Issue 224
31 January 2003
In its 19th year

Fullermoney

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

Stock markets are technically oversold in the short term but unlikely to see more than a "dead cat bounce" until Saddam Hussein is no longer ruling Iraq. Thereafter, we will see no more than a medium-term rally before the secular bear market continues.

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The PRC is boosting its bullion reserves as pressure to revalue the yuan increases.

China's foreign currency reserves are soaring, as it becomes the global manufacturer of last resort. Competition in a difficult economic environment is causing an increasing number of multinational companies to relocate manufacturing to China. Currently, no other country can match China's combined advantages of disciplined workforce, low wages and land costs, plus a steadily improving infrastructure. And China is becoming even more competitive because the yuan is pegged to a weakening US dollar. The PRC's trade surplus is growing between \$4 and \$5 billion a month. Its foreign currency reserves, which are mostly held in US dollars, were \$270 billion last October, according to The Economist. This figure is probably close to \$300 billion today.

Something has to give; otherwise China's role as global manufacturer of last resort could cause a global depression. With millions of Chinese citizens leaving rural areas, its overmanned agricultural sector and inefficient state industries for better opportunities in the new industrial zones, the PRC won't run out of willing workers anytime soon. This all but inexhaustible source of labour has kept wages low. Meanwhile, the US's rapid credit expansion and growing current account deficit is unlikely to strengthen the dollar. US M3 grew by 1.3 trillion dollars in the 24 months from January 2001 through December 2002 - an 18 percent increase, according to Jeff Fisher. This trend is unlikely to change for some time, as we have already heard from Alan Greenspan and Ben Bernanke. The Fed will pull all monetary levers in its fight to stave off deflation, double-dip recession, and to finance an expensive war against terrorism. As the dollar slides, manufacturing companies in the rest of Asia, Europe and elsewhere are under increasing pressure to move even more of their production to China, in order to compete. The alternative is for their governments and central banks to engage in competitive devaluation. Any of these trends - radical US reflation, the hollowing out of economies due to relocation of manufacturing to China, or competitive devaluation - carried to their logical conclusion, are ultimately ruinous for the global economy.

Fortunately, a much more palatable outcome is likely. China will eventually have to make its currency convertible and allow the yuan to float in the world's foreign exchange markets. This would revalue the yuan upwards, removing some of China's overwhelming competitive advantage, resulting from a currency that is clearly undervalued today. There may be an interim stage - revaluing the yuan against the dollar and perhaps pegging it to a basket of currencies. Whatever, with the dollar weakening, which enhances China's competitiveness, it is inconceivable that the yuan will remain pegged to the US currency at its present level of 8.28 per one US dollar over the long term. What is an appropriate dollar/yuan exchange rate? Opinions range from 7 down to 5 yuan per dollar.

A problem for China is that revaluation would result in an immediate and enormous loss on its foreign exchange reserves. Consequently China's government officials face a question of some urgency. What is an acceptable level of US dollar reserves, given that eventual revaluation of the yuan is all but inevitable? How about $400 billion, which on the present trend could be reached in a year? Presumably this would be unacceptable, assuming China's monetary authorities understand the extent of US credit creation, which they surely must. Even $100 billion seems high, but how does China reduce its US dollar reserves? It could spend some of it but the rate at which dollars are being accumulated is increasing, and the PRC will understandably want to maintain substantial reserves. It could give some of the money to developing countries, thus gaining influence, but China is not a charitable organisation. It could hedge some of its US dollar exposure in the derivatives market but that is only a temporary solution. It could exchange some dollars for euros, and has certainly done so, but how much can the single currency rise before Euroland panics and increases the supply? For the same reason, China has even less incentive to buy yen. There is no other reserve currency that is sufficiently liquid to absorb more than a tiny proportion of China's reserves. Moreover, in a deflationary environment no country wants its currency to appreciate against those of its trade partners. When they do appreciate, countries weaken their currencies by increasing the supply, as we have seen with the US Federal Reserve in recent years, as we are about to see from the Bank of Japan when the next Governor takes control on 20th March, and as we will no doubt see from the European Central Bank as an appreciating currency increases the risk of recession and deflation. This increase in the supply of fiat currency (paper money) is unofficially remonitizing gold.

For anyone with a little knowledge of financial history, gold's appeal as a store of value is both universal and timeless, albeit subject to fashion. A financial Rubicon was crossed on 15th August 1971, when President Nixon announced that foreign central banks could no longer exchange US dollars for gold. From that day onwards, there was no gold-backed paper currency, for the first time ever. Without the discipline of gold, most central banks and not least the US Federal Reserve, increased the supply of fiat currency significantly. Inflation inevitably followed and the price of gold rose from its previously fixed price of $35 an ounce in 1971 to a free market peak of $850 in 1980. The world's central banks had no choice but to fight inflation, which they did by tightening monetary policy, including raising interest rates to punitive levels. This gradually restored confidence in paper currencies and gold commenced a 21-year bear market, helped by central bank sales and hedging by mining companies in the 1990s. However gold bottomed between 1999 and 2001 as investors began to realise that it was historically cheap relative to most other assets, not least stock markets. Moreover, the US Federal Reserve had commenced a massive credit expansion - creating billions of new dollars, which could only weaken the world's main reserve currency.

China's obvious choice is to buy more gold while the price is low. Faced with a declining US dollar and an all but certain upward revaluation of the yuan at some future date, China has been buying gold recently. In December, it bought approximately $1 billion of gold, increasing its bullion reserves from 16.08 million ounces at the end of November 2002 to 19.29 million ounces at yearend - *see also Comment of the Day for 23rd January 2003 on www.fullermoney.com*. Will China buy more gold? Of course, if the country's monetary officials are smart, as I presume. Who wouldn't in their position? Could China swap most of its dollar reserves for gold? No, there isn't enough gold available. How much gold could China buy at a reasonable price? That depends on two factors - what Chinese monetary officials regard as a reasonable price, and how quickly everyone else catches on to the fact that China wants to boost its bullion reserves significantly. Why should China bother to buy gold at all if it can't buy enough to offset its dollar exposure? Because the price of gold is likely to appreciate significantly in terms of all fiat currencies over the next decade or two, even allowing for interest rates. In contrast, the supply of gold increases very slowly. According to the World Gold Council, there are only 145,000 tonnes of gold above ground, worth about $1.7 trillion at today's price. Even if China is buying, will other central banks sell more gold, especially after the European agreement to limit sales expires in 2004? Possibly, but that would not appear to be a smart financial decision, at least until the price of gold is several hundred percent higher.

Who else will buy gold? Bullion's advance in the 1970s was fuelled by investors, mainly in the US and Europe. Today, they have only just begun to buy gold, led by a few private individuals and hedge funds. The main private buyers during gold's new secular bull market, which has only just commenced, will come from the US, Asia, especially Japan, and lastly Europe. However the greatest demand for gold over the next 10 to 20 years could come from China and other countries with substantial foreign currency reserves.

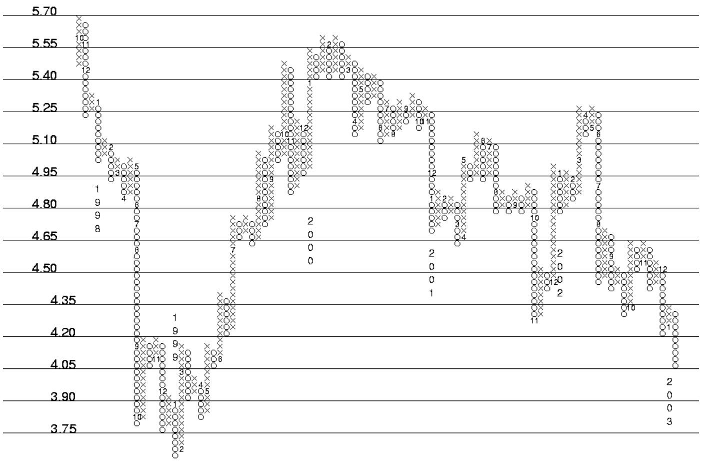
Interest Rates and Bonds

■ **Weak stock markets and weak growth will ensure further rate cuts.**

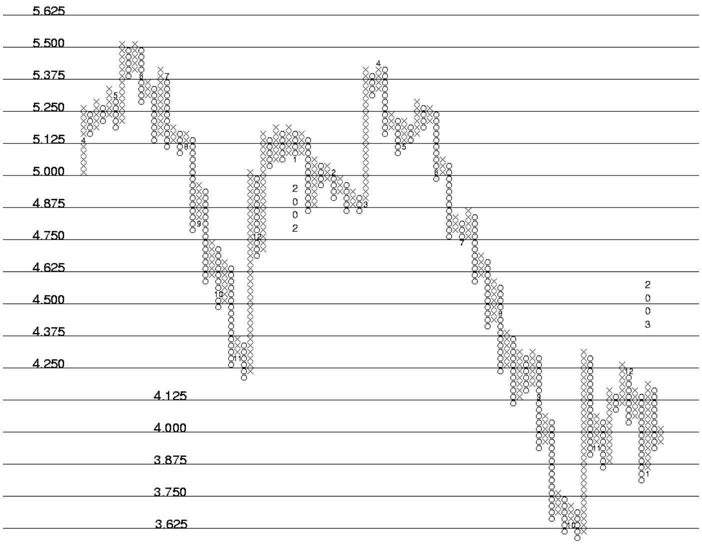
■ **Euro-bund 10-year yields are heading towards a test of their January 1999 low.**

The ECB is still behind the curve and will have to cut by at least another 50 basis points. Despite its deflationist mandate, the ECB is under increasing pressure to

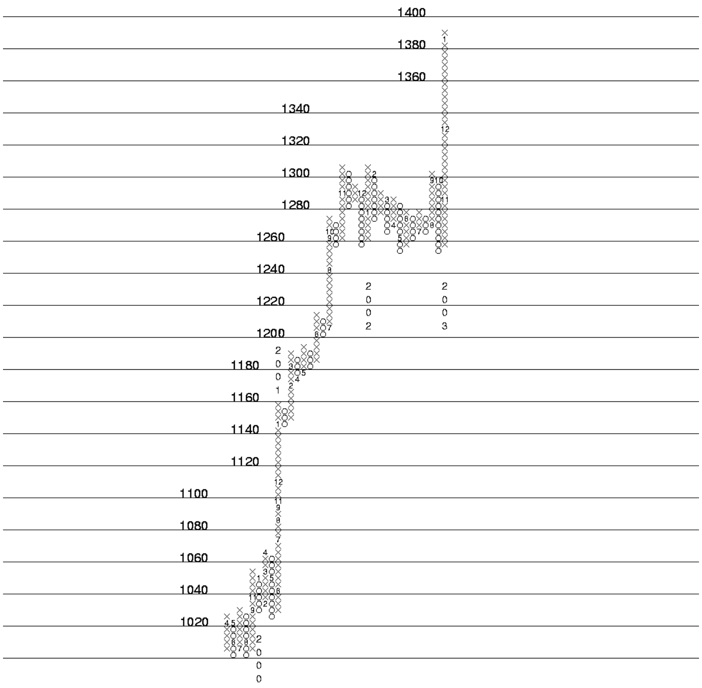
Euro Bund 10 Year Bond Yield (0.03)



US 10 Year Bond Yield (0.025)



MSCI Euro Dollar Index BBB Rated Total Return (4)



cut rates. Having been too optimistic on GDP growth, and with the euro strong, there is now little reason not to lower Euroland's short-term rates by another 50 basis points from the present level of 2.75 percent. Moreover European rates will almost certainly move even closer to the current US level of 1.25 percent later this year, before they next rise. Norway has slashed 100 basis points from its rates in recent weeks, and a substantial additional decline from the current level of 6 percent is probable, in a further effort to weaken the currency. As a petrol currency with a short-term rate of 7 percent, the Norwegian krone had become a collector's item during the last two years. Only concern over the UK house price bubble is deterring the Bank of England's Monetary Policy Committee from cutting rates as the economy weakens.

For Euro-bund yields, the big downtrend since February 2002 has been reaffirmed by a decisive break under the November 2001 and September 2002 lows. A move to 4.35 percent, which appears unlikely this side of a war against Saddam Hussein, is necessary to offset a further decline into the 1998-1999 trough down to 3.63 percent. While this trend cannot uncouple from US bonds for long, there is no reason why Euro-bund 10-year yields cannot move from their current premium over the equivalent US Treasury issue to a small discount. After all, the US economy is stronger than Euroland's and government borrowing is increasing faster as well. For US 10-year yields, the critical chart development remains last October's break in the downtrend. For the low at 3.575 percent to be taken out, investors would have to be more worried about deflation and/or double-dip recession. Conversely, growing confidence in the economy and/or supply concerns would produce an upside breakout at 4.300 percent. Triple-B rated bonds have done very well in recent years but the rally has lost momentum recently, as the stock market weakened. I would expect these bonds to remain steady while the S&P 500 is clearly above its October lows. However when they are broken, prices for all but top-rated bonds are likely to weaken on credit concerns.

Strategy on bonds - My view on bonds changed from long-term bullish to cautious three months ago, in FM221. Consequently I now have few bonds, not because their bull market is over - I do not see much evidence of this, although the rise in 10-year US Treasury yields from their October low is at least a warning shot. My concern with bonds is that everyone now owns them and the supply will increase as governments borrow more in their reflation efforts, not least the US. If/when it succeeds, US short-term interest rates will rise from their current 40-year low of 1.25 percent, with bearish consequences for Treasuries, especially long-dated issues. Meanwhile, the window of opportunity in Euro-bunds should remain open for a little while longer. However as a precautionary measure, I would want to be out of all government bonds shortly after any military move against Saddam Hussein commences. Traders could short the US 10-year contract on the first downward dynamic by futures prices. I expect regime change in Iraq - by invasion, overthrow or flight - to trigger a short-covering rally in stocks and profit taking in bonds. I would not want to hold corporate bonds during the next significant stock market sell off, although they should continue to outperform equities until a majority of investors conclude that the bear market is over.

Global Stock Markets

■ **No more than 'dead cat potential' for long-only investors until the Iraq situation is resolved, one way or another.**

■ **A post-Saddam relief rally is likely to be strong, but it will not end the secular bear market.**

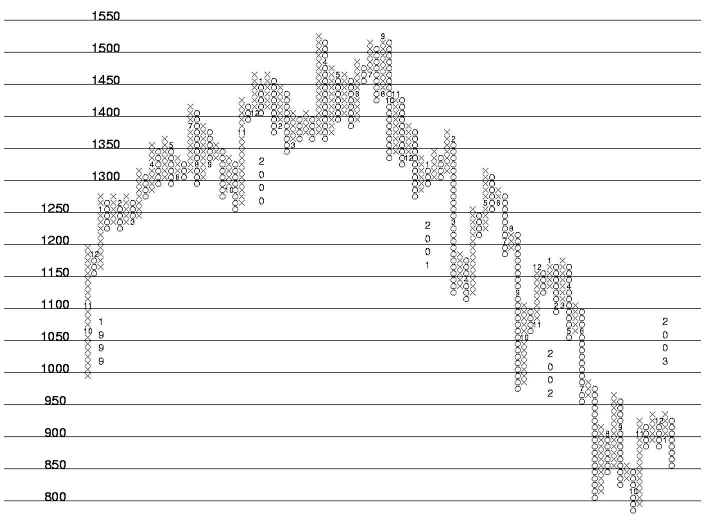
■ **The expectation of war will continue to deter demand for stocks but a short-covering rally is likely if/when Saddam is removed. This is a classic case of 'sell the rumour, buy the news'. Yes, there is a leap-in-the-dark aspect to any war and Saddam has some appalling bio/chem weapons but I suspect few of Iraq's military commanders will confront overwhelming odds in defence of this regime. Having discounted some of the worst scenarios, as is the nature of market crowds, investors will cover shorts and fuel a relief rally. This could be quite strong, given that oil prices will also be falling. Analysts will upgrade GDP growth and earnings estimates; business and consumer confidence will leap, and the US will be regarded as the saviour, rather than the problem - for a short while.**

Shortly after the pendulum of sentiment has swung from 'depression gloom' to 'end of the bear market' euphoria, investors will encounter the reality check of a secular bear market. Deflationary pressures will continue to inhibit growth, despite lower oil prices. Corporate profits will continue to disappoint, more often than not, due to lack of pricing power, slow growth, limited capital expenditure and waning consumer spending, mainly due to debt. There are likely to be more terrorist attacks on soft targets. It usually takes 10 to 20 years to recover from bubble excesses. Investors' heady euphoria of the late 1990s will gradually metamorphose into utter disenchantment. People will drift away from stock markets because they no longer trust their former heroes - the investment managers, brokers and supply-side analysts. Valuations may look reasonable by bull market standards but they have always become exceptionally attractive before bear markets end. Why should it be any different this time?

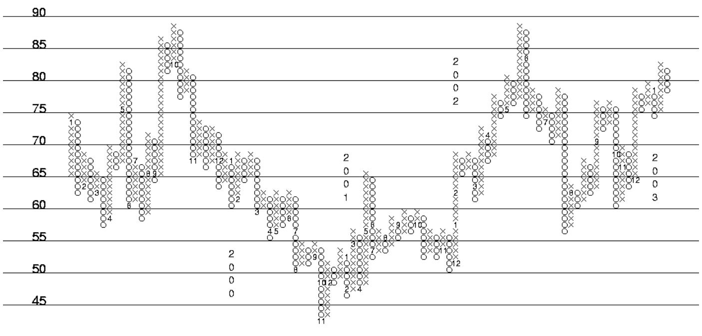
Chart review of topical and representative stock market indices - *The 3-box reversal point & figure charts shown are based on closing prices and taken from our website. Anyone interested in this chart service, which includes analysis and is updated daily, should register online at www.chartanalysts.com.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

The US's S&P 500 Composite Index (864) faltered beneath resistance evident near 960. The rally highs are still descending, reinforcing the overall downtrend. A rally to

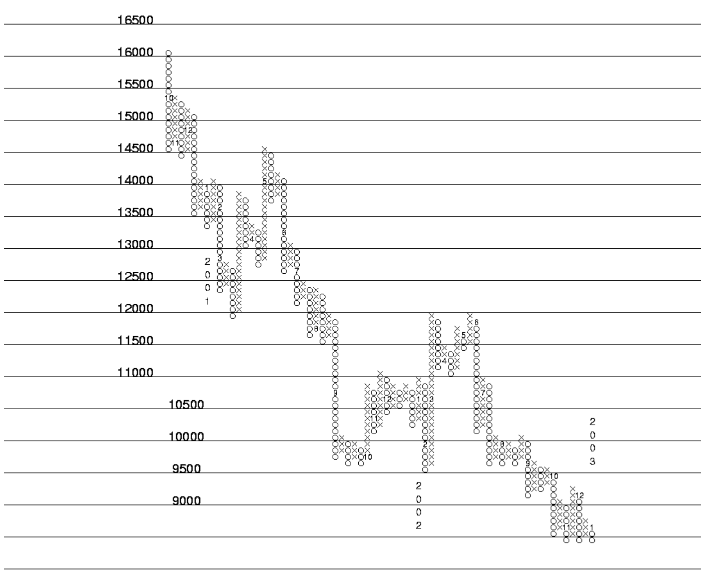
S&P 500 Composite Index (10pt)



Philadelphia Gold & Silver Index (1pt)

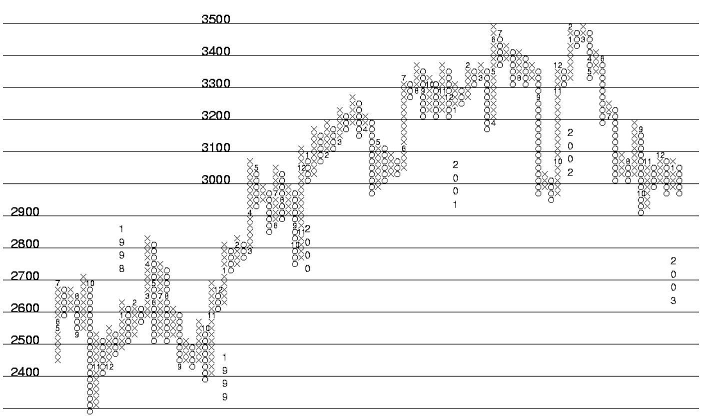


Nikkei 225 Stock Average Index (100pt)

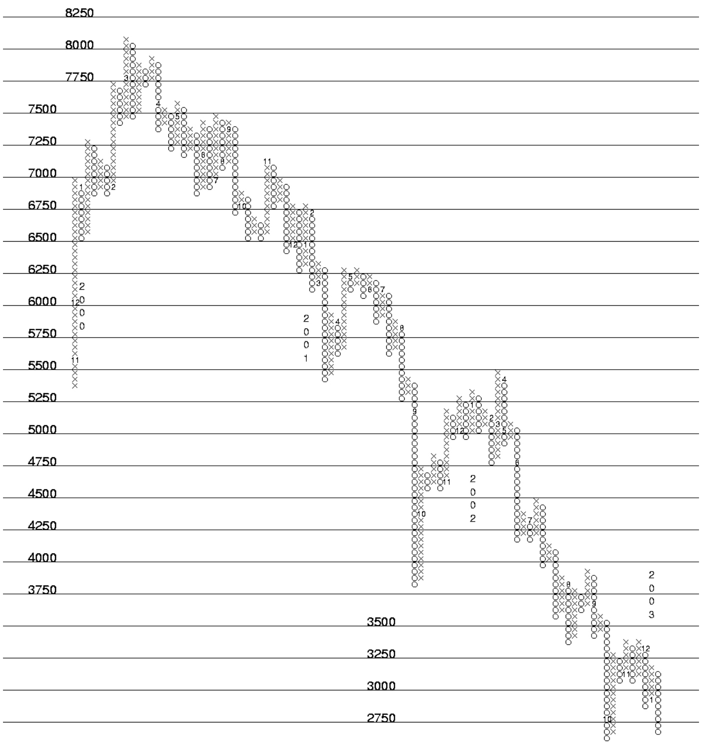


945 is the minimum required to question the ongoing bear market hypothesis. At some point, before the eventual bear market low, we are likely to see a somewhat bigger rally and/or longer sideways ranging phase. **The Philadelphia Gold & Silver Index (77.50)** continues to show a massive developing base formation, probably in its latter stages. A move to 73 is currently required to delay a further test of lateral resistance in the 88 to 93 region.

Australia S&P ASX 200 (20pt)



German DAX Index (50pt)



United Kingdom FTSE 100 Share Index (50pt)

Japan's Nikkei 225 Stock Average Index (8317) edged up from its October to December lows. However the overall bias remains downwards and 9300 is currently required to indicate a test of overhead trading.

Australia's S&P ASX200 Index (2964) has eased once again within a rounding top formation. A rally to 3100 remains necessary to indicate a somewhat higher phase of trading within this pattern.

Germany's DAX Index (2725) has fallen back to its October low where some steadying may occur. However the pattern of the last few months is consistent with the primary downtrend. A rally to 3400 is necessary to reaffirm support from the October low and indicate base development.

The UK's FTSE 100 Share Index (3561) has extended its progression of lower rally highs and lower lows - the defining characteristics of an orderly downtrend. A rally to 4000 is necessary to indicate loss of overall momentum within this configuration.

Strategy for stock markets - Among the stock market indices illustrated, there is only one that shows a base formation and bull market potential - the Philadelphia Gold & Silver Index. Consequently I prefer to remain overweight in this sector. However positions in gold shares need to be managed, due to their volatility. This is a straightforward buy-low-sell-high situation, using charts for timing. Accordingly, if prices remain firm over the next few weeks, I would be inclined to lighten positions in the event of a war against Saddam Hussein. I also hold gold funds, mainly Merrill Lynch's, which I regard as long-term investments. As for the rest of the market, since there is no evidence that the secular bear trend is ending or over, there are more selling than buying opportunities. My strategy is to short futures when rallies become overbought on stochastic indicators and also lose momentum near resistance levels within downtrends. I lighten on weakness and recently covered one-third of my short position. The only time I want to buy is after a climactic selling phase. We have seen 3 of these - September 2001, July 2002 and October 2002. There is a possibility of another capitulation phase if a war against Saddam Hussein is irrefutably imminent. In that event I will close all stock market shorts and open a few longs once the battle commences. I still hold a few high-yielding defensive stocks in UK tax-efficient ISA accounts. They have been underwater more often than not and I will probably sell when we next see a decent medium-term rally. That could occur once the Saddam situation is resolved.

Currencies

■ **How three paragraphs from US Federal Reserve Board Member Ben Bernanke helped to sink the dollar and remonetize gold.**

I'll wager Ben Bernanke wishes he had never made this speech. This former professor at Stanford University and newest member of the US Federal Reserve Board of Governors, having been appointed in July 2002, was honest to the point of naiveté. The title of his address before the National Economists Club, Washington, D.C. on 21st

November 2002 sounded reassuring enough - "Deflation: Making Sure 'It' Doesn't Happen Here". However the three paragraphs reproduced below caused ripples in the tide for both the US dollar and gold, likely to affect sentiment for years to come.

On gold, a fiat money system and a printing press
"The conclusion that deflation is always reversible under a fiat money system follows from basic economic reasoning. A little parable may prove useful: Today an ounce of gold sells for $300, more or less. Now suppose that a modern alchemist solves his subject's oldest problem by finding a way to produce unlimited amounts of new gold at essentially no cost. Moreover, his invention is widely publicized and scientifically verified, and he announces his intention to begin massive production of gold within days. What would happen to the price of gold? Presumably, the potentially unlimited supply of cheap gold would cause the market price of gold to plummet. Indeed, if the market for gold is to any degree efficient, the price of gold would collapse immediately after the announcement of the invention, before the alchemist had produced and marketed a single ounce of yellow metal.

"What has this got to do with monetary policy? Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

On devaluing the dollar
"Although a policy of intervening to affect the exchange value of the dollar is nowhere on the horizon today, it's worth noting that there have been times when exchange rate policy has been an effective weapon against deflation. A striking example from U.S. history is Franklin Roosevelt's 40 percent devaluation of the dollar against gold in 1933-34, enforced by a program of gold purchases and domestic money creation. The devaluation and the rapid increase in money supply it permitted ended the U.S. deflation remarkably quickly. Indeed, consumer price inflation in the United States, year on year, went from -10.3 percent in 1932 to -5.1 percent in 1933 to 3.4 percent in 1934. The economy grew strongly, and by the way, 1934 was one of the best years of the century for the stock market. If nothing else, the episode illustrates that monetary actions can have powerful effects on the economy, even when the nominal interest rate is at or near zero, as was the case at the time of Roosevelt's devaluation."

OK, Ben Bernanke was hypothesising (or was he?) but we get the point. His message, effectively seconded by Alan Greenspan somewhat later, is that the Fed will do anything required to avoid outright deflation. It has already gone a long way down the electronic printing press route mentioned in the second paragraph. And why did Governor Bernanke make so many references to gold? Note how he establishes the difference between gold, which will always be in limited supply, and a fiat currency, which can be produced at will, "at essentially no cost", creating what he calls "positive inflation". Note also Bernanke's enthusiasm for "President Franklin Roosevelt's 40 percent devaluation of the dollar against gold in 1933-34". These three paragraphs, coming from a Fed Board Member, have done far more than all the protestations from remaining gold bugs combined, to remind investors that bullion is hard money and therefore an infinitely safer store of value over the long term than any paper currency.

Using Bernanke's logic, since the Fed understandably fears deflation, has a weak economy and must help the government in funding an expensive war against terrorism, why not replicate Roosevelt's devaluation now and create a little "positive inflation"? It could boost GDP growth and lift the stock market, as occurred in 1934. Roosevelt was right to devalue the dollar against gold and there is a case for devaluation today, in the effort to avoid outright deflation and a possible depression. Without a gold standard no formal procedure is required. Bernanke's speech has effectively and rather cleverly set the trends in motion. And since it was delivered in a style appropriate for a professor of economics at a business school, no foreign government has accused the US of competitive devaluation. Incoming US Treasury Secretary John Snow can deflect any future criticism by paraphrasing Robert Rubin's mantra, "a strong dollar is in this nation's interests", without specifying when, while the Fed persists with credit creation.

There are tradeoffs to this policy. Since deflation is primarily a monetary problem, albeit considerably exacerbated in this cycle by China's role as manufacturer of last resort, it is very unlikely that the US will experience Japanese-style deflation over the next few years. However purchasing power will decline in absolute if not relative terms. As for implications for GDP and markets, we can only talk in terms of influences because there are many other factors to consider, not least including policy responses from other countries and the war on terrorism. However, what Bernanke signalled can only remain bearish for the dollar, although not overwhelmingly so because confidence in the euro cannot be high while Euroland's economy remains so weak. Also, Japan's next BoJ Governor will surely follow a path of radical reflation, capable of making the Fed appear to be in the hard money camp. Consequently, investors will not flee US assets en masse for stocks, bonds or corporate opportunities in Europe or Asia, especially as the American economy is still likely to outperform on a relative basis. However some are clearly hedging the dollar value of US investments, especially against the euro. Gold is the most obvious winner because people are becoming more aware of the inherent risks with fiat currencies. This can only contribute to the gradual remonetization of gold in people's eyes. Central banks are unlikely to worry about an appreciating gold price until inflation rather than deflation becomes an overriding concern. The Bernanke view is bearish for bonds, although not necessarily in the short term. It should cushion downside scope for stock markets somewhat, although it will not reverse the secular bear market beyond medium-term rallies.

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.*

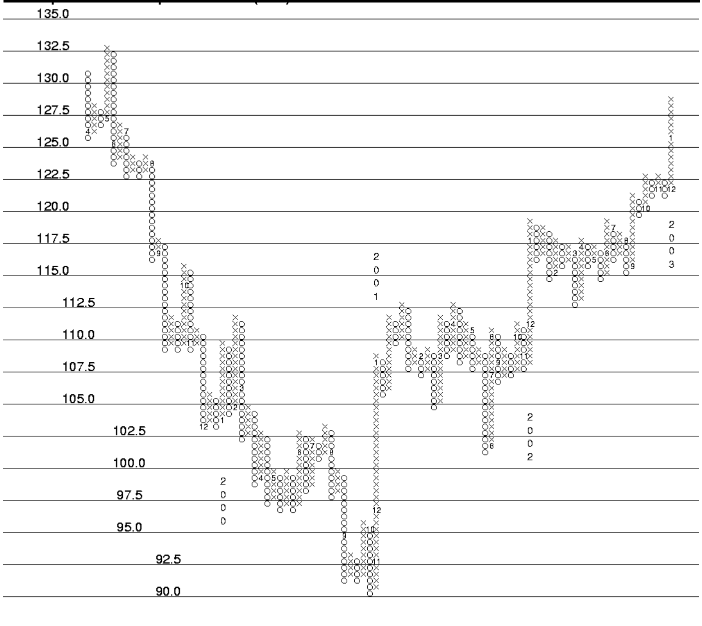
Euro/dollar ($1.0737) - The euro's steady advance from its first step above the base is becoming overextended and some psychological resistance may be encountered in the $1.10 region. Therefore we can expect the current advance to spill over into a ranging consolidation of gains before long. However there is nothing to suggest that we will see more than a temporary pause, probably of shorter duration than the late-June to early December band, before higher levels are seen.

Euro/yen (¥128.27) - The euro has pushed further into 1999's early trading. This move is well supported by underlying trading and the overall uptrend. Downward risk appears limited to small reactions before additional gains are seen. These are likely to be substantial over the medium to longer term.

Euro/Norwegian krone (NK7.4181) - The euro reached a low of at least medium-term significance against the Norwegian krone in early January, and it may even mark the bear market floor. While a partial retracement of recent gains is likely in a base extension phase, this should eventually support an additional recovery.

Euro/sterling (£0.6534) - The euro has now completed its very large base against sterling. A decline to £0.646, which

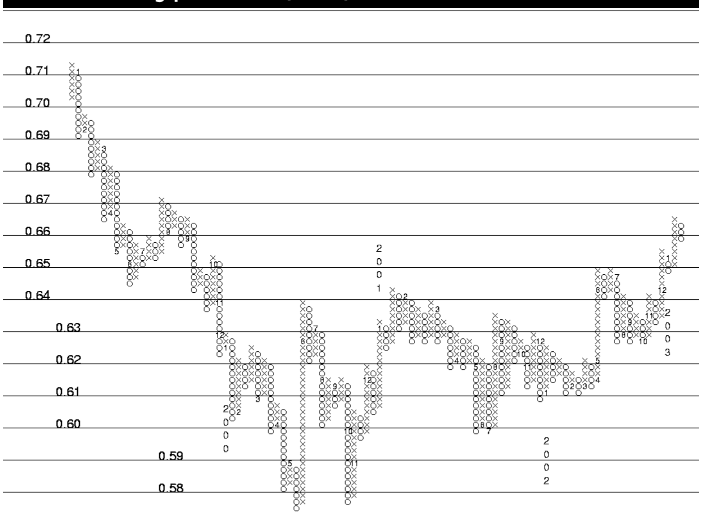
Japanese Yen per 1 Euro (0.5)



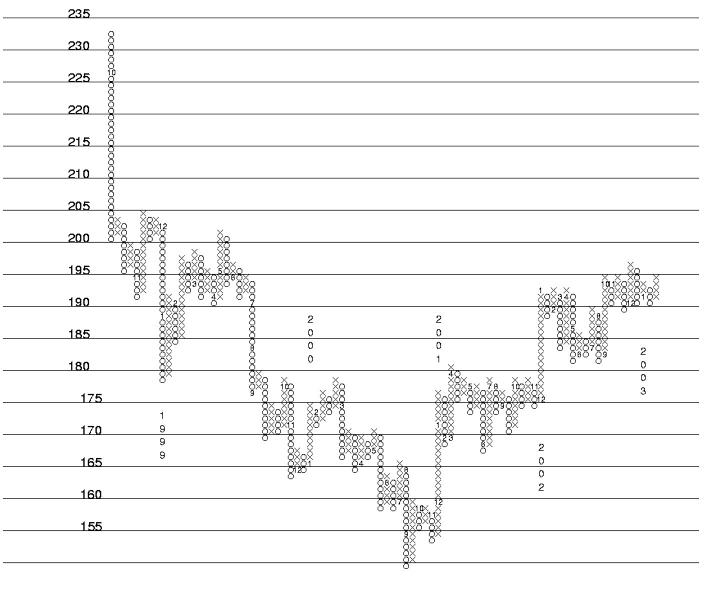
Norwegian Krone per 1 Euro (0.015)

US Dollar per 1 Euro (0.004)

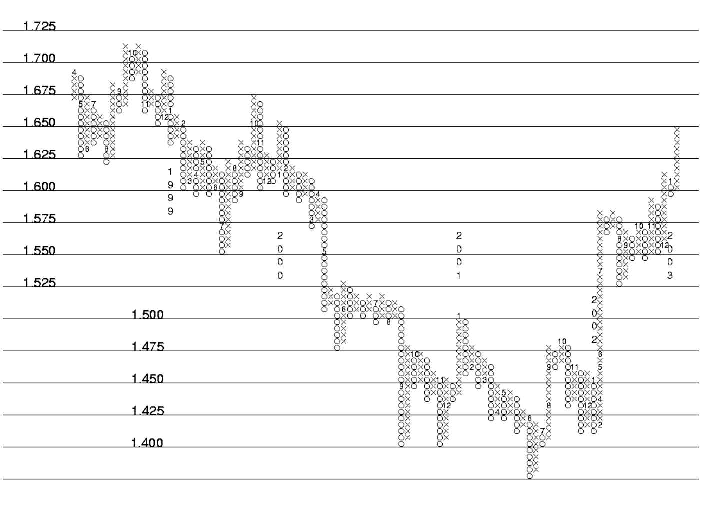
Pound Sterling per 1 Euro (0.002)



Japanese Yen per 1 Pound Sterling (1)



US Dollar per 1 Pound Sterling (0.005)



appears unlikely, would be necessary to suggest an upside failure and delay further gains over the medium term.

Sterling/yen (¥196.27) - Sterling's gradual uptrend against the yen is confronting both lateral and psychological resistance, which extends up to ¥205. Nevertheless, a move to ¥188 is now required to delay further sideways to somewhat higher ranging.

Sterling/dollar ($1.6437) - Sterling has been very firm since completing its first step above the base in late December. A move under $1.60, which appears unlikely, is required to offset some further push into extensive overhead trading.

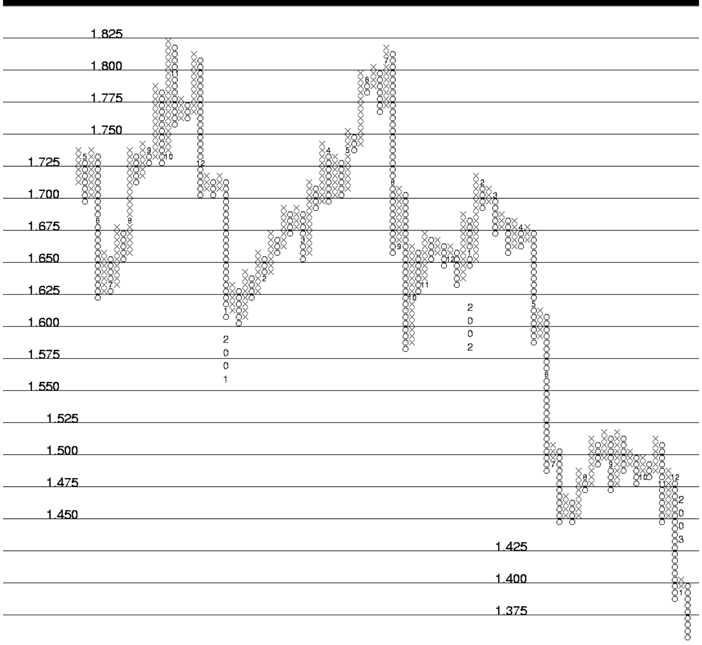
Dollar/Swiss franc (SF1.3685) - The dollar's decline against the Swiss franc is becoming somewhat overextended and approaching the important October 1998 low at SF1.315. However upward scope appears limited to a temporary technical rally before the large top area and downtrend lead to further weakness.

Australian dollar/US dollar (US$0.5875) - Following an additional build-up of support, the Australian dollar broke decisively through lateral resistance just above US$0.57, before pausing to consolidate. A move below this level, which appears unlikely, is needed to offset remaining scope for somewhat higher levels in coming months.

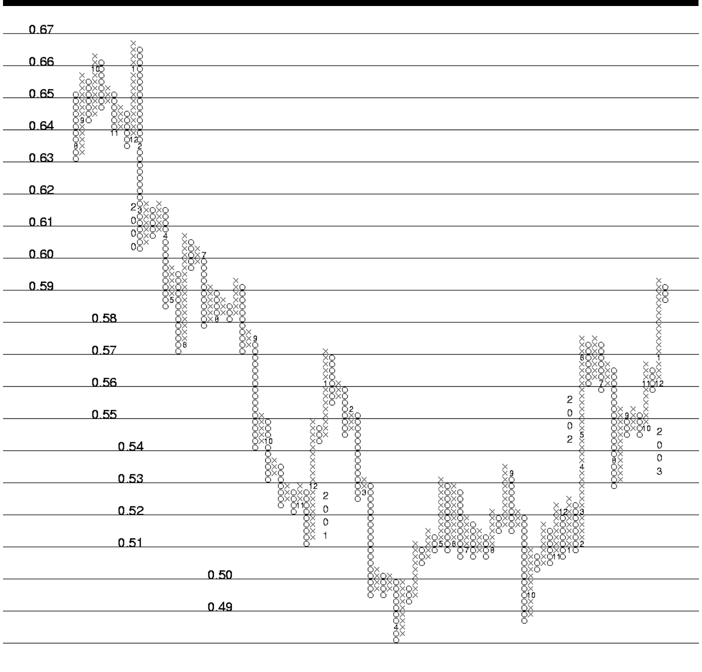
Dollar/yen (¥119.43) - The dollar continues to drift and is not far from psychologically important lateral support down to ¥115. A rally back towards ¥125 is required to reaffirm this floor dating back to February 2001.

Dollar/rand (R8.6350) - The dollar accelerated to a climactic peak at R13.40 in December 2001. The subsequent fall retraced most of that move and there is now initial evidence of potential base development for the

Swiss Franc per 1 US Dollar (0.005)



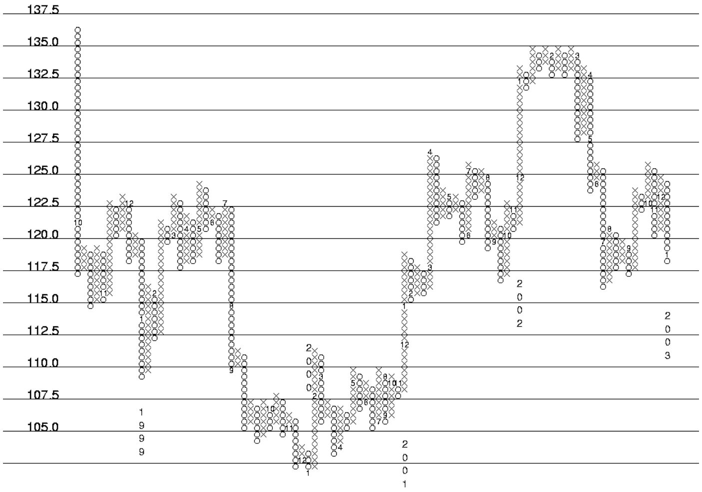
US Dollar per 1 Austrailian Dollar (0.002)



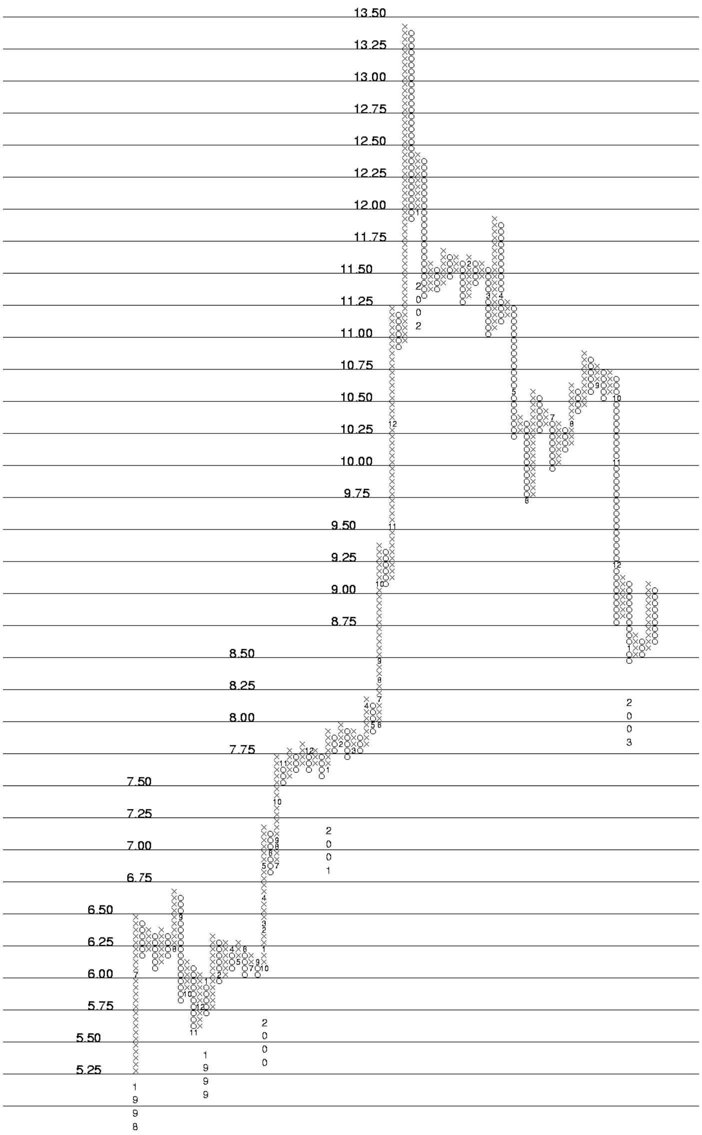
dollar.

Strategy on currencies - It has been a good market for most of the yen crosses recently. With short-term overbought conditions evident among the Europeans, I have reduced my euro/yen position by one-sixth and sterling/yen by one-quarter, while raising trailing stops on the former.

Japanese Yen per 1 US Dollar (0.5)



South African Rand per US Dollar (0.05)



With euro/yen, which is my main position by far, I would consider buying back on reactions of 2 yen or more. I haven't used stops on sterling/yen because it is too choppy. Instead, I continue to nibble when sterling weakens and lighten as it rallies against the Japanese currency. In line with my Audio comments, I would take profits on Norwegian krone/yen and not reconsider this trade. Yes the oil price is still high but Norway's government is now determined to soften the currency, so further interest rate cuts can be expected. When a government is determined to weaken its currency, I do not want to be long, even though it usually takes a while to convince the market. Two of the best yen crosses recently have been against the Australian dollar and especially the New Zealand dollar. As both are temporarily overbought, I would lighten if you have not already done so. My losing trade recently is dollar/yen, where I have paid more attention to MoF jaw-jaw than the chart. I'll probably ride this out, expecting to be rescued by Hayami's successor. I may even add if there is another sell off, or preferably, when Saddam is removed. Euro/dollar, where I got out much too soon in favour of euro/yen, now looks less of a certainty, at least while the short-term overbought condition persists. My Audio strategy is to Baby Steps lighten from $1.09. Also, I would not want to be short of the dollar if/when the US moves against Saddam. I suspect gold is the ultimate currency for this cycle. I buy gold-related instruments on easing. Iraq remains a classic case of, 'sell the rumour, buy the news'. In other words, don't be surprised to see temporary contra-trend reactions in all markets shortly after the fighting commences.

Commodities

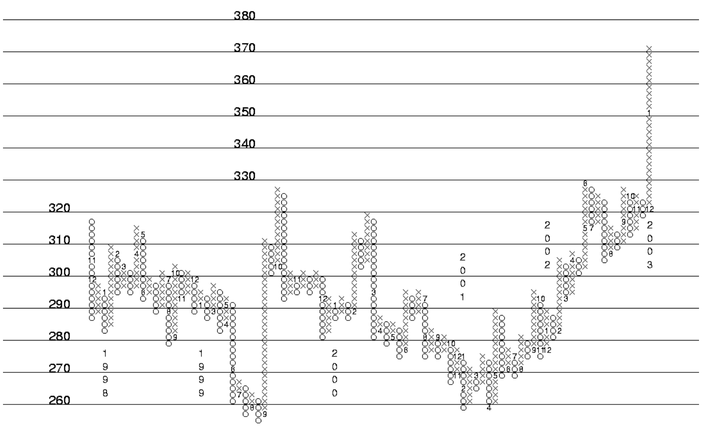
■ **Downside risk in gold appears limited to a small reaction and consolidation before higher levels are seen.**

■ **The big war premium is in oil.**

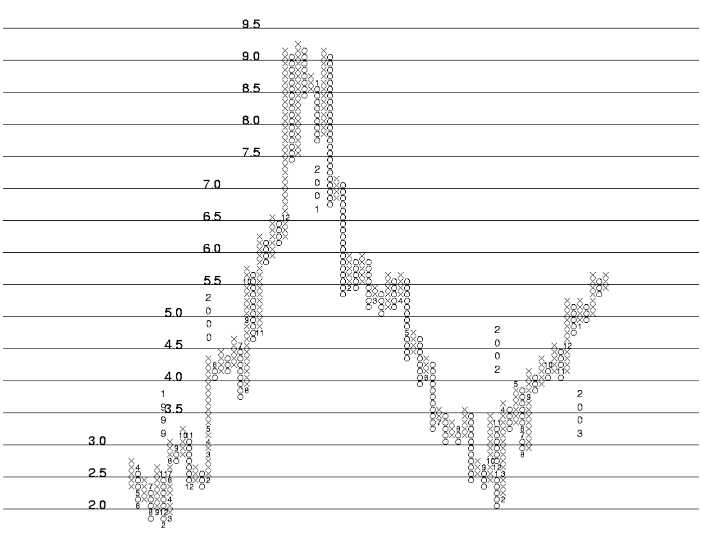
■ **The secular bull market, overlooked by most investors, is in commodities.**

Investors have only just begun to buy gold. The advance has paused following a recent high at $373.15, in response to a short-term overbought condition. I expect to see a period of ranging, during which recent gains

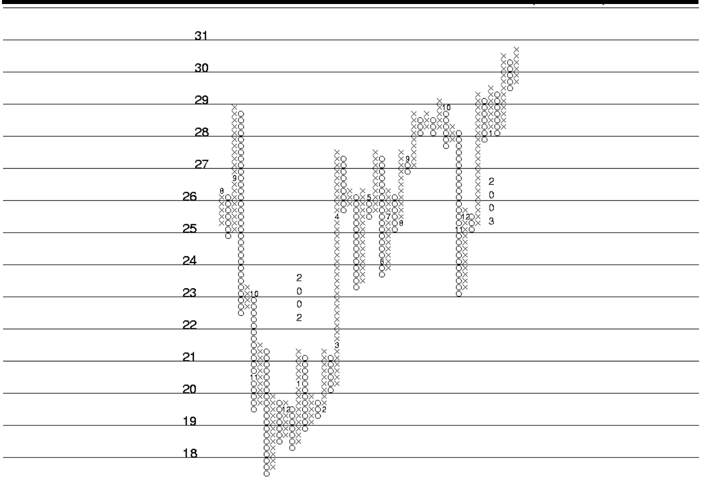
Gold CMX 2nd Month Continuation (2USD)



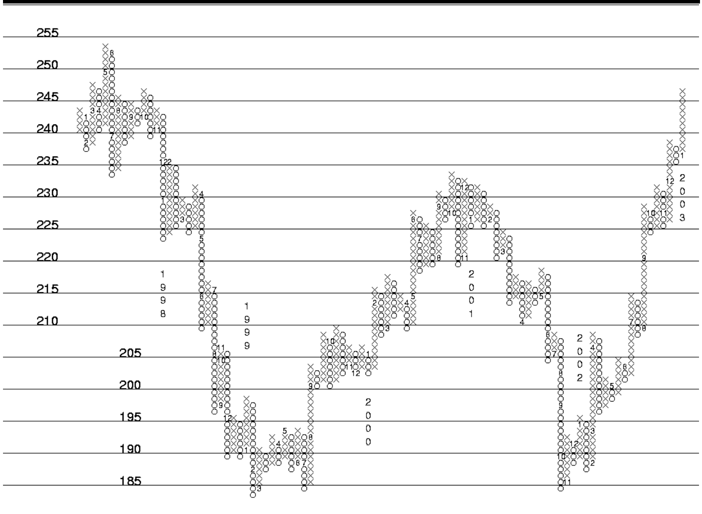
Natural Gas 2nd Month Continuation (0.1USD)



Crude Oil NYME 2nd Month Continuation (0.2USD)



CRB Index NYFE (1USD)



are consolidated. I doubt gold will move much below $350 during this phase, if that. Why? Because China is increasing its gold reserves, and other Asian and perhaps Middle Eastern central banks with large foreign exchange reserves are likely to follow this lead. While a portion of this demand could be offset by European central bank sales, there will be increasing pressure on them to hold dwindling gold reserves in a rising market. Japanese investors will continue to buy, knowing that the next BoJ Governor will weaken the yen. US and European investors hold little gold at present but are a significant source of future demand. Why should they buy? Two reasons - they no longer like the alternatives but everyone loves a bull market. Why buy stocks when the biggest bubble in history burst less than 3 years ago? Why buy bonds when they have already seen a huge bull market; deficits are rising; the supply is increasing, and debt problems persist? In contrast, gold is cheap relative to other investments; its bull market has only just begun and supply is limited. Much has been made of gold's war premium, estimated from $10 to $50. I think this premium is small, but likely to increase if war against Saddam Hussein becomes inevitable. Consequently, we are likely to see a temporary dip in the gold price if/when war commences, in line with whatever the consensus figure on the war premium happens to be. That should be a buying opportunity. I maintain that gold will move to at least $1500 over the next 10 to 15 years.

Petroleum prices remain very strong, reflecting the war premium and also chaos in Venezuela. My guess is that this combined premium could be as much as $15 for spot crude, currently trading at $33.62 (NYME). Moreover, it is very likely to rise on anticipation of war. Some pundits say the crowd is complacent in expecting the price to weaken if there is a war against Saddam Hussein. My own perception is that more people now hold this view than my own, which is that crude will trade below $20 within 6 months of Saddam's removal from power. Lower oil prices will be a temporary drag on the gold price.

A 5-year high for the CRB Index is no fluke. The new secular bull market is in commodities. Why? Because the long-term bear market in raw materials is over; they are priced in dollars; production has decreased in some instances, and China's imports of commodities are increasing rapidly. However, the CRB Index is likely to experience a sharp reaction if/when war against Saddam Hussein commences, because the price of oil will fall, temporarily affecting sentiment towards other commodities, and the dollar will experience a technical rally as short positions are reduced.

The Global Economy

- **Debt, deflationary pressures, oil prices and war fears continue to weigh on the global economy.**
- **Winners are only relative in the global GDP stakes.**

Debt problems are always a legacy of burst bubbles. Governments, corporations and consumers increase spending during bubble years. Hubris and narcissism replace reason as politicians, CEOs and speculators mistake luck for brains. As the good times roll on in a self-fulfilling prophecy, people are lured into taking ever-greater risks, rationalised on the basis of new technology, new paradigms, productivity increases, and their own sophistication, of course. Greed is the unifying factor during an inflating bubble, and woe betide any central banker with the temerity to question the collective sanity. Leverage is the corporate and consumer game as people borrow and spend to a degree not seen since the previous bubble, which few remember. Just like the Mad Hatter's tea party, all shall play and all shall have prizes. Bubbles seldom deflate slowly. Instead, they burst, due to higher interest rates, an external shock or because of their sheer weight and unsustainability. When stock market bubbles burst, corporate and consumer debt not only remain but increase, because people carry on as before, at least for a while, expecting the good times to return. Governments have the same expectations and increase spending, despite plummeting tax revenues, because they prefer to believe their own optimistic economic forecasts. When the good times fail to return, corporations and consumers are forced to retrench, which slows GDP growth. Governments are encouraged to take up the slack and spend even more. This will delay, and with luck, even prevent recession but the boom cannot return because of the debt overhang and damage to confidence caused by the burst bubble. The hangover can easily last for a decade or more. It will not be different this time, following what many regard as the biggest bubble in history.

Deflationary pressures are a feature of burst bubbles. Corporate spending is the first casualty of burst bubbles, and is eventually followed by a reduction in personal consumption. When some companies cannot service their debt and therefore default, borrowing costs for other businesses increase. Unemployment rises as more firms downsize. Consumer spending can be extended by lower interest rates, political exhortation and zero financing offers from corporations. However this only delays the eventual retrenchment. If/when house prices fall, the damage to confidence will make recession all but inevitable. In the current boom to bust cycle, globalisation and technology made a considerable contribution to the good times. However both factors contribute to a double-edged sword. Technological innovation makes most manufacturing transferable, and with a reported 20 million Chinese leaving rural agriculture for business enterprise centres, there is a seemingly inexhaustible source of cheap labour. When manufacturing relocates to China, unemployment problems in developed countries are exacerbated. Since the world cannot possibly consume all that it produces, prices fall, causing more businesses to contract or even fail. A weaker US dollar adds to deflationary pressures emanating from China, as the yuan remains pegged to the greenback. Service industries are not immune, as we have seen with call centres and some back office functions, which can easily be exported to developing countries such as India. Lastly, the high cost of petroleum, which contributes to PPI and CPI inflation while energy costs are rising, is ultimately deflationary. It has the equivalent effect of a massive tax increase, imposed by oil-exporting countries on businesses and consumers. While some oil revenue is recycled to the countries from which it came, this is far from a zero sum situation.

Oil continues to trade at levels that can only increase the risk of recession. The current war premium on the price of crude oil could be up to $10 and rising. Coincidentally, the political situation in Venezuela continues to deteriorate. This has drastically reduced the flow of oil from South America. Aside from a temporary reaction in late 2001 and early 2002, oil prices have been uncomfortably high since the second half of 2000. This would increase the risk of slow global GDP growth/recession at the best of times, which we certainly don't have in the aftermath of a stock market bubble.

Military expenditure aside, the expectation of war is not bullish for the global economy. Spending on armaments has unquestionably boosted the US and to a lesser extent the UK economy, relative to what would have otherwise occurred. However uncertainty over the timing of a probable war against Saddam Hussein, and if not the outcome, the aftermath of regime change in Iraq, is negative for global GDP growth. It adds to a general feeling of pessimism, defers business development plans and curbs travel. Concern over terrorism has a similar effect. Nevertheless, the departure of Saddam Hussein's regime, with or without war, would provide the world economy with some welcome respite. The oil price would fall sharply as hedge longs were reversed, and also in anticipation of increased production from Iraq in the post UN sanctions environment. There is no reason to assume that Islamo-fascist terrorism would increase following Saddam Hussein's removal from power. However it would strengthen the US's hand in dealing with other terrorist regimes, including North Korea, and it would deter state funding of terrorism.

Expectations for GDP growth are too optimistic. There is a new consensus, along these lines. The US takes out Saddam Hussein with ease (alternatively he scampers), oil prices fall and the American economy embarks on a sustainable expansion, helped by all the balance sheet restructuring that is supposed to be occurring. We hear that this will ignite growth in the Asian economies, especially among the former "tigers". Europe is supposed to "stabilise", while people are divided over whether the UK is a "miracle economy" or gets the wooden spoon.

I agree that Saddam runs, or is overthrown, or quickly defeated by the US-led forces, and that petroleum prices fall. Less expensive energy will help the global economy somewhat. Unfortunately, this won't solve the post bubble problems. Debt remains a millstone around the neck of corporate and consumer America, and is rising at a government and especially state level. The latter is important because rising state taxes (they are not allowed to run deficits) could more than offset Bush's tax cuts. California, which is crucial to US GDP performance, has the biggest state deficit so large tax increases are inevitable. Therefore after some respite as oil prices fall and share prices rally temporarily, the US economy is likely to ease once again. I regard "double dip" as inevitable - it's just a question of the length of time between the two dips. In other words, even if the US avoids recession in 2003 or 2004, it will probably succumb in 2005 as the pre-election stimulus tails off.

With the US economy underperforming, Asia won't get the stimulus people are forecasting. Moreover, Asia faces a severe and increasing headwind from China, which is hollowing out the region. Japan could do better if the right policy decisions are taken. For each of the last 10 years analysts have assumed that Japan was about to take the sensible economic steps, obvious to everyone, and pull out of its long slump. We are still waiting. The logjam may break as BoJ Governor Hayami's successor takes control of monetary policy on 20th March, but for over a decade Japan has seldom missed an opportunity to miss an opportunity.

Europe's usual problems of overregulation, overtaxation and high unemployment are now compounded by a strengthening euro. Exports have been the main engine for what little GDP growth Euroland has experienced. The strong euro will lower import costs but these have not been a problem in the deflationary global environment, oil prices excepted. Moreover, the gain on import costs will be more than offset by declining operating profits, in all sectors from exports to tourism. Should the euro establish a new trading range above $1.10, as many expect, Euroland's core economies could easily slide into recession. The UK economy has been overhyped, as most of its "superior" performance has come from consumer spending boosted by mortgage equity withdrawal. House prices are the new ATM in the UK. This is unsustainable and will be followed by a sharp decline in consumer spending, possibly commencing in April with the large increase in National Insurance (public health service) taxes, which will also hit companies. Increased public sector spending is a poor substitute for healthy industrial and consumer sectors. The UK will be forced to borrow even more than generally forecast and trade figures will continue to deteriorate.

The first target date for FM225 is Tuesday 25th February.

> *"The only thing necessary for the triumph of evil is for good men to do nothing."*
>
> Edmund Burke

Best regards - David Fuller

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Website: www.fullermoney.com ***Email:*** research@chartanalysts.com ***Tel:*** +44 (0) 20 7351 5751 ***Fax:*** +44 (0) 20 7352 3185 ***Single Issue Price*** £35