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

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A Wall Street-led summer consolidation for stock markets is underway. However there is little chance that the March-April lows will be tested during this temporary pause, due to aggressive monetary reflation and because many investors now feel they are underinvested in shares.

Central banks in the two largest economies and stock markets continue to target share prices. 'Don't fight the Fed' didn't work in 2001 and 2002, when monetary stimulus mainly amounted to interest rate cuts. Subsequently, Greenspan and Co have been much more aggressive in expanding the US monetary base, and the Fed almost certainly supported the stock market at its troughs, as market dynamics suggested at the time. Moreover, knowing the importance of sentiment and their ability to influence it, members of the normally Delphic Fed have actively talked down deflation fears. Not for them the ECB's haughty denials, which just seem out of touch. The Fed produced academic, although certainly not dry, papers starting with Ben Bernanke's shocker delivered on 21st November before the National Economists Club in Washington DC. In case anyone missed it, he said:

"...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."

And lest anyone thought Bernanke couldn't be serious, the Dallas Fed waded in a couple of months ago with its paper*, Monetary Policy in a Zero-Interest-Rate Economy, by Evan F Koenig and Jim Dolmas. These two make Bernanke sound almost like Austrian-School economist. Here's one of the money quotes:

"By coordinating with fiscal policy, the Fed could even implement what is essentially the classic textbook policy of dropping freshly printed money from a helicopter. In this case, the Fed would monetize government debt that had been issued to finance a tax cut."

There is no mistaking the Fed's intention. It wants everyone, and especially Americans, to know that it has the knowledge, weapons and will to prevent the US economy from slipping into a Japanese-style, not to mention 1930s-style, deflation. Taking the Fed at its word, and subject to short-term timing, this remains bullish for the

stock market until investors anticipate rising interest rates - bearish for the dollar which has experienced a technical rally recently - bearish for government bonds as fixed-interest investors begin to discount a higher rate of inflation, and bullish for gold over the longer term.

Japan has the greatest incentive to follow the Fed's lead. After years of persistent deflation, Japan's monetary policy is changing rapidly now that Toshihiko Fukui is running the BoJ. His predecessor, Masaru Hayami, had long been an obstacle in the path of more aggressive reflation. Hayami's chair was barely cold before Ben Bernanke had been invited to speak in Japan on measures to end the country's deflation. Addressing Japan's Society of Monetary Economics, in Tokyo on 31st May, the outspoken Bernanke proposed radical policies for Japan, including inflation targeting. BoJ spokesmen may have demurred publicly, perhaps for political reasons, but policies now resemble those of the US. Japan wants a weaker yen and has intervened aggressively in recent months to prevent its currency from appreciating against the soft US dollar. The difference this time is that a post-Hayami BoJ is not sterilising liquidity created by intervention. Japan has renewed efforts to lift its stock market, with greater success. Crucially, Japan's monetary base expanded 20.3 percent in June (YoY). Japan's Government Bond market, where 10-year yields fell to a ludicrous 0.43 percent in mid-June before spiking, has woken up to the new reality.

** See Comment of the Day for 24th June on www.fullermoney.com, for the full paper and additional discussion.*

Interest Rates and Bonds

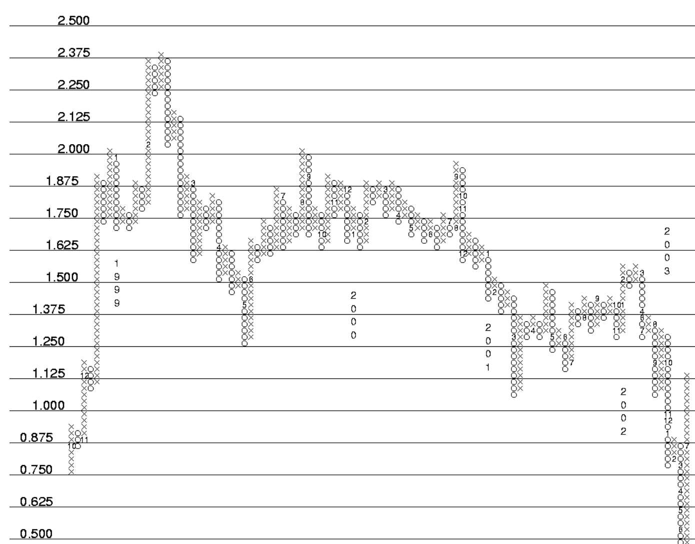
■ **Central banks will continue to err on the side of easy money. Further rate cuts are likely for the ECB and BoE, and while the Fed's bias remains towards easing, there is no need for an additional reduction.**

■ **The JGB bubble has burst, and US and European government bond yields have bottomed for at least the medium term.**

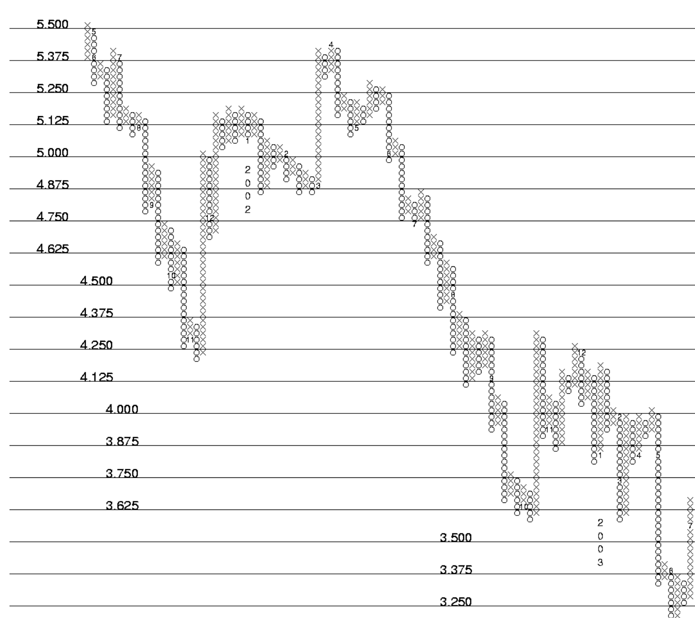
The ECB may delay because of firm stock markets and the euro's reaction. Euroland needs lower rates more than any other developed economic region. However due to the Maastricht Treaty, Euroland is unable to function like other regions, and with Germany and France continuing to ignore the so-called Stability Pact regarding budget deficits, the ECB may hang tough on rates, at least until the euro strengthens once again. We saw the same problem in Japan, when Masaru Hayami was Governor of the BoJ. The UK's weakest GDP growth in 10 years is reason enough for another rate cut by the BoE's Monetary Policy Committee. In the US, a record monetary and fiscal stimulus should be more than sufficient to lift the economy, despite high debt levels and corporate reticence towards expansion.

After the so-called "flight to quality" in government bonds in recent years, investors are beginning to

Japanese 10 Year Bond Yield (0.025)

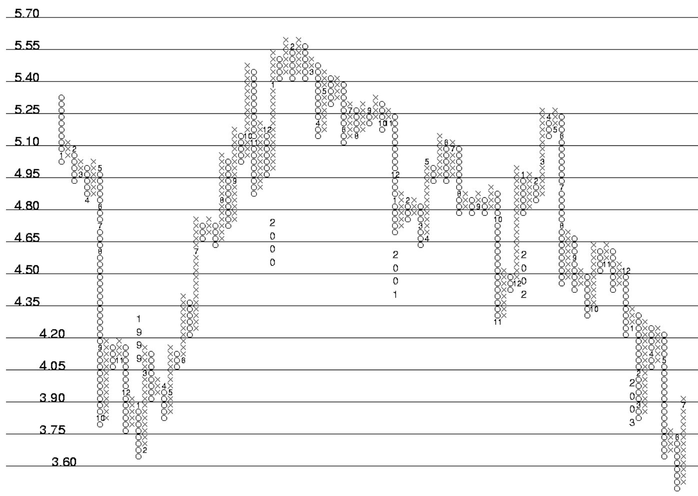


US 10 Year Bond Yield (0.025)



realise the risks. With financial instruments, whatever the demand, supply will eventually prove to be inexhaustible. If governments can raise money cheaply because the investment community is preoccupied with deflation fears, it will do so. We have certainly seen this in Japan, which currently has the biggest government bond market in the world, 42 percent larger than US government debt. Paradoxically, Japan also has the lowest yields, with the return on 10-year JGBs falling to a record 0.43 percent on 13th June - qualifying as the greatest bubble of them all. "The Emperor has no clothes" statement came from a BoJ official who described JGB yields as "ridiculous" in mid-June, and it spooked the market. No wonder institutional demand for Japanese government debt has slumped recently. With supply increasing, everyone knew that JGB yields could only reach such low levels because the BoJ was a massive buyer, creating the moral hazard for investors and prompting the quip - a risk-free return has become a return-free risk. If the BoJ is now questioning the

Euro Bund 10 Year Bond Yield (0.03)



logic of its JGB policy, some holders of Japanese government paper are understandably going to sell.

Today, there are bubbles in all government bond markets, due to concern over deflation. The recent spike in yields, commencing in mid-June, suggests that the worldwide government bond bubble has begun to deflate. Nevertheless there is an argument stating that yields could range near their lows for a lengthy period. This is just possible, especially if governments increase purchases of their own debt, but it is a forecast that one would expect from those who are overinvested in these issues. Additionally, given the low returns, there would need to be a reasonable prospect that government bond yields could fall considerably lower, to justify the risk. This could only happen if Euroland and the US succumb to Japanese-style deflation. It may be a valid concern for Euroland, but there are no grounds for doubting the Fed's resolve and tools for ensuring that deflation does not envelope the US. Greenspan and Co should win their battle, over time, at the eventual price of higher inflation. In all probability, this would put such upward pressure on the euro that the ECB would have to reflate.

Strategy on bonds - Subscribers may recall that I turned very wary of government bonds a few months ago, somewhat early, because of the bubble characteristics and better prospects for a significant stock market rally. Given the recent technical evidence that yields have bottomed, I would not assume that governments will succeed in pumping up this bubble once more, although that is a possibility. Personally, I have no developed country government bond longs. I do have a small amount of high-yield and corporate debt, which I will not increase. High-yield corporate debt may take its cue from stock markets, which remains in form, but the spike in government yields has changed the psychology for debt instruments. I have a small short position in US T-bond futures, which I have hedged from time to time with Bund futures.

Global Stock Markets

■ **The 'Baghdad bounce', liquidity and US presidential cycle should limit downside risk on Wall Street to a summer consolidation, prior to further gains.**

■ **Asian markets are now outperforming the West, and this trend should continue.**

The Fed and Bush Administration continue to target the stock market. If you are trying to avoid deflation, not to mention the possibility of a severe post-bubble economic slump, the monetary recipe is an enormous infusion of liquidity. The Fed has certainly obliged, and one litmus test of its effectiveness is the stock market. The Bush Administration has contributed massive fiscal spending, tax cuts and US Treasury Secretary John Snow's cheerleading. Combine this monetary and fiscal stimulus with the 'Baghdad bounce' after the S&P 500 Index had slumped 50 percent from its March 2002 peak, and summer consolidation aside, we have the ingredients for a 50 percent recovery, which would take the S&P to just over 1150 in 2004. Some say this could not happen, which suggests either that they have not bought into the rally, or they exited early. History is not on their side. Just look at Japan for the most recent example. The Nikkei staged 4 major rallies in the 1990s for an average gain of approximately 50 percent, all within a secular bear market. The first of the Nikkei's significant medium-term recoveries occurred after it had fallen 50 percent from its 1989 peak. Is this coincidence or fundamentals? Certainly not the latter and it happens too often to be pure coincidence. I say it is behavioural. Meanwhile, fundamental analysts look on the stock market as a lead indicator and can cite prospects for some economic recovery due to the same factors that have lifted share prices since March. A lack of pricing power remains a problem for corporations but some economic recovery combined with cost cutting is helping the bottom line. US exporters and multinationals also benefit from the weaker dollar. Since most stock markets track Wall Street, often with a higher beta, the global rally is unlikely to be more than temporarily interrupted by the US/European summer consolidation. Where will the demand come from? Underweight investors who hold lots of cash in money market funds and/or are overweight in bonds, which are no longer outperforming equities.

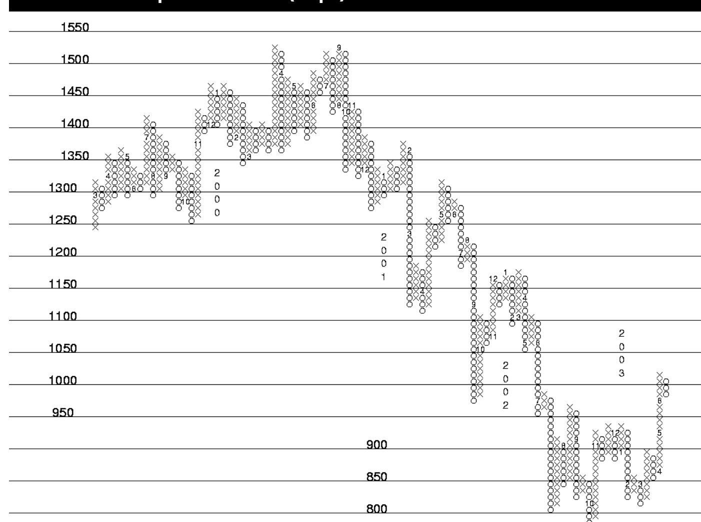
The summer consolidation/reaction for US and European stock markets is now a reality. FM228 mentioned a summer consolidation for Western stock markets and this prospect has been discussed almost daily in the Audio. However some pundits have been predicting that Wall Street would soon retrace most of its rally from the March lows. Reasons cited for such a severe shakeout have ranged from insider selling (a legitimate concern), to esoteric technical theories (best taken with a pinch of salt if unconfirmed by market dynamics) and the Fed's credit bubble (certainly a long-term problem). Insiders are like any other shareholders in at least one respect - having ridden the market all the way down, as many did, they can't resist selling some of their holding during a decent

rally. As to market dynamics, the US and European rallies have clearly lost momentum but I have yet to see anything suggesting that this is more than a temporary pullback and consolidation.

Will Asian markets also react in line with Wall Street's summer consolidation? Only if the US market experiences a significant retracement, and Asia should continue its recent out performance over the foreseeable future. Why? Because the Asian investment story is more compelling. Valuations are competitive, especially relative to Wall Street, and growth prospects are generally better, Japan excepted perhaps. However among big-cap markets, Japan is rapidly emerging as everyone's favourite recovery story. Some suspect this will once again be the triumph of hope over experience, and only time will tell. Nevertheless after a 13.4-year bear market, during which the Nikkei fell 80 percent, and with an "aggressive deflation fighter" (Prime Minister Koizumi's words) running the BoJ since 20th March, Japan will remain my prime recovery candidate, at least until the technical action deteriorates. The stock market is a lead indicator and with Japan's monetary base growing by 20.3 percent YoY as of June's data, the economy could surprise on the upside at long last. Emerging Asia probably has the best prospects, especially countries that benefit from China's growth, such as Thailand. Most investors have been underweight Asia, due to Japan and also SARS. Additionally, many have significantly reduced the equity portion of their portfolios in recent years, in favour of bonds. As some of this money flows back to stocks, will they buy overvalued Wall Street, or Europe under the strong euro cosh, or Asia? No contest - in my view.

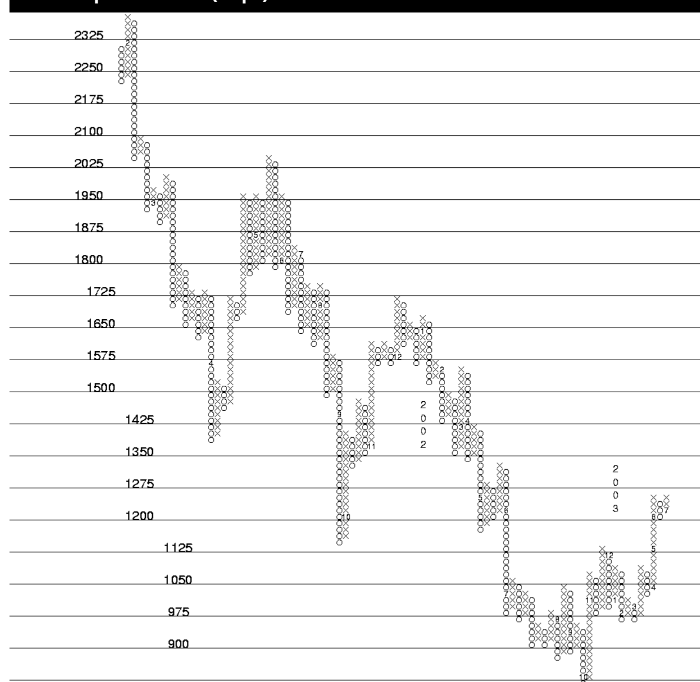
Chart review of topical and representative stock market indices - The 3-box reversal point & figure charts shown are based on closing prices and taken from our website. Anyone interested in this chart service, which includes analysis and is updated daily, should register online at www.chartanalysts.com.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

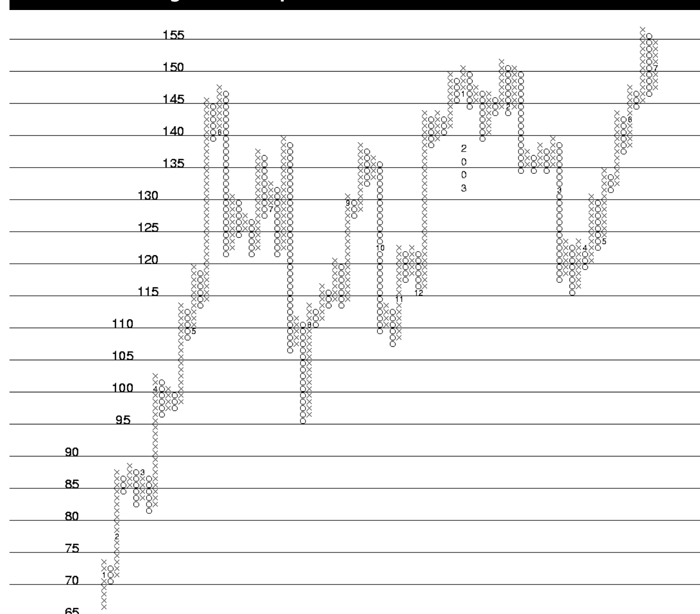


The US's S&P 500 Composite Index (986) has encountered resistance near the psychological 1000 level and commenced a consolidation above its small base. A move below 950 remains necessary to question somewhat higher scope over the medium term. **The NASDAQ 100 Index (1231)** is also consolidating above its small base. A move under 1125 is remains necessary to question a further test of overhead trading in coming weeks. **The Amex Gold Bugs Index (155)** of unhedged gold mines has not maintained its nudge above psychological resistance from the 2002 to early 2003 highs. A move below 145, breaking the progression of rising lows since the rally commenced at 115 in late March, is required to suggest some further pullback and consolidation before underlying support sustains higher levels.

Nasdaq 100 Index (15pt)

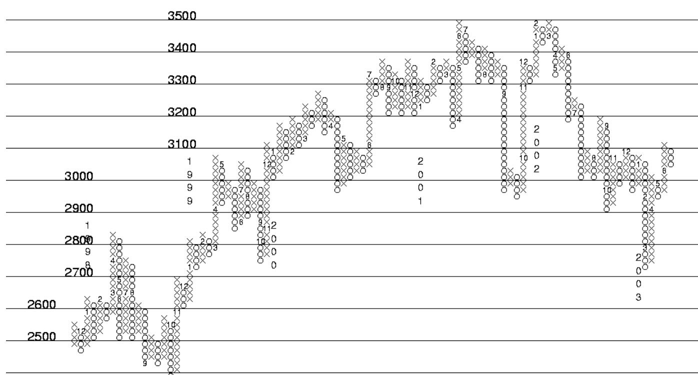


Amex Gold Bugs Index (1pt)

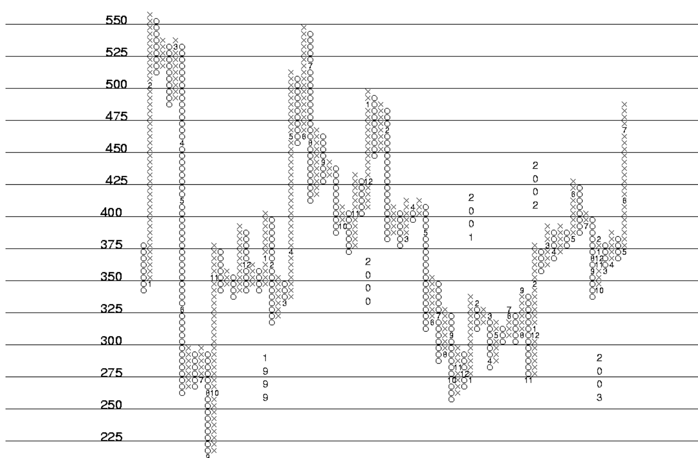


Nikkei 225 Stock Average Index (100pt)

Australia S&P ASX 200 (20pt)



Thailand Bangkok SET Index (5pt)



Japan's Nikkei 225 Stock Average Index (9548) has extended its biggest rally since February-March 2002, having earlier broken the medium-term downtrend. This is a classic example of the type-2 (of 3) reversal patterns as taught at The Chart Seminar. While there may be some psychological resistance near 10000, downward risk appears limited to a small reaction and consolidation before higher levels are seen.

Australia's S&P ASX200 Index (3028) has hesitated near the underside of its large, multiyear top after best gains since 4Q 2001. However a move under 2940 remains necessary to offset some further test of overhead supply in coming weeks.

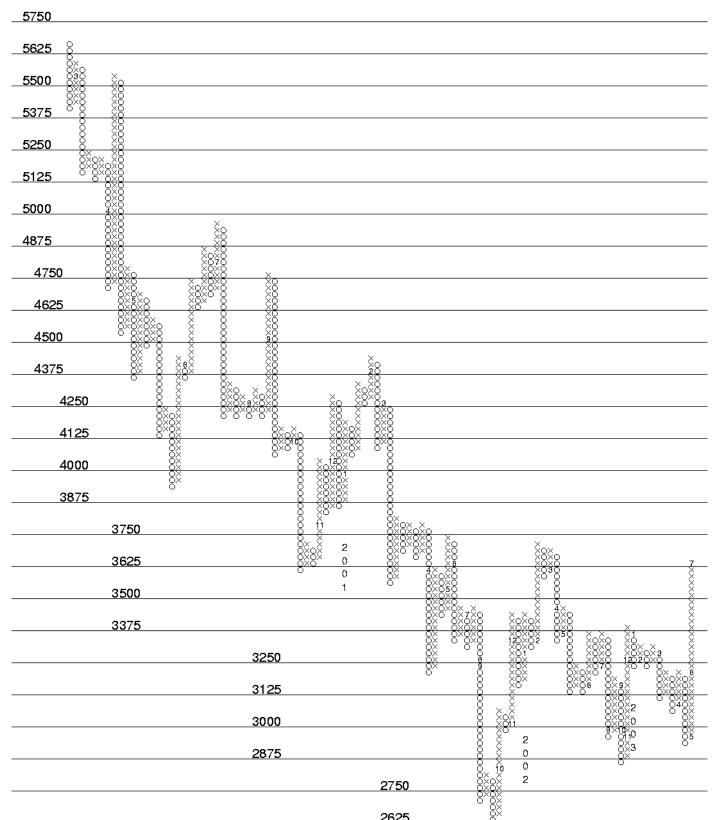
Thailand's Bangkok SET Index (496), a relative strength standout in recent years, has accelerated towards psychological resistance near 500. Consequently some consolidation of gains is likely before long, but the large underlying base should support higher levels thereafter.

India's BSE Sensex Index (3622) has surged above lateral resistance near 3375, providing additional evidence that the large trading range since mid-2001 is a base formation. While some consolidation of recent strong gains before long would not be surprising, a move back under 3375, which appears unlikely, is required to signal a lengthy pause before the overall pattern supports higher levels.

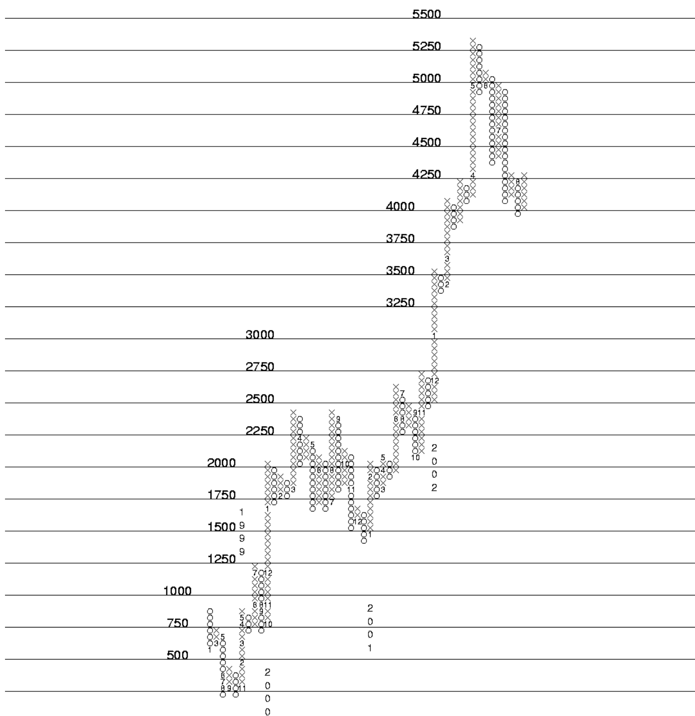
Russia's RSF Index (6215) - *see overleaf* - remains a world-beater, extending its break above the May 2002 peak. Note this year's progression of higher lows, with the last at 5400. A lower low and or significantly larger reaction is required to check uptrend consistency beyond a brief pause.

Germany's DAX Index (3240) - *not illustrated* - is consolidating gains and a move under 3000 is required to check upward momentum for more than a few weeks.

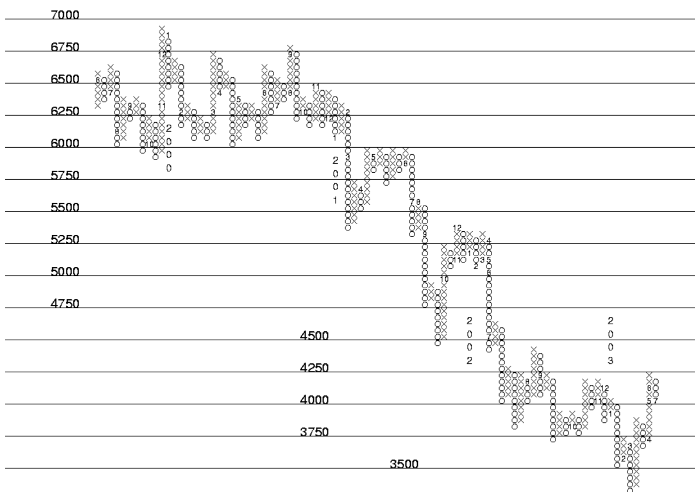
India BSE SENSEX Index (25pt)



Russia RSF Index (50pt)



United Kingdom FTSE 100 Share Index (50pt)



The UK's FTSE 100 Index (4021) has not maintained its nudge above the October-November highs at 4150 following the best rally since late September and early October 2001. Consequently further ranging near current and possibly somewhat lower levels is likely over the near term and a move to 4250 is required to reaffirm medium-term recovery prospects.

Strategy for global stock markets - As veteran subscribers know, I try not to issue recommendations or suggest portfolio weightings. This is not due to reticence in sticking my neck out, but it would feel presumptuous. Portfolios for whom? While all investors wish to protect capital and make it grow, thereafter their objectives, interests and tolerance for pressure and risk vary enormously. I believe I serve subscribers best by saying what I think and why. I also tell subscribers what I'm doing with my own money. In that vein, the biggest change in my stock market portfolio over the last month is that I have substantially increased my weighting in Asia. I was heading in this direction in FM228, discussed it almost daily in the Fullermoney Subscriber's Audio and mentioned being heavily overweight in Asia in FMP209. I'm not interested in a so-called balanced portfolio. If I don't like the market, I'm out. Conversely, if I think something is good, I'll aim to build a significant position, provided that it is performing. Accordingly, I sold my Intel, not because I didn't like it but as the US stock market had seen a major rally, I thought prospects were better in Asia. Also, I stopped putting new money in stock markets in May. Similarly, I sold Tomkins, originally purchased for its 7 percent yield, because I no longer wanted a UK manufacturing company due to sterling's strength. I do not regard any of my remaining UK positions, mostly in high-yielding shares, as more than medium-term trades. My intention is to lighten on strength, which for the overall market should carry into 2004. If the summer consolidation turns into a more significant correction, I might hedge the UK shares with futures, but I have not been tempted to do so to date. I also halved my position in the Merrill Lynch World Mining Trust. I used the money from these sales to increase my position in three London-quoted investment trusts (closed end funds) frequently mentioned in the Audio and variously cited in these pages since FMP202 (7th March 2003) - Aberdeen New Thai, JP Morgan Fleming Indian and Fleming Japanese. I bought these solely because I wanted participation in Thailand, India and Japan, preferably through UK-quoted ITs, trading at significant discounts to NAV. In adding to these positions, I was somewhat concerned about chasing markets that could be susceptible to short-term corrections. However when I look at long-term charts and see India's and particularly Thailand's base, and Japan's Nikkei rebound after an 80 percent decline, I still feel the risk is on the upside. My biggest stock market position by far is in Nikkei futures, where I have averaged up during the rally, protecting at least 80 percent of my position with in-the-money trailing stops. With shares, (including UK tax-efficient spread-bet positions, ITs and futures, I don't know precisely what my equity portfolio weighting is. At a guess, it's 60% Asia, 30% gold shares and funds, 9% UK high-yield shares and 1% US. Specific positions not mentioned are unchanged from FM228. Changes will be mentioned in the Audio, which is part of the Fullermoney subscription service.

Currencies

■ **A temporary change in perceptions towards the US dollar and euro, but this is unlikely to be a major trend reversal.**

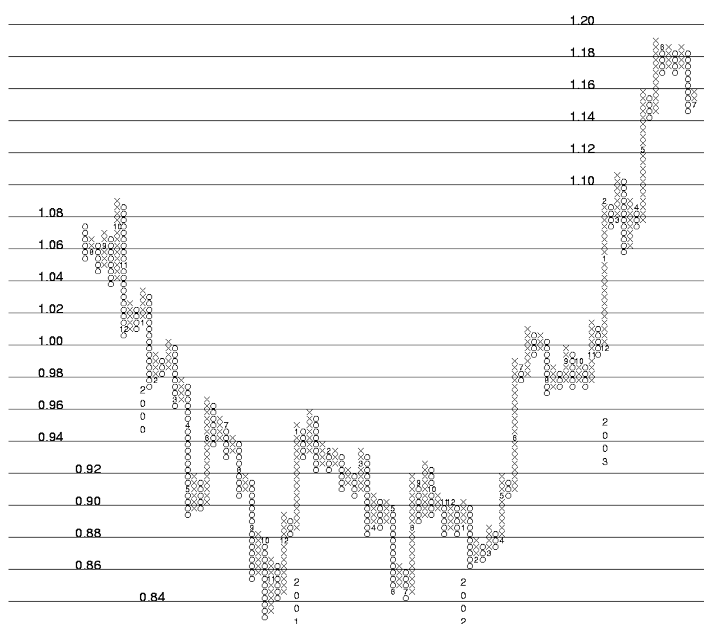
It's always risky to side with the consensus, but this time they are probably right. Yes, as a behaviourist, I'm aware that this is a highly subjective conclusion. Nevertheless, here's my case. The euro's advance became temporarily overbought following the acceleration mentioned in previous issues. The flip side of this coin is that the dollar's downtrend became similarly overextended. People had worried about the Fed's credit creation and the US current account deficit for months. Perceptions have to worsen for a well-known bearish story to extend a

downtrend, otherwise the concern is soon discounted. And so it was for a number of months, with worries fanned by Ben Bernanke and latterly the Dallas Fed, following papers on radical monetary measures for avoiding outright deflation. For most traders, selling dollars in this cycle meant buying euros. Then two events changed perceptions. The US-led stock market rally improved expectations for America's economy. Simultaneously, a number of European industrialists and several politicians warned that growth prospects were diminishing with the euro's rise. This proved sufficient to trigger profit taking in euro longs and dollar shorts, which became self-feeding as stops were hit. America's economy will certainly outperform Euroland over the next 12 months but this must be at least partially discounted by forex markets. Moreover, the euro's reactions means people are no longer calculating the damage caused to European economies by an appreciating currency. The longer-term stories, which can be temporarily overshadowed and we have seen recently, are US credit creation and concern over the current account deficit. Neither story will go away anytime soon, but as market concerns they are likely to resume centre stage before long. As for the yen, Japan's monetary policy now resembles that of US more than any other country.

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. Please note, the charts were completed before the comments and prices shown.

Euro/dollar ($1.1361) - The euro drifted lower after encountering resistance just beneath the psychological $1.20 level, in a correction that has now exceeded the two previous pullbacks within its uptrend, eroding minor support at $1.14 in the process. While there is no confirmation that the reaction is over - this would require an upward dynamic and/or move back over $1.16, it has reversed the previous short-term overbought condition, the decline is beginning to appear overextended and support commencing at $1.10 is extensive.

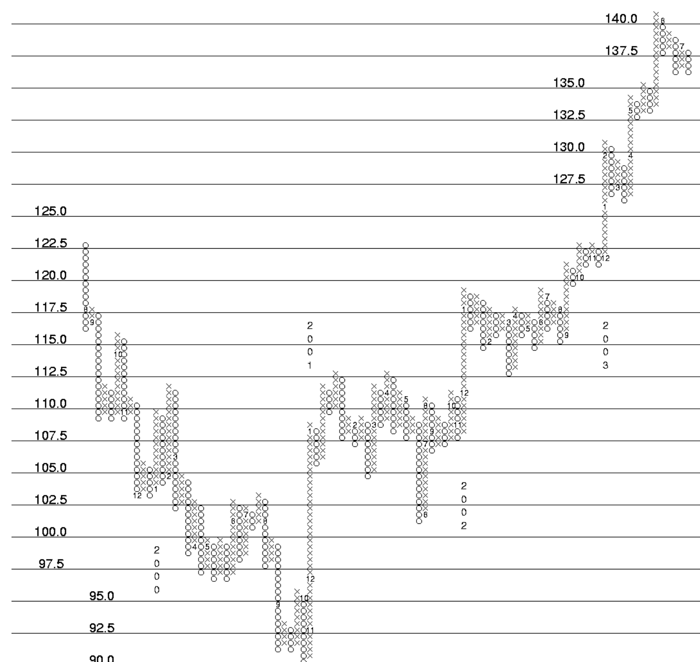
US Dollar per 1 Euro (0.004)



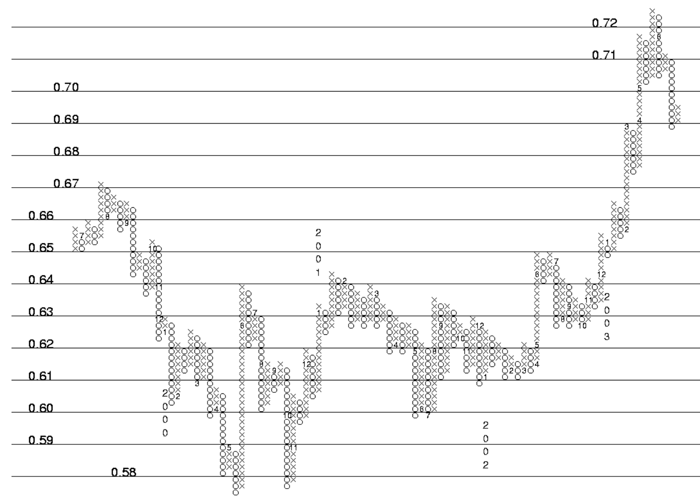
Euro/yen (¥133.99) - The euro has lost uptrend consistency and ranged lower in a probable medium-term consolidation after accelerating to the psychological ¥140 level. While a break in the progression of lower rally highs, with the latest at ¥137.50, is currently required to check the short-term downward bias, an accelerated rate of decline would be a precondition. Meanwhile, the next area of potential support is ¥132.50.

Euro/sterling (£0.6867) - The euro has extended its reaction in the biggest decline since the early-2001 pullback within the base. While there is no confirmation that this decline has ended, it is beginning to look overstretched and there is some support evident in the £0.6880 to £0.6740 region, which should cushion downside scope.

Japanese Yen per 1 Euro (0.5)



Pound Sterling per 1 Euro (0.002)



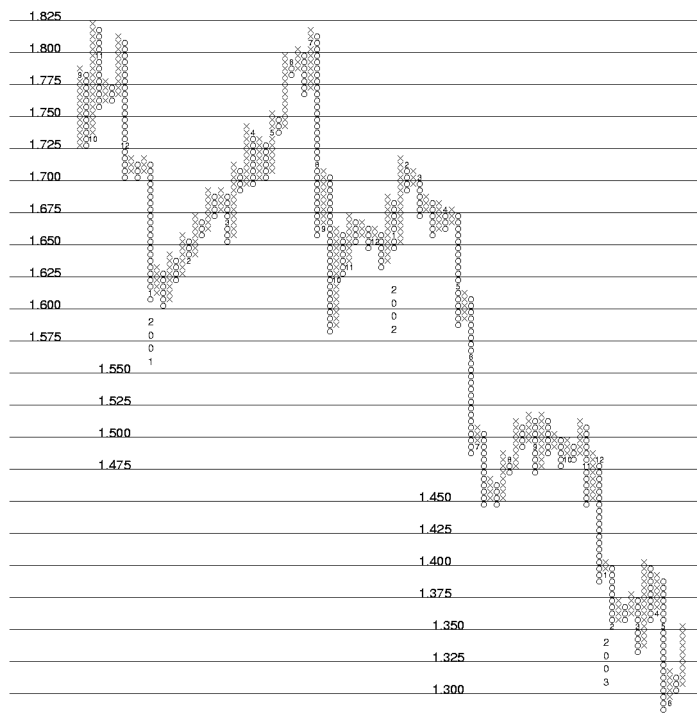
Euro/Swiss franc (SF1.5539) - The euro has resumed its recovery after encountering some resistance near the March 2001 high at SF1.5440. A move below SF1.54 is now required to check uptrend momentum beyond a brief pause.

Sterling/yen (¥195.16) - The pattern remains choppy, albeit with a ranging upward bias, and the pound has backed away from psychological resistance at ¥200. Nevertheless the additional build-up of underlying support suggests that this will be cleared, probably on the next rally, provided support is encountered in the mid to lower ¥190s.

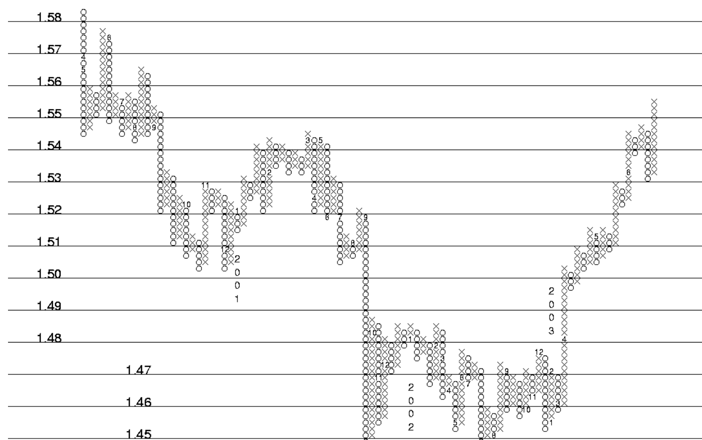
Dollar/Swiss franc (SF1.3671) - The dollar is seeing its best rally since the September 2001 rebound, only from a much lower level. It has also pushed above the mid-point of the January to early-May 2003 range, suggesting that a medium-term low was reached in late May. However this pattern is unlikely to sustain more than a sharp rally without further support building.

Dollar/yen (¥117.99) - While the dollar remains rangebound against the yen, its failed break beneath the September 2002 and March 2003 lows at ¥117 could be important. However a move to ¥122 remains necessary to reaffirm support and further recovery scope.

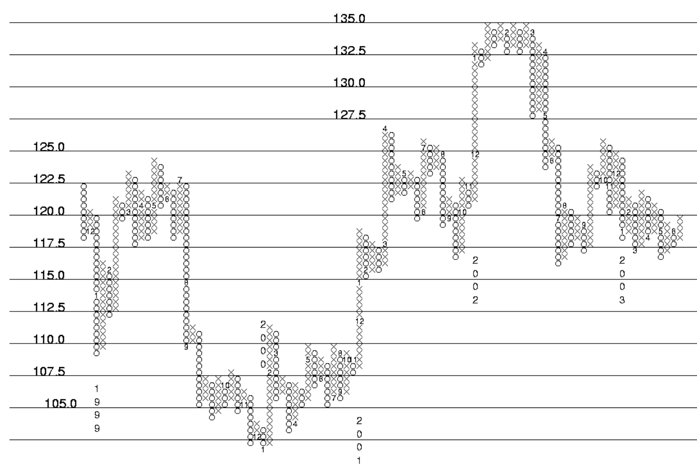
Swiss Franc per 1 US Dollar (0.005)



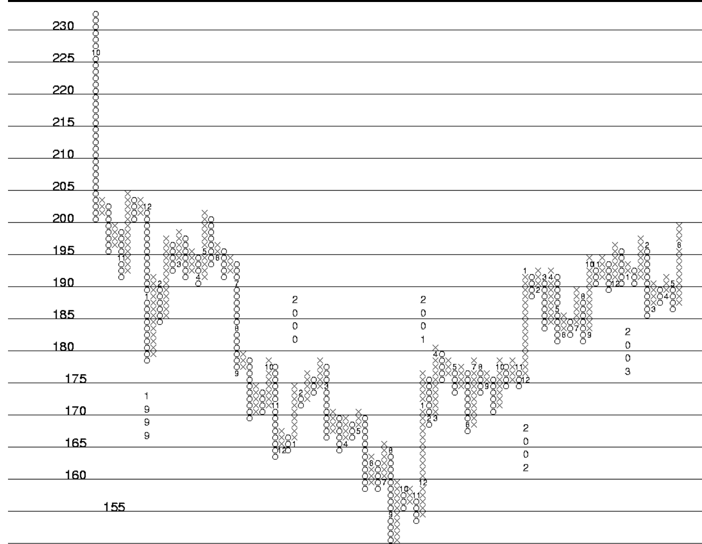
Swiss Franc per 1 Euro (0.002)



Japanese Yen per 1 US Dollar (0.5)



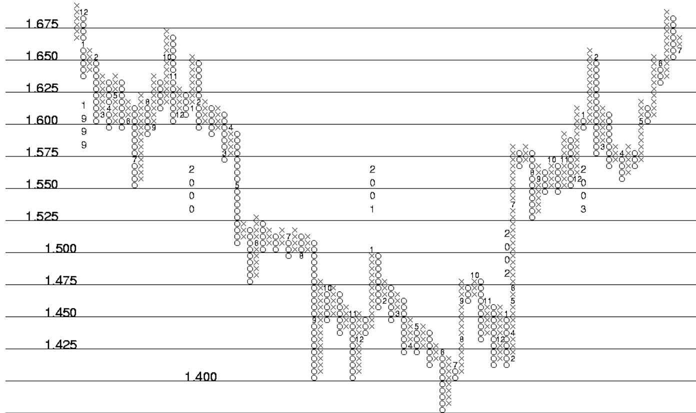
Japanese Yen per 1 Pound Sterling (1)



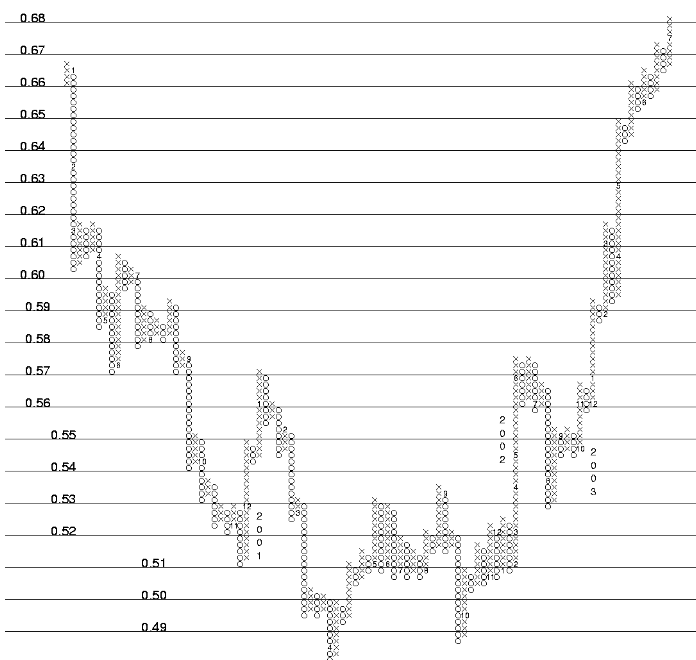
Sterling/dollar ($1.6529) - The pound is encountering resistance in the region of the 1997-1998 highs against the dollar. A move to $1.6450 would break the progression of rising lows and suggest some additional near-term easing.

Australian dollar/US dollar (US$0.6822) - Following a persistent advance and some trend acceleration in May, the Australian dollar has reverted to a slower, ranging advance in a further test of its important highs reached in 1998 and 1999 - not shown, see www.chartanalysts.com. While there is no evidence to date that this move is over, it is becoming very overextended. Watch for a reaction larger than the 4-units of scale (US1¢) and a break in the progression of rising lows to signal a potentially important peak.

US Dollar per 1 Pound Sterling (0.005)



US Dollar per 1 Austrailian Dollar (0.002)



Strategy on currencies - Once again, markets have proved that a clear consensus is a contrary indicator. In late May and early June, with the euro/dollar just under $1.20, the crowd was long euros and calling for levels of $1.25 to $1.40. Today, those forecasts are either seldom heard or the time frame has been pushed way out, because many speculative positions have been stopped out. With major chart support commencing at $1.10, I suspect the euro has entered a buying range on its recent move beneath $1.14. Who will be interested in buying on this pullback? I suspect Asian and perhaps some Middle Eastern central banks will be most interested, and speculators are likely to return following the first clear upward dynamic for the euro against the US dollar. I am looking to buy. Having been stopped out of most of my euro/yen and Swiss franc/yen at reasonably good levels in early June, I commenced repurchasing on a Baby Steps basis too soon. This is annoying, particularly because I identified the main risk in FM228 - Japan's stock market rally, which is changing expectations regarding its future economic performance. Consequently I have eroded profits from earlier trades and missed an opportunity to be more aggressive as the euro and Swiss franc become oversold against the yen. I lightened my sterling/yen position a little on the last rally towards the psychological ¥200 level but didn't raise my trailing stop sufficiently under the circumstances, and gave up too much profit as a consequence. It is with some chagrin that I repeat a basic truth - in markets, it is easy to be lulled into a false sense of security following a good run, when objective behavioural analysis should alert one to the increasing risks. Also, with markets, one never stops learning, and one sometimes has to relearn lessons that should but may not have been reviewed sufficiently. This is one very good reason why I write about investment and trading. Last month I cautioned that risks in the Antipodean currencies against the US dollar had increased following persistent gains. However, both the Australian and New Zealand dollars shrugged off key day reversals against the greenback and extended their rallies to historic resistance. Nevertheless even when a strong trend shrugs off a bearish dynamic, that signal usually warns that supply is beginning to increase relative to demand. The Antipodean currencies now show slowing upside momentum against the US dollar. The next development is likely to be a clear downward dynamic, capping these advances for at least the short term.

Commodities

- **The US dollar price of gold continues to range above its base, in the very early stages of a secular bull market.**

- **Upward scope for crude oil appears limited to ranging beneath its February-March peak in a period of extended top formation.**

- **The CRB Index also shows top formation extension.**

This is the stealth stage of gold's developing bull market. The early stages of secular bull markets are often invisible to the crowd, which has been conditioned by the prior bear trend. With gold, there is also a significant that does not want to hear talk of a bull market, due to the possible implications for other assets. Needless to say, neither factor will change what actually happens to gold over the next 10 to 20 years. In all probability, this course has already been determined by credit creation during the war against deflation - a threat both real and conveniently imagined by politicians, not to mention the bubbles created in all other asset classes. In other words, gold remains a value play. In the short to medium term, gold is overshadowed by the US dollar's rally and the firmness of stock markets. I expect further ranging centred on $355, in what I have previously described as the first step above the base. I remain a buyer of gold and other precious metals, and the shares of companies that mine them, on weakness. I continue to lighten on rallies. At this early stage of its secular uptrend, gold is a buy-and-hold investment only for the very patient.

Delays in resuming Iraqi production and concern over supplies from Nigeria have kept oil prices firm. While coalition forces successfully protected Iraq's oil installations

during the war, they did not prevent the looting of vital equipment. Additionally, there have been incidents of sabotage by the remnants of Baathist forces loyal to Saddam. Since supply concerns over Nigerian production remain, petroleum dealers have stockpiled reserves. This has kept petroleum prices firm but not pushed them sufficiently high for the US and other countries to release supplies from their strategic reserves. Nevertheless, production from Iraq can only increase in coming months, and few doubt that this country will be a major supplier of crude oil in future years. Nigeria will pump, because oil is its primary source of revenue. As for the all-important chart, this shows a Type-2 top in March, characterised by a severe reaction against the prior uptrend. Against this background the current rally looks like a typical and extended phase of top extension beneath the year's earlier high. While some further near-term gains cannot be ruled out, the next big move should be downwards.

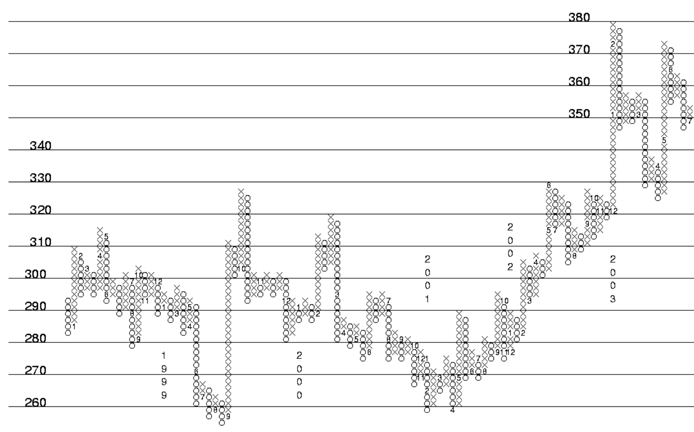
The CRB Index has more downside than upside scope from current levels. Note the very persistent uptrend, with the most consistent feature being the progression of higher reaction lows. Acceleration in January gave prior warning of the severe Type-2 reaction, which broke upward momentum. Here also upside scope is limited to some additional top extension before lower levels are seen.

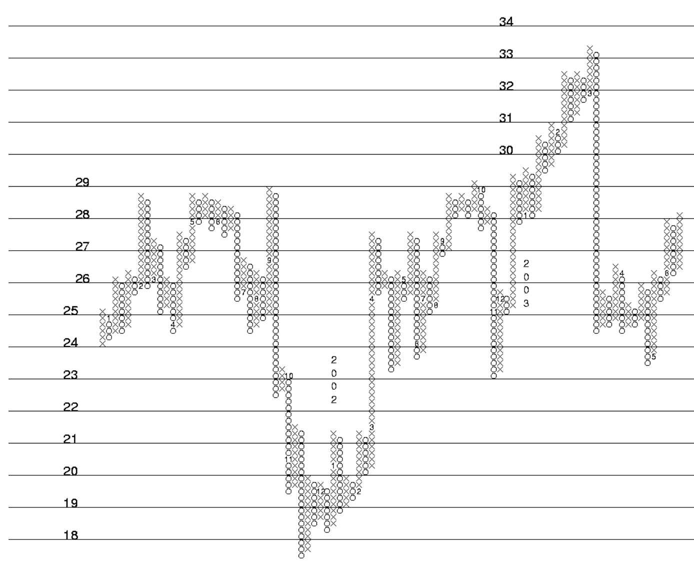
The Global Economy

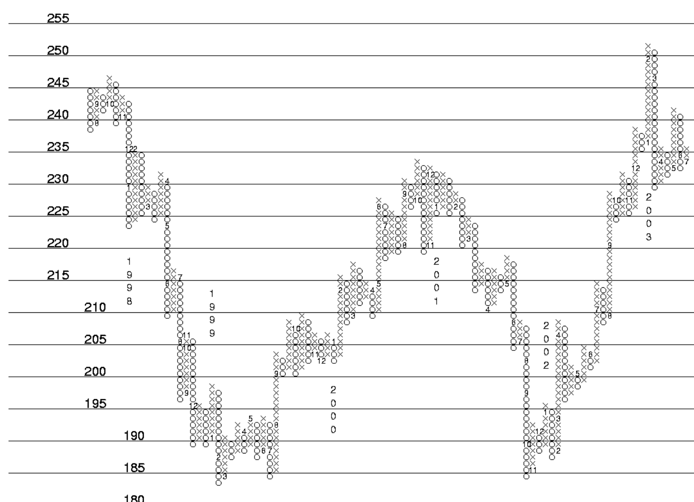
- **US monetary and fiscal stimulus will buy some GDP growth, but it is unlikely to be sustainable.**

- **The best GDP growth, such as it is, will come from Asia, although it will vary considerably from country to country.**

No effort is spared by the US Federal Reserve in its efforts to stimulate the US economy. The Fed's quarter-point cut on 25th June produced the lowest rates since 1958, and its bias is still towards easing. Greenspan has also pumped up money supply in the last three years and recently expressed his concern over the possibility of "an unwelcome substantial fall in inflation". Last year's bombshell by Fed Governor Ben Bernanke, on ways of avoiding deflation, was followed by an even more astonishing paper on monetary policy from Evan Koenig and Jim Dolmas of the Dallas Fed - see Comment of the Day for Tuesday 26th June on www.fullermoney.com. Given Greenspan's cautious, often Delphic comments, these radical, albeit hypothetical, policy discussions are unlikely to be examples of an indiscrete Fed governor and now senior researchers shooting from the hip. Bernanke's comments were intended to weaken the dollar, while Koenig and Dolmas' paper is an attempt to reassure corporate America that there will be no Japanese-style deflation in the US. The Fed has also been a substantial purchaser of US Government debt, signalling to the market that it is determined to keep long-dated interest rates low, while actively pursuing a somewhat higher level of inflation. This most radical monetary experiment by the US Federal Reserve in the modern era can only be described as pro growth. Crucially







for the Fed, this has not only prevented the US housing bubble from bursting, it is still inflating.

US fiscal policy has become even more stimulative. The Bush Administration hasn't curbed fiscal spending to rein in its deficit - it's increased the stimulus with substantial tax cuts. With the White House's re-election campaign underway, we can be certain that there will be no belt tightening prior to the November 2004 vote. While the Federal Government's extra spending is partially eroded by higher taxes in many States, which are not allowed to run deficits, the net effect is still very stimulative. Consequently US monetary and fiscal policy could not realistically be more conducive to economic growth over the medium term.

The US economy was always likely to improve following the war to liberate Iraq. Uncertainty prior to the war had weighed on both corporate and consumer confidence. It was a good excuse to defer plans and purchases, as people sat at home watching television coverage of events in the Middle East. Today, war uncertainty has given way to the Baghdad bounce, led by the stock market. The lowest interest rates in 45 years have kept property prices firm in most regions and encouraged mortgage refinancing. Strong real estate, rallying stocks, lower borrowing costs and extra income following tax cuts have inevitably reintroduced some of the vital 'feel good factor'. While the price of crude oil is somewhat lower than during the pre-war period, it has not yet fallen to levels predicted by some of us, due to delays in restarting Iraq's production. However, the supply of oil from Iraq can only increase - eventually substantially, and the market will anticipate this. Consequently the US economy should rebound during the second half of 2003 and there is little chance that it will slide back into recession next year. This GDP growth should be at the upper end of today's median forecasts, and stronger than any recovery seen in Euroland or Japan.

A US economic recovery over the next 18 months is unlikely to be self-sustaining thereafter. A re-elected Bush Administration is likely to rein in fiscal spending in 2005/6. Should the President not be re-elected, a Democrat administration would do the same, as its candidate will certainly target the deficits. The Federal Reserve may commence raising rates in 2004 and is very likely to slow credit creation as the economy recovers. With US short-term rates bottoming in 2003, the cycle of advantageous remortgaging will end. The cost of borrowing for consumers, corporations and the government is likely to edge higher in 2004. This will squeeze personal consumption because consumer debt remains near record levels. Similarly, debt-burdened corporations will have fewer funds available for capital expenditure. With limited pricing power, many companies will continue to favour cost cutting over expansion. Unemployment is unlikely to decline much and could even edge higher. In conclusion, following its initial rebound, the US economy is likely to muddle through at best. The Catch-22 is that a desirable rate of GDP growth would put sufficient upward pressure on interest rates to burst the property and bond market bubbles, while further deflating the stock market bubble. This is a probable recipe for recession in 2006 and possibly earlier. Consequently the Fed's main achievement this year and next will be to postpone the economy's cyclical corrective process, possibly making the eventual shake out worse.

Asia will benefit from the US's second-half 2003 and 2004 economic rebound. East Asian and South East Asian countries will also rebound from the SARS scare during the latter half of 2003. While SARS could theoretically reappear with colder weather, in one form or another, this is far from certain and medical communities will be on the alert this time. Meanwhile, most of Asia stands to gain from both consumer-led and export growth. Developing countries that gain from China's rapid development but don't compete head to head with the PRC, such as Thailand, should have above average growth for the region. The main question marks remain over Japan but at long last its monetary reflation is moving in a more radical direction.

Europe has the worst prospects among developed regions for the remainder of this year and 2004. Euroland's recovery potential is strictly limited while Germany hovers near recession and outright deflation. Better late than never, the Schroeder Government is now talking about "speeding up" tax cuts for consumers and small to medium-sized companies in 2004, a year earlier than previously planned. However with no control over monetary policy and fiscal expenditure limited by the so-called Stability Pact, Germany remains in a bind, with unemployment climbing. France is only marginally better off and strikes continue to impede any plans to alter the country's absurd early retirement policy. A key variable, also beyond the control of any government, is the euro. Further appreciation against the US dollar, which appears likely, would compound Euroland's economic woes. The UK's potential is limited by an increasing tax burden and onerous regulation. While past performance looks impressive relative to Euroland, it owes too much to a house price bubble and mortgage

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equity withdrawal. This form of consumption-led growth goes into reverse when interest rates next rise, which won't be for a while.

And Finally…

Mind Traps for Investors

The economy and stock market are not as connected as people think. Macro fundamental analysis of stock markets usually focuses on GDP growth forecasts as the critical variable. However a recent paper from Crestmont Research debunks this approach, citing some impressive evidence. I attached a link to the Crestmont's study, which interested parties can find on www.fullermoney.com, Comment of the Day for Wednesday 25th June. Here's a quote from Crestmont:

"Despite the general contention that the economy and the stock market are inexorably connected, the facts get in the way of confirming common wisdom. Economic growth is not the primary driver of stock market returns; stock market returns are driven primarily by a cycle in the P/E ratio. Although economic growth does increase the denominator in the P/E (earnings), actual returns are generally the result of trends in the P/E ratio. This and other research that Crestmont has conducted dispels this conventional notion."

If true, where does this leave fundamental analysis? If we accept the evidence and conclusion - "actual returns are generally the result of trends in the P/E ratio" - in other words, the main driver of share prices, up or down, is P/E ratio expansion or contraction, where does this leave fundamental analysis? Deficient as a standalone investment tool, in my view. Every student of technical analysis (TA) knows that markets move on sentiment. Price charts plot the money flows, and for those who know how to read them, reveal changes in sentiment. For instance, when an uptrend accelerates, it indicates mania, and forewarns of reversal. Conversely, an accelerating downtrend reveals panic, which is climactic. Delegates at The Chart Seminar, my 2-day workshop on Behavioural Technical Analysis, which I have taught since 1969, will recall my contention that the market is a mob. An important characteristic of the investment mob, is that it is manic/depressive. With stocks, accelerating charts equate to expanding or contracting expectations, reflected by expanding and contracting P/E ratios, assuming that there are earnings.

Is technical analysis a standalone tool?
Some investors say that technical analysis is not a standalone tool. I don't disagree, but if I had to choose between the chart and fundamentals, I'd take the chart every time. You've probably heard the adage: "Don't tell me what to buy; tell me when to buy". I maintain that technical analysis is a better tool for timing than fundamental analysis. Do technical analysts make errors in timing? Of course, because financial analysis is a matter of interpretation and also emphasis. Moreover, technical analysis is a broad church - meaning that people use different methods, which is why they sometimes disagree. However, technical analysis has a reality check - it is very hard to rationalise evidence if one is on the wrong side of a price trend for more than the very short term. Fundamental analysis is good for telling us that a stock, bond, currency or commodity is historically oversold or overbought, although this does not necessarily mean that the price is about to reverse anytime soon. An example of fundamental analysis at its best, is that it can identify the superior company. This information is most useful when it is supported by a price chart, indicating that the market is beginning to discount a favourable story. At Stockcube Research, we like chart facts rather than theories. What's a chart fact? It's either trending or it isn't, it's either relatively strong or weak; it either has volume confirmation or it doesn't, and if you know what to look for, it either has trend-ending characteristics or it doesn't. What is theoretical technical analysis? Just about everything else under the banner of TA. Should we ignore theoretical TA? Not necessarily, but I would always give the heavier weighting to chart facts.

"Simplicity is the mean between ostentation and rusticity."

Alexander Pope

Best regards - David Fuller

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