Issue 230
30 July 2003
In its 20th year

Fullermoney

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

Asian stock markets, particularly emerging Asia, continue to offer the best opportunities. However a further upward spike in long-dated government bond yields would jeopardise both the global stock market rebound and current prospects for some economic recovery.

Selling has remained light to date during the Wall Street-led summer consolidation for stock markets. Consequently improving sentiment since the March low has not been damaged and there are still more people wanting to buy than sell. However a new threat has emerged.

Improving sentiment is not yet a bearish indicator. Those who monitor market sentiment have been in a lather recently, citing a host of indicators including Wall Street insiders selling 4 shares for every 1 they buy, a VIX (CBOE OEX Volatility) Index reading near 20, a majority of bullish advisories and increasingly upbeat stories in the financial press. I do not dismiss or seek to rationalise any of these indicators, but they need to be viewed in context. Stock markets were under severe pressure for most of the 3-year period ending in March 2003. Based on historic precedent and not least the time-honoured adage, 'sell the rumour and buy the news', the onset of a widely anticipated war to remove Saddam was always likely to trigger a significant rally, albeit within a secular bear market, in my view. Moreover, central banks from the US to Japan had targeted their economies and stock markets with a massive monetary reflation, which continues. Against this background, I do not believe that a 5-month rally has unwound the oversold condition created by a 3-year decline. Similarly, I do not believe that all the excesses of Wall Street's secular bull market and bubble of the late 1990s have been unwound by a 3-year bear market, but this is less of an immediate concern.

Most of the price action remains positive. Stock market indices have seen very little erosion of support during the Wall Street-led summer consolidation, forecast by this publication. Instead, the lows are rising and it is overhead resistance that is tested and eroded. Market dynamics (big up-days versus big down-days), which I regard as a key indicator of buying versus selling pressure, and which are capable of changing sentiment, are still dominated by the upside. Few shares show significant breaks of uptrends and/or clear evidence of top formation development. Instead, uptrends are reinforced and lagging shares show evidence of base formation development more often than not.

Is this the 'wall of worry'? Interestingly, there have been a surfeit of warnings from individual analysts and strategists recently, featured by financial television channels perhaps still smarting from the post-1999 criticism that their guests were overwhelmingly bullish. These range from theoretical (rather than factual) technical analysis forecasts of a plunge, to reservations concerning valuations and the outlook for profits, to predictions of deflation and economic depression. Inevitably, there will be another sell-off at some point, and valuation or economic concerns that will weigh on stocks. Therefore I'm becoming less, rather than more, bullish as stock markets rise, but I'm still bullish. But for one proviso, I continue to envisage no worse than an extension of the summer consolidation, which may not be quite over.

What do I worry about? Long-dated government bond yields, which have risen significantly in the last several weeks. I am assuming that 10-year government yields have bottomed, although the evidence cannot possibly be conclusive since the lows to date were only reached in mid-June. If 10-year government bond yields have reached THE bottom rather than just another medium-term low, then the bond bubble is beginning to deflate. If yields spike upwards once again, clearly in excess of the sharp rise already seen, I believe stock market investors would also take fright. Central banks will obviously want to prevent this from happening, or at least postpone it. That will necessitate increased buying for their own account. Should government bond yields peak shortly and retrace some of their recent gains, even if only in an extended phase of top formation development, I believe this would boost the stock market rally as some investors switched to equities. I suggest that equity investors keep a close eye on long-dated government bond yields.

Interest Rates and Bonds

■ **Further rate cuts by the ECB and BoE remain possible, but the Fed is likely to leave rates on hold**

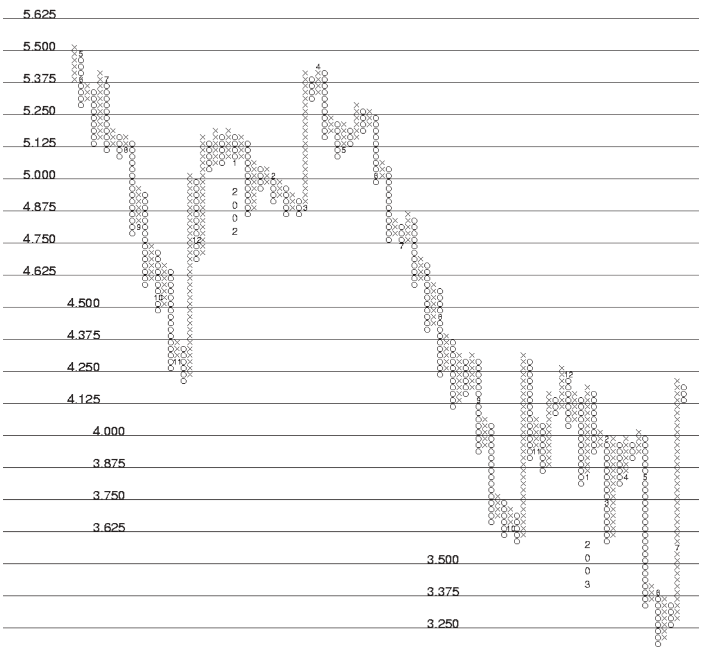
■ **More evidence that the bull market in long-dated government bonds is over.**

The BoE's Monetary Policy lowered rates by 25 basis points to 3.50 percent on 10th July, and will make further cuts. The main reason is minimal GDP growth following several tax hikes too many. UK growth prospects have been overrated against this background and unemployment would be much higher were it not for the bonanza in inefficient public sector jobs. Also, UK rates are high relative to its main trade partners. The ECB left rates unchanged on 10th July. There is certainly an economic case for another cut but the ECB is criticising Euroland's larger countries for exceeding the Stability Pact ceiling on government debt. Consequently there is a risk that the central bank will be less accommodative than circumstances require. We probably saw the Fed's final rate cut for this cycle following the 25 basis point reduction to 1.00% on 25th June. While the bias was left in favour of easing, the Fed is upbeat on the US economy for 2004, and may be right this time.

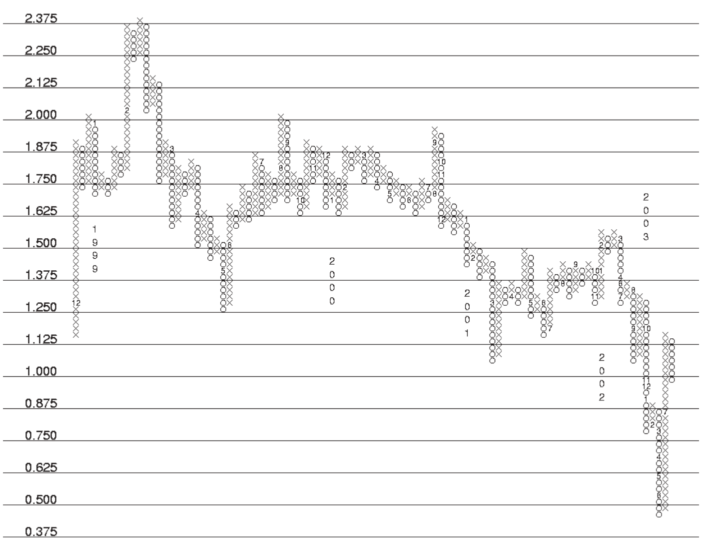
Calling the end of a 23-year bull market only a few weeks after the possible peak in prices (low for yields) is hazardous. But that is what some of you pay to have me do, presumably, in subscribing to Fullermoney. For many

Euro Bund 10 Year Bond Yield (0.03)

US 10 Year Bond Yield (0.025)



Japanese 10 Year Bond Yield (0.025)



readers, an advisory is no better or worse than the calls it makes. Success in this business is often a matter of guessing what the crowd is going to next, before the crowd has made up its collective mind. Refreshingly, anyone can do it, with a little experience and observation, but no one can do it consistently. This does not mean that we should never reach for the big calls. To do so need not be an attempt at heroics - I'm too old for that. It is better to be motivated by the realisation that once a bull or bear trend is recognised by the mainstream of analysts and investors, a considerable portion of the move will have already occurred. In my observation, the ability to call the end of a bull or bear trend near the peak or trough is seldom a matter of theory or luck. Instead, it is based on observation of human behaviour, and above all, rooted in price action. The ability to view this with perspective requires a considerable knowledge of market history. An American social philosopher said it best:

"The true prophet is not he who predicts the future, but he who reads history and reveals the present".
Eric Hoffer

What evidence suggests that the bull market in long-dated government bonds is over? For US 10-year Treasuries, a 23-year bull market during which yields fell from 15.32% in 1981 to 3.07% in June 2003 is certainly long in tooth. This was the lowest rate since 1958 - a time when US Government debt was not rising nearly so quickly and foreign central banks could still convert US dollars into gold at $35 an ounce. That US 10-year yields fell so low recently could only occur for the following reasons - investors had fled the stock market over the previous 3 years; they were discounting slow growth at best and the possibility of Japanese-style deflation, and some believed that the Fed would buy whatever quantity of bonds was required to prevent yields from rising. The reality check was provided by a rising stock market and a growing perception that the Fed would succeed in its all-out effort to inflate the US economy. US yields bottomed on 16th June, 3 days after a Japanese monetary official said the 10-year JGB yield of 0.43% was "ridiculous" - presumably no hyperbole there. European 10-year yields also bottomed on the 16th, and subsequently soared, so we have global commonality, which is often seen at important turning points.

If a 23-year bull market during which 10-year US Treasury yields moved from 15.32% to 3.07% isn't a bubble, what is it? I keep asking this question because bond experts from leading institutions have said we do not have a bond market bubble - see the Goldman Sachs detailed report posted on Comment of the Day for 15th July on www.fullermoney.com. In an article titled, "Promiscuity in the Pursuit of Virtue", which I posted on 16th July, high-profile bond fund manager Paul McCulley of PIMCO opined that the US Government bond market was a bubble, assuming that the Fed's reflation gained traction, but said it was a "rational" bubble. That sounds like an oxymoron to me. After 2000, market bubbles are no longer an esoteric or historical subject for the investment community. All this talk of a bond market bubble has spooked investors, some of which are succumbing to the lure of rising stock markets.

History's lesson is that multi-year trends in markets always overshoot, not least because the fundamental story producing the move is eventually exaggerated. Rational buying in the early stages of a long-term bull market eventually leads to momentum buying, which the crowd justifies by embellishing the story in its self-interest. Greenspan and the Fed certainly colluded with the market's natural inclination towards euphoria in a long-term bull trend, by talking about radical measures to keep rates low. More recently, in giving his upbeat assessment of the US economy, Greenspan has hinted that further measures by the Fed may not be necessary to defeat deflation. The global fixed interest markets have taken fright. I agree with strategists who say that US government bond bulls have not engaged in the extreme rationalizations that we heard during the tech euphoria, but is that the benchmark for a bubble? Or is it perhaps the most extreme example in living memory? Many investors accepted the deflationary liquidity trap argument, were fleeing the stock market and have been emboldened by the Fed's comments about lowering long-term yields. Perhaps they are right, but I don't think so, not when the Fed is releasing highly emotive papers on all the tools at its disposal for ensuring that Japanese-style deflation does not occur in the US, and backing its talk with inflation-seeding policies. Plunging yields for US and European long-dated bonds in May looks climactic and the subsequent sharp rebound reaffirms FM229's contention that lows have been established for at least the medium term.

Could yields experience no more than a sharp technical rally, then pause and eventually range lower as many investors in US long-dated Treasury Bonds hope? Even if the decline in yields is near its end or has even ended, could they range sideways in a lengthy phase of base formation development? Could Fed intervention prevent them from rising? Theoretically, anything is possible. However, government bond markets appear to have discounted more deflationary risks than are likely to be realized anytime soon. The Fed's success in pumping up asset bubbles is inflationary and even a modest economic recovery will put some upward pressure on short-term rates. Meanwhile, the supply of government bonds continues to increase. Consequently the risks in long-dated government bonds considerably outweigh the potential rewards.

Looking at the charts, European yields have had the smallest rise and the move does not yet look exceptional. Therefore if any developed country 10-year bond yields reach new lows over the next year or two, it is most likely to be in Europe. JGB yields have encountered resistance from overhead trading and require 1.175% to signal a further rise. US 10-year yields are testing the psychological 4% level. Any further near-term gains would provide additional evidence that the final low has been seen, and that downside scope is now limited to a partial retracement and base formation extension.

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 technical evidence that yields have bottomed for at least the medium term, I would not assume that governments will pump 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 debt, which I will not increase. Corporate debt may take its cue from stock markets, which remain in form, but the spike in government yields has changed the psychology for debt instruments. Consequently recent rates of return are unlikely to be repeated. Also, a further rise in developed country government yields would increase the risks for both corporate issues and high-yield emerging country government debt. If bond futures stage a technical rally, I will look for short selling opportunities.

Global Stock Markets

■ **Further gains remain likely for global stock markets, following Wall Street's summer consolidation, provided long-dated government bond yields do not rise too much.**

■ **This is not a new Wall Street-led bull market, and growing bullish sentiment should be regarded as a contrary indicator.**

■ **Emerging markets, particularly in Asia, should have the best prospects while stocks on Wall Street remain generally firm.**

■ **Japan remains the best recovery candidate among developed country markets.**

No other changes in the medium-term bullish outlook for global stock markets. This year's Fullermoney script for global stock markets called for a medium-term rally commencing with the war to remove Saddam Hussein, fuelled by an improvement in sentiment and a US-led effort to reflate the global economy. FM227 contained a table - Pre-Presidential Year Record Since 1915, showing that this was a cyclically bullish period for stocks, with the DJIA registering an average gain of 16.2%, while the S&P and NASDAQ averaged 12.8% and 34.6%, respectively, for the 3rd year of a presidential term, since their inception. FM228 contained another table - Percent Changes In The DJIA Between The Mid-term Year Low And The High In The Following Year, over 22 election cycles commencing in 1914. The DJIA recorded an average gain of 50.3% from the mid-term low to the high the following (pre-election) year. Wall Street is performing in line with the historic average shown by these two tables, evidenced by the DJIA's best gain this year to date of 12.12% (8341.63 on 31/12/02 and 9352.77 on 17/06/03) for the year, with 5 months to go. Using the mid-term year low to the following year's high comparison, the DJIA has gained 29.9% (7197.49 on 10/10/02 and 9352.77 on 17/06/03) to date, also with 5 months to go. I maintain the DJIA will recover further, because of the exceptional monetary reflation that is occurring. Citing Japan's four major rallies of the 1990s, during which the Nikkei registered an average gain of approximately 50% despite being in a secular bear market, FM228 mentioned that a 50% gain by the S&P from its October 2002 low was likely, probably at some point in 2004. This would take the S&P to just over 1150. The one known factor that could jeopardise this forecast for additional gains is the rise in long-dated government bond yields, should it continue. That would undermine confidence by creating concerns for growth due to the impact of long-term rates on house prices, consumer spending and corporate borrowing.

The summer consolidation has produced no more than a pause to date, within relatively narrow trading ranges. FM228 forecast a Wall Street-led summer consolidation, and FM229 commented that it was underway. I see little reason to expect more than a mild correction, provided 10-year government bond yields do not soar once again. However I am reluctant to assume that the consolidation is over until a majority of stock market indices, not least those of the US, maintain upward breaks from their current trading ranges, evident since mid-June for North American and European indices. More recently, Asian indices have seen their strong upward momentum wane, indicating that they too are digesting gains. Significantly, up days remain generally larger than down days, including during the current pause for many indices. Consequently, technical action to date is more often reinforcing rather than eroding bullish sentiment. We know that many central banks have targeted their stock markets, not least the Fed and more recently the BoJ. They have succeeded. Some of the excess liquidity created has found its way to the stock market. Low interest rates and rising stock indices have lured capital out of money-market accounts and siphoned it away from bonds. My impression is that there are still more investors looking to buy on a pullback than there are people waiting to sell on the next rally. However, the risks can only increase in line with rising share prices and progressively more bullish sentiment. While this is true in any market, the dangers are greater in this secular bear environment.

History suggests this remains a secular bear market. I've said this so many times over the last three years, that I need not review all the arguments. New subscribers who wish to delve into this can find ample information in the Fullermoney archives and on my website. I'll just summarise by saying there is too much debt - at government, corporate and consumer levels - for strong and sustainable economic growth to occur. If credit creation ensured prosperity, Zimbabwe would be booming today. Credit creation has postponed the significant recession that follows all bubbles. Without the recession the US economy and many others have no debt-liquidation trough from which to rebound. Meanwhile credit creation has kept valuations higher than they would otherwise be, especially in the US. Inevitably, many pundits now say a bull market is underway, and their ranks will grow with further gains. A more accurate description would be to label it a technical bull within a secular bear.

History shows that few, if any, stock markets will

uncouple from Wall Street's medium-term trends. However a number of favoured emerging markets will do considerably better than Wall Street during the rally phase, primarily due to their better growth prospects. Japan is another strong possibility, by virtue (if that is the right word) of its prior 13.4-year secular bear trend, which is almost certainly over.

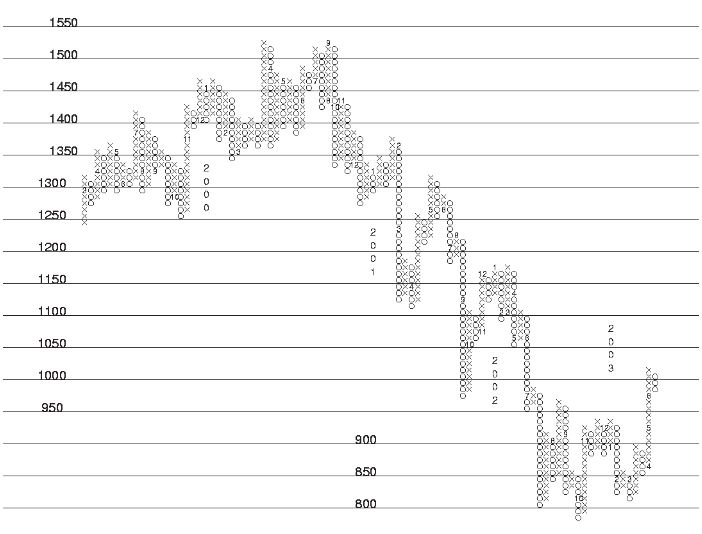
Emerging markets offer the best trading opportunities but they will also be the most volatile. In secular bear markets - US 1929 to mid-1940s, 1966 to 1981, 2000 to 2018(?), and Japan from 1990 to 2003 - it is the big sell offs that grab headlines and are subsequently most remembered. However historic charts show much more ranging activity than anything else, with markets rising and falling over the medium term, within broad trading bands. I suspect 1966 to 1981 could be a useful indication of potential for the in-fashion emerging markets over the next decade and more, due to Wall Street's dominant influence, although history never repeats itself precisely. Back then, all Asian markets were emerging, although Japan metamorphosed into a developed economy during that period, and they were all very fashionable due to the region's strong GDP growth. During Wall Street's rallies in the 1966 to 1981 period, it was not uncommon for Asian markets (ex-Japan) to gain 100 percent or more, reaching new all-time highs, only to fall back 70 percent or more during the US market's bearish phases. In the last decade, Singapore, Taiwan, Hong Kong, South Korea, and probably Malaysia have been re-classified as developed economies. As such, they do not have the same explosive growth potential as in the 1966 to 1981 period. However their economies should outperform other regions of the globe, and their stock markets are currently trading at more attractive valuations than in the West, although they are certainly not without risk. Developed Asia has suffered due to manufacturing competition from China and its economies are overly dependant on exports, especially to the US. While the SARS scare was hopefully a one-off, North Korea remains a dangerous wild card. Although North Korea is a global problem, it is understandably responsible for the lower stock market valuations in South Korea. Asia's emerging markets - Indonesia, Thailand, The Philippines, India, Pakistan and Sri Lanka - face less direct competition from China. Also, the first three countries mentioned benefit from commodity exports to the PRC, while Thailand and to a lesser extent The Philippines are favourite tourist destinations for China's growing middle class. Chart patterns for Asia's emerging market indices show better relative performance recently and/or larger base formations than for most other stock markets, indicating that they should continue outperform during the bullish phases for global stock markets. The tradeoff is that the downside during bearish periods will often be proportionate, and emerging markets also have a greater political risk.

If Japan's bear market is over, is it a buy-and-hold situation? Probably not, although if I were going to buy and hold any stock market, it would certainly be Japan, due to its 13.4-year bear trend, generally better valuations and a central bank that is finally tackling deflation. For these reasons and also because fewer people own it, I favour being overweight in Japan now that it is performing. However buy-and-hold became a grossly overrated strategy during the latter years of Wall Street's secular bull market ending in 2000. Even if Japan's secular bear market is over, as I believe, we can expect a significant pullback and base extension phase, commencing within the next 12 months, which may or may not coincide with a peak in Wall Street's medium-term recovery. Even though Japan has long had the lowest correlation with Wall Street among stock markets, it will inevitably be influenced by the next down leg for US indices, perhaps in 2005-2006, when I would not be surprised to see the DJIA, S&P 500 and NASDAQ at least test their 2002 lows. In that event, out performance by Japan might be no more than a pullback that encounters support above the Nikkei's lows. However this is conjecture. The important point today is that Japan is still conforming to the Type-2 downtrend ending (of 3 as taught at The Chart Seminar) in which it rises much further and faster than people expect. This bear market-ending up-leg has two stages - initially very persistent, which is then followed by a somewhat slower, ranging rally. I believe the second phase has commenced following the virtually uninterrupted surge to 10,000 for the Nikkei 225 Index. If Japan conforms to this typical pattern following a long and grinding bear market, it should recover at least 50 percent from its low - a minimum of 11,400 for the Nikkei, before the first significant pullback and lengthy base extension phase occurs.

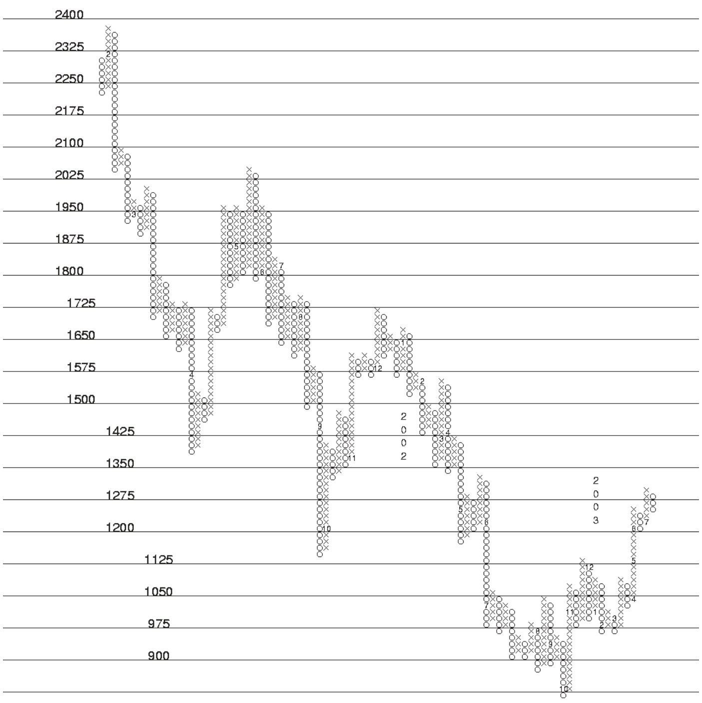
Chart review of topical and representative stock market indices - *The 3-box reversal point & figure charts shown are based on closing prices and taken from our website. Anyone interested in this chart service, which includes analysis and is updated daily, should register online at www.chartanalysts.com.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

The US's S&P 500 Composite Index (998) encountered resistance near the psychological 1000 level and a consolidation is underway, above the small base. A move

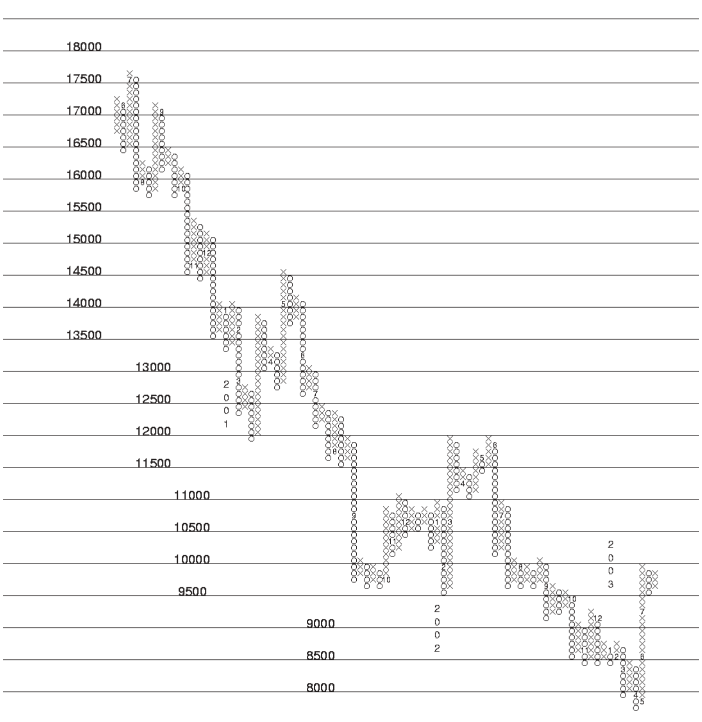
S&P 500 Composite Index (10pt)



Nasdaq 100 Index (15pt)

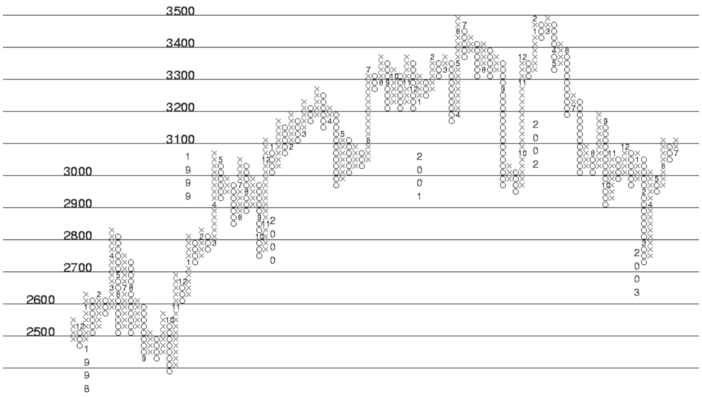


Nikkei 225 Stock Average Index (100pt)



Amex Gold Bugs Index (1pt)

Australia S&P ASX 200 (20pt)



below 950 remains necessary to question somewhat higher scope over the medium term. **The NASDAQ 100 Index (1281)** is also consolidating above its small base. A move under 1200 would confirm a deeper correction before a further test of overhead trading occurs. **The Amex Gold Bugs Index (166)** of unhedged gold mines has now broken clear of psychological resistance from the 2002 to early 2003 highs. A move below 150, which appears unlikely, is required to suggest an upside failure.

Japan's Nikkei 225 Stock Average Index (9840) has encountered resistance near the psychological 10000 level but given the strong upward move, breaking an 11-month downtrend, downward risk appears limited to a small reaction and consolidation before higher levels are seen.

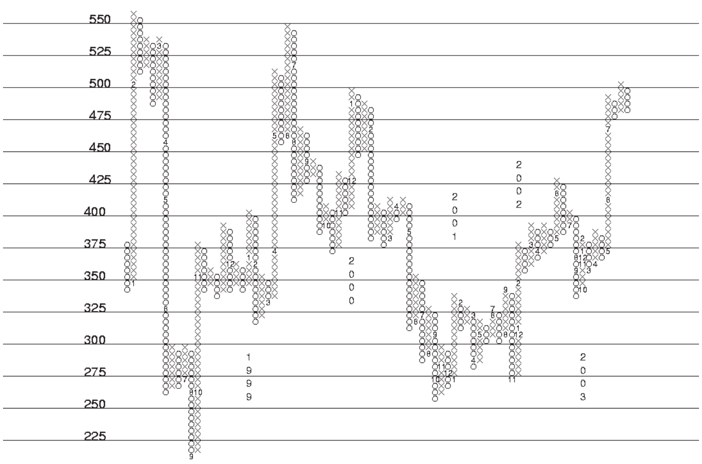
Australia's S&P ASX200 Index (3119) remains quietly firm in the lower region of its large, multiyear top after the best gains since 4Q 2001. A move under 2940 remains necessary to offset some further test of overhead supply in coming weeks.

Thailand's Bangkok SET Index (480), a relative strength standout in recent years, has paused after accelerating to psychological resistance near 500. A break beneath 475 is now required to indicate a deeper correction before the large underlying base supports an additional test of the 1998 to 2000 peaks up to 555.

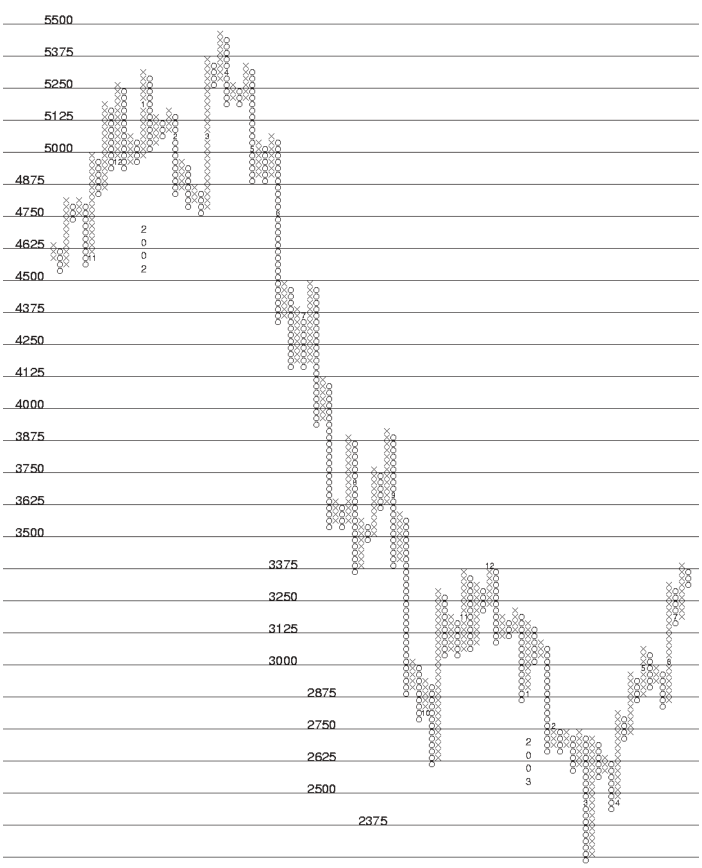
Germany's DAX Index (3417) remains steady in its consolidation of gains near the December 2002 high of 3375, and a move to 3125 is required to indicate significant resistance in this area.

The UK's FTSE 100 Index (4148) has encountered support

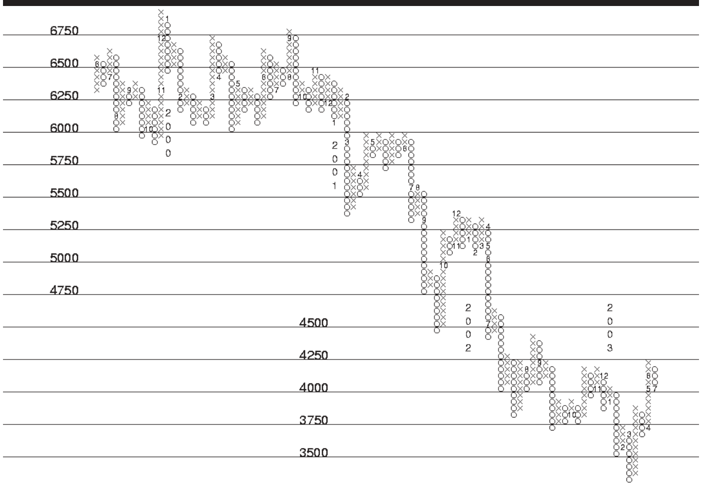
Thailand Bangkok SET Index (5pt)



German DAX Index (25pt)



United Kingdom FTSE 100 Share Index (50pt)



near 4000 during the present consolidation and a move to 4250 would reaffirm medium-term recovery prospects.

Strategy for stock markets - I still feel comfortable with what is close to my biggest position in equities for at least 5 years, because stock markets continue to perform as hoped. However I am not becoming more bullish as share prices rise. I'm becoming less bullish, because markets are no longer deeply oversold and have fulfilled more of their upside potential in what I regard as no more than a medium-term bull run. Accordingly, I have lightened my position in gold shares - my second largest weighting, by selling a leveraged stake in Newmont Mining (NEM). This does not mean that I do not like Newmont, which I own through other gold vehicles. Along with a lot of other people, I think it is the pick of the quality mines and the chart is developing nicely. I sold NEM because it had done well and I am gradually taking money out of the market. I sold it too soon, and I aim to do just that, rather than too late. If NEM were to fall back, and it may not for a while, I would probably buy it again. Meanwhile, gold shares and funds are approximately 25 percent of my equity portfolio, which is never balanced. Asian stocks, funds and investment trusts account for at least 65 percent of my portfolio, and my Stockcube contributory pension scheme has been invested in the manager's Pacific fund since early June, having been switched from European equities which I held previously for the currency. My biggest equity exposure by far is a long position in Nikkei futures, unchanged from last month. I have so far resisted the temptation to increase this during the recent pullback. Instead, I may wait for a signal from bank shares and/or the Second Section Index, or failing that hold out for a sustained break above 10,000 by the Nikkei, in which case I will raise my in-the-money stop and look for another opportunity to increase the position. The stop gives me close to a free ride, in that I am unlikely to lose more than some of my profit. Targets are 100 percent guess work, so of no analytical value, unlike overall trend consistency. However we all have expectations. In the Subscriber's Audio, I frequently mentioned at least 10,000 for the Nikkei 225 before a significant correction. After moving a little above this level, there was a pullback of nearly 6.6 percent in mid-July (based on daily high/low/close data, not shown), twice the size of the May and June consolidations, which were too small to register on the p&f chart shown earlier. If that's all the correction we see near current levels, then the Nikkei remains on course for my minimum 50 percent guesstimate of 11,400. I own only one Japanese share - UFJ Holdings Inc, purchased in mid-May and mentioned on the Audio, and resisted the temptation to sell when it more than doubled on the acceleration to ¥250,000. My reason? To my knowledge, there has never been a significant stock market rally off the low of a prior downtrend, without good relative performance by bank shares, which are a barometer of confidence. Looking at a long-term chart of UFJ - not shown - I think UFJ could rally to ¥400,000, a level last seen in February 2000. My additional Asian stock market investments are a Japan fund in another self-administered pension scheme, and the following investment trusts (UK-quoted closed-end funds) - Aberdeen New Thai and JP Morgan Fleming Indian (first mentioned in FMP202 on 7th March 2003), Fleming Japanese and Atlantis Japan Growth Fund. I estimate the Asian weighting at about 65 percent of my equity portfolio. The remainder would be approximately 9 percent mostly UK high-yield shares such as Lloyds TSB and 1 percent US biotech.

Currencies

■ **Every country wants a weak currency, only some are willing to do more to achieve it than others.**

■ **Rallies by the US dollar and yen against the euro are over but a period of range trading will follow.**

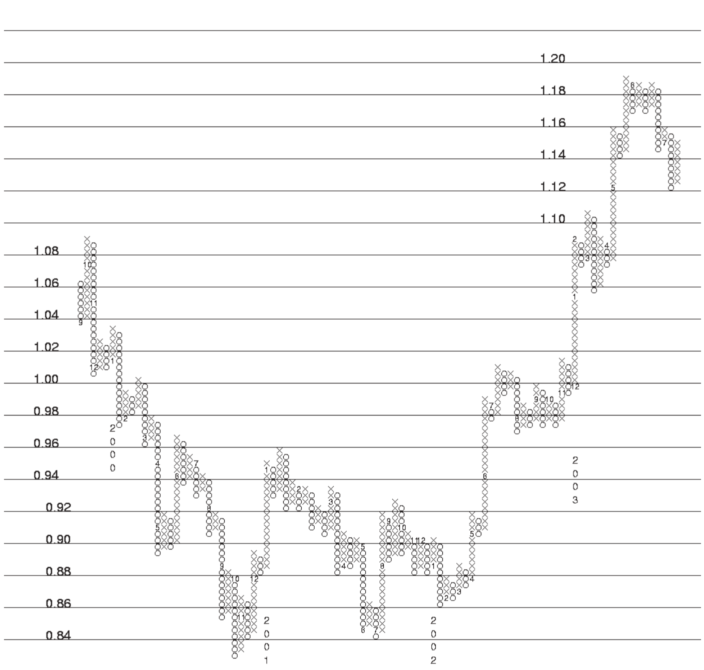
When Alan Greenspan looks in the mirror, does he say, "I print for America"? Yes, judging from the mother of all credit creations. Moreover, the distinguished Fed Chairman is not acting unilaterally. Ben Bernanke (the next Chairman?) has led the charge in terms of outlining the case for radical reflation over the last 10 months. I don't share the high state of dudgeon shown by many fellow scribes over the Fed's action, because after the 1990s binge, to introduce Austrian School economics in 2000, 2003 or any time over the next decade would push the US economy into depression, taking most other countries with it. However if we had adopted Austrian School economics in 1981, I would have sung the Hallelujah Chorus. Will the next most advantageous window of opportunity for scrapping the Keynesian overdose be 2018? Meanwhile, I wonder how often Greenspan reflects on this quote, from his comparative youth:

"In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. The financial policy of the welfare state requires that there be no way for the owners of wealth to protect themselves. Stripped of its academic jargon, the welfare state is nothing more than a mechanism by which governments confiscate the wealth of the productive members of a society to support a wide variety of welfare schemes. The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means to an unlimited expansion of credit (debt creation)."

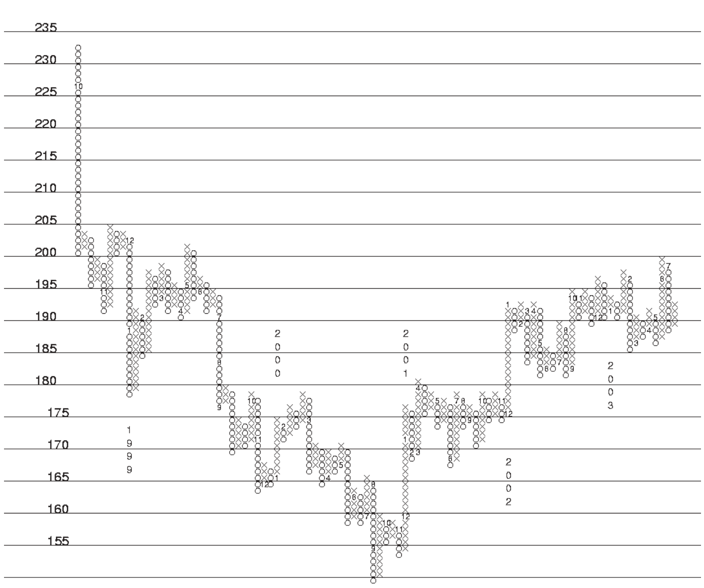
Alan Greenspan in The Objectivist newsletter published in 1966, reprinted in Ayn Rand's Capitalism: The Unknown Ideal.

Bottom line: Greenspan will create credit (effectively printing money) to keep the US economy highly liquid and the dollar soft, until growth is sufficiently robust to warrant higher short-term interest rates. If the dollar, which is inevitably subject to additional factors, not least perceptions regarding other currencies, then rises as a lesser evil in the eyes of currency traders, this will have the effect of tighter US monetary policy and take some of the pressure off short-term rates.

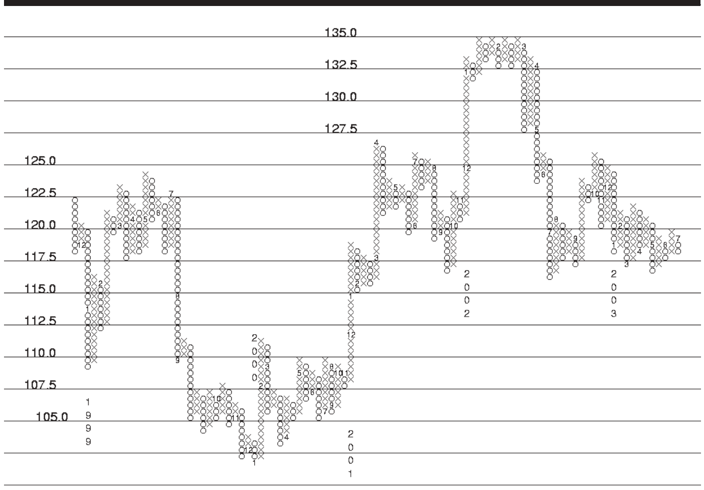
US Dollar per 1 Euro (0.004)



Japanese Yen per 1 Pound Sterling (1)



Japanese Yen per 1 US Dollar (0.5)



New BoJ Governor Toshihiko Fukui was hired to be a Greenspan clone, a role he plays with some obvious discomfort. One wonders why the man who recently said, "I don't 100 percent trust [imported] economic theories", accepted the job spec - "aggressive deflation fighter", in Prime Minister Koizumi's words. Perhaps it was for the honour, but it is easier to see why Koizumi hired Fukui, once he agreed to the agenda. As a former BoJ Board Member, and having been passed over when Hayami was appointed Governor in 1998, Fukui was expected to keep the BoJ's Hayami-loyalist miscreants in line, while presiding over a monetary policy expansion more radical than Greenspan's. Bottom line: Governor Fukui will do whatever is necessary to prevent the yen from rising, until Japan's economy regains some of its former glory.

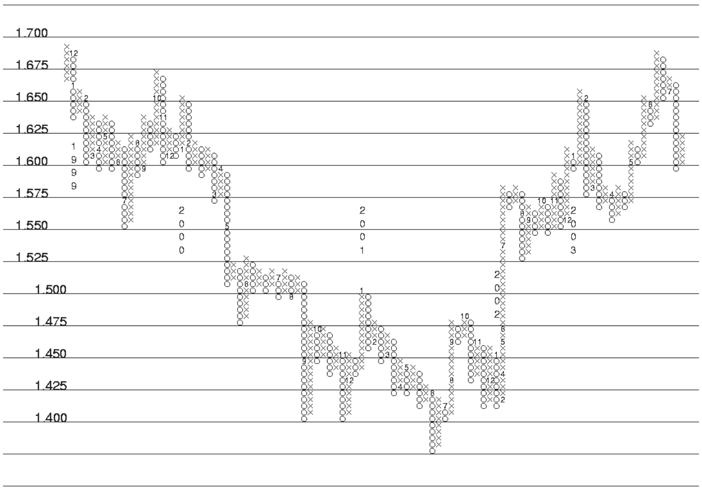
The ECB wants a weaker currency, sort of, but is unwilling to do much about it. Actually, it's worse. Tactically, ECB President Duisenberg is a Hayami clone, parsimonious with money supply because he wants Euroland's governments to deregulate and also bite the Stability Pact bullet, by sticking to the 3 percent ceiling on deficits. He's got a point but in remaining behind the curve in terms of monetary policy, he risks a deflationary slump in Euroland, aggravated by a euro that is too strong.

Other central banks with a strong currency also play pass the parcel. China doesn't have to do anything, because with the yuan pegged to the dollar the Fed is currently underpinning the PRC's mercantilist ambitions. In recent years the Swiss central bank has resisted a strong currency, inevitably with mixed success in this increasingly competitive game. The Australian, New Zealand and Canadian dollars were weak for so long that their central banks enjoyed the initial rebounds, until the shock-and-awe of potential consequence dawned on them recently. Bottom line: the Fed's actions compel other central banks to become born-again inflators, differing only in the degree of their credit creation.

The ballooning supply of dollars and yen via credit creation will worry currency traders even more than Euroland's economic weakness relative to the US and an improving Japan. There are swings and roundabouts, of course, but the euro will continue to be perceived as the least ugly reserve currency, more often than not. The main exceptions will occur when the euro is very overbought, evidenced by trend acceleration and complaints from Euroland's politicians and export companies. However we should expect a period of range trading between $1.20 to $1.11 for euro/dollar and ¥141 to ¥131 for euro/yen, because the June to mid-July contra-trend reactions were sufficiently large to cause some damage to the primary trends and also sentiment.

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.*

US Dollar per 1 Pound Sterling (0.005)



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

Euro/dollar ($1.1489) - After the biggest correction since base completion, the euro firmed above extensive support evident from $1.1040. The subsequent rebound suggests that the reaction low has probably been seen. However, the late-May to early-July setback did some damage to the primary upward trend. Therefore further support building, perhaps in the $1.17 to $1.13 region, may be necessary before the May high is successfully challenged.

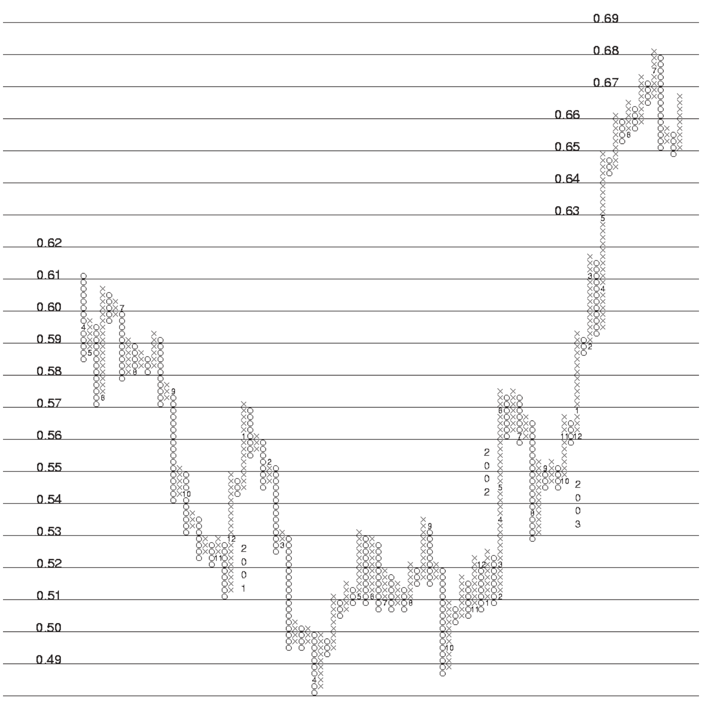
Euro/yen (¥137.27) - *not illustrated* - The euro's accelerated decline in the first half of July and subsequent rebound suggest that the reaction low has been seen. However here too the correction has done some damage to the overall upward trend. Consequently a partial retracement of the rally since mid-July in an additional phase of support building, is probably necessary before the late-May peak is successfully tested.

Sterling/yen (¥194.33) - Sterling's somewhat bigger correction within the ranging pattern evident since January 2002 suggests that here also some further support building will be needed before psychological resistance near ¥200 is cleared. A move below ¥185, which appears unlikely given the rising lows, is required to offset current scope for sideways to higher ranging.

Dollar/yen (¥119.46) - 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.

Sterling/dollar ($1.6267) - After encountering resistance in the region of the 1997-1998 highs against the dollar, the pound accelerated lower in the just half of July. An upside key day reversal on 21st July - *not shown, see daily candlestick chart on www.chartanalysts.com* - suggests that the reaction low has been seen. While sideways to somewhat higher ranging is likely, overhead resistance

US Dollar per 1 Australian Dollar (0.002)

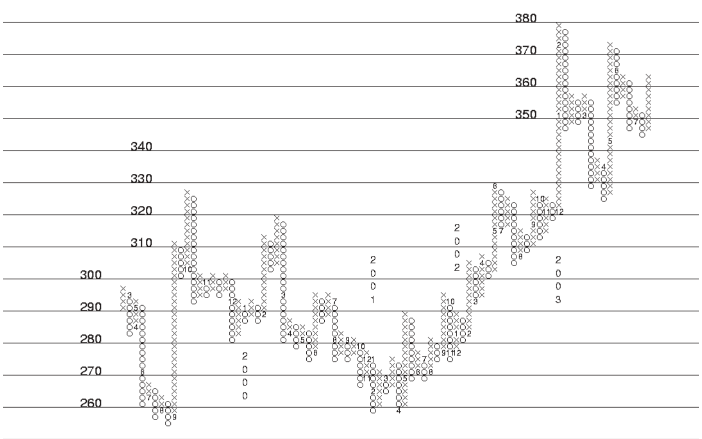


remains formidable.

Australian dollar/US dollar (US$0.6655) - The Australian dollar encountered resistance in the region of its important highs reached in 1998 and 1999 - *not shown, see www.chartanalysts.com* - and the subsequent sharp reaction indicates that a peak of at least near-term significance has been seen. A rally is currently underway but further resistance in the US$0.68 region is likely.

Strategy on currencies - I couldn't have done a worse job with my yen trades over the last couple of months, violating my trading rules from The Chart Seminar. I didn't lighten enough in late May as currencies accelerated against the yen. Then when my trailing stops were hit, I came back in too soon on the initial sell off and too aggressively, only to be bundled out as the declines accelerated, causing me to miss the turn. How embarrassing. With markets, one never stops learning and sometimes we have to relearn lessons that have not have been reviewed sufficiently. With most of my annual holiday coming up in August and September, I'll probably leave the currencies alone for a while and wait for the next opportunities when I can watch the markets daily. If I were long the euro, Swiss franc and sterling against the yen, I'd be lightening on a Baby Steps basis following 8 consecutive days on the upside by the single currency, and looking to add on the next reaction, provided there were no downward dynamics. A sharp setback would imply continued volatility and a possible retest of the lows. I would trade euro/dollar on the same basis, looking to buy in the $1.14 to $1.10 range, without necessarily expecting to see the lower level, and commence lightening above $1.16. These tactics will be review as required on the Audio. I expect a further period of ranging between the May/June highs and July lows for yen crosses and also euro/dollar, before the primary trends are extended.

Gold CMX 2nd Month Continuation (2USD)



Commodities

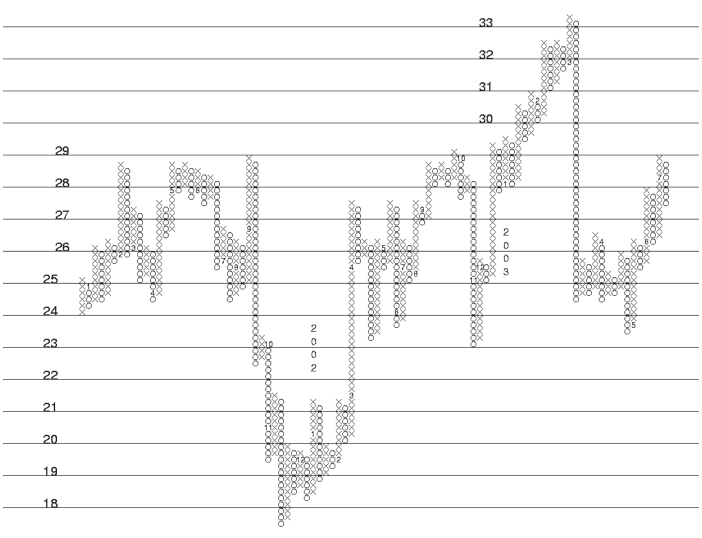
■ **Gold Bullion's stealth bull market remains on schedule, quietly consolidating before the next upward break.**

■ **Supply concerns have kept crude oil near $30 (spot NYME) but production from Iraq should increase dramatically in the next few years.**

Gold's 'first step above the base' consolidation is now in its latter stages. I have previously described this as a stealth bull market, because most people haven't noticed, or don't want to acknowledge that gold is under accumulation. A very large and powerful financial industry is wishing either bond or stock market prices to move higher, or both simultaneously. In their hearts and minds, gold is the uninvited guest at the party - a spoiler. This is a fantasy of course, encouraged by some frustrated gold bugs who have long predicted disaster for everything but the yellow metal. I have always viewed gold as a niche investment and currency. As an investment, gold is uninteresting when interest rates are high because it has no yield. Additionally, gold is overshadowed when stock markets are in form and expected to remain so. As a currency, gold is inconvenient to hold and therefore mainly of interest as a hedge against inflation. Today, gold is slowly working its way back into the investment community's consciousness. Knowledgeable investors want a hedge against credit creation and the bubbles it continues to create. Gold is cheap relative to most stocks, bonds, currencies and property. However this will change, judging from the chart. Gold is currently ranging in the first step above its base formation. These patterns can take many months to form and we have seen 7 and counting. Nevertheless the overall pattern of rising lows since 2001, and with gold continuing to rally more quickly than it falls since December 2002, the present consolidation may be only several weeks from completion. In terms of its secular trend, I maintain that gold today is where the S&P 500 Index was in 1982.

Oil supplies will increase faster than demand. Petroleum consumption is rising but with commodities supply is always the key variable. With crude prices

Crude Oil NYME 2nd Month Continuation (0.2USD)



averaging close to $30 (NYME) for the last 3 years, global production is rising, with the help of renewed investment and improving technology. While OPEC could reduce its production, the cartel also knows that Iraq should be capable of exporting 3 to 4 million barrels a day within two years. Oil supplies from Africa are also likely to increase. Consequently OPEC will have difficulty agreeing to, let alone enforcing further cuts in production. Technically, crude oil's upside scope remains limited to top formation extension. A move above $31 would open the door to somewhat higher prices but the next big move should be downwards.

The Global Economy

■ **Europe has the least favourable GDP growth prospects among developed regions.**

■ **US growth over the next year should be near the higher range of estimates, but it is unlikely to be sustainable.**

■ **Asia has the most sustainable growth prospects.**

Europe starts with a competitive disadvantage. Euroland is a semi-Socialist region. While each country has established its own policies and these vary somewhat, Euroland is generally higher taxed, more regulated and has stronger unions than Asian countries and the US. This puts Europe at an overall competitive disadvantage, as we know from comparative studies of GDP over the long term. The semi-Socialist system was not imposed on Europe's citizens. They chose it at the ballot box, and a majority still favour the welfare state to the more robust capitalist systems operated by Asia and North America. However Euroland's new Constitution will consolidate more power at the unelected centre, and no citizen will be given the opportunity to vote for or against greater control from Brussels. While the Constitution has yet to be finalised, we know its intent. The trend is towards a greater harmonisation of policies among states, ostensibly to eliminate "unfair" advantages, such as lower taxes. While this may seem like a good idea, it tends to enshrine mediocrity, with one-shoe-fits-all policies. We have already seen the problems created by a single monetary policy and there is no historical basis for assuming that any other harmonised policies will increase the region's GDP. Worse still for Euroland the ECB has singled out the Stability Pact, intended to limit budget deficits to under 3 percent of GDP for each euro-zone country, as one of its causes, even though it has nothing to do with monetary policy. In citing budget deficits in the larger countries as a reason for not providing a more aggressive monetary stimulus, ECB President Wim Duisenberg presumably wishes to be thought of as a good Bundesbank-style central banker. The trouble is, we currently live in a disinflationary, deflationary environment. Duisenberg is behaving like Masaru Hayami, the former BoJ Governor who compounded Japan's economic problems. Claiming the moral high ground of fiscal prudence, the ECB President is sleepwalking Euroland towards outright deflation. He is right about the need for deregulation, but having made the point, Duisenberg should provide the necessary monetary reflation. In championing Euroland's Stability Pact, he is defending the indefensible. In conclusion, Euroland's economy remains hamstrung by the old tax and regulatory problems, compounded by a strong currency and an inflation-fighting central bank, which has pushed Germany to the brink of outright deflation. However Euro-zone GDP growth will probably show a slight improvement during the second half of 2003 and first half of 2004. It will be helped by the global recovery, better-late-than-never rate cuts and because Germany, France and Italy are ignoring the Stability Pact. Nevertheless Euroland's GDP growth will continue to lag Asia and North America.

In the UK, Chancellor Gordon Brown has ruined the economy by slowly strangling it with ever-rising taxes. The UK has only managed to avoid recession for two reasons - public spending and personal consumption boosted by mortgage equity withdrawal. No economy can prosper when state tax-and-spend policies eviscerate private enterprise. Consumer spending financed by increased borrowing is unsustainable. Brown's spending plans will require higher borrowing and/or taxes. Neither will help GDP growth, which will be similar to Euroland's larger economies.

In the US, the massive monetary and fiscal stimulus continues. Unlike the recalcitrant ECB, and BoJ until recently, the Fed's monetary policy remains highly stimulative. Greenspan and Co are not only erring on the side of inflation, they would welcome an upturn in PPI and CPI data, as a defence against current and future deflationary pressures. The Fed's efforts to promote growth are matched by record fiscal spending from the Bush Administration, as it seeks re-election on 2nd November 2004 and continues the war against terrorism. This combined monetary and fiscal stimulus is unmatched by any other country and it is succeeding. Confidence has been improving since the war against Saddam Hussein because the US has prevented further terrorist attacks within its borders, the stock market is rising, and house prices remain generally firm. Yes, unemployment is rising but it is a lagging indicator. The reality is that most people have jobs and the 'feel-good factor' is back, albeit not at levels of the late 1990s. Serious problems for the US economy are unlikely to resurface until further down the road, when short-term rates rise. A re-elected Bush Administration is likely to rein in fiscal spending in 2005/6, to reduce the budget deficit. Should the President not be re-elected, a Democrat administration would do the same and perhaps raise taxes, as its candidate will certainly target the deficits. The Fed may commence raising rates in 2004 and will slow credit creation as the economy recovers. With both US short-term and long-term rates probably 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 is likely to remain near record levels because there has been no significant economic shakeout in the US. Similarly, corporate debt will probably remain a problem. With limited pricing power, many companies will continue to favour cost cutting over expansion. Unemployment is unlikely to decline significantly and could even edge higher. In conclusion, following its initial rebound, the US economy will probably slow again, muddling through at best. The Catch-22 is that a desirable rate of GDP growth for the Fed and White House would put sufficient upward pressure on interest rates to burst the property bubble, while further deflating the stock and bond market bubbles. This is a recipe for recession in 2006 and perhaps earlier. The Fed's main achievement this year and next will be to postpone the economy's cyclical corrective process, possibly making the eventual shakeout worse.

Asia faces neither Europe's regulatory problems nor the US's debt overhang. OK, there is Japan but no one can now doubt that monetary problems are being addressed much more aggressively. Consequently Japan is now many people's favourite recovery story. Asia's smaller economies, it should be remembered, experienced their financial crisis in 1997 and have learned from those problems. The entire region will benefit from the US economy's rebound over the next year. After several difficult years during which China's strong growth left much of the region's manufacturers at a competitive disadvantage, Asia's other countries are now profiting from commercial links with the PRC, including joint ventures, commodity exports and tourism. Following the SARS scare, Asia's consumer sector is beginning to recover. Consequently the Asian region is likely to outperform North America and Europe for the next several years, at least.

And Finally…

The Chart Seminar: Nov 6th and 7th 2003 - Yes, there will be a public venue for TCS this year, in London. Please note these dates, if you or any of your colleagues and friends are interested. We will email and post the new brochure and enrolment form in August. The early booking rate expires on 1st October and numbers will be limited to 50 delegates - no exceptions. For further information, email tcs@stockcube.com or call Mark Glowrey on +44 (0)20 7349 2127. Colleague Tim Parker will share the teaching with me, and introduce some new material. Cognoscente may be interested to hear that a brand new, state-of-the-art and highly desirable brolly has been produced, just for the occasion.

> ***"Positive or negative expectations become ingrained and self-fulfilling until markets become priced for perfection or for the worst possible outcome, until there is nobody left to buy or to sell. The investment cycle from sobriety to lunacy and back again is a crowd phenomenon. It must be measured in generations and viewed in conjunction with the credit cycle. No amount of interference by government policy makers can divert what is essentially the playing out of human nature. Attempts to intervene and control can only prolong the process and increase the amplitude of the cycle. The predisposition to do so is grounded in the failure to understand these elemental facts as well as the intellectual arrogance core to all social engineering."***
>
> *John Hathaway*

Best regards - David Fuller

Fullermoney a division of Stockcube Research Limited Suite 1.21 Plaza 535 Kings Road London SW10 0SZ UK
Website: www.fullermoney.com ***Email:*** research@chartanalysts.com ***Tel:*** +44 (0) 20 7352 5435 ***Fax:*** +44 (0) 20 7352 3185 ***Single Issue Price*** £35