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Searching for future trends

'86 forecasts – can so many pros be right?

Every December the press like to corral a lot of financial boffins and record their forecasts for the new year. This exercise is worthy of your sceptical attention because there is nothing like a market trend to shape peoples' views of fundamentals. A consensus view is often a useful contrary indicator because it tells us more about what investors have already done, and what they subsequently hope will happen, than of what the future holds.

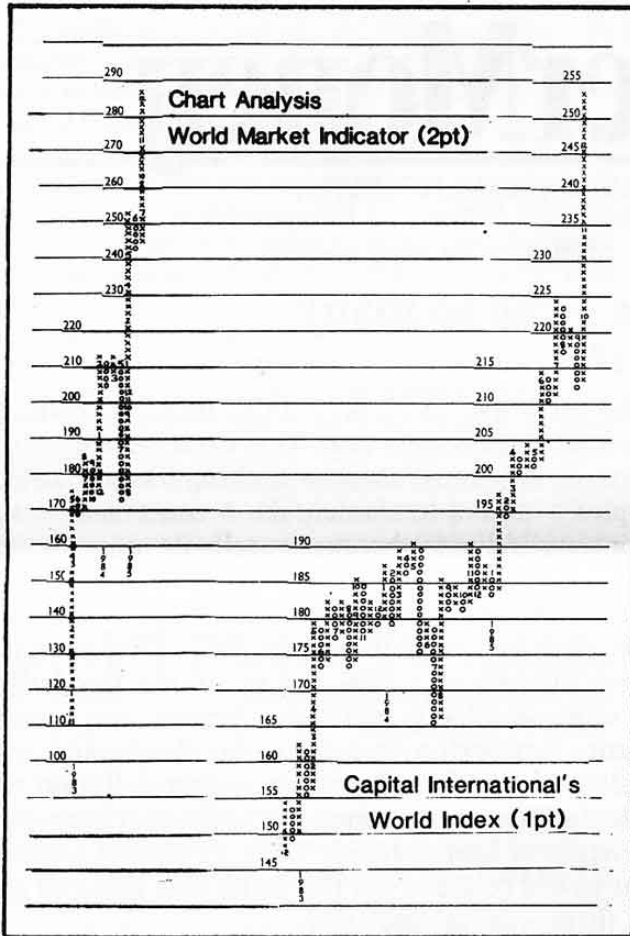
Remember the end-'84 predictions for '85? Despite the occasional aggressive forecast of a 10% rise or so, the few bulls among the herd were decidedly cautious. Among the more expansive participants retribution was a popular theme and we were warned of a slide into global depression, either deflation or the return of double digit inflation, a property collapse, cheap old masters and no shortage of bear markets. Oh ... I almost forgot: the banking system would collapse but the dollar was going to go up forever because there was no substitute.

Reading between the lines there had to be a lot of cash in dollar deposit accounts or their close equivalent. That money has helped to fuel the booming USA bond market and placed every stock market in orbit except for Singapore. The bears weren't totally wrong as soft commodities fell until June and base metals until the autumn. Nevertheless the widespread caution and outright bearishness of many end-'84 predictions proved to be an effective contrary indicator for '85. Fearing the worst I approached newspapers over the Christmas and New Year holidays with fear and trepidation.

As you would expect bulls were everywhere, big ones, small ones, pensionable bulls, fund manager types and broking bulls, but no one was more bullish than the economists. Can so many pros be right?

Yes they can, but probably only for the short term. Booming markets eventually absorb ready cash, discount favourable prospects and propel prices to levels that cannot be sustained when buying is replaced by profit taking. The unweighted Chart Analysis World Market Indicator is still rising at a steady rate, which means that stock markets are not overheated on a global basis ... yet. However, if or when this indicator accelerates like the Capital International World Index, which has a USA weighting of approximately 50%, a significant correction in global equities will follow. The markets that have risen the most should also experience the sharpest corrections.

The long term charts in our popular publication, INTERNATIONAL, show that every stock market enjoyed a bull trend in '83. Most entered '84 with an upward acceleration that proved to be



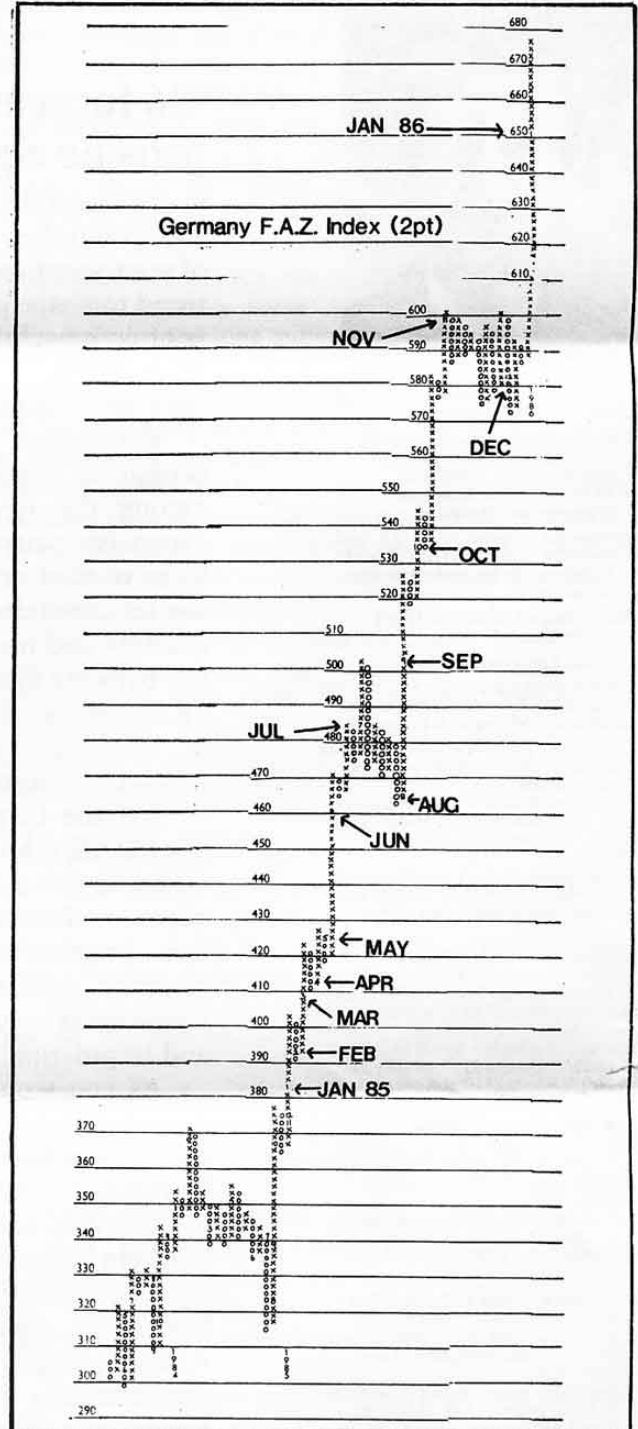
short lived. The corrections that followed were substantial for many bourses, lasted until August '84, and markets spent the remainder of the year clawing their way back to the highs. Statistically '84 was a non-event with most markets showing little percentage change. For investors the year was trying as many were forced out at losses in what felt like a bear market, and they were slow to return when prices rallied sharply in August '84.

European stock markets – Viewed in perspective, '83's gains were consolidated in '84, and that year's large trading range supported 85's strong advance. As to the future, '86 may start like a lion, but many bourses, and especially those of continental Europe, are becoming susceptible to the biggest shake-out since '84.

Most markets experienced a hiccup last summer (forecast in FM14) but that was minor relative to the overall gains. High flyers such as Belgium, France, Germany, Holland, Italy and Switzerland will be the most vulnerable. Investors should defer new purchases in those markets, protect current holdings with mid-point danger line (MDL) stops, or use trailing stops for shares that have accelerated above MDL congestion area points. I expect a shake-out within the next few weeks.

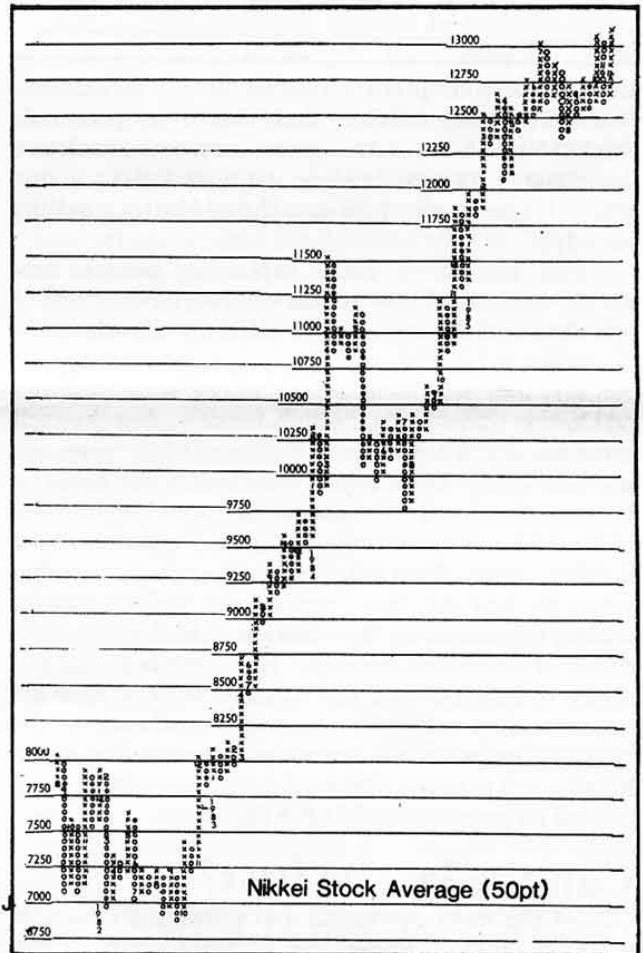
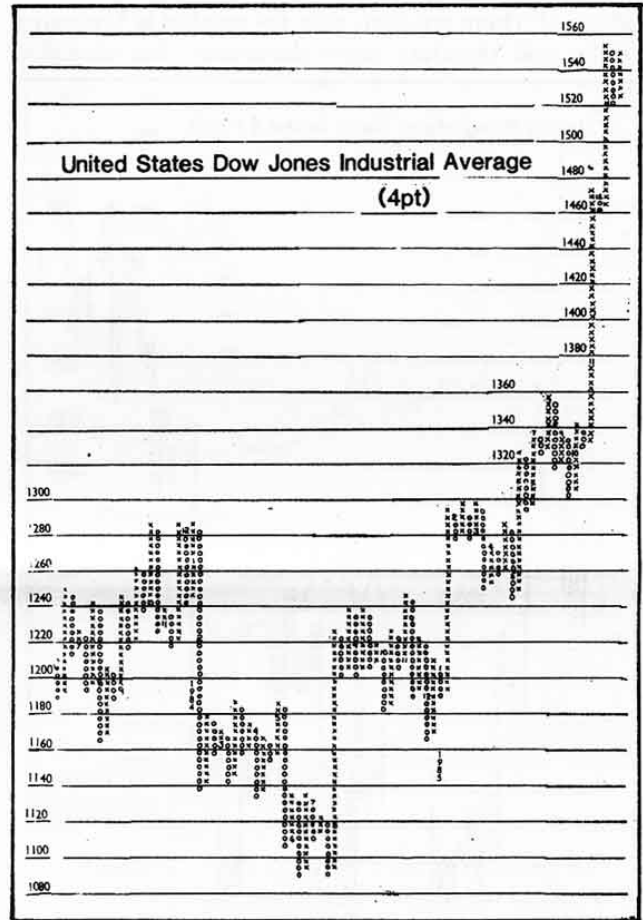
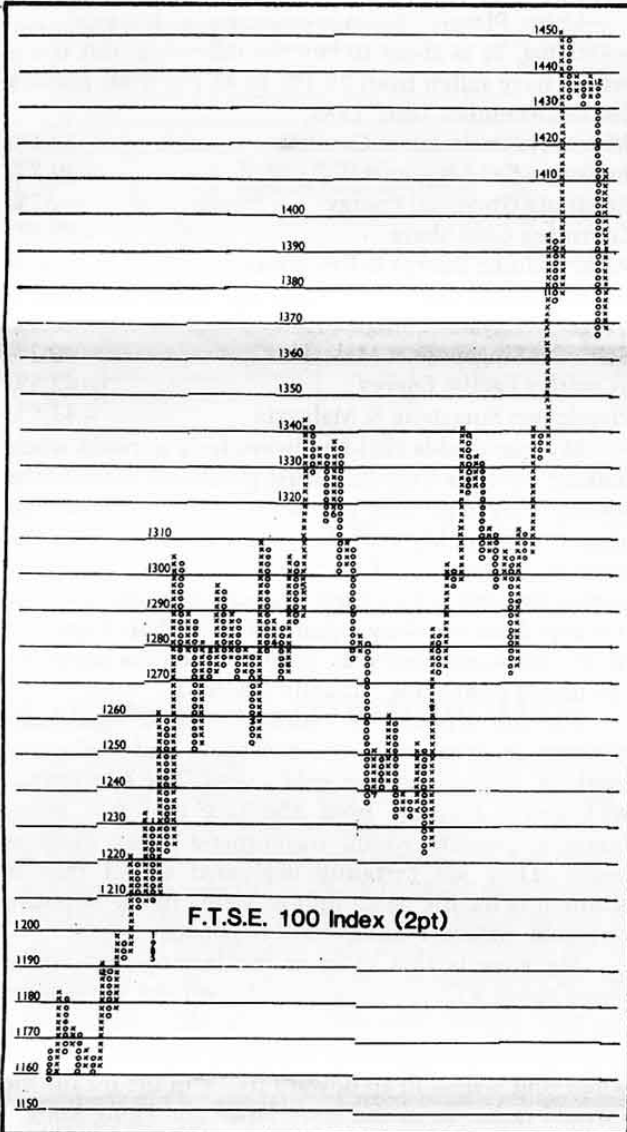
Study the chart of Germany's FAZ Index depicting the advance since mid-'83. I have marked the month to month moves from Jan '85 to Jan '86. Note how the May acceleration preceded the July correction and the October surge was followed by November's consolida-

tion beneath the roundphobia point at 600. The present acceleration could easily carry above 700, but the further it goes beyond that point the more severe the next correction will be. In any event, I expect a bigger shake-out than the 30 to 40 point reactions that punctuated '85's advance.



USA, Japan and UK – The big three capitalization markets – USA, Japan and UK are probably less vulnerable than the European markets mentioned above because their '85 gains were modest by comparison. Wall Street has accelerated but there is more than enough underlying support evident below DJIA 1300 to sustain further and substantial gains in

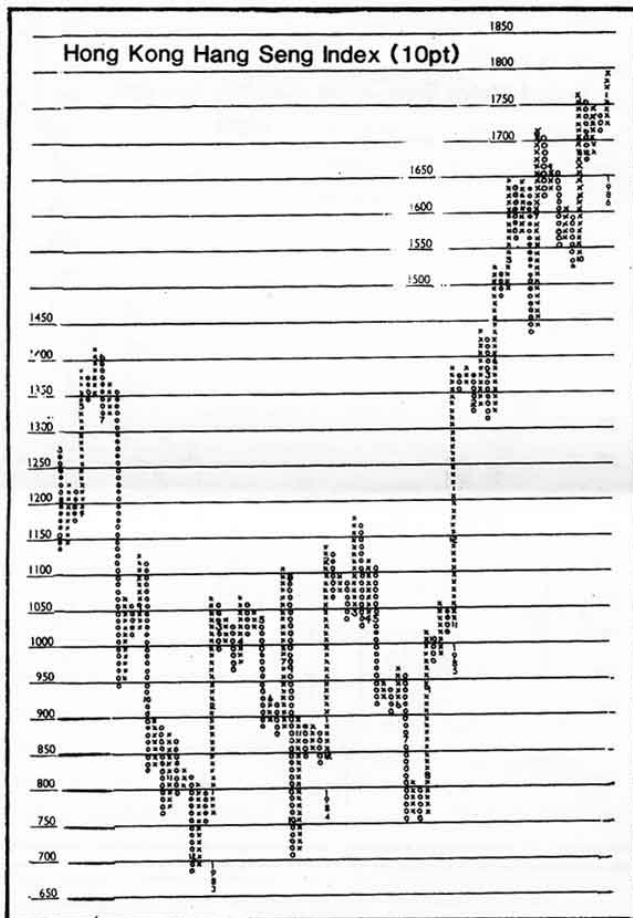
'86. Similarly, support below FTSE 1340 should propel the UK market higher, although further weakness in gilts could rein in equity potential. Tokyo saw most of its '85 gains during the first quarter and the Nikkei Stock Average has yet to break decisively above 13,000. A move to 13,500, which remains likely, would confirm further upward potential.



Hong Kong set to vault above '81 peak at 1810 – A rising consolidation pattern such as Hong Kong's, centred on 1600, can spell danger, especially if there is little follow-through after a new high is reached. I'm not too worried because the Hang Seng Index hasn't fulfilled all the potential from its big base formation evident below 1170. Provided there is no MDL violation at 1600, this pattern should support a surge towards 2000.

Stock market futures – My four point trailing stop on the Dec S & P 500 contract, recommended at 187.40 (FM18) kept you in all the way to 210.94 on Dec 20th, the expiration date. The only immediate question facing Wall Street's bull market is: will the market surge upwards from current levels or will we see a more extensive reaction and consolidation before the next

advance? There are signs that the market is becoming frothy and therefore more dangerous. For example,



there is the widespread optimism already mentioned; bonds are rapidly fulfilling their short term potential; the KC Value Line contract, with its more speculative components, is now leading the S & P 500, a role reversal from two months ago; the odd lotter is selling heavily.

This last factor needs explaining because few people understand how to use odd lot (transactions of less than 100 shares) data. We all know that the little guy sells into rallies, so analysts conclude that he is a contrary indicator. What they overlook is the fact that odd lotters have been net sellers for years, but they sell more heavily at tops than at bottoms. Many years ago the odd lotter would reliably become a net buyer at bottoms, but a bullish reading today would be net sales of less than 200,000, which can't be explained by a holiday period. That last occurred in early October when we had the most persistently bullish odd lot reading since summer '84 when the DJIA dipped briefly below 1100. Bearish readings – persistent net selling in excess of 300,000 – are less accurate because they are more frequent and often occur well in advance of the peak. Nevertheless odd lotters have never failed to sell heavily near peaks. (Net odd lot transactions are plotted on page 2 of INTERNATIONAL.)

Can the last be first?

One of the most successful and refreshingly humble investors that I know has a remarkably simple

investment strategy that has produced profits in excess of 50% per annum. He always has ten positions, trades only once a year, in January, when the entire portfolio is usually turned over. He does not believe that there are inferior fund managers, but is convinced that all markets are cyclical. Therefore, his new January purchases are the ten poorest performing unit trusts from the previous year.

Using Planned Savings magazine as his statistical watchdog, he is about to buy the following unit trusts which have fallen from 29.1% to 43.7% from January 1st to December 16th, 1985.

M & G Australasian & General	-29.1%
Britannia Gold & General	-29.7%
Britannia Universal Energy	-32%
Gartmore Gold Share	-35.5%
Aitken Hume Energy & Resources	-36%
Schroder Gold	-37.3%
Target Malaysia & Singapore	-40.1%
Schroder Singapore & Malaysia	-40.2%
Waverley Pacific Energy	-42.5%
Henderson Singapore & Malaysia	-43.7%

My friend adds that he always feels nervous when making his New Year unit trust purchases because the sectors they represent are always out of favour and appear to be highly speculative. He is consoled by the knowledge that capital appreciation is best achieved by buying low and selling high, and adds that the worst he has ever done is to buy a year too early. This happened in '85, his worst ever year, during which the portfolio, calculated in sterling, actually declined.

For the strategy to work in '86, a significant recovery is required in the Singapore and Malaysian markets, plus energy and gold shares. The contrarians will derive comfort from the fact that not many financial pundits would recommend those markets today. They are certainly depressed so all that is required is for the pendulum to swing in the opposite direction. Stranger things have happened.

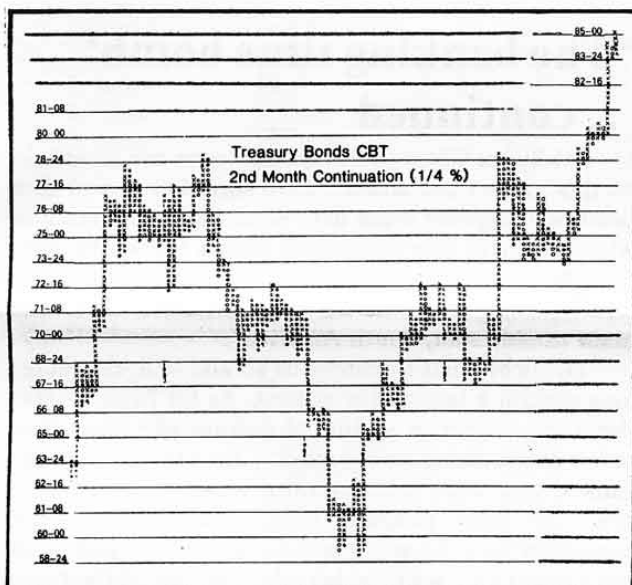
My view is that most of the lagging unit trusts listed above will continue to underperform for at least the first quarter. However they should improve once the high flying continental European markets peak and when gold is next in an upward trend. In the meantime I would rather be in the USA, Japan and Hong Kong.

USA bonds – another pause then further gains

Treasury Bond futures rallied throughout December and now look slightly overextended. A short term overbought condition exists which should lead to a pause and consolidation of recent gains before the upward trend carries much further.

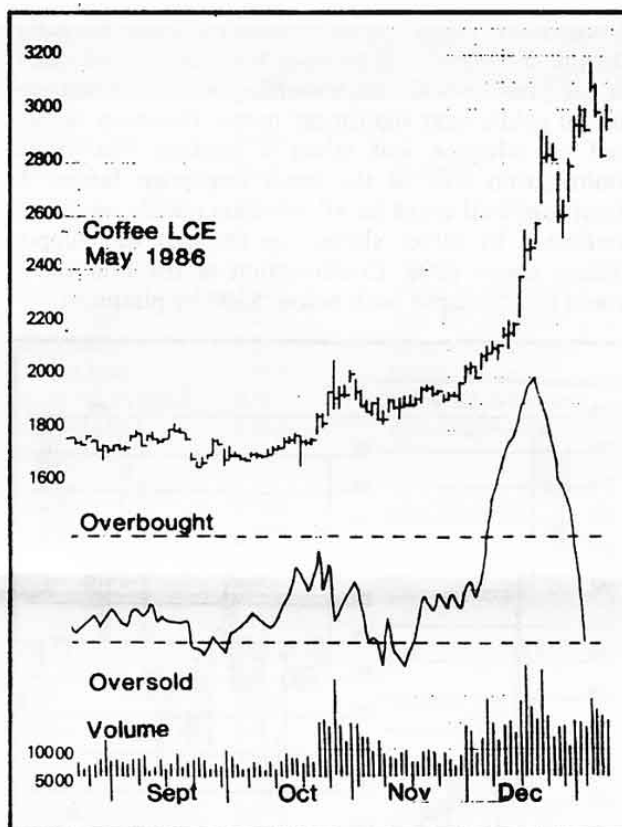
Some analysts believe that the bull market in Bonds is ending, but that view is not borne out by the charts. I have illustrated my case with the 2nd month continuation chart because it shows sufficient back history to include the '82/'83 peaks near 79-00.

Treasury Bonds did not regain that level until June '85, and it wasn't cleared until November. The June to November '85 trading range appears sufficient to support further gains once a small correction and consolidation has occurred, and further support is evident below 72-16. Additionally, the decisive break above the '82/83 peaks reconfirmed what looks like a long-term bull market.



Coffee leads commodities

Agricultural commodities continue to bottom out and develop base formations, and coffee prices rocketed in mid-December, boosted by drought problems in Brazil. A 50% gain in one month will obviously produce sharp reactions and the price is likely to churn near the £3000 roundophobia point. However, dwindling supplies, the possibility of permanent root damage due to the dry conditions, plus the frost season commencing in May, should keep coffee's bull market percolating for a while longer. That large base formation can support further gains in coming weeks, but given volatility, coffee trading is not for the faint-hearted. (Chart reduced from COMMODITIES.)

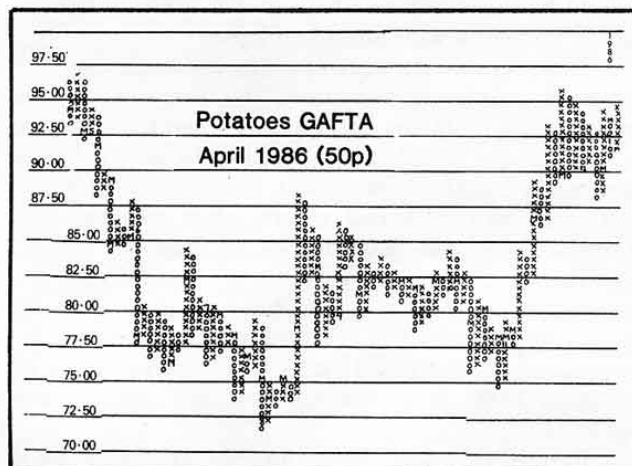


Potatoes – It's usually feast or famine for UK potato farmers as this small local market has provided plenty of action in recent years. The chart shows a rambling base formation centred on £80 that formed between June and November. The subsequent upward break was maintained and November's gains have now been consolidated. When buying potato futures one is betting that bad weather will continue (always more than a chance in Britain), but this chart can support a significant advance. Speculators should buy the April contract and protect this position with an eight pound trailing stop.

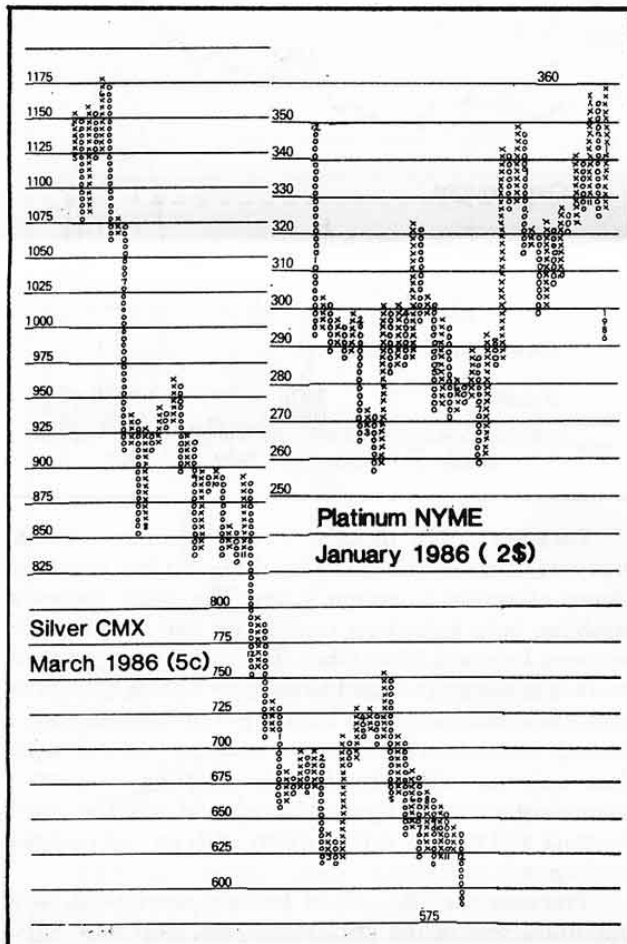
Precious metals – Gold bullion survived a very important test of the critical support level near \$310 when the price dipped to \$313 in early December. The bear's failure to force a decisive downward break will now encourage the bulls to have a go and gold appears capable of testing the August high of \$342.5, at least. Looking further ahead, the overall chart pattern (not shown) continues to resemble a developing base formation prior to an eventual recovery. It would require a decisive break below \$310 to alter this outlook.

While gold and most other commodities appear to be in the early phases of a recovery following the long bear markets, it is important to remember at this stage of the upturn that there is many a broken promise before orderly staircase upward trends become the norm. There are fewer participants at the beginning of a recovery and they remain cautious. Consequently initial upward breaks occur at infrequent intervals and are often reversed.

Diverging trends appear in other precious metals with platinum showing a gradual upward bias but



silver broke down to new contract lows in early December. Watch these two metals because they should provide both the leadership for and confirmation of gold's next significant move. Platinum would lead an advance and silver a decline, but trend confirmation will be the most important factor. A significant bull trend for all precious metals would be confirmed by silver slicing up through the supply evident above 620¢. Confirmation of the bear trend would be a collapse back below \$300 by platinum.



Share portfolio review

December has been another good month for the FM portfolio enabling me to raise closing stops for most positions. Among the most recent recommendations (FM18) Atlantic Richfield has underperformed Wall Street due to the collapse in oil prices, but no damage has been done to the overall pattern which remains bullish for the intermediate term. General Mills has been the strongest of my USA shares (note prices have been adjusted in line with the distribution) and Colgate appears to be completing its consolidation prior to a further advance.

Kyocera's performance in a quiet Japanese market demonstrates the elastic band effect causing prices to snap back once an extended but orderly trend is broken. The three British shares should strengthen now that the volatile UK market has completed its downward

correction. Gold bullion survived another test of critical support near \$310 and any further strength should produce rapid gains in South African golds.

FMs will have noted that many other international shares experienced small corrections and consolidations during Nov/Dec. Patterns will remain bullish provided the lows of those two months are not penetrated.

"The banking time bomb" ... continued

FM Byron Gloor in Switzerland sent me an article on this subject and added: "I am sure that part of this bomb will explode some day. What I am wondering is whether it will drag down bank stocks the world over. Even Swiss banks which to my knowledge have very small exposure, in relation to silent reserves, to the main trouble spot, South America".

The debt crisis threatens us all and will, therefore, long remain a fascinating subject. As for bank shares, these are subject to whims of fashion like any other sector of the global equity market. Less than a year ago bank shares were still described as an "unacceptable risk" by most pundits. When that becomes the consensus view for any market or sector, the rest of us can assume that we have been handed one of the most reliable buy signals. Japanese bank stocks led a spectacular recovery that has yet to peak in Europe or North America.

The one certainty of fashion trends is that they eventually change. When bank shares are next out of fashion due to renewed concern over bad debts or whatever, the sector will suffer world-wide, as it did a few years ago. The more ropery banks will fall the most, but others will decline as investors fear a ripple effect of defaults or withdrawals, and because other shares will appear to be a safer buy or hold. Swiss banks have less exposure to South America, but have been substantial lenders to South Africa. No one can say today when bank shares will top out, but we should spot the danger signals on the charts.

The more absorbing question is: can the global banking system produce a default-defying Houdini escape with so many dud loan portfolios? Perhaps it would be more accurate to ask: can Western central banks prevent a wide-spread collapse?

I suspect that the answer is yes, although there are no quick, painless or easy cures. The situation contains many of the problems encountered when living beside a live volcano. People do so because the land is fertile and major eruptions infrequent. Similarly most banks currently provide a real return (after inflation and taxes) at little risk. More banks fail than ever before, but there are many more banks, so I doubt that the percentage of failures to the total number of banks accepting deposits has changed much. Additionally, depositors in most failed banks have been protected by mergers, FDIC insurance schemes and central bank bailouts.

Returning to the volcano analogy, the bad news is

FM Share Portfolio

	Market	Share	Price Then	Closing Stop (c/s)	Price Now	Strategy
FM7 SEPT 84	Holland	Nederlandsche Middenstandbank	FL149	FL190	FL239	raise c/s to FL210
FM8 OCT 84	S. Africa	Vaal Reefs	R173*	none as cushioned	R220	hedge by shorting
	S. Africa	Randfontein	R202.5*	with hedge	R248	Apr '86 COMEX
	S. Africa	Kloof	R17*	profits from	R23	futures if London
	S. Africa	President Brand	R51*	April '85 COMEX	R52.5	bullion closes
	S. Africa	Harmony	R26*	short (\$340.4 to \$312.5)	R33	below \$310 for two consecutive days.
	S. Africa	Unisel	R17.2*		R18.5	
FM10 JAN 85	U.S.A.	McDonald's	\$57 ⁷ / ₈	\$65	\$79 ⁷ / ₈	raise c/s to \$67
	Germany	Daimler-Benz	DM626	DM975	DM1246	raise c/s to DM1100
FM11 MAR 85	U.S.A.	Gillette	\$58	\$63	\$69 ⁵ / ₈	raise c/s to \$65
FM12 APR 85	Hong Kong	Cheung Kong	HK\$15	HK\$17.9	HK\$21.4	raise c/s to HK\$18
FM18 OCT 85	U.S.A.	Atlantic Richfield	\$64 ¹ / ₄ *	\$59	\$63 ⁵ / ₈	hold/unchanged
	U.S.A.	Colgate Palmolive	\$29 ¹ / ₂ *	\$26 ¹ / ₂	\$31 ⁷ / ₈	raise c/s to \$27
	U.S.A.	General Mills	\$53 ¹ / ₈ *†	\$49 ¹ / ₂	\$60 ⁵ / ₈	raise c/s to \$53
	Japan	Fuji Photofilm	Y2015*	Y1930	Y2030	hold/unchanged
	Japan	Kyocera	Y3835*	Y3250	Y4590	raise c/s to Y3500
	Japan	Shiseido	Y1220*	Y1160	Y1440	raise c/s to Y1200
	U.K.	Marks & Spencer	167.5p*	165p	176p	hold/unchanged
	U.K.	Mowlem	312p	270p	322p	hold/unchanged
	U.K.	Redland	345.5p*	300p	340p	hold/unchanged

*Average price – SA golds includes FM16 purchases. † adjusted for distribution.

that none of us can move far enough away to avoid the consequences of a major eruption. If the global banking system blows its top like Mount St. Helens, or starts a financial mud slide reminiscent of the recent Colombian disaster, the effects would be so wide-spread that no amount of foresight or damage preventative measures would enable us to escape unscathed. The good news is that every financial seismograph is monitoring the LDCs and all other suspect borrowers. Without wishing to sound flippant, let alone complacent, I wonder if a collapse of the banking system has been too widely forecast to ever happen. Unlike the volcano which cannot be controlled, debtor nations and central banks can combine efforts to stave off disaster if the will to do so remains.

The biggest danger is of a political default by a populist government in a Latin American country, or a retaliatory default by South Africa due to political/economic pressure. The West could not prevent the former and it could only force the latter political default. The formal default on \$30 billion or more of debts would not necessarily break the banking system on its own, particularly if it had been anticipated, but it could trigger a sequence of copy cat defaults with consequences that could not be contained.

The next greatest threats to the banking system are a slide back into global recession, which would cause demand for debtor nation produce to plummet, or an

upward spiral in interest rates which would make even the payment of interest on LDC debts impossible. The West will try hard to prevent a slide back into recession and is succeeding at present. The global banking system needs time to absorb bad loans, perhaps decades, in an environment of comparatively low inflation and real economic growth. In present conditions there is an element of political control over interest rates and today's main bull market story is the US Federal Reserve's determination to get rates lower.

USA bank failures due to bad domestic loans receive a lot of publicity but should remain on a small enough scale to prevent a general loss of confidence and wide-spread run on deposits. My guess is that the global banking system will survive the next twelve months, at least, and probably look healthier at the end of '86, just as everything now looks much better than a year ago. I also think there is an even money chance that a banking disaster will be avoided this decade, but there is obviously no quick cure to the financial AIDS infecting banks. As a sensible precaution, none of us should have any deposits that are not fully covered by government guaranteed insurance schemes.

Why bank loan departments will always get in trouble – Do banks chase lending trends or do punters swarm on to easy money? The answer is that both occur simultaneously and often with disastrous consequences. Look at the evidence: banks funded the

1929 stock market bubble and more recently, the property and real estate boom of the mid-'70s that ended in collapse, the oil and gas speculation that is causing many of today's domestic banking crises in the USA, the potentially disastrous LDC loans that were rationalised on the "countries don't go bust old boy" basis, loans to the International Tin Council which is now in default and today's mania for leveraged buy-outs, guaranteed to exacerbate the next bear market.

Despite this appalling track record I doubt that bank loan officers are more irresponsible than anyone else. A problem of the last decade is that banks have received more depositors' money than it is possible to lend prudently. Knowing this, they search for "safe" borrowers and unwittingly underwrite the next great speculation. Each of the problem loan areas listed above was initially a sound commercial risk; however, as more and more banks rushed to jump onto the new and fashionable lending bandwagon, loan officers became less and less discerning. Their lack of prudence helped to attract a rush of new and less sophisticated opportunists lured by the promise of easy money and the prospect of quick profits. When the speculative bubble bursts the inevitable defaults follow.

LDCs don't contemplate paying back the loans – During a recent trip to a resources rich LDC that Western banks would still regard as a good prospect, I was enlightened by a senior banker from that country. He explained that local borrowers paid 13% for dollar loans which were then hedged against currency depreciation at another 5% per annum. I asked if there were many industries that could borrow at 18% and still make money. "Oh yes", he replied... "but we have trouble with the American banks". When I asked why, he said with no trace of irony: "Because they want the expiring loans to be repaid."

LDCs regard Western capital as an entitlement. This is because the money was borrowed so easily, in amounts so large, that the numbers no longer have any meaning locally. Common sense tells us that the LDCs can never repay the loans which the third world regards as school fees gladly provided. The West can go on rescheduling the debt and provide sufficient fresh capital so that the borrowers don't have to pay interest out of earnings, but in reality this money ceased to be a loan long ago. It would be much more realistic to regard LDC debt as a "commission" paid by the West in exchange for export orders. If banks are unable to write off the bad loans, the lending countries' corporate and individual tax payers will ultimately foot the bill.

The International Tin Council default – The ITC is too big a committee to agree on anything, let alone the repayment of hundreds of millions of pounds to LME members and their bankers. Most of the 22 member countries are consumers who feel that they have been unwitting if not totally unwilling participants in a debacle.

The producer countries largely responsible for the overly ambitious support programme funded it on borrowed money, refuse to take the rap because everyone else didn't consume enough tin, and regard

the poor old LME as more expendable than their mining industry. What is a few hundred million of someone else's money compared to the social and political consequences of more unemployment in their own countries?

Any producer sympathy for the LME was lost last June when the ITC buffer stock manager was prevented from executing the classic squeeze on hedge and speculative short positions. This was regarded by producers as interference with the free market and undoubtedly denied them speculative profits. The LME regarded the squeeze as a violation of the spirit of the market which was created primarily to provide a hedging facility for both producers and consumers.

I see no happy solution to the ITC default conundrum and fear that the Bank of England will have to cobble together some form of rescue funded ultimately by the long suffering British tax payer. A better solution, if you are not a banker, would be for the LME members' creditors to take delivery of the tin, while announcing to the world that they were burying it indefinitely. At least the ITC's debts have asset backing, albeit trading at prices well below the purchase price on secondary markets. At some distant future date there is bound to be another tin shortage, but today's stockpile meets the most cynical definition of a long term investment.

Meanwhile, thank heaven for charts. No technician would have been long tin and FM17's comment late last September as the price plunged through its three month floor at £9050, one month before suspension at £8360, was: "I would guess that the tin buffer stock manager could use another loan."

Stop press

USA bonds and equities have now peaked and it should take several weeks, perhaps months, before the highs are cleared. European markets are exceptionally vulnerable to a shake-out.

Gold is challenging overhead resistance but **silver** has yet to confirm upward potential for precious metals.

The dollar has fulfilled most of its short-term downward potential.

The photo competition (FM19) winning answer was Belgium shepherd.

The Chart Seminar '86 opens in Dubai on Jan 27, followed by Bahrain, Kuwait, Istanbul, Sydney, Melbourne, Auckland, Jakarta, Singapore, Kuala Lumpur, Hong Kong, London, Copenhagen, Frankfurt, Zurich, Milan, Paris, Brussels, and Amsterdam on June 30 and July 1.

A number of institutions have requested private chart seminars. I have no spare time before July; suggest you attend the venues above unless at least 20 people were involved. All enquiries should go to my PA, Karen Warrington – tel: 01-439 4961 – telex: 26581 MONREG G MNU131.

This issue was delayed over holidays but FM21 to follow before end Jan as there is much to write about.

Best regards
David Fuller