Issue 228
12 June 2003
In its 20th year

Fullermoney

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

This leg of the Wall Street-led rally is maturing - valuations, corporate ethics and the oil price will re-surface as concerns. However near-term downside risk appears limited to a summer reaction and consolidation, followed by somewhat higher levels.

Asian stock markets now offer the best opportunities in this era of slow economic growth, high valuations on Wall Street and credit creation.

Say goodbye to the Austrian school - we're heading for a Keynesian overdose. In an ideal world, every country would start with a clean slate and be managed in line with sensible, disciplined Austrian school economics. However as far as governments are concerned, we can't get there from here, because Austrian economic policies would result in pain before the benefits accrued, not least because of all the debt problems. Welcome to reality. We live in a troubled and chaotic world, in case anyone hadn't noticed. In democracies, governments would be thrown out of office at the next election if they became born-again Austrian economists. Autocratic regimes would face uprisings. This is why we are heading along the path of Keynesian overdose, in the form of credit creation. I'm less interested in debating the rights and wrongs of this course, although I imagine the venerable Lord Keynes would sue to have his name disassociated from today's economic policies, if he could.

My main concern, in these pages, is with where all this credit creation will lead in terms of markets. Think bubbles. You may have thought we had moved on from bubbles with the bursting of the tech and telecom mania in 2000, although you are undoubtedly aware of the property market bubble in some countries, recognised by everyone but estate agents and the lending banks. We also have a government bond market bubble, which is exceeding the previous stock market mania in some respects, unless one believes that a yield of 0.45 percent for Japanese Government 10-year bonds is a good return. One wag has described JGBs as evolving from a risk-free return into a return-free risk. Sure, Japan has deflation but with Hayami no longer at the BoJ, and following a little advice from the Fed's Ben Bernanke, the mother of all reflations is underway in the land of the rising sun. Today, the NASDAQ-led bubble of the late 1990s is being partially reflated, in the most tradable rally since the secular bear market commenced in early 2000. My guess is that this will spill over into a summer pause and correction before too long, only to be pumped up again in the autumn. I do not expect to see new lows for any stock market, for quite a few months. However, pumping up the US-led stock market rally, given the economic problems and Wall Street valuations, is a bit like me pumping up a patched inner tube on my bicycle. Just when it seems about right, the patch bursts. In other words, despite all the US's monetary and fiscal reflation, I would be very surprised if US stock market indices moved to new all-time highs over the next 10 years.

Happiness in markets is guessing where the crowd is heading, before it knows itself. Since telling the crowd where to go is no more effective than trying the same strategy with one's mother-in-law, I prefer to look at price charts for clues, on which I can hang a theory. Accordingly, I see no reason why investors should pile into European equities, which remain a high beta version of Wall Street. They *have* been loading up on the euro, and I suspect will continue to do so until the ECB eventually screams for help or turns radical. Meanwhile, demand for the euro may further inflate the region's bond market bubble, while undermining corporate earnings. If not Wall Street and not Euroland, beyond periodic rallies, surely a big chunk of money will be diverted to Asia. If so, there is only one Asian market capable of absorbing a significant amount of demand from global investors - Japan. I would not dare say this without some evidence, let alone back it with my own money. I first outlined my case for Japanese stocks in FMP208 on 14th May. That summary has been expanded and updated in this issue. As usual, the main evidence to date is technical. Those of you who have attended The Chart Seminar will recognise the Type-2 (of 3) bottom characteristics. If my analysis is correct, the Nikkei will continue to rise much faster than it fell to its low on 28th April. I would not be surprised to see it clear 10,000 before there is a significant consolidation. Remember, the first psychological perception stage during a major recovery by any market is disbelief, because few people own it. Some of the smaller Asian markets should do even better. Japan's bubble burst 13.5 years ago, while the so-called 'little tiger' markets had their crises in 1987. Today, Asian stock markets offer competitive valuations, developing bases and better growth prospects - yes, perhaps even Japan, now that the LDP, MoF and BoJ are cooperating more than they are blaming each other for Japan's economic crisis.

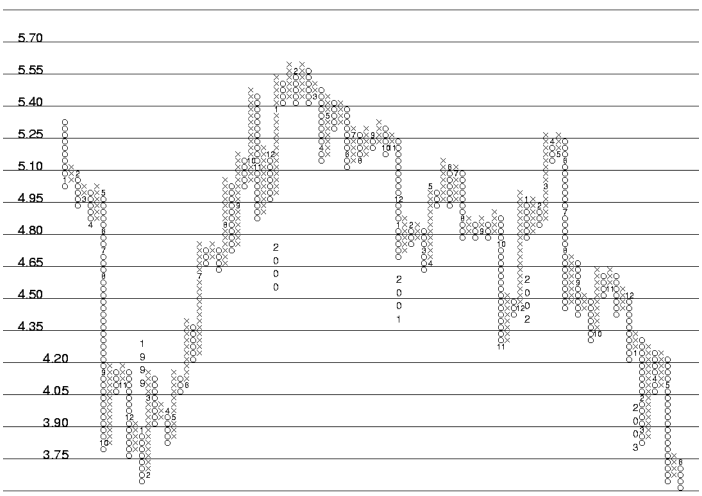
Interest Rates and Bonds

■ **Central banks will err on the side of easy money. Further rate cuts are likely from the ECB and BoE, although the case for another reduction by the Fed is questionable.**

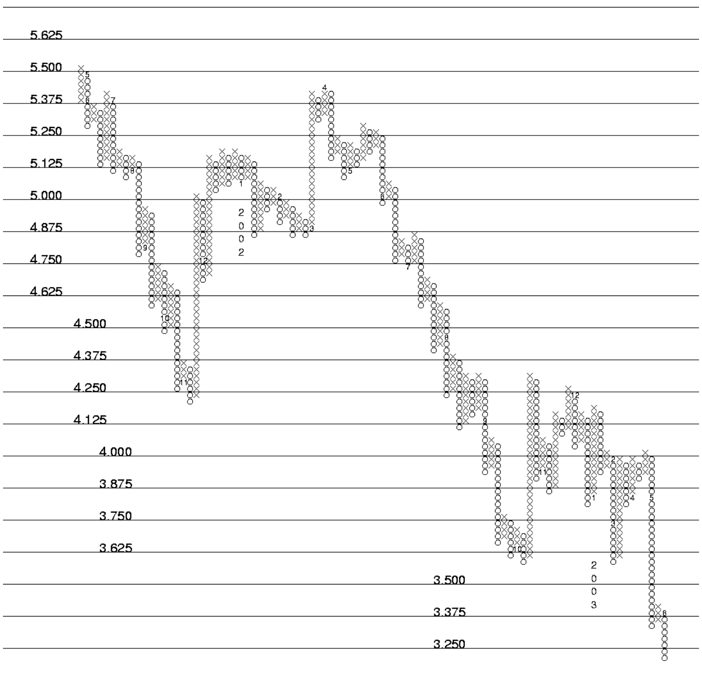
■ **Government bond yields have resumed their declines, helped by deflation fears and liquidity, but a bubble mentality is developing.**

The ECB's 50 basis point cut on 5th June is unlikely to revive Euroland's economy. It helps, of course, but won't curb the euro's strength for long. Therefore the ECB will remain under pressure to slash short-term rates towards the current US level of 1.25 percent. Only house price inflation stands between the BoE's Monetary Policy Committee and the next UK rate cut. However with sterling now rising as a high-yield currency, UK short-term rates are unlikely to remain at 3.75 percent for much longer. A majority of economists now expect the Fed to cut rates by 25 basis points to 1 percent on 25th June. However this would be of little economic help but might increase fears for the economy. Consequently the Fed may choose to retain what little interest rate ammunition it still has.

Euro Bund 10 Year Bond Yield (0.03)



US 10 Year Bond Yield (0.025)



Markets often overshoot but this continued decline by long-dated yields is unsustainable unless the world really is heading for Japanese-style deflation. The case for lower yields is tenuous, although that has seldom prevented market trends from reaching extreme valuations. The US and Japan are engaged in a very aggressive monetary reflation. In fact, the Fed and BoJ would welcome evidence of inflation, as a sign that deflationary pressures were waning. However a yield-starved market fears deflation more than inflation. This calculated gamble by investors is based on hopes that inflation will remain at bay, and that central banks will continue to buy government bonds in their efforts to revive GDP growth. Looking at the charts, bond investors/speculators may be right, for a while, but this is not a scenario for restful sleep. Yields are plunging and this is likely to be followed by an upward spike.

Strategy on bonds - I'm surprised by the latest strength of bond markets, but I shouldn't be. The latter stage of a bull market is often extremely persistent, until the trend suddenly commences a reversal. Meanwhile, these markets have entered bubble territory. One can run with this, preferably using trailing stops - actual or at least mental. The danger is in succumbing to the rationalisations of *bubblemania* and regarding each setback as a buying opportunity. I regard government bond longs as in-form speculations, to be closed on the first sign of a spike in yields, and am inclined to short futures on the next downward dynamic. I rate corporate bonds as a hold.

Global Stock Markets

- **Liquidity and the psychological 'Baghdad bounce' are lifting stock markets.**

- **Secular bear markets are punctuated by a number of significant technical rallies, but forecasts that we have seen the final lows should be regarded as a contrary indicator.**

- **Wall Street's best gains are usually found between the low of the second year of a four-year presidential cycle and the high of the following year.**

- **Evidence that Japan's stock market bottomed in late April is increasing.**

2003 remains on course to be an up year for Wall Street, lifting other markets in the process. The Bush Administration and the Federal Reserve have their feet firmly on the fiscal and monetary accelerators. While this was also true last year, stock markets commenced 2003 from lower levels, apprehensive about not only the post-tech bubble problems and valuations, but also the war to liberate Iraq. Persistent monetary reflation eventually has a cumulative affect - all that liquidity sloshing around the system has to go somewhere. Bond markets have been the big beneficiaries, both government and corporate. However talk of a government bond market bubble and with no less an influential figure than Warren Buffett saying that he now rates high-yield bonds a hold rather than a buy because prices have risen, investors have been reappraising equities. Once they do that from a position of underweight, the glass is perceived as half full rather than half empty. While the fundamental case for equities is less convincing when subjected to close scrutiny, historical evidence suggested that a 'Baghdad bounce' was all but inevitable once the war commenced. This has been a good medium-term rally, albeit within a secular bear market, and with resistance rather than support levels giving way, there is no factual technical evidence that the rebound in share prices is over. Even after allowing for a summer correction/consolidation, I maintain that 2003 will be an up year for Wall Street and most other stock markets. For this to occur, the 31st December 2002 levels of DJIA 8341.63, S&P 879.82 and NASDAQ Composite 1335.51, must be exceeded at yearend 2003.

It pays to run with the medium-term trend while monitoring the behavioural clues. A little over three years into a secular bear market for North American and European stock markets, and perhaps some others, if we waited until valuations looked irrefutably historically attractive before buying shares, I'd have many more grey hairs because it would be a long wait. We would also miss some very tradable rallies. Some investors will understandably prefer to wait for valuations on Wall Street and in other developed country markets that compare favourably with previous bear market lows. They want a buy-and-hold environment. Don't we all but I'm not prepared to wait a generation or more for the very best opportunities. I'll settle for a lesser opportunity, if that's what's on offer. Moreover, I don't think great valuations and a buy-and-hold environment are necessarily one and the same. Valuations can bump along for years at attractive levels, as we saw in the late 1970s and early 1980s, before the secular bull market gets underway. After a long bearish phase, it often takes time before the crowd becomes interested. The best buy-and-hold opportunity, although it takes nerves, is during the bubble-inflating years, last seen on Wall Street between 1995 and March 2000.

Since valuations on influential Wall Street are not that attractive, what investment strategies should we consider for stocks? Obviously not buy-and-hold, although there are trading opportunities. The best occur after a period of panic selling, as I have said before - September 2001, July and October 2002, and March 2003. Once indices rally more than 20 percent, it would be prudent to assume that we have seen the best portion of gains that are likely to occur. Chart reading remains essential for timing. Any loss of momentum beyond a brief pause should be considered a warning. Downward dynamics and any other evidence that prices are beginning to fall faster than they had previously risen would constitute a sell signal. The granting of covered calls and/or hedge selling of futures would lower downside risk after technical rallies wane. During bear markets, net short positions obviously make sense. Futures contracts are obvious candidates because of their liquidity. Many hedge funds trade 'spreads', which are offsetting long and short positions in related stocks or indices, with timing based on oscillators that depict historic deviation in relative performance. *Note: Stockcube's EFM Tech division produces 'spreads' recommendations for hedge funds.* During secular bear markets, many of the best long only opportunities occur in emerging markets, some of which will offer more attractive valuations and/or stronger economic growth. The better performing emerging markets will do particularly well during global rally phases but risks increase sharply during the worldwide downturns.

Wall Street's best gains usually occur after the mid-term lows - I first published this table *(see overleaf)* in 1994. It's an appropriate follow-on from the Pre-Presidential Election Year Record Since 1915, shown last month in FM227.

Percent Changes In The DJIA Between The Mid-term Year Low And The High In The Following Year.

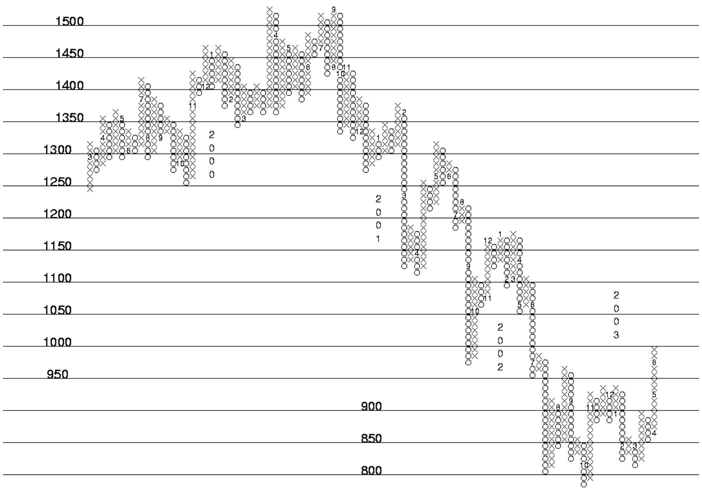
Date of Low	DJIA	Date of High	DJIA	Percent Gain
Jul 30 1914	71.42	Dec 08 1915	134.00	87.6%
Jan 15 1918	73.38	Nov 03 1919	119.62	63.0%
Jan 10 1922	78.59	Mar 20 1923	105.38	34.1%
Mar 30 1926	135.20	Dec 31 1927	202.40	49.7%
Dec 31 1930	157.51	Feb 24 1931	194.36	23.4%
Jul 26 1934	85.51	Nov 19 1935	148.44	73.6%
Mar 31 1938	98.95	Sep 12 1939	155.92	57.6%
Apr 28 1942	92.92	Jul 14 1943	145.82	56.9%
Oct 09 1946	163.12	Jul 24 1947	186.85	14.5%
Jan 13 1950	196.81	Sep 13 1951	276.37	40.4%
Jan 11 1954	279.87	Dec 30 1955	488.40	74.5%
Feb 25 1958	436.89	Dec 31 1959	679.36	55.5%
Jun 26 1962	535.74	Dec 18 1963	767.21	43.2%
Oct 07 1966	744.32	Sep 25 1967	943.08	26.7%
May 26 1970	631.16	Apr 28 1971	950.82	50.6%
Dec 06 1974	577.60	Jul 16 1975	881.81	52.7%
Feb 28 1978	742.12	Oct 05 1979	897.61	20.9%
Aug 12 1982	776.92	Nov 29 1983	1287.20	65.7%
Jan 22 1986	1502.29	Aug 25 1987	2722.42	81.2%
Oct 11 1990	2365.10	Dec 31 1991	3168.84	34.0%
Apr 04 1994	3595.35	Dec 13 1995	5235.62	45.6%
Sep 04 1998	7400.30	Dec 31 1999	11568.77	56.3%
			Average Gain	**50.3%**
Oct 10 2002	7197.49	May 30 2003	8868.33 (as of 30th May)	23.2%

Note: *In the unlikely event that the DJIA peaked for the year on 30th May, gains from the mid-term year low to the high the following year would be the 3rd smallest in 23 US presidential election cycles since 1914.*

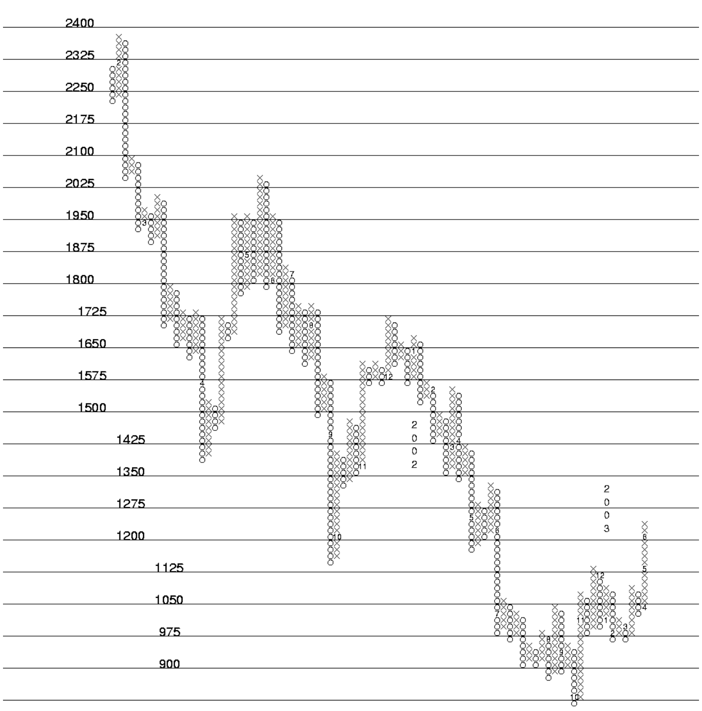
There are 10 reasons why Japan's stock market probably bottomed in late April. I first questioned whether Japanese stocks had reached an inflection point on 12th May in my Comment of the Day on www.fullermoney.com. On 14th May I listed 10 reasons in FMP208 for why Japan had probably bottomed, although one can never be sure about a bear market ending until a substantial recovery has occurred. Here's an updated and expanded version. **1) The BoJ** - I have always maintained that Japan's economic prospects would not really improve until former BoJ Governor Masaru Hayami had retired. His term expired on 19th March. Prime Minister Junichiro Koizumi promised to replace Hayami with an "aggressive deflation fighter", and while many commentators were disappointed and dismissive of Toshihiko Fukui's appointment as BoJ Governor, actions speak louder than words. Monetary reflation has accelerated; MoF-directed intervention to weaken the yen is no longer being sterilised by the BoJ, and the central bank is now working fully with the Government. While lagging economic statistics will not show evidence of an improving economy in Japan over the near term, the news is usually worst at the bottom. **2) The yen** - Similarly, based on historical evidence, I have long maintained that Japan could not pull out of its deflationary slump without devaluing the yen. This has been partially achieved as the yen has fallen a long way against most currencies, the US dollar being the main exception. **3) Sentiment** - Most investors have given up, saying, "Japan is a basket case". Yes, but a decline of 80 percent from the 1989 high rings a bell for me. The Japanese public is mostly out of the stock market, but it has a very high savings rate. Sentiment is usually most bearish at the bottom. **4) Needs must** - Stock market performance is further jeopardising Japan's economic prospects and is a national embarrassment. Prime Minister Koizumi faces a re-election challenge in the autumn because his term as LDP President expires on 30th September 2003. **5) Support buying** - The government is buying stocks, mainly from the banks, although not to the extent that I have often advocated as part of a radical reflation. **6) Valuations** - Japan's stock market sells at approximately 60 percent of book value, compared to 3-times book on Wall Street, according to most estimates. With Europe's corporate outlook clouded by the euro's strength, Japanese stocks arguably represent the best value among developed country markets, although earnings prospects need to improve to ensure significant demand from investors. **7) Weightings** - Today, almost every institutional investor is underweight Japan. Meanwhile, a weakening yen following the Nikkei's long bear market means that no European investor has been able to buy Japanese stocks more cheaply. **8) Timing** - While an 80 percent decline for the Nikkei and a 13.5-year bear market do not guarantee a first-in-first-out role for Japanese stocks, it certainly puts them among the candidates for a major recovery. While I maintain the US's secular bear market will run for years, albeit punctuated by significant medium-term rallies such as we are currently seeing, Japan has the lowest correlation to Wall Street of any major stock market. **9) Leadership** - No significant stock market rallies occur from bear market lows without good relative performance from bank shares. Having fallen to 7 percent of market capitalization, compared to over 20 percent in most other markets, Japan's banks have recently begun to reverse their lengthy period of underperformance. **10) Charts** - The Nikkei and Topix Indices registered downside failures in late April, while the Topix 2nd Section (often a leader in Japan) bottomed in December and continues to recover. Both the Nikkei and Topix have broken their sequence of lower rally highs for the first time since last November. Additionally, previous rallies by both indices over the last year have looked like no more than a brief period of short covering. However both have now rallied, retained over half the gains during a brief pullback and then extended the rally, for the first time since May 2002, and from much lower levels. Among individual shares, in addition to banks, key household name Japanese stocks such as NEC, NTT, NTT DoCoMo and Toshiba have shown both relative and volume strength.

If I'm right about Japan, the Nikkei should rally back above 10,000 considerably more quickly than it fell from that level to the low of 7603.76 on 28th April. The Nikkei last saw 10,000 in August 2002. What could go wrong? All bets are off if any of the above-

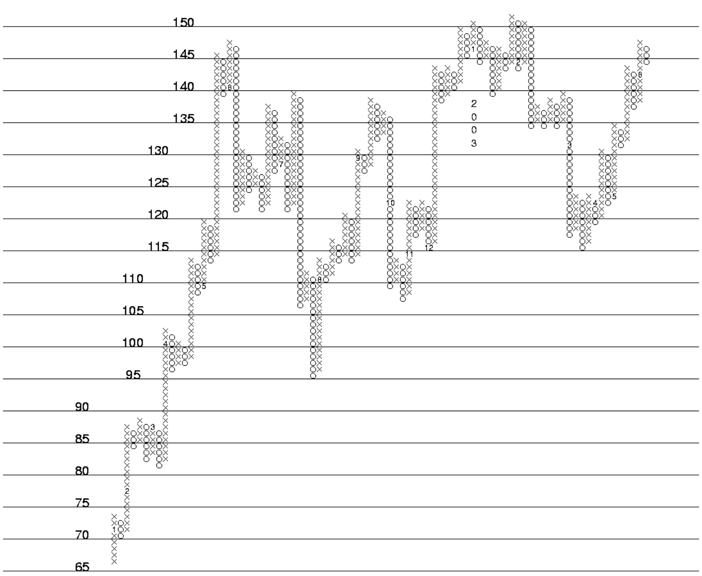
S&P 500 Composite Index (10pt)



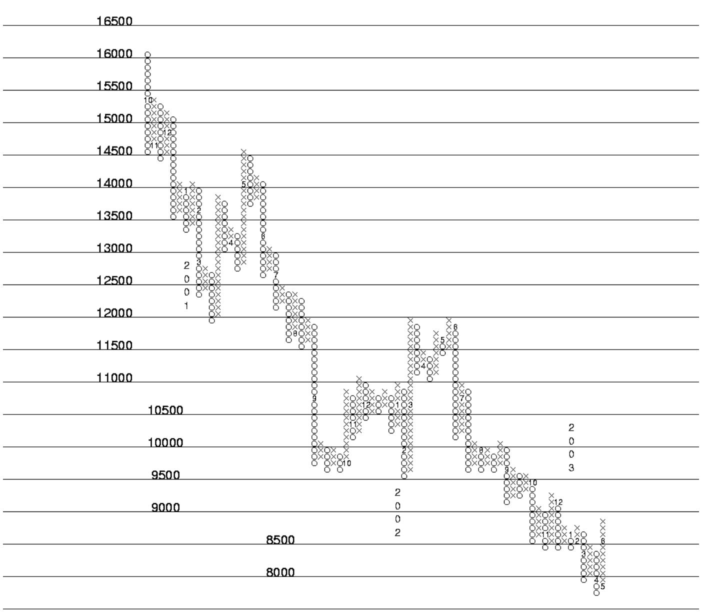
Nasdaq 100 Index (15pt)



Amex Gold Bugs Index (1pt)



Nikkei 225 Stock Average Index (100pt)



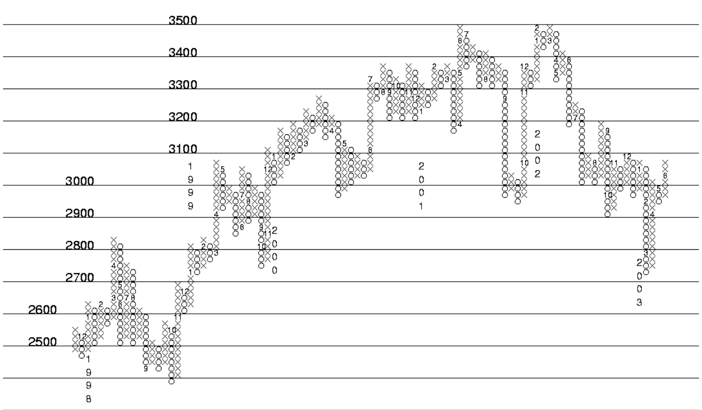
mentioned indices or shares fall to new lows. In terms of policies, Japan's politicians and ruling bureaucrats have seldom missed an opportunity to miss an opportunity during the long economic and stock market slump. While the BoJ, MoF and Prime Minister are now working together, there are other bureaucrats and politicians, not without influence, who oppose the current policies and could impede progress. The "big one" (earthquake) could hit Tokyo, although that would soon become bullish for construction shares. Meanwhile, I remain a born-again bull of the Japanese stock market.

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, these charts were prepared before the final prices shown in the comments below.*

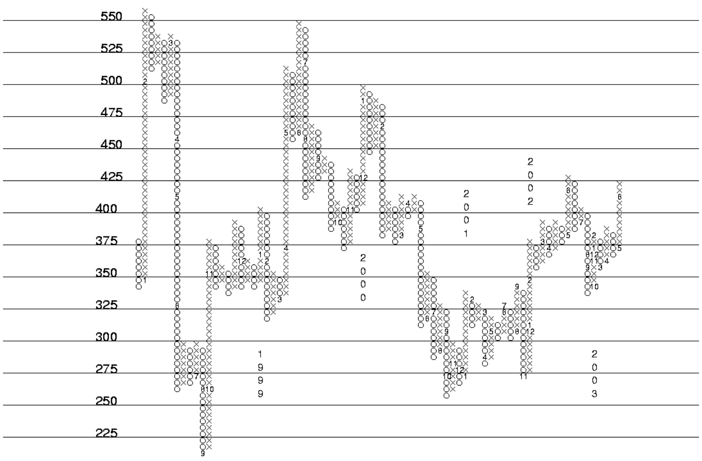
The US's S&P 500 Composite Index (985) appears to have completed a small base. A move below 950 is currently required to question continuing scope for some additional gains. **The NASDAQ 100 Index (1213)** has also completed a small base. A move under 1125 is now required to question a further test of overhear trading. **The Amex Gold Bugs Index (144)** of unhedged gold mines has rallied towards psychological resistance from its 2002 to early 2003 highs, up to 151. A move to 139, beyond the midpoint of the last step, is needed to question a further test of the current range's upper side.

Japan's Nikkei 225 Stock Average Index (8890) has seen its biggest rally since March 2002, and has broken the medium-term downtrend. In the process, it has confirmed two downside failures. I maintain we saw an important low in April and this recovery is likely to be extended before we see a reaction and consolidation.

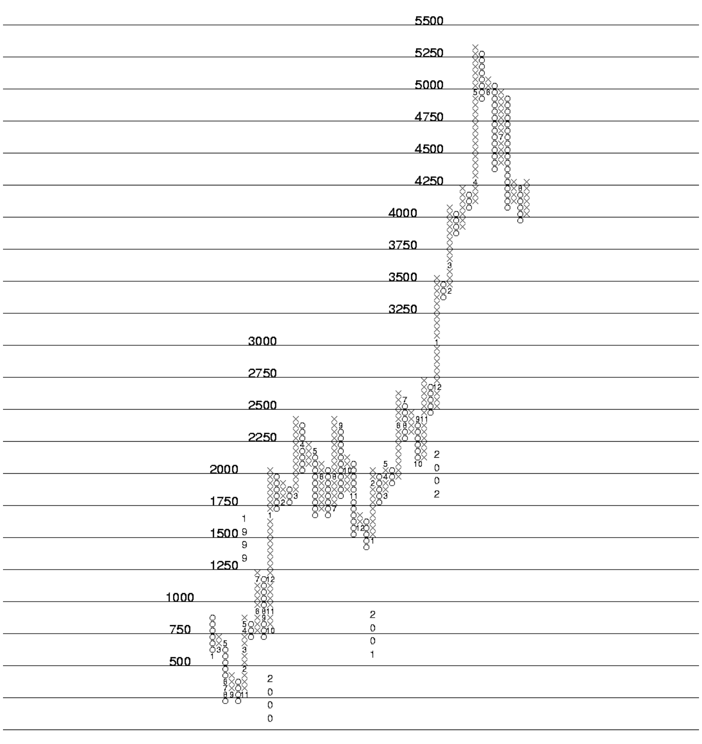
Australia S&P ASX 200 (20pt)



Thailand Bangkok SET Index (5pt)



Russia RSF Index (50pt)



Australia's S&P ASX200 Index (3070) has pushed further into the underside of its large, multiyear top, scoring its best gains since 4Q 2001, moving above psychological resistance near 3000. A move under 2940 is needed to offset some further test of overhead supply.

Thailand's Bangkok SET Index (422) has been a relative strength standout in recent years and shows evidence of a multiyear base. After months of quiet ranging it has rallied sharply recently and should at least test the June 2002 high of 425.

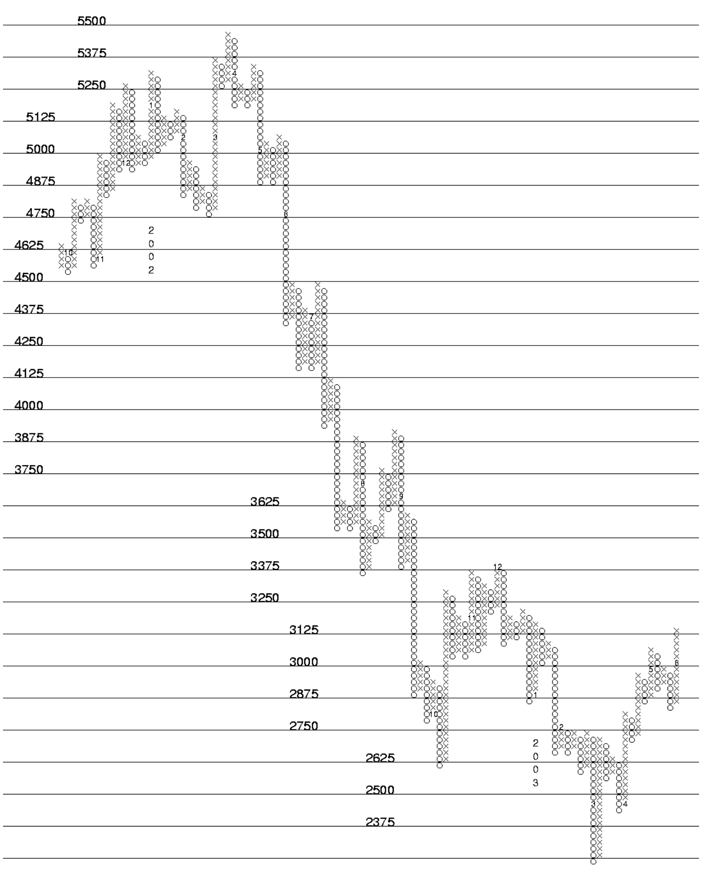
Russia's RSF Index (5369) remains a world-beater, and it has extended its break above the May 2002 peak. Note this year's progression of higher lows, with the last at 5250. A lower low is required to check uptrend consistency beyond a brief pause.

Germany's DAX Index (3155) has pushed above its May high and a move under 2925 is required to check scope for somewhat higher levels.

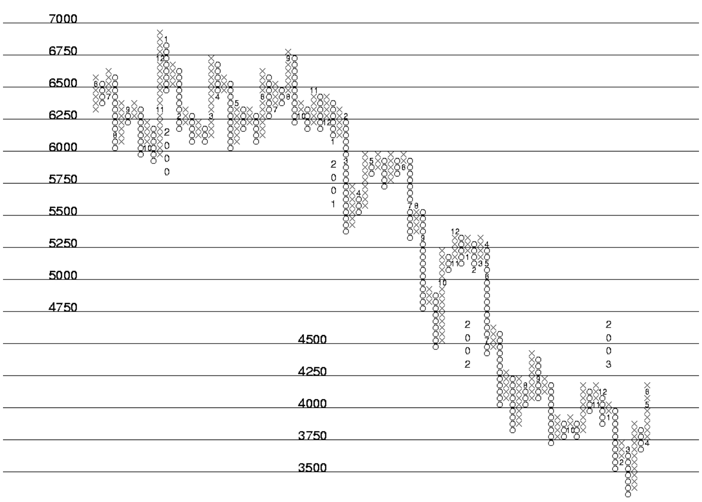
The UK's FTSE 100 Index (4133) has continued to edge higher in the best rally since late September and early October 2001 and should at least test the October-November highs at 4150.

Strategy for global stock markets - The medium-term rally has crossed a significant threshold with the all-important S&P 500 Index's move up through psychological resistance in the 950 region. If it can hold above that level, consolidate gains and extend the rally, I'll remain long, holding some high-yielding UK stocks, including Boots, Lloyds TSB, Northern Foods, Sainsbury and Tomkins. Of these, Boots and Northern Foods were purchased too soon last year, but have seen a considerable recovery. Among telecoms and techs, I did buy Vodafone, mentioned as a possibility in FM227, but decided against Nokia due to the euro's strength. I also hold Intel. In Japan, I bought UFJ Holdings, because I can't recall a significant rally off a major low without good participation by bank stocks. I also have a position in Atlantis Japan Growth Fund, an investment trust (closed-end fund), which has held up remarkably well considering that I bought it way too soon. I did eventually open small positions in the two investment trusts mentioned in FMP 202 (7th March) - JP Morgan Fleming Indian and Aberdeen New Thai, and I have bought the Fleming Japanese Investment Trust. All of the above mentioned investment trusts are listed in London. I currently hold more stocks than at any time in the last 5 years but my overall exposure is small relative to capital, because I expect no more than a tradable rally in a secular bear market for the US and European equities. Consequently I stopped buying in May and probably won't put any more new money in this type of stock, although I might switch positions, or reduce exposure. Among gold stocks, I hold Newmont, Harmony and Durban Roodepoort Deep, but sold Barrick when it ran ahead after the share buyback announcement. All of these positions have been mentioned on various occasions in either Fullermoney or the Audio. In my self-administered pension scheme I also have some country funds, and where my options are restricted, I'm now consolidating these in Japan. In futures, I'm long the Nikkei. In summary, my main strategy could be described as favouring high-yield stocks, Asian recovery and gold, with active use of futures as this is mainly a trading rather than buy-and-hold environment. However, if any market has reached a buy-and-hold level,

German DAX Index (25pt)



United Kingdom FTSE 100 Share Index (50pt)



it is Japan. Of course there are lots of problems, as is the case at any bear market bottom, but I now suspect the price is right. Elsewhere, when bear market rallies exceed 20 percent, as we have recently seen for Wall Street and several other markets, I prefer to think about lightening rather than increasing positions. Subject to chart action, first to go will be the low yield stocks. I maintain that yield has become a collector's item in this cycle of low interest rates and deflationary concerns. Consequently, I may just hedge the high-yielding stocks with futures if the rally appears to be failing, unless I get lucky and further gains reduce yields to well below the 5 percent level. Given the trading environment, I may change positions quickly, but this will be mentioned on the Fullermoney Audio, available to all subscribers at no additional cost. If you are interested in the Audio, but do not have a login name, you can request one using the email facility on www.fullermoney.com.

Currencies

■ **Supply considerations are the main factor moving currencies today. This continues to favour the euro, periodic consolidations aside, because the US and Japan are printing, while Euroland is not, at least not yet.**

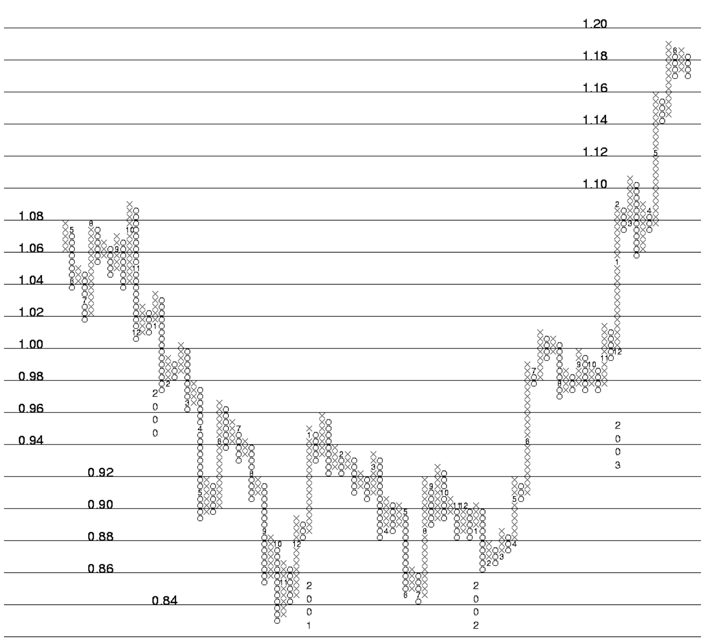
Currency trends are momentum driven, with participants focussed on the fundamental flavour of the month, which usually persists for a number of months. Ever since the Bretton Woods Agreement of fixed exchange rates was scrapped in favour of floating rates in 1971, analysts have struggled to understand what causes one currency to appreciate or depreciate against another. And just when they think they have sussed the relevant fundamental factor, it perversely changes. I remember when money supply was the fashionable fundamental, only to be replaced by interest rate differentials, then GDP growth, comparative rates of inflation, then deflationary considerations, political factors and supply changes due to monetary policy, over and over, in no particular order. In other words, the relevant currency fundamentals are a moveable feast. Needless to say, this is highly disconcerting for any financial market people trying to understand why forex trends do not reflect their particular topic of interest or concern. This apparent problem is certainly not unique to currency markets but it is greater in forex, where the decision is much more likely to be based on a relative comparison rather than absolute consideration. For example, an absolute decision would be to buy euros and hold them on deposit, much as one would buy and hold a stock, bond or gold. However most currency market transactions involve buying or selling one against another, as in long euro against the dollar, which is of course identical to short dollar against the euro. An equivalent stock market transaction would be what is generally called a 'spread', such as long Nikkei/short DAX, or long Vodafone/short France Telecom, or any other long/short combination. 'Spread' trades are popular with some hedge fund managers but are used by comparatively few other investors or traders. Because currency trades are relative rather than absolute comparisons, as in, "Yes I think the US economy will outperform Euroland but what about the deficit?", or whatever, one can't open a currency trade without considering two currencies. This effectively doubles the complexity of fundamental currency analysis. Returning to the share example, one may prefer Vodafone to France Telecom, and in buying the former one is not automatically shorting the latter. Consequently people who actually succeed in trading currencies are observers, more than estimators of value, because value is a particularly abstract concept in forex. Currency traders aim to identify the fashionable fundamental, and base most of their buy/sell decisions on price chart action.

Today, currency traders are less interested in GDP growth, not least because there is little of it. It was quite different in the late 1990s, when people bought the US corporate proforma earnings growth story, which turned out to be mostly hot air. With the dollar in retreat it is hardly surprising that they are no longer interested in marginal growth stories, which currently favour the dollar. Inevitably, concern over the US deficits has resurfaced with the dollar's decline, but the real worry is supply. The US is printing - probably more than ever before. We were told this could or would happen by Fed Governor Ben Bernanke, and we can see the data. We know that the Fed is worried about deflation, and determined to avoid it. Alan Greenspan has indicated that the Fed has limited experience in dealing with deflation and that it is more confident, after the 1980's experience, of dealing with inflation. Consequently the Fed would welcome some inflation, particularly in the form of corporate pricing power, and it will err on the side of inflation. Japan, in the post-Hayami era, is even more anxious to see some inflation. Therefore it is openly debating more radical methods of reflation, and this time there is cooperation rather than opposition from the BoJ. Moreover, the MoF and BoJ have been much more aggressive in terms of intervention, since Hayami's term expired. We should not underestimate their willingness to ensure that the yen does not appreciate against the dollar. What about the euro? The economic story is worrying but the market is understandably focussing on supply. While Euroland's exporters are complaining about the single currency's strength, a relieved and hubristic ECB is enjoying the rally. So far, the ECB is content to pare interest rates but shows no signs of following the US and Japan down a path of radical reflation. Consequently the euro has been close to a one-way bet against the dollar and yen for nearly one and a half years, and there is no evidence that these trends are over, although they are punctuated by small reactions and consolidations, as we have seen recently. These are likely to become more frequent and larger, as the clamour of protest over the euro's strength becomes louder. At some point the ECB will have to reflate much more aggressively and weaken the euro, or risk a severe deflationary slump in Germany, but this volte face does not appear to be at hand. The euro's strength has inevitably lifted other European currencies such as the Swedish krona and Swiss franc. Second to supply considerations among the three big reserve currencies, there is another currently fashionable statistic for currency traders - yield. High-yielding currencies have been strong recently, and will remain popular while interest rates are not only low but also still declining.

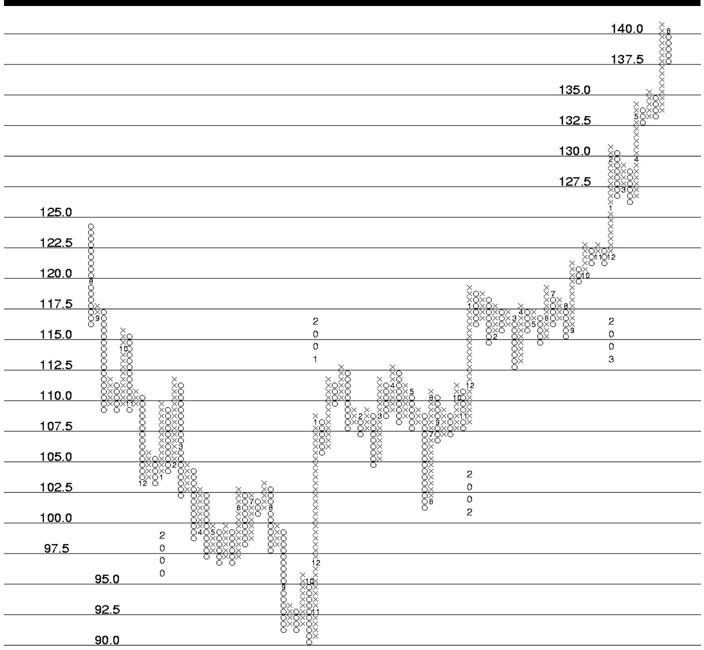
Chart review of important and topical currencies
- *These and hundreds of other 3-box reversal closing basis point & figure charts are available on our website, www.chartanalysts.com and are updated daily. All comments refer to closing levels for US trading hours. Please note, the charts were completed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

Euro/dollar ($1.1754) - Following new highs the euro has encountered resistance just beneath the psychological $1.20

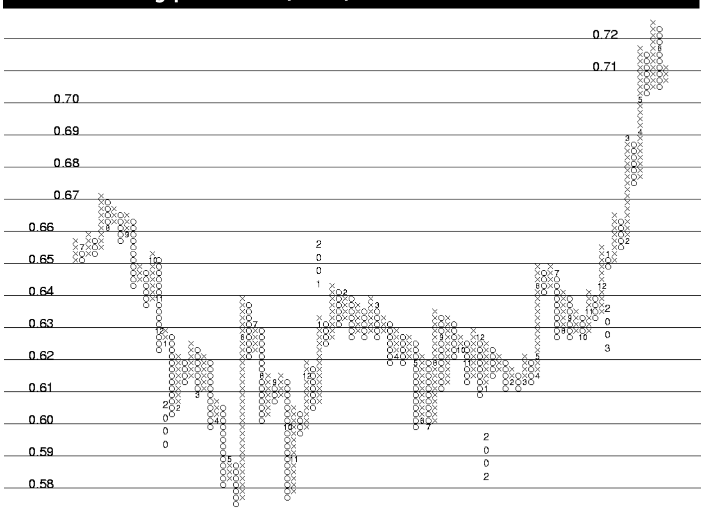
US Dollar per 1 Euro (0.004)



Japanese Yen per 1 Euro (0.5)



Pound Sterling per 1 Euro (0.002)



level. A decline to $1.1640 would suggest some additional consolidation before the uptrend is extended.

Euro/yen (¥138.44) - Here also the euro has paused in a probable consolidation after accelerating to the psychological ¥140 level. A move to ¥141 is now required to reaffirm the uptrend. Conversely, a move below ¥134, which appears unlikely, would indicate that a peak of medium-term significance had been reached.

Euro/sterling (£0.7049) - The euro shows a loss of trend consistency following a failed upside break in late May and the biggest correction since last July. Consequently some additional ranging is likely near current levels, in an extended consolidation before the large underlying base supports renewed strength.

Sterling/yen (¥196.46) - The pattern remains choppy because this is a less dynamic trend than we see for Continental European currencies against the yen. Nevertheless the additional build-up of underlying support suggests that no more than temporary resistance will be encountered near the January high of ¥197, before the psychological ¥200 level is tested and eventually broken.

Dollar/Swiss franc (SF1.3093) - *not illustrated* **-** The dollar has steadied following its break beneath the October 1998 low at SF1.315 - *not shown, see www.chartanalysts.com* - and the January to early-May 2003 range. However overhead trading should limit upside scope to a temporary rally and a rebound to SF1.365 is required to suggest a downside failure.

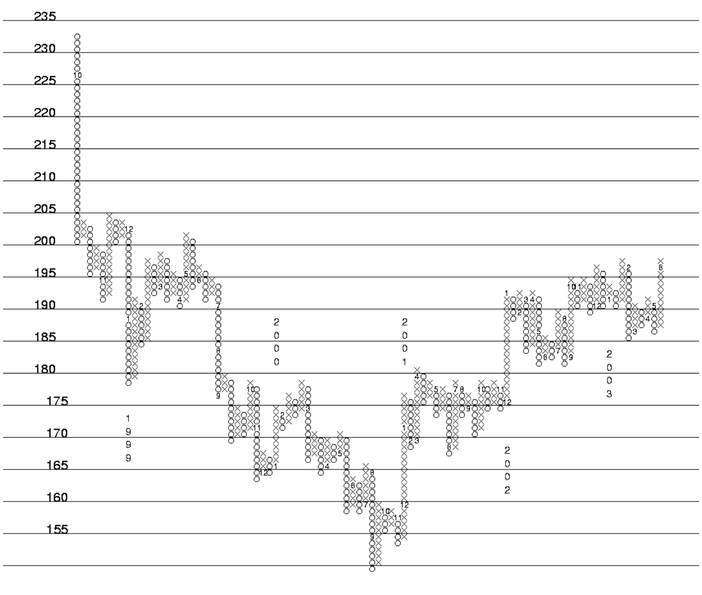
Dollar/yen (¥117.79) - While the dollar remains rangebound against the yen, its failed break beneath the September 2002 and March 2003 lows at ¥117 could be important. However a move to ¥122 remains necessary to reaffirm support and further recovery scope.

Sterling/dollar ($1.6675) - *not illustrated* - The pound has moved back above the January high at $1.6550. A move to $1.6250 is required to indicate more than brief resistance in this region here before historic overhead trading - *not shown, see www.chartanalysts.com* - is further tested.

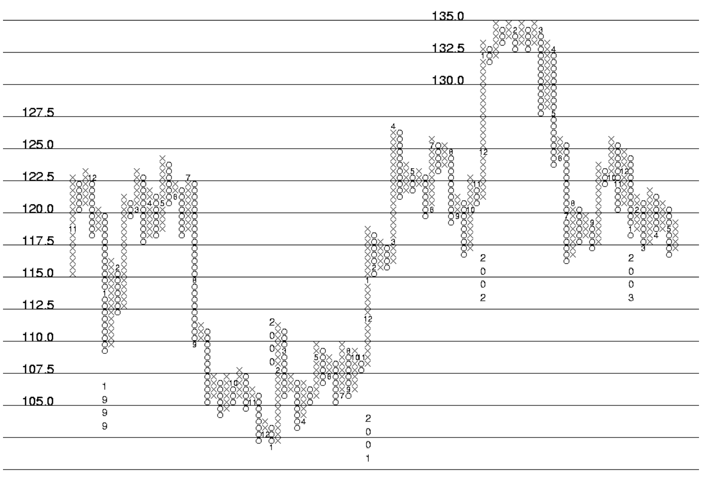
Australian dollar/US dollar (US$0.6606) - Following a persistent advance and some trend acceleration in May, the Australian dollar is encountering resistance near important highs reached in 1998 and 1999 - *not shown, see www.chartanalysts.com*. Moreover, daily charts show a key day reversal on 6th June - not illustrated. This suggests a loss of upside momentum for at least the short term.

Strategy on currencies - Last month I cautioned that long euro had become a crowded pitch, and that further gains would inevitably be followed by a correction, albeit within the overall upward trends. My strategy for persistent trends is a trailing stop, which I tighten in the event of acceleration. As discussed on the Audio, I re-entered euro/yen on trend resumption in mid-May, used a tight trailing stop for 70 percent of the position and was stopped out just

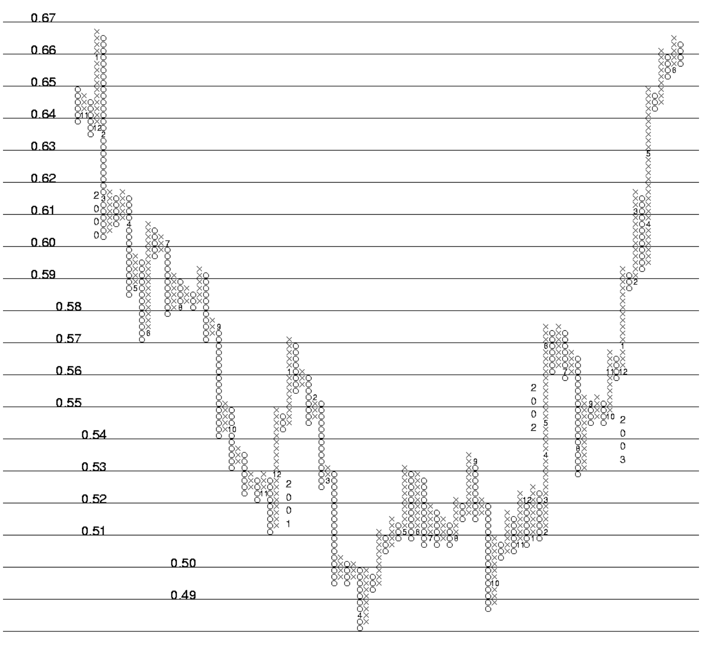
Japanese Yen per 1 Pound Sterling (1)



Japanese Yen per 1 US Dollar (0.5)



US Dollar per 1 Austrailian Dollar (0.002)



above ¥139. I added to the remaining position on further easing as there have been no downward dynamics to date. However this will remain a moderate-sized position until the euro either weakens further on profit taking, or registers another upward dynamic as we saw in the first half of May. Similarly, over half of my Swiss franc/yen long was stopped out at a profit as the Swiss currency eased in sympathy with the euro and I have subsequently picked up more on the pullback towards the large underlying trading range, which should offer good support. I bought dollar/yen following the upside key day reversal, triggered by BoJ intervention on 19th May, when the dollar fell to nearly ¥115. Since this has a ranging rather than trending pattern, I closed the position on 30th May, and hope for a another pullback below ¥117, in which case I will probably commence light buying on the Baby Steps basis. Once again, all these trades are discussed in the Subscriber's Audio, as they occur. Similar tactics would have been suitable for the other rewarding yen crosses, such as the Norwegian krone, Australian, New Zealand and Canadian dollars, which I know are of interest to subscribers. My only reason for not trading them as well is that they are not available for my UK tax efficient spread-betting account. My one concern in shorting the yen is that a revival of interest in the Japanese stock market will firm the currency from time to time, before increasing supply from the BoJ forces it lower. Not surprisingly, euro/dollar has lost upward momentum following the latest strong advance. While it is possible that a move under $1.16 would trigger stops leading to a further correction, I note from daily charts that dynamics within the present trading range remain on the upside. Therefore while any additional downward move could be frightening for a day or two, for those who are long euros, I would regard it as a buying opportunity. The Australian dollar's advance accelerated back to levels against the greenback last seen in 1999 and early 2000, and there was a downside key day reversal on 6th June, suggesting that additional upside scope is now limited for at least the short term. The New Zealand dollar has done even better but some loss of upside momentum is also evident. Consequently risks in Antipodean currencies against the greenback have increased.

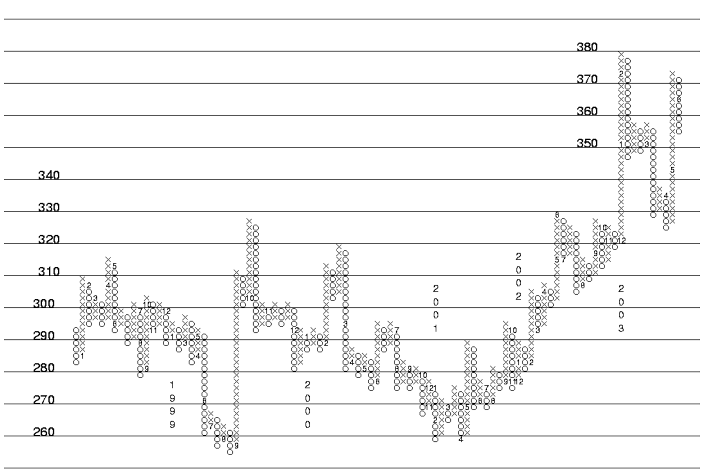
Commodities

■ **Gold is ranging in its first step above the base, in the very early stages of a secular bull market.**

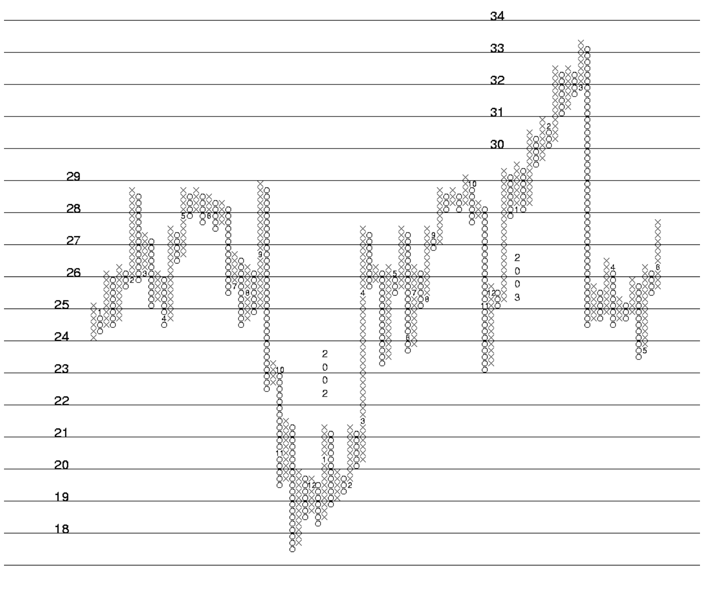
■ **Crude oil has rallied but upward scope is limited to top formation extension.**

The US dollar remains a big influence on short-term swings in the gold price. This is to be expected in the early stages of a secular bull market, when very few people are gold bugs. In comparison with the US stock market, gold bullion today is where the S&P 500 Index was in 1982. Over the much longer term, the fundamental factor driving gold's bull market will be the debasing of all fiat (paper money) currencies through excessive credit creation.

Gold CMX 2nd Month Continuation (2USD)



Crude Oil NYME 2nd Month Continuation (0.2USD)



Crude oil has broken above lateral resistance at $29 (NYME). This appears to be a combination of short covering, a delay in resuming production from Iraq, OPEC's talk of a production cut and somewhat lower than expected US reserves. While there is currently no evidence that the May-June rally has ended, any additional gains above $30 will be difficult to maintain beyond the short term. Supply can only increase.

The Global Economy

■ **In the ever-difficult post-bubble environment, prospects for individual countries will vary according to structural differences, psychology, energy prices, debt, democratisation, SARS, terrorism and of course monetary and fiscal policies.**

■ **The post-stock market bubble macro economic problems remain considerable.**

Where's the 'Baghdad Bounce'? Many commentators, myself included, predicted a modest economic rebound following regime change in Iraq, as the war cloud of uncertainty lifted. This remains likely because consumers are no longer glued in front of the TV, or as fearful of travel, and businesses need not postpone any prior spending plans, in case the war had gone badly. However there will be regional variations and a strong rebound relative to downturns experienced in the 1980s and 1990s remains all but impossible in the developed economies, due to post-bubble problems, especially debt. Developing economies are by no means immune from these difficulties, but some of them will benefit from special circumstances, not least the transfer of manufacturing to low-cost regions. Here is a brief country and regional assessment.

USA - Alan Greenspan has certainly reiterated the Fed's determination to fight deflation, with every monetary tool available, and he is not alone, as we know from previous comments by other Governors, particularly Ben Bernanke. Not surprisingly the Bush Administration favours this, as it is now focusing on the President's re-election, in addition to the war against terrorism. Consequently no monetary, fiscal or persuasive effort will be spared in encouraging consumers and businesses to spend. An effective politician, George W Bush is likely to achieve much of what he wants in terms of tax cuts, which will contribute to the stimulative efforts and eventual feel good factor. The declining dollar will help by boosting operating profits of US multinational companies, increasing the country's competitiveness and ensuring more domestic holidays in favour of the annual junket to Europe. If efforts to prevent further terrorist attacks of consequence within the US remain successful, and if oil prices resume their March-April slide, as they easily could, US GDP growth during the second half of 2003 will surprise on the upside.

Canada and Mexico - These two countries would be the main beneficiaries of a US economic rebound.

UK - Second only to the US, the UK can expect a modest Baghdad bounce; fiscal spending will remain stimulative, and interest rates will probably be lowered by the BoE's Monetary Policy Committee. However ever-rising taxes remain a huge drag on business confidence and investment, not to mention consumer spending. The house price bubble is a major threat, although it may be a problem deferred by lower interest rates.

Euroland - The door to much-needed structural reforms has been all but closed by minimal growth, budget deficits, weak governments, union power, political intransigence and hubris. An inexperienced ECB, although not short on hubris itself, is hemmed in by a deflationary mandate. Also, following the euro's humiliating 1999-2000 slide, finally checked by multilateral intervention, the ECB appears more interested in proving its inflation-fighting credibility than in addressing the current problem. It is always easier to relive the battle won than to face the next challenge. Meanwhile, Euroland's export companies are reeling in shock and awe due to a runaway euro, whose strength owes little to economic performance. Consequently much of the region is sliding into recession and may even underperform Japan over the next year or two. Fortunately there are exceptions. France, which has completely ignored the Stability Pact 3 percent ceiling on budget deficits, a lead most of Euroland is having to follow, also ignored the European Commission and cut personal taxes. This latter move is entirely responsible for France's 1Q 2003 economic growth of 0.3 percent. When will Germany's Schroeder, the UK's Blair/Brown team and other Socialist-leaning politicians accept the first law of economics - the surest way to increase national wealth is to boost incentives for everyone.

Japan - Is the recently announced Resona Bank bailout further evidence of an inflection point for Japan? Yes. Countries no longer let their commercial banking sector go bust, which would result in a 1930s-style depression. Instead, they bail them out through the yield curve (encouraging commercial banks to borrow from their central bank at preferential interest rates and invest the proceeds in government bonds, which are supported by the same central bank). When that no longer works, as we see in Japan, because JGB yields have approached zero, the government injects cash in a de facto nationalisation of worst-case banks. This looks like the beginning of radical reflation, which I have long regarded as inevitable for Japan, and necessary to revive the economy. Further evidence is provided by increased currency intervention, totalling over ¥4 trillion (about $34 billion) so far this year. While the MoF has a long history of intervention, previous efforts were sabotaged by former BoJ Governor Masaru Hayami, who sterilised the extra liquidity created by selling bonds. The new Governor, Toshihiko Fukui, is working with the MoF, not against it. When Japan succeeds in breaking its slow motion deflationary spiral, a surprisingly strong economic rebound should follow.

China - Understandable public concern aside, SARS should have only a minor and temporary impact on China's GDP growth. SARS remains statistically insignificant, despite the risk of mutation and even though an effective vaccine has yet to be developed for this serious respiratory illness. China remains in the golden period of its economic emergence, due to an effectively inexhaustible source of cheap labour and land, a disciplined and market-oriented government, and an undervalued currency (the Chinese yuan, also known as the rimimbi, was devalued by 10 percent in 1994 and re-pegged to the US dollar). The only unique feature about China's economic emergence is the country's size. Otherwise, we have seen similar metamorphoses, from practically nothing to modern and prosperous economies, on most continents. China's particularly rapid economic development owes a great deal to the transfer of technology. Inevitably there will be setbacks, as we have seen with all other developing countries, but China today is approximately where Japan was in the early 1970s and Singapore in the early 1980s. Obviously China's impact on the world economy will be much greater, due to its size, ensuring genuine superpower status within a few years. China will remain a world-beater in terms of GDP growth for many more years.

India - The world's largest democracy, India is the one country that could rival China as an inexpensive manufacturer of last resort. It has the population, land mass and rule of law. Additionally, India has formidable potential in financial services and software writing. Unfortunately, India is also a kleptocracy (I'll offer bribeocracy as an even better description), and riven by its caste system and religious enmities. If/when these impediments are largely overcome, India will be well on course for economic superpower status. Hopefully, this will not be a wait in perpetuity.

Asia's smaller economies - I have neither the space nor the on-location experience and expertise to do justice to this important section of the global economy. However there are several themes that have been and will remain crucial to long-term success - democratisation, including equal opportunities for women and minorities. Where this has been achieved, countries have flourished. China's emergence as a most formidable economic competitor has obviously caused dislocations, which are unlikely to be permanent. Each of Asia's smaller countries should have the resources, particularly intellectual, to find their niche, not only with the West but also with a rapidly developing China. Less developed countries such as Thailand, The Philippines and more recently Vietnam have considerable potential in terms of natural resources and tourism. While SARS has severely damaged Asia's tourism potential this year, hopefully this is no more than a temporary problem.

Financial imbalances will remain a problem for many years. I've written about this many times, not to mention the articles posted on my website, so I'll summarise briefly in this comment. While there has been some improvement in corporate debt levels, the overall burden remains excessive, especially for a disinflationary world, where there is very little pricing power. Consumer debt levels vary considerably from country to country, but are particularly high where there has been considerable speculation in housing, and therefore property price inflation during recent years. Australia, the UK and USA are prime examples. Private consumption in these countries has been boosted by mortgage equity withdrawal, but this flow of funds will go into reverse when interest rates next rise. Government debt has ballooned in many countries, with no end to these deficits in sight. Despite this, the scramble for yield has continued, contributing to a developing bond market bubble. With unemployment rising and with growth in corporate profits more often due to cost cutting rather than increasing prices and/or sales, consumer and corporate confidence remains subdued. Additional ingredients in this recipe for a dysfunctional global economy are expensive oil and terrorism by Islamic extremists. China's unique role as global manufacturer of last resort has added to deflationary pressures elsewhere. Many governments, not least the US and Japan, are responding by reflating as seldom before. This course, which is closer to the Keynesian rather than Austrian school of economics, is cushioning the post-stock market bubble downturn but it also prolongs many of the problems. Consequently GDP growth in most countries is likely to remain generally slower than we saw in the 1980s and 1990s. As governments attempt to reflate their way out of these problems of debt, slow growth and deflationary pressures, the seeds of the next inflationary cycle are being sown.

And Finally…

Tactics are always discussed on the Subscriber's Audio - Should you ever want my latest thoughts on markets, in addition to this letter, just listen to my daily Audio, available to all paid-up Fullermoney subscribers. The Audio is on my website - www.fullermoney.com - and you will require a login name, which you can request via the site email facility. While on the site, you can also check my Comment of the Day, which contains various articles, research reports and my comments.

FM delay - I've been running somewhat behind with copy production recently, but bear with me - I'll catch up. Meanwhile, I trust you find this issue useful.

"No man sees far; most see no farther than their noses."
Thomas Carlyle

Best regards - David Fuller

Fullermoney a division of Stockcube Research Limited Suite 1.21 Plaza 535 Kings Road London SW10 0SZ UK
Website: www.fullermoney.com ***Email:*** research@chartanalysts.com ***Tel:*** +44 (0) 20 7351 5751 ***Fax:*** +44 (0) 20 7352 3185 ***Single Issue Price*** £35