ideas but actually do very little. The illusion is of being in control, but reading between the lines, they apparently lack the confidence, will and/or political clout to do much, at least until another crisis erupts. The latest concerns Japan's banks, which will have to be bailed out for an unprecedented third time in four years. While governments often have to bail out their banks during recessions, inevitably at a cost to the taxpayer, in the developed world they usually have a clear plan for economic recovery. Unfortunately, this is not the case in Japan. Koizumi says he will do whatever is necessary, but not much happens. Shiokawa, who by his own admission knows little about financial matters, contradicts himself more often than not. Worst of all, Hayami has not done enough to boost money supply. Although this has edged back up to 3.6 percent (M2+CD), it remains much too low to stimulate growth in the current deflationary environment. Hayami often says that he has done enough and apparently believes that the US recovery will revive

Japan's economy. He's dreaming. Meanwhile, 1,543 companies failed in January - a 10.6 percent jump from a year earlier, owing 1.43 trillion yen ($10.8 billion), according to Tokyo Shoko Research Ltd. The problem, as we all know, is a destructive deflation, defined as falling output, prices and profits. In 2001 Japanese consumer prices had their biggest decline for 30 years, property values are still falling, the economy contracting and corporate bankruptcies set a post-WW2 record. The US Government is so concerned about the implications of Japan's current and potentially long-term decline, from both an economic and regional security perspective, that a stream of senior officials has visited the country in recent weeks, including President Bush on 17th February. However there is little that the US can actually do, other than inquire, encourage reform and provide advice if requested. With Japan's economy facing the abyss, its Economic and Fiscal Policy Council has belatedly issued a report titled, "Issues on Deflation". Apparently, it offers no fresh policies to tackle deflation and merely repeats what we already know - the BoJ should ease monetary policy further and work closely with the government to clear the mountain of bad loans at banks.

Nothing really improves in Japan until the BoJ halts deflation. It's no secret that net deflation or inflation over a lengthy period for an economy only occurs if monetary policy is mismanaged. BoJ Governor Hayami is responsible for Japan's ongoing deflationary crisis, as I've long maintained. Once a deflationary psychology takes hold, a zero interest rate strategy is no more effective than "pushing on a piece of string", as Keynes first observed. An expansionary fiscal policy by central government offers some cushion, as we have seen in Japan over the last decade, but at the cost of a rising budget deficit. A weaker currency helps temporarily, but does not solve the underlying problem. Moreover Japan is probably beyond the point where conventional measures can reverse economic decline anytime soon, because several years of strong GDP growth are required to reduce government and corporate debt to manageable levels. It is not easy to pull out of a deflationary spiral, as Japan has discovered. The sane way out of this crisis, I maintain, is inflation targeting and radical reflation by the BoJ. This means printing money aggressively. I believe Japan could begin to reverse its economic decline within a year, by printing money and using it to purchase Japanese property and shares, until prices are clearly appreciating. Once Japanese citizens see an end to equity and real estate deflation, confidence will improve, unleashing public savings and jumpstarting the economy. The transformation from non-performing 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 the Government's Recovery Portfolio to pay back some of its burgeoning debt. Once the economy rebounds, if the necessary and obvious restructuring followed, Japan could enjoy a lengthy recovery. Will Hayami reflate sufficiently to check deflation? I certainly hope so, but there is scant evidence to date. However he eventually bows to pressure, as we have seen with the increased purchase of JGBs announced on 28th February. Meanwhile, Shiokawa has been talking about buying shares from the banks. This idea has been floated before in Japan and actual implementation could only help, if it is part of a major reflation.

I would really like to say something nice about Euroland's economic outlook but it isn't easy. Europe remains a great place to visit but too often a lousy place to do business. For many Europeans, the trade-off is a very acceptable 'cradle to grave' welfare net, world-class health service and trains that generally run on time. I understand European priorities, which are usually established through the democratic process. However the conundrum for Socialism is that it causes people to believe less in themselves and more in the state, which can seldom fulfil expectations because it is a big, unwieldy and often foolish bureaucracy. The ever-present embarrassment for Socialist governments is unemployment, which leads to daft policies such as France's 35-hour week, phoney job creation schemes and laws that deter real employment because it is so difficult to shed labour no longer required. The latest 'stupidity watch' incident is a ruling by a French court that McDonald's has to take back two staff it fired for theft, even though the company is suing them for E172,140 allegedly stolen. Since this sort of attitude can only reduce the number of jobs available, no wonder French unemployment is approaching 9 percent. It is even higher in Germany, where Chancellor Schroeder's Government has made union works councils more powerful, increased protection for workers against dismissal and forced companies to allow staff to work part-time. Germany is sliding in Japan's economic direction, albeit without the prior bubble, because the government opposes market solutions. The latest example is political pressure on the banks to prop-up KirchHolding GMbH, the media giant ailing due to E5.7 billion in debts. It will be interesting to see if voters opt for more of this nonsense from the French and German governments in this year's elections, or elect candidates favouring more market-oriented policies. Meanwhile the US engine of growth may not pull Euroland out of economic contraction as many hope. Demand from America's consumers may hold up but there will be less tourism due to 9/11 and perceptions of anti-Americanism following criticism of the Bush Administration by some of Europe's politicians. Moreover, US corporate spending will remain considerably weaker than in the late 1990s, defence industries excepted. However, the military build-up will favour high-tech industries in Taiwan and South Korea, rather than capital goods from

Europe. In the UK, New Labour continues to raise taxes, which increasingly resemble the European economic model rather than that of the US, thus undermining a key element of Margaret Thatcher's successful revolution. According to a recent article by the economist Keith Marsden, published in the Wall Street Journal Europe on 13th February, UK taxes have increased £105 billion since 1996, the last full year of Tory Government. As a percentage of GDP, taxes under New Labour over five years have averaged 37 percent, compared with 34.8 percent during the last five Tory years. We can be certain of another large tax hike in the upcoming budget, to finance an intended overhaul of the duff rail system and to pour more money into an inefficient National Health Service. The trade-off, as we always see with significantly higher taxes, is likely to be a decline in the UK's long-term growth rate.

Monetary and fiscal reflation leave the US temporarily buffered from domestic and international problems. Greenspan's monetary stimulus has been massive and sufficiently early to ensure one of the shallowest recessions in US history. Bush's Administration has piled in with tax cuts, subsidies and welfare support (the 'butter'), and a massive increase in military spending (the 'guns'). These measures can only boost the US economy, which I maintain will grow by at least 2 to 3 percent in 2002. With energy prices moderate, the environment could only be more stimulative if US long-term interest rates were lower and every other country's economy less weak. That's the good news. Looking further ahead, for the US to embark on another major, sustained expansion such as we saw in the 1990s, it will first have to successfully negotiate its way through a mine field of domestic and international problems. The US economy is overly dependent on the consumer, currently running high debt levels. As short-term interest rates start to rise, probably before yearend, the credit card bills will feel considerably more expensive, causing households to retrench somewhat. Capital spending is likely to remain the US economy's soft spot for some time. The worst excess of the 1990s was the leveraging up of corporate balance sheets with debt, in the naïve belief that there would be no economic downturn. Enron has shown us that for some companies, debt levels are even higher than generally believed due to off-balance sheet items. It will take years to pare back this burden, which is weighing on corporate profits and therefore GDP growth. There will be no booming stock market enabling companies to switch rapidly from debt to equity financing, partly because higher share prices will invite far more secondary offerings than we saw in the 1990s. On the international front, there is no other economic engine of consequence to boost demand for US products. Instead, Japan remains the greatest threat to a global economic recovery, and it may yet export deflation. Europe's growth is likely to remain sluggish, due to over regulation, high taxation, the lack of fiscal and monetary policy harmonisation, the ECB's inflexible mandate and the one-shoe-fits-all monetary policy. In conclusion, the US economy is likely to do best among the majors, but we should not expect too much, beyond this year's rebound.

And Finally…

Another Enron movie, as art imitates life - Guess what? Action hero Arnold Schwarzenegger is producing and starring in a new thriller based loosely on 9/11 *and* Enron. Since you may just be able to resist paying to see this film, I'll reveal the dramatic ending. Kenneth Lay, Jeffrey Skilling and Andrew Fastow are running amok in Houston (although you never see them together). The city is in flames. Suddenly, at his moment of evil triumph, Skilling rips off his plastic face - and guess what? It's Osama bin Laden! Cut to another part of Houston and scam artist Fastow pulls off his plastic face. Unbelievably, it's Osama again! Then Lay does the same. You guessed it - the evil one, having escaped from Afghanistan in an off-balance sheet oil barrel, has been Enron's top three executives all along. OK, it stretches credulity a bit but go with the flow. This is an action film. So where's Schwarzenegger you ask? Well, he starts out as an all-American chemistry teacher and football coach at the local high school, who has tragically lost his family in the mêlée. Cutting to the chase, good gal and Enron whistle-blower, the fulsomely proportioned Sherron Watkins, nabs Osama during his moment of gloat. Sherron yanks off her plastic face, and it's really Arnie! I smell Oscars, all the way to the bank.

The Chart Seminar 2002 - Initial returns confirm we will have an international group of delegates at the London venue on 2nd and 3rd May, including some Fullermoney subscribers. This ensures a wide-ranging review of the markets during my workshop featuring Behavioural Technical Analysis. Come along to learn, contribute, enjoy and profit.

Global Markets - Prospects for 2002 - I'll be a speaker at this Society of Investment Professionals and Society of Technical Analysts joint discussion on 5th March 2002, 17:45pm start, at the offices of Daiwa SB Investments, 5 King William Street, London EC4N 7JA. There is a £20 charge for non-members and limited seating. All enquiries to uksipstaff@uksip.org, tel: 020 7796 3000, fax: 020 7796 3333.

The target date for FM214 is the week of 25th March.

"The greatest deception men suffer is from their own opinions."

Leonardo da Vinci

Best regards - David Fuller

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