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

The Japanese yen is weakening once again and should fall a lot further in coming months.

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Further cuts in short-term rates remain possible. Among long-dated government bonds, only JGBs are performing (due to deflation and BoJ purchases) as North American, European and Antipodean issues have reflected inflation concerns.

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Japan's economic crisis and its resolution will continue to provide once in a generation opportunities for investors and speculators

The Triple Play revisited - An update of market opportunities created by Japan's worsening economic problems is warranted, given the increasingly public debate this situation has engendered and the arrival of reformist Prime Minister Junichiro Koizumi. My earlier analysis was first published on 16th March, included in FM202 and I discussed it on several of CNBC Europe's programmes. A central point was that many of the most advantageous market developments follow financial crises, which necessitate fundamental reform. Given that Japan is the world's second largest economy, with highly liquid markets, decades could pass before a similar situation pertaining to a single country arose. The Triple Play outlined three sequential strategies for investors and speculators - first in the yen, then the Nikkei and eventually Japanese Government Bonds (JGBs).

1. Short yen - This remains my favourite trade, as it has been for most of the last year, subject to market timing. It is increasingly clear that only a massive monetary reflation will enable Japan to pull out of its deflationary spiral. Unfortunately for Japan, BoJ Governor Masaru Hayami has procrastinated for years, allowing the yen to remain at a level that has compounded the country's economic problems. However Hayami is increasingly isolated and criticised by Government officials, with a bluntness that would raise eyebrows even in Western political circles. It will be interesting to see whether Koizumi squeezes Hayami out of the BoJ or keeps him as a scapegoat. Meanwhile, the central bank Governor has partially bowed to pressure by increasing purchases of JGBs to boost money supply. One consequence of Hayami's prevarication has been a slower decline by the yen to date, which is likely to result in a larger overall devaluation because Japan's economy is back in recession. I maintain that the yen will fall to at least ¥160 against the US dollar and we could easily see ¥150 versus the euro within eighteen months. While major moves seldom occur in straight lines, a consolation with short yen positions during volatile periods is that they provide interest rate differentials in excess of deposit accounts. My preferred strategy is to buy the dollar, euro or sterling against the yen on easing, lighten somewhat on rallies and protect core positions with trailing stops when gains are strong.

2. Long Nikkei - A weakening yen will eventually be bullish for Japanese stocks, boosting operating profits for exporters with a knock-on effect throughout the entire economy. Many Japanese stocks are cheap on a price to cash flow

basis due to the long bear market and restructuring. Japan is the only country actively targeting its stock market. It needs to ensure a floor near 13000 for the Nikkei 225 Stock Average to prevent commercial bank assets from falling below capital adequacy requirements. Meanwhile, Japan's banks will sell up to 15 trillion yen ($120 billion) of stocks to a government-backed fund. Koizumi will shortly announce various reforms, including tax incentives, to encourage individuals to invest more than they save. All of this will be bullish for Japanese equities over the longer term. However there is a considerable risk that other economic measures, including the writing off of bad loans and reduced fiscal spending, will make the economy even weaker before it recovers, as Koizumi himself has stated. This would not help corporate profits and Japan's stock market could undergo a lengthy base development before a significant recovery is seen. Suspecting that Japan is more tomorrow rather than today's opportunity, my current strategy is to gradually accumulate investment trusts (closed-end funds) on easing. I also purchase Nikkei futures on setbacks, for trading purposes.

3. Short JGBs - Japanese 10-year Government Bonds currently yield a meagre 1.175% - lowest in the world by far. However Japan's government debt has the worst credit rating among developed countries, having soared to a third-world 135% of GDP and still climbing. This paradox exists because as the only performing market in Japan over the last year, JGBs continue to attract domestic support. The BoJ is now the largest single buyer of Japanese government debt as part of its reflation effort. While Japan accounts for approximately 11% of global equity capitalisation, its equivalent figure for government debt is approaching 28% - more than any other country. When the Japanese economy eventually recovers interest rates will rise, unleashing a bear market in JGBs, which I suspect will be the biggest ever seen in terms of wealth destruction. However those who wait for the trend to reverse, and then short JGBs, would profit in proportion to the Japanese economy's rebound and the extent of inflation this produces. Meanwhile JGB yields are likely to fall even further and the eventual low could easily be a year or two away. My strategy is to wait until the charts provide a clear signal.

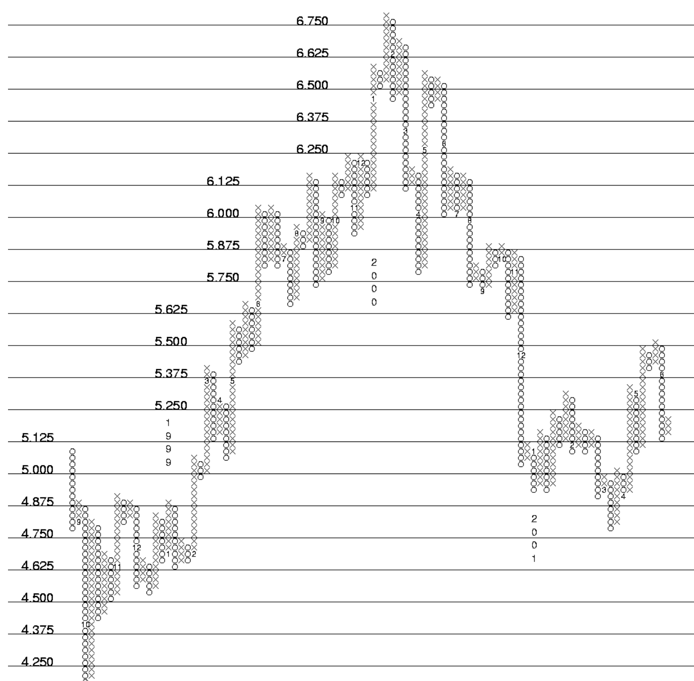
Interest Rates and Bonds

- **Further cuts in short-term rates remain possible.**

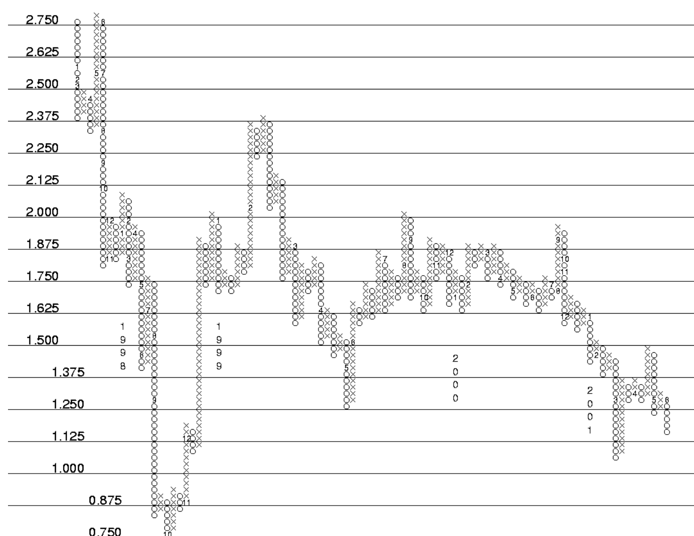
- **Among long-dated government bonds, only JGBs are performing as North American, European and Antipodean issues have reflected inflation concerns.**

Greenspan will err on the side of monetary easing. Arguably, the Fed erred in raising interest rates too high last year, after the NASDAQ bubble had burst and following a tripling of oil prices due to OPEC's production cuts. However the world can be grateful that Greenspan stopped tightening after hiking the Federal Funds Rate to 6.5% in May 2000, especially when many economists were calling for 8%. In deciding to lower the FFR by another 25 basis points at the FOMC meeting on 27th June, Greenspan was

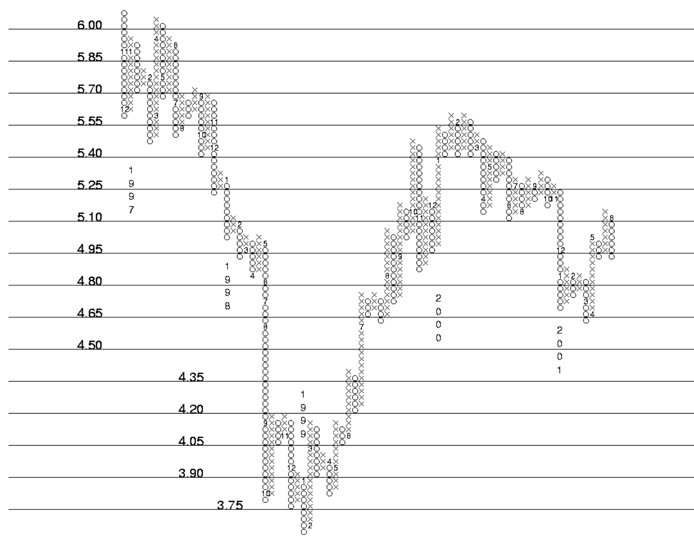
US 10 Year Bond Yield (0.025)



Japanese 10 Year Bond Yield (0.025)



Euro-Bund 10 Year Bond Yield (0.03)



overlooking recent signs of firming from Durable Goods Orders, New Home Sales and Consumer Confidence. The Fed Chairman certainly does not want to damage consumer confidence against the background of weak corporate profits, rising unemployment and the sharpest US economic slowdown for decades. Moreover, with the ECB way behind the curve of declining growth and Japan's economy slumping once again, only the US is capable of leading the world out of this slowdown, and a widespread improvement may not occur before next year.

Deflation and the BoJ's purchases are pushing JGB yields lower. Paradoxically, the world's least attractive bond market in term of supply and yield is the best performing. That is because even 1.175% is preferable to holders of yen than the all but nonexistent return in deposit accounts and Japan's ongoing deflation of 1% or more grosses up the yield. Moreover, the BoJ is a big buyer in its efforts to reflate, even though Hayami is dragging his feet. JGB yields should test 1%, at least. Yields in the other major government bond markets have eased a little recently, in line with weaker stock markets and also a technical reaction following their surge during April and May. The charts show potential overhead resistance. A further push into the 1999-2000 top areas would increase the inflation warning.

Strategy for bonds - From a conservative investment perspective, I'm staying with FM200's strategy, which favours shorter maturities, from 3-year government instruments to bills. Spreads between long-dated government and corporate bonds should narrow once again if the March to April lows for stock market indices hold. However I would continue to tread cautiously in this market, as there is still a possibility of some notable scares and/or defaults, which would temporarily weigh on better quality issues. I have no positions in bond futures at present and this is unlikely to change soon. I would certainly not short JGBs, as some strategists have advocated, while yields continue to move gradually lower and the fundamental changes that will eventually cause them to rise significantly could be many months away.

Global Stock Markets

- **Weak corporate profits versus interest rate cuts.**

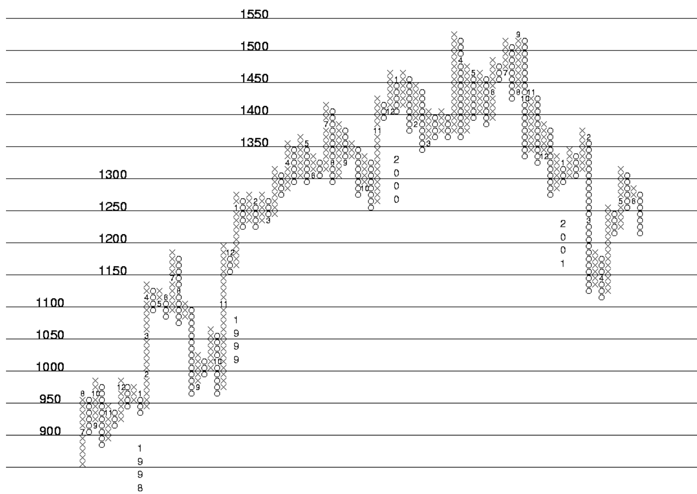
The fundamental background continues to weigh on sentiment. Since mid-2000 I have been warning that global GDP forecasts were too optimistic. A year or more ago most economists were overly influenced by previous US economic strength, technology-related productivity increases, low inflation and generally strong stock markets. The first problem surfaced during 1999 when petroleum prices tripled in response to the OPEC cartel's supply cuts. This tax on consumption and investment by oil producers could only slow global GDP growth and increase inflationary pressures. Meanwhile, Greenspan commenced tightening US monetary policy to rein in accelerating growth encouraged by the runaway NASDAQ. Europe also raised short-term interest rates, not

NYSE Cumulative Advance/Decline (Weekly)

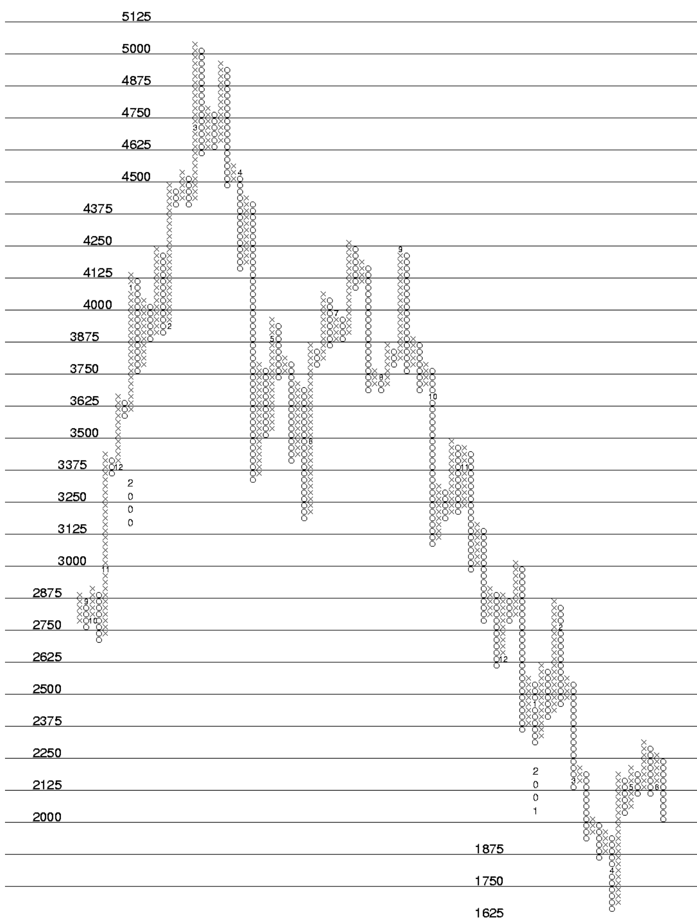
because growth was strong but to combat inflation caused by high prices for energy and the weak euro. The global TMT bubble burst in March 2000 while short-term rates continued to rise. With US economic growth slowing sharply in response to these developments, Greenspan commenced what has been an aggressive cycle of monetary easing, loping 275 basis points off the Federal Funds Rate between January and June 2001. Initially, this encouraged hopes of a V-shaped landing by the US economy. Euroland's officials hubristically and naively forecast that their region would be immune to the US slowdown. Consequently the ECB, with its strict mandate on inflation, fell behind the curve of events and has only cut rates by 25 basis points to date. This obviously hasn't helped but the global economy was never likely to respond vigorously as it had following reflations in response to stock market slumps in 1987 and 1998. We now know that corporations were the biggest gamblers in the global TMT bubble and there is no quick recovery from losses on ill-timed investments, debts, inventory overhang and falling demand. Petroleum prices remain uncomfortably high and this is a much greater problem when GDP growth is weak rather than strong. Asia, far from being the global economy's most dynamic region as in the 1980s, remains the biggest problem typified by Japan's slide back into deflationary recession. Disconcertingly for investors, the world's three big economic blocks are simultaneously weak for the first time in many years. Few market sectors are immune to the problem. Expectations for a rebound by corporate profits have been pushed into 2002.

Lower rates are usually bullish for stocks. Against the sobering background above, the good news (and it's significant) concerns short-term rates. Historically, rate cuts by the Federal Reserve have been very bullish for US equities. In 19 previous cycles of lower rates commencing in 1914 the DJIA showed a gain 12 months following the first cut on all but two occasions, both occurring during The Great Depression. Better still, after a third cut the Dow failed to show a gain a year later on only one occasion. However there is a risk that the current cycle of lower rates will disappoint due to concern over valuations and corporate profits. Just before the Fed's first cut on 3rd January the DJIA closed at 10646.15. To date it has mostly traded below this level and many other US equity indices have faired worse. I maintain that if the Dow is not higher by 2nd January 2002, then the global economy, not just the

S & P 500 Composite Index (10pt)



NASDAQ Composite Index (25pt)



US, will be in a mess. Since stock markets usually improve at least six months before their respective economies, the key question is have we passed the inflection point where investors are looking beyond the economic slowdown to the recovery that will eventually follow monetary easing? Technically, there are some encouraging signs such as a steady performance by cumulative advance/decline data, the April-May rally (now partially retraced) and generally low expectations for share performance. However support needs to be encountered near or above the March-April lows if current activity is to resemble base building activity prior to some additional strength. Even in this event I maintain that we could see years of ranging during which earlier excesses are corrected. This would create an overall market neutral environment, punctuated by rallies and sell offs in response to interest rate cycles. If so, index-tracker funds, recommended by so many financial advisors, would continue to disappoint but there would be increased scope for discretionary fund managers who were also market timers.

Chart review of topical and representative stock market indices - *The 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.fullermarkets.com or www.chartanalysts.com. Price levels mentioned refer to market closes.*

The US's Dow Jones Industrial Average (10410) - *not illustrated* - predictably encountered resistance from the upper side of its broad trading band extending back to April 1999. Having failed at the upper boundary, another rebound is necessary to offset some further test of the middle to lower side of this overall range extending down to the March 2001 low near 9400. **The Dow Jones Utilities Index** (349) - *not illustrated* - has often been a lead indicator for Wall Street and it has been declining towards the January and March lows evident between 340 and 350. A move to 368, clearing the last little rally high, is currently required to reaffirm support from these prior floors. **The S&P 500 Index** (1207) has been under performing the DJIA since September 2000 and the April-May rally was checked by the lower side of the large, rounding top area. A move to 1320 is required to reaffirm support from the March-April low and signal a further test of overhead supply. **The NASDAQ Composite Index** (2027) rally was checked by initial resistance at 2300. A move over this level is necessary to offset prospects for a potentially lengthy base extension, including a further test of the April trough.

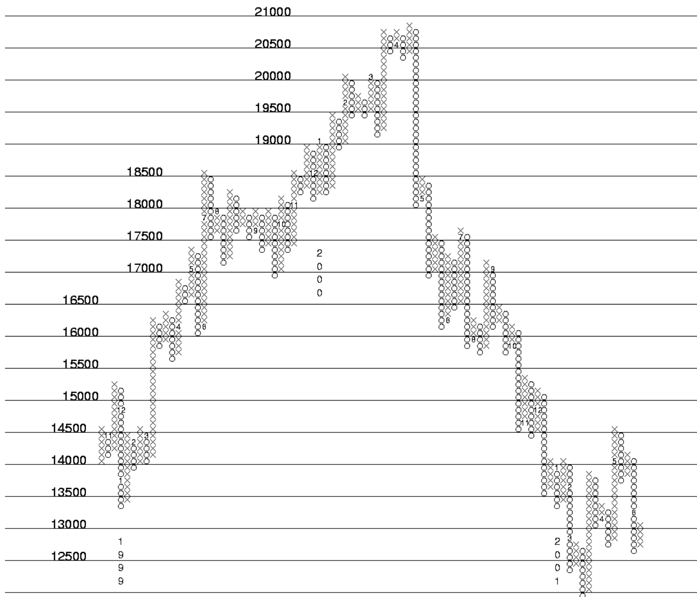
Japan's Nikkei 225 Stock Average (12978) has steadied above the March trough following an extensive pullback and a sharp rebound is required to question the current outlook for a lengthy phase of base extension.

Hong Kong's Hang Seng Index (12962) saw its rally checked by the underside of the large, rounding top area. A move to 13950 is now required to indicate a further test of overhead supply and reaffirm support from the April low.

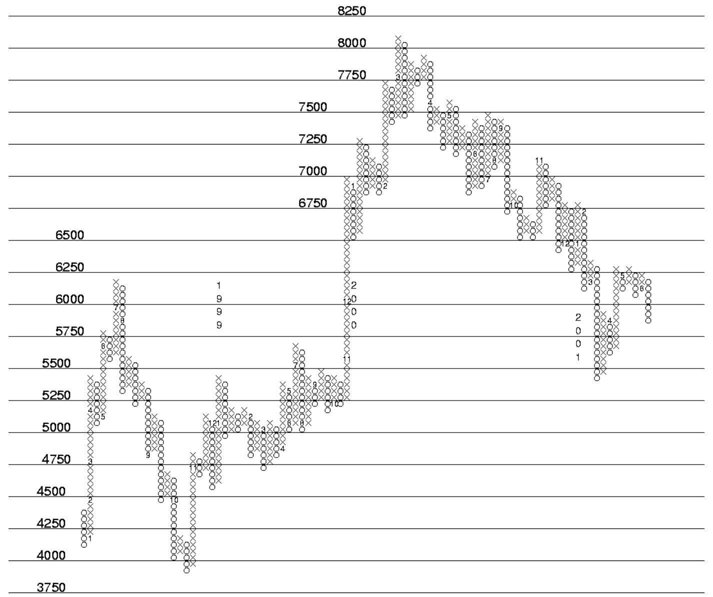
Australia's ASX All Ordinaries Index (3370) has paused following its push to a new all-time high in May. It has a long history of not maintaining upside breakouts but a move under 3300 remains necessary to offset higher scope and suggest another medium-term failure.

France's CAC 40 Index (5092) saw its rally checked by the overhanging top area and is testing its March trough. Another strong rebound is needed to reaffirm support from this region down to 4850.

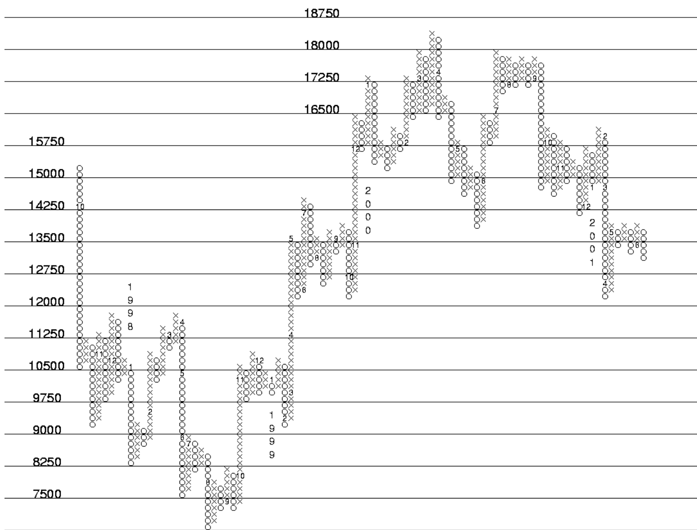
Nikkei 225 Stock Average Index (100pt)



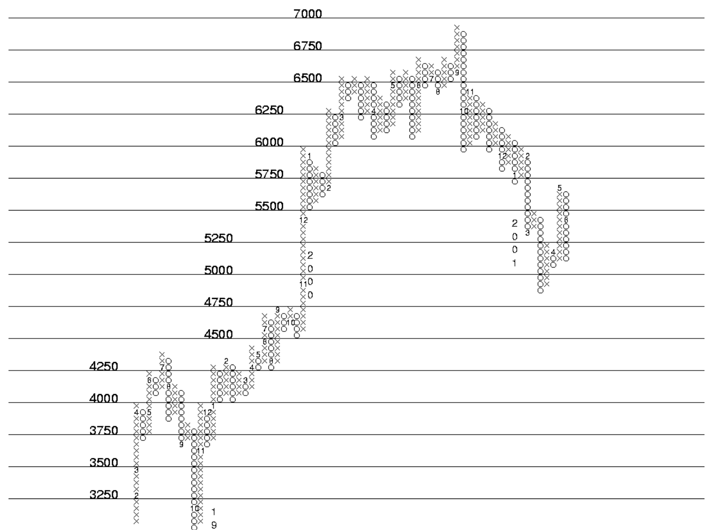
Germany DAX Index (50pt)



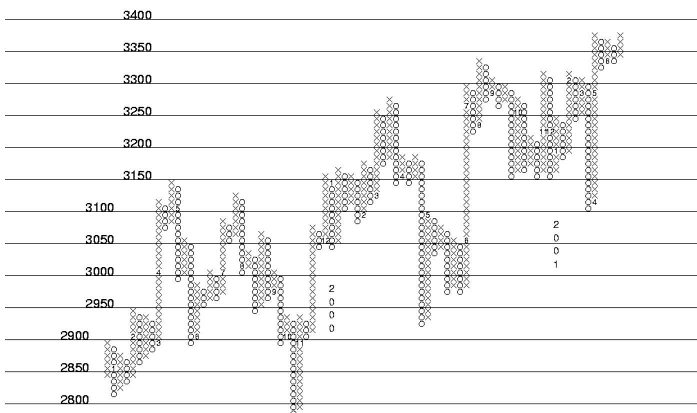
Hong Kong Hang Seng Index (150pt)



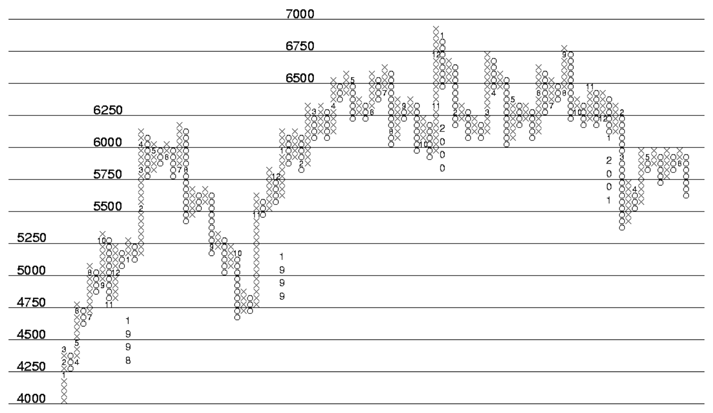
France CAC 40 Index (50pt)



Australia All Ordinaries Index (10pt)



United Kingdom FTSE 100 Share Index (50pt)



Germany's DAX Index (5786) is similarly testing its March trough down to 5400 and a move to 6300 is required to reaffirm this prior support and indicate a further test of overhead supply.

The UK's FTSE 100 Index (5569) has fallen back from lateral trading near 6000 once again and needs a push over this level to reaffirm support from the March low and suggest a test of broad band highs established over the last

three and a half years.

Strategy for stock markets - Charts of stock market indices are a concern because there is too much evidence of top formations and/or downtrends, and too little evidence of base formations. Technically, the most favourable development was the climactic looking downward acceleration in February and March, followed by rebounds to question some of the downtrends. However a number of indices have retraced most of those gains recently. Breaches of the March-April lows that persisted beyond the very short term would open the door to additional declines. Looking further ahead, I believe we are in a primarily ranging environment, not dissimilar to what some of us recall from the late 1960s into the early 1980s. Instead of big, all encompassing bull markets we had medium-term 'sweet spots' mainly due to rate-cutting cycles. These were followed by bearish phases, usually as rates rose. Some of the declines were severe - notably 1973/4. Currently, we are six months into a rate-reduction cycle and this favourable influence won't end until investors begin to discount the next round of tightening. However I believe there are too many uncertainties for this to be more than mildly bullish for the majority of stock markets. Therefore I am not now adding any further share recommendations, following last month's first toe in the water this year, confined to a few energy stocks and some Japanese shares supported by large bases. I still favour these sectors and stocks, and the energy issues are a better buy today having fallen to or beneath the lower side of my suggested ranges. Investors suspect that Bush's energy policies will be watered down in Congress. Sentiment has also been affected by lower prices for petroleum products recently, notably gasoline on increased supplies, waning demand and rumours that OPEC might increase production at its July meeting. Obviously oil-importing countries would welcome an increase in production quotas but this is very unlikely, given falling prices, as OPEC Secretary-General Ali Rodriguez has indicated recently. My hunch is that energy shares are experiencing no more than a short to medium-term correction in what will remain a firm sector overall, supported by multi-year bases on many of the charts and an oil price that OPEC will attempt to keep above $25 (NYME). If correct, the shares should rebound in the next few months. Among national markets, I maintain Japan is the most interesting due to its poor economic performance, which has created fundamental value and should be the catalyst for necessary reforms by Prime Minister Koizumi's Administration. Japan's Government has targeted the stock market, announcing funds to buy shares from the banks over the next few years. Meanwhile, it needs to keep the Nikkei from dipping below 13000 more than briefly, if lending institutions are to maintain capital adequacy requirements. Tax incentives are planned to entice private investors back into equities. The main risk for those of us investing in Japan is that economic problems could lead to a long period of base formation development near current levels. Therefore Japan should be viewed as a long-term play and I would hedge the currency risk. The London-quoted but dollar dominated Atlantis Japan Growth Fund, first mentioned in FM203 and where I have a small position, is becoming interesting once again. Recently trading just over $9 and with a discount to NAV of 16%, I regard AJG as a buy on easing. In futures, I recently established small long positions in the Nikkei and MIB30 but am only looking for a technical rally.

Currencies

■ **The yen has completed its medium-term contra-trend rally and the BoJ will have to flood the market with liquidity.**

■ **Will the US abandon its strong dollar policy or intervene to support the euro?**

■ **One-off cash transactions have weakened the euro but will support it as the new notes become available.**

The yen's bear market could run for years but it will be punctuated by several more ¥6 to ¥8 corrections against the dollar. Multi-year trends are produced by major changes in fundamental economic factors. For the yen, the most important of these is a chronic deflationary slump from which Japan cannot now escape without a massive reflation. In markets, the biggest moves occur following an overreaction of extreme proportions, which becomes the seedbed for fundamental change. The yen's move to ¥79.75 against the US dollar in 1995, partially in response to fashionable talk of Japanese economic superiority and the "Pacific Century", was one of the all-time great overshoots. Since a currency is never evaluated in absolute terms but relative to another unit of exchange, bipolar developments usually coincide to produce moves of historic extremes. Significantly, the US pursued a deflationary policy, commencing with Nixon's scrapping of the Bretton Woods agreement of fixed exchange rates in 1971. This was temporarily abandoned by Reagan in the early 1980s but then reinstated until Treasury Secretary Robert Rubin's intervention in 1995. Today, those who believe the dollar is rather high against the yen at ¥124, such as lobbyists for the US National Association of Manufacturers, should look at the long-term chart. Thirty years ago the dollar's high was ¥357.62. It last crested ¥250 in 1985. The 30-year average has only recently dipped under ¥190. By this measure, the dollar is extremely cheap. Hands up anyone suspecting that pattern-focused chartists will be talking about completion of a multi-year head &

US Dollar / Japanese Yen (Quarterly) from 1971

shoulders base when the dollar moves above ¥160 next year. Is the yen's current level justified by comparative economic performance over the last decade and prospects for the next few years? I think not and GDP growth rates are much more important over the longer term than current account data. This is particularly true for the US, where the trade deficit is very misleading - due to globalisation - as I have written on many previous occasions.

With trends, moves of short and occasionally medium-term duration are often extremely consistent, proceeding in line with market psychology until everyone participating is similarly positioned, at which point momentum wanes and a reaction commences. These corrections are inevitable over time and punctuate all long-term trends. While small contra-trend moves can be entirely technical, medium-term reactions are usually triggered by events. For the yen, there are several reoccurring events. In Masaru Hayami, Japan has a central bank governor who makes even Wim Duisenberg look competent. Hayami, author of an ill-timed tome "The Day The Yen Gained Respect" (1995), pines for Japanese economic supremacy while perversely keeping money supply too low, compounding deflationary forces. Under pressure from everyone else, he is reflating but so far it has been a case of too-little-too-late. The consequence of Hayami's obstinacy, not to mention the slow pace of Government reforms, will be a longer and deeper bear market for the yen. Another event is the frequent jawboning by Hayami and also various other Japanese monetary officials who fear a too weak yen almost as much as a too strong currency. With a big trade surplus, albeit shrinking, they are sensitive to former charges of competitive devaluation. While US officials are likely to tolerate a weaker yen, provided it is accompanied by economic reforms, Japan's Asian neighbours would be more concerned. Taiwan and South Korea compete directly with Japan. However Japan's main concern is China, with whom trade relations have deteriorated in recent months. The PRC warned that it might devalue its exchange rate when the yen was weakening rapidly last March. In April, Japan's former Prime Minister Yoshiro Mori, just before his resignation, slapped a 266 percent tariff on Chinese mushrooms, onions and rushes for tatami mats. Needless to say this infuriated China, which after unsuccessfully lobbying Junichiro Koizumi for their removal, has retaliated with a 100 percent import duty on selected Japanese consumer goods including air conditioners, automobiles and mobile telephones. I maintain it is only a matter of time before China devalues the yuan and a weaker yen is a convenient excuse. However, with an upper house election on 29th July and the probability of a lower house vote in September, Japan will remain sensitive to any sharp move by the yen. Officials jawboned it lower in April and more recently talked it up after the brief decline below ¥120 against the dollar. Significantly, it required far more effort to talk the yen up than down recently. Finally, a weak euro tends to siphon speculative selling pressure away from the yen while also triggering further capital repatriation by Japanese investors.

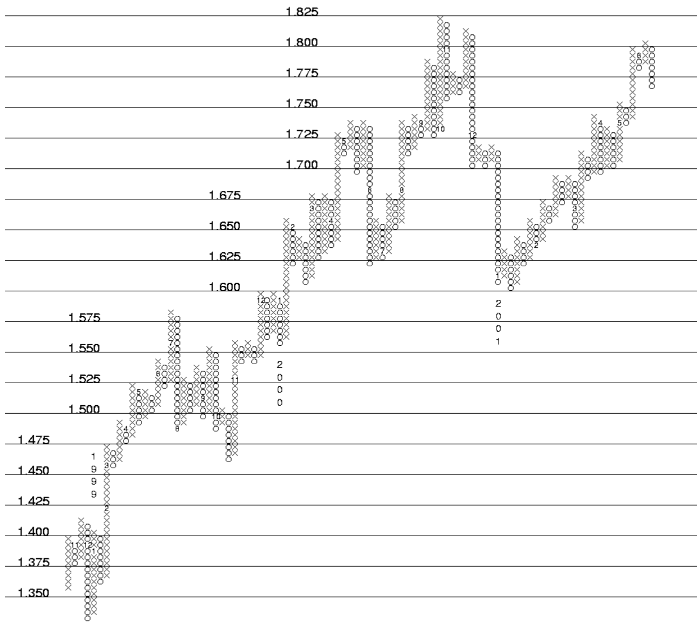
Further multi-lateral intervention to support the euro would suit most interests. With the US economy slowing and given Paul O'Neill's previous jobs as an executive with International Paper and CEO of Alcoa for 13 years, rumours have circulated that the US Treasury Secretary would ditch the official strong-dollar script ever since his nomination last October. This is in spite of O'Neill's repeated denials that he would abandon the mantra - "a strong dollar is in our interest" - introduced by Robert Rubin in 1995. US lobbyists for Business Roundtable, which represents 150 chief executives from large corporate exporters, plus the National Association of Manufacturers want action to rein in the dollar. America's farmers would have a similar view although many are partially subsidised. While the Bush Administration will not be unsympathetic to these interests, especially given the economic slowdown, arguably more US companies benefit from the firm dollar. Also, Alan Greenspan would not want a weaker currency, which could only increase inflationary pressures, especially with US money supply expanding rapidly as the Fed attempts to cushion economic slowdown. The currency problem is less an issue of dollar strength than euro weakness. Therefore the sensible move, in almost everyone's interest, would be another multi-lateral support operation for the beleaguered single currency, provided it doesn't recover on its own. Just because the US rightly favours a strong dollar, this does not mean that they want it to go on appreciating against everything else.

Cash hoards of shortly to be obsolete currency have weighed on the euro. Billions of marks and other European currency paper, stashed over decades in socks and under mattresses within former Comecon countries is being ditched before it ceases to be legal tender on 28th February 2002. Similarly, cash hoards of European currencies held by criminals and also black economy earners within Euroland are being converted. Finally, every tourist who previously stashed excess European notes in a bureau drawer for the next holiday is now dumping the soon to be obsolete paper. The US dollar is the preferred currency for most of these people, especially as they cannot yet switch to euro notes before 1st January 2002. This one-off event is contributing to the euro's weakness. My guess is that most of the one-way conversion will have been completed by mid-autumn. Come January, cash conversions (as opposed to bank account transactions) can only favour the euro, if only because none of the groups mentioned above will have the single currency's paper. Big-time criminals will love those 1000-euro notes, worth considerably more than a 100-dollar bill. That's the theory but will this be enough to trigger a decent rally by the currently unpopular euro? Probably, in which case we should see some upward dynamics on the charts before yearend. In that event, I would not be surprised to see the euro test its two-year highs near US$0.97 before end-Q1 2002.

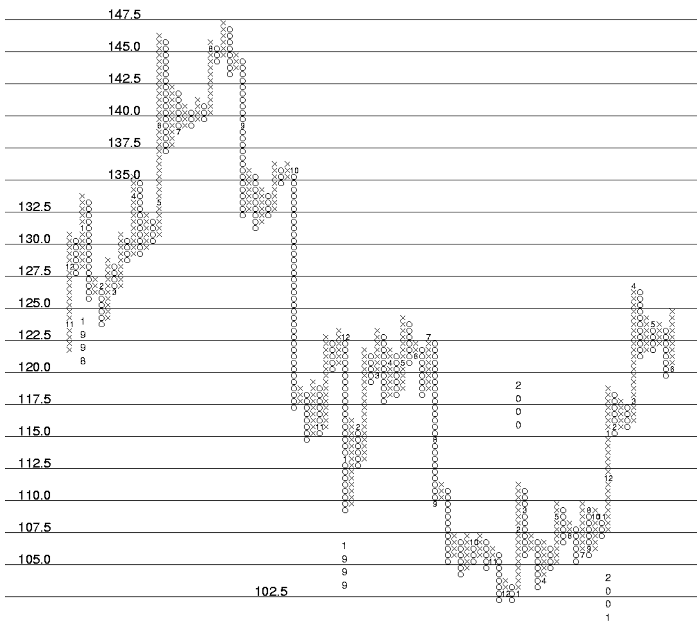
Review of currency point & figure charts - *These and hundreds of other closing basis charts are available on our websites www.fullermarkets.com, shortly to become www.chartanalysts.com and are updated daily. All comments refer to closing levels for US trading hours.*

Dollar/yen (¥123.83) - The greenback's rebound provides

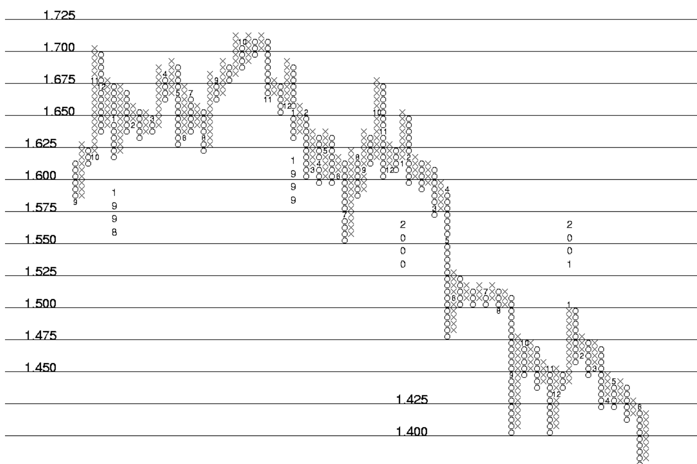
Swiss Franc per 1 US Dollar (0.005)



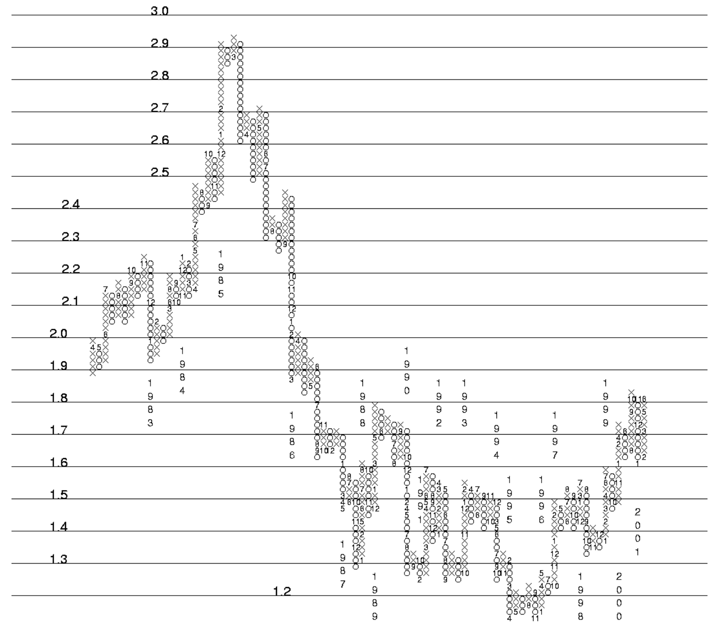
Japanese Yen per 1 US Dollar (0.5)



US Dollar per 1 Pound Sterling (0.005)



Swiss Franc per 1 US Dollar (0.02)



convincing evidence that it has seen the low for a medium-term correction, which commenced in April. If so, and a move under ¥122 is now required to question this hypothesis, no more than temporary resistance is likely to be encountered between current levels and the April high before the overall upward trend is extended. The next advance could be strong given the lengthy consolidation.

Sterling/dollar ($1.416) - The pound has not maintained its break under the September and November 2000 lows at $1.40. A move to $1.43 would break this year's progression of lower rally highs, providing further evidence of an important downside failure, in which case sterling would probably range somewhat closer to its January high of $1.50.

Dollar/Swiss franc (SF1.766) - The most important development within the last year evident on the SF0.005 scale was the sharp reaction in Nov-Dec 2000, breaking a two-year uptrend for the dollar. This year's retracement has been much more gradual, suggesting that at least temporary resistance would be encountered near the October high as we are now seeing. Most uptrend consistency characteristics have been lost, commencing with a slight acceleration in May, followed by an upside failure at SF1.80 and a lower low. A decline from the recent high in excess of 8-units of scale (SF4) would be another inconsistency. A move to SF1.805 is now required to offset current scope for sideways to somewhat lower trading over the medium term. However, the long-term SF0.02 scale chart shows a multi-year base, which should cushion downward risk for the dollar and eventually push it higher.

Euro/yen (¥106.79) - After rolling over against the yen following its explosive yearend advance, the euro fell sharply in May, breaking its January and February reaction lows in the process. However good support was encountered from prior trading evident below ¥102.5. Consequently it is quite

likely that we have now seen the reaction low for this base extension phase, following the recent decline which slightly breached ¥100 on an inter-day basis. A move beneath this level is required to indicate a more lengthy pause but the more probable outcome is a test of the Jan-Apr highs at ¥112.5 where no more than temporary resistance is likely to be encountered.

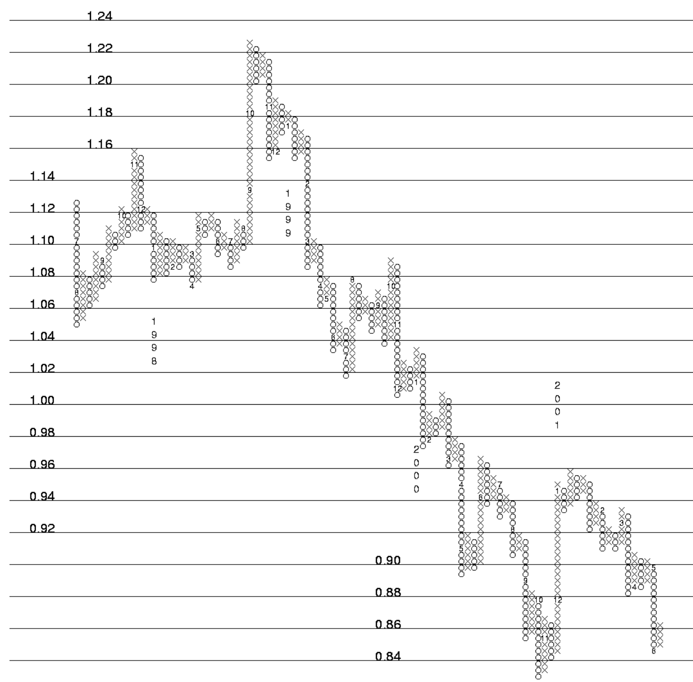
Euro/dollar (0.8627¢) Similarly (but shown conversely to dollar/Swiss franc above) the euro's retreat to test its yearend 2000 trough was much more gradual than the rally from that low. Consequently the overall pattern still looks like a medium-term base. While it is too soon to rule out some further weakness, consensus forecasts for a new low by the euro may be a contrary indicator. The single currency has steadied and a decline to 84¢ is required to delay scope for an additional recovery.

Euro/sterling (0.6093p) - The euro remains basically rangebound against sterling in what is probably a base extension phase. While the single currency's rally in early June was the largest since the failed upward break in January, much of this move has been retraced so a push to 0.6225p is required to halt the sequence of lower rally highs and reaffirm support from the May-Oct 2000 lows at 0.5750.

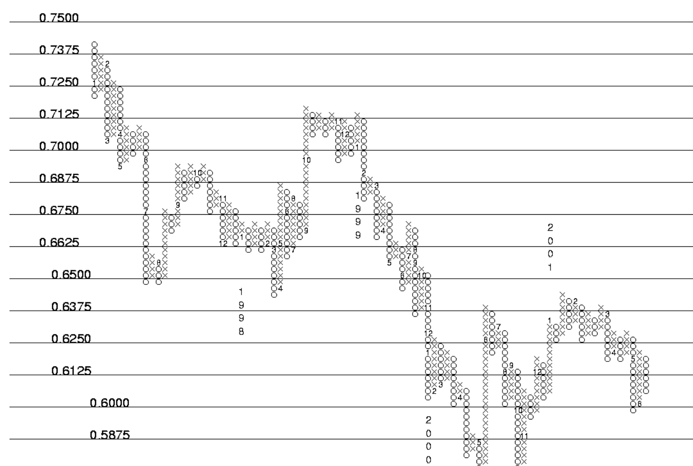
Strategy for currencies - I maintain that short yen is the big play among easily tradable currencies. Judging from the charts, the Japanese unit has completed a two-month correction and should resume its longer-term decline against other reserve currencies in coming weeks. Accordingly, I have increased my dollar/yen and euro/yen positions, now partially protected with in-the-money stops for money control purposes. My position is still considerably smaller than what I had three months ago, before being stopped out, but those trades were leveraged up in line with the trend and protected with trailing stops. I will use a similar strategy, perhaps augmented with the Baby Steps tactic of buying lightly on easing and taking partial profits on strength, assuming the dollar and euro extend rallies against the yen. However I hope to anticipate the next medium-term consolidation. This is never easy but one warning sign would be another bearish consensus similar to all the ¥140 forecasts against the dollar that we saw last March. Acceleration would be another trend-ending signal, particularly dangerous if accompanied by warnings from Japan's Government that the yen was falling too rapidly. In that event one should be reducing positions and/or tightening trailing stops. I think euro/yen could outperform dollar/yen from current levels, at least for a while, but it is also more volatile. Other candidates against the yen are the Australian and Canadian dollars plus sterling, subject to timing. While I prefer euro/yen to euro/dollar, I maintain that retests of the low are a buying opportunity for three reasons. The euro is undervalued, subject to intervention and there is likely to be a surge of demand for the notes once they are issued in January 2001, because no Eastern European or any other holder of cash (as opposed to bank accounts) will have any. The market should anticipate this demand.

Japanese Yen per 1 Euro (0.5)

US Dollar per 1 Euro (0.004)



Pound Sterling per 1 Euro (0.0025)



Commodities

■ **Prices for crude oil and gasoline are testing support.**

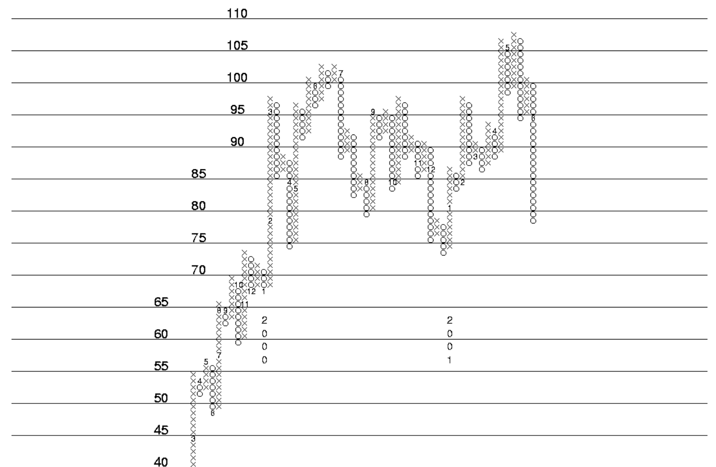
■ **Gold will require further base development before this pattern supports a recovery in line with gradually improving fundamentals.**

Is OPEC beginning to lose control? The global slowdown has reduced demand. Production from Iraq and other sources has increased, including above-quota leaks from the Cartel. Prices for gasoline futures have fallen by nearly a third following panic buying in April and May, which pushed contracts to new highs. Lows for broad trading bands dating back to January 2000 are being tested by both gasoline and crude oil. These patterns have looked like developing top formations for many months. The main question has always been how long will prices remain historically high before the economic forces of lower consumption, substitution and particularly higher production drive them lower? Since oil is a rigged market, the answer depends on OPEC. If they do nothing, petroleum contracts are unlikely to encounter more than temporary support near their range lows. However if OPEC can muster support for another round of production cuts and prevent cheating, it could prop up the market for a few more months. Nevertheless all cartels fail over the longer term.

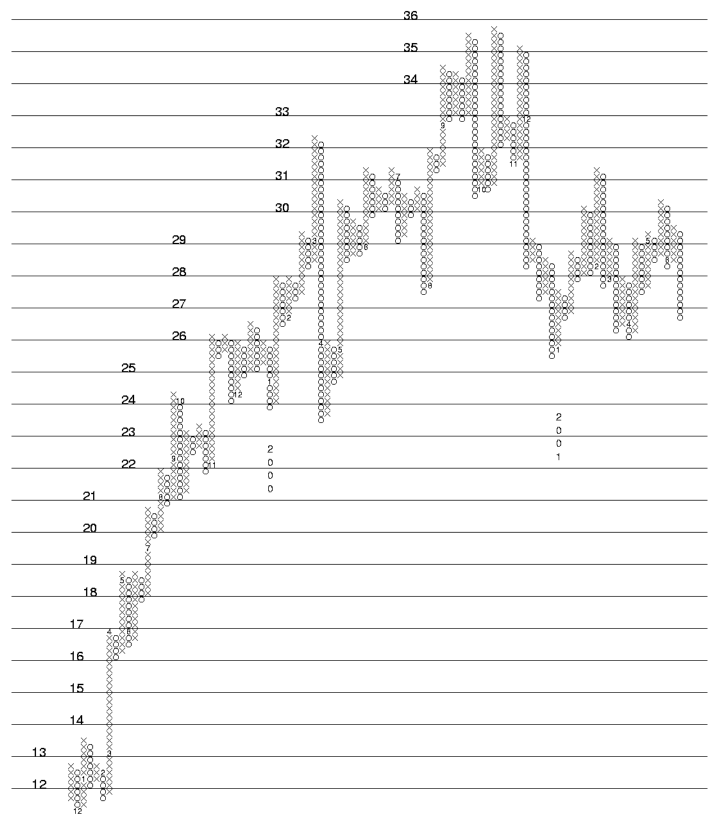
Central banks will create another round of inflation once deflation is widely perceived to be the greater threat. Blips aside, we could be years away from another inflationary cycle but events are moving in that direction. Greenspan is pumping up money supply aggressively and Japan will have to print trillions of yen over the next few years to stem its deflationary spiral. Nevertheless this is unlikely to create an inflation problem any time soon, because the Fed will rein in prices by easing back on the monetary accelerator as the economy recovers. Japan needs a small amount of inflation, which would be much less destructive than the current situation. The ECB's current brief is to contain prices. The real seedbed for inflation will be a lengthy economic slowdown, which need not necessarily develop from the current environment but is probably inevitable at some stage. When that happens, I suspect even the ECB will be compelled to become a born-again inflator. Meanwhile, gold bullion's retracement of the May rally suggests that a lengthy additional period of base formation extension is likely.

Strategy for commodities - Agricultural prices are amazingly low and susceptible to production scares. However these have been infrequent and insufficient to check most of the overall downtrends, to which the dollar's strength has contributed. Having found it easier to lose than make money in this sector recently, I have no positions at present but would be tempted by steadier chart action following persistent weakness.

Gas Unleaded NYME 2nd Month Continuation (1USc)



Crude Oil NYME 2nd Month Continuation (0.2USD)



Gold Bullion (Weekly)

The Global Economy

■ **Global GDP growth is still weakening, despite monetary stimulus.**

■ **Only the US is currently capable of leading the world out of its economic slowdown.**

■ **Some stagflation is inevitable, particularly in Europe.**

Energy costs and the burst TMT bubble continue to weigh on GDP growth and there is always a time lag before changes in monetary policy take effect. Petroleum prices have eased over the last month but remain uncomfortably high, particularly for many countries that have seen their currencies weaken further against the US dollar. Consequently energy prices remain a major drag on the global economy and only a small proportion of this "fuel tax" by OPEC is being recycled to oil-importing countries in a way likely to cushion its negative effects. The deflating TMT bubble was always likely to cause lingering problems because speculation was not limited to the US's Joe Public and his many aliases around the globe, as we can see from Nortel Networks astonishing $19.2bn loss in Q2. TMT companies were the biggest gamblers of all in their drive for market share and that elusive quarry known as global domination. Much of the sector is now in recession as even old economy companies have cut back sharply on their productivity-enhancing technology expenditure. Unemployment - always a lagging indicator - is now rising worldwide in a trend that could persist for many months. Many US companies, which are less regulated than in most other countries and therefore usually respond quickly to changing economic conditions, delayed in making layoffs due to the previously tight labour market and in hope that Fed rate cuts would enable growth to rebound quickly. European employment legislation has only postponed a larger increase in unemployment, which has remained much higher for Euroland's larger countries than in other developed nations. In Japan, the numbers out of work will continue to rise as companies restructure to counter the deflationary recession and the Government reduces fiscal spending which created the massive budget deficit. Rising unemployment will curb consumer spending, extending the global economic slowdown and the risk of widespread recession cannot be ruled out. Against this background Greenspan's aggressive rate-cutting policy since January looks appropriate but it usually takes at least six months and sometimes considerably longer before changes in monetary policy take effect. Unfortunately, the ECB fell behind the curve of events due to hubris, overoptimistic forecasting and an inflexible charter. This has further undermined confidence in the euro, aggravating inflationary pressures, which additionally compromise the ECB's flexibility. Consequently, Euroland's slowdown will be deeper and persist for longer than would have occurred given a more suitable monetary policy for the circumstances. In the UK, fiscal spending has cushioned negative effects from the foot and mouth epidemic and slower global growth. The Government's recent proposal to ease regulations for small businesses and lower taxes are a welcome reversal of direction but will have little effect on the short to medium-term outlook for slower growth in line with the worldwide trend. Japan's deflationary contraction has been reconfirmed by Q1 GDP figures of -0.2%. The BoJ is printing but not nearly enough, judging from woefully low money supply data, which has edged up to only 2.9% (M2+CD).

The hope, albeit naïve, was that Europe and perhaps Asia would take up economic leadership when US growth slowed. The reality is Europe's inevitable slowdown in line with the global trend, with its engine of old - the large German economy - continuing to underperform regionally. Euroland's self-sufficiency is a myth against the background of high prices for energy and the burst TMT bubble. Also, there is no 'Buggins's turn' to economic performance. The US outperforms Europe over the long term because it has fewer restrictions and more opportunities. Neither a single currency nor Euroland federation will overcome these obstacles, although they could make it worse. Hands up everyone who thinks Germany's currency would be stronger, inflation lower and perhaps GDP growth stronger without the euro and bungling ECB. Asian economies will not lead the world, as they did in the 1970s and 1980s without a healthy Japan. Hopefully, Prime Minister Junichiro Koizumi will prove to be Japan's Margaret Thatcher in more than hairstyle but we won't know for quite a while. Meanwhile, his proposed weaning of the economy from the opiate of fiscal pork can only make matters worse before they improve, as even the trendy new PM has stated. Koizumi's immediate problem is to whip the irredeemable Masaru Hayami and his BoJ colleagues into line because a massive monetary reflation is Japan's least torturous path to an eventual sustained recovery. China is an increasingly important player on the global economic stage but currently is little more than a manufacturing base for products conceived and designed by companies from other countries, mainly the US and Japan. Realistically, this means only the US is capable of leading the world out of its current economic slowdown. Greenspan

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has moved boldly providing the monetary stimulus and President Bush's tax cuts will help but given everything else, we are talking about a modest U-shaped recovery at best.

Stagflation now, more inflation later? If you thought the ECB was hard to defend, just wait! Previously it was blamed mainly for the euro's weakness, to which we can now add rising inflation and shrinking growth. Of course the ECB is not responsible for OPEC's price hikes, which have caused much of Euroland's stagflation but the beleaguered central bank certainly hasn't helped matters. The single currency's weakness contributed to Euroland's export-led growth last year. Now we only see the inflationary consequences. In contrast, the strong dollar has helped to curb US inflation. However productivity increases all but vanished as GDP growth slowed dramatically. Share options no longer hold the same promise of remuneration so everyone employed, from CEOs to mailroom staff, will push for a higher salary despite layoffs. Unemployment is rising but only from an historically low level in the US. These trends are likely to be repeated in the UK, reintroducing stagflation, which had been absent for many years. Looking further ahead and judging from surging US money supply, Greenspan is willing to risk inflation while the threat of recession persists. He cites oil as the main problem and is banking that corporate pricing power will remain low. He is probably right but it could be a different story when global GDP growth next improves. Unless The Great One steps on the monetary break early in the next cycle, as he may, it could take more than another leap in technology efficiency to contain prices. In a once in a generation change, people in developed countries now regard deflation as a greater evil than inflation. This perception would intensify during a long economic slowdown and be reflected at the ballot box. Japan's Government is likely to restaff the BoJ and launch the mother of all reflations. Slow growth will certainly tempt Euroland's politicians to question the ECB's primary focus on prices. Overcapacity will cease to be a factor restraining inflation as firms downsize and existing plant becomes obsolete. Meanwhile, the price of gold is slowly building a base.

And Finally…

UK policy following the election - The UK election never produced a protest vote, as I had hoped, to prevent Labour from romping home with another big majority. I was away for most of the campaign but as my daughters summarised events, Labour stole the opposition's best clothes and the Conservatives often appeared fuddy-duddy or intolerant. While I do not favour proportional representation, despite the merit of making every vote count, because it too often results in weak government beholden to single-issue pressure groups, political domination by a single party breeds arrogance and corruption. The UK saw this in the latter portion of the Conservative's four consecutive terms and Labour's first four years were not short of incidents. However, the re-elected Government is showing acute political antennae, at least initially. Prime Minister Tony Blair knows that in his second term it will be harder to blame failures on the last Conservative Government. Moreover, familiarity can easily lead to contempt with the electorate. The wildcards over which the UK Government has virtually no control are global economic events. These were mostly favourable for the Government during the previous administration but risks now appear greater. Chancellor Gordon Brown's 'war chest' is unlikely to benefit from another windfall such as the telecoms license auction and will dwindle rapidly if growth continues to slow while fiscal spending is rising rapidly. Aware of this hazard, he has adopted another Conservative theme in promising to reduce regulations and taxes for small businesses. This would be a welcome change of direction. Wisely, Blair and Brown have ruled out an early referendum on the euro. Overwhelmingly, the UK public wants to retain the pound. At today's forex rates entering the single currency would lock the UK into a very uncompetitive position, worse than what Germany has experienced. An effort to talk sterling down would risk inflation and be provocative for countries already members of the single currency. Alleged long-term benefits of the euro, frequently mentioned by the Government, remain conjecture. The quixotic ECB and its currency have won few plaudits to date and the real tests lie ahead as economic growth slows and euro notes replace the money of individual countries from 1st January 2002.

The Chart Seminar 2001 - My next seminar will be a return to the Zurich Marriott on 12th & 13th July, a good time to visit that fine city. The two days should be interesting given market risks and opportunities. The final venue for TCS will be in London on 29th & 30th November. For a brochure and enrolment form, email sarahhewett@fullermarkets.com. Come along to learn, contribute, enjoy and profit.

New websites - From next month, Fullermoney will be gaining its own website at www.fullermoney.com. Online subscribers will still be able to view my latest copy and back issues via the internet at the above address. Additionally, the Fullermarkets chart libraries will be re-launched under the name Chartanalysts and will be available both in printed copy and online at www.chartanalaysts.com. Some of my veteran subscribers may remember that these chart services used to be published under the Chart Analysis brand, and thus as we re-structure our range of services, we also regain a link to the company's history.

The target date for FM206 is Friday 20th July.

"When we remember we are all mad, the mysteries disappear and life stands explained."
Mark Twain

Best regards - David Fuller

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