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

The perception that war against Saddam Hussein is very likely in the next couple of months has suspended the seasonal rally for stock markets. A temporary rebound should occur shortly after military action commences.

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Gold breaks above lateral resistance - this looks like base completion. Oil continues to regain the war premium and Venezuela's strike has also contributed to this temporary strength.

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Will the global economy experience a healthy recovery as forecast by most politicians, or will the next few years be characterised by deflation, stagflation or even an inflation problem? You can't fault the US for effort in trying to stimulate GDP growth but will it make matters worse later? History's lesson is that the post bubble environment will continue to cause problems for many years. Until GDP growth rebounds and looks sustainable, governments will increase their deflation-fighting efforts.

12 And Finally....

Are you seeing the Fullermoney Plus (FMP) updates? For my latest thinking, check the Audio.

The long view - Debt problems are increasing in the post bubble, slow growth environment. All governments will be under increasing pressure to reflate. The next secular bull market will be in gold and commodities.

Most investors, not to mention financial advisors, will resist this conclusion, for understandable reasons. They want the 1990s to return, providing them with strong economic growth, booming stock markets and house prices. In other words, let's have another bite at the cherry. Wouldn't it be nice if the last cycle was repeated in the current cycle. We would all know exactly what to do - leverage up in tech stocks and become buy-to-let landlords. "OK", the investment firm experts say, "the 1990s were exceptional and won't be repeated over the next few years, but index-tracking finds will still be nice little earners, providing 6 percent or more on average per year." As for those soaring property prices, estate agents reassure us that any softening will be temporary and followed by a plateau at worst.

The burst bubble's inconvenient legacy changes everything. Corporate debt, consumer debt and now government debt in the US, UK and many other previously prospering countries is increasing. This is not a happy scenario for the global economy because it adds to deflationary pressures. How do we deal with debt when we can't generate sufficient growth, income and profits to pay it off? The disciplined and resourceful cut back on spending and eventually earn their way out. The weak default. Governments eventually inflate their way out of debt problems.

Is the US still the engine for global GDP growth? Everyone still looks to the US consumer. Forget it. After the binge, Americans will have to retrench because household net worth, according to some sources, is falling at an annual rate of $1.8bn, while mortgage debt is rising nearly 13 percent per year, which is 4 times faster than GDP growth. The Federal Reserve is encouraging overextended consumers to continue spending, just long enough it hopes, for another cycle of corporate capital expenditure to kick in and take up the slack. However companies are reluctant to spend because they have little pricing power and overcapacity. Increased borrowing certainly isn't the answer, because despite a Federal Funds Rate of 1.25 percent, credit ratings have fallen for most companies, driving up the cost of loans. Where corporations are able to increase profits, it is mainly due to downsizing. Rising unemployment won't help consumer spending. Companies entice consumers with zero-financing offers but increased spending today means less spending tomorrow. So the government steps in with tax cuts and a massive increase in fiscal expenditure. This will postpone recession but it is also causing the budget deficit to soar. The US's greater monetary and fiscal stimulus should ensure that it continues to outperform most other developed economies, but Americans will no longer be the consumers of last resort, as in previous years.

If not the US, who else? Euroland's core economies hover on the brink of recession. The UK's problems are similar to the US, only worse. Japan's already weak economic prospects are deteriorating, according to the Bank of Japan. What about the rest of Asia, especially China? Currently, it appears to be a zero-sum game because with its cheap land and labour force, China is sucking manufacturing away from other Asian countries, especially those with developed economies. China is an exporter, not an importer, at this stage of its development. This compounds global deflationary forces.

More deflation and stagflation, and eventually inflation as all governments reflate. The West will probably avoid outright deflation as currently seen in Japan and some other regions of East Asia. Nevertheless slow growth will persist, adding to disinflationary/deflationary pressures, particularly in manufacturing, retailing and tourism industries. Corporate profits will be further squeezed by wage pressures. With public sectors increasing as a percentage of total GDP, unions will be emboldened to push for higher wages, adding to government costs. This is a recipe for stagflation. Governments will be blamed for the problem. Pressure to do something - to cope with debt problems and disgruntled voters, will temp them to err on the side of too much reflation. Once an inflationary cycle commences it is very difficult to control. Precisely how this long-term cycle plays out will depend on events currently unknown. Also, the gradual move from deflation or stagflation to inflation will vary considerably among countries, depending on the policies of their respective governments and central banks. We are only in the 3rd year of this cycle, which could easily last another 15 years or more. For investors, gold and commodities will offer some of the better opportunities.

The Dow/Gold Ratio - When I first mentioned the Dow/Gold Ratio last May (FM216), it stood at 31.6, after an all time peak near 45 before the stock market bubble burst. It is 24.8 (8442 divided by 340) as I complete this issue. The historic mean for over 100 years is 5. I maintain we will see the Dow/Gold Ratio fall to at least 15. You can see a chart of the DGR on www.fullermoney.com. Just scroll down Comment of the Day to Monday 16th December 2002.

Interest Rates and Bonds

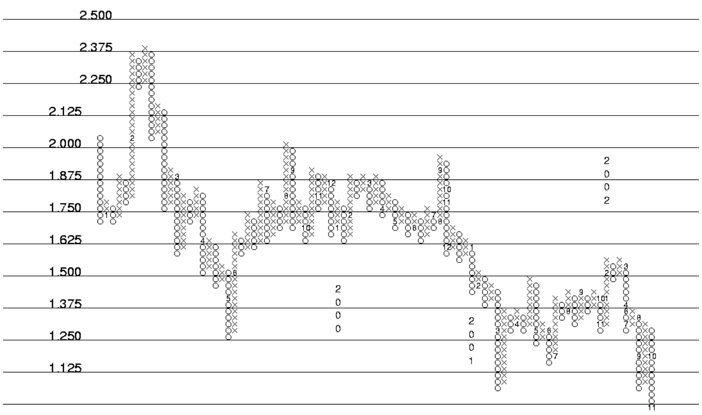
■ **The interest rate cuts may be over, at least for a few months.**

■ **Quality bonds have had a great run in recent years but these gains will be eroded when stock markets recover and interest rates rise.**

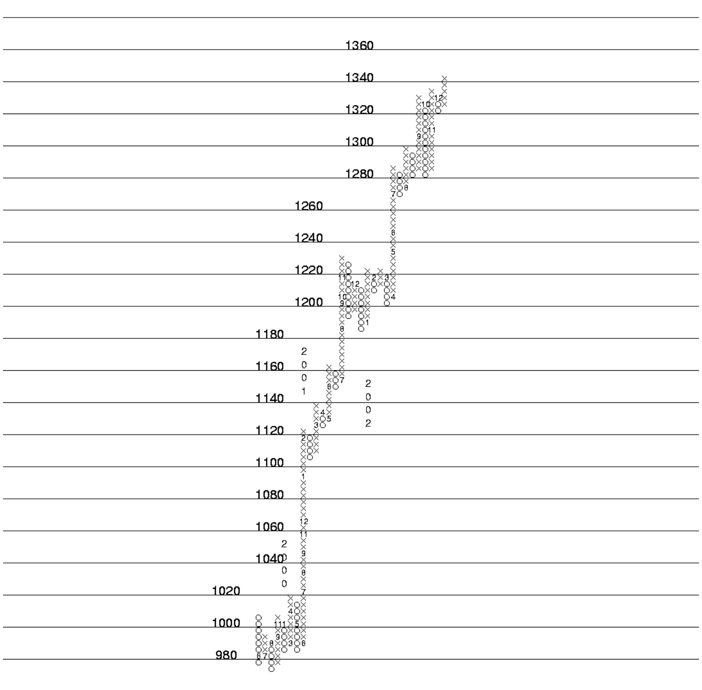
The ECB finally did what everyone told them to do. In cutting rates by 50 basis points on 5th December, from 3.25 to 2.75 percent, the ECB was anticipating that Euroland's inflation would dip under its 2 percent mandated ceiling. Until this occurs, the central bank will have little room for further cuts, whether needed or not, if it sticks by its own rigid rules. The Bank of England's Monetary Policy Committee would have cut rates, had it not been concerned about house price inflation. This factor will probably stay their hand for at least another couple of months. With US rates already down 525 basis points to a 41-year low of 1.25 percent, and with arguably the best performing major economy, Greenspan is unlikely to cut again. Events will determine whether the next move on rates is up or down. Given a brief war to remove Saddam Hussein and little collateral damage, the oil price would tumble, sentiment improve and stock markets rally on justifiable expectations of better economic growth ahead. Against this background the US would lead a cycle of somewhat higher rates, probably commencing in the second or third quarter of 2003. Conversely, with no regime change in Iraq but with the perception of imminent war continuing to influence petroleum markets, OPEC would be in a stronger position to sustain today's high prices. This would weigh on the global economy and increase the possibility of further rate cuts, particularly in the UK and Euroland. Additionally, in the unlikely event of a difficult, demoralising and costly war, the US could easily slide back into recession, weakening the economies of most other countries in the process. This would also necessitate lower short-term rates.

For long-term timing, watch these bond charts closely. All good things come to an end, and in markets, prices change well before the consensus. Looking at the charts, has the long-term bull market in bonds ended? The only potential evidence of this was the trend-breaking rally in US 10-year bond yields. However it is too soon to say that this is more than a medium-term rally, particularly as the other charts shown have not mirrored the US Treasury move. The 10-year Euro-bund, which generally tracks its US equivalent, still has a higher yield and consequently saw a much smaller rally in October. For the Euro-bund, a rally to 4.65 is needed to confirm support near the November 2001 and September 2002 lows, and signal somewhat higher levels. This is unlikely without a further recovery by stock markets. Interestingly, 10-year JGB yields have fallen below 1 percent. However the two main buyers are the Bank of Japan and the country's commercial banks. However the latter only buy because they know the BoJ is propping up this market, giving them a much needed guaranteed return. Problems will eventually occur if/when the BoJ is no longer willing to support the market and Japan's economy recovers more than a blip on the screen. Globally, the MSCI A rated and BBB rated Total Return Indices, which contain mainly sovereign issues, show that the bull market is still intact. However, given the gains already seen, the risk can only increase as bond prices rise and yields fall. Tempted by low yields, supply will increase to meet demand. Many bondholders will reduce their fixed interest investments if/when stock markets rally, and global GDP growth improves, bringing forward the prospect of higher short-

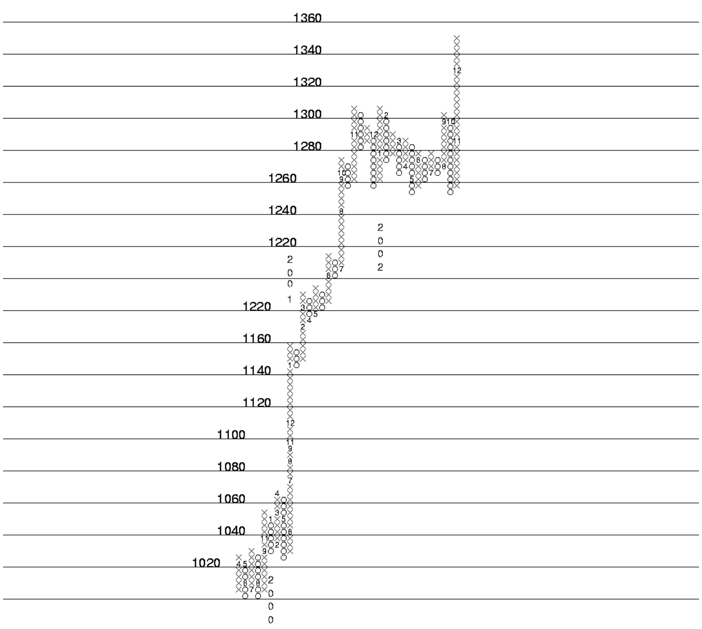
Japanese 10 Year Bond Yield (0.025)



MSCI Euro Dollar Index A Rated Total Return (4)



MSCI Euro Dollar Index BBB Rated Total Return (4)



term interest rates.

Strategy on bonds - My personal view on bonds changed from long-term bullish to cautious two months ago, in FM221. Today, I have few bonds, not because their bull market is over - I see little evidence of that although the rise in US 10-year Treasury yields looks like a warning shot across the bows to me. Of greater concern is the deflation fighting by the Fed and Bush Administration, resulting in increased supply of US government debt. Also, we can expect a massive monetary reflation by the next Bank of Japan Governor, when that yet to be announced individual takes over on 20th March 2003. Euro-bunds are probably safer but their directional move is likely to be dictated by the US market. Meanwhile, the US dollar price of gold just hit a 3-year high - not a great story for bonds. For government bonds to do a lot better than the considerable bull market that we have already seen, requires at least one of the following interrelated factors: stock markets slump beneath their October lows, the US heads for a double dip recession and the deflation-fighting measures fail. While all three are possible, many bond investors are already positioned for such an outcome. Consequently, the 'shock' for government bond bulls would be a further stock market rally in 2003 and a somewhat better economic performance, keeping deflation at bay. Because so many people own government bonds, I feel there is more to lose in this event than there is to gain if the first scenario unfolds. Both scripts are plausible, in my view, even though I maintain stock markets are unlikely to sustain more than a medium-term rally. Of course share indices could behave in a laterigrade fashion for a lengthy period, in which case quality government bonds should remain generally firm, enabling holders to pocket the yield. BBB rated corporate bonds, which have outperformed higher rated company and also government debt since the stock market rally commenced on 10th October, should generally track stock markets. Bottom line - I would continue to ease out of bonds, or at least shorten maturities. An alternative strategy would be to use trailing stops of not more than 10 percent.

Global Stock Markets

■ **A perception that war against Saddam Hussein could be close at hand is dominating short-term sentiment once again.**

■ **Technically, moves over the August highs by the S&P 500, DJIA and FTSE 100 indices are required to improve the near-term outlook.**

■ **Japan's stock market performance following its burst bubble in 1990 is still the best guide for equities in most other countries.**

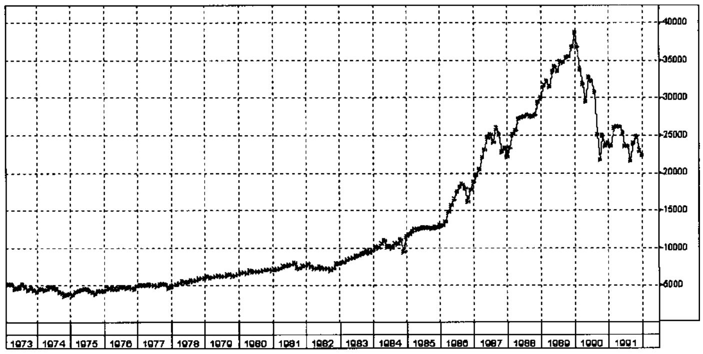
The prospect of war outweighs other considerations. The rebound commencing on 10th October was partially due to a reassessment of the military risk concerning Iraq. Once the US decided to work through the UN Security Council, the threat of war was no longer imminent.

However, it was all but inevitable that when investors next sensed that war against Saddam Hussein could be close at hand, selling would regain the upper hand. This has happened following the 8th December declaration by Iraq that it had no WOMD. Few people believe it and the US-led coalition's preparations for war have continued. Additionally, after an eight-week rally on Wall Street, the market was overbought and near important psychological resistance from the August highs. Until investors either suspect that war is no longer a near-term prospect, or the battle commences, it will be difficult for stock markets to sustain another significant rally. The economic news is certainly not sufficiently favourable to lift share markets on its own. If fact, disappointing data remains the norm rather than the exception. My view has been that the prospect of war would interrupt the medium-term rally but that the October lows would probably hold on Wall Street and for a number of European markets, followed by some further recovery once a military move against Saddam Hussein was underway. While still possible, in terms of timing it is best to move in line with the short-term trend, especially on the downside in what I maintain is a secular bear market. The reality is, uptrends following the October lows for stock market indices have lost momentum and need to be reconfirmed with upside breakouts. Moreover the long-term downtrends remain intact.

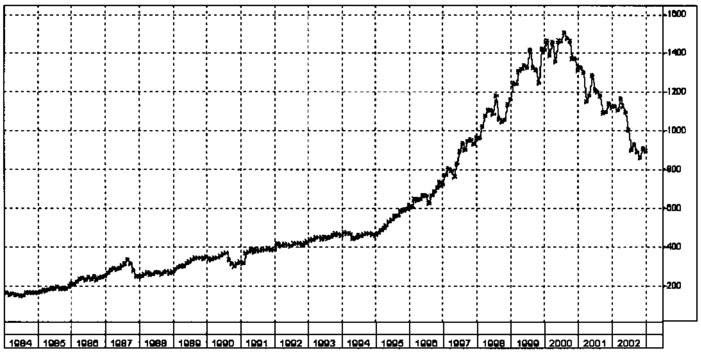
The August highs are psychologically significant. European markets seldom uncouple from Wall Street's overall trend, and most have underperformed the States throughout the bear market to date and during the rally from October's lows. Consequently an upside lead is required from the S&P 500 and DJIA before a further recovery will be indicated. Many technicians cite long-term downtrends, including moving averages for the indices. These are certainly relevant but the important psychological levels, in terms of a further recovery, are likely to be the August highs near S&P 960, DJIA 9100. These were tested in early December and they halted the rally. Interestingly, the NASDAQ Composite and NASDAQ 100 indices cleared their August highs but could not remain above those levels. Europe's lagging indices now face hurdles from their early-December highs before they can rally towards the August barriers. For the FTSE 100 Index, there is the October to early-December lateral resistance at 4200. If the S&P and DJIA can lead an upside breakout, and this may require uncertainty over Iraq to be resolved one way or another, many more investors will believe that the bear market is over. They will also regard the July to October lows as troughs within completed base formations. This latter conclusion would be correct, but only in terms of an extended rally within the secular bear market, in my view.

Most people reject comparisons with Japan's post bubble stock market experience. This is understandable because the entire financial industry and millions of investors have a vested interest in a positive market outlook. Unfortunately, history is not on their side. Secular bear markets, caused by all the prior excesses and abuses, follow burst bubbles. Corporate and consumer debt levels need

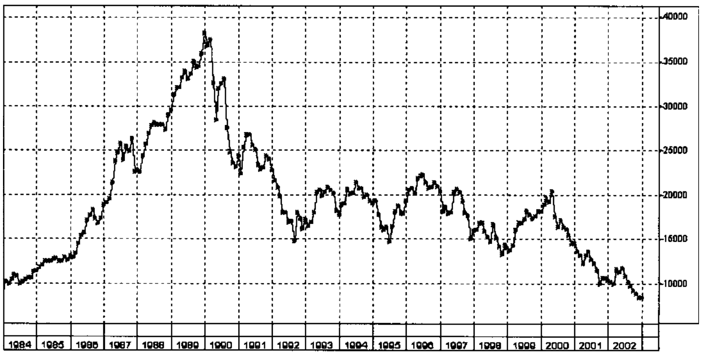
Japan's Nikkei 225 from 1973-1991



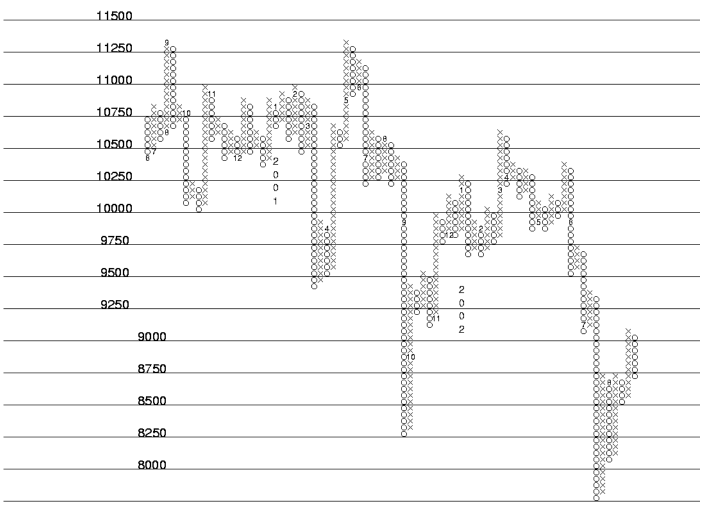
USA's S&P 500 from 1984-2002



Japan's Nikkei 225 from 1984-2002



Dow Jones Industrial Average (50pt)



to be reduced. This takes time and can be a drag on GDP growth. A reappraisal of stock markets causes valuations to revert from way above to well below their historic mean, before the bear market low is seen. This process usually takes considerably longer than three years. Of course one can argue that Japan's bubble experience of the 1980s is different than what occurred in the US, and to a lesser extent in Europe during the 1990s. Yes, but many feel the US bubble was even bigger than Japan's. Behaviourally, they were almost identical, as I have discussed in previous issues. One hopes that the US and Europe will deal with the bubble aftermath more successfully than Japan. This remains to be proven, and a weaker global economy, experiencing deflationary pressures, may impede recovery. Meanwhile, a comparison of Japan's stock market cycle, with that of the US 10 years later, is too similar to be dismissed as coincidental. The first chart shows Japan's Nikkei 225 from 1973 through 1991. The second chart shows the S&P 500 from 1984 through mid-December 2002. Both reveal long, gradual bull markets, accelerating nearly fourfold in the last five years. Both show the subsequent 50 percent fall, followed by a rally. The third chart brings the Nikkei up to date. Many medium-term rallies have occurred but there is still no conclusive evidence that it has bottomed. The point is not that the S&P will move in a similar fashion to Japan over the next several years. This is unlikely for a variety of reasons. Instead, it is a reality check for those who say that Wall Street's bear market is over. Historic evidence, and not just the recent Japanese example, shows that post bubble bear markets do not end with declines of only 50 percent. There is also a risk that it takes many years before the final low is reached.

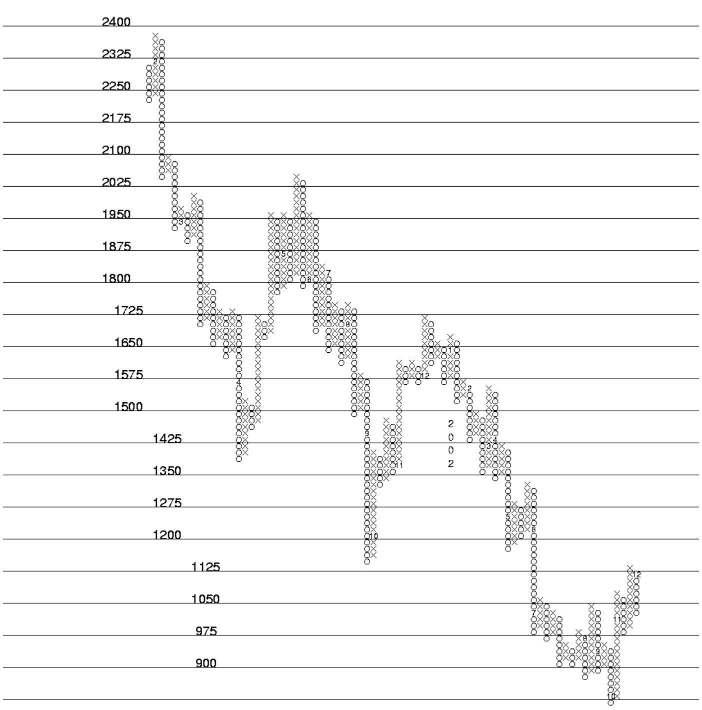
Chart review of topical and representative stock market indices - *The 3-box reversal point & figure charts shown are based on closing prices and taken from our website. Anyone interested in this chart service, which includes analysis and is updated daily, should register online at www.chartanalysts.com.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

The US's DJIA (8557) recently lost momentum beneath its August high and has just seen its biggest reaction since the October low. A break in the progression of rising lows would indicate a further retracement of recent gains. **The NASDAQ 100 Index (1040)** has backed away from initial resistance from the September 2001 and May 2002 lows, and requires 1140 to signal a further test of overhead trading. **The Philadelphia Gold & Silver Index (75.79)** shows a massive developing base formation, probably in its latter stages. The recent move over September's high has opened the door to a test of lateral resistance in the 88 to 93 region.

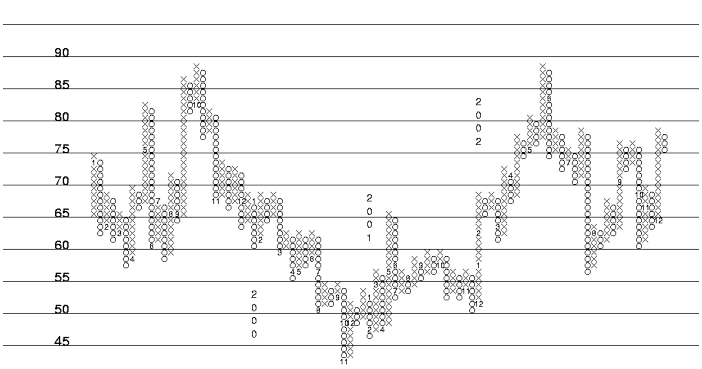
Japan's Nikkei 225 Stock Average Index (8511) has fallen back to its October/November lows where some support may be found. However the overall bias remains downwards and 9300 is currently required to indicate a test of overhead trading.

Singapore's Straits Times Index (1343) has fallen back to the September 2002 low where some support may be encountered and it is also within the more important September 2001 trough. However a break in the progression of lower rally highs since the March peak at 1800 is required to suggest more than a small rally.

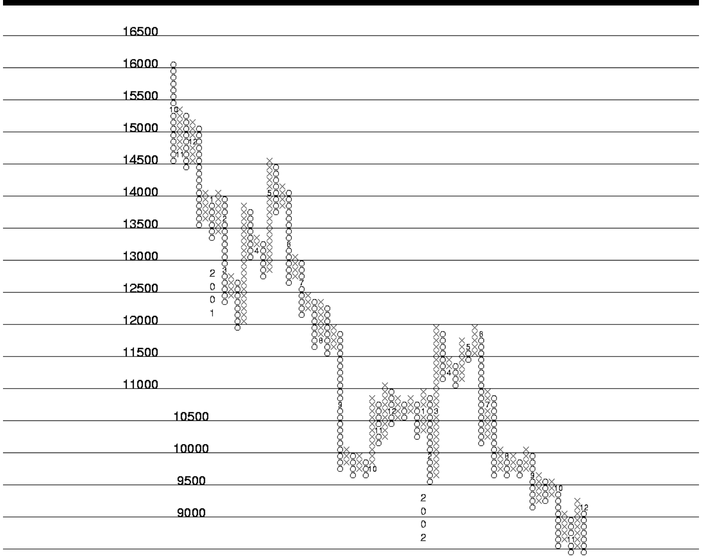
Nasdaq 100 Index (15pt)



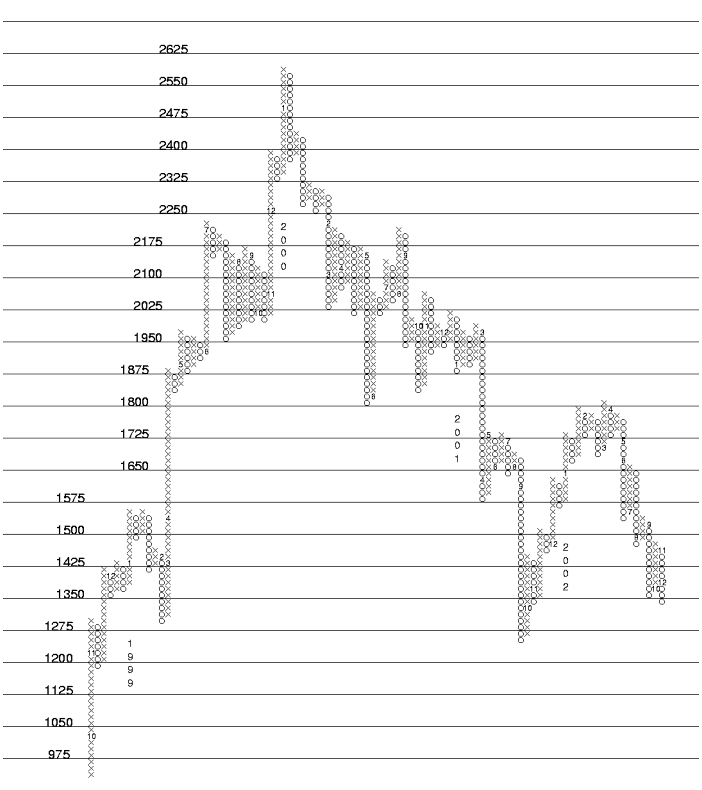
Philadelphia Gold & Silver Index (1pt)



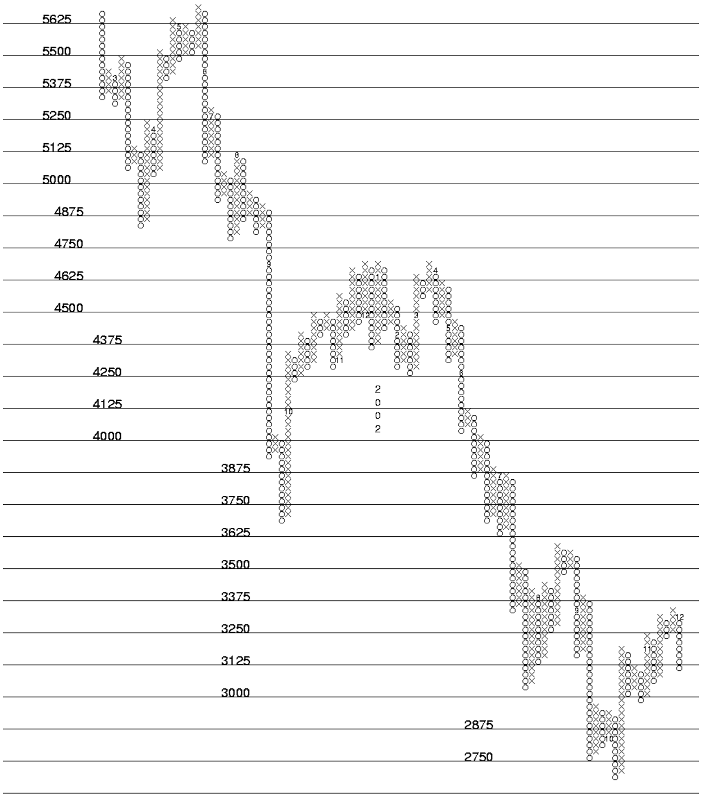
Nikkei 225 Stock Average Index (100pt)



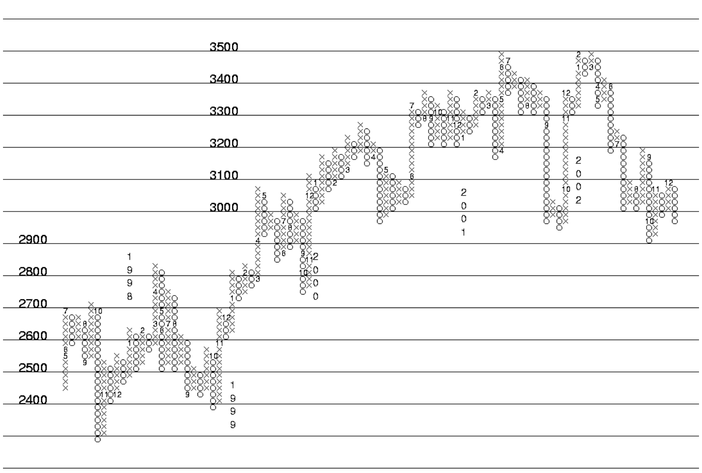
Singapore Straits Times Index (15pt)



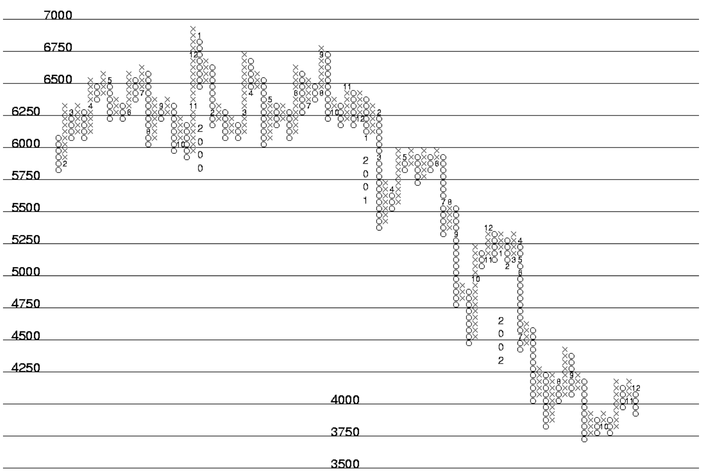
France CAC 40 Index (25pt)



Australia S&P ASX 200 (20pt)



United Kingdom FTSE 100 Share Index (50pt)



Australia's S&P ASX200 Index (2986) has eased once again within this rounding top formation. A rally to 3100 is required to indicate a somewhat higher phase of trading within this pattern.

France's CAC 40 Index (3139) has steadied above the psychological 3000 level but now requires 3350 to reaffirm the recovery since October and a possible test of the August high at 3575.

Germany's DAX Index (3140) - *not illustrated* - has also firmed above the psychological 3000 level and 3400 would suggest some further test of overhead trading. Conversely a close at 3050 would indicate a probably break of 3000 to follow.

The UK's FTSE 100 Share Index (3908) shows an overall loss of downward momentum, possibly indicating the formation of a small base. However a break above 4200 is required to indicate a further rally towards the August high.

Strategy for stock markets - As I complete this issue stock markets have corrected a short-term overbought condition and firmed. The near certainty that there will be no US-led military move to replace Saddam this side of Christmas has enabled investors to focus on seasonal factors once again, and the possibility of somewhat better profits for 4Q 2002. However upside scope is probably limited until the DJIA and S&P 500 break above their August highs, and the Iraq situation is resolved one way or another. Needless to say, sentiment would improve if these two indices moved above 9100 and 960, respectively. However, I continue to regard forecasts that the bear market is over by an increasing number of brokers and investment managers as a contrary indicator. OK, there has to be a statistical chance that they could be right, but all post bubble history argues otherwise. Meanwhile, sentiment is always a far better indicator of what people have done, rather than of what the market will do. As we move beyond the yearend holidays, war concerns can easily overshadow all other considerations, including low interest rates, fiscal spending, somewhat higher corporate earnings and technical improvements since 10th October. Also, a lesson of these post bubble markets is that it is risky to buy following a technical rebound. The best buying opportunities occur following panicky sell offs. Tactically, I would be reluctant to increase longs this side of a probable war, which would create a better buying opportunity. However I would consider lightening longs, especially with trading positions, on any additional near-term strength. Additionally, I continue to short lightly as near-term indicators become overbought and/or rallies lose momentum, but I would cover and probably reverse to long shortly after military action commenced. For those who are not traders and are already in the market, as most of us are to some degree, you will probably have a better opportunity to raise more cash once Iraq is no longer a concern. However, few charts show patterns capable of supporting more than technical rallies. I continue to assume that we are seeing no more than a medium-term recovery in what remains a secular, post bubble reversion from extreme overbought to what I suspect will eventually be extreme oversold conditions, in terms of historic valuations. FMP196 (4/12/02) focussed on gold and silver shares, which had firmed near prior support. Most have rallied strongly and bullion's break above $330 is very encouraging. If this move is extended, as is quite possible, and confirmed by the price of gold in other currencies, the shares could do extremely well. A rising gold price would improve earnings prospects dramatically. I wish to remain overweight in gold shares but my strategy is to buy on weakness and lighten after a good run, because of their volatility. However, provided gold maintains its recent breakout, let alone moves higher, I may not lighten significantly until the rallies lose momentum beyond a brief consolidation. My strategy on all other positions mentioned in recent issues is unchanged.

Currencies

■ **The euro is now the clear favourite among the three main reserve currencies but the dollar should stage a temporary rally when Saddam is removed from power.**

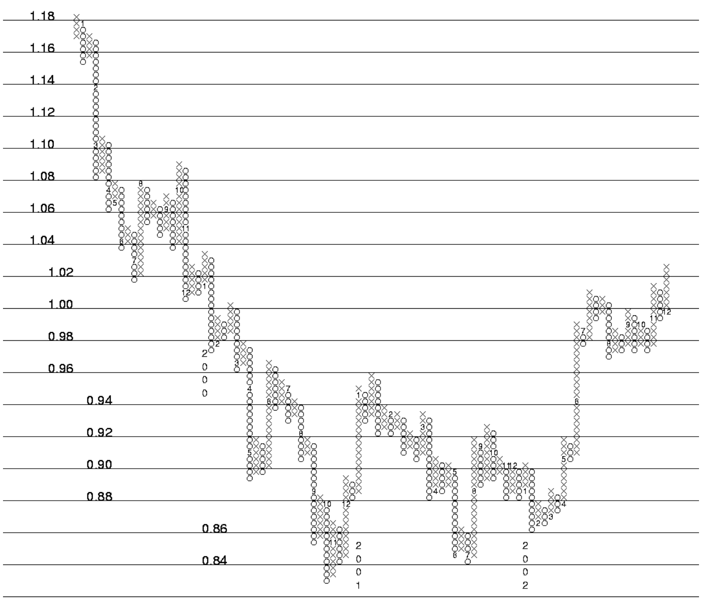
■ **Sterling should move somewhat higher against the dollar, while weakening versus the euro.**

The euro is still recovering from a previously oversold position after three consecutive years of declines following its launch. Its trough, you may recall, was established following multilateral intervention to support the single currency, which had become an embarrassment for Euroland's ministers. Today, few people would regard the euro as a choice plum, given Europe's sclerotic economies, an unwieldy plan to increase the European Union by many more member states, and the European Central Bank's deflationary mandate. However in this currency contest, it is the least ugly that wins the prize. As for the dollar, everyone knows it was overvalued following the bubble years. Once the US stock market tumbled and interest rates were slashed, a lengthy correction became inevitable. Greenspan has been pumping huge quantities of liquidity into the US financial system ever since the bubble burst and a Fed governor recently mentioned that there would be no limits on monetary policy in the effort to prevent deflation. Lastly, as the dollar weakens people worry more about the US current account deficit. The yen is no alternative to the dollar, not to mention the euro, despite Japan's current account surplus, which is the legacy of mercantilist policies over many decades. Yen deposits pay no interest and the economy remains trapped in a destructive deflationary cycle. The Ministry of Finance and the Koizumi Administration want a weaker currency, unlike the Bank of Japan. However in appointing the next BoJ governor, who will take office on 20th March, the Prime Minster has said he wants "someone who has conviction, and someone who will aggressively fight deflation". We can expect the mother of all reflations from the BoJ next year.

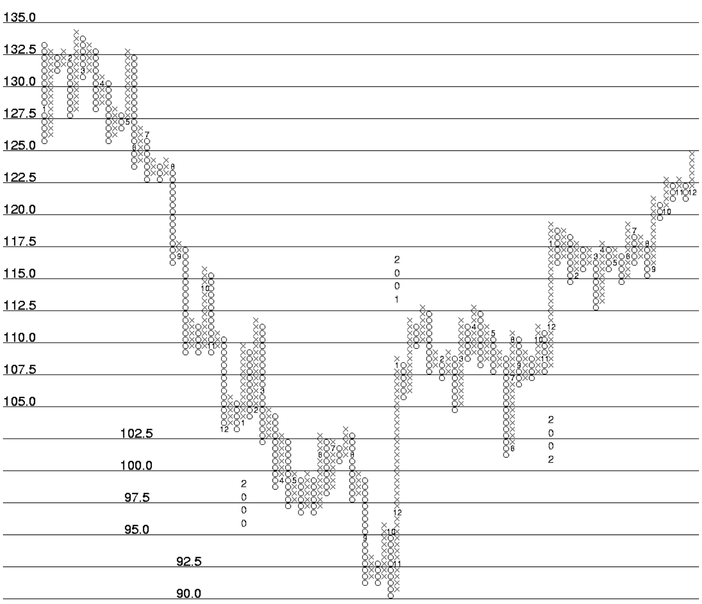
There you have it, game-set-and-match for the euro in this three-way contest, at least for a while. However it should have at least one stumble on the way to my long-stated target of $1.10 - $1.15 next year, and a temporary overshoot is possible, given the nature of markets. Assuming the US does remove Saddam Hussein, the dollar should rally temporarily against the euro. Lesser stumbles for the euro could occur on concern over Euroland's and especially Germany's continued economic decline relative to the US, which will benefit from a somewhat softer dollar. Therefore new US Treasury Secretary John Snow will be content to see the dollar ease. He won't need to talk it down because the trend is doing quite nicely. Officially, US spokesmen will repeat, when asked about the dollar, "America's policy is unchanged. We support a strong dollar." Anything else would roil the markets. As the euro appreciates, watch for eventual protests from Euroland's exporters. This will be the first evidence that the single currency has commenced the latter stages of its recovery. Meanwhile, it should move a lot higher against the yen.

Sterling continues to outperform the dollar on interest rate differentials and a mistaken belief that the UK economy is in better shape than the US. This might just lift the pound to $1.70 - $1.75 against the greenback, with the help of higher interest rates, but it won't last. Britain's current account deficit is widening and the tax structure is moving steadily in Euroland's direction. The UK economy will continue to underperform Chancellor Brown's forecasts and with the property bubble bursting, a decline in consumer spending will force the Government to borrow even more. The IMF has already expressed concern. This will encourage the UK's pro-euro lobby, contributing to further easing against the single currency.

US Dollar per 1 Euro (0.004)



Japanese Yen per 1 Euro (0.5)



Pound Sterling per 1 Euro (0.002)

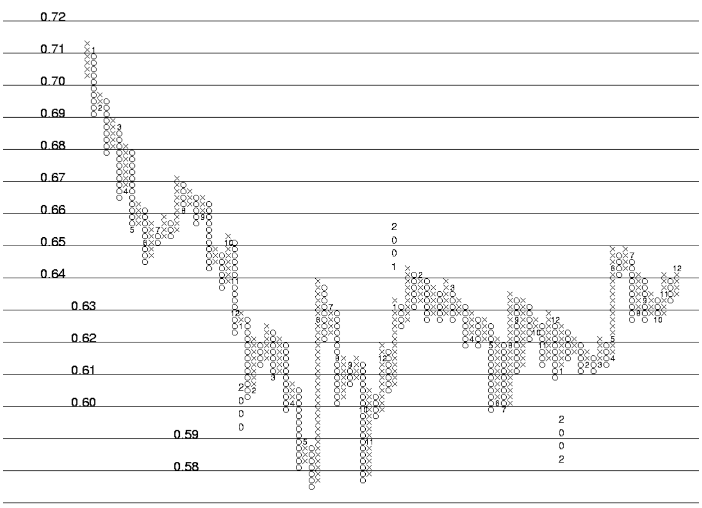


Chart review of important and topical currencies **-** *These and hundreds of other 3-box reversal closing basis point & figure charts are available on our website, www.chartanalysts.com and are updated daily. All comments refer to closing levels for US trading hours.*

Euro/dollar ($1.0306) - The euro has completed its first step above the base, after nearly six months of consolidation. A decline back beneath $0.99, which seems unlikely, would be required to question current scope for additional gains.

Euro/yen (¥124.52) - The euro has encountered some resistance near ¥125, from the underside of its trading range during the first five months of 1999. However a move under ¥121, which seems unlikely, would be necessary to indicate more than brief resistance here. Extensive underlying support and the increasingly orderly trend suggest a move to at least ¥130 before long.

Euro/sterling (£0.6430) - Is gradually ranging higher in an extended base formation. A break above £0.65, which appears likely before long, would signal further gains.

Sterling/yen (¥193.46) - While the pound could not maintain this month's break above the October-November highs at ¥194, a move to ¥188 would be required to indicate a more significant loss of momentum. The more likely outcome is a resumption of the uptrend before long, which remains well supported.

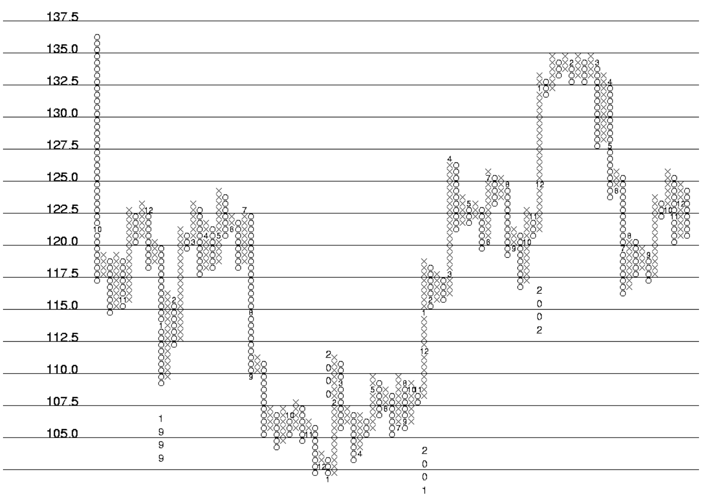
Dollar/yen (¥121.30) - This remains the weakest of the major yen crosses. Nevertheless there is more support than resistance near current levels. Sideways to higher ranging is likely.

Dollar/Swiss franc (SF1.4325) - The greenback has completed its first step beneath the top, in breaking beneath SF1.4450. A rally to SF1.4850, which seems unlikely, is needed to offset lower scope and a test of the October 1998 to January 1999 trough down to SF1.3150.

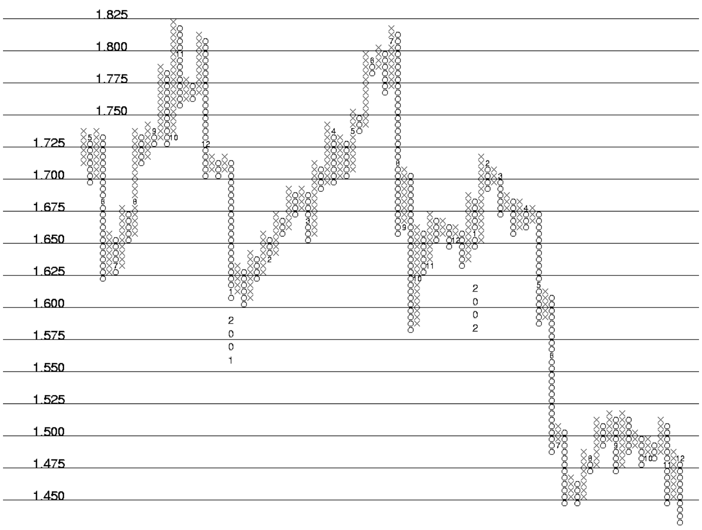
Australian dollar/US dollar (US$0.5662) - The Australian dollar's additional build-up of support should enable it to test the formidable psychological barrier just above US$0.57 once again, eventually breaking higher.

Strategy on currencies - Euro/dollar and Swiss franc/dollar are now trend-running rather than Baby Steps plays, following their recent breakouts. I usually prefer to play the euro against the yen, for the sake of simplicity, and have leveraged this position up, protecting the core holding with loose trailing stops. Since 2 to 3 yen reactions have been frequent, I do a little Baby Steps buy-low-sell-high trading to lower overall costs, lightening longs when Bloomberg's Stochastics Indicators (short-term overbought/oversold) are overbought, because I know may traders watch these closely. When the euro breaks above resistance near ¥125, I will stay with this strategy if it pushes steadily towards the early-1999 high at ¥134. However if it shows a loss of momentum and begins to range relative to what we have seen recently, I'll probably use more Baby Steps, reducing the core longs on rallies. The other possibility is that the euro accelerates higher, which would be extremely good

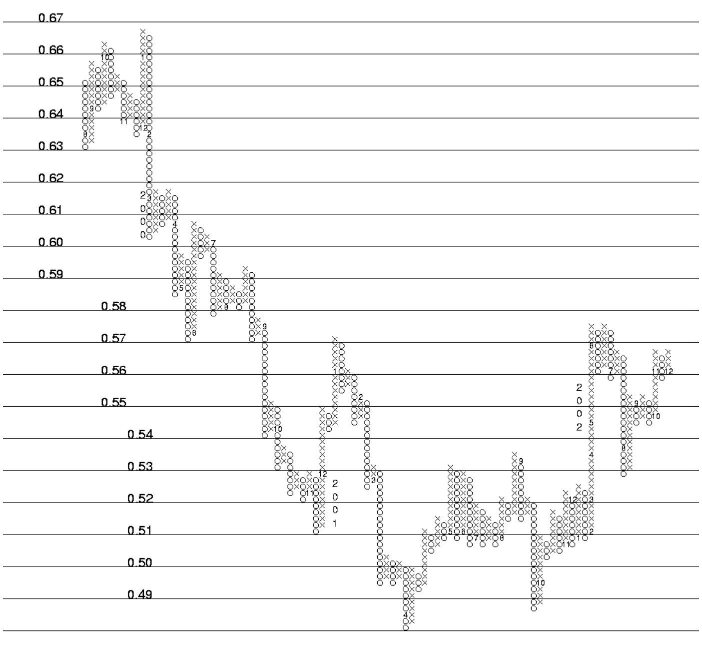
Japanese Yen per 1 US Dollar (0.5)



Swiss Franc per 1 US Dollar (0.5)



US Dollar per 1 Austrailian Dollar (0.002)



news while it lasted. In this event, I would run trailing stops for the entire position, some of which would be quite close. Once out, I would not consider buying back until the Stochastics became oversold and a significant reaction had occurred. It is impossible to outline a strategy for all eventualities here, but I comment on these currency trades daily in my Audio. The best play against the yen has been the Norwegian krone - a petrocurrency with a 700 basis points interest rates advantage. I don't trade it because unfortunately it is not quoted by my tax efficient UK spread-betting facility. However many subscribers have been running NK/yen longs very profitably, by trading through banks. The risk with this trade is a drop in the oil price, which could cause the crowd to exit at the same time, producing a sharp reaction. Consequently, if I had this position, I would close it the instant a war against Saddam Hussein commenced, or at least use a tight stop. I do trade dollar/yen, now entirely on a Baby Steps basis. While there are no money back guarantees in markets, I like knowing that the MoF will threaten intervention near ¥120. While it ranges, as we now see between ¥120 and ¥124, it's a nice little earner.

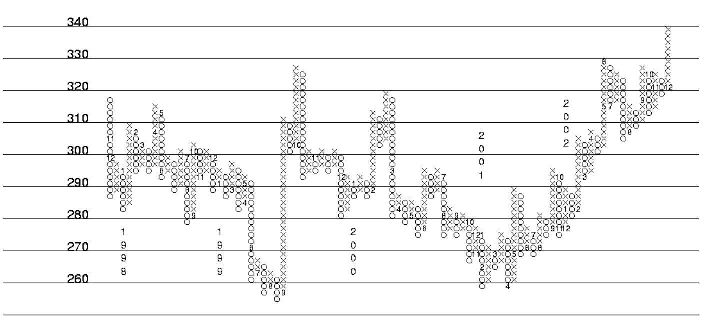
Commodities

- **Gold breaks above lateral resistance - this could be base completion.**

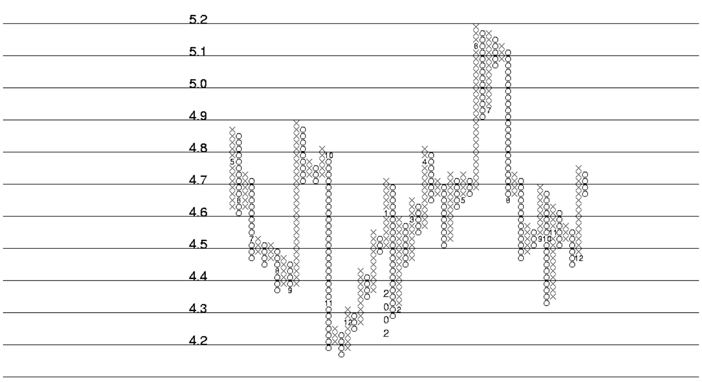
- **Oil continues to regain the war premium and Venezuela's strike has also contributed to this temporary strength.**

If gold bullion maintains this break above lateral resistance in the $225 to $330 region, it will confirm base completion. This breakout, if maintained, could have very important implications for other investment categories and the US dollar. Moreover, if gold completes bases against other leading currencies, it will have gone a long way towards being remonetized in the eyes of international investors. Many will resist this conclusion because gold had a 21-year secular bear market. Consequently they have dismissed gold or gold-related instruments as viable investments. Most broking and fund management firms fear the implications, should the gold price establish an uptrend, these being diminished confidence in other asset classes. However you and I can only deal with the reality that markets provide. I try not to have a favourite asset class, other than what happens to be in form. I am always interested in recovery situations, since most secular bear markets are eventually followed by bull trends, often of a similar duration. What would fuel a long-term recovery for gold? Investment demand from holders of US dollars, including Americans, China's Government, the Japanese and hedge funds. Japanese investors could also resume their purchases of gold in preference to yen-denominated assets, especially when the next BoJ governor announces an inflation target, and joins with the MoF and Koizumi Administration in seeking to weaken the currency. There is also the often-rumoured possibility of a bear squeeze in gold, although that could only produce a temporary spike. While gold's long-term outlook is unequivocally bullish in my view, secular uptrends usually begin slowly. It has already

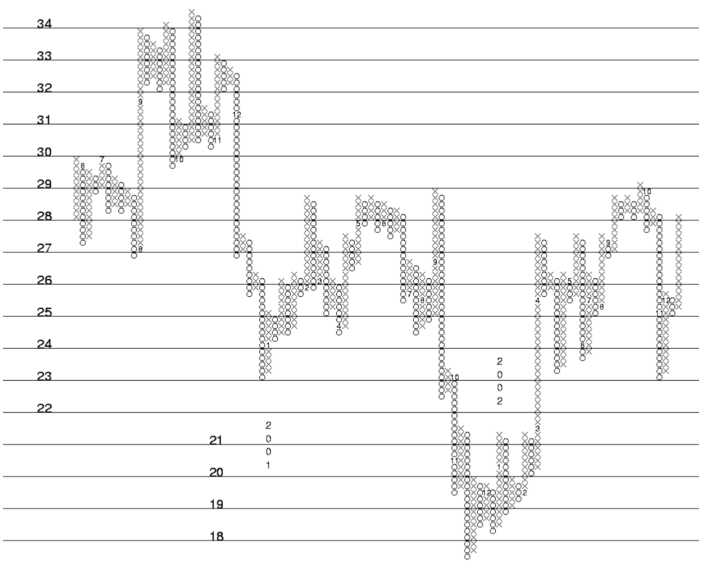
Gold CMX 2nd Month Continuation (2USD)



Silver CMX March 2003 (0.02USD)



Crude Oil NYME 2nd Month Continuation (0.2USD)



taken five years to complete a base in the US dollar price of bullion. Following breakouts from these formations, there is often a lengthy consolidation of gains, referred to at The Chart Seminar as the first step above the base. For gold, the next lengthy pause could coincide with weaker oil prices. Silver's usual role is to track gold, albeit with a higher beta. It has lagged for some time, due to lack of interest, but should catch up fast as gold extends its breakout.

There is no shortage of oil capacity. High prices for most of the period since late 1999 have inevitably encouraged additional capacity. Moreover, technology has played a greater role in oil discovery and retrieval than ever before. This includes deep water drilling, lowering the cost of production from oil-rich shale and sand deposits, and new methods to extract oil from fields previously thought to be depleted. Consequently only two factors are enabling prices to remain at today's levels - political unrest in Venezuela and the expectation of war in Iraq. Of these, the latter is infinitely more influential. Fearing a price spike, suppliers have boosted inventory and few dare to sell short. However the probability, suggested by the last Gulf War and the price charts, is that there would be only a small spike at most, and that the price would plummet following the removal of Saddam Hussein. Yes, there is a chance, albeit small in my view, that something could go badly wrong during regime change, and it is the nature of markets to discount this fear. Therefore the war premium has returned in recent weeks. However once the Iraq issue has been dealt with, everyone in the petroleum markets will know that the era of high prices is over for a few years. Long hedges in futures will be reversed, producers will pump more to offset falling revenue and buyers will reduce inventory. This will be reflected by the market, which would also discount the doubling of Iraq's production as UN sanctions were lifted. Crude oil would soon fall below $20 and could easily reach $15. The alternate scenario is that there is no war. In this case petroleum prices would also fall but it would take longer. Meanwhile, the war premium is increasing and the price of natural gas has more than doubled from January's low. This is not helping the global economy.

The Global Economy

■ **Will the global economy experience a healthy recovery as forecast by most politicians, or will the next few years be characterised by deflation, stagflation or even an inflation problem?**

You can't fault the US government for effort in trying to stimulate GDP growth but will it make matters worse later? Fiscal spending is booming as President Bush, with an eye on the 2004 election, is determined not to repeat his father's defeat, largely due to a weak economy, when seeking a second term. Having regained control of the Senate, the administration will increase its use of a proven formula for growth - permanent tax cuts. The replacement of US Treasury Secretary Paul O'Neill and White House economic advisor Larry Lindsey is part of an effort to increase confidence within the business community and on Wall Street.

Over at the Federal Reserve, monetary policy has been just as stimulative, with short-term interest rates at a 41-year low of 1.25 percent. This is actually below the rate of inflation. Chairman Greenspan, in addition to pumping money into the economy, has urged the public to keep on spending. While no US government spokesperson is likely to publicly abandon the strong dollar policy, they would welcome a further, gradual decline by the greenback because deflation is feared much more than inflation. The government is doing everything in its considerable power, in an effort to prevent a sharp drop in consumer spending before corporate capital spending eventually increases. Unfortunately, this will not necessarily be a case of - gain today, less pain later. It could also be a matter of - gain today, more pain later.

History's lesson is that the post bubble environment

will continue to cause problems for many years. Unfortunately, this is not just a matter of financial sophistication and economic management. Bubbles are a reoccurring human psychosis. Consequently they may not be preventable. However they can certainly be made worse, as can their aftermath. The important issue today, is what policies will limit damage and increase long-term recovery prospects? Needless to say, there is no consensus as to what should be done. However policy makers will recall and learn from the most recent mistake, in this case Japan's post bubble experience, and endeavour not to repeat it. For instance, Greenspan knew that the BoJ tightened monetary policy for three years - 1990 through 1992, to ensure that Japan's property and stock market bubble really had burst. Consequently the Fed Chairman commenced lowering rates in January 2001, nine months after the stock market bubble had burst, and has cut them by 525 basis points in 12 steps to date. The Bush economic team knew that Japan had raised taxes, compounding economic stagnation, so the US has cut taxes and will do so again.

Due to the imprecise science of economics - because aside from infrastructure an economy is less of a machine than a synthesis of multi-facetted behavioural patterns plus money - pundits will endlessly debate the pros and cons of fiscal and monetary policies. However there would be little merit in deliberately pursuing a path that unnecessarily increased the risk of a slide into destructive deflation, defined here as falling output, prices and profits. Nevertheless there are tradeoffs. While increased fiscal spending in a weak economy will cushion economic contraction and reduce the current risk of deflation, it also produces a ballooning budget deficit. If sufficiently strong growth does not occur over the next few years, enabling government debt to be reduced, this borrowing will be a significant problem in the future, especially during the next economic downturn. Obviously the government does not want the fear of terrorism or any other psychological factor to trigger a double-dip recession. However by encouraging people to borrow and spend more now, it risks further inflating the house price bubble and compounding a consumer debt problem.

Corporate debt is the unpleasant legacy after bubbles burst. As stock market bubbles inflate, businessmen think they are geniuses and therefore entitled to vast riches. They dramatically increase corporate borrowing in order to expand more rapidly. Then they over produce and make too many takeovers, for which they over pay. Ethics are lost in the scramble and too many skim off what they can. The post bubble environment is inevitably deflationary because growth slows; there are more goods than can be consumed, and profits fall. For many corporations the only growth is in the size of their debts, which are much more difficult to service, let alone reduce, in the post bubble environment, despite lower interest rates, which may only be nominally lower. Consequently many businesses contract, through plant or office closures, staff layoffs and the sale of subsidiaries, often at knockdown prices. Some companies contract to the point of extinction.

When a bubble is inflating, the public, at least those who invest in the stock market, also believe they are geniuses. They too leverage up and spend more. The fashion for conspicuous consumption continues long after the bubble has burst, because even though they know they have less disposable income from stocks, people expect and hope for the good old days to return. A not very objective financial industry, especially TV channels, colludes with this fantasy. However as returns continue to disappoint, many investors turn to property, buying houses, trading up or improving what they own. A burst stock market bubble can actually encourage a property bubble, although in Japan's case they were coincidental. Encouraged by lower nominal interest rates and still hooked on consumerism, many people borrow against their homes to finance consumption, believing that appreciating house prices will more than offset their equity drawdown. When a property bubble bursts, the economy really is in trouble because most people have a far higher percentage of their wealth in their homes than in the stock market. Psychologically, they can easily sell stocks, and soon feel quite good about it if the market continues to fall. However if one's house is depreciating in value, escape from the downtrend is not so convenient. The negative wealth effect of falling house prices hits consumption hard.

Governments often increase spending during bubble years, especially when surpluses occur due to increased tax revenue. However, since politicians are at least as susceptible to narcissism as anyone else, the incumbent party believes it is responsible for the good times, which should therefore continue. Consequently there is no belt tightening in terms of public spending, even when tax revenues are clearly and inevitably falling in the post bubble environment. Instead, most governments raise taxes to cover the shortfall, which deters wealth creation. Meanwhile, there is increased pressure from public sector employees, who were left behind during the bubble years due to the nature of their work, and understandably want their share via higher wages. As post bubble economies continue to slow, many governments continue to raise taxes, ensuring less growth from the private sector, and they borrow more to cover the shortfall. Growth continues, albeit often at a declining rate, but the more efficient private sector is contracting relative to the less efficient public sector. Increasing deficits are a rising tax on current and future economic growth. This is a proven recipe for economic stagnation. Once in this difficult situation, governments will try to reflate their way out. Their policies, together with global trends, will determine whether this effort is successful, or results in at least one of the following - inflation, stagflation or deflation.

The global trend is mainly disinflationary and deflationary. Nevertheless economic data is usually skewed. Today there are pockets of inflation, mainly from public services, also service industries such as insurance, and property prices have risen strongly in a few countries during the last several years. Among major countries and economic regions, the US alone continues to pull all monetary and fiscal levers, and is therefore most likely to avoid outright deflation, such as we see in Japan and several other countries, apparently including China. Deflation in China is a surprising turnaround since it had a double-digit inflation problem less than a decade ago. Also, even if the official report of 7 percent GDP growth is an exaggeration; it is probably at least 3 to 4 percent per annum. However there is little doubt that China is a major factor behind global deflationary pressures, as its cheap labour undercuts manufacturing costs elsewhere. This has convinced an increasing number of companies that they must relocate plant and machinery within China, in order to survive. The rest of Asia's picture is mixed, but where growth fades, deflationary pressures will be paramount, as we have seen with Japan over the last four years. Euroland's core economies are currently experiencing some stagflation. Germany in particular is susceptible to outright deflation, as government tax increases to pay for the welfare state and keep the budget deficit from surging above the Stability Pact's 3 percent ceiling have sapped enterprise and damaged morale after a decade of minimal growth. Fear of terrorist attacks, however statistically unlikely that this unpleasant possibility would actually injure many Americans and Europeans, is nonetheless deflationary for the travel industry and popular tourist spots. In contrast, regime change in Iraq by military means is unlikely to have any deflationary effect, unless the effort somehow went badly wrong. While this is just possible, as there is a leap in the dark aspect to any war, it is extremely unlikely.

Until GDP growth rebounds and looks sustainable, governments will increase their deflation-fighting efforts. The US is already doing so. Japan has recently targeted its currency and this effort will increase once BoJ Governor Hayami has been replaced on 20th March. Among major central banks only the ECB continues to wear the hairshirt, primarily due to its deflationary mandate. However, a fudging of the stability pact is underway and criticism of the ECB within Euroland is increasing. Assuming the post bubble environment remains one of generally low global GDP growth, as history would suggest, and disinflationary/deflationary pressures are further compounded by China's unique effect on global manufacturing due to its size, deflation will exceed terrorism as public enemy number 1. More countries will increase their monetary and fiscal stimulus. They will eventually succeed in the fight against deflation but another of history's lessons is that the seeds of another inflationary cycle will have been sown in the process. Nevertheless the next global inflationary problem is probably at least a decade away.

And Finally…

Are you seeing the Fullermoney Plus (FMP) updates? - I still hear from veteran subscribers who either do not see the FMP single-page updates, which average 3 a month, or mistakenly think that these are only available at extra cost. This confusion may persist because when the FMPs were first launched in January 1997, to provide more Fullermoney timing calls between the main issues, they were an additional cost. This policy changed approximately three years ago. Consequently all paid-up subscribers are entitled to the 12-page monthly issues and the FMP updates, but they need to be online. Immediately upon release of FM and the FMPs, a notification email is sent to all subscribers. All you need to do is go to my website - www.fullermoney.com, and type your personal password in the 'members login' area on the home page. This will give you access to the latest copy, which you can read online and also print, should you wish to. If by any chance you have not been issued a password to the members area, subscribers can ask for one by using the website email facility.

For my latest thinking, check the Audio - The biggest addition to the Fullermoney service in many years is the Audio, which I record most days. This enables me to update views and strategies, and to comment on breaking news stories of international interest. There is no extra charge for the Audio, which can be accessed once you enter your password in the 'members login'. If you don't already have audio software you will need to download this from the website, and you will also need either desktop or headset speakers. For comment on a specific market or event, preferably of general interest, send an email request via the site. Unfortunately I will not be able to post any more Bloomberg interviews on the site, as they no longer provide CDs of these sessions. Fortunately I am able to provide much more detail in the Audio.

The first target date for FM224 is Friday January 24th.

> "The desire for imaginary benefits often involves the loss of present blessings."
>
> Aesop

Best regards - David Fuller

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