Issue 216
29th May 2002
In its 19th year

Fullermoney

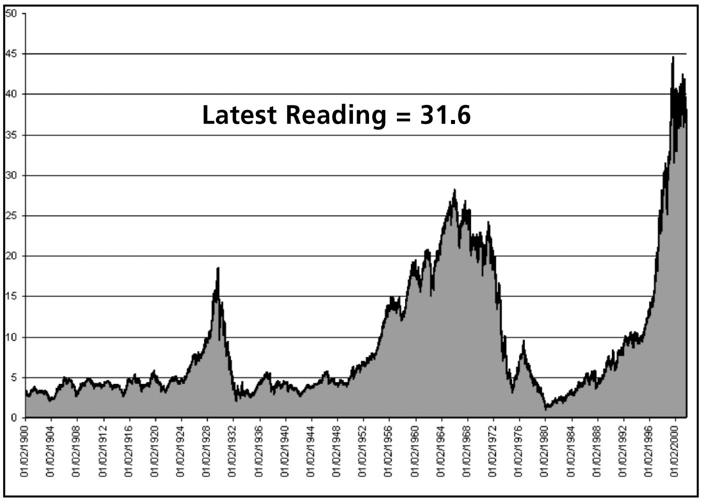
Global Strategy and Investment Trends by David Fuller www.fullermoney.com

Fear will keep US and European stock markets on the defensive, but Japanese equities are benefiting from a change in sentiment. Conservative investors are rebalancing portfolios in favour of corporate bonds.

Is gold's rally too hot to last or just beginning?

We can relax, there are still lots of gold bears around. For starters, there are the mining companies, which embraced hedging for many years, often as a matter of survival. And shucks, if you can hedge one year's production, why not 10 or 20 all at once? It sure beats sweating in a mineshaft, while listening out for the canary. The mining companies have been scrambling to reduce their forward sales, but when someone shouts "fire" in a crowded theatre, not everyone makes it to the exit. There are some very large hedge positions out there, which is one reason why the price has been ranging steadily higher this year. Exchange data on commercial positions also shows that some heavy hitters have been selling gold futures, just as they have done to cap previous rallies over the last many years, with considerable success. Could they succeed this time as well? The Financial Times' Lex Column thinks so, and recently referred to "a natural cap, as rising prices tempt renewed hedging and central bank sales". You can see their entire comment, and my response, on www.fullermoney.com Tuesday 7th May's item. Well, Lex may be right but one of history's better lessons is that people, even Nobel Prize for economics boffins, take a good idea such as hedging future mine production in a bear market, which may be worth leveraging two or three times, and do so well that they crank up the leverage in a colossal gamble. It works just fine…until the trend changes, as it always does. Lex is extrapolating - with the conviction often shown at seminal turning points for markets. All will be revealed, to coin a phrase, and if those commercial sellers are unable, or the central banks are unwilling to cap gold's rally soon, it will get messy for those who are short. In the finest Darwinian tradition, markets can be ruthless when they smell a wounded (overleveraged) player.

Dow/Gold Ratio - 1900 to 2002



Gold is old money. Inevitably, a 20-year bear market spawned lots of gold bears. The two main arguments are that it has been demonetised by central banks, which consequently have lots of gold to sell. I mostly agree with both premises, but feel the real issue is the price of gold relative to other assets. I do not expect any major economy to move back onto a gold standard, although a very small financial centre state could do so. A gold standard would now be too risky for the US or any other significant country. Just imagine what would happen if an Osama bin Laden or Saddam Hussein type, or some considerably less malevolent nutter who happened to have lots of money, decided to do a Nelson Bunker Hunt and bid the price up. The US and every other country on the gold standard would either have to sell the yellow metal, which isn't how a gold standard should work, or more likely they would have to hike interest rates until bullion prices stopped rising. This could have a catastrophic effect on their economies. However, just because central banks have demonetised gold - defined as no longer pegging their currencies to its price - we should not assume that the yellow metal no longer has a monetary role. Every man-jack and free citizen can choose to monetize gold for himself, by purchasing bullion or its proxies as a store of value. More of us are doing this, judging from the price trends for gold and the shares of companies that mine it. Also, on occasion, some of the world's central bankers, when pondering where to place their excess reserves, will look at the three main reserve currencies - US dollar, euro and yen - and hold their noses, whether for economic or political reasons. Gold is an obvious alternative to fiat money. I do not consider gold to be "real money", although it has a greater claim to that status than cowrie shells, glass beads or the paper stuff. Gold's universal appeal as a store of value over centuries is due to its unusual combination of characteristics. Gold is pretty, does not tarnish, is virtually indestructible, can be refined to a uniform standard and is in limited supply. This is also true of platinum, palladium and to a lesser extent silver, but only gold is yellow, adding to its appeal and making it harder to mistake for something else. However "real money" is in the eye of the beholder. Instead, I consider gold to be old money. As such, it will always be a store of value, albeit fluctuating with fashion, just like a fine painting or antique in mint condition.

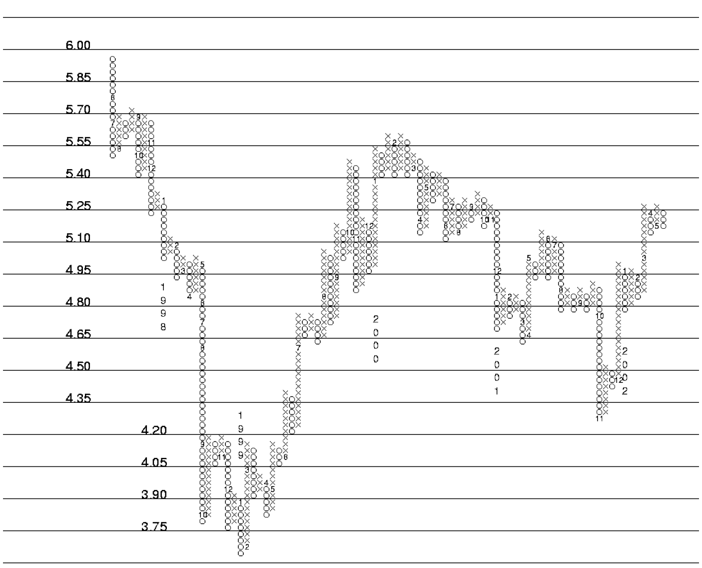
Gold is a value play. We all make mistakes from time to time, but smart monetary officials don't go on selling the cheapest asset in their portfolio, à la Gordon Brown on behalf of the UK Treasury. The best investment advice any of us will ever receive is, buy-low-sell-high. This is gold's appeal today. Although well off its bear market low of $251.95 on 27th August 1999, it is still very cheap relative to financial assets and property. Stocks and houses have been hyped for years. We certainly had a stock market bubble and people are increasingly talking about a property bubble. Could we really speak of a gold bubble before it took out the 1980 high of $850? Today, most people consider that level unimaginable. However the Dow/Gold Ratio (DGR), while coming down from its 1999 all-time peak of 45.5, is still a heady 31.6. In other words, the Dow Jones Industrial Average is trading at 31.6 times the price of gold, well above its 1966 and 1929 peaks, when two earlier super-cycle bull markets ended at 28 and 18 times gold, respectively. Following the 1966 and 1929 stock market peaks, the DGR fell back to its historic mean of 5. Could this happen again? It's not impossible judging from over 120 years of history, although I consider it less likely because there is no longer a gold standard. However I have no trouble envisaging a DGR of 15 within the next 5 years, which would require the gold price to more than double, assuming the Dow managed to stay at 10000.

Interest Rates and Bonds

- **Central banks are proceeding cautiously on rates while GDP growth remains weak but stagflation is evident.**
- **US and European long-dated government bond yields have stopped rising.**

US 10 Year Bond Yield (0.025)

Euro-bund 10 Year Bond Yield (0.03)



Stagflation is back. Most of Europe hovers near recession, including the UK, where consumer spending is tailing off. On the Continent, the issuance of euro notes and coins is proving to be more inflationary than politicians hoped and promised. The weaker dollar will nudge US inflation upwards. This puts more pressure on central banks to lift rates, although they understandably do not want to choke off the hoped for economic recovery. The CBs may get a break in the form of somewhat lower oil prices. Meanwhile, they are erring on the side of inflation because they fear deflation more.

This looks like further base extension for 10-year government bond yields. The US yield has led on the downside since April and extended its reaction recently with the move to 5.125. Consequently, 5.3 is currently required to offset current scope for some further retracement of gains and 5.425 to reaffirm the prior uptrend. Euro-bund yields have lagged on the downside but require 5.28 to resume their advance. The more likely development is a further decline in line with the V-bottom, right-hand extension base pattern as taught at The Chart Seminar.

Strategy on bonds - In a slight change of strategy, I think conservative investors could reduce their 3-month government bills position and move some capital into longer maturities for the next few months. However for capital appreciation I continue to favour quality corporate bonds. Debt reduction will be an important theme for the next several years, as companies seek to replace borrowing with equity financing. Consequently there could be a squeeze on lower-risk corporate issues. In futures, I have retained the small position in June Euro-bunds, looking for a technical rally. I will probably roll this position into the September contract.

Global Stock Markets

- **The problem for indices has been that big-cap seldom equals value. However the stealth bull market in small to mid-cap value stocks continues and the background environment will remain neutral/positive for a while longer.**
- **Two short-term scripts for stock markets - you choose.**
- **Over the longer term, the dominant theme remains reversion to the historic mean.**

The neutral/positive outlook is least evident from stock market indices. These have underperformed, particularly where there is a large TMT component, smaller Asian markets excepted. One reason is the considerable influence of investment management firms, particularly in the North American and European markets. These continued to gain market share in the 1990s, often creating a liquidity problem for managers. Consequently, they congregated in big-cap stocks, including popular TMTs, driving up valuations relative to other shares. Index tracker funds compounded the problem. As these grew in popularity, attracting increasing amounts of cash, their

New York Stock Exchange Cumulative Advanced/Decline (Weekly)

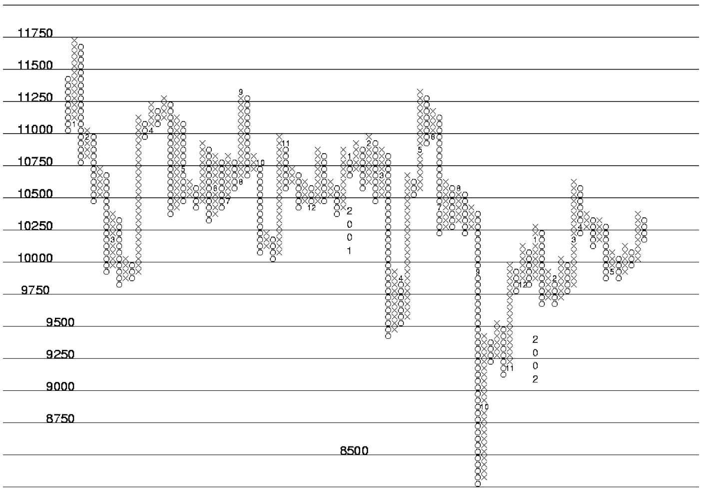
buying became a self-fulfilling prophecy. New demand drove big-cap stocks ever higher, until rising interest rates, the burst TMT bubble and the increased cost of energy ended the super-cycle bull market in 1999/2000. Over the last year and a half, the virtuous cycle for big-cap stocks has turned vicious, as pension funds have shifted money to corporate bonds and the poor performance of index tracker funds has caused investors to seek alternatives. Among equities, the obvious candidates have been value stocks, defined here as companies with high yields and low P/E ratios. These were old economy stocks, shunned during the tech mania. Fortunately for investors, who moved with the change in sentiment, there were more depressed value stocks - small and mid-cap companies - than overpriced big-cap and TMT shares. Consequently, the overall downward bias for most stock market indices has masked a stealth bull market in value stocks, reflected by the Cumulative Advance/Decline Line for the New York Stock Exchange. This has been rising since October 2000, due to the change in fashion and low interest rates. This trend is likely to continue for a while longer but will end when we are further into the next cycle of rising short-term interest rates, and value stocks are no longer a bargain. Price charts will determine the precise timing but as a rule of thumb, when dividends fall below 4 percent, value will be increasingly questioned. At the bottom line, many of the shares that have appreciated most over the last year remain boring, albeit respectable, companies. Unless they are demonstrably growth stocks, why hold on when the share price trend loses momentum? There are fewer compelling growth stories in the current economic environment.

Base characteristics favour the short-term bullish case. Most stock market indices were in retreat from mid-March to early May, especially those of Europe and North America. The persistence of this decline created a more deeply oversold condition than we saw in February, which produced a sharp, albeit short-lived rebound. The recent decline ending in early May accelerated towards the year's former lows, which were exceeded by the NASDAQ and S&P 500. FM175 (8/05/02) commented on the climactic nature of this decline and scope for a technical rally. The subsequent upside dynamics (strength shown near the lows) suggests that this rally could carry somewhat higher, possibly testing and even exceeding the year's upper boundaries in some instances. Significantly, the S&P 500 has not maintained its break of the February lows, and even the NASDAQ is close to a downside failure. Breakouts that are not maintained are often followed by tests of the patterns' opposite boundaries - in this case the January to March highs. Ever since last September's lows, described in this publication at the time as the most oversold condition since 1987 and 1974, I have mentioned the V-bottom with right-hand extension base characteristics, as taught at The Chart Seminar. While the February and May lows hold, these patterns will remain capable of supporting somewhat higher levels, during a window of opportunity before short-term interest rates rise across the board. Investors can even look forward to somewhat better corporate profits, especially in 3Q and 4Q 2002.

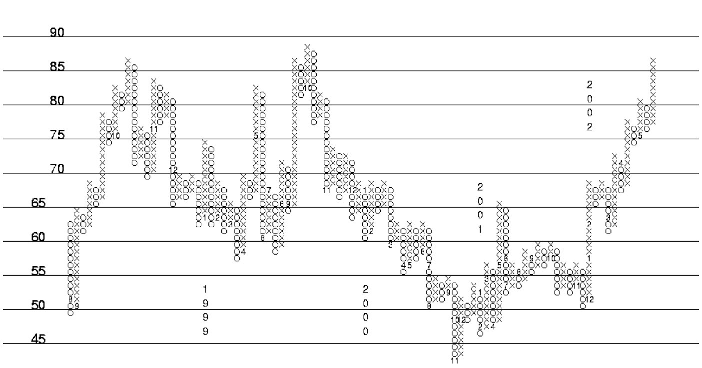
Trend action and leadership favour the short-term bearish case. This can be stated more readily, starting with index charts that look scary. Overhead supply on most indices is massive. The main trends are mostly declining, as are long-term moving averages. Taiwan and South Korea, which had two of the best performances following last September's lows, have lost their uptrend consistency. What leads on the upside, often leads on the downside. Investors are spooked. They no longer believe what the companies say and they don't trust the brokers' analysts. Fear is ascendant. You don't buy stocks when gold is in form, mines excepted.

Reversion to the mean is a lengthy and periodically brutal process. Since I've written about this at length, especially in FMs 213 through 215, I'll summarise briefly here. The once-in-a-generation super-cycle bull market commencing in 1983, ended in 1999/2000. It was characterised by far greater excesses than we saw in 1966, when an earlier super-cycle bull trend ended. These included too much debt, the ramping of share prices (especially TMTs) and dodgy accounting. Debt will be a drain on earnings for years to come. Post-bubble disillusion by investors is increasing and will persist for a long time. Tighter accounting standards will suppress corporate profits relative to previous expectations. GDP growth is generally slower for at least a decade in a post-bubble economy and recessions often occur more frequently. In this environment people will demand better value from shares and a higher payout in the form of dividends. Capital also flows away from stocks during reversion to the mean, because they are no longer viewed as a certain bet to outperform other investments, such as bonds, property, cash, collectables, precious metals and other commodities. You won't hear much about this from equity managers - we never do when they are on the wrong side of the mean. Meanwhile, the moderate recovery in stock markets from last September's lows will be capped by overhead supply evident on longer-term charts. The next bearish environment, probably in line with higher short-term interest rates, should exceed the September 2000 lows. Reversion to the mean is a lengthy process often taking a generation to purge prior excesses and recreate the fundamental and behavioural conditions for another super-cycle bull market. Also, during the unwind, markets don't just revert their historic mean - they overshoot, as we last saw in 1974. The consolation for investors is that there will be many opportunities - both long and short - provided we monitor price charts and do not expect any trend to last beyond the medium term.

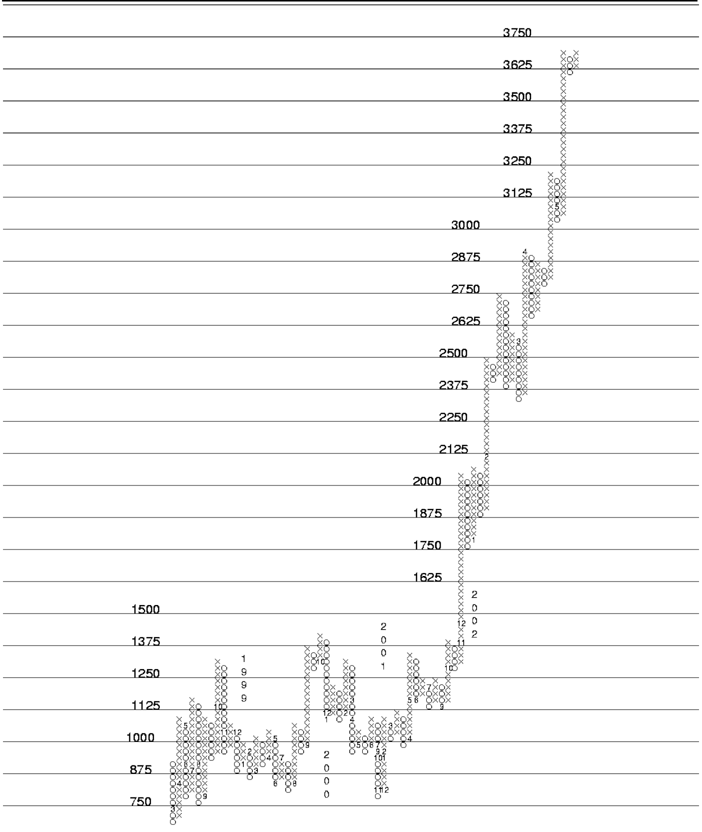
Dow Jones Industrial Average (50pt)



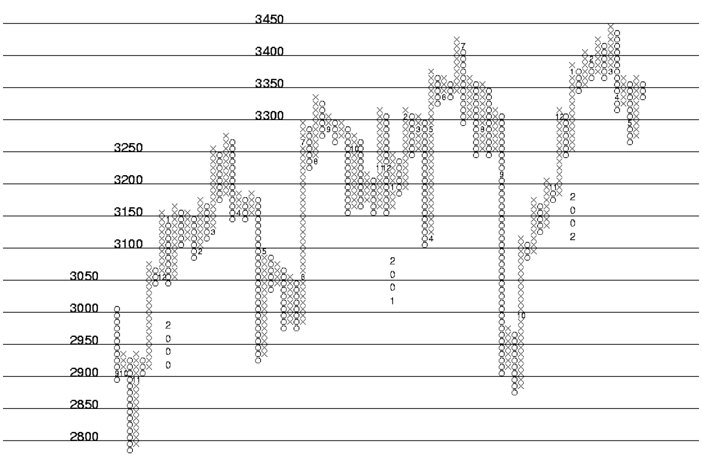
Philadelphia Gold & Silver (1pt)



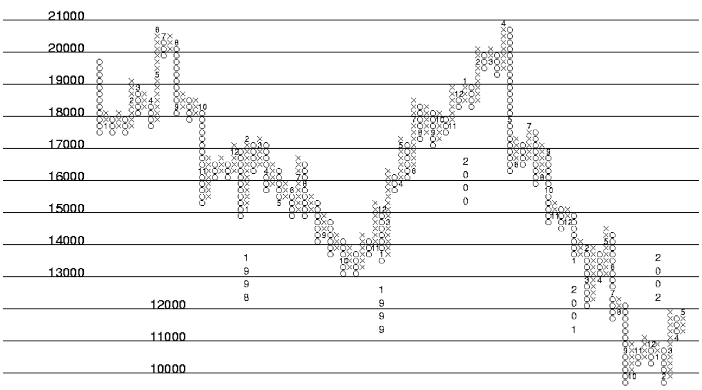
South Africa JNB Gold Index (25pt)



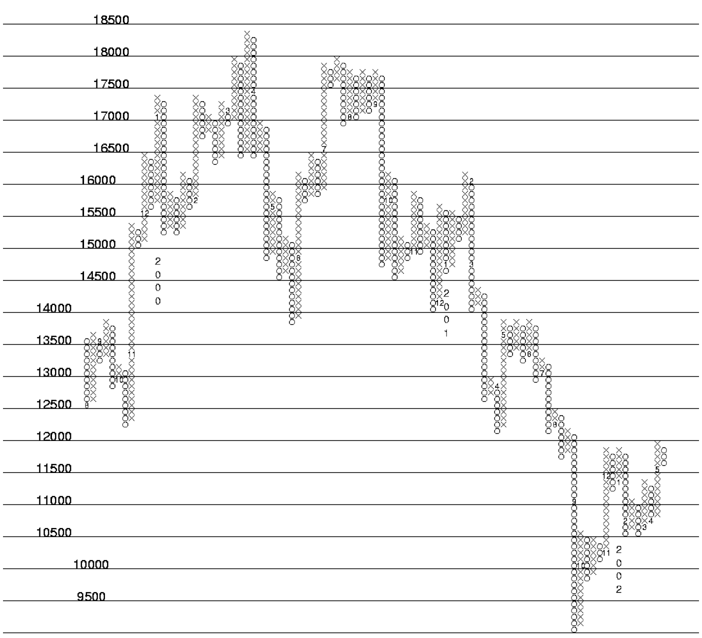
Australia All Ordinaries Index (10pt)



Nikkei 225 Stock Average Index (200pt)



Hong Kong Hang Seng Index (100pt)



Significantly, the entire stock market did not form a bubble. Consequently the trend for indices should more closely resemble 1966 to 1983 - *see FM214* - rather than the DJIA post 1929, gold after 1980 or the Nikkei following its 1989 peak.

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

The US's Dow Jones Industrial Average (10104) Has rallied from its April-May lows in a further test of overhead resistance which looks formidable. Nevertheless, a move to 9800 is required to break the sideways to slightly higher bias since late November. **The Philadelphia Gold & Silver Index (85.84)** is a welcome new addition to our extensive website chart libraries. It's been volatile in the past but I suspect activity since 1998 is all part of a large base formation. The PGSI is currently trending towards former resistance in the 86 to 93 region, and a decline to 75 is currently required to question pattern consistency.

South Africa's JNB Gold Index (3383) extended its surge away from the base formation. While many now regard this move with alarm, it needs to be viewed in perspective. The massive base was formed over many years and large patterns, once completed, often support explosive moves. In this case, the move was boosted by the rand's earlier devaluation. While the JNB Gold Index's rate of advance will prove unsustainable, none of the ending characteristics taught at The Chart Seminar - acceleration relative to the trend to date, severe reaction against the trend or a large rollover pattern, is currently evident. A move under 3000 is required to question trend consistency.

Australia's All Ordinaries (3335) lost its uptrend consistency from the September low earlier this year, evidenced by type-2 (of 3) trend-ending characteristics as taught at TCS - a loss of momentum, wedging, upside failures and finally a severe reaction relative to the trend. It has subsequently steadied in what looks like right-hand top extension and 3450 is needed to challenge this hypothesis.

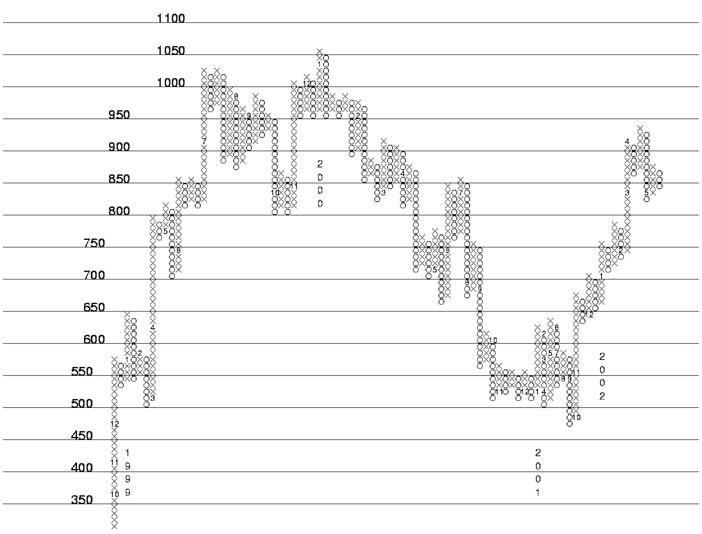
Japan's Nikkei 225 Stock Average (11976) found support at 11000 from the upper side of the September 2001 to March 2002 range. While a break of this level would suggest further easing, a move above 12000 would provide additional evidence of base development. While the pattern suggests the path of least resistance is upwards, the yen's recent rally could be a problem for Japan's stock market, unless quickly reversed.

Hong Kong's Hang Seng Index (11564) has hesitated after pushing above the December-January highs at 11800. While this has not yet confirmed an upside failure, the problem may be massive overhead supply and 12000 is needed to reaffirm recovery scope.

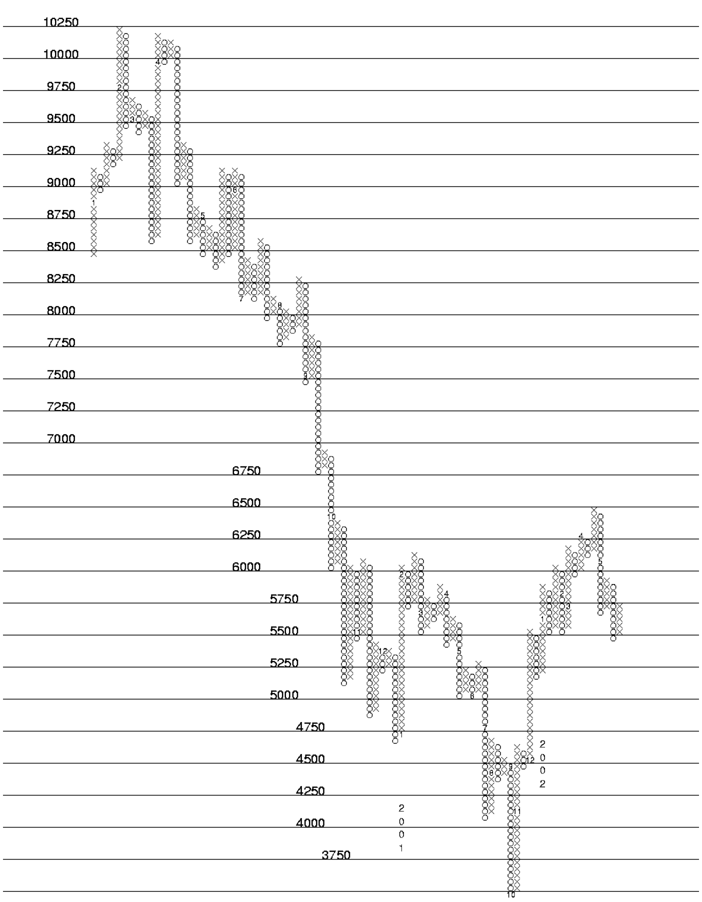
South Korea's KOSPI Index (840) - *see overleaf* - has lost its uptrend consistency. Consequently 940 is required to reaffirm the prior advance and offset scope for a further retracement of gains.

Taiwan's Weighted Price Index (5729) - *see overleaf* - broke its sequence of higher or equal reaction lows since

South Korean KOSPI Index (10p)



Taiwan Weighted Price Index (50pt)



September with a sharp (type-2 as taught at TCS) reaction, before steadying. A move over 5750 would suggest top extension before a further retracement of gains is seen.

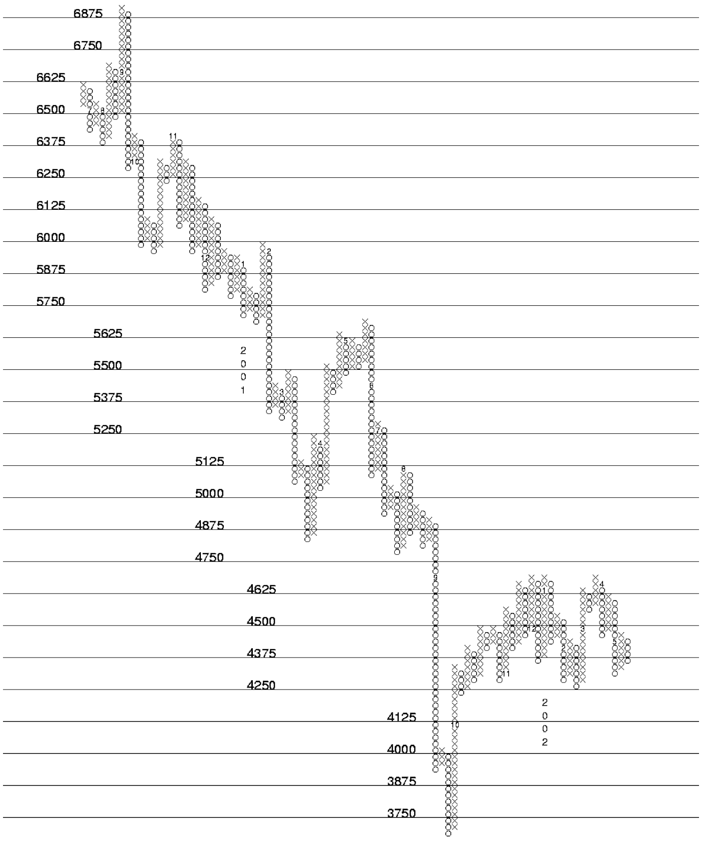
France's CAC 40 Index (4360) has been slowly rolling over following the September to November rally. A move to 4700 remains necessary to reinstate recovery prospects and the pattern would deteriorate further at 4200.

The Netherlands' AEX Index (492) has not maintained its break above the mid-November to early-March range, the likely problem being extensive overhead supply. A move to 532 is now required to reaffirm the recovery.

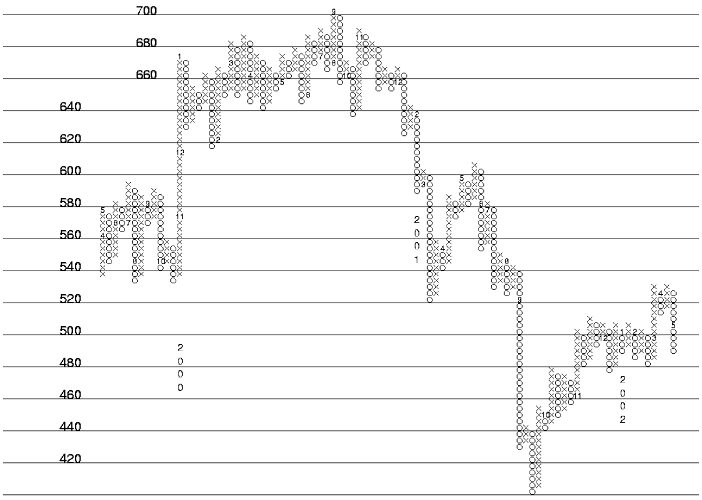
The UK's FTSE 100 Index (5136) remains rangebound but the dominant features are overhead supply and an overall downtrend. A move over 5400 is currently required to indicate somewhat higher scope.

Strategy for stock markets - The risk in holding high-yield, low-multiple value stocks is that once they recover sufficiently to lose their bargain status, the possibility of being dragged down by an indices sell off and/or "surprise" interest rate hikes increases. They also face competition from bonds. I believe this remains a risk worth taking, given the Advance/Decline performance shown earlier. However, I would slavishly follow price chart performance. Once the orderly uptrends lose consistency as taught at TCS, and I'd use P&F or weekly candlestick data for this assessment rather than short-term data, discretion becomes the better part of valour. As one who never has a balanced portfolio, I remain overweight in gold shares and related mining issues. Last month I sold most of my Merrill Lynch World Mining Trust too soon, having been concerned about a loss of form by some of its industrial metal shares. However, MLWM's orderly uptrend has marched steadily higher, demonstrating that there is a dearth of quality, managed products available in this sector. Fortunately, Barrick Gold, which I mentioned purchasing last month - partly on a contrarian view and because of its large base, has done even better. I also bought some Newmont, only an initial position because everyone seemed to be recommending it and it was underperforming. We now know why - it hasn't lifted much of takeover mine Normandy's hedge position, according to Tim Wood - *see www.fullermoney.com for Monday 20th May*. Newmont also has some lateral resistance near $30, so I'll add to my position on either a setback or breakout above this level. I also hold the Merrill Lynch Gold & General Fund and Durban Roodepoort Deep, both from pension stale bull positions finally come good. The latter hasn't been helped recently by the rand's partial recovery, but the overall chart action remains good. Finally, I'm chagrined at not having bought Silver Standard Resources Inc, mentioned in FMP176 (14/05/02) but if some of my subscribers bought it before the 50 percent surge, that's sufficient compensation for me. Elsewhere, I still hold a small position in the Atlantis Japan Growth Fund, and am encouraged by its recent performance plus the TSE2 (Second Section) Index's strength. My view on other positions mentioned in FM215 remains unchanged. In futures, I took profits on my NASDAQ 100 futures long, mentioned in FMP175 (8/05/02), because it exceeded my minimum target of 1300 and was strictly a short-term trading position, established in hope of a short-covering rally. Given my short-term bull/bear arguments above, I'm generally undecided and waiting for another extreme of sentiment, but would probably prefer to sell a tiring rally than buy following an additional sell off. That said, I have opened a long in Nikkei futures near current levels.

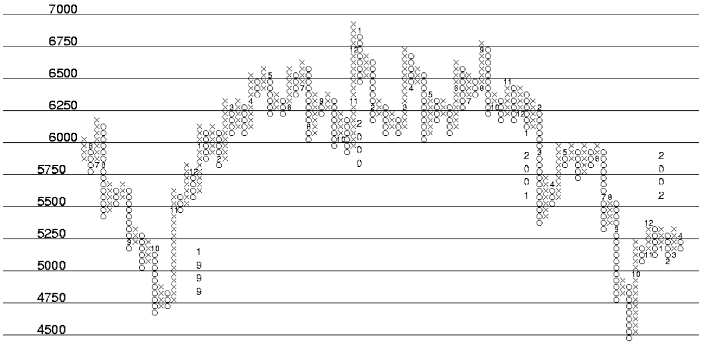
French CAC 40 Index (25pt)



Netherlands AEX Index (4pt)



United Kingdom FTSE 100 Share Index (50pt)



Currencies

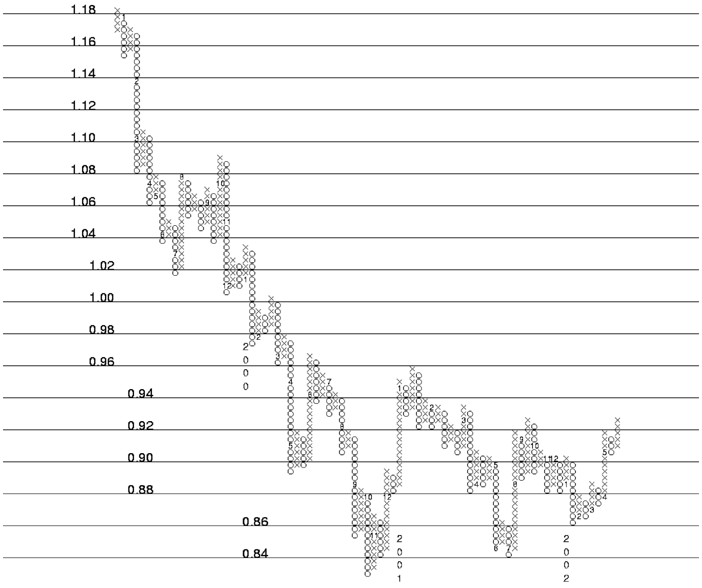
■ **The euro's recovery is underway and it will overshoot within the next two years.**

■ **The yen's strength is mostly against the weak US dollar, and it won't last.**

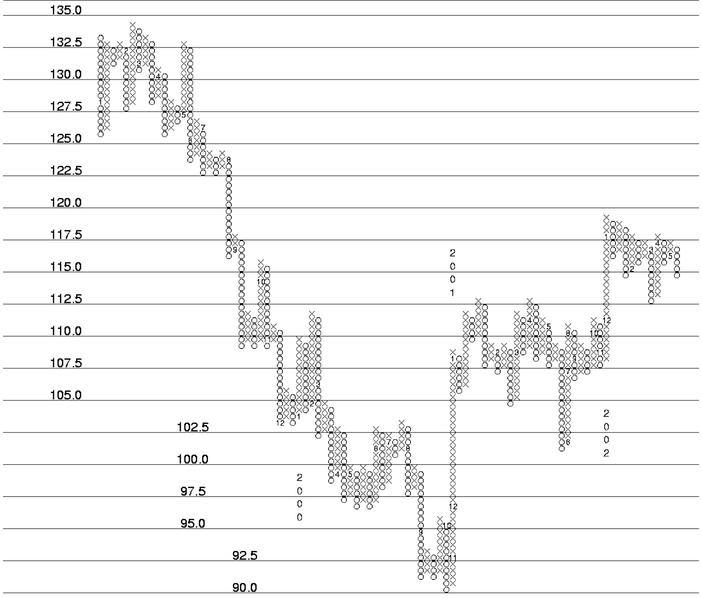
Euro-revulsion was evident at each of the base formation's three lows. Extremes of sentiment are always a contrary indicator and the lows in October 2000, July 2001 and January 2002 occurred in a rising sequence. This provides irrefutable evidence that demand for the euro has been increasing. The single currency's base building process has been lengthy, due to four reasons: it was a virtual currency until this year; the dollar was more popular; the greenback also yielded more, and cash hoards of marks and other European currencies were being cashed in. Since this money could not be exchanged for euro paper, prior to January 2002, most was converted into US dollars, with a considerably smaller flow into the Swiss franc and sterling. The euro is now rising for four reasons: people are worried about the dollar; the greenback yields less than the euro; there is no longer any overhanging supply of Euroland's former currencies, and central banks are increasing their diversification into the single currency because it is rising. Of these, central bank diversification is the big factor. This commenced with the ECB, understandably, which held most of its reserves (via member state CBs) in dollars, along with every other central bank. Consequently diversification will be a one-way flow for a year or two. However the euro is unlikely to move higher in a straight line, because markets seldom do; confidence in the single currency is only skin deep, and the US economy will remain stronger than Euroland. Nevertheless, the euro's base formations clearly indicate higher scope versus the dollar and many other currencies. It should recover more than most people currently expect, because it is the nature of markets to overshoot. I expect the euro to reach at least parity with the dollar and would not be surprised to see $1.10 within two years. The danger period for currency traders will be when the ECB worries out loud about the euro's strength. Over the much longer term, I expect the US dollar to eventually resume its secular bull market from the 1995 lows, underpinned by stronger GDP growth.

Sentiment indicates that traders have been closing yen shorts. When the dollar reached ¥135 in January and February, forecasts were all on the upside - from ¥140 to an eventual ¥200. Today, we hear ¥120 to ¥80. What's changed? Not a lot, other than the dollar is no longer in favour. Consequently, traders have drifted away from the dollar/yen carry, and to a lesser extent reduced positions in most other yen crosses, because these trades have been far less lucrative in recent months, due to predominantly ranging activity. Also, a stronger performance by Japan's stock market, following Government intervention in February, has attracted foreign demand. The yen's recent strength has certainly worried the Government, judging from its latest intervention on 22nd and 23rd May, near ¥124 against the US dollar. The Ministry of Finance

US Dollar per 1 Euro (0.004)



Japanese Yen per 1 Euro (0.5)



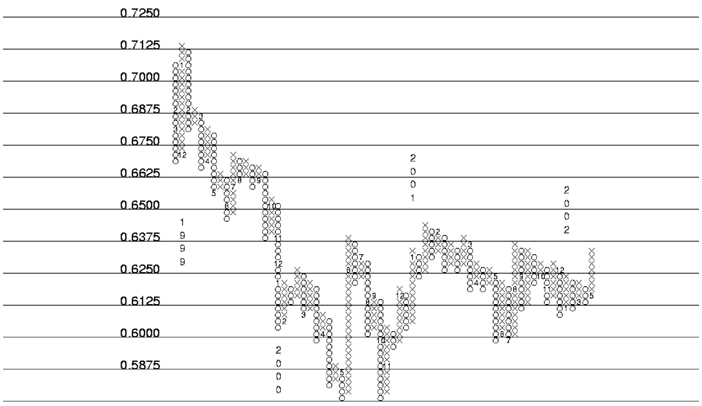
previously intervened around ¥118, following 9/11. Prior to that, it had sold the yen on several occasions in the ¥101 to ¥107 range. Significantly, the MoF has been lifting its intervention threshold over the last three years. We can conclude that few people in the Government are complacent about Japan's economic recovery prospects. Consequently, continued jawboning by monetary officials (Hayami excepted) is likely and direct intervention if the yen continues to strengthen for any reason. Meanwhile, the above-mentioned reversal from bearish to bullish sentiment towards the yen among Western commentators is a contrary indicator. Japanese investors have been voting with their feet this year, by purchasing gold and moving money offshore. In a country noted for consensus and where few rock the boat, maverick Japan bears such as Takashi Asai have guru status - *see www.fullermoney.com, Friday 17th May's comment.*

Chart review of important and topical currencies - *These and hundreds of other 3-box reversal closing basis point & figure charts are available on our website, www.chartanalysts.com and are updated daily. All comments refer to closing levels for US trading hours.*

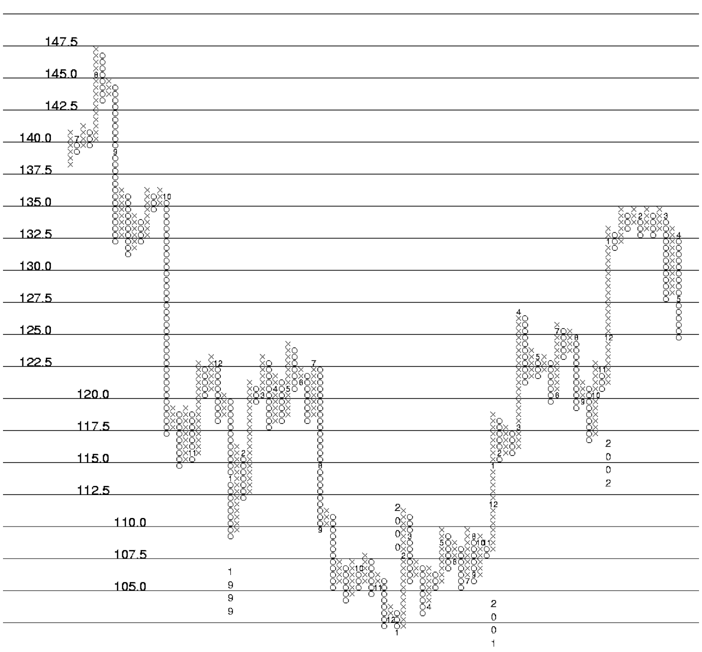
Euro/dollar ($0.9207) - The recovery since January's low at $0.86 is consistent with the base building hypothesis. Moreover, the rally has gathered pace in the last two months, suggesting that the pattern is nearing completion. The downward trend connecting January and September 2001's highs has been broken and the lows have been rising since October 2000, albeit gradually. A decline to $90 is required to show more than brief resistance at the September 2001 high near $0.924.

Euro/yen (¥114.88) - This year's pattern continues to resemble the first step above the base, as taught at The Chart Seminar, although a move to ¥112 would question this hypothesis by breaking the March low and re-entering the base formation. Conversely, a move over ¥118 would indicate that the pattern was nearing completion and resumption of the overall upward trend.

Pound Sterling per 1 Euro (0.0025)

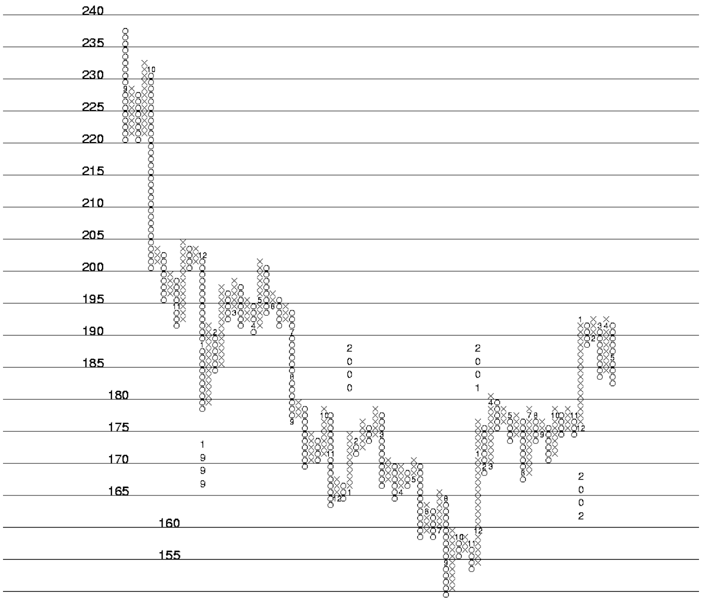


Japanese Yen per 1 US Dollar (0.5)

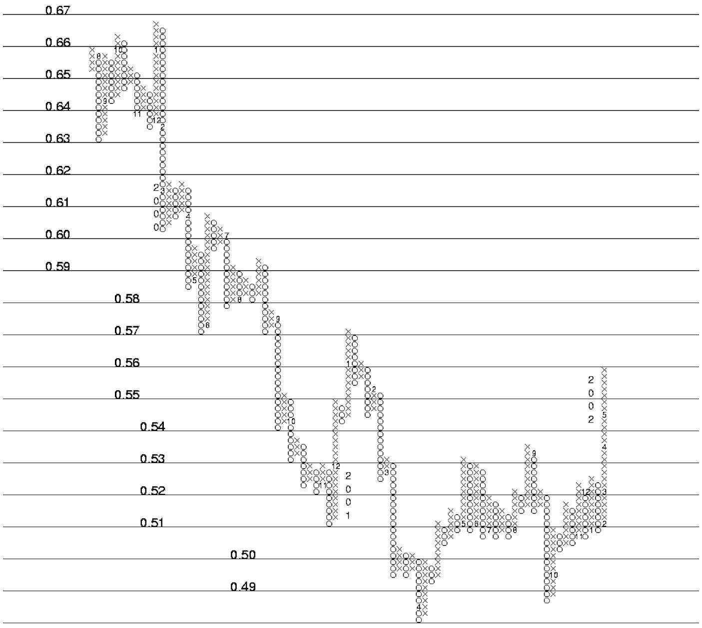


Euro/sterling (£0.6316) - This overall pattern continues to look like a base in the latter stages of development. This scenario will gain further validity at £0.6375, which would clear the August high.

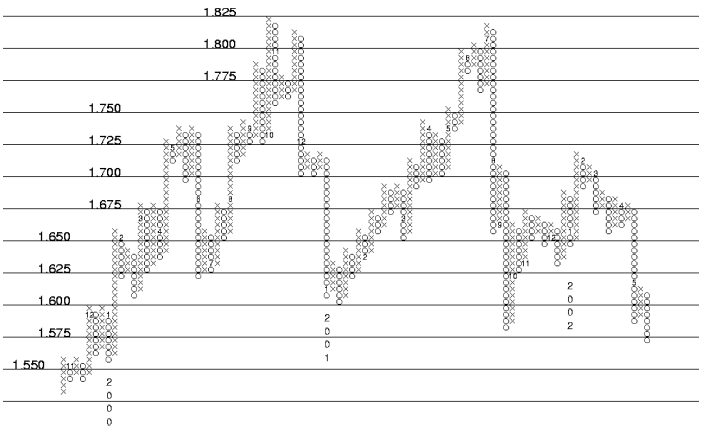
Japanese Yen per 1 Pound Sterling (1)



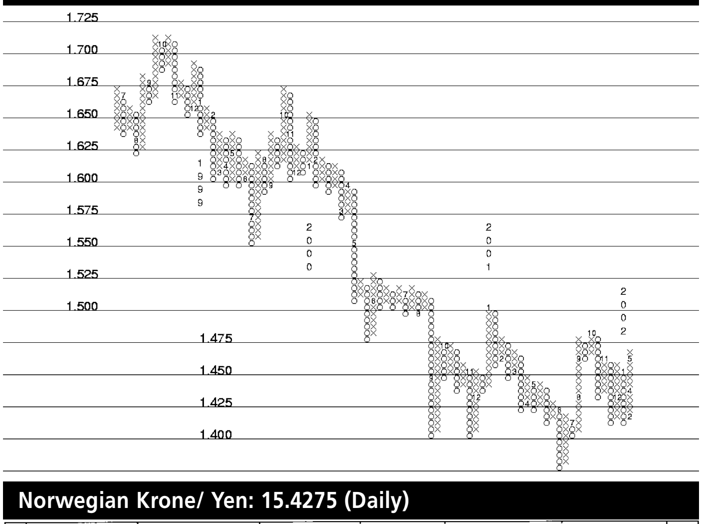
US Dollar per 1 Australian Dollar (0.002)



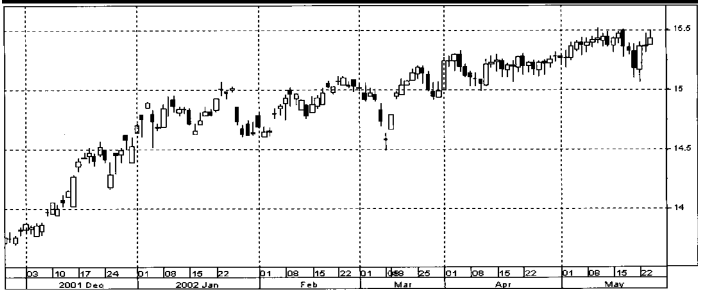
Swiss Franc per 1 US Dollar (0.005)



US Dollar per 1 Pound Sterling (0.005)



Norwegian Krone/ Yen: 15.4275 (Daily)



Dollar/yen (¥124.74) - The dollar has re-entered its base formation, broken the March low and seen its biggest decline since mid-1999. This questions the overall uptrend and while underlying support should cushion downward risk, a move back over ¥127.5 is needed to reaffirm base support.

Dollar/Swiss franc (SF1.5834) - This pattern has long looked like an extended top, with the most notable feature a tendency for the greenback to fall faster than it rises. The 2001 lows have now been broken and a move to SF1.615 is needed to suggest a downside failure.

Sterling/yen (¥181.74) - The pound has fallen beneath its March low but is still above the base, which commences at ¥180. A move back into this pattern is required to further question the overall uptrend.

Sterling/dollar ($1.4581) - The pound has broken above its November and December highs, providing further evidence that the range since September 2000 is a medium-term base. A move above the October 2001 high at would reaffirm this hypothesis by breaking the long-term progression of lower rally peaks.

Australian dollar/US dollar (US$0.5578) - The Australian currency has pushed steadily higher since February, and the gain from September's floor is the biggest since the August 1998 low. Some resistance may be encountered from the January 2001 peak and lateral trading near US$0.57.

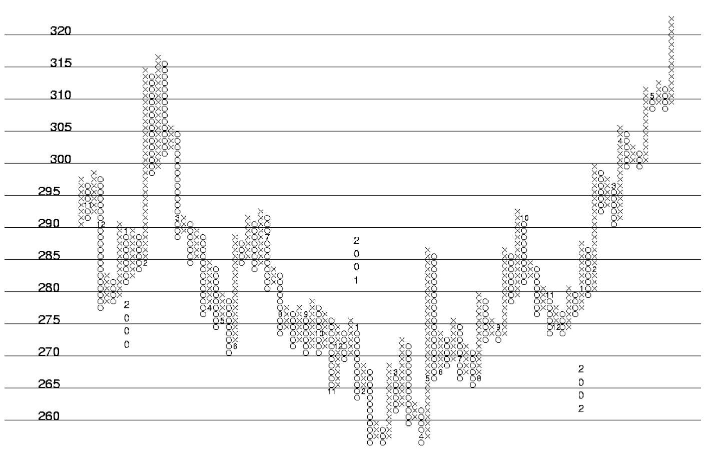
Strategy for currencies - Among reserve currencies, I continue to favour the euro, which remains a buy on reactions against the dollar and yen, and it's generally a good idea to lighten positions on rallies. Long-term yen bears, of which I remain a card-carrying member, have had a difficult time recently, although less so if they used the Baby Steps, buy-low-sell-high range trading strategy that I have long advocated. The current situation is interesting and should ultimately be profitable. The yen has rallied back to resistance and Japan's MoF has ordered the BoJ to intervene twice, so far, in May. The main short-term risk for yen bears is Japan's stock market, which continues to show relative strength. If it recovers further or at least remains firmer than most other stock markets, as I suspect, this could support the yen for a while longer. The problem is not so much a "wall of money" flowing into Japanese equities, but a general belief that a rising Nikkei is yen-positive. This sentiment deters speculative selling of the Japanese currency. However, if Japan is intervening, as we have seen recently, that's good enough for me. My in the money stops were hit and I have subsequently replaced, with a current weighting heavily in favour of euro/yen, followed by sterling/yen and a smaller stake in dollar/yen. However, if my tax-advantageous dealing system allowed, I would be long Norwegian Krone/yen and South African rand/yen, the latter being much more speculative but attractive if one is bullish of gold. A consultancy client of mine recently established a NK/yen position 3 years forward. He received 700 basis points per annum, locking in a total interest rate return of 21 percent, if he holds to maturity. The chart suggests he will reap a capital gain as well.

Commodities

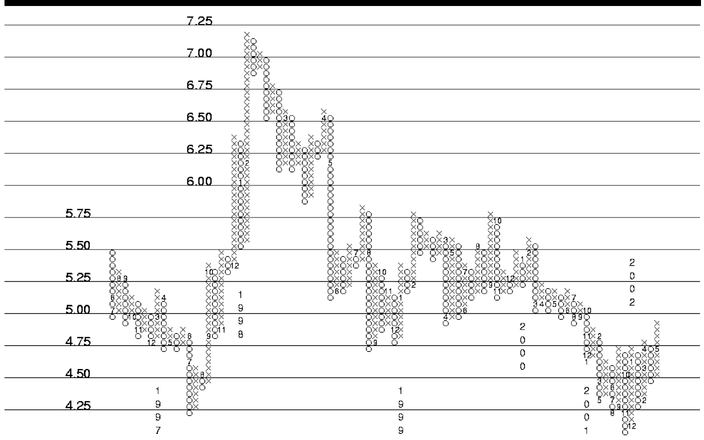
- **What could slow or even reverse gold's rally?**
- **Silver has completed its base formation.**
- **Crude oil is encountering resistance from its top formation.**
- **Coffee is encountering support at historic lows.**

Everything has been moving in gold's favour recently but this is not a constant. Fear has been fuelling the rising gold price. It started in Japan, with fear of bank vulnerability, especially as the Koizumi Government has reduced its guaranteed coverage for depositors against default in two stages - 31st March 2002 and also 2003. Investors in many countries have been more fearful of stock markets, causing some of them to buy gold and especially gold shares. They also have less confidence in paper currencies, including the US dollar in recent months. Mining companies have been major buyers, fearing that their hedging policies have turned from virtuous to vicious circle. Concern over the Israeli/Palestinian and India/Pakistan conflicts has also supported gold. A trend driven by fear alone requires deteriorating expectations regarding whatever asset categories people are abandoning. This is seldom sustainable beyond the medium term. Consequently, improved confidence in Japan, a firmer trend for stock markets and/or the US dollar, and political settlements in the Middle East and South East could easily spark profit taking in gold. Bulls of gold do not need to fear increased mine output or scrap supplies until bullion trades at considerably higher levels. In fact, mine output has declined in recent years, due to low prices. Similarly, we are unlikely to see aggressive hedging until gold has risen to levels generally regarded as unsustainable. Interest rates are another relevant factor. When they rise, it will make gold more expensive to own relative to assets that provide a yield. All of these concerns can lead to profit taking and a correction

London Spot Gold (1USD)



Silver CMX 2nd Month Continuation (0.05USD)



Crude Oil NYME 2nd Month Continuation (0.2USD)

in gold, but they are unlikely to derail the bull market, which is arguably only in its early stages.

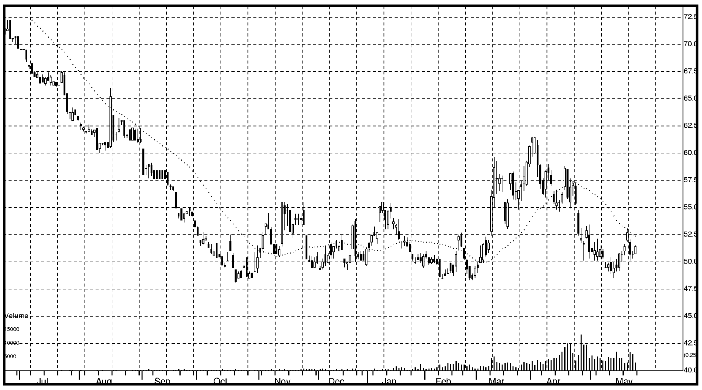
The main if not immediate concern for gold bulls is central bank sales. In theory, the CBs could swamp the gold rally at any time by unloading more of their reserves. How realistic is this? Not very while the price remains under $500 an ounce. Three years ago the European CBs agreed to requests from mining countries, especially those in Africa, not to increase their annual sales above 1500 tonnes until at least 2004. It is not impossible that political pressure, from gold producing countries and from voters in the European countries, including the UK, could lead to fewer CB sales in future. There is no suggestion that the US would sell any of its gold reserves. Consequently, we can probably forget about the possibility of increasing CB sales of gold until the price is much higher. Moreover, it is possible that some CBs in Asia or the Middle East might actually add to their gold reserves. In conclusion, investors can expect a long-term bull market for gold. While the price action will be volatile from time to time, gold has only recently completed its base formations against the main fiat currencies. There is a cyclicality to all markets, which is part fundamental and part psychological. Gold experienced a 20-year bear market, which drove it to extremely depressed levels, particularly relative to financial assets and property. Consequently, gold could easily remain in an overall bull market for a decade or two, first as a value play and much later as another bubble. My minimum long-term target is $1000. A generation has passed since we last saw gold fever. In the minds and hearts of men, no acquisition fever has ever burned longer or hotter than gold fever.

Silver's move to $4.75 (CMX, 2nd month continuation) in April was not maintained. However its latest push to a new high for the year has occurred after support was encountered near $4.45, well above the January floor. Consequently a close below $4.75 is now required to question the base completion hypothesis. The 2nd month continuation chart also shows a considerable amount of overhead supply. However, the hallmark of a true bull market is that it often pushes through potential resistance with ease. We are about to find out if silver has really commenced a significant recovery. I'll give the upside the benefit of doubt, provided the April low holds.

Crude oil has not maintained its move above the April high. This upside failure is another indication that resistance is being encountered from the January 2000 to September 2001 top formation, since a small base was completed at $22 (CMX, 2nd month continuation). A close below $25.8 would break the last remaining uptrend consistency characteristic - higher reaction lows, suggesting that oil was heading back down to at least $22.

You may have seen the articles on coffee prices, which languish near historic lows due to oversupply. However the chart indicates that support has been encountered beneath 50¢ (CSCE Jul) once again. A break of the October to May lows is now required to offset current scope for a recovery rally.

Coffee CSCE July 2002



The Global Economy

■ **Will inflation or stagflation be a problem?**

■ **For the US economy, opinion varies from robust recovery to double-dip recession.**

Conventional wisdom maintains that there will be very little inflation. The concern has been over deflation, which we have long seen in Japan and also global manufacturing sectors over the last three years or more. These trends are likely to continue, because there is insufficient demand relative to capacity for manufacturers to have much pricing power, while Japan is unlikely to adopt an inflation target before BoJ Governor Hayami's term expires on 20th March 2003. High oil prices are always deflationary, albeit after initially lifting CPI and PPI data. The generally low level of most other commodities, especially foods, helped to reduce inflation. Debt is certainly deflationary and there is plenty of that about. A fall in house prices would be deflationary. What about inflation? It is certainly increasing in the services sectors, as we all see when renewing insurance policies and on receiving local government (council) tax bills. Wage costs are likely to increase, despite higher unemployment. Middle management will press for higher salaries because share options hold little appeal when stock prices are flat or declining. Unions will increase pressure for higher wages, having fallen further behind remuneration for senior management during the bubble years. In Euroland and notably Germany, unions are also pressing for more pay following years of comparative restraint while budget deficits were pared, as required by the Stability Pact.

Long-term cyclical factors are also likely to affect prices over the next decade or more. Deflation will become public enemy number 1 after the next recession or two, just as we saw with inflation in the 1980s. The West voted for inflation fighters then and we will call for deflation fighters in future, especially when house prices experience a significant decline. Meanwhile, the US Federal Reserve has been pumping aggressively, to limit fallout from the burst TMT bubble. Japan's Government will surely appoint an inflationist (although he won't be called that) for the post-Hayami era. Japan will require the mother of all reflations to banish deflation and put the economy on course for a significant recovery. Euroland is currently experiencing stagflation. The ECB's mandate is to keep inflation under 2 percent, regardless of what is happening to growth. Once politicians and the public recognise that the euro is just a single currency, rather than an elixir for the region's GDP, as it was often hyped, they will call for a more flexible mandate. In other words, the 2 percent ceiling on inflation will be turned into a guideline, subject to circumstances. Newly re-elected French President Jacques Chirac and his Budget Minister Alain Lambert have already signalled that France won't eliminate its deficit by 2004, a goal of the EU agreed only two months ago. Chirac has promised to boost spending on police and the courts, while also cutting taxes. This can only be inflationary and The European Commission, the EU's executive arm, has criticised France, Germany, Italy and Portugal for failing to meet deficit reduction commitments. Looking well down the road, once inflation becomes part of the collective conscious, it becomes self-feeding and a problem, for which the mirror image will be an increasing price for gold in all currencies.

Regarding the US economy, many people can't see the wood for the trees. In the market's manic/depressive manner, people are focussing on the statistic du jour, causing them to lurch daily from expectations for a sustained recovery to a slide back into recession. Forget it, because the news will be varied. Instead, focus on the big themes, such as oil, interest rates and fiscal policy. Oil is a negative influence at its recent level of $28.45 (spot crude NYME), despite the dollar's decline against some currencies, and won't be in the 'positive for growth' column until it's back below $25. Moreover, anything over $30 a barrel beyond a brief spike would be extremely bearish for the global economy, both psychologically and economically. I'm reasonably hopeful that this won't happen, primarily because of non-OPEC production capability and today's moderate demand. However, the situation is obviously delicate, given Middle East tensions, which are imposing a fear premium. After oil, the next big story is short-term rates, which remain at a very stimulative 40-year low in the US. Consequently, the Japanese deflationary syndrome, with monetary policy "pushing on a piece of string", remains unlikely for the US because a destructive deflation has not taken hold, thanks to Greenspan's rate cuts. However there are debt problems aplenty, especially for corporate borrowers. Few beleaguered companies can raise capital via secondary offerings or the sale of subsidiaries, and long-term rates are not cheap. The main good news resulting from this steep yield curve is that banks can still borrow cheaply from the Federal Reserve and recapitalise by investing in US Treasury bonds. They need this transfusion because a significant slice of debt is going to money heaven. As for fiscal spending, the US military gets most of what it wants for the war against terrorism. Also, with this being an election year, Congress and the White House have thrown billions at farmers. This is on top of Bush's $1.35 trillion, 10-year tax cut. Meanwhile, tax receipts have plunged without the capital gains and bubble economy. The Government and State deficits are likely to be larger and persist for longer than people currently expect. This will weigh on the dollar, although not against the yen, as Japan's problems are infinitely worse. As for GDP growth, the US is on its own, because it won't get much help from stagflating Europe and deflating Japan. Nevertheless, a 'guns and butter' economy should experience moderate growth this year. I'm staying with my US GDP forecast of at least 2 to 3 percent growth in 2002. It's the next recession that concerns me. My guess is that this will occur in 2005, following the presidential election, or it could arrive much sooner if the oil price trades above $30 for a few months. House prices will remain a much bigger influence on consumer sentiment than the stock market. If/when they crack from coast to coast, the US will experience a sharp recession, with a knock-on effect globally.

And Finally…

Daily comments on www.fullermoney.com - As most of you know, I joined the growing band of bloggers, by relaunching my website with a daily comment. This is an additional service for subscribers - current and prospective - enabling me to comment on subjects and events, which I would not ordinarily have room to cover in my letter. I'll not be making timing calls on the site, as they are for paid-up subscribers, but I will include links to articles of interest and related charts, with the latter drawn from www.chartanalysts.com, including its popular new service - C2F2, covering currencies, commodities and financial futures. Feel free to mention the site to others, and send me an email when inclined.

The earliest target date for FM217 is Friday 21st June.

"Work is much more fun than fun."

Noel Coward

Best regards - David Fuller

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Website: www.fullermoney.com ***Email:*** research@chartanalysts.com ***Tel:*** +44 (0) 20 7351 5751 ***Fax:*** +44 (0) 20 7352 3185 ***Single Issue Price*** £35