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

Global stock markets are oversold once again but uncertainty over Iraq, not to mention the economic and earnings problems, continue to weigh on equities. Bonds remain a much better investment than stocks, due to deflationary pressures. The Japanese yen is resuming its long-term downward trend.

Watch Japan - its performance is a roadmap for post super-cycle bull market reversions and the deflation quagmire.

We can learn from history - there is no mystery about what is occurring in US and European stock markets today. An increasing number of analysts, mainly from stockbrokers, are talking about "good value" at today's levels. Many investment managers agree with them. Bearish cynics say, "these people are not objective because they are worried about their jobs". I'm more concerned with the point of reference. When the press repeats that some equity indices have fallen to their lowest levels since the early 1990s, and analysts point out that valuations for a number of companies compare favourably with that period, they are correct. However, today's economic and technical conditions bear little resemblance to the early 1990s. In fact, they are worlds apart.

It's the psychology, stupid, to paraphrase Bill Clinton. Eight years ago, stock markets were in the second half of their super-cycle bull market and approaching the bubble years. Confidence among investors was growing because practically everyone agreed - "equities outperform all other investments". Three years ago a sure-fire bestseller was published - "Dow 36,000", written by James Glassman, an investment journalist at The Washington Post, and Kevin Hassett, a former senior economist from the US Federal Reserve. Their startling contention - stocks had been undervalued for decades. Therefore by 2005 investors could expect a dramatic one-off upward adjustment in prices. Upping the ante, David Elias followed with -"Dow 40,000: Strategies for Profiting From the Greatest Bull Market in History". Not to be outdone, Charles Kadlec and Ralph

Comparison of the S&P 500 (lagged 129 months) and the Nikkei 225

Acampora co-authored - "Dow 100,000: Fact or Fiction". No prizes for guessing their conclusion. Talk about psychology! Serious people bought these books, because they tapped into the prevailing narcissism - specifically, instant gratification and entitlement.

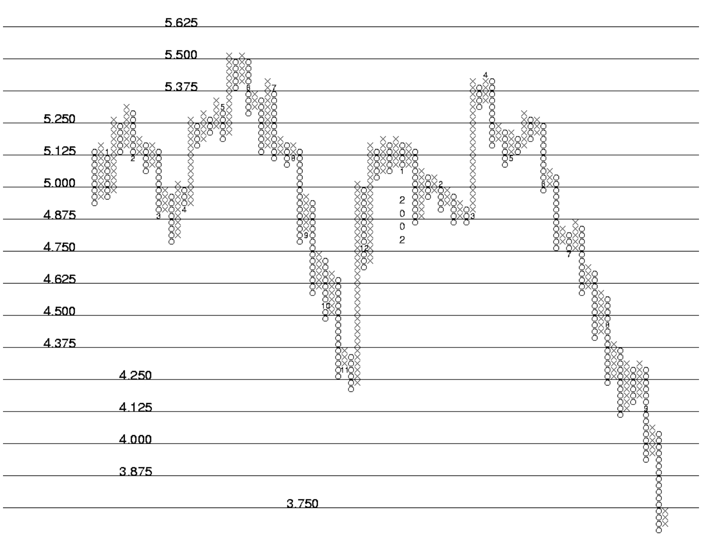
Hope springs eternal, but does anyone seriously think we are returning to the mid-1990s anytime soon? Presumably not, so how about a gentler version, in which stocks bottom out and appreciate at a modest pace, as some suggest? That would be nice but as the local yokel said to the city slicker asking for directions, "You can't get there from here". There is nothing new about the market drama that is unfolding. Super-cycle bull markets are a cyclical event, occurring approximately every other generation. They usually coincide with a technological breakthrough. These big bull markets are followed by a generation-long unwind, during which equity valuations don't just revert to reasonable levels, they eventually approach record lows. Why should it be any different this time? The bursting of market bubbles has always had economic consequences. To quote Clinton in another context, "It's the economy, stupid".

Our best guide is the unwinding still occurring in Japan, following its bubble peak in December 1989. Yes, there were inevitably many differences, and hopefully this will continue to be the case going forward, especially regarding monetary policy and the competence of overall governance in the US. However the similarities are undeniable and include massive bubbles, hubristic excesses of greed and corruption, excessive debt, subsequent deflationary pressures, loss of confidence in the market and a painful unwind. The similarity of stock market action in Tokyo and on Wall Street is both startling and sobering. Both experienced nearly fourfold gains in the last five years of their respective bubbles. The topping process was equally similar and although Tokyo initially fell more rapidly, a lagged graph of Wall Street's bear market places it precisely in line with Tokyo today. My thanks to friend and investment manager Bernhard Allgäuer of LGT Capital Management in Liechtenstein for sending me the graphic overlay reproduced on the front page. Japan's bull market and unwind to date is depicted by the solid line. The lighter, dotted line, barely discernable because of its identikit action, shows the US market, lagged by 129 months - the time elapsed between their respective peaks. At some point the graphs will inevitably diverge, hopefully in Wall Street's favour. Meanwhile, there is no reason why the secular bear markets in North America, Europe and other parts of the globe should end soon. However they will be punctuated by periodic rebounds, some of medium-term duration, just as we have seen in every other cycle.

Interest Rates and Bonds

■ **Weak stock markets and deflationary pressures make further rate cuts more likely, although the situation is complicated by the prospect of a war against Saddam Hussein.**

US 10 Year Bond Yield (0.025)



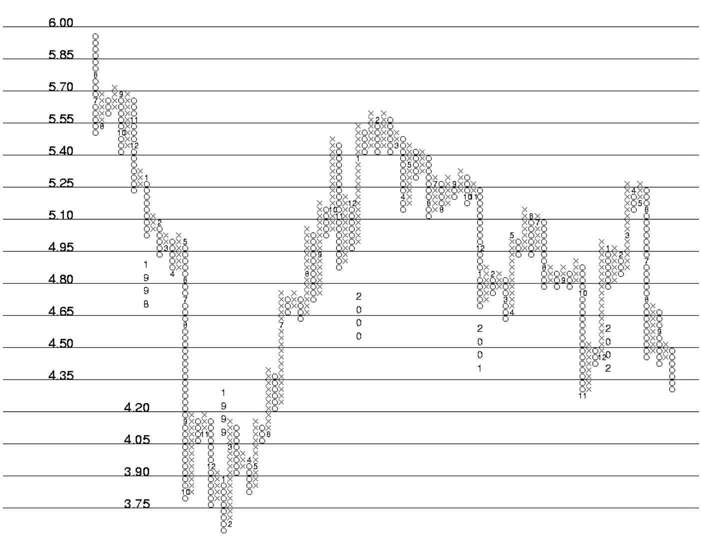
■ **US 10-year yields have fallen considerably further than Euro-Bunds, but charts suggest the latter will follow America's lead.**

■ **The Bank of Japan will have to buy even more JGBs to prevent yields from rising.**

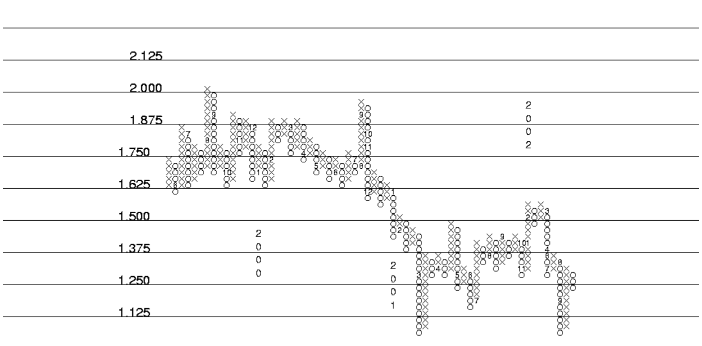
The ECB needs to cut rates but has been deterred by its deflationary mandate. Euroland's weakening economies need lower rates. However the region's inflation is only just below the ECB's mandated ceiling of 2 percent. Money supply growth of 6.5 percent (M2+CD) is above target, although arguably low given the increasing deflationary pressures. The UK economy needs lower rates but the BoE's Monetary Policy Committee is deterred by house price increases, despite growing evidence that these have peaked in the south of England. Japan pared rates to near zero a long time ago but with money supply growth averaging 3.5 percent, a further stimulus is urgently needed. Ironically, the case for lower rates is less urgent in the US, although the Fed is more likely to cut than the ECB or BoE. However with the Federal Funds Rate at 1.75 percent, Greenspan will want to retain some ammunition in case there is a further shock due to stock market weakness, a military strike against Saddam Hussein or further terrorist attacks against the US.

Historically, Bund 10-year yields have usually been lower than those of the US. However the US rate fell to a 55 basis points discount recently, the biggest discount that I can recall. This is surprising because US growth is stronger and its government deficit is increasing more rapidly, necessitating a greater supply of new bonds than will occur in Euroland. While the US chart is becoming more overextended, it has broken decisively beneath the 1998 (not shown) and 2001 lows. A rally clearly in excess of the brief rebounds within the downtrend in recent months remains necessary to break downward momentum. The pattern for Euro-Bunds suggests that it will follow this lead, taking out the November low at 4.26 before long, on the way to a test of the January 1999 trough between 4.17 and 3.63.

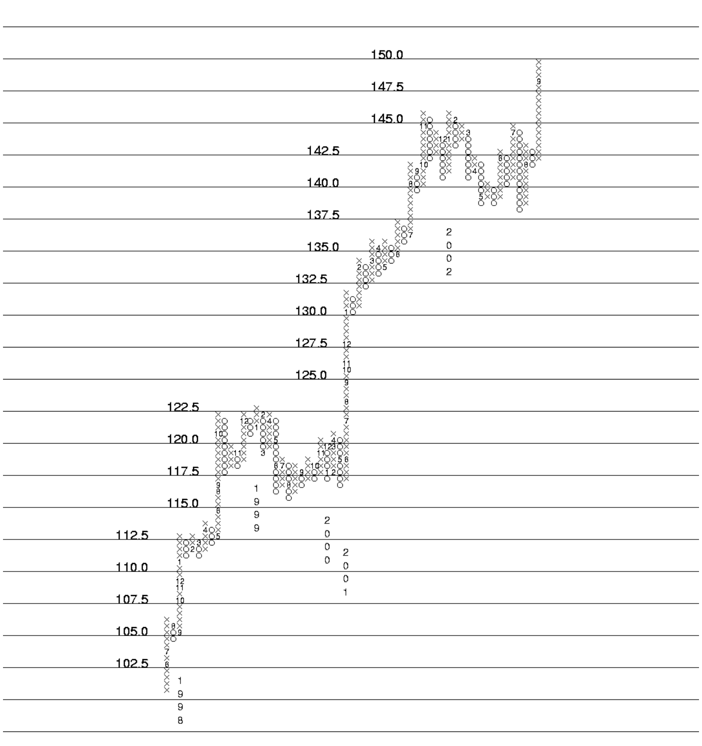
Euro-bund 10 Year Bond Yield (0.03)



Japanese 10 Year Bond Yield (0.025)



Dow Jones Corporate Bond Index (0.5)



Why would anyone want to buy Japanese Government Bonds? The yen is suspect; the supply of JGBs gargantuan, the yield meagre and its downward trend was decisively interrupted when BoJ Governor Hayami announced on 18th September that the central bank was going to buy shares from the clearing banks. This was followed by a poor auction of JGBs, because investors feared the BoJ might buy fewer bonds if it was also buying shares. The BoJ has painted itself into a corner, first by creating Japan's deflation, which the current Governor Masaru Hayami has not tackled effectively, due to his preoccupation with the ruling LDP Party's policies, and his preference for a strong yen, regardless of the economy's weakness. Ironically, only Hayami can now prevent a surge in JGB yields, by becoming an even bigger buyer of last resort. Will he do it, financed with printed money? Probably, because Japan's commercial banks would be the biggest losers if yields rose, exposing their capital adequacy deficiencies far more than the weak stock market. However, one can never be sure with Hayami.

Strategy for bonds - The risk with quality government bonds is that yields have been driven lower in recent months by a flight of capital from stock markets. Consequently, there will be some profit taking when stocks next stage a rally. Nevertheless, this risk looks acceptable in the case of Euro-Bunds or UK Gilts, where the fall in yields has trailed behind US Treasuries recently. The best way to counter this risk would be with quality corporate bonds, A-rated or better, and I would remain very overweight in this sector. Their yields should fall when investors regain some confidence in the stock market. One can certainly find higher yields, but in this economic environment, it is not so easy to differentiate between so called "fallen angels", with very little risk of default, and junk bonds that live up to the name. However the ability of a company to generate cash is obviously vital in assessing risk. I would continue to hold the US-listed closed-end (investment trust) Munienhanced Fund Inc (Bloomberg code MEN US) first mentioned in FM218. My own preference is to keep a significant proportion of capital in cash, using futures for trading opportunities in other markets. In futures, my tactic last month was to take profits on all remaining bond longs and go lightly short for a trade. This was not a good idea because the stock market rally soon faded, driving more money into government bonds. I'm now looking to buy Dec Euro-bund futures, lightly and preferably on easing, protected with trailing stops. I'll abandon this strategy when the rising lows are eventually broken. The last one was at 110.47 on 11th September.

Global Stock Markets

■ **The crunching supply problem for stock markets - institutional investors are moving from overweight to underweight relative to bonds, and no one wants to increase their equity weighting.**

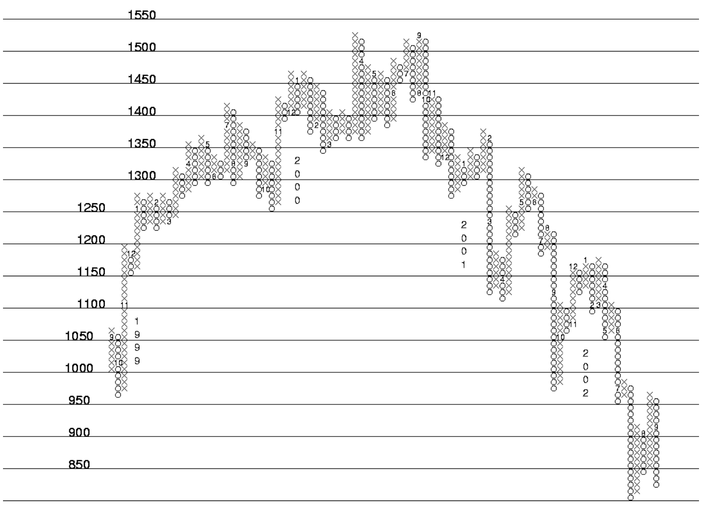
■ **Uncertainty over Iraq is deterring demand for equities but we should see a short-covering rally once the US-led forces remove Saddam.In the 1990s, most institutional investors in North America and Europe increased their portfolio weighting in stocks to record levels.** The whole system was equity based, especially in the US, where bonds were often viewed as boring and an inefficient use of capital. Only the most conservative, old-fashioned investors bought fixed interest. Bonds provided the means for corporations to raise money, so they could purchase more IT and finance share buyback schemes. Embracing the equity culture, insurance companies and corporate pension funds piled into stocks as never before. Today, many are forced sellers, especially life insurance companies with contractual pension liabilities. Regulators are breathing down the necks of these insurers, because weak stock markets jeopardise their ability to meet future liabilities. Pension fund trustees realise that they can no longer count on stock market returns above the historic averages. They now suspect that equities could underperform for many years, as valuations revert from extreme overvaluation to undervaluation. Consequently they have been shifting portfolio weightings in favour of bonds. Private investors, disillusioned with index tracking funds, are also switching to bonds. This preference for fixed interest will persist for so long as investors expect a deflationary rather than inflationary environment. Who is increasing their equity weighting today? Very few investors, which is why supply has swamped demand.

It's been shocking, even for stock market bears. In persistently talking about a long-term reversion by equity valuations from one extreme of the mean to the other, eventually ending with big-cap stocks selling at an average of 10 times earnings and yielding 4 to 6 percent, I've been quite bearish. However this is no cause for boast. Regrettably, I haven't been bearish enough, despite repeating that in a post super-cycle reversion, most of the "surprises" are nasty. I've frequently been surprised by the extent of scams, debt levels, profit meltdowns and the persistence of downtrends for share prices and indices. Despite a strong preference for bonds over stocks, I've been too quick to take profits in bond futures, cut short positions in stock market futures too soon and worst of all, too eager to open index futures longs following sell offs. Aiming to improve on this performance, I'll repeat one of my other conclusions and make it a personal mantra - I'll only buy for a bounce after a panicky, accelerated sell off.

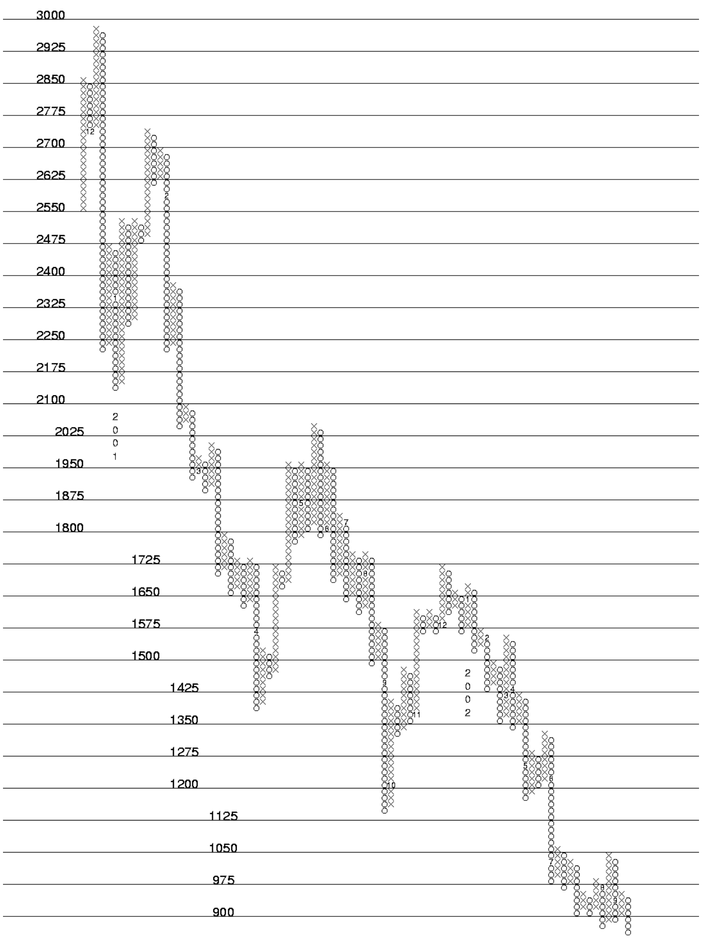
Have we seen capitulation selling recently? Not in my view, although we have certainly seen persistent selling, creating short-term oversold conditions. However in a bear market, indicators are frequently oversold, to little effect. There have been two waves of capitulation selling in the last 12 months - September 2001 and last July. On both occasions, I wrote that we had seen medium-term lows, albeit within the long-term bear market. This was true a year ago but European stock market indices recently broke their July lows. Among US indices the DJIA and S&P 500 have held up marginally better and have steadied near the lows reached two months ago. In conclusion, the rallies have become smaller and of shorter duration. Poor performance, financial scandals, weak economic conditions, too many earnings shocks and now uncertainty over Iraq are weighing on stocks.

When will we see another rally? We are seeing one

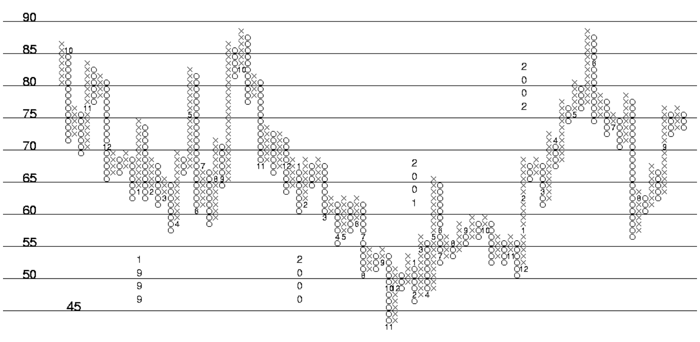
S & P 500 Composite Index (10pt)



Nasdaq 100 Index (15pt)



Philadelphia Gold & Silver Index (1pt)



as I complete this issue but there have been no upward dynamics, to date, similar to what we saw in July, so it may not last long. I see only two potentially bullish factors on the horizon - interest rate cuts and the successful removal of Saddam Hussein's regime. Weak economic activity, deflationary pressures and falling stock markets should cause central banks to cut rates before yearend. However, lower short-term rates have not triggered more than temporary rallies in the past and further reductions are widely expected. Therefore cheaper money is unlikely to be a significant factor. However a favourable outcome in Iraq would have a more positive influence on sentiment. The current uncertainty can only deter investors from buying. They logically conclude - "the market is weak so there is no hurry, and there is no need to buy before a probable war, which is always a leap in the dark. If disaster is averted and Saddam removed, we can jump back into the stock market on the first evidence of a rally." History supports their conclusion. This is another case of "sell the rumour, buy the news". A short war and successful result for the US-led forces would remove uncertainty, boost confidence and cause the price of oil to plunge. However, if the war ends badly, which is possible but probably unlikely, stock markets would take another hit. If there is no war and Saddam stays in power while UN arms inspection/ destruction is resumed, there could be some temporary relief for equities.

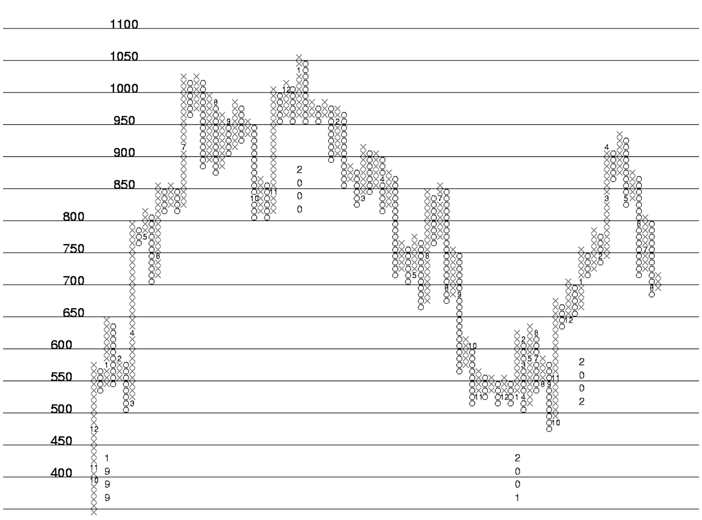
Chart review of topical and representative stock market indices - *The 3-box reversal point & figure charts shown are based on closing prices and taken from our website. Anyone interested in this chart service, which includes analysis and is updated daily, should register online at www.chartanalysts.com.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

The US's S&P 500 Index (840) encountered stiff resistance from initial overhead supply. While some steadying may be seen near the July low, the overall downtrend remains intact and consistent. **The NASDAQ 100 Index (876)** is interesting because of its massive fall from a high of 4816 in March 2000. While downward momentum has slowed in recent months, creating a potentially bullish falling wedge pattern, these patterns are notoriously difficult to anticipate. Currently, there is no evidence that the final low has been seen. A move to 970 is required to confirm another downside failure and 1050 to provide clear evidence of base formation development. **The Philadelphia Gold & Silver Index (72)** shows a massive, multi-year base, almost certainly in the latter stages of development. However resistance has been encountered at 76 once again, so a push above this level is required to signal a further rally towards the pattern's upper boundary near 88.

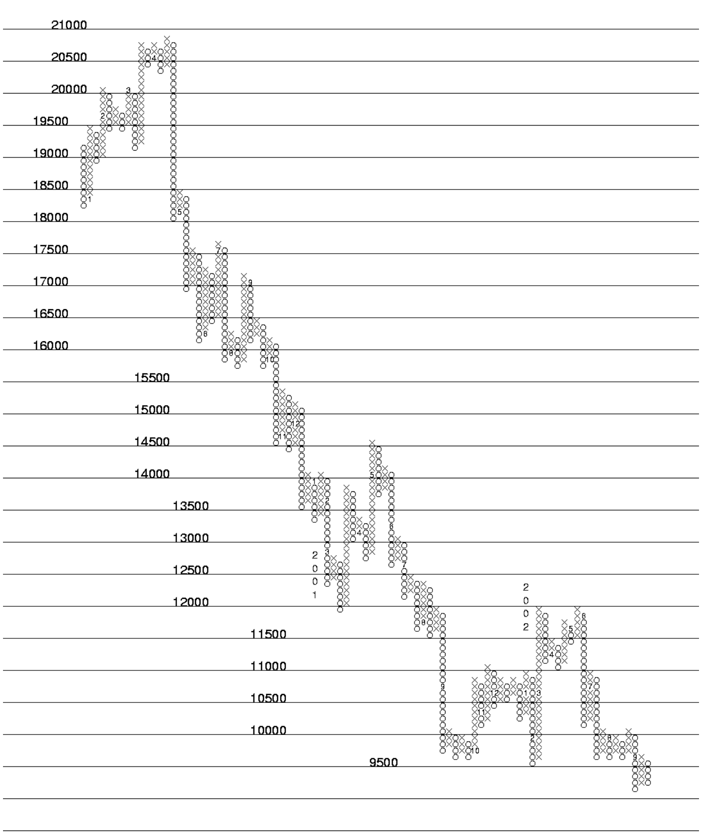
Japan's Nikkei Stock Average (9165) is barely steady beneath lateral trading near 9500 and needs 10000 to signal a potentially significant downside failure.

Australia's S&P ASX200 Index (2991) has fallen back to its July-August lows, which may offer some support. However the overall pattern looks top heavy and a move to

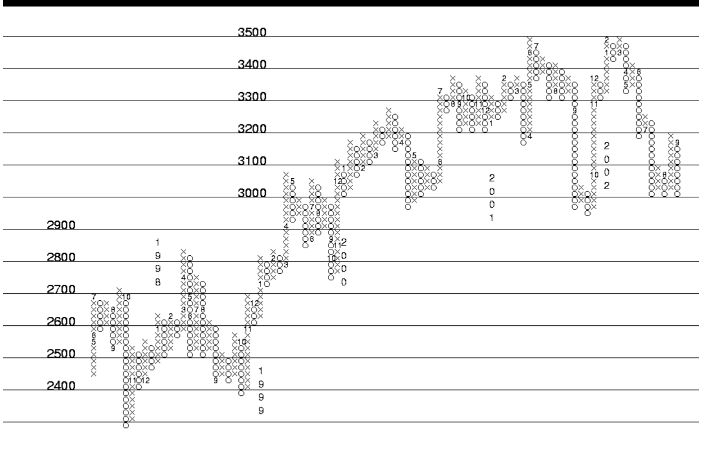
South Korea KOSPI Index (10pt)



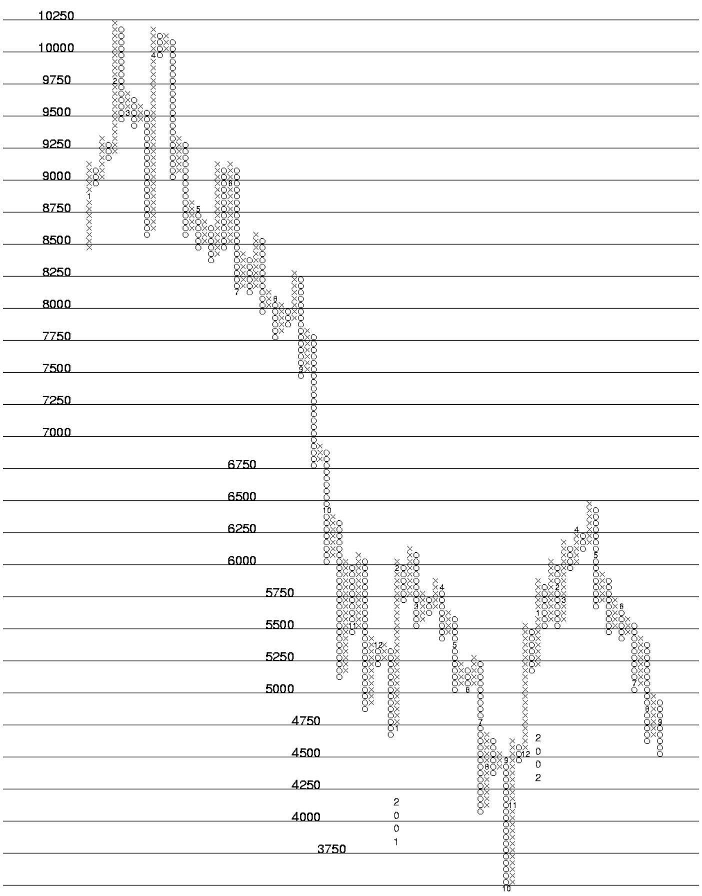
Nikkei 225 Stock Average Index (100pt)



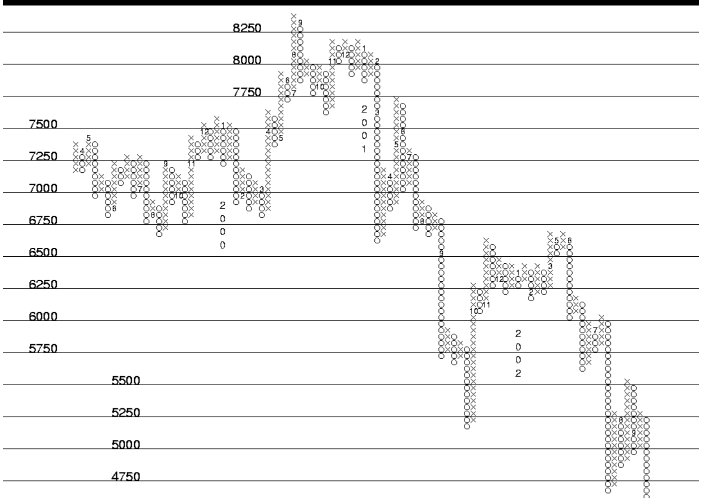
Australia S&P ASX 200 (20pt)



Taiwan WPI Index (50pt)

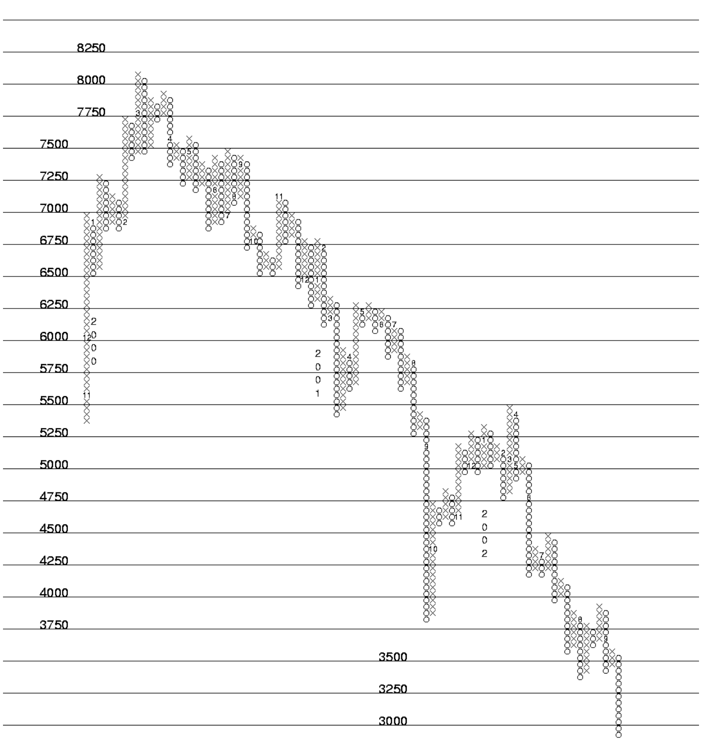


Swiss Market Index (50pt)



United Kingdom FTSE 100 Share Index (50pt)

German DAX Index (50pt)



3200 is required to question scope for lower levels before a sustainable floor is reached.

South Korea's KOSPI Index (658) - *see previous page* - is still retracing strong gains following the September 2001 low. A break in the progression of lower rally highs, with the latest at 730, is needed to break downtrend consistency.

Taiwan's Weighted Price Index (4186) has been just as consistent on the downside - lower lows and lower highs - as it was on the upside - higher highs and higher lows. Therefore it will not be difficult to spot changes in pattern consistency, the most significant of which would be a break in the progression of lower highs, currently requiring 4700.

Germany's DAX Index (2962) is beginning to look overextended once again, following its latest fall. However a rally above 3500 is required to suggest more than temporary firming.

Switzerland's SMI Index (4644) saw its rally reversed by overhead supply and the July low has given way, in line with other European indices. While some steadying may occur in response the latest decline, there is still no evidence that a significant low is at hand.

The UK's FTSE 100 Index (3696) looks temporarily oversold within its primary downtrend. A move to 4250 is required to question the overall downward bias.

Strategy for stock markets - Last month I felt we should see some further rally and that it was a rally to sell into. What we have actually seen is a reversal of the late-July/ early-August rally, with many indices falling to new lows. Personally, I'm mostly in cash, bonds and yen shorts. My main equity holdings are in gold shares and it's been a yoyo ride. I'm hoping bullion rallies above $330 in the next few months, at which point I may lighten my holding in gold shares. Living in the UK, I also hold several ISAs, mostly in the few high-yielding UK stocks that I first mentioned almost a year ago. I'll probably sell these if/when we get a significant rally. I maintain that captive equity players will generally lose less money and outperform their benchmark indices in stocks that have high covered yields, although I would be wary of banks in this environment. Among TMTs, I would only have the very best, such as Microsoft and Nokia. If you don't need to be in the stock market I would stay out. In futures, my toe in the water purchase of the NASDAQ on 10th September, mentioned in FMP189, headed south within 48 hours and I took the loss. I was overeager, having missed the late-July/early-August rally, being on holiday at the time.

Currencies

■ **European currencies lead upside breakouts against the yen; further gains to follow, despite Hayami.**

■ **The euro will probably see a further consolidation of this year's earlier gains before capital flows support somewhat higher levels.**

Currency traders have reassessed Japan's economic situation and voted with their feet. People are beginning to recognize one of history's more important lessons - no country escapes from the grip of a destructive deflation, defined as falling output, prices and profits, without a significant devaluation. Charts indicate that another upward leg has commenced against the yen. However participation at this stage is light, judging from media comments. Many traders, who were previously bearish of the yen and made money by shorting it in 4Q 2000 and 4Q 2001, have abandoned positions following months of whipsaw ranging, not to mention the dollar's fall. Nevertheless, their decisions are considerably influenced by charts. If upside breakouts against the yen by the Norwegian krone, Swiss franc and euro are maintained, as I suspect, returning demand should support significant gains over the next few months.

What about Hayami? Veteran subscribers will recall that he is psychologically wedded to the concept of a strong yen. Remember, shortly after the Japanese currency reached a ruinously uncompetitive level of ¥80 to the dollar in 1995, Hayami published a book called, "The Day the Yen Gained Respect". The US economy has experienced significant growth since then, while Japan Inc has remained stagnant, with finances deteriorating. Arguably, the yen at its recent low of ¥115 versus the dollar was no less overvalued than in 1995. Presumably Hayami would not agree but as Governor of the BoJ, his forecasts for the economy have been seriously wrong. Hayami's policies have been criticised publicly - an extraordinary development for Japan - by members of the ruling LDP Party and the MoF on numerous occasions. He remains under enormous pressure, as we see with the recent decision to buy shares from the commercial banks. Hayami now has less than 6 months before his term at the BoJ expires. Will he defy the near consensus in favour of more radical reflation in Japan? Possibly, but probably less adamantly than before. Meanwhile, the forex market will increasingly look beyond Hayami's tenure at the BoJ. I maintain both the dollar and euro will move above ¥200 within the next 5 years.

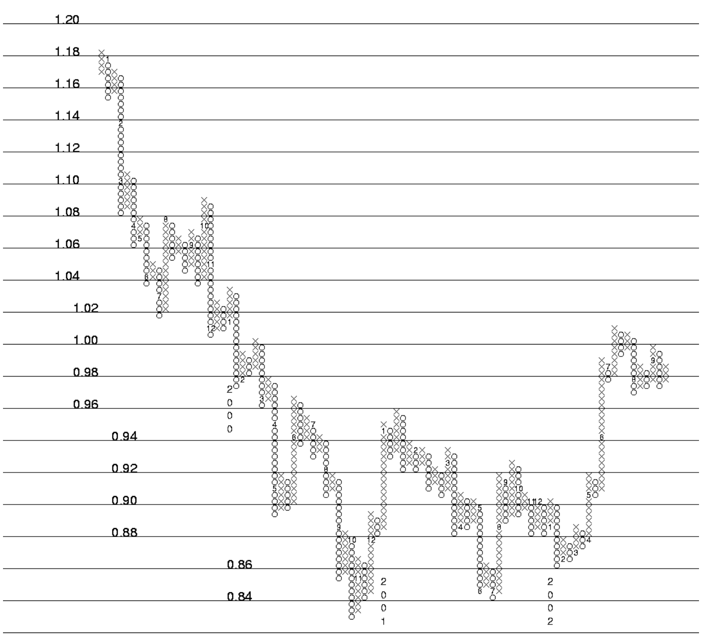
Bullish sentiment (always a contrary indicator) towards the euro versus the dollar has waned. Remember when many people said the euro would fall to $0.83 to $0.80, or lower, as it was ranging near $0.86 early this year? This told us that the crowd was short euros. Conversely, after it had surged over parity and briefly to $1.02 in July, many were betting on $1.10 before yearend and $1.20 or more next year. This told us that the crowd was long euros. Today, that bullish sentiment has dissipated, although there are more euro bulls than bears versus the dollar. This would change on a move beneath $0.96 for more than a day or two, which could easily occur. Speculators are drifting away from euro/dollar and shorting the yen against various currencies, including the euro. Also, there is nothing happening in Euroland to make people bullish of the single currency. Instead, it is now a question of which reserve currency looks least ugly. This is in the eye of the beholder, of course, with the key variable being the medium-term trend. The euro became least resistible from April to mid-July. Thereafter, some traders had a brief flirtation with the yen. Today, short-term traders aren't sure whether they want euros or dollars, but they definitely wish to sell the yen. Relatively narrow ranging patterns, such as we currently see for euro/dollar, reflect uncertainty. Consequently forecasting, let alone trading them, is generally a mug's game. Nevertheless, readers expect me to so here goes. I believe the odds marginally favour a further exodus from euro/dollar longs, which pushes it below $0.96. However I doubt it will fall much below $0.94, and only briefly if at all. Thereafter, I suspect the earlier trend, which is underpinned by a base, will reassert itself, helped by interest rate differentials, concern over the US current account deficit and some reallocation of central bank reserves, which are still overweight in US dollars. My target, first mentioned last year, remains in the $1.10 to $1.15 region, and there could be a temporary overshoot.

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.*

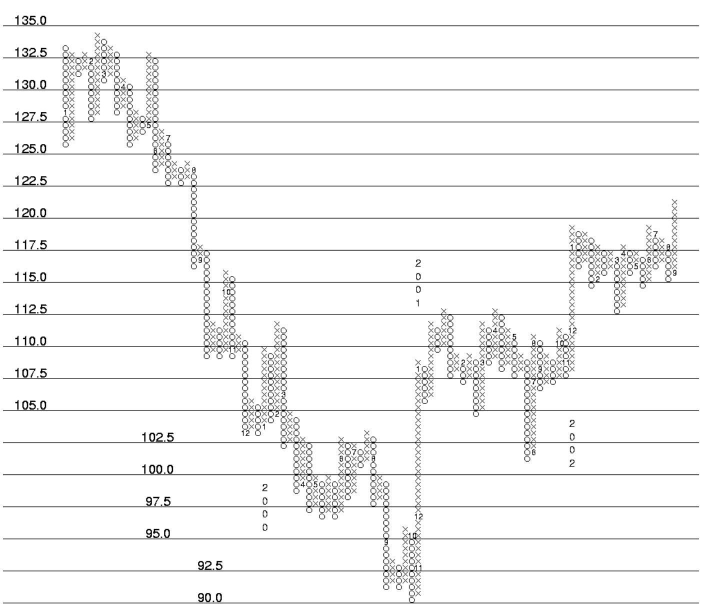
Euro/dollar ($0.9766) - *see overleaf* - This pattern suggests more profit taking than accumulation of euros at present. Consequently the short-term risk is slightly tilted to the downside, although support from the upper to mid-region base should cushion downside risk during this phase, prior to a resumption of the recovery, signalled by a sustained break above the intra-day high near $1.02.

Euro/yen (¥119.65) - *see overleaf* - Significantly, the January to mid-September 2002 range is much tighter than the January to early-December 2001 band. This indicates waning selling pressure relative to accumulation,

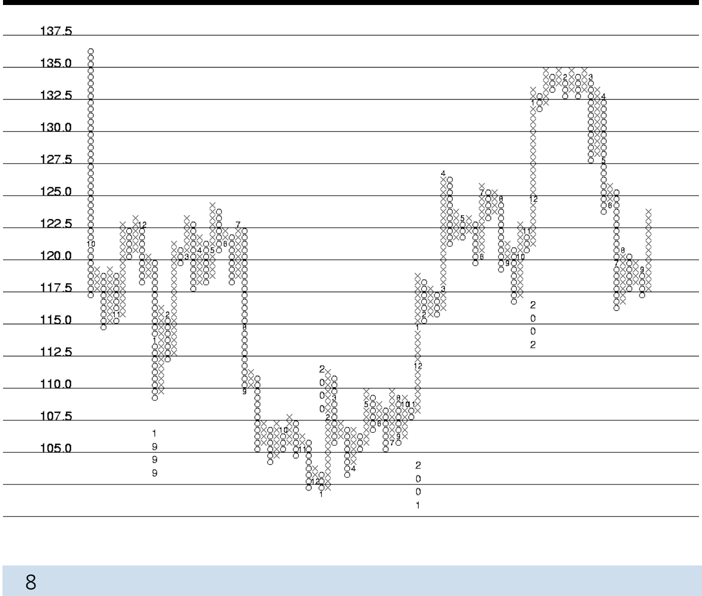
US Dollar per 1 Euro (0.004)



Japanese Yen per 1 Euro (0.5)



Japanese Yen per 1 US Dollar (0.5)



and the latter recently fuelled a breakout. Also, the 1Q 2002 reaction bounced off initial support at ¥112.5. Consequently, current downside risk is probably limited to ¥119 during a brief consolidation. Prior resistance from the early-1999 top up to ¥134 was established too long ago to be of more than minor psychological significance. More importantly, the euro's recovery phases against the yen have been quite sharp. Therefore the current advance could easily challenge the former peak region before another multi-month pause occurs.

Dollar/yen (¥122.63) - The greenback has broken upwards from the small base formed near the September 2001 low. While the very sharp March to July 2002 reaction broke the symmetry of this pattern, I am inclined to view it as an extension of the upper base, which has H&S characteristics extending back to late October 1998. If this assessment is correct, the dollar should push back to its high near ¥134.50, more quickly than it fell from that level.

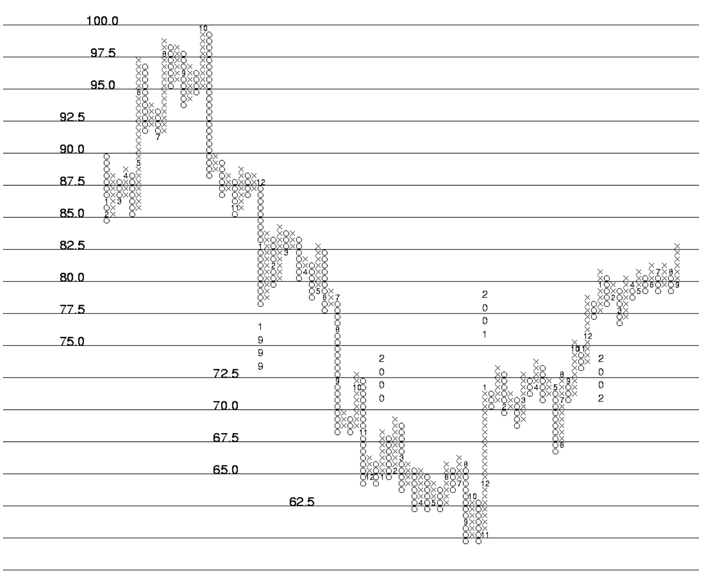
Dollar/Swiss franc (SF1.4970) - The current range is most likely a lengthy redistribution beneath the large top area. However, it could support some additional recovery, perhaps even testing the underside of the top near SF1.58, before the dollar resumes its decline.

Swiss franc/yen (¥81.57) - The Swiss franc gave up very little ground during this year's lengthy consolidation, which has now launched another breakout. A move back beneath ¥80, which appears unlikely during the current consolidation, would be necessary to delay upside scope beyond a brief pause.

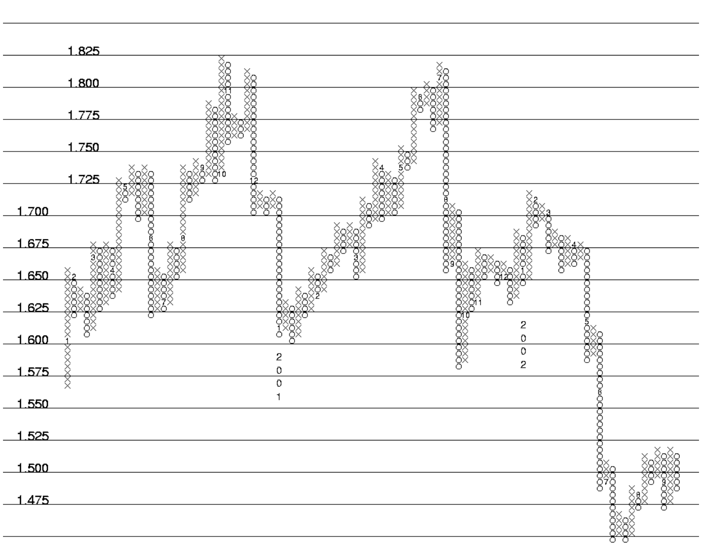
Sterling/yen (¥190.76) - The pound has encountered good support just above its large H&S-type base during this year's lengthy consolidation. The January to April highs are being challenged and should soon give way. The over all pattern can support a renewed advance to at least ¥205 in the next few months.

Strategy for currencies - Significantly, Continental European currencies have now broken to new highs for the year against the yen, reaffirming their long-term upward trends. Moreover, all other viable currencies have appreciated against the yen recently. Assuming European currency breakouts are maintained, as appears likely, we have clear evidence that the next leg in the yen's long-term devaluation has commenced. Accordingly, I have shifted tactics from range trading, which I did less often than I should have, to trend running, augmented with a small amount of Baby Steps buy-low-sell-high trading, long positions only. In other words, I'm now able to protect core longs against the yen, discussed in FM219, with in-the-money (on average) stops, which limit risk to some profit erosion, while leaving the door open to further gains. The European currency breakouts were decisive and the prior ranges large, so we could see a big advance over the next few months. However, there was some acceleration in reaching the recent highs, which does not appear significant on longer-term charts, but has resulted in a small reaction and consolidation. Therefore, I am adding to longs on

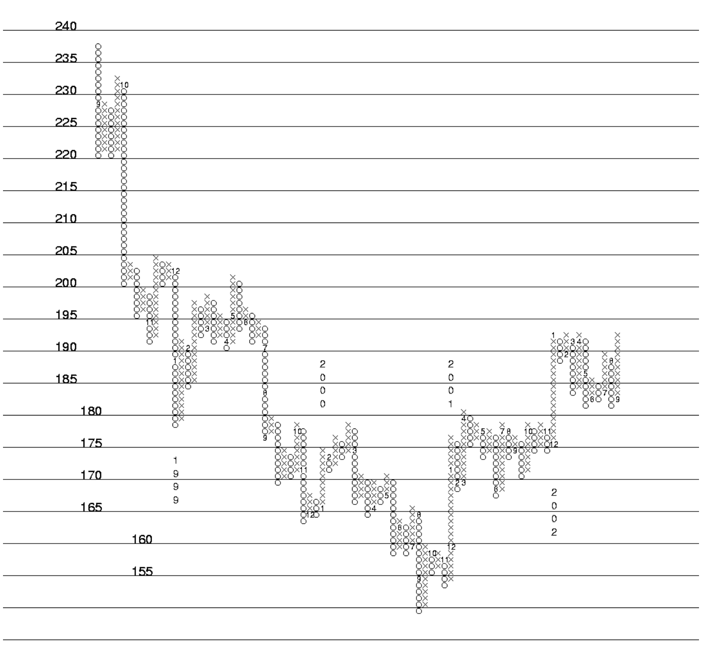
Japanese Yen per 1 Swiss Franc (0.5)



Swiss Francs per 1 US Dollar (0.005)



Japanese Yen per 1 Pound Sterling (1)



easing and lightening positions a bit on rallies. Overall, I'm gradually increasing my position but also trading with up to 10 percent of my longs against the yen, hoping to lower average entry prices and harvest any small ranges that occur during consolidations. This is generally more profitable than buy-and-hold, and preferable to tight stops, which risk taking one out on a minor move. I'll use tight stops and lighten when the consensus tells us that every man and his dog are short yen. This is certainly not the case today. The Norwegian krone, with an interest rate differential of over 700 basis points, was first to reach a new high against the yen, closely followed by the Swiss franc, euro and Swedish krona. Using futures, I concentrate on euro/yen, sterling/yen and dollar/yen, but there are plenty of other candidates for those who trade spot currencies. If a major move has commenced, as I suspect, it's not a bad idea to augment trading by purchasing a little of whatever is lagging on the upside against the yen. I'm currently not interested in trading any currencies other than yen crosses.

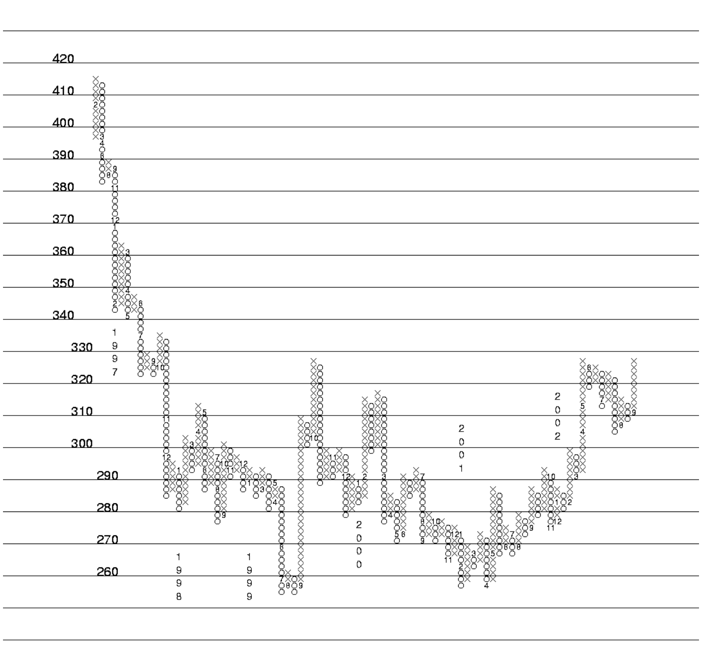
Commodities

■ **Gold is in the early stages of a long-term bull market, following its 20-year bear trend.**

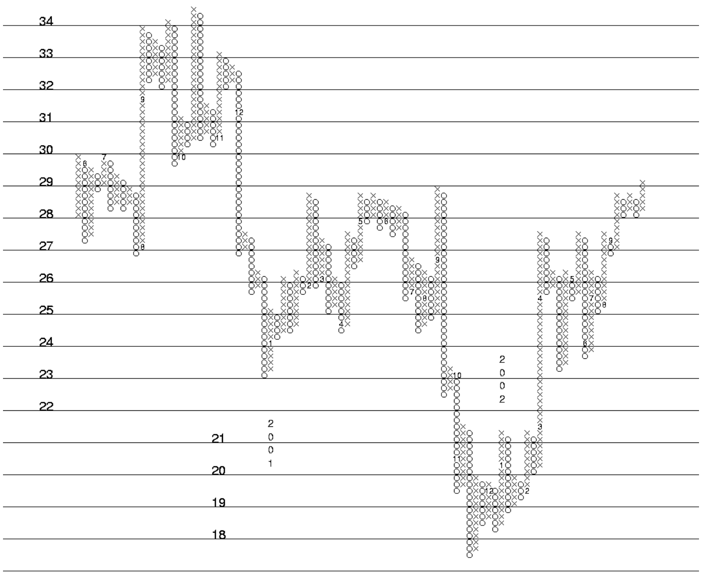
■ **Petroleum prices reflect a war premium but would plunge after an invasion to replace Saddam Hussein's regime commenced.**

Gold has established support in the upper region of its multi-year base. A potentially important change is now evident on the gold chart. After bullion spiked to $326 in September 1999 and $318 in February 2000, it fell back sharply. Those highs established the upper parameters of the base but the August 1999 low had not been tested. That occurred twice in the first half of 2001, followed by an orderly rally to last June's high. Subsequently, the price has seen a much smaller correction than in previous years. While it is still encountering resistance from the

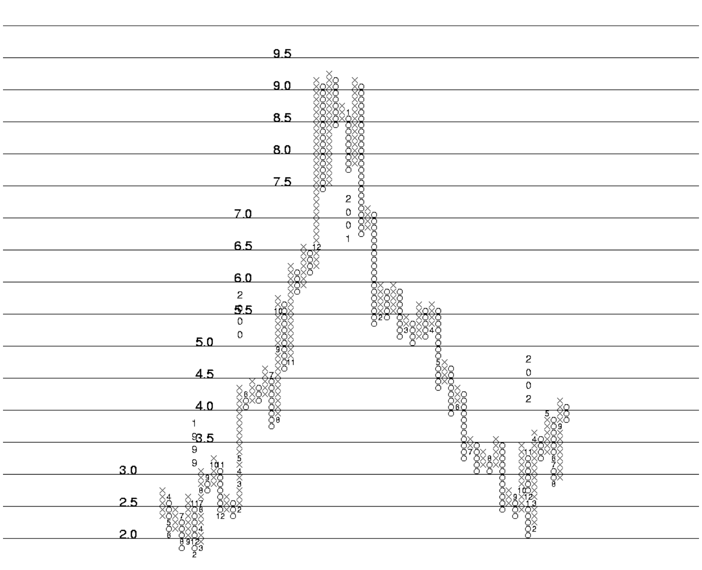
London Spot Gold (2USD)



Crude Oil NYME 2nd Continuation (0.2USD)



Natural Gas 2nd Continuation (0.1USD)



upper boundary, a close beneath July's low at $304 on this 2-dollar scale is required to confirm more than temporary resistance near the base highs, and signal further easing into underlying support. Conversely, a clear break over $330, which appears more likely in coming weeks, would indicate base completion and further gains to follow. Gold experienced a 20-year bear market. The base formation suggests that a long-term cyclical recovery is in its early stages. If so, there have to be some good fundamental reasons. I'll mention two. The gold price is a measure of confidence in paper currencies and financial markets. Investors have understandably lost confidence in stocks. If central banks pull all the monetary levers over the next few years, as I suspect, to lift the global economy out of deflation, investors will gradually lose confidence in most currencies. When the bond market takes fright because central banks are stoking inflation as the lesser evil, gold will be fully remonetized in the eyes of investors. I expect to see a gradual, ranging recovery by gold over the next fifteen years or more, which eventually culminates in another bubble peak, well above the 1980 high.

The war premium is extending crude oil's push into the 2000-2001 top area. Developments concerning Iraq are obviously dominating sentiment. OPEC's disquiet over the removal of even the most odious Arab dictatorship is demonstrated by their scrapping of the previous formula for increasing output, when prices sustained rises above their benchmark near $27. No trader dares short in the countdown to war in the Middle East. Western refiners and suppliers have stockpiled inventory. The US is still increasing its strategic reserves. Speculators are long petroleum futures. The oil chart shows no evidence that this rally has peaked but history suggests energy prices will plummet once the fighting starts. I don't think oil will spike as much as people fear and I expect the price of crude to fall back under $20 (NYME) within six months following the removal of Saddam's regime. Fortunately for consumers, the price of natural gas is a long way beneath its 2000-2001 peak. Nevertheless its price has also risen, with the help of tropical storm Isidore.

The Global Economy

- **Deflationary pressures are intensifying in all regions of the globe, and two of the three key central banks are not doing anything about it.**

- **Prospects for the global economy continue to deteriorate.**

Euroland is sliding towards deflation as the ECB adheres to its inappropriate mandate. People talk about investors living in the last cycle but what about central bankers? Understandably, the mindset of elderly Germans and an influential Dutchman, judging from ECB President Wim Duisenberg's comments, is to fear inflation. They and/or their parents experienced hyperinflation twice in the last century. Relax guys; you're not in danger of repeating that any time soon. Planning for the euro didn't help. In fact it produced a psychosocial updated version of the old fears. The Bundesbank worried that it might surrender its cherished mark for Italian lira, under the euro banner. Opportunistic roundups of prices for goods and services following the currency changeover have not helped sentiment. Consequently the ECB has maintained a hard line on rates ever since the post-9/11 cuts, while joining the political cheerleaders in seeing GDP growth just around the corner. The sad thing is that they almost believe it, as if growth, like the tooth fairy, was about to visit them in the night. Short of a significant rebound by European stock markets, which would be interpreted by the ECB as a lead indicator, this mindset will have to change. However the timing is complicated by a probable move to liberate Iraq if the UN Security Council does not agree on a new programme of inspections, which is then accepted unconditionally by Baghdad. Central banks, not just the ECB, want to retain some monetary ammunition, just in case the removal of Saddam Hussein's regime is undertaken, and is not a smooth operation. Even if the ECB lowers rates sooner rather than later, as many hope, it may be another case of too little too late, given dwindling growth, rising unemployment and with the price of oil trading at a war premium. Euroland has not developed a consumer-led economy and is overly dependent on exports. With global GDP growth stagnating and the euro appreciating, export to whom?

The Bank of Japan's monetary policy is not addressing the serious problem of deflation. The ministry of finance issues Japanese Government Bonds. The commercial banks buy most of these, using money borrowed from the BoJ at nominal interest rates. This is effectively a no risk trade because the BoJ buys huge quantities of JGBs every month, often from the commercial banks. This keeps yields low but the extra money is being recycled through the banking system, back into bonds or deposits with the central bank. Meanwhile, credit in Japan remains very tight because the commercial banks will not risk further bad debts by lending to companies or individuals, when they have an all but guaranteed, albeit modest, return from this financial paper chase. It's called playing the yield curve - a process that helps to recapitalise lending institutions, albeit not at a sufficient rate to offset bad debts from an economy in the grips of a destructive deflation. Money supply has remained at a woefully low average of 3.5 percent (M2+CD). Worse still, when excess liquidity does show up in the banking system, particularly after MoF directed foreign exchange intervention to weaken the yen, the BoJ mops up these funds by selling short-dated securities from its portfolio. This process is called "sterilization", and it has kept the yen artificially strong for too long, given intervention to weaken it, the low yield and Japan's comparatively weak economic performance. Consequently the MoF and BoJ are at loggerheads, with opposing views and policies more often than not. Despite efforts to paper over these differences, which is the Japanese way, they rupture forth periodically. The latest escalation of tensions occurred on 13th September when Vice Finance Minister for International Affairs Haruhiko Kuroda, speaking at an international seminar, offered several measures to combat Japan's deflation, including "abrogation of central bank independence". This was a signal, rather than a realistic legislative proposal, and Kuroda would not have sent it without the blessings of Finance Minister Shiokawa and Prime Minister Koizumi. It worked, after a fashion. Five days later, BoJ Governor Hayami announced that he would buy stocks from Japan's beleaguered banks, to help them meet capital adequacy requirements at the 30th September valuation. This steadied the stock market and sent the yen into a tailspin, as currency dealers concluded that Japan would not somehow muddle through its deflationary crisis. Instead, radical reflation beckons - specifically the printing of money for the purchase of assets. Despite a weaker yen being a lifeline for Japan's export earnings, Hayami may try to minimise the currency's decline, as he has on previous occasions. Meanwhile, he can't be replaced until his term expires on 20th March 2003. While many commentators, citing the BoJ's purchases of JGBs, have mistakenly concluded that Hayami is doing all he can to revive Japan's moribund economy, nothing could be further from the truth. Japan's deflation is largely a domestic problem. The country is not in hock to foreigners, because it holds over 90 percent of its own debt - government, corporate and domestic. Japan's private savings are massive but people won't spend while the destructive deflation persists. An inflation target would help, but Hayami has previously rejected this strategy. His actions (or inaction) remain critical to Japan's economic prospects. By stating that the BoJ will purchase shares from banks, he will help them to meet this month's capital adequacy deadline but this won't boost the economy. Japan's commercial banks will just plough the money received from share sales back into JGBs, which Hayami must also continue to purchase. Otherwise, yields would soar, causing massive capital losses for the banks, which have been leveraged buyers of JGBs. Think how much more effective the BoJ could be if it bought Nikkei futures. Instead, it will wind up with a portfolio of individual shares - merely a change of ownership that will have only a moderate impact on sentiment. Meanwhile, the BoJ's arbitrary portfolio of individual shares will be less marketable and the banks have lost an opportunity for capital appreciation at some future date. Most importantly, there is an air of panic to the BoJ's latest policy announcement, which will do nothing to eliminate Japan's destructive deflation.

Only Greenspan and the Fed have recognised and addressed the deflation risk. Some fear that he has gone too far by encouraging an unsustainable level of consumer spending. Homeowners have remortgaged at today's lower rates and withdrawn capital for spending. This increases the risk of future problems when rates eventually rise and/or house prices fall. Banks have cut back on corporate lending but loans to the public have soared, as have credit card defaults. US consumers are buying lots of cars due to zero financing costs from the manufacturers. Free credit will always boost spending - for a while, but is unsustainable. US unemployment is only half of Euroland's but is edging higher. Government spending on subsidies and especially defence is helping the economy to outperform Euroland and Japan, but at the cost of a rising budget deficit.

Japan's problems are a warning for other countries. Keep an eye on the yen, Nikkei and JGBs because Japan's deflation could spiral. This would have a very negative impact on the global economy, particularly in Asia. The entire region is overly dependent on exports to the US, which is less able to be the consumer of last resort. Similarly, Euroland is too dependent on the US and Germany appears to be following Japan's deflation cycle, albeit without the prior bubble. The US economy is somewhat stronger but rising debt for the government, corporations and consumers is not a good omen for the future. Last but not least, an oil price near $30 (NYME) considerably increases the risk of global recession.

And Finally…

Is property the worst investment during a deflation? Investors have been fleeing the stock market for the "safety" of bricks and mortar. In the UK, there is an obsession with climbing onto the property ladder, at whatever the cost in terms of mortgages. To not own your own house or flat is considered a financial tragedy. Trading upwards in homes has long been a national pastime. People have been emboldened to speculate in property because of "low interest rates". Bores for Britain, who babble about property prices, are evident at many social functions. And yes, I'll admit to envy regarding those who cleverly enriched themselves with little effort by leveraging up in property over the last 30 years. Meanwhile, real estate experts (not necessarily the most objective observers) reassure us that there is no bubble, except possibly in buy-to-let, but conclude that the rate of property appreciation is likely to slow somewhat. I suspect a cluster graph of long-term forecasts by property agents would show a majority extrapolating 5 to 10 percent per annum appreciation for perpetuity. Haven't we heard this before?

I appreciate the psychological importance for many of owning the roof over their head, and would never ever suggest that someone sell their home. It is an emotional as well as financial investment. However I am convinced that the property market is cyclical, just like everything else. It has had a very good run recently, particularly in the US and UK. Looking ahead, I believe we have a bubble, which is certain to burst. The degree of deflation experienced will determine the extent of the subsequent reaction. Without a destructive deflation, defined here as falling output, prices and profits, such as we have long seen in Japan and more recently in Hong Kong, the setback might be no more than 20 to 30 percent over the next few years. Will we experience a destructive deflation in North America and Europe? Hopefully not - central banks should be able to avoid it, assuming no major environmental or military disaster occurs. However, the risk of deflation is currently much greater than the risk of inflation. Most homeowners have mortgages and their ability to service these could be compromised by a destructive deflation. Rental income would decline or even vanish, leading to lower prices for commercial and buy-to-let properties. This would affect sentiment in all sections of the property market. Property has to be repaired and insured, creating a reverse yield, relative to quality bonds, deposit accounts and dividend-paying stocks. Therefore one can lose a lot of money in speculative property if prices stand still for any length of time. Surely this is only acceptable with one's primary residence, which may not be making one richer but offers all the comforts of home. We often hear that property prices in desirable locations cannot fall because of a shortage of supply. Try telling that to the Japanese and residents of Hong Kong. For safety in a destructive deflation, I would prefer cash, government and/or quality corporate bonds, and stocks with covered dividends, to property.

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The earliest target date for FM221 is Friday 25th October.

"All the world's a stage and most of us are desperately unrehearsed."

Sean O'Casey

Best regards - David Fuller

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