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In its 19th year

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

Risks for stock markets in the short to medium-term are on the upside. Over the longer term they remain on the downside. Government bond yields have bottomed for at least the near term. The US dollar is in a temporary recovery phase against the euro. Gold is consolidating within a secular recovery.

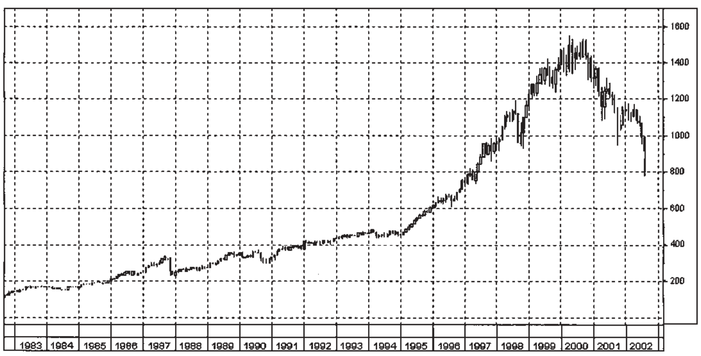
Stock markets are staging a medium-term recovery before the post bubble bear market eventually resumes.

Is the Nikkei's ranging decline commencing in 1990 a road map for the S&P 500 Index? In general, I take historic comparisons with a grain of salt. Cycles seldom repeat precisely, especially when comparing different eras, economic fundamentals and participants. Nevertheless there is a recurring behavioural pattern because each generation of humanoids is subject to the same phases of fear and greed. Crowd psychology leads to a repetition of trend phenomena - from short to long term. The monitoring and analysis of market sentiment, revealed on charts, is the bedrock of technical analysis.

Today, for perspective in context, look at earlier post bubble environments rather than data during the super-cycle bull market which ended in 2000. The biggest mistake investors make is to expect or hope for a repetition of market action seen within the previous cycle, even after that cycle has clearly ended. Consequently comparisons such as, "this is the best value since the early to mid-1990s", are likely to be misleading, since there is scant reason why that slice of market history should repeat itself over the next few years. Instead, we should look at what markets have done following earlier super-cycle

Japan's Nikkei 225: 9620 (Monthly)

US's S&P 500: 940 (Monthly)



bull markets. While there will inevitably be fundamental differences, the prevailing psychology will be similar, and few of us would underrate the importance of sentiment in driving markets. In FM214 (27/03/02) I included a chart of the DJIA from 1966 to 1983, spanning the end of one super-cycle bull market and the beginning of another. Basically, the DJIA ranged for seventeen years beneath a ceiling just over 1000, experiencing five bearish phases, of which the most severe was 1973/74 - *see Archives on www.fullermoney.com.*

Bubble scandals may make Japan post 1989 a better guide for the US market than the 1966 to 1983 period for Wall Street. Earlier in the year, when looking at the two post super-cycle bull markets in the US during the last century, I felt that what followed 1966 was more relevant than post 1929. I haven't changed my mind, and although we have many of the preconditions for an economic depression, I do not expect the monetary blunders of the 1930s to be repeated. Technically, 1966 also seemed the more apt comparison because the main bubble was in TMT shares and many old economy small capitalisation companies traded on historically low multiples and high yields as the NASDAQ peaked in March 2000. However vastly greater financial scandals have been revealed in the post 2000 period than we saw in the late 1960s - specifically the unholy alliance involving senior corporate management, investment bankers and auditors. This is reminiscent of Japan following 1989, when a stream of CEOs and senior government officials resigned in disgrace following the disclosure of financial scandals.

The S&P 500 Index's long bull run to the peak in 2000 is remarkably similar to Japan's bubble cycle ending in 1989. The two monthly candlestick charts cover S&P and Nikkei data from late 1982. Consequently one does not see most of the long, ranging advance that preceded the Nikkei's bubble years. However it was very similar to what you can see for the S&P. Interestingly, both of these gradually rising platforms launched remarkably similar bubble phases, spanning just under six years. Look at the Nikkei's 1984 to yearend 1989 advance, taking it from 10000 to almost 39000. The S&P's identikit move in time occurred between 1995 and early 2000, also resulting in an almost fourfold increase from just above 400 to nearly 1600. Following their respective peaks, the Nikkei nearly halved in under a year. The S&P has fallen more slowly, registering a 50 percent decline in a little over two years. After falling to 20000, the Nikkei recouped just over a third of the decline, rallying 35 percent in six months. The S&P's recent decline beneath 800 established preconditions for a medium-term rally. A similar gain by the S&P from its low at 775 would take it to 1050, where plenty of chart resistance is evident - *see Global Stock Markets, page 3, for more on this rebound.*

Will the S&P still be testing reversion lows more than twelve years after its peak, as is the Nikkei? Hopefully not, because I do not expect the Federal Reserve to repeat the Bank of Japan's monetary blunders. However post super-cycle reversion to the eventual bear market low has always been a lengthy process, taking eight years following the 1966 peak. The DJIA post 1966 and the Nikkei post 1989, plus the valuations eventually reached, and the accompanying psychology are a better guide to what Wall Street and most other stock markets under its influence will do during the next decade or more, than valuation comparisons with the early 1990s. Behaviourally, everyone who could participate was involved in the last big bull market in Japan and the US. They thought it would go on forever. In 1974 many US and European private investors said, "I'll never trust the stock market again". Japanese investors have shunned their stock market in recent years. Meanwhile, periodic rallies delay the capitulation process, which I believe will eventually create outstanding value.

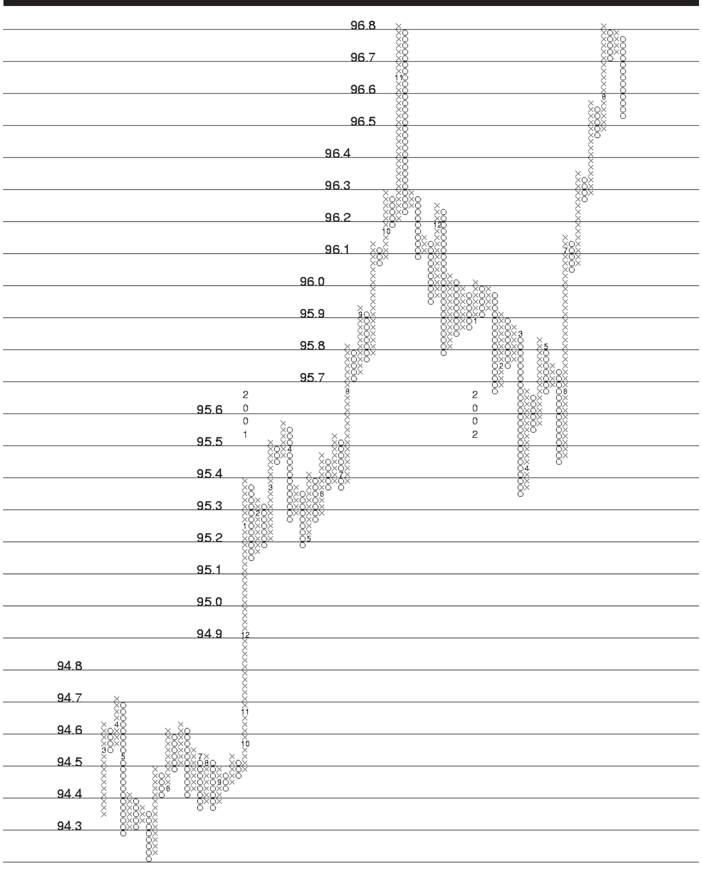
Interest Rates and Bonds

- **Central banks will be less inclined to lower interest rates while stock markets rally.**

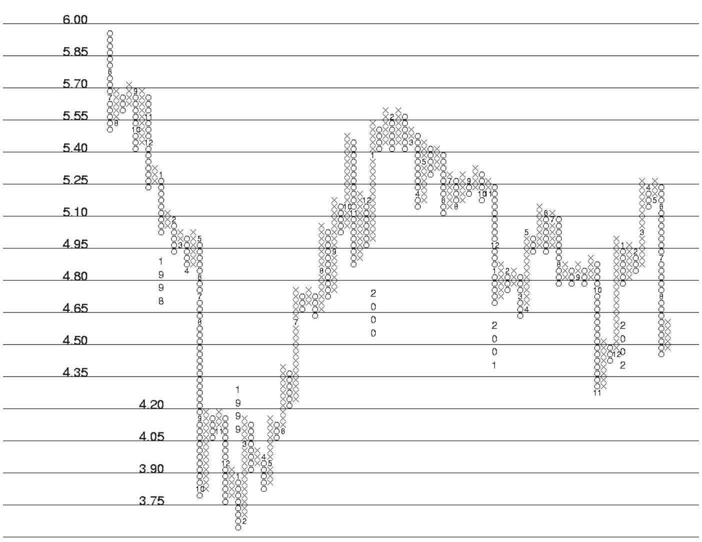
- **Government bond rallies are overextended and losing momentum.**

Freefalling stock markets put the CBs under pressure to lower rates, and they would have almost certainly done so had the declines continued. However, with most share indices now rallying, the urgency has gone and they are likely to wait for more economic data. After all, they were preparing to hike rates only a few months ago. If stock markets stage a major rally over the next three to six months, the pendulum of expectations regarding rates will swing back in favour of increases. Conversely, new lows by leading US and European share indices would increase fears

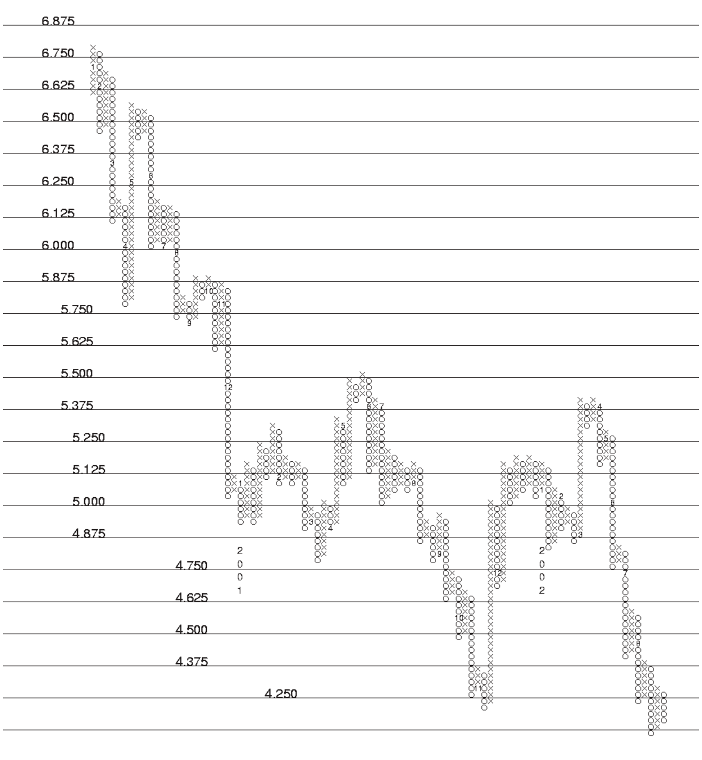
Euribor 3 Month LIFFE March 2003 (0.02)



Euro-bund 10 Year Bond Yield (0.03)



US 10 Year Bond Yield (0.025)



of a deflationary recession, leading to rate cuts.

The 3-month Euribor (LIFFE Mar) has fallen back from its November 2001 peak. This is representative of other European and also US short-term government rates. Peaks of at least near-term significance have been established. These markets will most likely continue to take their cue from stock markets over the next few months. US 10-year Treasury Bond yields look similarly overextended after falling marginally beneath their October 1998 and November 2001 lows. While some steadying is now likely, a sharp rally is required to reaffirm strong support near the former lows. The yield for 10-year Euro-bunds has steadied after a sharp fall but remains above its 2001 low and significantly higher than the 1998/99 floor. Some additional near-term firming is likely here as well. Over the longer term, bond yields will obviously reflect sentiment regarding growth versus recession and deflation versus inflation. Recent lows have partially discounted deflationary concerns, which may or may not materialise beyond what we have already seen. It is too soon to make the macro call, at least for me.

Strategy for bonds - Having strongly favoured bonds over equities in recent months, I specified a strategy change in FMP186 (15/08/02). This was to take profits by shifting from comparatively low-yielding government issues - from short-term to 30-year treasuries - in favour of higher-yielding, quality corporate issues, preferably triple-A. A more conservative choice would be to stay in cash. High-yielding lower rated bonds should rally somewhat in line with stock markets but these are much more risky, particularly in the current environment of record corporate defaults. In futures trading, I would be completely out of longs and lightly short for a trade. From a conservative perspective, I would probably stay with the US-listed closed-end (investment trust) Munienhanced Fund Inc (Bloomberg code MEN US), which has a portfolio of investment-grade municipal obligations. This may ease a little in the short-term as the stock market rally progresses but the long-term chart for Munienhanced Fund Inc looks attractive.

Global Stock Markets

- **A medium-term recovery is underway for most stock markets, which will probably be slower than the rebound from 21st September's lows but could last somewhat longer.**

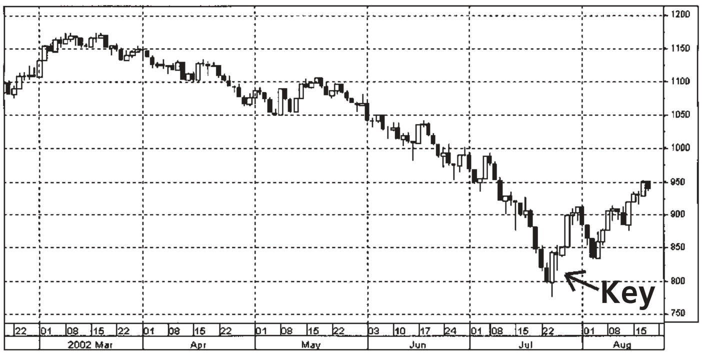
- **Market implications of a probable move by the US to replace Saddam Hussein's regime in Iraq with a democracy.**

- **While the short-term trend is upwards, I do not believe we have seen the final lows during what I maintain is a lengthy reversion to the mean and beyond.**

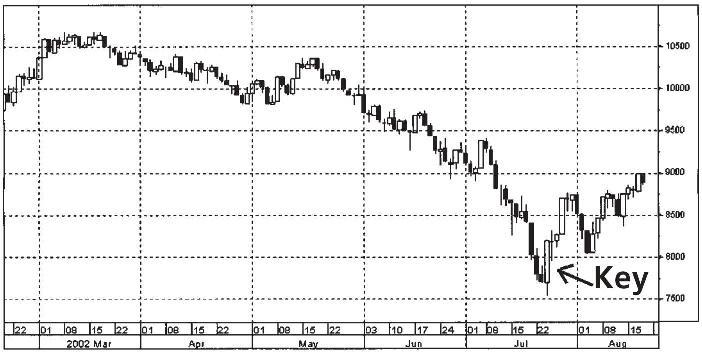
- **Inevitably there is more value in the markets following big declines but is a comparison with the last ten years the relevant benchmark?**

Markets were more oversold in late July than shortly after 9/11. The CBOE OEX Volatility Index, known as VIX, has been a good indicator of selling climaxes. It rallied to 56.74 on 24th July, a level not seen since 21st September and before that, October 1998, when markets rebounded on rate cuts following the Long-Term Capital Management collapse and Russian debt default. The US mutual fund industry experienced record outflows last month (July). Price charts accelerated downwards, with the S&P 500 Index falling exactly 50 percent from its all-time peak at 1552.87 on 24th March 2000 to its recent low of 775.68 on 26th July. Needless to say, the financial press was uniformly grim. Both the S&P 500 Index and Dow Jones Industrial Average bottomed with dynamic running key day reversals - the most important ending signal taught at The Chart Seminar. A partial retracement following the initial bounce established a

US's S&P 500: 940 (Daily)



US's DJIA: 8925 (Daily)



higher low on the index charts. Government bond indices plunged during a panicky flight to quality. All the above provides compelling technical evidence of a medium-term floor. I believe US and European indices, at least, have seen their lows for the year. Initially, the rebound may be slower and more rangy than what we saw post 21st September, due to investors' fears, but it should last at least three to six months. I expect the primary downtrends to be tested. European indices should track Wall Street, with some outperforming, just as they did on the downside. The correlation with Asian indices is much looser, but Wall Street's influence will lend support. If I'm wrong, particularly concerning US and European stock market indices, the first clear evidence would be breaches of the early-August lows.

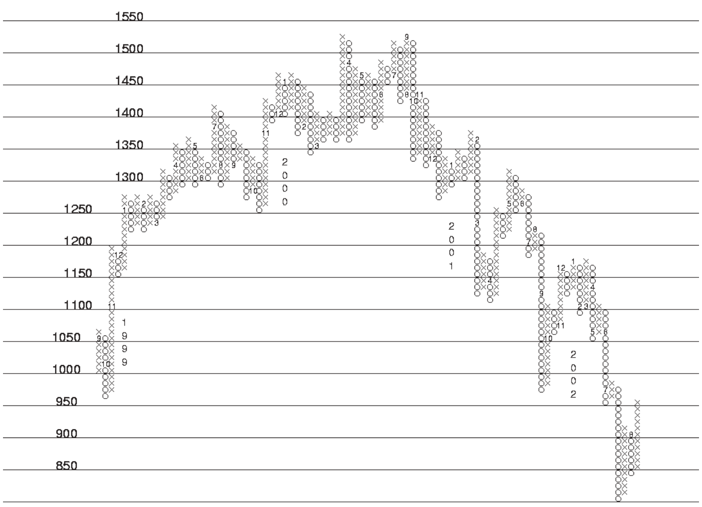
I assume the Bush Administration will remove Saddam Hussein from power. I have no information on this subject other than what I read but I assume that George W Bush is resolute in his war against terrorism, including pre-emptive action. We know many people have considerable reservations concerning military action against Iraq, especially in Europe. This will add to the uncertainty, which markets abhor. However, since a strike against Saddam is widely expected, it has been partially discounted by stock markets. I have no idea what type of attack Bush will launch. While this is being debated by the Administration, the President and his advisors will not have abandoned hope that Saddam is somehow overthrown, albeit recognising that this is a remote possibility. Meanwhile, their rhetoric is likely to have some restraining influence on Saddam and his weapons procurement programmes. Stock markets would be least affected by a successful surgical strike against Saddam. The most worrying scenario would be the more conventional build up for a large invasion. Armchair military strategists are already talking about the price of oil spiking above $40, financial market turmoil, a chemical warfare counteroffensive by Iraq, attacks on Israel and oil installations, and a protracted door-to-door conflict in Baghdad. While theoretically possible, these are worst-case scenarios. It is much more likely that Saddam is quickly removed or isolated, with his military showing more interest in the succession programme than a death struggle against US forces. On past evidence, markets would rally sharply on the first indication of military success by US forces, in direct proportion to whatever prior sell off had occurred. Moreover, the US's objective is not just to remove Saddam with minimal damage to Iraq's civilian population and infrastructure, but to replace his regime with a functioning democracy - *see "Washington Anoints Saddam's Opposition", by Wall Street Journal Editor Robert Bartley, available on 'Comment of the Day' for 13th August 2002, on www.fullermoney.com.* Needless to say, this would have profoundly positive implications for the Middle East and the war against terrorism.

You don't hear much about reversion to the mean from the investment industry. As subscribers know, I've been talking about a reversion to the historic mean by equity valuations, including an overshoot, for many months, both in these pages and on my website - www.fullermoney.com. I keep repeating the message because it is extremely important to know where we are in the big cycle, assuming there is an historic sequence, sufficiently consistent to represent a recurring pattern, and therefore be of considerable analytical significance. I believe the evidence is compelling. Wall Street's super-cycle bull markets last approximately a generation, with the bubble phase occurring in the final few years. Over the previous century these include the post World War 1 advance ending in 1929, 1948 to 1966 and 1983 to 2000. Due to the US market's influence, few other stock exchanges have uncoupled for very long. Bear markets of severity in proportion to the prior excesses inevitably follow, with the low (reversion overshoot) occurring a number of years after the bubble peak. Reversion is not a rapid process, as many would wish, because investors previously conditioned by the prior bull market keep hoping and therefore positioning themselves for its return. The eventual low is reached in a final wave of capitulation, during which people abandon expectations for a market recovery, and a partial rebound and lengthy convalescence follows. It takes approximately another generation - 1929 to 1948, 1966 to 1983 and for Japan, 1989 and counting - before another super-cycle bull market commences. Despite this history and compelling evidence that a super-cycle bull market bubble burst in March 2000, subsequently revealing innumerable excesses and scandals, we seldom hear about reversion to the mean due to behavioural reasons. For many financial industry professionals, being on the wrong side of a reversion is too alarming a prospect to contemplate, let along publicise. I sympathise because many of these people are wondering if they will have jobs, or experience a salary decline to the level of genteel poverty that independent analysts such as myself have always known. Far better, emotionally, to debunk a reversion to the mean hypothesis, especially as there is no guarantee that it will occur. People hope that "it's different this time". In any event, the market is cheaper than it was so analysts and investment managers are beginning to talk about "the best value for many years".

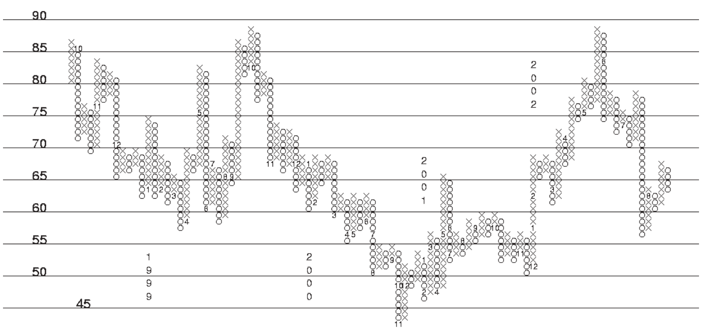
During a reversion to the mean, markets eventually reach exceptional valuations. Stock markets are a lot cheaper today than they were two-and-a-half years ago. Consequently research reports are beginning to emerge from brokers, pointing out that valuations have fallen back to levels not seen since the early 1990s. My website "Comment of the Day" for 15th August quoted The Independent's Hamish McRae's article on a bullish HSBC circular, concerning the UK market. So should we get excited? Only for a technical rebound, in my view, which will reward clever traders but ultimately prove a rally to sell into. At bottom line, I do not consider valuation comparisons with middle or pre-bubble stages of the last super-cycle bull market to be the appropriate benchmarks during a mean reversion. They provided the launch pad for the last super-cycle bull market's bubble phase, which is not likely to be repeated for over a generation. As evidence of value, HSBC's report mentioned that 30 percent of FTSE stocks yield more than gilts and 20 percent of the market is on a price to book ration of less than one. That's not bad but in a post super-cycle bull market reversion to the historic mean for valuations, which have always included a massive downside overshoot, most FTSE stocks, not just 30 percent, should yield more than Gilts. I would also expect far more than 20 percent of the market to trade on a price to book ratio of less than one. HSBC's prospective P/E for the FTSE 100 Index of between 12 and 13 sounded like Rosie Scenario to me. While I still harbour a suspicion that 3Q and 4Q 2002 earnings could contain some pleasant surprises, primarily because of all the write-offs in the second half of 2001, I do not believe they would be sustainable. Consider four items, in addition to disappointing growth - option expensing, hopefully an end to proforma earnings and off-balance sheet debt, and pension underfunding. No broker will site 1974 ratios as a benchmark, although that was the trough during the last reversion to and beyond the mean following an earlier super-cycle bull market, which all but ended in 1966. I just checked with my friend, subscriber and fellow scribe Peter Bennett - peter.bennett@jmfinn.com. He said that in December 1974 the UK's FT30 Share Index briefly traded at a dividend yield of 11 percent and a trailing P/E of 3.8. I certainly hope we don't return to those levels but I would not be surprised if we eventually got halfway there.

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.*

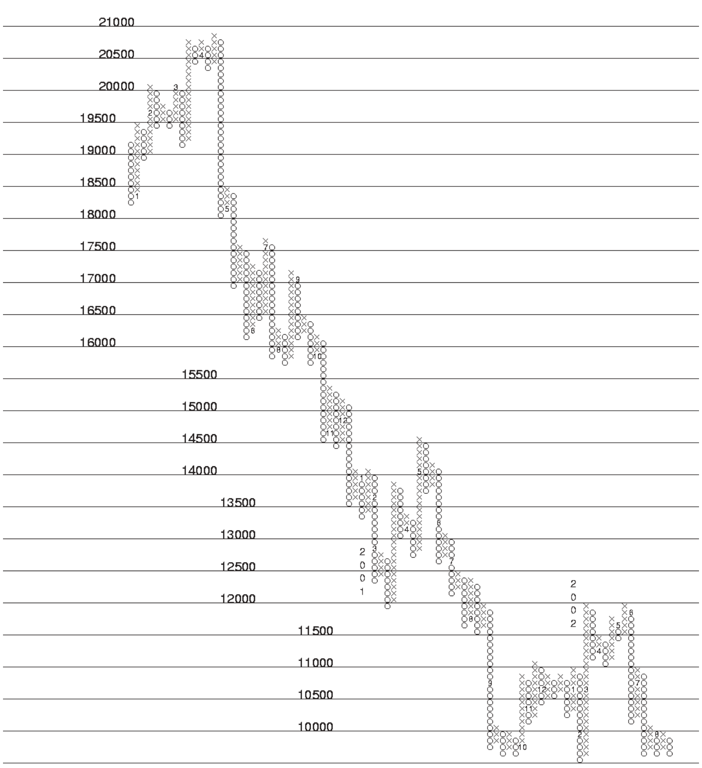
S & P 500 Composite Index (10pt)



Philadelphia Gold & Silver Index (1pt)

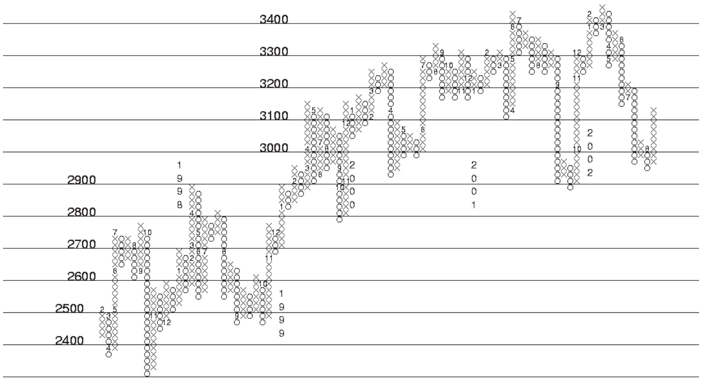


Nikkei 225 Stock Average Index (100pt)

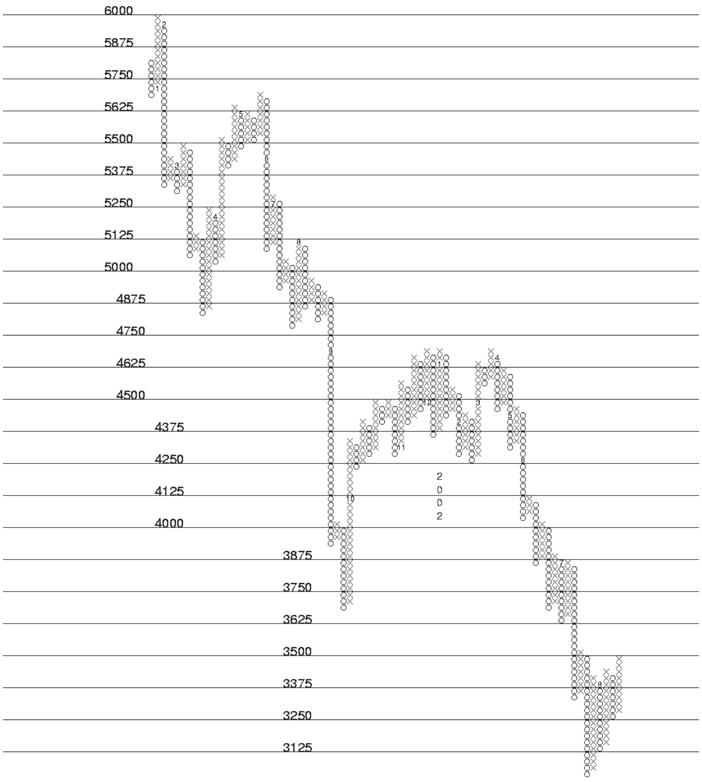


The US's S&P 500 Composite Index (945) accelerated to a low near 800, in a move that was even more extreme than the May to September 2001 decline. Consequently it should move into overhead resistance commencing at 950, perhaps testing the overall downtrend. A close at 830 is required to challenge this hypothesis. **The Philadelphia Gold & Silver Index (62)** accelerated lower before encountering support in the lower region of its large, ranging base formation of

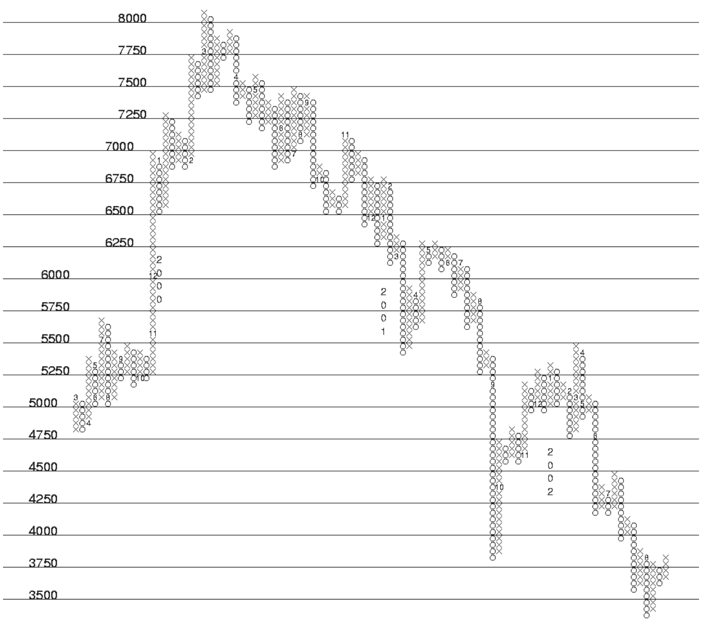
Australia All Ordinary Index (20pt)



France Cac 40 Index (25pt)



German DAX Index (50pt)



almost 5 years duration. While this former support should continue to cushion downside risk, some further ranging may be necessary before another test of the upper boundary can be sustained.

Japan's Nikkei Stock Average (9599) - *see previous page* - is barely steady in a test of its lows near 9500, dating back to September 2001. Although it has shown strength relative to the US and European markets in holding above this level, and the global environment is currently favourable, a move back above 10000 is required to signal a recovery phase.

Australia's All Ordinaries Index (3148) has been outstanding in overall relative strength, and support has now been encountered above the September low. Nevertheless, the overall pattern continues to look top heavy and resistance can be anticipated as the former highs are approached.

France's CAC 40 Index (3493) fell nearly all the way back to its September 1998 low before checking short-term downward momentum. A decline to 3200, which currently seems unlikely, is required to check current scope for an additional recovery, which should at least test initial resistance near 3700.

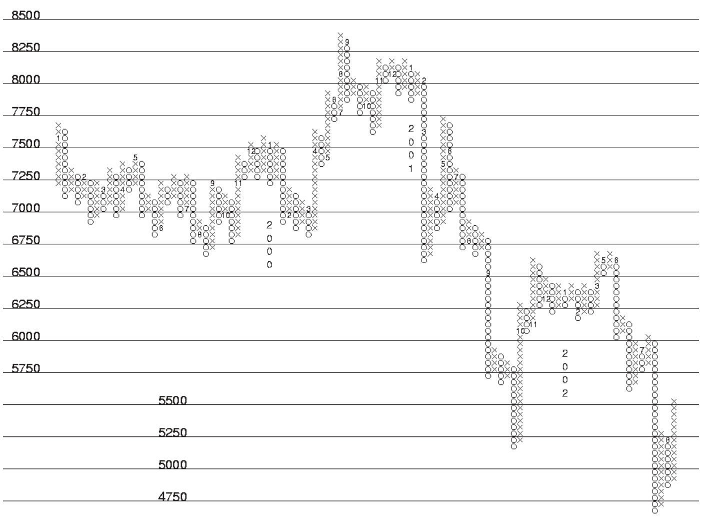
Germany's DAX Index (3838) fell to its lowest level since April 1997, before similarly checking downside momentum. It is already pushing above the September 2001 low and decline to 3550, which seems unlikely at present, is required to offset scope for an additional rally.

Switzerland's Swiss Market Index (5534) also slid to its lowest level since April 1997 before rebounding strongly. By not sustaining breaks of important previous lows in the 5250 to 5150 region (partially shown), it has indicated scope for a further recovery. However overhead supply is considerable, particularly above 6000, and likely to impede upward scope without a prior consolidation.

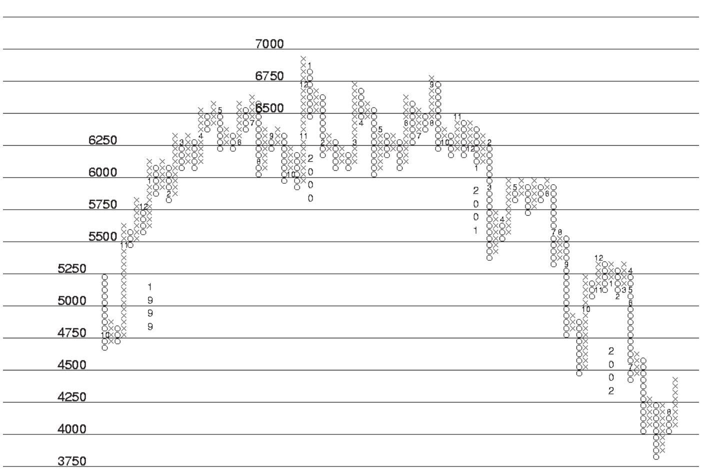
The UK's FTSE 100 Index (4426) fell back to levels not seen since 1996 before rebounding to test the underside of its September 2001 low. A move under 4200 is required to question scope for a push above that level, perhaps testing the overall downtrend in coming months.

Strategy for stock markets - Last month, when addressing the question, should one buy for a bounce? - given all the technical evidence of a deeply oversold condition - I wrote, only as a trade. Regarding should investors sell? - I said we should see a better selling opportunity before yearend. The rally to date has been significant on Wall Street and in European markets. Late July's climactic background and the subsequent technical action suggest this rally will carry higher. I would not be surprised to see recoveries of at least 30 percent for many indices, with a number of particularly oversold shares doing considerably better, as is the nature of markets. Overall, I believe this is a rally to sell into, although I'm not yet lightening in any of the few shares that I personally hold and have mentioned in this strategy section previously. I'll wait until we see overconfidence and

Swiss Market Index (50pt)



United Kingdom FTSE 100 Share Index (50pt)



waning momentum on the indices. Unless markets continue to climb very quickly, I do not expect this to be a serious risk until much later in the year, and the rally could last longer. During mean reversions, contra-trend recoveries can persist for a number of months, and on rare occasions, for a year or more. I continue to hold the gold shares previously mentioned but regard these as long-term hedge holdings. Also, my policy will always be to lighten on strong rallies because these stocks are among the most volatile. Gold shares may underperform over the next few months because bullion is undergoing a medium-term consolidation and investors are certainly not worried about inflation. Nevertheless, I believe gold remains a value play, a comparatively safe haven in uncertain times and that central banks' efforts to combat deflation over the next few years will eventually bring back inflation. The Japanese stock market is badly in need of a weaker yen, which it may get before long.

Currencies

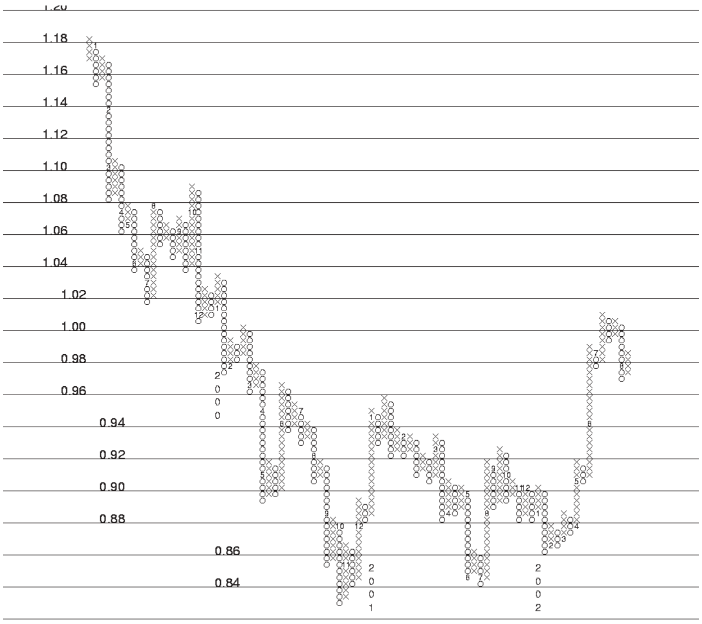
■ **The euro will see a further consolidation of gains before capital flows reluctantly support an additional recovery by the single currency.**

■ **Sure the dollar has problems, but so does the euro, not to mention the yen. Gold anyone?**

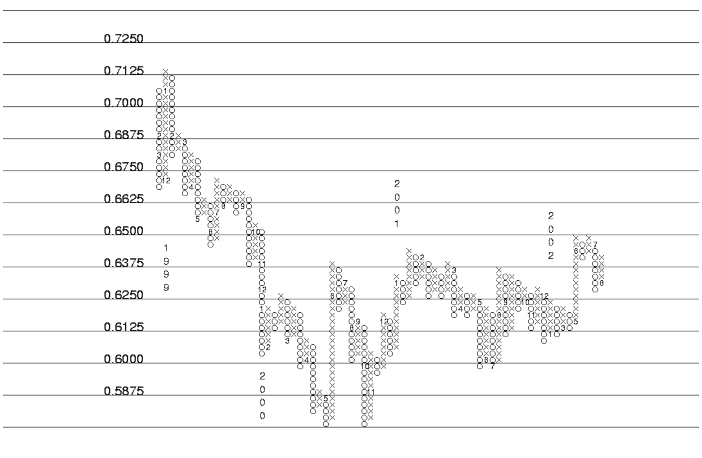
Sentiment continues to provide the best timing information for the euro and any other reserve currency. People talk their book; otherwise they would be schizophrenic, as I have said before. Remember when people last said the euro would fall to the $0.83 to $0.80 region against the dollar? It wasn't that long ago - January to March this year. With almost everyone short, the euro could only go up, completing its base. When it got above parity, the consensus was $1.15 to $1.20, possibly before yearend, signalling that most traders were long. Many still hold this view, so the euro remains susceptible to some further consolidation, probably taking it beneath the August low to date. However I doubt it will fall much below the $0.96 to $0.94 region during this consolidation, which looks like the first step above the base, as taught at The Chart Seminar. These patterns can take months to form. I maintain we will eventually see at least $1.10 to $1.15, but probably not until next year. A behavioural clue that the euro's correction was all but over would be a consensus that mid-base support was likely to be tested. Inevitably, euro sentiment will generally be the inverse mirror image of how people feel about the dollar. Having sold the dollar for five months, traders have created conditions for a further technical rally.

With currency fundamentals, it is more often an issue of what looks least bad, rather than what looks good. Understandably, people loved the dollar while it was going up and the US economy was receiving plaudits for banishing the business cycle. Needless to say this was before Wall Street and corporate America became textbook examples of moral drift. Once the dollar slipped from its pedestal, everyone rediscovered the current account deficit. A new sweetheart currency had to be found among the donkeys on offer. The yen remains an accident waiting to happen, given Japan's imminent slide back into recession, not to mention a gradual deflationary spiral. Neither the Swiss franc nor sterling is sufficiently liquid to be a home for the world's reserves. Also Switzerland and the UK cannot match Euroland and the US in terms of economic base. Consequently the euro is selected as the dollar's main alternative by default, even though it does feel like an arranged marriage with someone else's reject. If the Germans don't love the euro, why should anyone else? Few seasoned observers have any confidence in the ECB, let alone its duff mandate, which is a charter for slow growth and deflation. A single monetary policy for Euroland's diverse countries inevitably misfits nearly all. Nevertheless, central bank reserves have to be kept somewhere. With perhaps 70 percent still in the greenback, that's too high a proportion to be in anyone's long-term interests. Consequently a gradual rebalancing from dollars to euros should underpin the single currency in the mid-$0.90s region, helped by a further diversification by non-US investors away from their overweight position in US corporate bonds. The eventual cap on the euro's recovery will be weak growth in Euroland and regional talk of unwarranted currency strength. For the long term, the world needs at least two viable, liquid reserve currencies. If

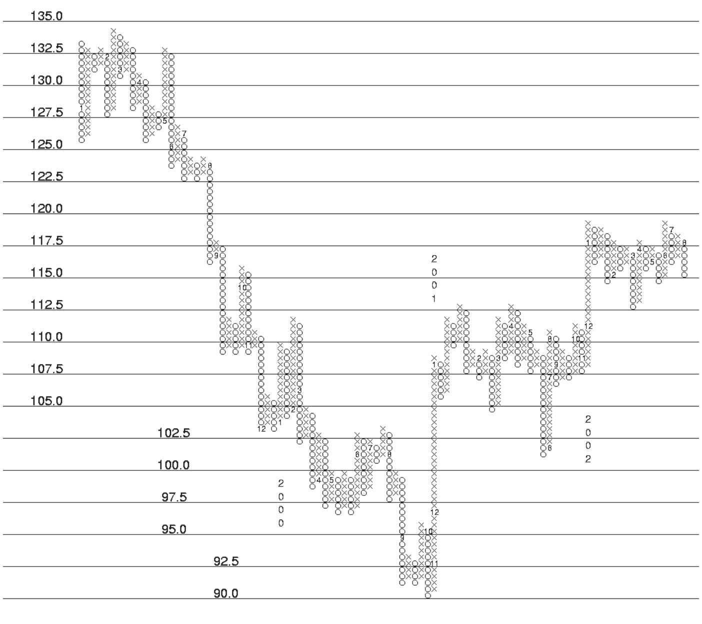
US Dollar per 1 Euro (0.004)



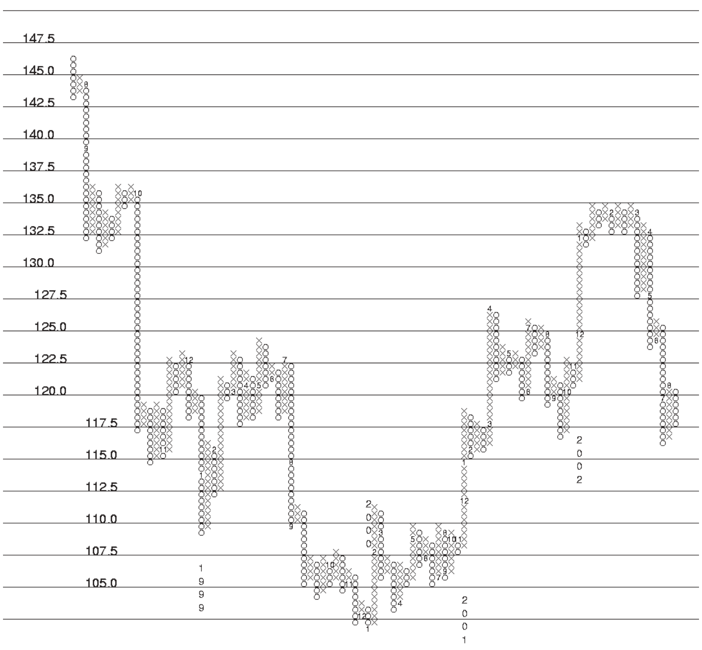
Pound Sterling per 1 Euro (0.0025)



Japanese Yen per 1 Euro (0.5)



Japanese Yen per 1 US Dollar (0.5)



people lose confidence in both the dollar and euro, we'll see it reflected by the price of gold.

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

Euro/dollar ($0.9786) - The euro has lost uptrend consistency and can therefore be expected to range for several more weeks and perhaps month, probably on either side of currently levels. Support from the upper to mid-region of the base should cushion downside risk during this phase, prior to a resumption of the recovery, signalled by a sustained break above the intra-day high near $1.02.

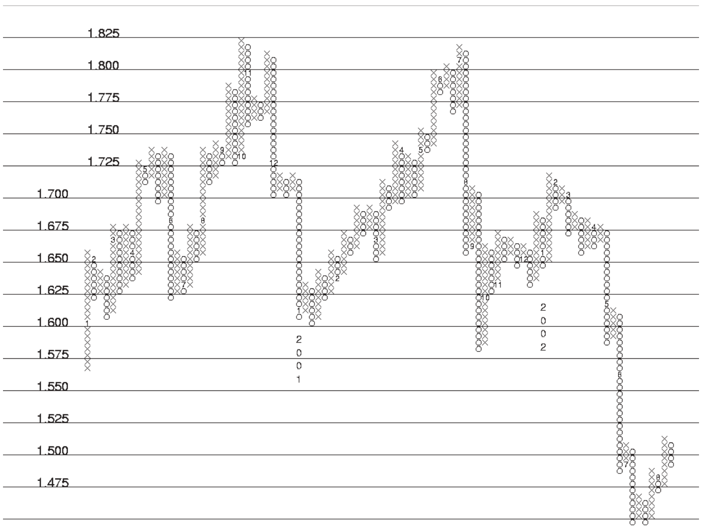
Euro/sterling (£0.6400) - The base breakout has not been maintained, indicating that further ranging will occur before the euro's recovery continues. This eventual upside potential would be negated only in the unlikely event of a break in the progression of higher reaction lows.

Euro/yen (¥116.12) - The euro remains rangebound in its first step above the base. A breach of the May low at ¥114.5 would indicate some further easing before the uptrend is resumed, the latter confirmed by a push over ¥120.

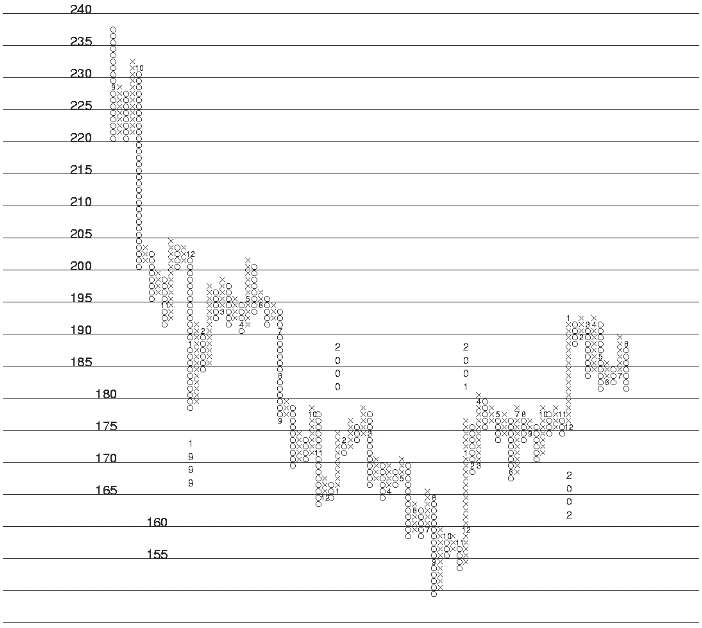
Dollar/yen (¥118.67) - The dollar looks oversold, has been finding support near its September low and appears to be building a small base near current levels on daily charts. A break in the progression of lower rally highs, requiring a close at ¥121 would reaffirm recovery scope.

Dollar/Swiss franc (SF1.5001) - A technical rally is underway for the dollar and this should range somewhat

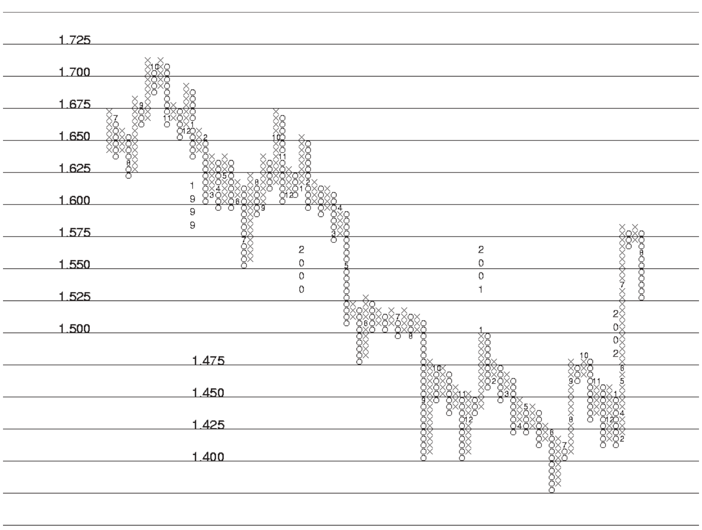
Swiss Franc per 1 US Dollar (0.005)



Japanese Yen per 1 Pound Sterling (1)



US Dollar per 1 Pound Sterling (0.005)



higher, given the extent of this year's earlier weakness and limited overhead supply beneath SF1.58.

Sterling/dollar ($1.5286) - The pound's surge during June and July has been checked and partially reversed by heavy overhead resistance. While it is too soon to say that this reaction is over, support commencing at $1.50 should cushion near-term downside risk.

Sterling/yen (¥181.38) - Sterling's rally within the current range to test its upper boundary in late July was soon reversed. While some steadying is occurring around lateral trading near ¥180, another rebound is required to reaffirm support in this area and the gradual overall uptrend.

Strategy for currencies - Roiling stock markets have unnerved people, curtailing activity elsewhere. This has led to a general unwinding of speculative positions, including currency trades. The environment will probably change during the next few months, possibly commencing in September as many traders return from holiday. However with a further recovery in euro/dollar probably a number of weeks or even months away, we should see further interest in the yen carry. The safest of these trades are probably in the higher yielding, viable currencies, notably Norwegian krone/yen, followed by Australian dollar/yen, and probably euro/yen over sterling yen because of its better overall chart pattern. Dollar/yen offers the lowest interest rate differential but could produce a bullish "surprise" due to its near-term overall rally potential. There is little doubt, at least in my mind, that Japan has a serious problem due to the yen's strength, which is certainly not justified by economic conditions, as a stream of financial officials in Tokyo continue to point out. They are also willing to intervene near current levels, which offers another cushion in addition to interest rate differentials. These two factors are more important, I believe, than the yen's continued firmness. However part of the near to medium-term problem for yen bears is Japan's very low money supply growth, currently languishing at 3.3 percent (M2+CD). The BoJ is expanding Japan's monetary base quite aggressively but it is all recycled through the banking system and back into JGBs, creating profits for Japan's lending institutions, although not enough to offset the continued rise in non-performing loans. Hayami is helping the banks, not trying to weaken the currency. The net effect is a shortage of yen actually in circulation. Consequently the yen's big decline is likely to occur post Hayami, as I have said before. He cannot be replaced before 20th March 2003. Nevertheless, the markets will probably anticipate the appointment of a genuine reflater, capable of making even Alan Greenspan blush. Tactically, I want to be there (short yen) but the position needs to be actively managed. If I short yen and use stops for whatever reason, I'm disappointed more often than not. What works is Baby Steps accumulation of whichever higher-yielding currency is temporarily easing against the yen, and offloading most of the position on rallies within trading ranges. Eventually, uptrends against the yen will resume and trend-running tactics will be appropriate once again. Meanwhile, I'm not holding my breath.

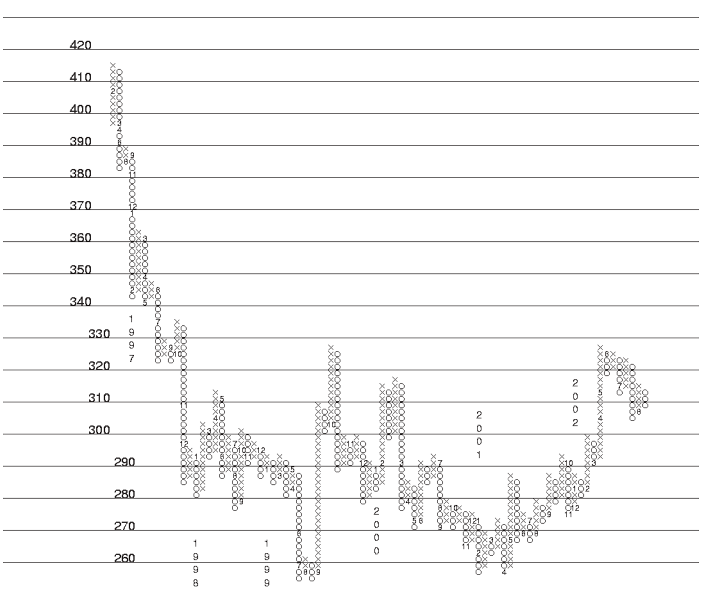
Commodities

■ **It may take a while before gold resumes its long-term cyclical recovery.**

■ **OPEC and stockpiling are pushing up the oil price.**

Gold is still consolidating earlier gains. We have seen a 10 percent reaction from the June High during this process to date, by no means an exceptional move. However both short-term activity and the considerably bigger pullback by gold shares suggests that this consolidation could persist for several more months. This process might just take gold a little lower for a brief period, but the large multiyear base should cushion downside risk. Gold remains a value play relative to financial assets and it is also a hedge against deflation. However, it is inflation fears that really fuel bullion rallies and the opposite anxiety has been expressed recently. On a macro view, continued deflationary pressures can only result in more counter measures by central banks. Eventually, every central bank always has and always will, I suspect, eventually pull the monetary levers and print money, because they fear deflation even more than inflation. They will fight the problem at hand - in this case deflation, to prevent it spiralling out of control. They will eventually encourage a little inflation, confident or at least hoping to prevent rising CPI and PPI problems from becoming a problem. The US Federal Reserve, wishing to stimulate the US economy to finance the war against terrorism, has been printing for some time. I suspect Japan will appoint an inflationist to replace BoJ Governor Hayami next March. There is every likelihood that the ECB's deflationist mandate will be reviewed as Euroland's economies generate little growth and unemployment rises. This should be very bullish for gold over the next decade.

London Spot Gold (2USD)



Crude Oil NYME 2nd Continuation (0.2USD)

Crude oil has pushed to a new high for the year. A decline below $26 (2nd month position NYME) is required to offset some further test of the 2000-2001 top area. The global economic environment is not conducive to higher oil prices, which are impeding GDP growth. However this is not a true free market because the OPEC cartel is maintaining production cuts. There has also been stockpiling, by the US Government to replenish its strategic reserves, and suppliers of refined petroleum products as a hedge against shortages in the event of a war against Iraq. Consequently upward pressure on prices is likely to be of short to medium-term duration, subject to US plans regarding Saddam's regime, which have yet to be finalised. Over the longer term, oil near $29 a barrel or higher is not sustainable, given global production capacity and slow economic growth.

The Global Economy

■ **With US GDP growth having slowed sharply in the second quarter, and looking none too robust currently, other economies are in trouble.**

■ **Global GDP growth will remain weaker than hoped, due to declining confidence, debt, deflationary pressures and high oil prices.**

■ **House prices will remain the biggest influence on consumer sentiment.**

The dependency syndrome is part of the problem. Globalisation is a very good thing, as everyone with a bit of socio-economic nous realises. It increases global GDP growth by facilitating trade, raises standards of living and lowers unemployment more often than not, reduces wealth disparity subject to standards of governance within countries, while facilitating mutual understanding and tolerance among people of different cultures. It enables more people to concentrate on what they do best, while fulfilling their additional economic requirements and aspirations through trade. Globalisation's critics are carping - just look at the quality of life in countries outside the free trade loop, usually due to tyrannical governments. There is no sensible alternative to globalisation, unless we believe that countries can prosper by isolating themselves from everyone else. Nevertheless, even some supporters of globalisation claim that it creates a synchronicity, meaning that we all sink or swim simultaneously. Why should this be, given the diversity of economic activities among countries and the ability of most to control their own monetary policy and fiscal spending? The answer is dependency, not due to coercion or hegemony, but by choice. Everyone wants to export to the US, and so they should, but not to the exclusion of a balanced economic approach. Today, European economic spokesmen say the region will be fine, so long as the US economy recovers. The Japanese declare the same, and so does just about everyone else. Consequently there is one economic engine - by default. This is not a healthy situation and the solution lies in the hands of those countries and economic blocks that choose to remain overly dependent on the US economy, rather than become engines of global growth.

Global GDP growth is likely to remain weaker than hoped for a considerable period. Consumer confidence is waning in the US and UK; it was never very strong in Europe during recent years and has remained subdued in Japan. Confidence is also starting to decline in the rest of Asia, following a rebound in line with regional stock markets after 9/11. It has seldom been lower in South America, where much of the continent remains in economic chaos. None of this is surprising given stock market weakness, corporate and consumer debt, rising unemployment and a general perception of crisis. The overall impression that we are in a very difficult and challenging period is reflected and reinforced daily in the press and media. In some respects, this is a cyclical/behavioural inverse mirror image of sentiment seen throughout much of the 1990s, particularly in the US and also the UK, the latter being inevitably influenced by trends across the Atlantic, given all the historic, cultural and economic ties. Sentiment will improve temporarily, in line with the next medium-term rally for stock markets, but the long-term proclivity will be for consumers in North America and Europe to spend less and save more, a trend that will accelerate if/when house prices succumb to deflationary pressures and/or higher interest rates.

Corporate and consumer debt reduction will inevitably curtail growth. The shaky edifice of the 1990s' prosperity was overly reliant on debt, particularly among corporations. This is now undergoing a dismantlement, which will continue for years. Balance sheet leverage - the big, self-serving fad of the bubble market - is always a two-edged sword, as I have said for years. The problems arise during an economic slowdown, let alone recession, as all now see. Few highly leveraged companies can grow their way out of debt in this environment, which becomes self-perpetuating. Only companies that are comparatively debt free will be able to raise capital through secondary offerings of shares, and only the best private firms will be able to go public. In the battle for survival, let alone a return to prosperity, companies will have to reduce debt by more draconian means - layoffs, closures and the sale of assets, often at fire-sale prices. Low nominal interest rates will not help, because it is the real (inflation adjusted) rate that counts, as we have long seen in Japan. While deflationary pressures and slow GDP growth persist, companies will have very little pricing power, further curtailing profits. They are cutting back on capital expenditure as a matter of financial necessity. For many firms, profit increases such as there are, will be achieved by downsizing. Among North American and European consumers, a loss of confidence due to the absence of a bull market for stocks, layoffs and particularly an eventual decline in house prices, will cause people to cut back on spending and increase savings. Debt reduction is a positive step and will eventually create the foundation for renewed prosperity, but it is a lengthy process. Governments will combat the slowdown by increased fiscal spending, creating ballooning budget deficits. Many will also print money. Over the very long term, the consequence will be higher inflation and interest rates.

Meanwhile, oil prices remain too high, curtailing GDP growth and compounding deflationary pressures. To stimulate growth, the world needs the price of oil to be under $20 a barrel (NYME). Above $25, it weakens growth in oil-importing countries, particularly among developing economies. Today, petroleum prices are much higher than justified by economic conditions, due to OPEC cutbacks and also stockpiling, especially by the US prior to ousting of Saddam Hussein's regime in Iraq. This has offset additional supplies from non-OPEC sources, creating a war premium. Many analysts fear a spike to $40 or more, as occurred just prior to the last Gulf war, when the US and its allies liberated Kuwait. While just possible, historic precedent suggests that any sharp increase from current levels would be short-lived, even if Saddam torched Iraq's installations, as his army did in Kuwait before fleeing. Moreover, an Iraq ruled by a democratic government friendly to the US and free of UN sanctions, could greatly increase production. This would weaken OPEC's cartel, leading to lower oil prices.

From Alan Greenspan onwards, everyone is hoping that house prices do not fall, but that would be

at odds with a deflationary environment. Property prices are such an emotive topic, especially in the current economic environment. You have probably seen a number of articles on this subject, and my overall impression is that most conclude by saying that we do not yet have a house price bubble, that price appreciation is logical and justifiable, but home owners and new buyers cannot expect the same percentage increases seen in recent years. Most warnings concern the 'buy to let' market. Have we heard any of this before, albeit in the equity context? I believe so, and suspect we can draw a behavioural conclusion. Only a small minority recognise, let alone exit a bubble market while it is still inflating, because it is very profitable while it lasts and the post-bubble scenario is too frightening to contemplate. Consequently most "experts" reassured us about tech stocks and generally high valuations, merely cautioning that double-digit returns might not be sustainable. It's easier to explain the risks of too much leverage, as we heard in the context of TMT shares in 2000 and 'buy to let' property today. I claim no expertise regarding real estate but as a student of financial history, including socio-economic trends, I think most people are in denial concerning property, just as they were with stocks. Rightly or wrongly, most analysts conclude that a deflationary environment will persist for a long time. If correct, this means that debt, including mortgages, will be a considerable problem. History shows us that deflations are all encompassing. Japan post 1990 is the most important recent example, and I believe Japanese property prices have generally mirrored the Nikkei, albeit peaking somewhat later. Low nominal interest rates are not a panacea in a deflationary environment, where real (inflation adjusted) rates are often high. Property in the US, UK and many other regions is by no measure an equivalent bubble to what occurred in Japan during the late 1980s. However that is not the point. As a lagging indicator, house prices in the West have appreciated significantly in recent years and are only just beginning to reflect the deflationary trends evident in all other markets. The only way I could envisage real estate prices avoiding the general downward pull would be if the global economy suddenly catapulted from a slow-growth, deflationary environment into a strong, sustained recovery and higher inflation. Even in this unlikely event, the prospect of higher real interest rates would cause some problems for people who have leveraged up in property. Meanwhile, if/when house prices fall back, this will have a significant impact on consumer spending.

And Finally…

I'll be away until Monday 2nd September - One can never have too much of a good thing so I am leaving on the 23rd for a little more cycling therapy but will be back in the office on 2nd September.

Tim Parker will be guest editor for the www.fullermoney.com "Comment of the Day" while I am away - I'm delighted with the increasing number of visits to this site, which is an additional service for subscribers, featuring the free "Comment of the Day". Some subscribers have been sending me articles or research reports for potential comment and inclusion on the site. These are greatly appreciated, in addition to your emails.

The earliest target date for FM220 is Friday 20th September.

> *"Everyone is born a genius, but the process of living degeniuses them."*
>
> *R Buckminster Fuller*

Best regards - David Fuller

From Pictureline in the Times

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