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

A short-term overbought condition has developed for stock markets and events in Iraq are likely to be an increasing influence. Nevertheless chart action and seasonal factors suggest some further gains.

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If Japan's Nikkei 225 Stock Average remains a roadmap for Wall Street, what is the best that the S&P 500 Index could do over the next few months? Rally 50 percent from its 10th October low at 768.63 to 1153.

How relevant is Japan's bubble experience? People resist this comparison for all sorts of reasons but there is no better guide. Wall Street has closely tracked Japan from the beginning of its super-cycle bull market, all the way to the bubble peak and subsequent fall to date, albeit with a time delay of a little over 10 years. You will see an overlay chart covering the latter stages of these moves in my September issue (FM220) and on my website, in the Comment of the Day archives for that month. OK, we could argue about cultural and economic differences, but let's look at the market facts. Between 1971 and 1985 the Nikkei rose almost 500 percent. The S&P matched this move between 1981 and 1995. Japan's bull market accelerated in the bubble years, with an additional gain of almost 300 percent between 1985 and end 1989. Wall Street experienced an almost identical move between 1995 and March 2000.

'Bubbleology' psychosis has few geographic or cultural boundaries. In the 1980s, most people believed that Japan had developed a superior economic model, evidenced by the country's rapid growth and outstanding technology. In the 1990s, the US corporate model was lauded as a world-beater, evidenced by growth and technological innovation. Neither success story lived up to its hype. Market bubbles breed the worst excesses of narcissism, because people believe they are geniuses. Bubbles create moral vacuums since extreme narcissists believe that it is good to always want more, and that they are entitled to anything they want. However clinical narcissists are never satisfied that they have enough, so they bend the rules of ethical behaviour in pursuit of more personal wealth. Japan's bubble produced a plethora of corporate scandals, exposed in the early 1990s, and exceeded only by the US's scams uncovered after its bubble burst in 2000. Japanese and American households consumed as never before in the bubble years.

After a 50 percent decline from its bubble peak, the Nikkei rose 50 percent. The S&P's bear market reached the 50 percent milestone in July, rallied for a month, fell back on fears of an imminent war against Saddam Hussein, but rebounded once again as the threat of military action receded. If Wall Street continues to follow Japan's road map, the S&P could rally as much as 50 percent from its 10th October low at 768.63, reaching 1153. In this event, almost everyone would be forecasting considerably higher levels for the following months and years. They would not have history on their side. I regard a bear market rally of 50 percent over the next few months as the best-case scenario. Some technicians believe the S&P will run into a wall of resistance in the 950 to 1000 region. We'll soon see but I suspect this is unlikely, unless arms inspectors find Iraq in serious breach of the UN's resolution, causing war to become an imminent prospect. However even in this event, I suspect the October lows would hold and that an additional recovery would commence shortly after regime change, before the secular bear market resumed. Obviously the US market and others in its sphere of influence will not follow Japan's prior course indefinitely, but similar events and behavioural patterns suggest that it is still our best guide.

Interest Rates and Bonds

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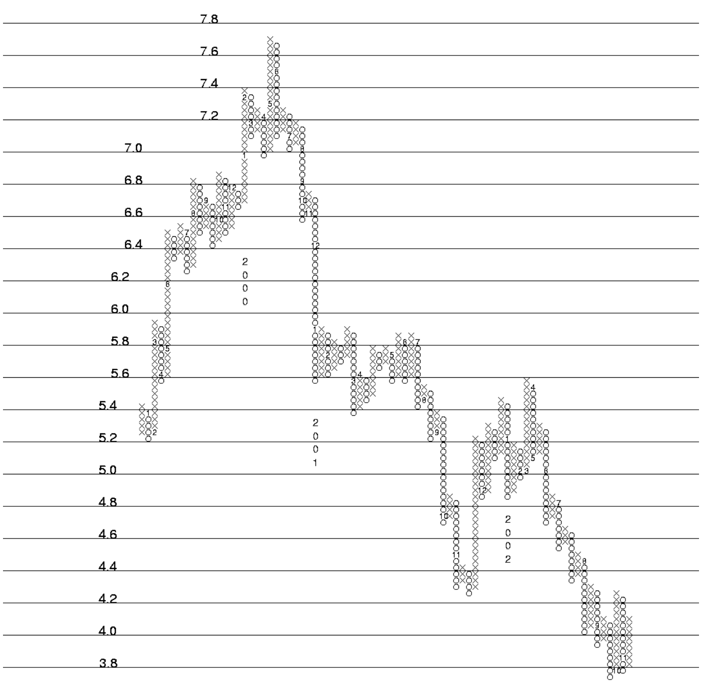
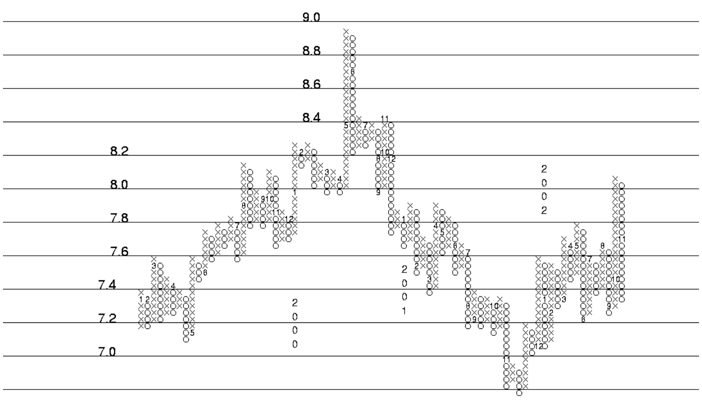
- **The spread between AAA and BBB rated corporate bond yields is narrowing in line with the stock market rally.**

Europe certainly needs lower short-term rates. The European Central Bank is likely to abandon its hair shirt policy over rates, at least partially, judging from recent statements. For Germany and Euroland's other big

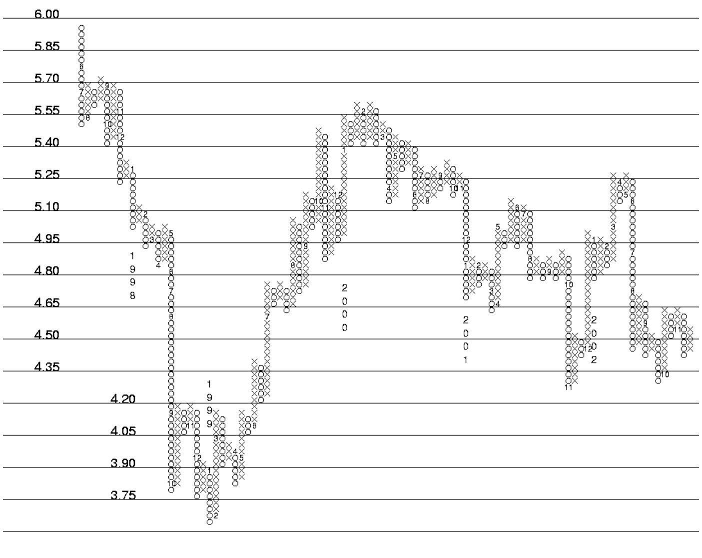
MSCI Euro Dollar Index AAA Rated Yield (0.04)



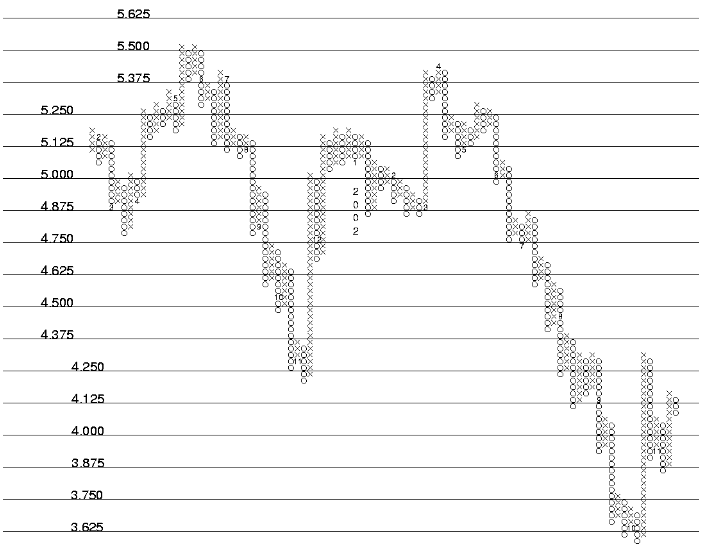
MSCI Euro Dollar Index BBB Rated Yield (0.04)



Euro Bund 10 Year Bond Yield (0.03)



US 10 Year Bond Yield (0.025)



economies teetering on the brink of recession, this will be another case of too little too late but it is better than no cut. UK manufacturing could certainly use lower rates but the Bank of England's Monetary Policy Committee has been deterred once again by house price appreciation. It does not want the property bubble to inflate even further. In the US, the Federal Reserve and Treasury remain focussed on the race to stimulate corporate capital expenditure before consumer spending further subsides. Failure to do so would certainly tip the economy back into recession. Consequently Greenspan will not hesitate to cut the Federal Funds Rate from its present 40-year low of 1.25 percent, should economic data deteriorate over the next few months. Japanese rates are already near zero but Prime Minister Koizumi is certain to appoint someone more accommodating on other aspects of monetary policy than current Bank of Japan Governor Hayami, who's term expires on 20th March.

US government long-dated bond yields are consolidating prior to a further test of overhead resistance. The p&f chart shows that a significant low was reached at 3.575 percent in early October. Following a retracement of approximately 60 percent of that month's rally, yields are pushing higher once again. The current consolidation should enable potentially formidable lateral resistance in the 4.2 to 4.3 region to be tested once again. Euro-bund yields show a similar although less volatile pattern, possibly because they did not fall as far during the April through September decline. A move to 4.65 percent would clear initial resistance and indicate somewhat higher levels. However, government bond yields are likely to ease once again when investors conclude that the stock market rally is over.

The stock market rally has increased confidence in higher-yielding, lower-rated corporate bonds. Widening yield spreads between AAA and BBB rated corporate bonds has been an understandable feature of the post bubble environment for shares. However, the stock market rally commencing on 10th October has increased confidence, causing bond investors to reduce exposure in top-rated issues in favour of the higher yields evident in more risky corporate debt that was previously shunned. We can expect this narrowing of spreads to continue while the equity rally persists, before widening once again when the next decline in stocks triggers another flight to quality.

Strategy on bonds - Having much preferred bonds to equities throughout most of post bubble period to date, especially government and A-rated or better corporate issues, I favoured taking profits in my previous issue (FM221), because of the stock market rally. My preference was for cash so I missed an opportunity in B-rated issues, which have done well during the share market rebound commencing on 10th October. This window of opportunity will stay open for as long as stocks remain in a short-term uptrend. However I'm not tempted to chase, especially with the possibility of a military move against Saddam Hussein in the next few months. My overall strategy is to raise cash.

Global Stock Markets

- **If/when the prospect of war against Saddam Hussein appears imminent, stock markets will weaken, at least until hostilities commence.**

- **Corporate profits will disappoint more often than not, for a number of years, with or without some economic recovery.**

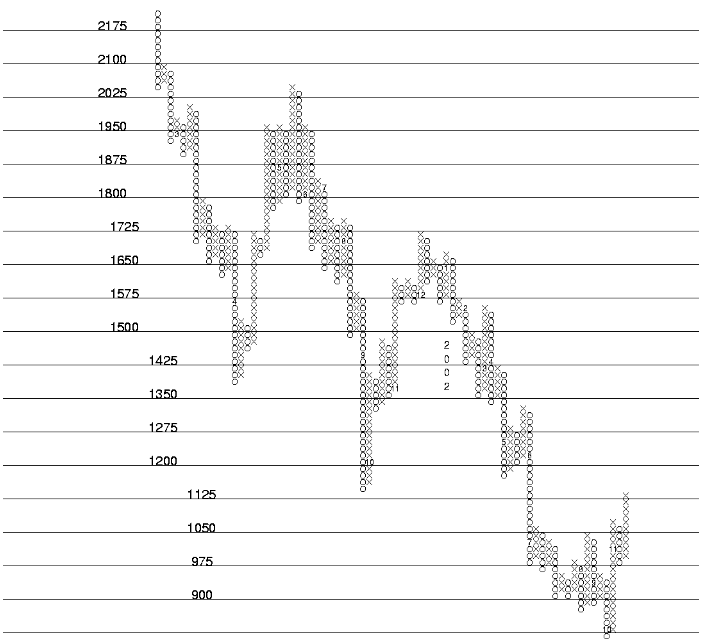
- **Technically, the medium-term rally window remains open, albeit within a secular bear market.**

Psychologically, the near certainty of war would override other considerations by investors. Fear of war in the Middle East by November was one good reason why stock markets were so weak in September and early October. Those fears abated on 10th October when opinion correctly shifted in favour of renewed arms inspections by the United Nations, giving Saddam another chance to comply. The Iraqi dictator's understandable decision on 13th November to accept the UN Resolution for Resuming Arms Inspections, rather than face imminent removal from power, has given investors a bit more breathing room in which to contemplate improved technical action since 10th October, plus favourable seasonal factors. However, if/when Dr Hans Blix and his team return to the UN Security Council to report interference and subterfuge by Iraqi officials, the prospect of war against Saddam Hussein will move centre stage once again. Also, it could happen much earlier with the 8th December deadline for Saddam's Administration to make a full disclosure of its weapons programmes. Anyone who read the grudging acceptance letter from the Iraqi Foreign Minister (see text on www.fullermoney.com, 18th November's Comment of the Day) will note, amidst the bombast, a repeated denial that any weapons of mass destruction programmes exist. If this is soon proven to be a lie, as must be a possibility, Iraq will be in serious breach of the UN's latest resolution. That would certainly be bearish for all stock markets, because the prospect of war would deter demand and prompt selling. Investors will worry about the worst-case scenarios, as they always do when faced with uncertainty, especially as there is a leap-in-the-dark element to even the most one-sided conflict. However, most historical precedent, including the last Gulf War, suggests that stock markets will rally sharply once hostilities commence, in yet another example of 'sell the rumour, buy the news'.

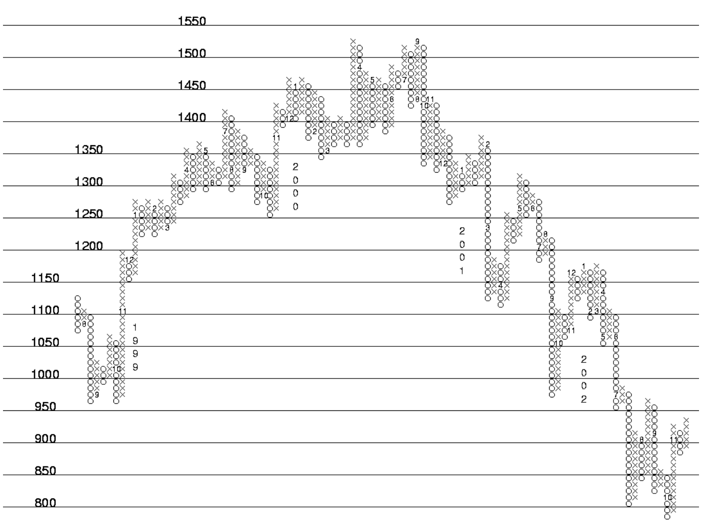
Unfortunately, most of the generation that commenced trading stocks in the 1982 to 2000 super-cycle bull market will be slow to adapt to the new post bubble reality. That's human nature. Markets condition expectations and responses, in the Pavlovian tradition. Moreover there is denial. Wouldn't it be nice if we were somehow in an equivalent period to the early 1990s, as some suggest, at least in terms of valuations. We could fill our portfolios with "bargains", sit back and enjoy the ride. And why not leverage up in anticipation of another bubble around 2008, which we could all play more successfully than the last one, enabling us to buy that extra property or two. Brokers and long-only fund managers, who don't know or don't want to know their market history, are especially susceptible to this line of wishful thinking. Who wants to contemplate a challenging market environment, in which we have less job security, there are few sustainable uptrends and declines often exceed rallies, in both speed and extent? OK, we're not gipsy fortune-tellers and no one knows what the future holds, so the optimists are in with a punters chance, as they say. However bad things happen in the post bubble environment. Look at Japan, which saw its bubble burst in 1990. Consider the post 1966 environment, through 1974 and beyond. And the 1966 highs were less a bubble than a bit of irrational exuberance. Look at post 1929, or any of the great bubble aftermaths of earlier centuries. Why should it be different this time? There is very little GDP growth in the global economy and it is disturbing that the US economy and stock markets have not responded to all the interest rate cuts - something we had not seen since the 1930s. Worryingly, companies leveraged their balance sheets in the late 1990s, often to boost their share prices through stock buybacks and serial takeovers. According to some estimates, US corporate borrowing rose from $600bn in the latter 1990s to over $1.1tr in 2000. Today companies are paying dearly for this debt, which saps earnings, and most of the takeovers have become an additional liability. Firms with big, unionised labour forces have underfunded pension liabilities, which are a further drag on earnings. Corporations have little pricing power, because thanks to the microprocessor and globalisation, the world is producing far more goods than it can consume. Consequently profits, such as they are, are often achieved by cost cutting, especially staff reductions. Meanwhile, the ticking bomb is less al-Qaeda, although it certainly remains a serious concern, than property bubbles in the US and UK. Lending institutions have been throwing money at homeowners and property speculators, causing mortgages to soar in both countries. Job losses in London's financial community have climbed to at least 120,000 since the stock market bubble burst. This has now pierced the property bubble in the UK's Southeast, and the effects will inevitably spread to other regions of the country in coming months. The US is similarly vulnerable as property values in New York and other financial centres provide the first evidence of a deflating bubble. Meanwhile, mortgage equity withdrawal, which is encouraged by refinancing following interest rate cuts, has reached 6 percent of disposable income in the UK and between 2 and 2.5 percent in the US, according to some sources. In other words, for each £100 pounds earned net of tax, people in the UK are spending another £6 on average, effectively consuming their homes, brick by brick. This can only be a future problem in the making.

Breaks above the August highs by US and other stock market indices would further improve sentiment. The medium-term recovery is still underway. US indices have consolidated their gains since rebounding from the July lows in October and nudged above their early-November highs. The DJIA recently recorded its seventh consecutive week

Nasdaq 100 Index (15pt)

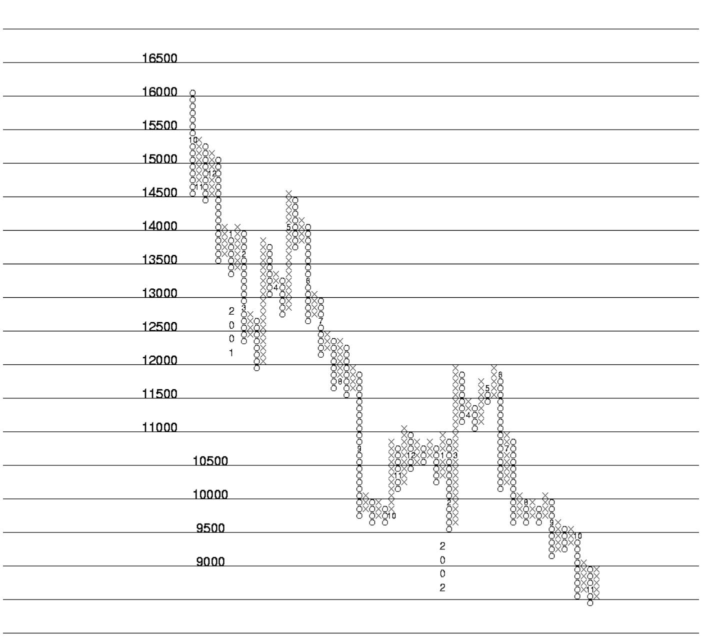


S&P 500 Composite Index (10pt)

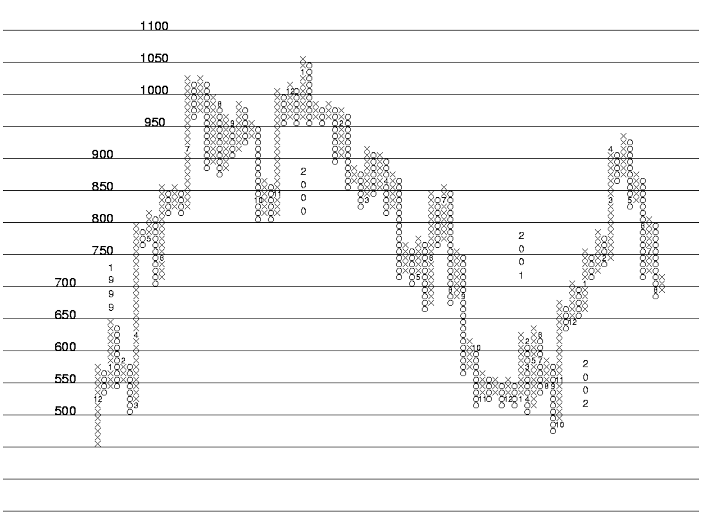


of gains for the first time since 1999, providing further evidence that investors are returning to the market. The NASDAQ is leading the recovery, in a reversal of its post March 2000 form, and has already cleared its psychologically important August high. This improvement by tech and telecom stocks underlines the firmer tone. Seasonal factors are bullish. European markets will follow the US lead. Among major stock markets, only Japan has been conspicuous by its underperformance, but even it has firmed recently. Inevitably, the medium-term rally's next big test will come from developments in Iraq, following 8th December, as discussed above. Once investors sense that war is imminent, the stock market rally will go into reverse, at least until the move for regime change commences. Nevertheless there is a good chance that the October lows for US and European markets will hold during the pre-war reversal, followed by some further gains in the first few months of 2003. However, excesses from the US's bubble -

Nikkei 225 Stock Average Index (100pt)



South Korean KOSPI Index (10pt)



the biggest in history - will not be unwound in three years, anymore than Japan's were following its burst bubble in 1990. Understandably, few people wish to believe that Wall Street and other stock markets tethered to its performance could follow Japan's path, but this is precisely what has happened so far, on the way up, during the subsequent 50 percent decline by the S&P 500 Index and medium-term recovery from that psychological milestone. The Nikkei 225 Stock Average remains our pre and post bubble roadmap, with a time lead of almost 11 years, as I have illustrated in earlier issues and on my website.

Chart review of topical and representative stock market indices - *The 3-box reversal point & figure charts shown are based on closing prices and taken from our website. Anyone interested in this chart service, which includes analysis and is updated daily, should register online at www.chartanalysts.com. Price levels mentioned refer to market closes. Please note, the index levels shown below were updated through the market close on 28th November, a day after the charts were prepared.*

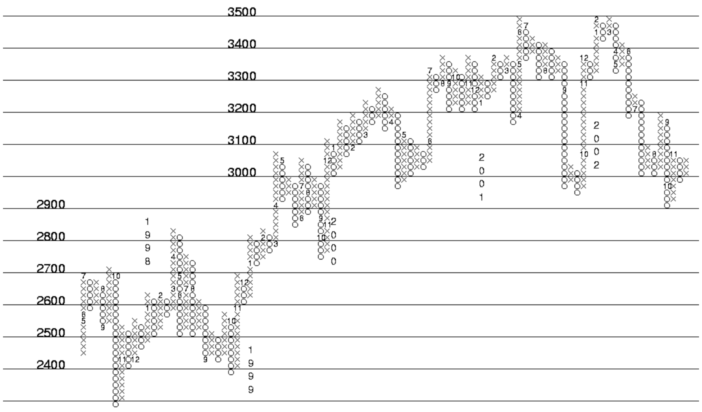
The US's S&P 500 Index (938) has pushed above its early-November high, opening the door to a test of very important psychological resistance from the August high and also the underside of what many technicians refer to as the "massive head & shoulders top", spanning July 1998's peak and subsequent reaction that year, all the way over to the September 2001 low and the following rally peaking in January 2002. I remain uncomfortable with this H&S interpretation, because with any ranging rally and subsequent decline, one can identify numerous H&S-like patterns, which questions their relevance. However I do not underestimate the psychological significance of the 950 to 1000 range for the S&P. With so many people focussing on this region, it is unlikely to be overcome easily. However if/when it is cleared, the ranks of forecasters proclaiming "a new bull market" will certainly swell. Meanwhile, a decline to 870 is required to significantly delay some further test of overhead resistance. **The NASDAQ 100 Index** (1125) has rallied nearly 40 percent from its October low. While this is a substantial gain, it is not statistically significant relevant to other good rallies since the March 2000 peak, nor is the numerical gain unusual. However, this recovery has occurred from a lower level, following a decline of 83 percent. Moreover the NASDAQ is now higher than it was 5 months ago, something we have not seen since the bubble burst. In also being the first index of consequence to clear its August high, the NASDAQ shows evidence of base formation development. While this is likely to be a lengthy process, involving at least a retest of the low at some point, and the rally is approaching resistance, a move below 975 is currently needed to show a significant a loss of near-term upside momentum.

Japan's Nikkei 225 Stock Average Index (9176) did not maintain November's new low. This first hint of improvement in several months has now been followed by a break of the previous rally high, not yet shown on the chart, which was updated a day earlier. While this has checked the downtrend, with a new closing low in early November it would be premature to talk about more than a catch-up technical rally at this stage.

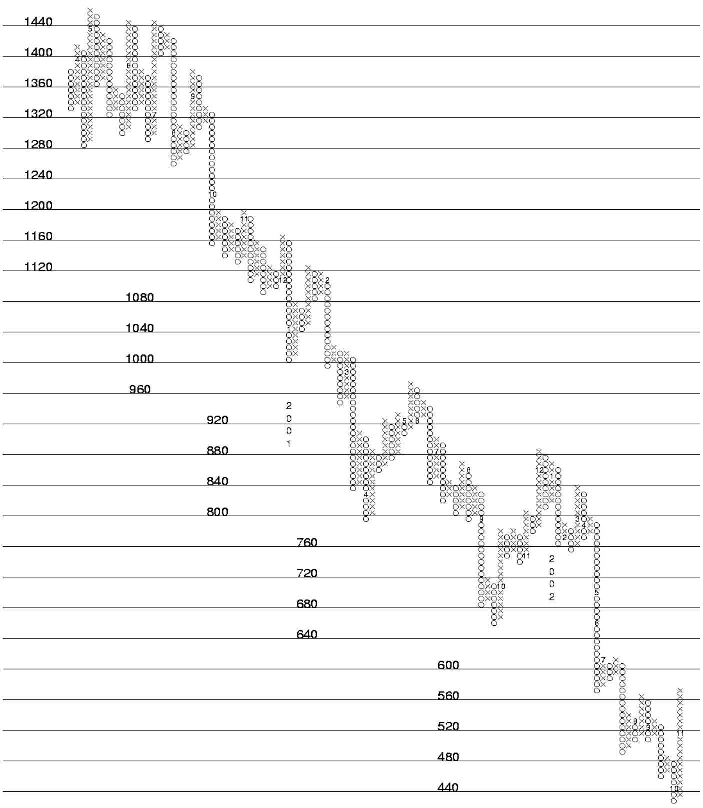
South Korea's KOSPI Index (715) accelerated lower in September and early October before encountering support within the upper region of its 2000-2001 trough. It has subsequently broken the progression of lower rally highs evident since May, indicating scope for some additional recovery.

Australia's S&P ASX 200 Index (3044) - *see overleaf*- has followed its failed break under the three lows established in April 2000, September 2001 and July-August 2002, with a consolidation of gains. A decline to 2960 is now required to offset some further recovery, albeit limited by heavy

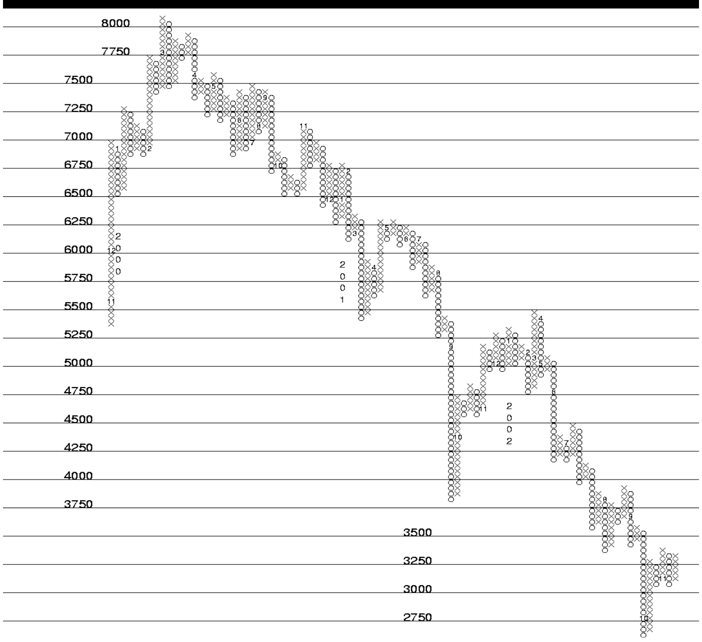
Australia S&P ASX 200 (20pt)



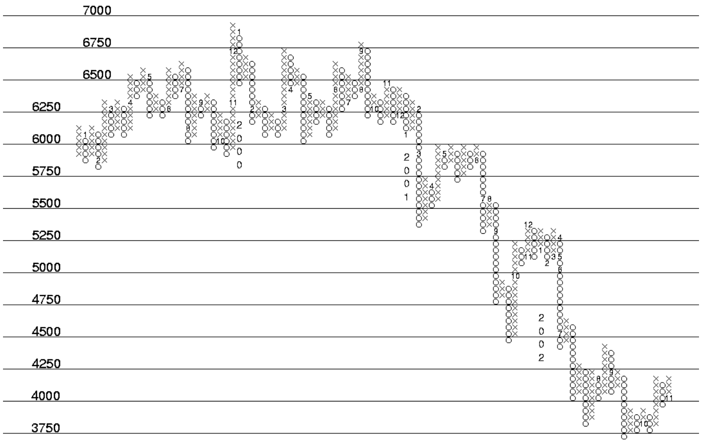
Sweden OMX Index (8pt)



German DAX Index (50pt)



United Kingdom FTSE 100 Share Index (50pt)



overhead supply.

Germany's DAX Index (3360) bounced following its accelerated decline in September and early October but is currently hesitating near the early-November high. Consequently a close at 3400 is required to indicate a further test of overhead resistance.

Sweden's OMX Index (584) has experienced one of the stronger rebounds, clearing the August high as well. However any further near-term gains would be difficult to maintain without a prior period of consolidation.

The UK's FTSE 100 Index (4185) needs a close at 4200 to indicate some further scope towards the August high.

Strategy for stock markets - Most indices have ranged gradually higher after their brief burst upwards following lows on 10th October. Some of the gains have been quite strong, particularly in tech stocks where many hedge funds had their largest short positions. Now that these shorts have been considerably reduced, an important source of demand has been removed. Improved sentiment also indicates that long only buyers have been returning. Needless to say these people would be further emboldened if more of the August highs were taken out anytime soon. However, forecasts that the bear market is over by an increasing number of brokers and investment managers should be treated as a contrary indicator. OK, there has to be a statistical chance that they could be right, but all post bubble history argues otherwise. Meanwhile, sentiment is always a far better indicator of what people have done, rather than of what the market will do. A number of short-term overbought conditions have developed as I complete this issue. The rally is approaching critical levels of prior resistance, particularly the all-important (psychologically speaking) S&P 500 Index. Iraq and a probable war against Saddam Hussein will be back in the spotlight before long, ending the current lull during which UN arms inspectors have been preparing to resume their search. War concerns alone can easily overshadow all other considerations, such as favourable seasonal factors, lower interest rates, fiscal spending, somewhat higher corporate earnings and recent technical improvements. Tactically, I would be reluctant to increase longs this side of war, which would create a better buying opportunity. However I would consider lightening longs, especially with trading positions, on any additional near-term strength. I'll be looking for opportunities to short once these rallies roll over and/or are checked by downward dynamics, before covering and probably reversing shortly after military action commences. For those who are not traders and are already in the market, as most of us are to some degree, you will probably have a better opportunity to raise more cash once Iraq is no longer a concern. However, few charts show patterns capable of supporting more than technical rallies. I continue to assume that we are seeing no more than a medium-term recovery in what remains a secular, post bubble reversion from extreme overbought to what I suspect will eventually be extreme oversold conditions, in terms of historic valuations. My strategy on all other positions mentioned in recent issues is unchanged.

Currencies

■ **The euro/dollar rate may have found its script for a further advance - renewed concern over the current account deficit.**

■ **Japanese officials' public squabbles and indecision are weighing on the yen once again but have the country's commercial banks been told to repatriate capital from overseas before selling domestic assets?**

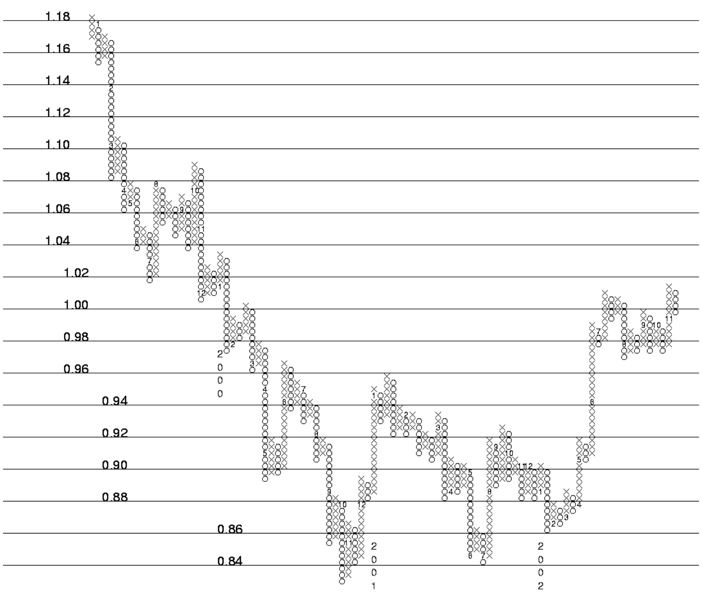
In markets, never mind the "facts" - it's perceptions that count. Markets are not intellectually/analytically complicated, despite the frequent analytical hype. Instead, and not surprisingly, markets are appropriately and mockingly human in their psychological nuances. How could it be anything else, since humanoids do the buying and selling? Patronising men have said the market is like a woman. Perhaps, but have you ever met a bloke who was any less capricious or mercurial when it came to money and markets? I haven't, myself included of course, which brings me to the US current account deficit. In the eyes of the market this is either an irrelevancy or a serious concern, depending on the dollar's trend, naturally. My own view on the accuracy of the deficit (and this is also an irrelevancy, except for stats wonks) is that it is wildly misleading. Why? Because the US at least partially owns, through foreign affiliates, much of what it imports. Moreover, most of what the US exports is produced by similar and at least partially owned foreign affiliates of US multinational companies. In other words, the US is rather adept at playing the globalisation game but this is not reflected in the current account data, which if taken at face value, suggests that the US is either inefficient, profligate or both. However this is also an irrelevancy in terms of the market, where the mob will believe what it wants to believe, dictated by the trend. Currently, it is worrying about Euroland's feeble overall growth. However when the single currency next firms from support to retest $1.02, people will focus on America's current account deficit. Meanwhile, the slow moving euro/dollar longer-term trend continues to indicate that the single currency is likely to appreciate somewhat further against the greenback, following a short-term correction as resistance was encountered in early November, a little under the July high of $1.0212. This should be contained by initial support in the $0.99 to $0.96 region. Thereafter, my long-standing forecast is to $1.10 to $1.15, with the possibility of a temporary overshoot, at least until Euroland fusses loudly about the "excessive strength" of its currency.

Japan's bureaucrats are showing a new sense of urgency. They may not be achieving much but activity has increased, similar to frogs in a pot, stirring from their languor as heat from the fire below increases. Unfortunately, it's mostly bickering rather than any quantum leap in deflation fighting, as consensus-favouring Japan remains unable to agree on policies. Hayami and Co at the BoJ are dead set against an inflation target, which Koizumi and the MoF favour. Hayami says this would push up bond yields and damage the central bank's credibility - as if it had any credibility to lose after four consecutive years of deflation on his watch as BoJ governor. 10-year JGB yields of just over 1 percent can only mean that monetary policy is deficient. It may not improve until Hayami is replaced on 20th March, when his term expires. The BoJ is printing lots of money, but it is being recycled through the commercial banks, which plough it straight back into JGBs. This buys up government paper but is of little help to the private economy. Meanwhile, Hayami 'sterilizes' (mops up) any liquidity that leaks into the economy, because he is trying to prevent the MoF from weakening the yen. There are rumours that he has also told commercial banks to sell overseas investments rather than domestic shares or bonds, should they need additional capital. This would increase repatriation, providing further support for Japan's currency. Judging from the charts, it would only slow the yen's devaluation. International investors continue to pull money out of Japanese stocks, which have underperformed US and even European equities in recent weeks. Forex traders prefer most other developed country currencies to the yen on yield considerations, and the dollar because of the US's better growth potential. Additionally, recent calls in Japan for big tax cuts and much more fiscal spending can only mean another jump in government debt, necessitating further printing of money by the BoJ.

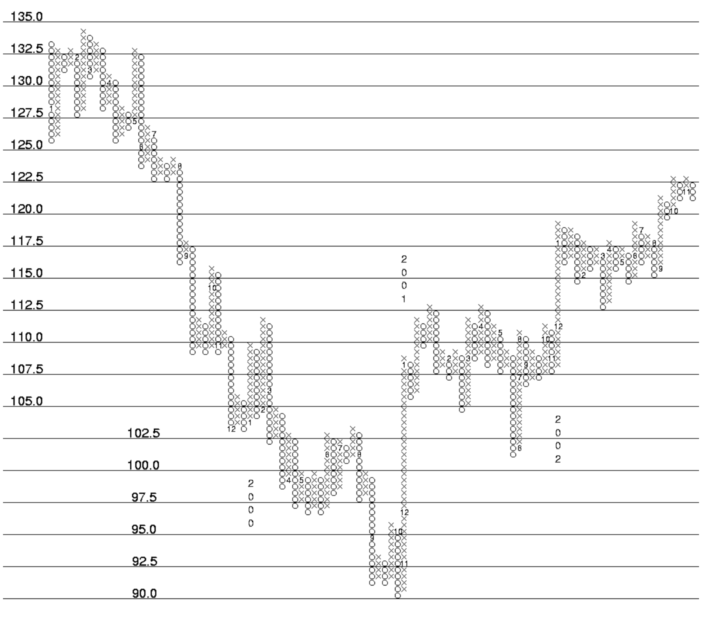
**Chart review of important and topical currencies - ***These and hundreds of other 3-box reversal closing basis point & figure charts are available on our website, www.chartanalysts.com and are updated daily. All comments refer to closing levels for US trading hours.*

Euro/dollar ($0.9912) - *see overleaf*- Last month I felt the current trading range had a top heavy appearance, suggesting a temporary dip before completing this first step above the base and breaking to the upside. Instead, the euro ran to a new closing high but couldn't maintain it. Failed breakouts are sometimes followed by a test of the opposite side of the pattern. However the recent decline has been orderly, so with no downward dynamics, I suspect downside scope from current levels is quite limited. Moreover the present consolidation and underlying base should eventually support a further recovery for the euro.

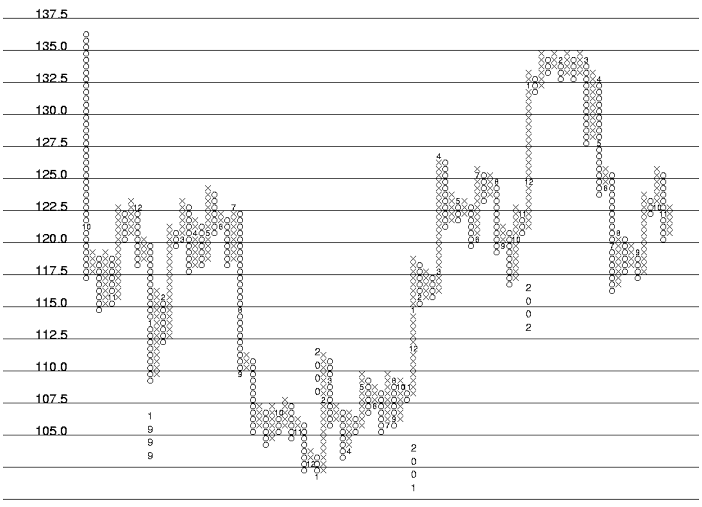
US Dollar per 1 Euro (0.004)



Japanese Yen per 1 Euro (0.5)



Japanese Yen per 1 US Dollar (0.5)



Euro/yen (¥120.41) - The euro fell back from its high for the year, suggesting further ranging near current levels before extensive underlying support and the long-term uptrend sustain higher levels.

Dollar/yen (¥121.78) - The dollar bounced from ¥120, the upper side of the small July to early-September trading range. Consequently a close at ¥119.5 is now required to delay scope for sideways to higher ranging

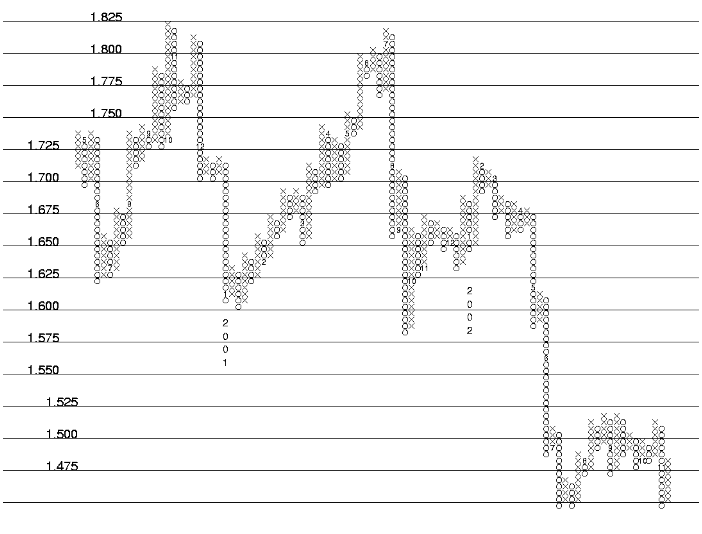
Dollar/Swiss franc (SF1.4895) - The greenback eased steadily in late October and early November to test its July low at SF1.445, and it is moving just as steadily up from that level as I complete this issue. While an upside breakout at SF1.520 would indicate some further recovery towards overhead trading, the more likely event is that resistance will be encountered beneath that level, followed by a retest and break of the July-November lows.

Sterling/dollar ($1.5435) - The pound was unable to maintain its early-November breakout. Nevertheless, support within the present trading range and from the underlying base should cushion downward risk before long, followed by a further test of overhead resistance from trading prior to April 2000.

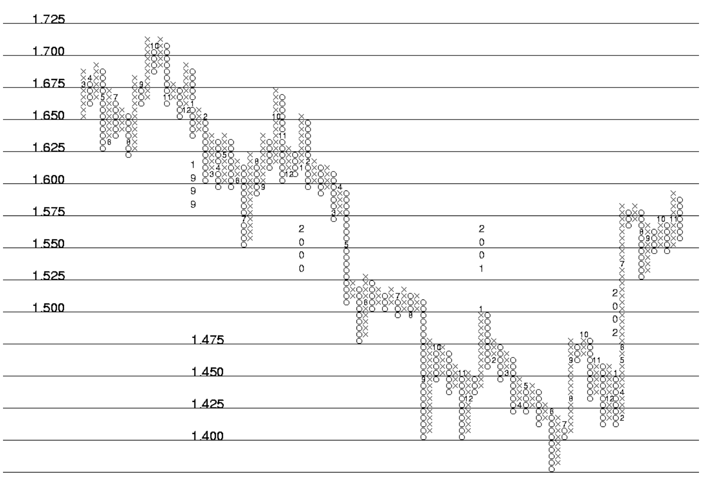
Australian dollar/US dollar (US$0.5555) - The Australian dollar's rally has been checked by resistance evident just above $0.57. While this remains a formidable psychological barrier, underlying trading resembles a large, developing base with H&S characteristics, capable of eventually supporting higher levels.

Strategy on currencies - Markets have been choppy, which is not conducive to leveraging on strength or trend-running tactics. Also, whipsaw moves in trading ranges, even within primary trends, are stressful. Traders know these pressures come with the territory but that is little consolation when so much emotional energy is wasted. However, one tactic is appropriate for the volatile environment that we have seen recently. It's the Baby Steps buy-low-sell-high range-trading strategy that I often advocate. Where I have used this recently, lightly scale-down buying the euro in the upper $0.90s against the dollar and trading out near $1.01, or purchasing the greenback against the yen after it has already fallen back to prior support and everyone is talking it lower except for the MoF, and then lightening on the next rally, especially when short-term indicators such as Stochastics (TAS 'GO' on Bloomberg) are overbought, I make money. However these are not big profits because gains are taken quickly. Also, and crucially, in averaging on a losing position when getting on board, albeit lightly, one is incurring open position losses, which must be kept small relative to one's capital available for this type of trading, otherwise there is no monetary discipline. Obviously people who do not trade within their capital allocated risk going bust. They may get away with it a few times but people who 'go for broke', eventually *do* go broke. Returning to my own trading, mostly against the yen, had I used Baby Steps recently in euro/yen and sterling/yen, I would have done very nicely. However I didn't, because I was

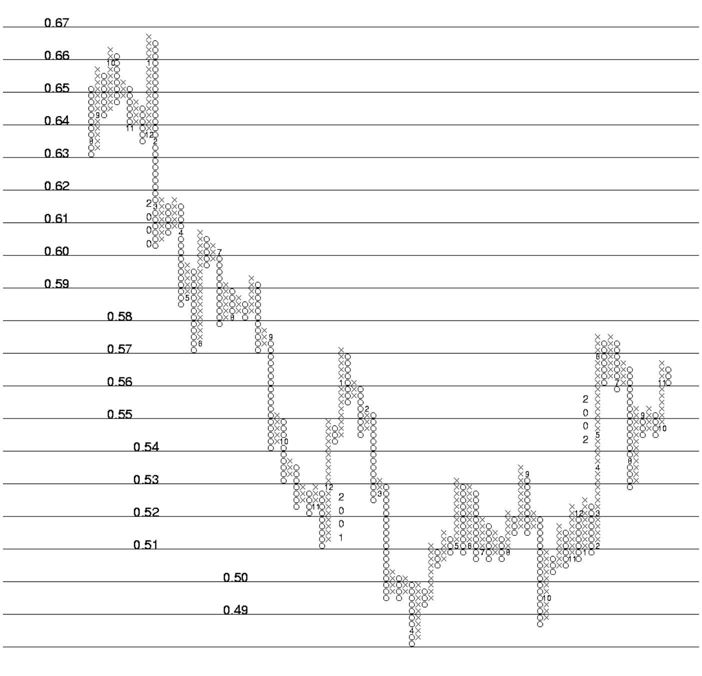
Swiss Franc per 1 US Dollar (0.5)



US Dollar per 1 Pound Sterling (0.005)



US Dollar per 1 Austrailian Dollar (0.002)



hoping that the big trend would reassert itself. It didn't. Consequently gains were eroded and I was stopped out of euro/yen, and found myself scrambling back in at higher levels within the ¥120 to ¥123 range, which is statistically insignificant but not insubstantial when one has leveraged positions and emotional energy is being expended as gains appear and disappear just as quickly. I detail this, not I trust, as an act of narcissistic and self-indulgent masochism, but because I believe in full disclosure as part of the learning process. I offer my views in this publication, on my website and in my audio recordings for subscribers. I don't tell people what they should do, which would be arrogant and presumptuous, but I mention what I do in the markets. At the bottom line, trading and investing isn't easy. However if we read the charts, are alert to the underlying psychology, try and understand the economic background and exercise monetary discipline, we can make a nice living in the markets most years, and it sure beats the gaming tables which hold no interest for me. Back to Baby Steps range trading versus trend running, you and I can only deal with the reality provided by the markets. Most reserve currencies are in primary uptrends against the yen, the dollar being the most arguable exception, and also have positive interest rate differentials. Therefore I will trade accordingly, combining an element of Baby Steps with trend running. Recently, a tactic based entirely on Baby Steps would have worked best, as mentioned above. However, while the primary trends remain intact, odds favour eventual breakouts and further upward steps against the Japanese currency. Look for sustained breaks to new rally highs for the year against the yen by several of the lead currencies, such as the Norwegian Krone, in which case trend-running tactics will be preferable to Baby Steps, at least until the next trading ranges become apparent.

Commodities

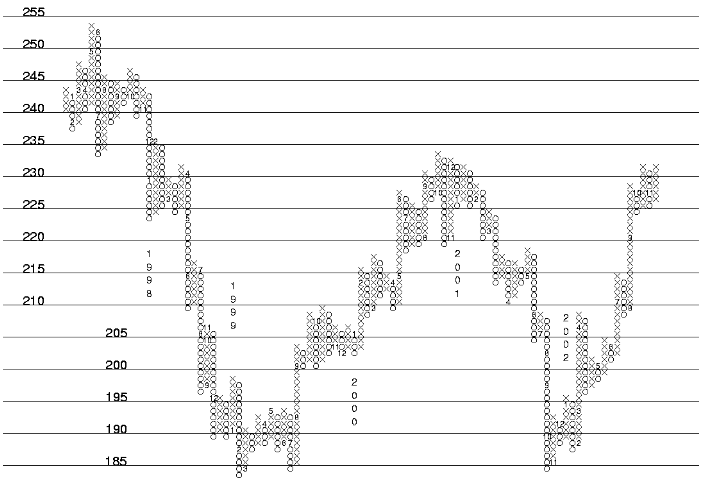
- **CRB Index of commodity prices remains near a 5 year high, despite slow GDP growth.**

- **The war premium for petroleum futures is returning.**

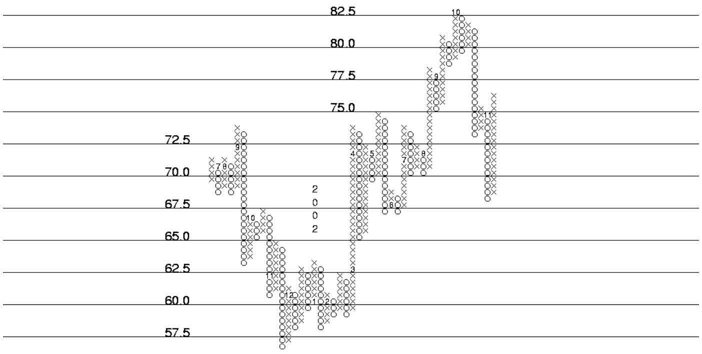
- **Gold bullion continues to encounter resistance in the $325 to $330 region, which it must clear decisively to complete the multi-year base.**

The paradox of a strong CRB Index, when global GDP growth is weak and deflationary pressures abound, is explained by food and energy costs. Turbulent weather conditions in some critical agricultural regions, including the US, are an important contributor to this year's price rises. With so many crops affected, is this due to a fluke coincidence or global warming? No one knows for sure but the trend has been for more erratic weather recently, ranging from drought in some areas to excessive precipitation elsewhere. Energy costs are another major factor. OPEC's additional cutbacks lifted prices earlier this year and they received a further boost as dealers hedged long in August and September, in anticipation of a war against Saddam Hussein. Prices fell back after President Bush rallied United Nations support for a new

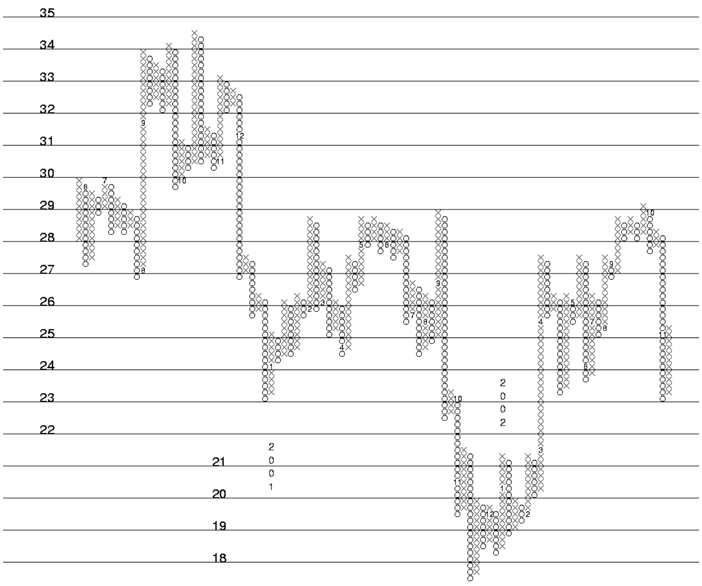
CRB Index NYFE (1USD)



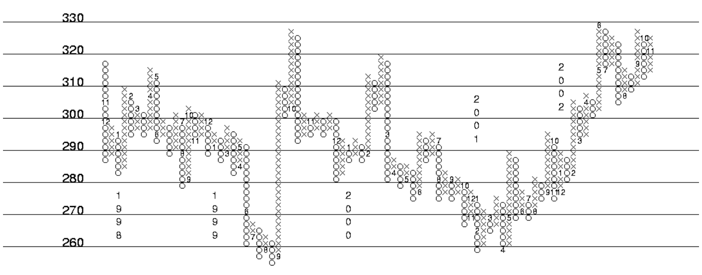
Heating Oil NYME January 2003 (0.5USD)



Crude Oil NYME 2nd Month Continuation (0.2USD)



Gold CMX 2nd Month Continuation(2USD)



resolution against Iraq's regime, including the return of arms inspectors. However the war premium is returning as petroleum traders anticipate further tensions once the inspectors get close to Iraq's alleged WOMD facilities. If war appears imminent, prices will probably surge, only to fall back sharply once hostilities commence, as we have seen previously.

Gold has backed away from resistance once again but is likely to firm on Middle East tensions. Bullion fell back from lateral resistance as war fears abated and global stock markets rallied. However it continues to range in the upper region of what clearly looks like a massive base, which has been forming over the last 5 years. If the lows within this pattern's upper range continue to edge higher, as they might on Middle East concerns and as a hedge against the possibility of further stock market turmoil, the prospect of an upside breakout before long remains technically possible. That said, there are few calls more difficult than the timing of a breakout, especially from multi-year bases. Meanwhile signs of a potential decline back to the middle/lower region of gold's base, which seems less likely, would first emerge with a break of the rising lows evident since the June-July correction to $304, on this $2 scale chart based on US closing prices.

The Global Economy

- **Deflation, debt and default remain serious problems for the global economy.**

- **2002 will be the 4th consecutive year of record corporate debt defaults.**

- **Crude oil is still trading at deflationary levels, influenced by expectations of a war against Saddam Hussein.**

- **Terrorism is deflationary in terms of consumer spending.**

- **And now the good news - the green shoots of democracy are evident in more countries than ever before in human history.**

There is no easy solution to the deflationary pressures. Unless you remember the 1930s, this is new territory for most of us. "Just a minute", some say - "there is little likelihood that the US, UK and most other countries will follow Japan's route, let along repeat the 1930s depression". And so we hope, but the trend is still moving in the wrong direction.

Consider Japan. Despite much debate - argument really - over how to handle the banking crisis, very little has been achieved. Japan's lending institutions remain technically insolvent, and with non-performing loans increasing faster than they can be written off with yield and capital appreciation gains from the BoJ-supported government bond market, banks are understandably reluctant to lend. The Nikkei 225 Stock Average Index hovers near its lowest level since 1983. Property values have fallen accordingly. The yen remains overvalued; exports are falling, while capital expenditure remains weak, as does consumer spending after a brief improvement in 3Q 2002. With both the RPI and CPI in their fourth consecutive year of decline, Japan's deflation not only persists, it is also intensifying.

Consider China. The world's manufacturer of first resort, China inspires both admiration and fear, the latter because its cost effectiveness and seemingly unlimited labour force is compounding global deflationary pressures. Many see China as the next great global superpower. Well, organise 1.3 billion people and you are a power by definition. However it is increasingly difficult for China to export more to a slowing global economy and deflationary pressures are intensifying. While it is impossible to get accurate information, especially from the government, many reports mention China's rigid political system, overemphasis on central planning, heavy subsidies, endemic corruption and ballooning unemployment as reason enough for concern. Membership in the World Trade Organization will subject China to some unfamiliar competitive pressures. Read "The Coming Collapse of China", by Gordon G Chang, published by Random House.

Consider Germany. The world's third largest economy has been largely stagnant for over a decade. With unemployment rising, consumer demand and capital expenditure weak, Germany is sliding along Japan's path, albeit without the prior bubble. While part of the problem is psychological, as Germany has increasingly faced an identity crisis since the euphoria following collapse of the Berlin Wall, this angst is partially due to the system. Germany has far less control over its economic destiny in the single currency and an increasingly political Euroland. Arguably, Germany needs short-term interest rates at the US level of 1.25 percent, or lower. Instead, the ECB must consider all of Euroland and work within its self-imposed deflationary mandate. Consequently the rate remains at 3.25 percent. Consider the absurdity of a one rate (mis)fits all system, whereas if free to establish rates independently, the high/low spread among Euroland's individual states could easily be 500 basis points. Similarly, it is harder for Germany to tackle structural problems, let alone increase fiscal spending as would seem appropriate for an economy in danger of sliding into deflation, when faced with the (in)Stability Pact.

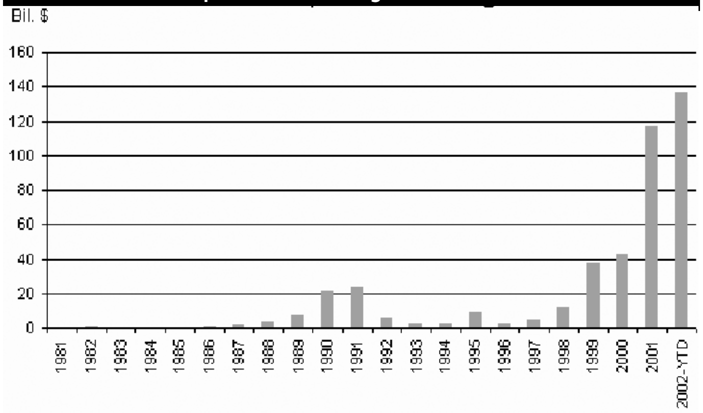
Consider the US. Arguably, America has a better chance of avoiding outright deflation than any other country. This is due to the early implementation of an expansionary monetary policy, tax cuts and a sharp increase in fiscal spending. However, in the late 1990s, the US produced the biggest stock market bubble in history. An unusual characteristic of that bubble was the leveraging of balance sheets, for stock buybacks and serial takeovers, often for little reason other than to boost the value of management's options. Meanwhile, consumers, heady with bubble prosperity, spent as never before. Today, despite low interest rates and massive fiscal spending, the bursting of what many consider to be a real estate bubble could push the economy into a deep, deflationary recession - *see Sir John Templeton's comments on the US real estate bubble on www.fullermoney.com, Comment of the Day for 11th November.*

Consider the UK. As with America, the UK economy has done comparatively well due to strong consumer demand and increased fiscal spending. However, the former has peaked, while government borrowing and tax hikes increasingly fuel the latter. Gordon Brown's next and biggest grab will hit the middle class in April, when National Insurance payments become a progressive rather than fixed tax. What effect will this have on the UK property bubble, which is proportionately larger than its US counterpart? It should certainly help to reverse the upward spiral for UK house prices, a process that has already commenced in London and other parts of the South Eastern UK.

Consider the rest of the world. All of East Asia is heavily dependent on exports to the West, especially the US. Consequently they are extremely vulnerable to any further economic slowdown in North America and Europe. Australia's previously strong economy has been hit by a crippling drought. Central Asia and the Middle East are hampered by religious strife and extremism. Most of South and Central America's economies are in varying stages of crisis. Africa is barely on the economic radar screen.

Global corporate debt default continues to soar. "Annual Global Corporate Defaulting Debt Amount", according to Standard & Poors, was all but non-existent in the early 1980s, before edging up to about $8bn in 1989, before jumping over $20bn during the recession years of 1990 and 1991. It then subsided for most of the decade before jumping to a record of nearly $40bn in 1999. That figure was marginally exceeded in 2000 but defaults really soared in 2001, nearly reaching $120bn. The 2002 tally to date, presumably through September, was nearly $140bn. To pose the rhetorical question, after 4 consecutive records for annual corporate debt defaults, does anyone expect this problem to end soon? Corporate debt defaults increase

Annual Global Corporate Defualting Debt Amount



Source: Standard & Poor's Risk Solutions.

the borrowing costs for other firms, which lowers profits in a slow-growth environment, contributing to deflationary pressures.

The price of crude oil is still a problem for the world economy. If the oil traders and suppliers expect war, they understandably cover shorts, increase longs and stockpile reserves, as we saw from late May through to the end of September. If those fears subside, as occurred last month, these positions are unwound. I reckon that at $31 (spot NYME) a barrel in September, the war premium was $10 to $12 dollars. Nearly $6 of this premium was wiped off as fears subsided last month and in early November. However the market will certainly firm if/when Saddam Hussein tests the patience of UN inspectors, the Security Council and especially the US. I maintain that anything above $25 a barrel is a problem for the global economy. The good news, judging from market history, is that once the US military actually moved against Saddam, traders would reverse their surplus petroleum positions, causing the price to plunge below $20 a barrel within a few months.

Terrorist attacks in Bali and Moscow, and the recent broadcast reputed to be by bin Laden, won't help consumer confidence. I was sitting in CNN's studio on the evening of 12th November, when news of the tape aired by Qatar-based Al-Jazeera TV crossed the screens. Stock markets soon retraced what had been a good rally earlier in the day, as investors contemplated the effects on consumer sentiment of these latest threats, allegedly by bin Laden. This is just what al-Qaeda wants, of course, as it wages a psychological war against civilization over the airwaves, coupled with occasional terrorist attacks on mainly soft targets, killing and maiming innocent civilians. As terrible as the actual attacks are for those injured and their families, the psychological damage to society as a whole can also be pervasive. Concern over terrorism will obviously result in people travelling less and spending less, however remote the chance of them being directly affected. Even a half point off GDP due to terrorism makes a big difference, especially when growth is already weak. This problem will not go away quickly.

We can be optimistic about the continued spread of democracy. The clash of civilizations sought by bin Laden and his ilk will not occur. Their efforts are a last, desperate attempt to reverse the tide of freedom and democracy. There has never been any doubt that the progressive forces would triumph. The only unknowns concern time and cost. However we can be sure that the war against terrorism will mean much more than just re-establishing the old status quo. Democracy will eventually sprout in the Middle East and other regions where autocracies currently rule, just as we have seen in much of Eastern Europe since the Soviet Union collapsed. This will produce a peace dividend and be good for global growth, not least in the regions reformed.

And Finally…

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FM223 will be released in the second half of December.

> "Charles Darwin used to say that whenever he ran into something that contradicted a conclusion he cherished, he was obliged to write the new finding down within 30 minutes. Otherwise his mind would work to reject the discordant information, much as the body rejects transplants. Man's natural inclination is to cling to his beliefs, particularly if they are reinforced by recent experience - a flaw in our makeup that bears on what happens during secular bull markets and extended periods of stagnation."
>
> Warren Buffett

Best regards - David Fuller

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