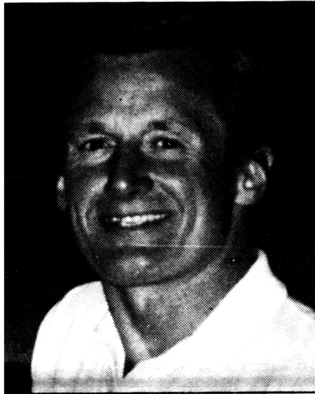
FM3

FullerMoney

Late May 1984

THE INTERNATIONAL INVESTMENT NEWSLETTER



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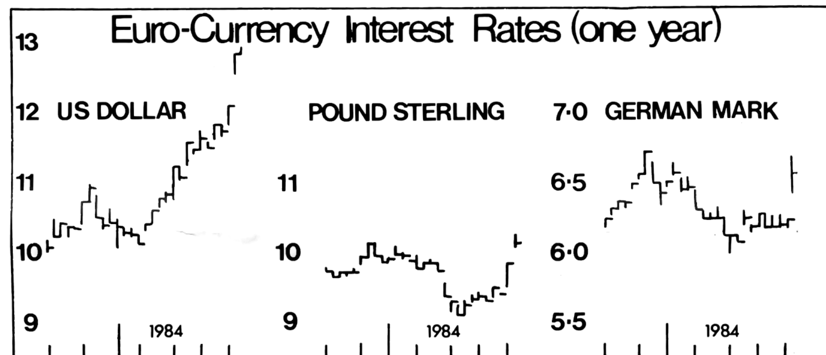
Interest rates say it all

A scary development is rapidly unfolding on the international interest rate front, as the upward potential indicated by the charts last month is becoming a costly reality. U.S.A. interest rates gapped upwards this month, causing havoc in the credit markets and checking the modest rally in American share prices. Inevitably rates in the U.K., Germany and many other countries followed the lead from North America – there is no escaping the leash effect that I mentioned in this context last month. Nevertheless the last thing most commentators were expecting was a rise in European rates. That was supposed to be America's problem, due to a runaway budget deficit. In contrast the U.K. and Germany had trade surpluses and comparatively small public sector borrowing requirements. America was advised to get its house in order so that Europe could proceed with the next round of interest rate cuts. Everyone wanted lower interest rates so that in the U.K., for example, gilts could break upwards out of their lethargic pattern, the F.T. 30 Share Index march on to 1000, and gold begin its long awaited sustained recovery.



Never mind the contradictory nature of those expectations, people wanted cheaper money so they preferred to ignore any argument to the contrary. The problem is that aside from local patriotism, there really isn't a good reason why anyone should buy long gilts yielding 11 per cent when they won't even buy treasury bonds which offer a 13.5 per cent return. What we now have is a developing interest rate crisis, of global proportions, that can only get worse in the short term. That is why gilts are now moving down and the equity bull markets are over. The economies of the developed nations are now strong enough to withstand higher real interest rates in the short term, but a sustained rise would choke off the recovery and repeat the financial crisis of 1982.

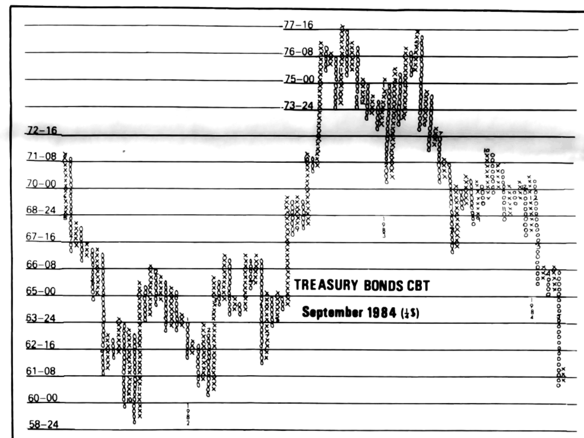
The greatest problem concerns the less developed country (LDC) mega-debtors who have experienced no recovery and are not in a position to absorb higher interest rates. An increase of one per cent for U.S.A. interest rates adds approximately 3.5 billion dollars to the annual costs of the debtor nations. They cannot and will not put up with that, bringing the political default a step closer. Watch Brazil and Argentina in particular, for they would suffer least from a formal default and repudiation of all foreign debt. They are among the few countries that could still feed their people without outside help, and their large food and raw material exports would leave them in a strong position to conduct foreign trade on a cash or barter basis. Note the words of Argentinian economics minister, Aldo Ferrer: "In effect, our beef exports have been expropriated to pay the banks. People cannot be expected to understand why they should suffer to pay for that." Schemes to "cap" interest rates paid by LDC's whenever international borrowing rates rise above a certain level, with the extra "capitalised," i.e., added to the loan principal, as discussed by this month's bankers conference in New York, amount to no more than further shuffling of the deck chairs. The only hope for a satisfactory solution to the debt crisis required many years of stable growth world-wide, against a background of low inflation and low interest rates, plus particularly good economic management in all the LDC countries. That unlikely scenario never rated better than a 1000 to 1 chance. Rising debt burdens increase the chance of a left wing, or even right wing, Populist demagogue rising to power in Argentina or Brazil during the next few years, who will repudiate all foreign debt.

U.S.A. financial institutions in particular will feel the pressure of rising interest rates on several fronts. Renewed anxieties over the LDC loans will be accompanied by concern over shaky domestic loans. The Continental Illinois crisis is typical of what can be expected. The loss of confidence will pull money out of the banking system and increase their costs as traders shun bank certificates of deposit in a flight to quality. Small bank failures in the States total 26 so far this year, a trend that can only accelerate and exceed last year's total of 48. The slump in bond prices will produce more shocks similar to insurance broker Marsh and McLennan's 160 million dollar loss on speculative trading. Bond dealers have taken a pounding this month as a new issue of 10 year treasury bonds attracted few buyers. The growing inventory losses have weakened several Wall Street firms and could force a rescue operation.

Who or what is to blame for these alarming problems just when the industrial nations were benefiting from an expanding economic recovery? The mischievous blamed Dr Doom, otherwise known as Henry Kaufman. This is ridiculous because forecasters spot fires rather than start them. If Kaufman had been wrong, his prediction of spectacularly higher interest rates, unless there were significant budget cuts, would have triggered a rally. Another scapegoat was "bankers greed" according to President Reagan, while his press secretary, Larry Speakes, blamed Paul Volker and the Federal Reserve. While I'll never be an apologist for banks, interest rates respond to market forces. The Federal Reserve could have postponed the problem by allowing the money supply to expand at an even faster rate, but this would have guaranteed double digit inflation in the U.S.A. by year end, as well as higher interest rates in 1985. The yawning Reagan/Congress budget deficit is the real culprit because the government's voracious appetite for capital is coinciding with an expanding corporate demand for funds. However, without that large deficit there would have been no European or Pacific Basin recovery, and the severe recession at the beginning of this decade could have slid into a depression. Henry Kaufman's conclusion during a recent speech in London provides an appropriate last word: "We cannot have every day a perfect day in the financial community. We each have our day in the sun, and we will each have our day in the shadow."

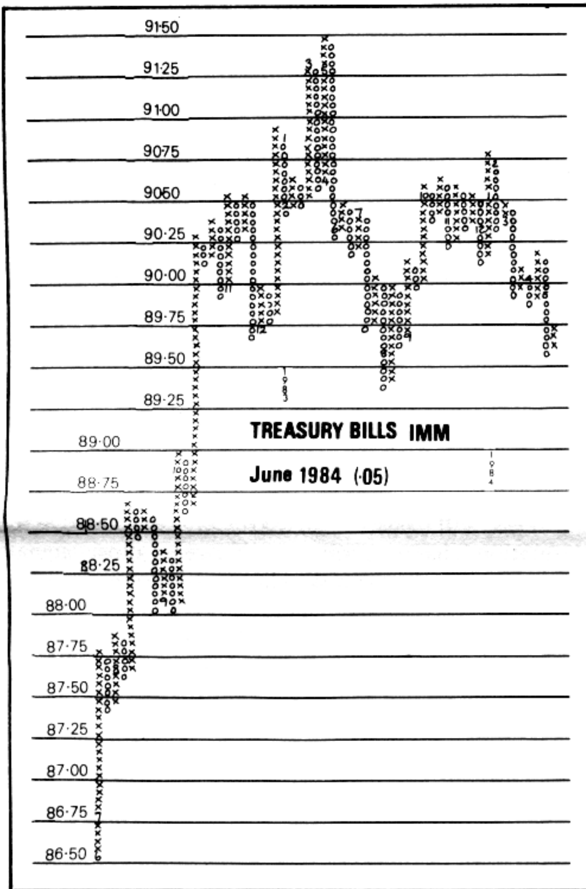
Gilty of bondage

The cynic said: "If a man tells you his word is his bond . . . . take his bond." Unless of course that man happens to be ex-stockbroker, Donald Regan, currently the U.S. Treasury Secretary. The herd took one look at his latest bond offering and thundered off in the opposite direction. That debt auction flop blew a few holes in underwriters' balance sheets and may cause a bankruptcy. More importantly it represents a "buyers strike" that will help to push interest rates higher still. Look for temporary support on the September treasury bond futures chart near the psychologically significant 1981/2 lows, followed by a brief technical rally or two, and then another downward move.

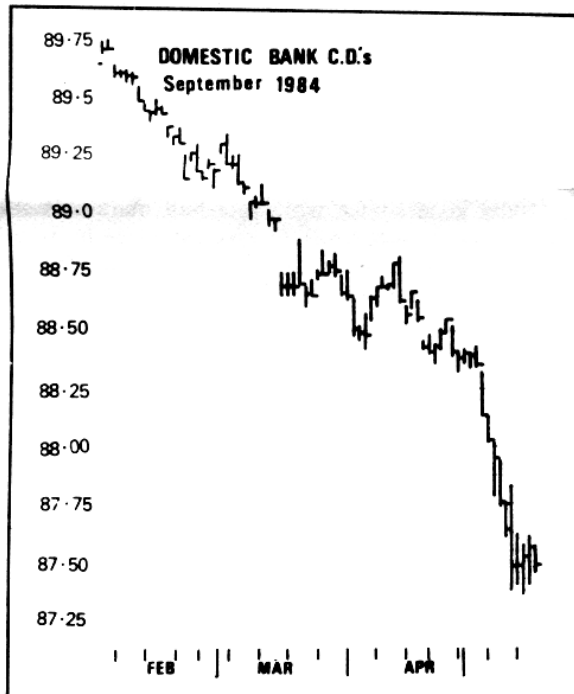


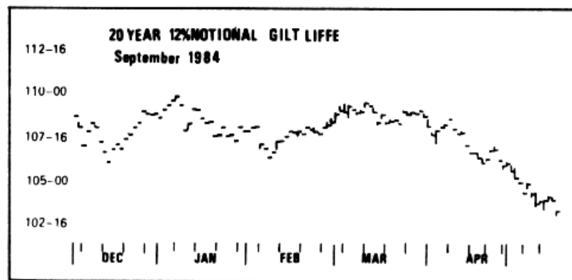
I have also included a chart of the June treasury bills contract because it shows enough back history to include that big rally during the second half of 1982. The chart looks top heavy doesn't it? A further fall to 88.00 could easily occur over the next few months.

While treasury bills are the U.S. Government's short term paper, domestic bank c.d.s are issued by American banks. Consequently c.d.s fall even faster



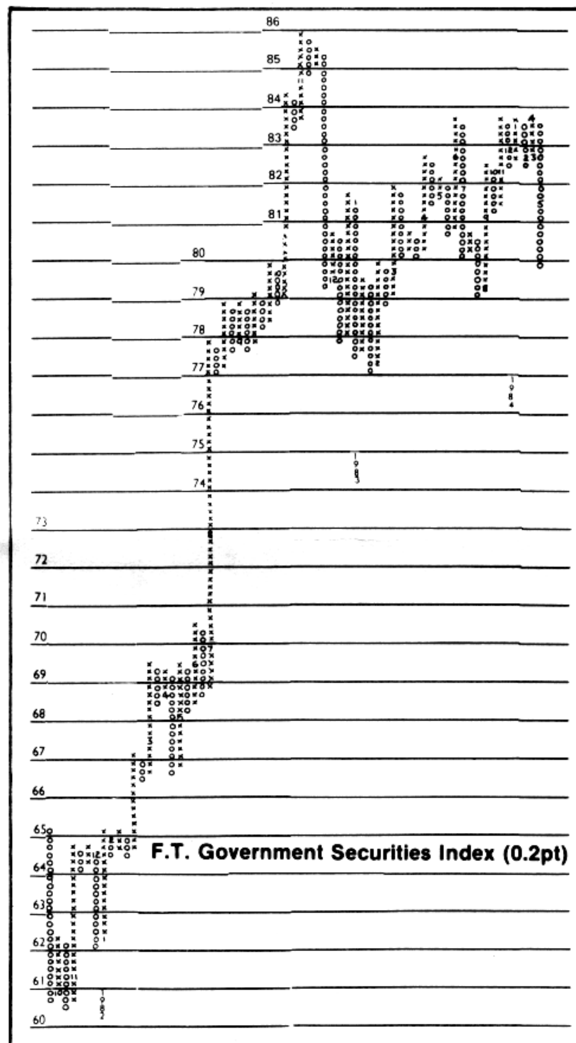
than t-bills when interest rates are rising and bank loan portfolios are subject to extra scrutiny. This phenomenon is known as the flight to quality. The chart of September c.d.s formed what I call the Beachy Head pattern, named after Britain's favourite suicide





spot. At Beachy Head, overseas readers, the ground slopes gently downwards for several hundred yards to the edge of a steep cliff. The chart shows that c.d.s took the plunge early this month when Continental Illinois' problems surfaced anew. A bank failure of this magnitude will ensure that the t-bill/c.d. spread will not narrow until interest rates peak at some future date.

The Beachy Head pattern is also apparent on the September 20 year 12% notional gilt chart, caused by a steady price erosion over the last month. In disagreeing with the bullish consensus for gilts last month, I included a point and figure chart of the June contract which showed a large resistance barrier at 110.00. The

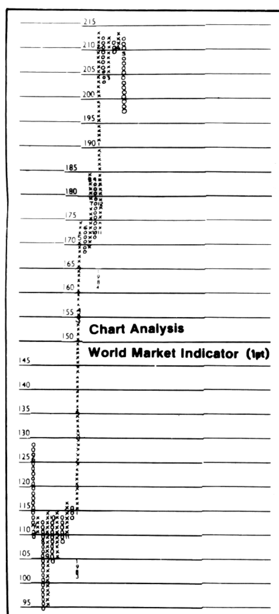


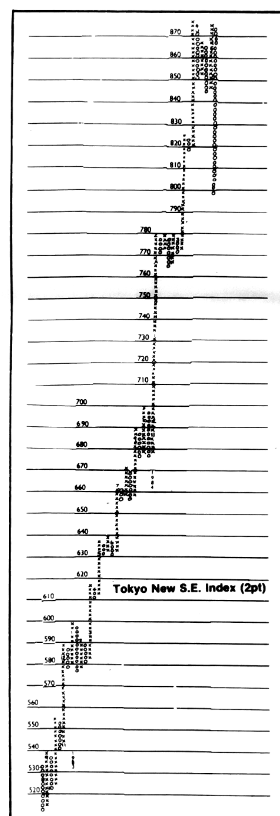
slightly lower resistance point on the September contract was never threatened , and previous support near 106.00 has been penetrated decisively. It's still not too late to short gilt futures in anticipation of a move below par.

The F.T. Government Securities Index shows enough back history to enable us to view gilts in perspective. A spectacular bull market followed the September 1981 low, culminating in a spike peak a year later. Chart seminar delegates will recognise the type two and three top formation characteristics – an out of character downward spike followed by a long period of churning. We can expect the reaction lows at 79 and 77 to be taken out during the next few months, followed by a further decline to 73, at least.

The Chart Analysis World Indicator confirms a bear trend for all stock markets

This important chart appears on page 1 of our International Point and Figure Library each week. It is an indicator rather than an index, designed to anticipate the main trends for most stock markets. As a reliable lead indicator it is much more effective than the Capital International World Index which is weighted according to market capitalization. Readers last saw Chart's World Indicator in FM1, when I pointed out the early February sell signal. It has now broken below the February and March lows confirming a global bear market for shares. To judge the accuracy of this indicator, look at the unbroken progressions of higher lows since the August 1982 low at 94 until this month. In other words, each downward reaction encountered support at a higher level, consistent with an overall upward trend for shares. Additionally, each high, or rally peak, occurred at an equal or higher level from September 1982 until March 1984.





After the Tokyo and London blow-off . . . the blow-out

My blow-off headline in FM2 attracted press comment because it conflicted with the bullish consensus for Japanese and U.K. shares, but this interest waned when both markets continued to rise for a whole fortnight. New friends from my chart seminars, however, will have recognised the type one and two top formation characteristics. In between those signals there was a five week churning action enabling investors to get out near the highs as advised. Subsequently Tokyo has fallen like a stone while London has merely sagged. This is consistent with the greater percentage advance seen in Japan, aided by a 50% margin rate subsquently raised to 60%.

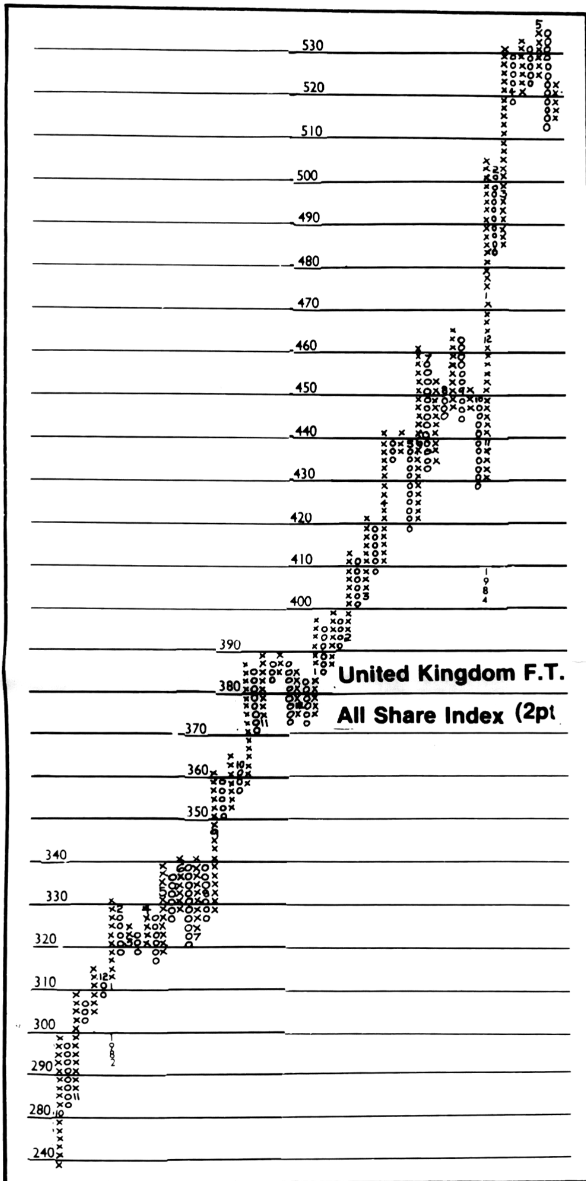
Don't expect much from temporary rallies in response to short-term oversold conditions. That margin increase in Japan won't introduce new cash; it will just tempt reckless investors to run losses a little longer until the next collapse forces them out. Don't be misled by the comforting murmurs about a consolidation from Japanese analysts who haven't seen a bear market before, or data on the economy that will remain irrelevant until prices are much lower. The speculative bubble has burst and the cash inflow that fuels bull markets will be reversed as unit holders in Japanese trusts sell or switch to a deposit fund. I don't expect the Tokyo New S.E. Index to test its recent high during the remainder of this year, and it could easily fall to 700.

Returning to the London stock market, many commentators are saying "forget about the indices and just concentrate on individual stocks". That is generally good advice while the bull market is still intact because there will be very extensive leads and lags as sector rotation works through the market. Nevertheless one should also keep an eye on the indices because they provide perspective, and their trends have a major impact on crowd psychology. Also, when the bull market ends, all those reliable support levels on the way up suddenly lose their potency and resistance levels become the new impenetrable barriers. This change may be unmistakable on an index, and the chartist who fails to appreciate its significance will soon lose confidence in his methods and credibility among his followers.

When I look at the U.K. stock market today I am filled with feelings of deja vu. The tremendous rise that has included all market sectors, and the confident projections for earnings and dividends in the distant future, remind me of May 1972. Then, as now, the

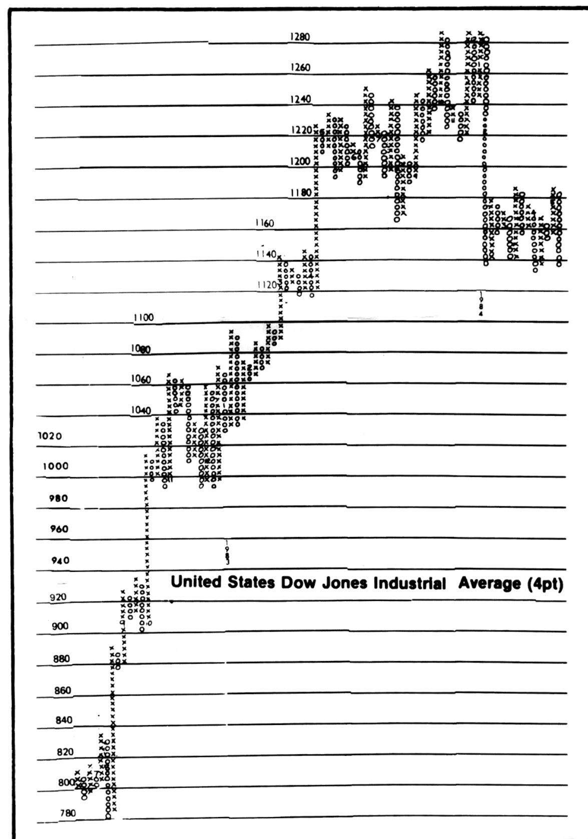
technical vulnerability of shares was clearly evident and gilts were leading the way down. Most people chose to ignore the obvious warning signs because there were plenty of bullish arguments espoused by the fully invested. Expectations follow markets upwards, and when prices eventually peak, expectations continue to rise until evidence to the contrary becomes overwhelming in the declining market trend. The same phenomenon in reverse occurs at the end of a bear market. The fundamentals are very different today from twelve years ago. Inflation broke the 1972 cycle; real interest rates will undermine today's recovery. I don't know how far the market will fall any more than anyone else, but the bear trend could be substantial given the previous rise. I'm not forecasting a 1974 decline, but we could easily see a replay of 1973's downward trend. Don't be lulled into a false sense of security by the belief that you hold superior shares. In a bear market they drag them out one by one and shoot them. This market has undeveloped potential for panic.

In 1972 the safe havens were the major beneficiaries of inflation - commodities, land and other tangibles. Real interest rates make the tangible investment much more risky today, but an insured deposit account is attractive. Compounded interest won't ever make you rich, but it will protect your capital and produce a real return after inflation and taxes. Don't tie up your capital in long term deposits because UK interest rates are sure to go higher. Speculators can still short the FT-SE and S + P indices, suggested last month, in addition to the notional gilt short mentioned earlier. For the lowest risk consider "out of the money", rather than "in the money", put options.

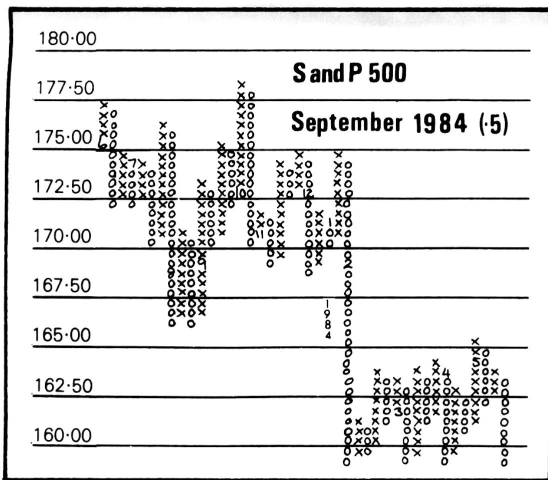


Bonds seal Wall Street's fate

It is now just a matter of time, and very little at that, before Wall Street takes the next downward step in its bear market. U.S. shares may offer the second best fundamental value after Hong Kong, but that won't prevent a further decline that should soon take the D.J.I.A. below 1100. FM2 stated that all the indices would have to "break decisively above their March highs to neutralise the prospect of another downward step for U.S.A. equities." The best gain proved to be less than 2% above the March high, hardly threatening the large May 1983 to February 1984 (type 3) top areas. Throughout this last month market breadth (shares up



versus shares down) has been deteriorating. Optimists clutching at straws have commented on how well the market has held up in the face of a bond slump. Don't you believe it. The stock market looks like a wobbly fighter soaking up punishment. Don't let the knockout punch land on you as well. Investment managers should maintain the S. & P. and N.Y.S.E. futures hedge shorts. My suggested very close stop at 164 (September) for speculative shorts (as opposed to hedge sales) was overcrowding the position, although I doubt anyone could have lost more than a point, but let me know how you fared. It is still not too late to short Sept. S. & P. futures. The 164 stop looks better this time. Lower this to 161 on a decisive break below the February/March lows. Take 50% profits neaı 150 and ride the remainder with a trailing 5% stop.



After the big three, a tale of top formation development and completion

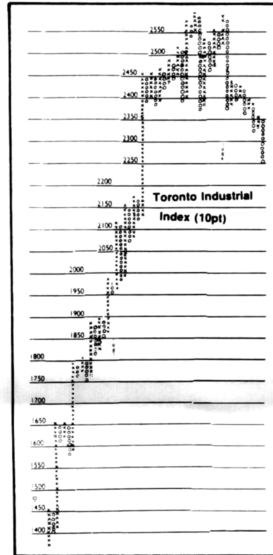
The Wall Street leash effect, to which I frequently refer, will reign in all but the strongest markets. When the big three bourses, U.S.A., Japan and U.K., which account for about 68% of the world's equity capitalization, start to fall in tandem all other markets will be close behind. I have included sections of the charts from INTERNATIONAL to illustrate the point.

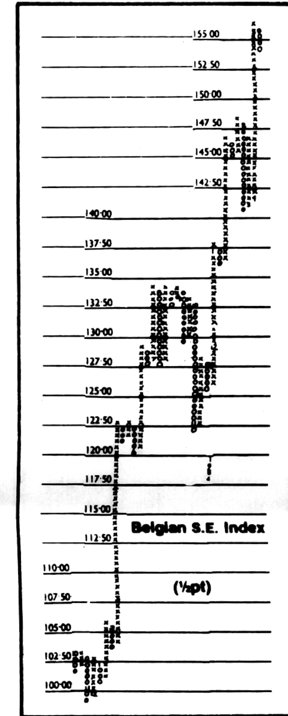
The Toronto Industrial has broken decisively down out of a huge top formation. Remember, when all that churning was taking place above 2400, shares were changing hands. Anyone who bought up there is losing money, will be reluctant to buy again until prices are much lower, and may even sell to limit losses.

The Belgian Index is rock steady, but it is dominated by one stock. Watch out if Petrofina closes below BF7900.

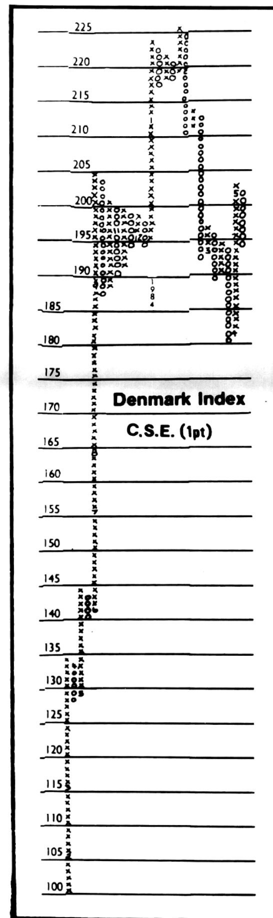
Denmark is forming a type 3 top formation.

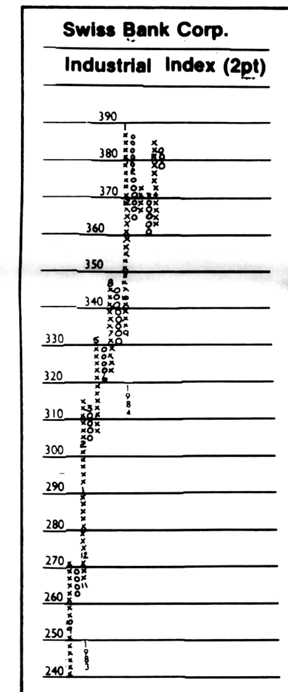
The Swiss Bank Corp. Index has lost upward momentum. A close at 390 would extend the bull's life, but after five months in this pattern time is running out.

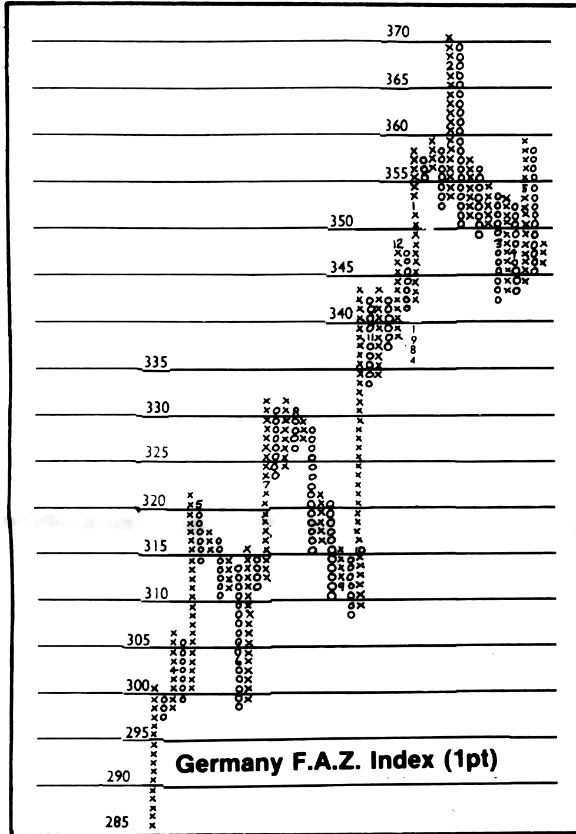




Germany's F.A.Z. Index shows more underlying support than most other market indices, but the type 3 top characteristics – churning, time and size of pattern

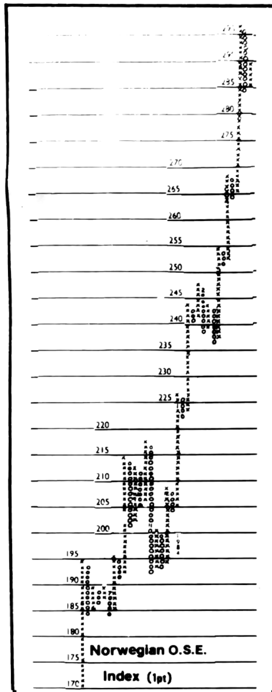


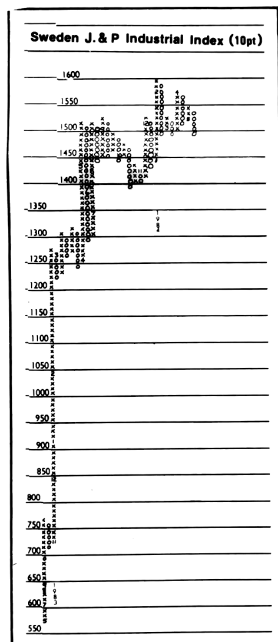


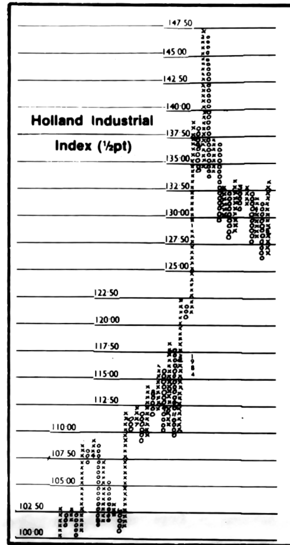


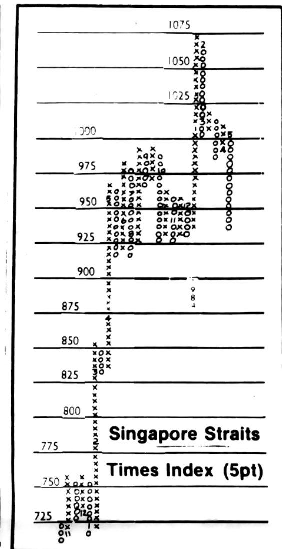
– are evident. I advised you to buy Deutsche Bank below DM360 in FM2. It is approaching that level but defer purchases until the next cycle. I am more bearish now that a global upward spiral for interest rates is under way.

The Norwegian O.S.E. Index is accelerating – a









type 1 top characteristic. Japan shows what happens when the music stops.

The size of the type 3 top on the Swedish Index is scary.

Holland's Industrial Index completed a type 1 top in February, and the present rally is unlikely to go much further.

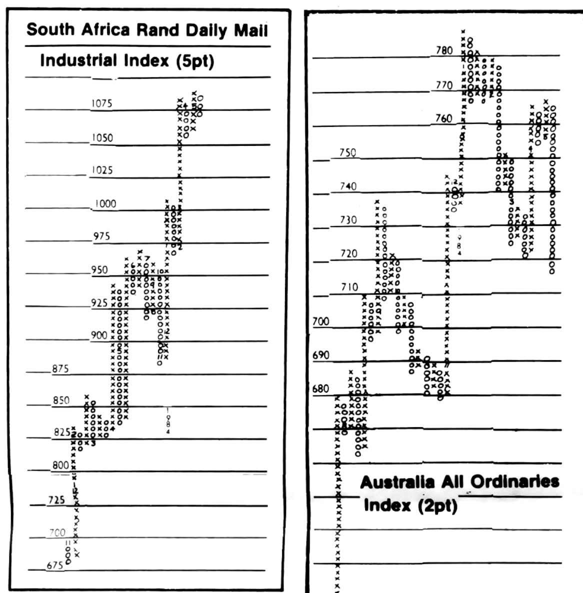
Singapore's Straits Times Index has now spent thirteen months developing a type 3 formation. When I visited that pleasant country in November, I surprised many delegates by forecasting an upward break. The market rallied another 10% to a new high, but Wall Street's February drop slammed a lid on distant Singapore. Defer purchases of DBS, mentioned in FM2.

I had one of my most enjoyable seminars with a lively audience in Sydney last November. In the concluding forecasts I had no hesitation in predicting a new high for the Australia All Ordinaries Index. Select leading shares were starting to break upwards in Australia, generally ahead of the rest of the world; the global bull trend was still intact and the evidence of a strong economic recovery, long forecast by shares, was only just emerging. A great deal has happened since **Australia hit its peak in January, starting with Wall Street's slump and spiralling interest rates. This index** now shows churning type 3 top formation development and is unlikely to test its peak again in the current cycle.

The Metals and Mineral Index (not shown) has already broken down out of a large top area.

The S.A. Rand Daily Mail Index has the best chart that I have shown in this section (that isn't saying much), but this upward trend must be moving into injury time given what is happening elsewhere. Maybe it will stay up until Britain's long overdue rugby tour is over, I'll have a lot more to say about South Africa after my three city seminar tour in late June/early July.

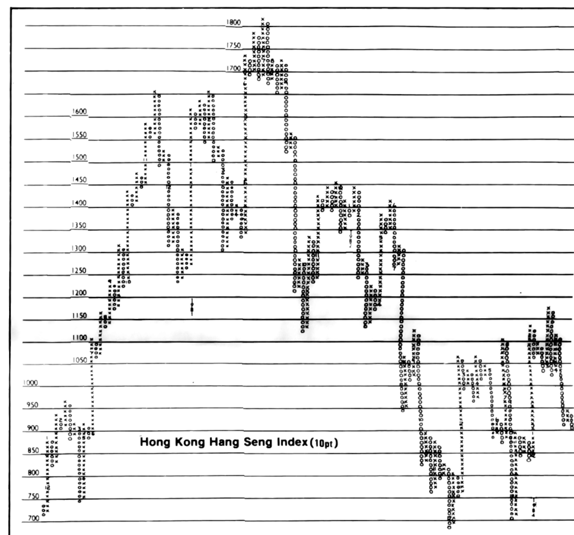
Helen Brewer has arranged a tremendous show on chart trading and investing, including tactics, timing and forecasts. Delegates will get my latest workbook, charts and tapes of the entire two-day seminar. You can join me at the Cape Sun in Cape Town, June 25 & 26;



the Royal Hotel in Durban, June 28 & 29; or the Sandton Sun in Johannesburg, July 2 & 3. They will be lively seminars and I'm really looking forward to each one. If you are interested but unable to attend, the workbook, teaching charts and tapes are available as a mail order package. All enquiries should be sent to Helen Brewer Asso. (Pty) Ltd., P.O. Box 93323, Yeoville 2143, South Africa, tel: 011 834-7471, telex: 8-6259SA, teletex: 4-50093-HBA.

Every market cycle produces an enigma. Hong Kong has the best growth record in the world over the last forty years and its export industries are booming today. On current price earnings ratios and conservative estimates for the next twelve months, Hong Kong shares represent the best fundamental value in the world today; however, past performance and present growth potential are now secondary considerations for investors concerned about the countdown to 1997. Without the China factor it is reasonable to assume that the Hang Seng Index would have breached 2000 earlier this year. Instead, it languishes below 900 and appears capable of testing the 1982/3 lows near 700. The chart is not encouraging with its overhanging supply, and having failed to perform in the global bull cycle, it will be under pressure in the emerging bear trend.

A few weeks ago, when I was more optimistic about the potential for stock market sleepers or late developers, I contacted an old friend Roy Crabbe, who is Managing Director of Wocom Securities (Europe) Ltd. Few people know as much about Hong Kong shares as Roy, so I asked him to list his long term favourites among the leading companies. They are New World, Swire Pacific, China Light & Power, H.K. Electric Holdings, H.K. Land, H.K. & Shanghai Banking Corporation, Jardine Matheson, H.K. & China Gas and Cheung Kong. Remember these companies; they are inexpensive today and will probably become even better buys in a few months time. Because of my concern that Hong Kong will now be dragged lower by other markets, I am not including any further details at this time, but will probably recommend these companies at a future date. In the interim, contact Roy Crabbe at Wocom House, 1A New Street, London EC2M 4TP, tel: 01-623 3444, for further information.



Hong Kong perspective

My interest in things Chinese began gastronomically in the 1960's when an old friend, Deson Sze, one of Wall Street's senior and certainly most colourful mining analysts, introduced me to the restaurants in New York's Chinatown. These unprepossessing establishments, serving primarily Cantonese cuisine, were a short walk from the heart of Wall Street. Deson, who came from a wealthy Chinese banking family, had escaped from Mao's revolution in a laundry basket, carrying nothing more than the clothes he was wearing and a violin, aboard a ship heading for the West. He seemed to know all the Chinese restaurateurs in New York, shrewdly favoured the establishments where the chef was the majority shareholder, and would regale us with amusing and lively discourse ranging from the origin of a favourite dish to life as a boy in China. When news of a new arrival from a name restaurant in Hong Kong, or occasionally when a seafaring cook from the mainland had jumped ship and found his way to New York's Chinatown, no mining story or chart recommendation took precedence over an early visit to test the new arrival's culinary skills.

My first introduction to the pragmatism of Hong Kong-style business ventures occurred twenty-five years ago when a recent emigre from the Colony invited Deson and me to back one of New York's first Szechuan restaurants. When I expressed concern as to the profit potential for this venture on seeing the remarkably reasonable menu prices, my entrepreneurial, ex-waiter new friend, Wing Fat, explained wisely that "American people pay too much tax". We would do well he explained because officially "Chinese restaurants in New York never pay tax because they always just break even". Since all the

records were kept in Chinese, and no westerners could have profited so efficiently, the Internal Revenue never questioned the results.

From that introduction my interest in the oriental way of life developed although I had no first hand experience prior to four visits to the Far East during the last two and a half years. The first was as a tourist to Hong Kong, while the last three have included chart seminars in Hong Kong, Singapore, Kuala Lumpur, Manila and Jakarta. While each city, its people and surrounding countryside hold a special fascination, Hong Kong remains my favourite Far Eastern city. Although the people are less welcoming initially than in Kuala Lumpur, Manila and Jakarta, Hong Kong cannot be topped in Asia for sheer variety. Foreigners sometimes complain about the frenzied existence along Central, Hong Kong's main business district, but from almost anywhere on the island you can run quickly up Victoria Peak and around the top. I have done this many times and always found the Peak uncrowded, tranquil and the views spectacular. In fact there is no harbour sight more breathtaking than Hong Kong from the Peak, unless you are on Kowloon side, looking across the water towards Central at night.

Hong Kong's principal business and residential districts are crowded by any standard. Apartments as in New York are small and extremely expensive despite the post 1981 drop in property values, although the view is considerably better than Manhattan's unless you are very unlucky. People who find Hong Kong claustrophobic do so because they seldom leave the main island. I know of no other major urban centre that can be left behind so quickly by a short drive to the new territories, for example, where you can walk around Plover cove for hours without seeing another soul. There are also a variety of boat trips to surrounding islands, all totally different from urban Hong Kong and worth exploring. My favourite is the ferry ride to Lantau Island, where you can take a rickety bus up the mountainous terrain to the old Po Lin Monastery. Book for lunch on arrival and try to join a large table if you are few in number, because there is no menu or choice. The ascetic silent staff simplify matters by giving you what they think you need. Provided you are sharing as part of a large table, the variety of tastes and textures experienced during that simple but delicious meal will improve your assessment of vegetarian diets. Following lunch I recommend the picturesque walk down a trail to a small fishing village. If you are fortunate enough to know someone in Hong Kong who owns one of those wide-bodied motorised wooden junks, they make a great picnic/party boat. A mere 20 minutes journey from the port at Aberdeen will take you to several uninhabited small islands dotted with little coves and sandy beaches.

People have complained to me that Hong Kong is a cultural desert; with some justification if they enjoy the theatre, concerts or browsing around museums, and the locals are certainly no respecters of their architectural heritage. However, Hong Kong has a thriving commercial oriental art market. The Colony is a clearing centre for objets d'art of the region, ranging from Chinese antiquities from the mainland to a plethora of eighteenth and nineteenth century sculpture from Burma, Nepal and Thailand. People have claimed that Christies and Sothebys in London will auction better examples of oriental art than can be found in Hong Kong. They are quite wrong. The auction houses produce the occasional spectacular item but never see the range of quality and especially the quantity of works found in Hong Kong. There are also a lot of fakes, some of a standard that will fool the auction house experts. It's very much caveat emptor and it helps to know your dealer. The most common fakes are the popular colourful vases that can be easily reproduced, but if your aesthetic tastes also run to the more esoteric, you are less likely to be taken. Two of my favourite shops are along Hollywood Road where there are many antique stores offering items ranging in price from 500 to 50,000 Hong Kong dollars. One is Eastern Dreams, run by the delightful Chan family – Irene, her sister Kitty and a brother who is the principal buyer. They have a wide range of attractive items and few visitors will be able to browse without making a purchase. The other is Netsuke, opposite the old Man Mo temple, which is run by Jerry Lo. He has some of the nicest eighteenth and nineteenth century Buddhas in Hong Kong and there is also a superb range of bronze sculpture from Nepal. Needless to say there is a seemingly endless variety of shops in Hong Kong, most of which are open until late evening. The colony is a consumers' paradise in every respect.

Hong Kong is also one of the great food centres of the world, but I find the seafood surprisingly overpriced relative to everything else on offer. There is a variety of superb restaurants to choose from and I have never had a disappointing meal. It is fun to venture beyond the hotel restaurants and fancy banquet halls on gastronomic missions. The best dim sum I have ever had is at the restaurant on the second floor of the City Hall building. If you are staying at the Regent Hotel in Kowloon, which I also recommend, take the Star Ferry over to the Hong Kong side. After disembarking, turn immediately left and walk about 100 yards to the first large building which is called City Hall. The dim sum is served from early morning until about 2.00 pm. Ordering from the passing trolleys is great fun and I challenge anyone to spend more than £5 for two people. Arrive early to avoid the queue and also because they start to run out of the most popular dishes after 1.00 pm.

On my last visit to Hong Kong in December, seminar supremo Irvine Laidlaw treated us to the kind of meal no tourist would discover on their own. It was at Lye Mun, a little fishing village on the edge of Kowloon. You can't drive into Lye Mun, so you park your car by some squatters' huts, walk over a few open sewers, along an earthen street through a corrugated iron settlement, until you suddenly arrive at a whole street of large glass tanks teeming with every conceivable fish from the area. If you have ever enjoyed an aquarium, Lye Mun is almost worth visiting for the sights. After selecting your fish you pop into the nearest restaurant and get them to prepare it to your

specification. My favourite is steamed with ginger and spring onion. On leaving the restaurant we passed a street vendor offering candied walnuts. When we declined an invitation to purchase after accepting a sample taste, he said without rancour, "OK,you no buy goodbye." In the heart of capitalism time wasters are hurried along to make way for the next consumer.

If you like to shop you will love Hong Kong. A short stroll along any of the side streets off Nathan Road, on Kowloon side, will soon unleash all of one's acquisitive instincts. Every specialist shop is bulging with the latest in cameras, watches, audio visual equipment, jewellery, ivory, objets d'art, clothes, etc. You name it – Hong Kong's got it, and all at the most competitive prices. Most of these shops are open until late in the evening seven days a week. Customers are seldom badgered as in third world countries, but show an interest in any item and you will receive tireless, efficient , informed and courteous assistance. I would rather shop in Hong Kong than anywhere else in the world.

I could probably fill several issues of FullerMoney with my favourable impressions and recommendations of things to do in Hong Kong. I have allowed this much space to whet the appetite of those readers who have yet to experience and enjoy one of the world's unique centres. It is not, I hasten to add, a nostalgic review of things destined to sink forever beneath the dull grey tide of communism. I have read every article that I could find on Hong Kong during the last three years, and the concensus view portrayed is filled with pessimism. Like all colonials the Chinese residents have little affection for their administrators, even though all of them have enjoyed political stability for many years during which a number have also prospered. They know that their success was due to their own entrepreneurial skill and plain hard work. They recognise that British rule consisted of masterly inactivity, presided over by civil servants, who while biding time until their retirement, were guided by a strong sense of ennui. Devoid of reforming zeal and with any social conscience left to the family, where it is most effective, the laissez-faire policy enabled the industrious Chinese to work economic miracles. These people now feel that an indifferent Britain has handed them over to the Communists without consultation. This is particularly galling for the older residents who had escaped communist rule, worked hard and successfully under British administration, but are denied access to the U.K. in their perceived time of need.

Hong Kong's commercial rivals have been quick to conclude that the colony is finished. Their views are coloured by the hope that competitive pressures will ease and that they stand to gain in direct proportion to Hong Kong's further problems. The British press has been pessimistic for different reasons since Hong Kong is the Empire's last significant outpost. If administrative benign neglect helped the Colony flourish, it is also a British success story. Only a wild-eyed idealist would forecast that Hong Kong's next twenty years will be better than the previous score. Many observers fear that any variation in Hong Kong's routine or regime will, as in ecological disasters, turn a once fertile land into a barren desert. They envisage a continued exodus of capital and talent, leading to a loss of business confidence, against a background of steady ideological and bureaucratic encroachment from Peking. Any assurances to the contrary emanating from the mainland are felt to be worth no more than the "special status" guarantees accorded Shanghai.

This last point is surely true. Communist China's rulers will not feel unduly constrained by any assurances offered in 1984. All parties to the present discussions will be long dead or in retirement by 1997, at which point Hong Kong's fate will be sealed by Peking's self-interest. The mistake is to assume that this has to be bad for Hong Kong's economic freedom or development. No one knows what type of regime will exist in Peking in 1997, although the present trend is towards a watered down version of communism that harbours a strong inclination to accommodate one billion peoples' capitalistic instincts.

When I went to mainland China last December, I was struck by the zeal for materialistic achievements, whether a new palatial hotel for visiting businessmen, private allotments beside the old commune fields, or the televisions proudly displayed in a show village. I did not quibble with my guide over the absence of any electricity, but when I questioned her on the timing of this change in attitudes and new taste for what would have been dismissed as bourgeois a dozen years ago, she showed a convenient loss of memory concerning recent Chinese history. The point is not that I was being conned, but that China's upheaval of just over a decade ago was an embarassment to be forgotten.

China will not sacrifice Hong Kong on any radical ideological altar because she does not need another Shanghai, but Hong Kong is a very useful export window. History shows that once the revolution has been secured and consolidated, economic considerations gain the ascendency, however slowly. Mao led the revolution, and as an old man, succumbed to the vanity of its revival. Those fervent red guards have no status in China today. Their time spent away from school or a trade has left them behind, the most backward members of a nation anxious to at last tap its development potential. It is highly probable that China will not be troubled by another retrograde ideological convulsion until anyone who remembers the red guards is long dead. The masses show much more enthusiasm for an increased standard of living than they ever did for Maoist slogans. The profit and loss column is studied with far greater interest than the little red book ever was.

It is hard to know whether China's tough talk of a few months ago, which sent shock waves through Hong Kong's financial markets, was shrewd negotiation or naivety. It no longer matters because Peking spokesmen will have learned the importance of a laissez-faire policy if Hong Kong is to remain a vibrant profit centre and China's gateway to the West. What we all know is that communism does not

produce many profits, but that does not mean that many communists are not interested in profits. Witness the Soviet Union's frequent forays into the commodity markets, for example. Deng Xiaoping knows that he can allow Hong Kong capitalist autonomy without "corrupting" one billion Chinese living in a totalitarian society. The two different societies need not mingle much more than they do at present. He and his successors can keep them separate while deciding whether or not to introduce further capitalist reforms on the mainland. The temptation to do so will be considerable. Deng Xiaoping knows that the legendary Chinese work ethic vanishes without personal incentive. He also sees the staggering economic success achieved by Chinese people throughout the capitalist countries in Asia. His and all of China's economic interests lie in promoting not smothering Hong Kong. Deng's colleagues are more interested in reforming China than Hong Kong. Witness Prime Minister Zhao Ziyang's recent statement that, "We must do away with egalitarianism in industry."

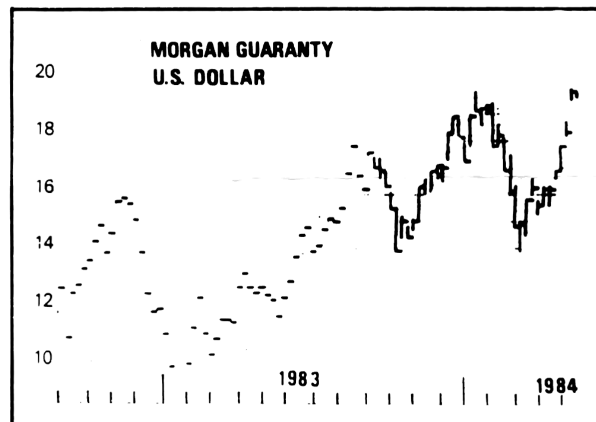
Finally there is the Taiwan factor. For historical and economic reasons all of China's rulers seek an eventual re-unification of Taiwan with the mainland. The importance of this goal will be more than enough to silence the radical communists who would be tempted to meddle in Hong Kong's way of life, because it could not be achieved unless China ceased to be a backward nation. Taiwan is probably militarily untouchable for at least a lifetime, by virtue of being over a hundred miles from the mainland and with a vastly superior navy and airforce. The tentative re-establishment of direct economic links between Taiwan and China will depend much on how Hong Kong fares over the next twenty years.

No one likes uncertainty, least of all the financial markets. Nevertheless, in free wheeling Hong Kong people have thrived on economic uncertainty and have never been able to look to the State for security. Those who can afford to will take sensible precautions by acquiring foreign passports and hedging their positions by moving capital or corporate bases out of Hong Kong, just as we in the West move capital at the first hint of a weakening currency, let alone exchange controls. The passport will buy peace of mind, which is essential for getting on with the business, while as Jardine has indicated, the overseas base will reassure non-Hong Kong business partners. Additionally, one of the most positive steps Hong Kong people could take during the remaining years of British administration is to encourage more westerners to live and operate businesses in the Colony. American financial concerns in particular have shown an increased interest in Hong Kong. They and others should be encouraged for what they can contribute to continued economic development, and they would leave the five and a half million Chinese residents feeling less isolated. I suspect the British will continue to turn administrative control over to the Hong Kong Chinese during the next thirteen years. That should make a contribution to increased confidence among locals and will avoid a power vacuum when London's civil servants leave.

I have presented the minority optimistic view about Hong Kong's future. It is no more than an opinion, but in an uncertain world, Hong Kong still provides an environment in which the entrepreneur can flourish. This will ensure that the flow of capital and talent will not be one way. For every successful businessman that leaves, another will emerge from the five and a half million population or be attracted from outside. Hong Kong works – that is its passport for the future.

An oscar for the dollar as the yen flunks its screen test

With a flair for the dramatic worthy of Hollywood, the dollar bull market is not dying gracefully. Pumped full of lead from the pencil of every economist (and many a chartist), it thrashes around the market, receives an interest rates transfusion, and rallies back for more punishment. Those of us tempted to forecast its decline should ask: can so many economists possibly be right? Far from hitting its panic point at Dm2.55 against the German mark, the dollar has rallied back to within spitting distance of its high. It has also moved fractionally above its January peak at +19.8% on its Morgan Guaranty Weighted Appreciation/ Depreciation Index, action not easily mistaken for a death rattle. Meanwhile everybody's favourite yen is suffering vertigo, because while it ran upwards, Japanese interest rates did not. Because the Yen was previously very strong against all currencies the Japanese have little incentive to match recent interest rate increases; therefore, the Yen is likely to retrace more of this year's gains over the short term.



The dollar is a tough call. The churning chart action is a warning sign to bulls, but the M G Index is a long way from the +14% floor that must be penetrated to confirm a bear trend. An old high is a psychological resistance point and the chart shows that moves to new high ground have not been maintained over the last two years. The Index looks overextended and further resistance is likely to be encountered near the January high. A bull technical case would not be re-confirmed unless a platform to launch a further rise is established

above +20%. Conversely, another rollover top formation is necessary before a test of the +14% floor can be anticipated. I would do nothing in the currency markets until the chart outlook is clearer.

As to fundamentals, strong U.S. corporate borrowing should continue well beyond a peak in the economy. Together with new Treasury borrowing, this will keep interest rates high. In the absence of a weak economy, the Federal Reserve has little reason to reflate unless another 1982 Mexican style debt bail-out becomes necessary. I believe this will happen at some stage because the worst part of the debt crisis lies ahead of us. European governments will get little response from the U.S. to cries for a lower deficit. These exhortations are seen as partly political since the deficit played an instrumental part in Europe's recovery to date. The U.S.A./European interest rate differential would be narrower if Reagan dropped the tax deduction on personal overdrafts, but this would never happen before an election. A word of caution for dollar bulls – if Europeans wanted to reverse the slide in their currencies, they could do it at a stroke with an EEC interest equalization tax. Getting Europe to agree on any joint action is a tall order, and I would oppose such a move which would be an infringement on investment freedom, but the tax would halt Europe's funding of the U.S. deficit overnight.

Gold tarnished by dollar strength

I'm feeling uneasy over gold because rising interest rates are not only delaying a recovery in precious metals, they could easily produce another sell-off. This year's lowest spot gold fixing at $363 in London has held so far, with the help of Middle East unrest and bank jitters, but that may not last. Gold bulls should hold no more than a 10% hedge position, while interest rates continue to rise. Gold shares now look shaky after a big rise. Traders should take profits but look to buy back if prices return to the 1983 lows. Gold shares always bounce back because there aren't very many of them relative to the potential investment demand. I have it on good advice that the capitalization of British Petroleum, for example, is greater than the entire South African gold sector. Speculators may even short precious metal futures on rallies, but this is risky since rising interest rates contribute to global instability which should cause other investments, like stocks, to fall faster than bullion.

The KGB's crossed line

London's crossed telephone lines are legendary, but I was astonished to dial in on a KGB conversation. Fortunately I tape all my calls, so I can share the experience with you.

"Good news, Comrade, we finally got a computer."

"What kind?"

"A Sinclair ZX81."

"Isn't that an English computer?"

"Yes."

"How did we get it out?"

"Simple – we just poured vinegar on it, wrapped it in a Financial Times and carried it out right under their noses?"

"Cunning!"

"Listen, don't you think some of the stories we have put out recently are a bit far fetched?"

"You mean the one about Reagan being an actor?"

"Yes."

"I agree, we don't tell them the way we used to, but at least it's better than the truth."

"Right, as Comrade Shakespearsky said: 'Oh what a tangled web we weave when we say what we believe.' Profound isn't it?"

"He had a way with words."

"The trouble with telling the truth is that you can never remember what you said."

"Too right, stick to the party line and you never have to worry."

"You can bet your life on it."

"Don't say that!"

"Sorry, it was just a figure of speech."

"Our propaganda is good enough under the circumstances. I mean the CIA are just as bad with that one about us selling mustard gas to the Iraqis."

"Yeah, we haven't had mustard since it was selected for a five year plan."

"What kind of gas did we sell to Iraq?"

"Nerve, of course."

"Where do we get the nerves?"

"No problem, they come in bulk from the psychiatric hospitals."

"What about quality control?"

"Listen, in that quantity you have to expect some of the nerves to be frayed."

"Nobody's perfect."

"Not after the psychiatric boys get them."

"Speaking of nerves, how is nail production?"

"Hanging in there, but we still get only twenty per person unless genetic engineering can produce more limbs."

"Isn't science wonderful."

"Say, where is Comrade Chernenko these days?"

"I'm told he is in Afghanistan."

"Isn't that dangerous?"

"No, he's supposed to be opening a school."

"Do you believe that?"

"Yes, its an institute of mines."

"Fossil fuels or minerals?"

"Land – we got the idea from the CIA after reading about something called project NIG NIM in the April issue of a London investment letter smuggled in by our boys."

"Sinister, the CIA will stop at nothing."

"You knew they were ruthless when they kidnapped all our top ballet dancers."

"Yeah, just imagine what could have happened in Los Angeles."

Stealthfully yours,
David Fuller