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

Stock markets reflect expectations for a longer war in Iraq than previously hoped, but a medium-term rally is likely once investors perceive that the conflict is nearing its end.

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Three anomalous and related factors have aggravated economic problems during a period of monetary stimulus - the high price of oil, events related to UN Resolution 1441 and concern over terrorism. Following the war for regime change in Iraq, most economies are likely to improve more than expected, at least for a while. Macroeconomic problems remain considerable.

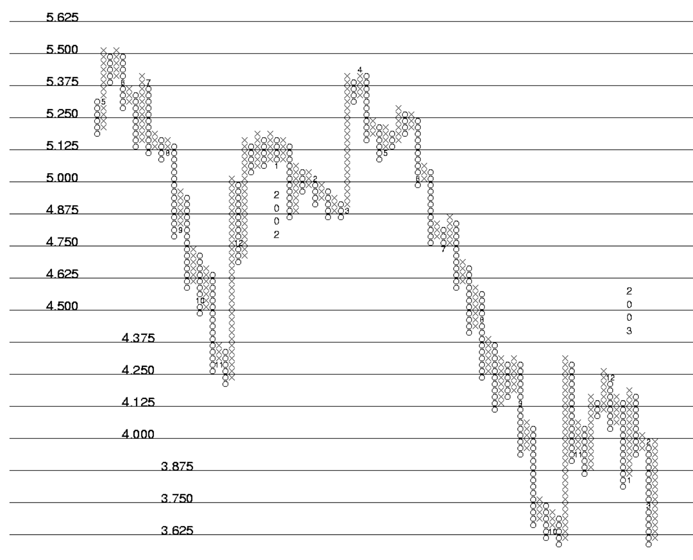
Further volatility in most markets is inevitable, given mood swings in investors' expectations regarding the war in Iraq.

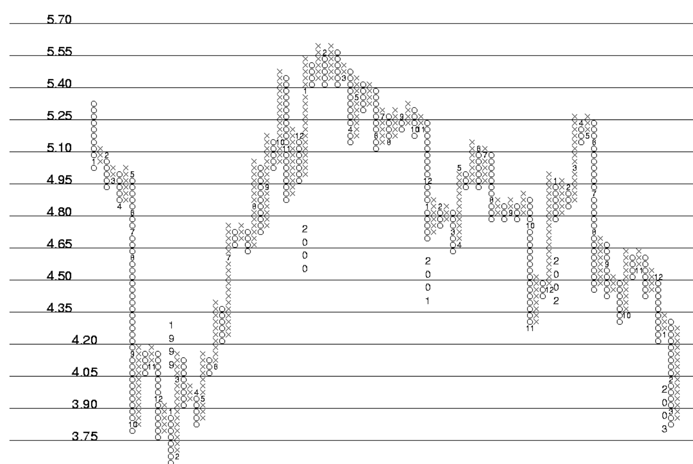
Was initial optimism the triumph of hope over experience? Perhaps, although it is really too soon to say. The only certainty is that so far, no one knows the outcome of this war, not to mention the longer-term geopolitical and economic ramifications. Worldwide, there were more people opposed to the war than for it. However once it started, most who were not sympathetic to the Iraqi regime hoped for a quick victory and small number of casualties. Markets reflected this hope and initial optimism, which was bolstered by memories of the 1991 Gulf War and the more recent military success in Afghanistan. Consequently there was a sharp fall in the price of oil, a brisk stock market rally in the few days before the war commenced and an equally sharp fall in "safe haven" government bond prices. The euro's advance was checked, as the US dollar firmed, and gold continued to shed its war premium. The rationale behind these moves is now being reassessed.

The main setback for US and British forces has been in the propaganda war. Compared to other wars, there have been comparatively few civilian casualties to date, mainly due to precision targeting and a strategy by the US and Britain that values civilian lives more highly than military expediency. While any civilian losses are regrettable, some are inevitable and need to be weighed against the loss of life over many years caused by Iraq's brutal regime. Fortunately casualties to date among US and British forces have also been small relative to other wars. Unfortunately, the propaganda defeats are increasing. US and British troops have not been greeted as liberators to the extent predicted by their governments, whether due to fear of reprisals by the Iraqi regime, or because foreign troops are seen as invaders rather than liberators. Iraqi PR has improved considerably since the 1991 Gulf War rants by Saddam Hussein and his Vice-President Tarek Aziz. In this war, Iraqi Information Minister Muhammad Sa'id al-Sahhaf and especially Iraqi Vice President Taha Yasin Ramadan have been much more effective. From Al-Jazeera TV to EuroNews, broadcasters have certainly not been sparing in showing human tragedies, angry anti-US mobs and anti-war demonstrations. Most British and US press have also covered these incidents, as they should in the interests of truth, but there is no way to cover atrocities perpetrated by Saddam's Ba'ath Party, Fedayeen and National Guard in Basra and elsewhere. Critics of the war have been emboldened by the Iraqi resistance.

Investors are repositioning for a longer, more difficult

war. Stock markets are technically vulnerable once again and short-sellers are reopening positions. Government bonds have firmed in response to a short-term oversold condition. The euro has steadied against the US dollar once again following its biggest correction since the base was completed. The price of crude oil has bounced following its mid-March drop of nearly 29 percent (spot NYME). However the most significant technical dynamic recently was the rebound by North American gold shares on Friday 28th March. They are often a lead indicator for gold bullion, which has steadied near $330, the upper region of its multiyear base. All precious metals look oversold. Needless to say war news will remain critical to market sentiment. The military outcome is not in doubt - only the cost, including lives lost and the duration of this conflict. Events can change quickly. When markets sense that regime change is imminent, we can expect at least a partial reversal of the market action mentioned immediately above.





Interest Rates and Bonds

■ **Further rate cuts by the Bank of England and European Central Bank are likely.**

■ **Long-dated government bond yields are easing once again and will continue to do so while stock markets are weak. However the sharp mid-March rally in yields is a warning of what could easily occur once the war ends.**

A long war would all but guarantee additional rate cuts. Conversely, capitulation of the Iraqi regime in the next few weeks would reduce the likelihood of short-term rate reductions by central banks. Even though a longer war would keep petroleum prices higher than would otherwise be the case, central banks will be much more concerned about weak GDP growth than inflationary pressures, particularly as oil prices are likely to slump again once regime change in Iraq is achieved.

Government bonds became oversold during the mid-March sell off. This was a countermove, due entirely to the rally in stock markets. Investors in government bonds should take heed. There is only one script that will provide significant additional declines for yields - Japanese-style deflation in Europe and North America. Is this possible? Yes. Is it likely? No. For Europe and North America to follow Japan's path would require monumental policy errors by the European Central Bank and the US Federal Reserve. The deflation risk is higher in Europe, due to the ECB's mandate and the Stability Pact limiting government spending, but it beggars belief that European central bankers would not respond in time to problems that everyone else would see. However a cynic might conclude that it has often paid to underestimate central bankers. The Fed has already signalled its deflation-fighting intentions, loudly and clearly. The US's next monetary problem is likely to be inflation, but that is at least several years away.

Strategy on bonds - Government bonds remain a safer investment than stocks but they won't maintain the performance of recent years, unless global depression beckons. This remains a risk in a post-bubble environment but should be avoided by credit creation, barring some horrendous and hopefully preventable mishap. Last month I mentioned shortening maturities and/or standing aside on the first sign of military action against Saddam Hussein, in anticipation of a setback in response to a temporary rally by stock markets. I added that one could lengthen maturities once again after the share market rally lost steam. This has worked, even though the bond sell off commenced, in line with the stock market rally, a week before the war. At best, the bull market in government bond prices could either move somewhat higher for a few more years and/or plateau. However every holder and potential buyer of bonds should ask themselves the following question. If they need to borrow all that money, do I really want to lend them my capital at today's yields, other than for philanthropic reasons? Not unless we have clear evidence that central banks are willing to buy most of their respective governments' debt issuance, as we have seen in Japan. I maintain that anyone buying 30-year bonds today could see much of their capital destroyed by the next inflationary cycle. Total returns from corporate bonds should continue

to outperform stocks over the next few years (although not during stock market rallies) due to the fixed-interest sector's generally higher yields and somewhat lower risks. However a diversified portfolio is required because defaults increase in the post-bubble environment, as we continue to see. In futures, I am lightly long, using trailing stops. This is only a short-term trade and I may short on evidence of a stock market rally following regime change in Iraq.

Global Stock Markets

■ **Did the Federal Reserve intervene in the US stock market a week before the military strike against Saddam Hussein? Probably.**

■ **The fog of war compounds the fog of research.**

■ **This war is unlikely to have a big impact on the long-term outlook for global stock markets.**

We can seldom be certain about Fed intervention in the stock market but it does occur. The Fed tends not to disclose intervention, with the exception of multilateral currency forays, which are extremely rare. However we know it does intervene, and that it has a mandate to help maintain orderly markets. This is invariably a smoothing operation. When the Fed enters the stock market, usually via futures, it does so to check or prevent a market panic. It is not trying to micromanage the market, let alone buy a bull trend, which wouldn't work in any event. After the Fed buys S&P futures to check a market slide, it will ease out of this position on the following rally. The Fed almost certainly intervened shortly after 9/11, again in July 2002 and also the following October. A pre-war sell off would qualify as an intervention situation. While the S&P Index was not in freefall, it had dropped back from resistance near 950 and was approaching the July and October 2002 lows near 770. Given the psychological importance of those lows and the larger declines occurring in Europe, Alan Greenspan certainly had grounds for intervention, which would have occurred on the 12th and 13th of March. The 13th's upward dynamic broke the market's downward momentum by triggering a short-covering rally. Inevitably, there are tradeoffs with intervention. Short covering and then some long buying quickly corrected an oversold condition and reduced buying power. This leaves the market more vulnerable to another sell off, in the event of a longer and more difficult war, relative to prior expectations.

Military personnel talk about the fog of war, but what about the fog of research? Financial market research is an imprecise science, as every analyst knows. In order to have a fighting chance, one should approach the market challenge with humility, objectivity, knowledge of market history and an ability to interpret price action. It can be very helpful to have an appreciation of value, particularly in an historic context. However value is an abstract concept. In other words, it's in the eye of the beholder. Therefore one needs to be an amateur psychologist, monitoring the vicissitudes of crowds. Why amateur? Why not replace the technicians, value analysts and economists with analytical psychologists? No offence to therapists among my readers, but they would probably get hung up on their id and mother relationships. Market psychology is the study of the mob, best achieved by monitoring sentiment and above all, understanding the behavioural implications of chart action. While sufficiently doable for one to profit from the markets each year, if willing to go long or short as conditions dictate, market research is never easy. One has many hunches, both good and bad, but market research will always be an inexact science, for obvious reasons. People talk about the fog of war but we also have the fog of research. Moreover the war has compounded the usual difficulties of research. While war persists, it will remain the dominant influence on sentiment and therefore market trends. Needless to say this is disconcerting, because the war is both a disturbing distraction (however necessary or not, as one may believe) and by attempting to factor it into our research, we are trying to be armchair generals far from the action. That is an unfamiliar position, made more difficult because we also know that truth is the first casualty of war.

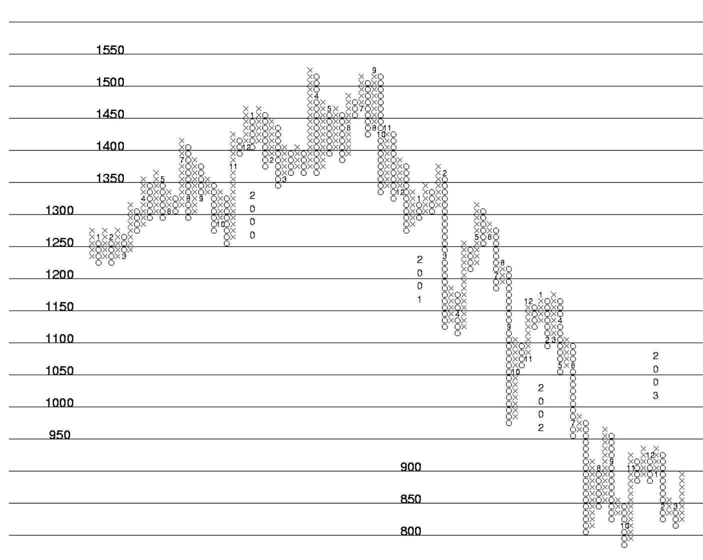
Despite military uncertainties, we can still analyse expectations. Uncertainty during the pre-war period weighed on stock markets. Consequently, many people, myself included, were looking for a technical rally once the military action commenced. The rally started a week early, probably triggered by Fed intervention and/or a false start similar to sprinters jumping the gun because they have been held in the starting blocks for too long. The shock and awe rally used up a considerable amount of financial firepower, particularly in terms of short covering. We know from prior comments that most investors were expecting a short war, lasting no more than a few weeks. While this could still be the case, it is proving more difficult than hoped, for a variety of reasons discussed in the press and TV programmes daily. Therefore the market is beginning to factor in a longer war. This change in perceptions has snuffed out the rally, as investors variously cease buying, sell some longs and open new short positions. However they are unlikely to sell aggressively, knowing that Saddam Hussein, if he is still alive, and most of Iraq's military command could be wiped out with one or two well-timed military strikes. In that event, stiff resistance from Saddam's Fedayeen, the Ba'ath Party and Republican Guard could dissipate quickly. While the danger of guerrilla tactics by small groups or lone snipers is likely to remain a serious military concern for some time, markets will take their next bullish cue from regime change in Iraq and especially a declining price for crude oil. Petrol prices are likely to resume their initial fall following regime change, moving quickly towards $20 a barrel. The prospect of these events could enable the early-March lows for most stock market indices to hold. Regime change in Iraq and lower oil prices should trigger another stock market rally, with its length and duration largely influenced by perceptions regarding the broader implications of this war.

Periodic rallies aside, the macroeconomic problems will continue to limit upside scope for many years. Inevitably there are parallels between today's valuations and the early 1990s, which are often cited as justification for long-term bullish views. I'm more concerned about the

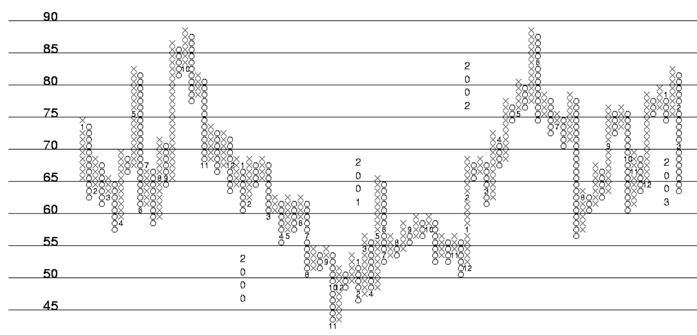
differences. Back then, the world was in the middle of a secular bull market. Today, I maintain we are in a secular bear market. Back then, companies were not suffering from a lack of pricing power. Balance sheets were not weighed down with heavy debt burdens in a deflationary environment. Famous and long-enduring companies were not facing bankruptcy. Last month (in FM225) I talked about valuations at length, so I'll just summarize here. The toll of economic problems related to the biggest bubble in history are likely to result in fabulous bargains in terms of equity valuations, which we last saw in the early 1980s. Back then, the S&P 500 Index yielded 6.21 percent (2Q 1982). Today, it yields 1.61 percent. I believe the S&P 500 Index will yield at least 5 percent before another secular bull market is launched. It will probably take years to get there, through a combination of lower levels for the Index and a very long period of primarily sideways ranging, during which GDP growth is sufficient for companies to raise their dividends considerably. Meanwhile, valuations are sufficiently low for stock markets to experience periodic rallies of medium-term duration, followed by sharp sell offs and lots of sideways ranging. The good news is that in terms of total points lost, we have seen most of the bear market. Unfortunately, many indices could still fall another 25 to 50 percent over the next few years. Overall, I would not be surprised to see many peak to trough falls of approximately 75 percent, similar to other secular bear markets. However the first indices to fall that far will almost certainly decline further. A number of emerging markets are likely to outperform developed regions, during the rally phases, due to their higher growth rates. Among these should be China, India and Thailand.

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. Please note, these charts were prepared before the final prices shown in the comments below.*

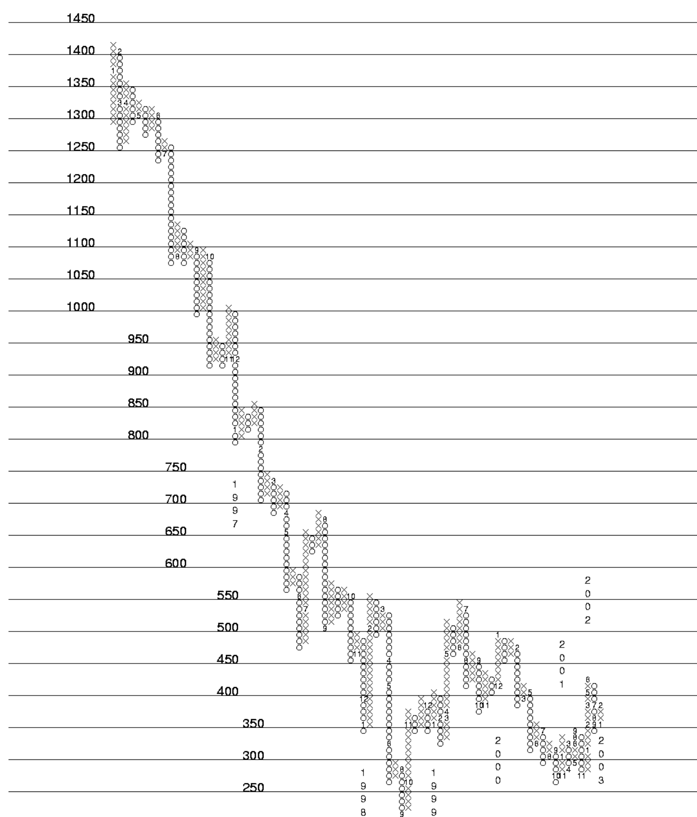
S&P 500 Composite Index (10pt)



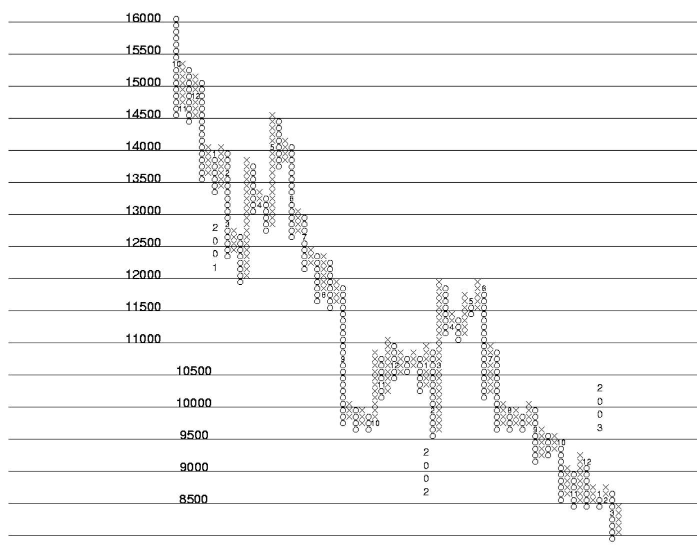
Philadelphia Gold & Silver Index (1pt)



Thailand Bangkok SET Index (10pt)



Nikkei 225 Stock Average Index (100pt)



The US's S&P 500 Composite Index (863) rebounded from above its July and October 2002 lows but remains well within the overall downtrend channel. A rally to 945, which seems unlikely this side of regime change in Iraq, remains necessary to break the downtrend and signal a medium-term rally. **The NASDAQ 100 Index (994)** - *not illustrated* - has continued to hold up better than most and shows evidence of a small base. However it needs to break above significant lateral resistance in the 1125 to 1150 region to complete this pattern. Conversely, a decline to 945 would open the door for a test of the October low. **The Philadelphia Gold & Silver Index (66.74)** fell back sharply from the upper side of its massive developing base formation, delaying completion of this pattern for at least several more months. Nevertheless an upward dynamic on 28th March (not shown) suggests that it will maintain the sequence of rising reaction lows. Therefore the next big move should be another test of the upper boundary, and eventually lateral resistance in the 88 to 93 region.

Japan's Nikkei 225 Stock Average Index (7972) has fallen back from initial resistance evident at 8400, in price action consistent with its ranging downtrend since last July. A move to 8500 is required to question the continued outlook for sideways to lower scope.

Australia's S&P ASX200 Index (2885) has rallied to the underside of its large, multiyear top, which is likely to provide stiff resistance. A retracement of recent gains appears imminent.

India's BSE Sensex Index (3071) - *not illustrated* - continues to shows relative strength and what may be a developing base formation. However resistance from the upper side of the overall ranging pattern has turned back the yearend rally, indicating scope for a further decline towards the lower side of the trading band formed since the September 2001 low at 2625.

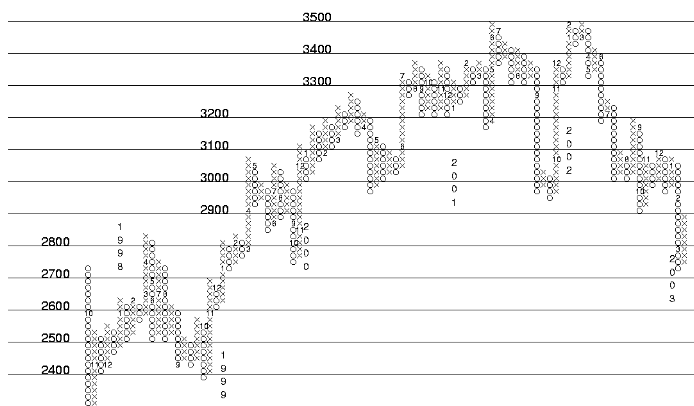
Thailand's Bangkok SET Index (365) is relative strength standout, with evidence of a multiyear base. Nevertheless, overhead resistance is likely to impede upside progress and cause some retracement of recent gains, until the next global rally occurs.

France's CAC 40 Index (2628) - *not illustrated* - rebounded sharply in mid-March but this rally is now being reversed by overhead resistance and the primary downtrend. A move to 2900 is required to offset current scope for at least a retest of the low at 2425.

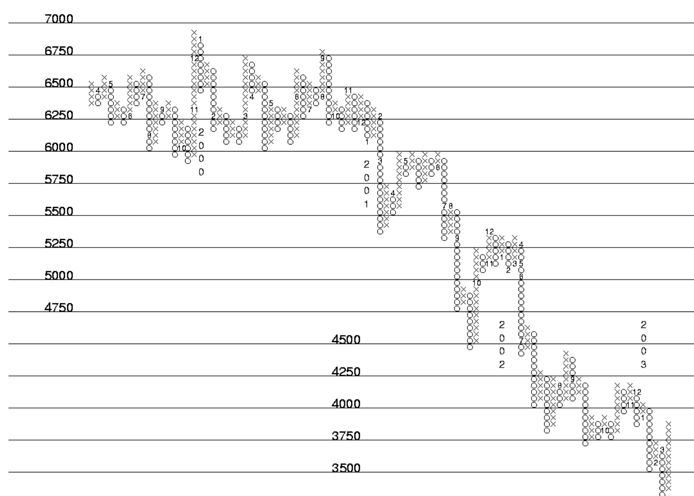
Germany's DAX Index (2432) - *not illustrated* - also rebounded but initial resistance has checked the recovery. A move to 2750 is needed to negate present potential for a further retracement of the mid-March gains.

Switzerland's Swiss Market Index (4064) - *not illustrated* - is falling back from lateral resistance near 4400 and a move to 4480 is necessary to offset an additional retracement of recent gains.

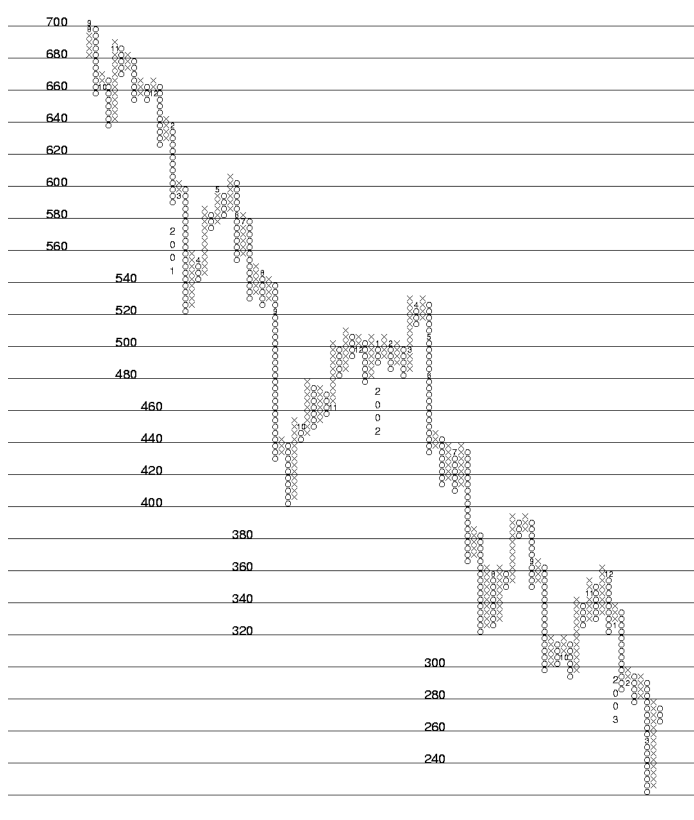
Australia S&P ASX 200 (20pt)



United Kingdom FTSE 100 Share Index (50pt)



Netherlands AEX Index (4pt)



The Netherlands' AEX Index (251) is similarly retracing rebound gains after faltering near initial overhead resistance. A move to 280 is now required to offset a retest of the March low.

The UK's FTSE 100 Index (3625) saw its sharpest rally in many months but this too was halted by overhead supply. A rally to 3900 is needed to offset scope for an additional retracement of recent gains.

Strategy for global stock markets - My preference in a bear market is to sell index futures when rallies lose upward momentum and to defer most purchases of stocks until there is evidence of capitulation selling, previously defined here as markets in freefall and, ideally, a VIX Index (OEX Volatility Index) reading over 50. Precious metal mining shares are the exception, but they should only be purchased after periods of weakness, such as we have seen recently. Upward dynamics near prior support levels by North American gold shares on Friday 28th March were impressive, indicating scope for additional and potentially significant rallies. I like this sector for the very long term but repeat that the shares need to be traded, because of their volatility. I regard current levels as a buying range and favour leading mines, such as Newmont, which I own and have mentioned previously. I also like gold funds and hold Merrill Lynch's, which are good for large or small purchases - check the web for details. There is a new gold share fund, recently launched by P&C Global Wealth Managers. This was set up by my old friend Iain Little, who has been mentioned in these pages on occasion over the years. The management company is in Cyprus - P&C Global Fund Management Ltd., Nafpliou 15, 3025 Limassol, Cyprus, Tel.: +357 25 87 83 84, Fax: +357 25 87 83 85, E-mail: pc.global.fund@unipal.net). Being new, it is small - a little over $5 million, which means it can be nimble in these fast-moving markets. The management team is very experienced, mostly ex-Merrill Lynch. The minimum investment is US$100,000. Another old friend, Urs Frommelt of LGT Capital Management in Liechtenstein manages a gold fund. Urs is a very experienced technician. You can read about Urs and his fund on this web address - http://www.lgt-bank-in-liechtenstein.com/lgt/cms/documents/cm/en/downloads/berichte/berichte_monat/oeff_preciousmetalfund_e.pdf. As always, neither Stockcube Research Limited nor myself has any financial incentive whatsoever in mentioning these or any other funds. I have not yet invested the family ISA's for this year (these are small, UK tax-efficient accounts), leaving the money in cash. However on evidence of capitulation selling I will be tempted by a combination of high-yielding shares with good dividend cover, and/or the London-quoted Aberdeen New Thai investment trust (closed-end fund), code ANW LN, or the JP Morgan Fleming Indian IT fund, code JII LN. Meanwhile, in terms of futures I am lightly short the NASDAQ 100, using a trailing stop. I will probably reverse this position on the first evidence of an upward dynamic, preferably associated with regime change in Iraq.

Currencies

- **The BoJ's Toshihiko Fukui is no Masaru Hayami clone.**

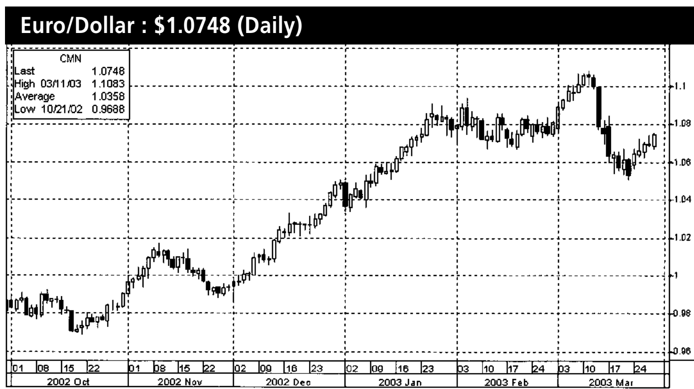
- **The euro has established a trading range against the US dollar following its recent high.**

- **The US dollar will eventually move somewhat lower against the euro but there will be no collapse.**

- **Could the US and other economies experience hyperinflation within the next 20 years?**

Could this BoJ appointment save Junichiro Koizumi? Probably not, but it should provide a temporary lifeline for Japan's prime minister, who has lasted longer than most but may be past his sell by date, judging from the low approval rating. Numerous critics said that Fukui would be no different from Hayami. Surely no one else could be as incompetent and obstinate as the former BoJ Governor. Wisely, Fukui did not take the helm promising radical reflation. That would have been rash, definitely not the Japanese way and it would have invited criticism, especially from abroad. Also, there are certain to be some Hayami clones among the BoJ's Board Members, with whom Fukui will need to work. This reality may be why his first move has been to increase the purchase of shares from Japanese banks (a Hayami policy) to help them meet capital requirements. While this is treating the symptom of deflation rather than the cause, the new Governor appears fully aware of the deflationary problem (how could he not be?) and the need for much more radical reflation than we saw under Hayami. While Fukui may proceed cautiously, he won't be short of advice. Neither was Hayami, but it caused him to bridle. Fukui, in contrast, is close to the MoF and he will have some loyalty to Prime Minister Junichiro Koizumi, who appointed him. Meanwhile, legislators have urged the BoJ to set an inflation target, consider buying exchange-traded funds, which are index-based investment vehicles, and real-estate-related securities. Another policy option frequently mentioned is the purchase of foreign bonds, which is the equivalent of printing money. Japan's deflation is so firmly entrenched that I suspect Fukui may eventually need to purchase Japanese property and stocks on the open market. Radical reflation should be bearish for the yen, although this depends on perceptions relative to other currencies.

One of my hypotheses has been that the onset of war against Saddam Hussein would produce a number of contra-trend reactions, including a temporarily firmer US dollar. The behavioural reason was that concern over the war was a factor contributing to selling the dollar. In the event, these contra-trend reactions commenced shortly before the widely anticipated military action. The euro was unable to sustain a move above psychological resistance at $1.10 and fell sharply, breaking the February range low at $1.0650 in the process. This correction of nearly 6 cents to date was the biggest since July/August 2002. But as it occurred more quickly and from a higher level, there is a good chance that the euro could fall temporarily beneath minor support at $1.05, when regime change in Iraq is achieved. Before then, the euro will rally within its new range on delays and setbacks in the war against Saddam Hussein. Overall, chart action looks very much like a



medium-term correction for the euro, meaning that sideways ranging is likely for several weeks and perhaps a few months, before the overall uptrend is resumed.

Why should the euro eventually resume its uptrend against the dollar, when the US economy is so clearly stronger, more adaptable and resilient than Euroland? There are a number of reasons. Unofficially, the US is happy to see a softer dollar, which will increase the competitiveness of US goods. Geopolitical considerations following 9/11, including the freezing of suspected terrorist organisation funds, has caused a number of Middle Eastern investors to pull out of the US. More importantly, the Federal Reserve continues to rapidly increase the supply of dollars in circulation. This is to avoid Japanese-style deflation, help to finance the current account deficit, fund the war against Saddam Hussein and also global terrorism. Since everyone in the forex markets knows this, it is partially discounted, which is another reason for the euro's present correction. More importantly, with no end to the US's rapid reflation in sight, many central banks with large surpluses will continue to diversify away from the US dollar. Remember, 77 percent of the reserves held by central banks were in US dollars at the beginning of 2002, according to most estimates. That was an overweight position by any definition. It did not make sense. The problem was in finding a viable alternative. Understandably few central banks wanted yen, because of Japan's deflation, which is unlikely to be reversed without an eventual devaluation, if the last 200 year's financial history remains a reliable guide. There is insufficient liquidity in the Swiss franc, sterling and the Australian dollar for these currencies to rival the US dollar as significant repositories for central bank reserves. As for hard money, there is not enough gold available for more than a small diversification into the yellow metal. This leaves the euro by default, despite Euroland's basket-case economies, institutionalised structural rigidities, and a belief among many outside the region that a single currency for an increasing number of culturally and linguistically diverse countries is likely to be a dodo. Aside from the essential issue of liquidity, the euro has another advantage - its supply is increasing far less rapidly than the quantity of additional dollars and yen.

While the dollar will eventually weaken somewhat further, talk of a collapse against the euro is unrealistic. In fact, periodic stories of the dollar's demise are a contrary indicator, indicating that people are heavily short. I can envisage the dollar, which after all is just a fiat currency, losing a great deal of purchasing power relative to the price of gold over the next 20 years. To put this in perspective, I can image the dollar price of gold price rising several hundred percent within the next 2 decades. However the dollar will not and cannot experience a similar decline against the euro or any other fiat money, because that would literally cripple the economies faced with a dramatic appreciation of their currencies. Long before this happened, they would respond in the only way possible - by increasing the supply of their currency. They would most likely commence doing this, if necessary, once the dollar fell beyond another 20 percent from current levels. Additionally, the biggest holders of dollars, other than Americans, are the central banks of Japan, China and Euroland. Japan dare not sell dollars for its own currency because an appreciating yen would aggravate the country's deflation. China is switching some of its reserves into euros and to a lesser extent gold, but with the yuan pegged to the dollar, it is also benefiting from the increased export advantage resulting from a highly competitive currency. Euroland's position is similar to Japan's, although without net deflation at this stage. The ECB sold dollars to support the euro in 2000. It certainly won't do so while the euro is appreciating.

Despite these constraints, some people fear hyperinflation in the US within the next 20 years, due to excessive credit creation in order to prop up the economy, fund deficits and reduce debts, while waging costly wars against rogue regimes and terrorist organisations. They contend that the US *needs* inflation, in order to avoid a sustained deflationary slump and possibly economic depression. They have a point, reinforced by Fed Governor Ben Bernanke's extraordinary speech last year - see FM224. Moreover fiat currencies have a poor history in terms of maintaining purchasing power. I have long maintained that when deflation was perceived to be a much greater threat than inflation, the Fed would become born-again inflators. They have certainly crossed that Rubicon. There can be no doubt that the Fed will err on the side of inflation, although it could be years before this becomes part of the public consciousness - resulting in a self-feeding inflationary mentality - as we last saw in the 1970s and 1980s. Additionally, long-term inflationary cycles beget deflationary cycles, which beget inflationary cycles, and so it goes. I have little doubt that inflation will be a problem, most likely 10 to 20 years from now, although sustained upward pressure could emerge sooner, depending on a range of variables, including the monetary policies of other countries.

Needless to say, the US Federal Reserve, led by Alan Greenspan and his successors, will maintain that it can fine tune monetary policy sufficiently to avoid future inflationary problems. They will be sincere in both view and effort, because no developed country's central bank willingly unleashes either chronic deflation or inflation, at least not in this era. This is precisely why the Fed has been so aggressive in its efforts to avoid Japanese-style deflation, let alone a replay of the 1930s. Nevertheless, there is no doubt that the US economy is hooked on credit creation.

Businesses have long been exhorted to borrow and spend, as have consumers. And they did just that, which is an important reason why there was a stock market bubble in the late 1990s and to a lesser extent, a property bubble today. The former burst 3 years ago and the latter is beginning to deflate. Capital expenditure collapsed with the former and more recently consumer spending has tailed off in line with property prices. While the anticipation and reality of a Gulf war has contributed to decreased spending, most of it would have occurred anyway, as part of the macroeconomic post-bubble trend. Therefore while both capital expenditure and consumer spending should experience a post-war rebound, it is unlikely to be sustainable beyond a few months. There is simply too much debt for a vigorous, sustainable economic expansion to occur. Rising unemployment will compel both the Fed and executive government to persist with aggressive monetary and fiscal reflation, respectively. Increased fiscal spending and sluggish economic growth will result in larger deficits. While deflationary pressures or stagflation persist against this background, both the central bank and treasury will continue to err on the side of future inflation.

Aggressive reflation will not be confined to the US. While America has been high on credit creation in recent years, most other countries have been hooked on exports to the US. Some are also reliant on US tourism. Consequently, the economic problems of other countries are often greater than those of the US, which is more self-contained. Global economic problems will compel other countries to adopt expansionary monetary and fiscal policies, where possible. Euroland currently faces the most constraints, due to the ECB's deflationary mandate and the Stability Pact on fiscal spending limits. However both are likely to be fudged, rewritten or ignored, especially when the euro resumes its rally against a background of rising unemployment, with both factors exacerbating deflationary pressures. Globally, the pressure to reflate will ensure that today's deflationary problems gradually give way to another cycle of inflationary pressures within the next decade or two. The only question concerns the amount of inflation that each country will experience. This is unanswerable today and will depend primarily on monetary policy decisions yet to be taken.

There is one factor exclusive to the US. When the entire world is dependent on its currency as the primary medium of exchange and store of reserves, these countries have collectively, albeit unwittingly, handed the US an invitation to abuse. The main abuse of a currency is to increase its supply well in excess of GDP growth. When this occurs over a lengthy period it sows the seeds of future inflation. Neither the US nor any other democracy will risk a potentially serious inflation problem, except during difficult times. These *are* difficult times. Need an extra $75bn to fund a war against a genocidal dictator, another large slug for the ongoing war against terrorism, billions in aid and loans for other countries, more billions to revive the US economy? - print it.

Chart review of important and topical currencies
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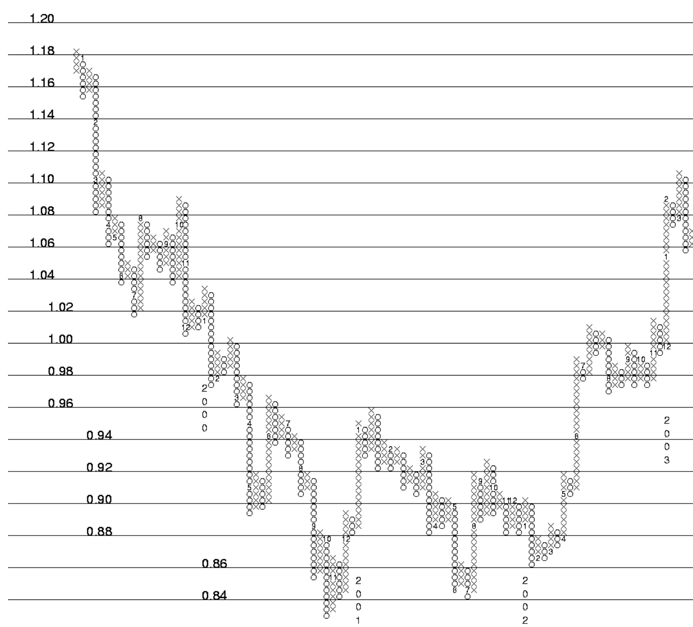
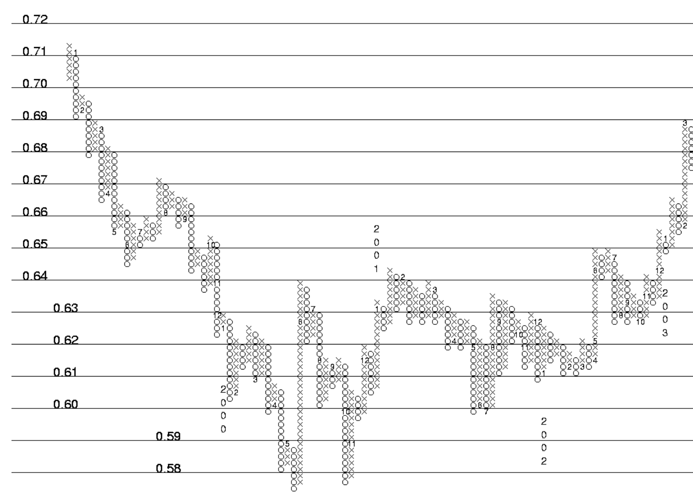
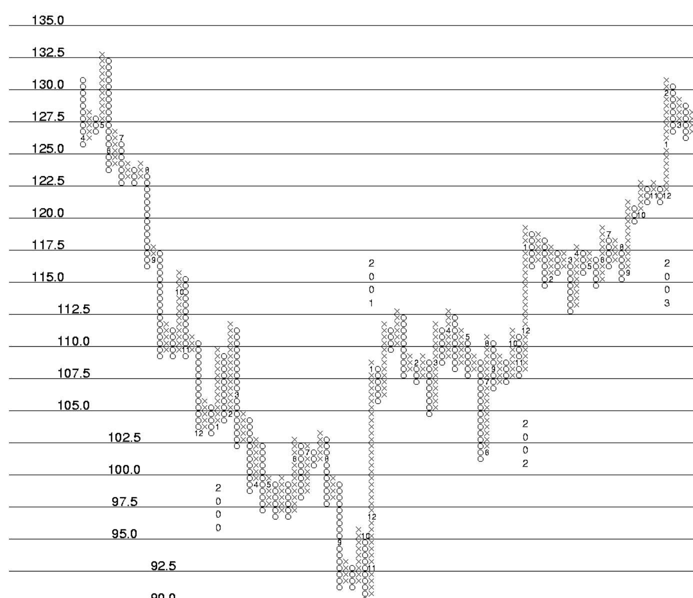
US Dollar per 1 Euro (0.004)



Pound Sterling per 1 Euro (0.002)



Japanese Yen per 1 Euro (0.5)



www.chartanalysts.com and are updated daily. All comments refer to closing levels for US trading hours.

Euro/dollar ($1.0778) - The euro has fallen back from psychological resistance near $1.10. This reaction is larger and occurred more quickly than the earlier July/August correction. Therefore further ranging is now likely, which could persist for up to several months, during which the euro is unlikely to move much above its recent high but could ease somewhat lower. This sideways trading range should eventually be resolved on the upside, with the next target being $1.15.

Euro/yen (¥129.20) - The low for this consolidation may have been reached in mid-March, and a close above ¥129.50 would provide further evidence of this. A break above February's high near ¥130.50 should be followed by at least a test of the early-1999 peak at ¥134 - not shown, see www.chartanalysts.com (requires subscription).

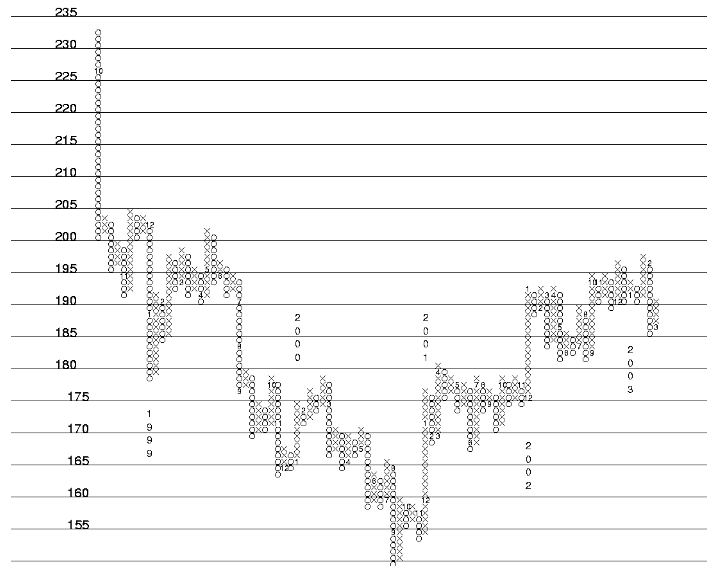
Euro/sterling (£0.6848) - February's gains represented trend acceleration. Therefore an additional consolidation is likely before the euro's base supports higher levels.

Sterling/yen (¥188.66) - The pattern remains choppy because this is a less dynamic trend than we see for Continental European currencies against the yen. Nevertheless we have probably seen the reaction low and sideways to higher ranging is likely, towards psychological resistance near ¥200.

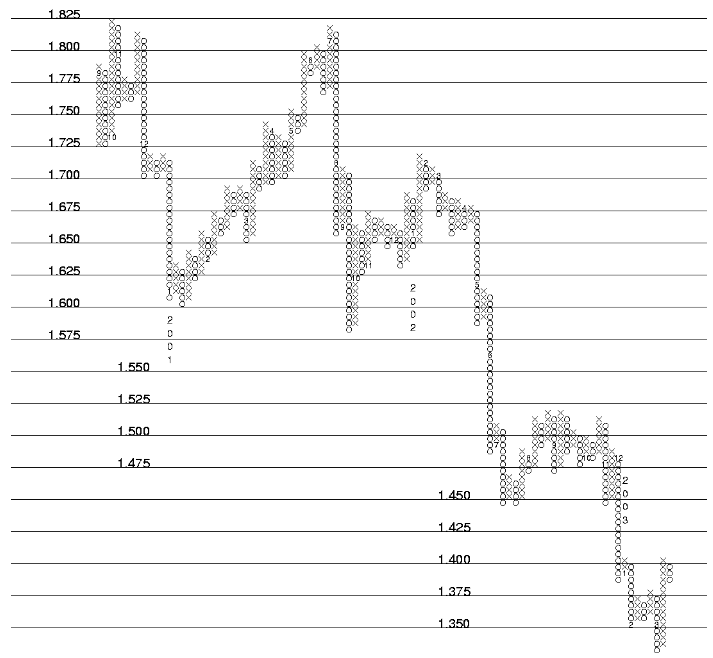
Dollar/Swiss franc (SF1.3698) - The dollar encountered support above its important October 1998 low at SF1.315 - not shown. However upward scope appears limited to the possibility of a small additional recovery before the large top area and downtrend lead to further weakness.

Dollar/yen (¥120.16) - The dollar has once again bounced from psychologically important lateral support down to ¥115. The move above ¥121.50, although not maintained, provided the first evidence of increasing demand relative to supply by breaking the recent progression of lower rally highs. This is shaping up as an "H&S" failure, for reasons mentioned in earlier issues. However ¥126 is required to

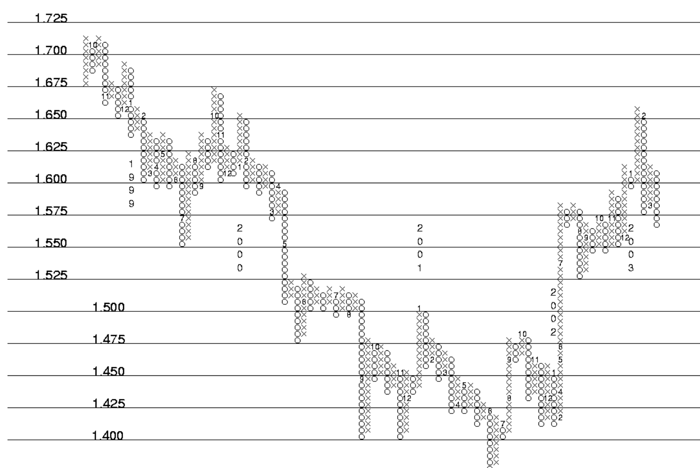
Japanese Yen per 1 Pound Sterling (1)



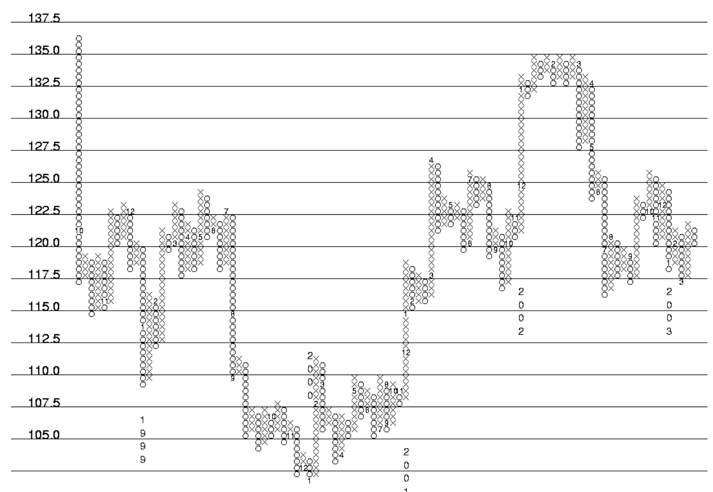
Swiss Franc per 1 US Dollar (0.005)



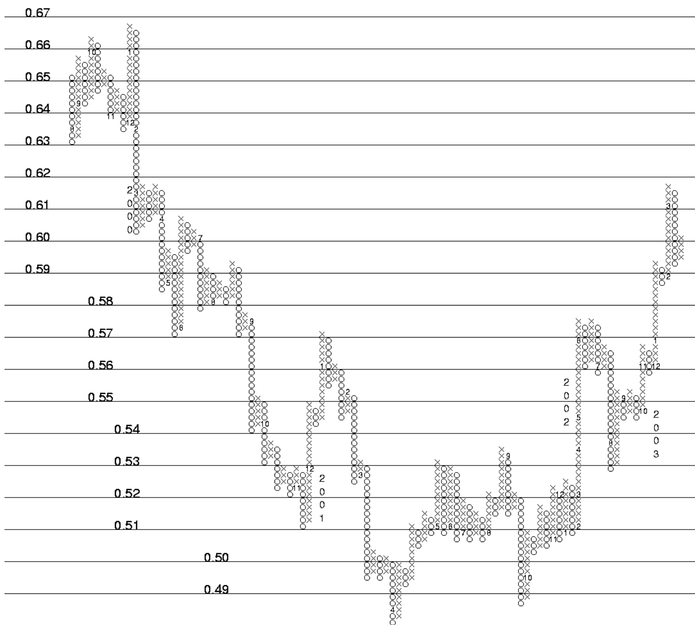
US Dollar per 1 Pound Sterling (0.005)



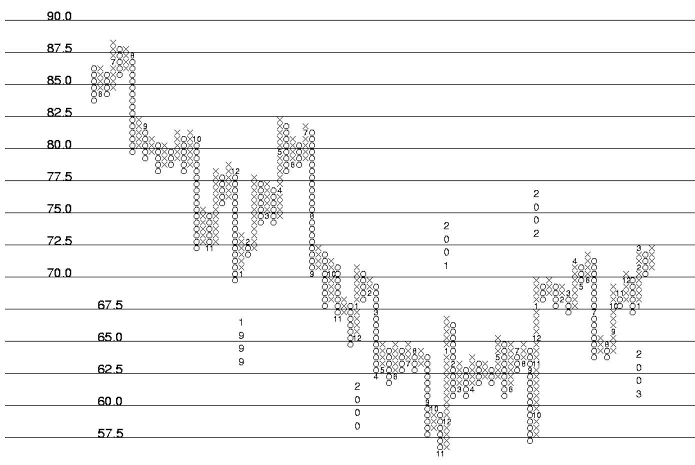
Japanese Yen per 1 US Dollar (0.5)



US Dollar per 1 Austrailian Dollar (0.002)



Japanese Yen per 1 Austrailian Dollar (0.5)



reaffirm the floor dating back to February 2001.

Sterling/dollar ($1.5740) - The pound fell back from prior resistance above $1.65 (partially shown) more quickly than it rallied, suggesting that the upper boundary will not be retested quickly. However support evident from $1.58 should continue cushion downside risk, followed by sideways to somewhat higher trading.

Australian dollar/US dollar (US$0.6010) - Trend acceleration in January and February has given way to the sharpest correction since last July and August. While the Australian dollar has steadied at initial support, this appears insufficient for the uptrend to resume and a period of ranging is likely.

Australian dollar/yen (¥72.03) - is approaching its early-March high just under ¥72.50, which may provide temporary resistance. However the build-up of underlying support suggests that the next significant move will be upwards.

Strategy on currencies - I was tempted by euro/dollar during the recent setback but purchased euro/yen instead. I suspect the dollar will swing back and forth on war news, as may sterling. However in an appropriate goodbye wave to Masaru Hayami, the yen commenced weakening on the former BoJ Governor's last day in office. People who had closed yen crosses on disappointment following the announcement of Toshihiko Fukui's appointment are reassessing and returning. While I'm back in euro/yen, I have only a third of my former position because of the current consolidation. I may continue with some Baby Steps buy-low-sell-high trading but will probably leverage up on a sustained break to new highs, protecting with trailing stops. I'll trade sterling/yen on a similar basis but lighten more on strength due to its greater volatility. Also, sterling is not so strong overall as the euro. I expect a further recovery by dollar/yen on favourable war news. I comment on these trades daily in the Audio, which is part of the expanded Fullermoney service for all subscribers. If you would like to hear this, just request a login name, if you don't already have one, via the www.fullermoney.com email contact facility.

Commodities

- **Petroleum prices are still a problem for the global economy and are unlikely to see another sharp fall until shortly before the war is over.**

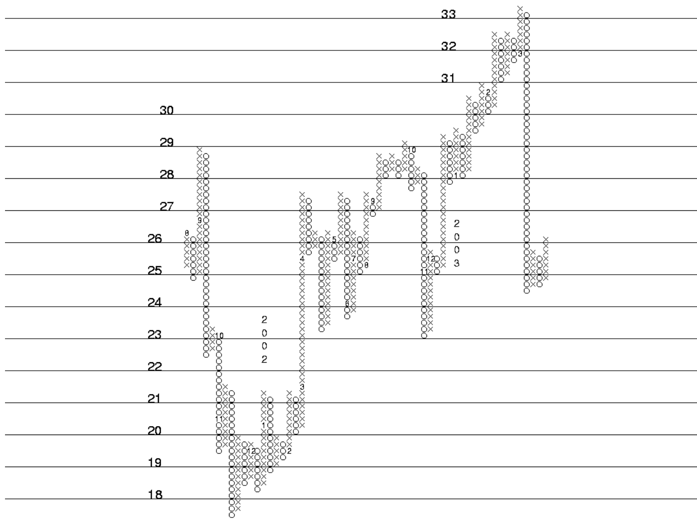
- **Gold is encountering support from the upper side of its multiyear base formation.**

- **The CRB Index has established a medium-term peak.**

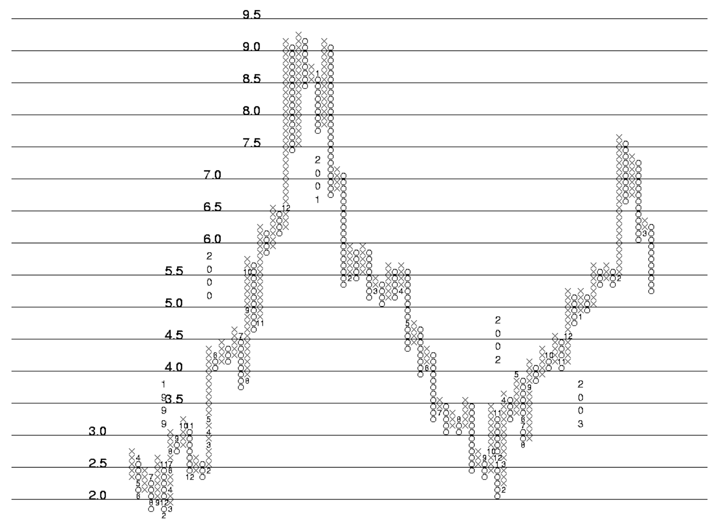
Crude oil plunged in mid-March but has recovered over a third of that decline. This rally is temporary. We now know that serious damage to Iraq's production facilities is extremely unlikely. While the uncertainty of war will keep prices higher than fundamentals of supply and demand would otherwise suggest, it would require another Venezuelan-type crisis, perhaps in Nigeria, for crude oil to test its February/March highs. I maintain that prices will fall to the $20 to $15 range (NYME) within 6 months after the war ends.

The next big move for gold will be on the upside. Gold pulled back further than I expected, but then markets are full of surprises. A contributing factor was the hike in margin requirements for US gold futures contracts, which capped the rally. This looked gratuitous, especially as margin requirements for stock market futures were never increased during the bubble. Since talk of a gold bubble at $389 was risible, many bullion traders interpreted the margin increase as a warning shot by the Fed. They could be right. Nevertheless, gold's chart action is not at all unusual. Following breakouts from bases, prices often return to the upper side of the pattern during a ranging phase that I describe as the first step above the base. These patterns can take months to form, before the bull trend is resumed. Gold is unlikely to be an exception as dealers are wary following the margin hike and large pullback. If the

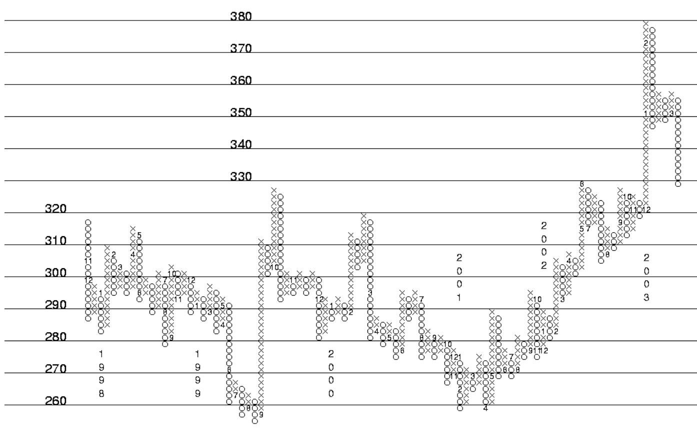
Crude Oil NYME 2nd Month Continuation (0.2USD)



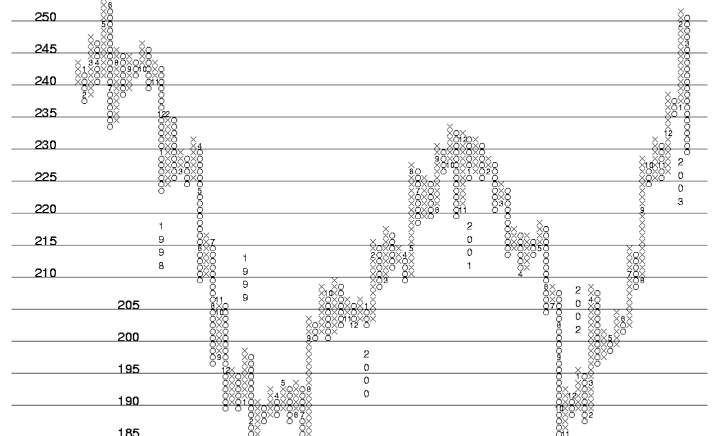
Natural Gas 2nd Month Continuation (0.1USD)



Gold CMX 2nd Month Continuation (2USD)



CRB Index NYFE (1USD)



margin rate is not now reduced, with bullion $50 lower, traders will have another reason to conclude that the Fed is not friendly to an appreciating gold price. Whatever, there is a secular trend at work, which neither the Fed nor any other government agency can prevent, although they can micromanage it. My long-term script for gold is unchanged. A 10 to 20-year bull market has only just begun. There will be long periods of ranging during the early years, in line with most secular trends. The chart will show a series of steps, with most occurring at higher levels than the previous trading range. The biggest gains are achieved towards the end of bull markets. The bullion price should eventually reach levels several times higher than we see today.

Falling oil prices were the main contributor to the CRB's sharp reaction, forewarned by the prior acceleration. Sentiment in many other commodity markets was affected by cheaper oil and gold prices. Currently, the CRB looks oversold and should see a partial retracement of the recent decline. However the February high is unlikely to be tested for a considerable time.

The Global Economy

■ **Three anomalous and related factors have aggravated economic problems during a period of monetary stimulus - the high price of oil, events related to UN Resolution 1441 and concern over terrorism.**

■ **Following the war for regime change in Iraq, most economies are likely to improve more than expected,**

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at least for a while.

■ **Macroeconomic problems remain considerable.**

Of these oil is both the most volatile and most important. Oil has been a problem for the global economy since mid-2000, when it first moved above $29 (NYME) a barrel. While there was some respite a year later as the price fell back towards $15 - it then rose again due to OPEC cutbacks, a build-up of US strategic reserves, the Venezuelan strike and hedge longs prior to the war for regime change in Iraq. Predictably, the war premium contracted sharply once the military move against Saddam Hussein commenced, because there has been no major disruption to supplies. Also, the Venezuelan production crisis appears to have ended, and the supply of oil from that country is rising. However the price of crude oil is unlikely to fall in a straight line, especially as it will take time to achieve regime change in Iraq given the surgical nature of this military campaign, in order to limit infrastructure damage and especially civilian casualties. Nevertheless I have long maintained that the price of crude oil would decline to $20 shortly after regime change has occurred, and that it could even reach $15 within another 6 months. This is likely even if the current war proves to be much more difficult than that of 12 years ago, as I expect, due to the hazards of taking and administering Baghdad, and other major cities in Iraq. These will include guerrilla attacks by remnants of troops loyal to Saddam, who feel that they have little to lose. Needless to say, an oil price below $20 would remove a very serious problem for the global economy.

The political impasse over UN Resolution 1441 has been bad for GDP growth. At minimum, it was a major distraction. At worst, it eroded confidence in the alliances that have helped to preserve peace and develop prosperity for Europe and the US during most of the post WW2 period. This has inevitably affected confidence at both corporate and consumer levels. The bruising diplomatic encounter is a detriment to transatlantic commerce, investment and travel. Hopefully, this is a temporary problem and the nadir of a major division among allies has passed.

Terrorism is bad for economic growth, which makes it an effective tactic for its perpetrators, even if the incidents are infrequent and generally minor. When people stay home to watch news reports covering terrorist attacks, or the capture of terrorists, it means they are not shopping, going to restaurants or planning holiday trips. Consequently terrorism has an economic impact, way beyond the isolated, generally minor and usually remote instances of actual attacks. This is not just limited to hotel/resort bookings and airline ticket sales. There is a big knock-on effect from reduced travel, consumer spending, and deferred business plans. This will certainly persist during the war and beyond, at least until people are satisfied that terrorism is not increasing as a consequence.

Sentiment should improve during the next few months, yielding some economic benefits. This view assumes that there will be no major disaster in the war for regime change in Iraq, or devastating terror attack of 9/11 proportions. While the latter has long appeared to be a waning threat, the uncertainties of war, not to mention the inherent dangers in occupying cities, means that risks will remain high. Unfortunately, these could persist for months, however justified the cause of liberating Iraq from a genocidal dictator's regime. Nevertheless, despite Middle East uncertainties, there is scope for believing that sentiment will improve in the post-war environment. For initial evidence, we have the recent rally by most stock markets. While this was always likely once the war to liberate Iraq commenced, and actually started a week earlier, it can only help to dissipate some of this year's earlier gloom. The lower price for oil will provide a more rapid and widespread boost than any tax cuts, and the US and Europe should be able to at least partially repair the recent rift. As the pendulum of sentiment swings away from a very negative pre-war position, economic data should improve somewhat. Given a reasonably stable situation in Iraq and the Middle East in general, which must be a possibility, global GDP growth could rebound for a number of months. However, most of the well-known macroeconomic problems, discussed at length in previous issues, will remain.

And Finally…

"Never, never, never believe any war will be smooth and easy, or that anyone who embarks on that strange voyage can measure the tides and hurricanes he will encounter. The Statesman who yields to war fever must realise that once the signal is given, he is no longer the master of policy but the slave of unforeseeable and uncontrollable events. Antiquated War Offices, weak, incompetent or arrogant Commanders, untrustworthy allies, hostile neutrals, malignant Fortune, ugly surprises, awful miscalculations all take their seat at the Council Board on the morrow of a declaration of war. Always remember, however sure you are that you can easily win, that there would not be a war if the other man did not think he also had a chance."

Winston Churchill, "My Early Life," 1930.

Best regards - David Fuller

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