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EVEN IF OIL'S DRAMATIC RISE STALLS, HIGHER TAXES & ENERGY WILL LEAD TO GLOBAL RECESSION IN 2006

BARMAC MARKET DIRECTIONAL INDICATOR:-
BUY SIGNAL -issued on 28th MAY
Market up 5% since signal.

1.GLOBAL ECONOMY
Oil & recession
Money supply growth
Crippling wealth – House price wealth illusion

5.INTEREST RATES & BONDS
Rate cuts imminent
Gilts to correct

6.EQUITIES
Global liquidity lifts all ships
Barmac buy signal
Tokyo approaches key level

8.CURRENCIES;
Dollar consolidates
Pound weakens

9.COMMODITIES
Oils boils over
Gold in triangle.
Copper hits new high
FCOJ passes $100

The dramatic price rise of oil has been the big, big story of the last eighteen months or so. The recent spikes to around $60 a barrel have sparked a tidal wave of price predictions for where oil might go now. Some believe that oil could go as high as $100 whilst others (Morgan Stanley) predict a retrenchment down to at least the mid $40's.

Quite honestly we know not who might be right but we do suspect that the damage has already been done to the global economy and that an era of historically high (over $40) energy prices are here to stay. The world's industrial nations will have to adjust to higher energy costs, which will act as a hidden tax and a brake on growth as financial wealth is transferred from consumers of power to the producers.

We have already witnessed a partial slowdown year to date as energy costs act as a drag on economic activity but next year US/UK fiscal policy could well provide a savage headwind.

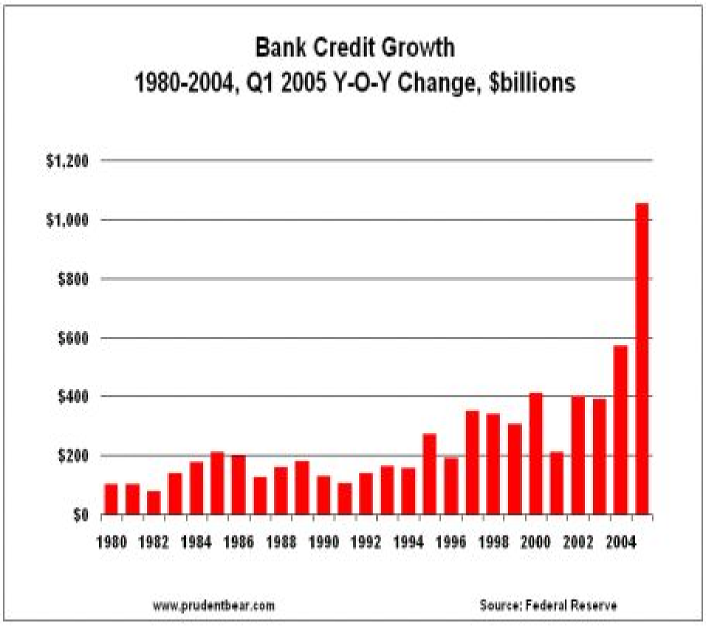
In the US the twin deficits are much more likely to be tackled by a president in his final term. Indeed the second year of the presidential cycle has historically been bad for economies and markets. With Alan Greenspan's retirement we expect the US authorities to both raise taxes and cut Government expenditure in an effort to curtail the huge budget deficit.

This is not good in the short term. Due to the huge trade deficit, US interest rates could well remain near current levels or even slightly higher into next year. This combination of economic headwinds will be extremely sobering when twinned with historically high energy costs.

The UK does not escape the above problems on two grounds. Firstly, our beloved chancellor has been playing fast and loose with the public finances and has run up a huge budget deficit of his own (a moments silence please while we roll around with laughter at his implausible protestations about when the current economic cycle begins and the so-called golden rule). This huge budget deficit can only be plugged by higher taxes as the current hard Labour Government will not countenance any expenditure cuts (apart from in the armed forces).
Secondly, the UK housing slowdown will scupper consumer demand and depress tax returns during 2006. This combined with yet higher taxes will create an un-virtuous circle just when a US slowdown may be beginning to bite.
Then like all good recipes throw in a pinch of high energy prices and you have all the ingredients for recession in the UK in 2006.

US MONEY SUPPLY GROWTH

The chart below highlights perfectly the massive acceleration in the growth of liquidity sloshing around the Dollar world. This rising tide of money has lifted "all boats" and has helped create various asset bubbles around the globe (property in UK, manufacturing in China etc**).** The pace of credit creation appears to be accelerating over the past few weeks.



Robert McHugh makes the following observation's last week. "*M-3 is rising hard again, the Federal Reserve pumping aggressively in clandestine fashion. Seasonally adjusted M-3 rose 18.1 billion last week, is up 42.2 billion over 2 weeks, is up 64.0 billion over 3 weeks, and 152.6 billion over 12 weeks. These translate into the following annualised rates of growth in the money supply: 9.7%, 11.4%, 11.5%, and 6.94%. But these are government adjusted M-3 numbers. Take a look at the profligate growth in the raw M-3 figures this week: Up $79 billion in just the last week alone, a 42.5 percent annualised rate of growth! Up 98.6 billion the past two weeks, a 26.6 % annualised rate of growth.*
The Fed is not tightening money supply. Oh, sure they are raising short-term interest rates, but it is a great deception thrust upon a wanting investment community. M3 growth is on fire!"

We suspect that the Fed has had one overriding objective ever since it began to raise short-term interest rates from 40-year lows in June 2004 – re-arm the interest rate gun, so that it can lower rates again when necessary, without first triggering a systemic breakdown in the markets.
If Robert McHugh is right in saying that the Fed is expanding M3 at a rapid rate once again, Greenspan is clearly erring on the side of future inflation. This will obviously have implications for markets.
Assuming rapidly expanding M3, this would be another wave in the rising tide that lifts all market boats. Thus we are bullish short term for all global equity markets. However markets would not necessarily benefit in the longer-term as the inflationary consequences would see higher bond yields and an increasing headwind for stock markets.

Interestingly here in the UK money supply is accelerating by over 13%pa (over 5x both current inflation and GDP growth). We know this because the Governor of the Bank of England told us so (personally honest). When we asked him to explain the reason behind this growth he diplomatically said he was unsure but wondered if Government borrowing and (over) spending might be juicing up the money supply.
If this is the case do not expect any excessive rate cuts in the UK for some time as the inflationary

nature of money growth will make all Central Banks very cautious. So our guess is that rates may come down only very slowly despite possibly both housing and economic slowdowns.

Do inflating house prices truly enrich homeowners? Do they enrich the nation? Our short answer to both questions is a categorical no. The ugly truth is that both are impoverished. Dr. Richebächer explores...

CRIPPLING "WEALTH"
by Dr. Kurt Richebächer

Let us start with a quote from Friedrich von Hayek: "The means of perception employed in statistics are not the same as those employed in economic theory." American economists think far too much in statistical terms, regardless of underlying economic processes. While the statistics do, indeed, show general enrichment, in reality, there is none at all. The homeowner has zero gain in his comfort of living or income.

This perception of wealth has its true basis in nothing but the famous "greater fool theory"; that is, in the expectation that there will be a greater fool to buy the acquired house later at a higher price. Deluded by this wealth chimera, private households have run down their savings and piled up astronomic debts to be repaid with future earned income.

Where, then, are the economic benefits? The one obvious visible benefit is in the push to GDP growth from higher consumer spending, which also increases current incomes. Yes, but much of that spending on cars, furniture and houses is borrowed from the future. That is, the borrowing pulls future spending into the present, but, of course, at the expense of such spending in the future.

If you think it over, you realize that in reality, such a borrowing/spending bubble adds nothing to economic growth. It only distorts the time pattern of spending in relation to its long-term trend, as in the case of the consumer determined by the underlying rate of income growth.

The second problem is that such a bubble distorts and deforms the direction of demand and production in the economy. Consider these grossly disproportionate increases in U.S. domestic spending since 2000: consumer durables +30.8%, residential building +29.5%, non-residential investment +5.8%, imports +23.5%, exports +5.8%.

Strikingly, all economies with housing bubbles have features in common that were, in the past, generally associated with ailing economies. These are collapsed savings; skyrocketing debts; chronic, large trade deficits; and booming residential investment, but weak business investment.

This coincidence is not accidental. The common denominator of these countries is runaway consumer spending. That is the key point. The big spending excesses in these countries are in consumption, while business fixed investment is in the doldrums. Policymakers and economists in the countries with these symptoms are the first in history to proclaim that people and nations become richer with consumer borrowing-and-spending binges.

Consumption never creates wealth. It is categorical: Capital decreases when consumer spending exceeds production. What is happening in these countries is the exact opposite of wealth. It is capital consumption in the sense that consumption absorbs a growing share of GDP at the expense of investment and the trade balance.

On the macro level, this is impoverishment. As a matter of fact, it is statistically easily verifiable. It shows in the comparison of soaring U.S. foreign indebtedness to the lagging growth of the domestic capital stock, as measured by net capital investment.

U.S. net foreign debts are increasing at an annual rate of around $700 billion, or 6% of GDP. The available data for America's net fixed investment end in 2003; in that year, net private domestic investment amounted to $529.9 billion, or 4.8% of GDP. Of this total, residential building accounted for 3.4% of GDP and nonresidential investment for 1.4%.

Traditional economic thinking assumes that higher consumer spending stimulates businesses to increase their spending on capital investment and employment. This went badly wrong. It has not been realized that excessive consumption, taking up a rising share of GDP, has the exact opposite effect of depressing savings, investment and the trade balance through well-known crowding-out processes.

If you think all this over, you will realize that the American economic reality on the macro level is not record wealth creation, but national impoverishment, foreboding a declining living standard. Take the borrowed import surplus away, and U.S. living standards collapse.

Among the industrialized countries, Japan and Germany are the two great exceptions that have missed the global housing bubble. Japan is still struggling with the aftermath of its building bubble in the late 1980s, while Germany is struggling with the building bubble that developed in eastern Germany in the wake of unification.

Yet speaking of a global housing bubble, we hasten to emphasize again that there is one all-important difference in such bubbles. There are countries where rising house prices have been isolated events in the price system without significant effects on the economy, and there are countries where the housing bubbles have become the dominant influence both on the economies and financial systems.

This really is the dividing line between bubble economies and nonbubble economies.

The inflating house prices in Europe have even failed to prevent a slow decline of consumer spending. Consumers maintained their high saving rates.

Now one question: What does this aversion to consumer borrowing have to do with monetary and fiscal policies? What does it have to do with fundamental economic weakness? Absolutely nothing.

It has to do with a traditional cultural aversion in Europe to consumer borrowing for purposes other than building or buying a house.

And of course, it is stupid to believe that this aversion can be broken with still lower interest rates. In the first place, it robs the savers of income on their large mass of existing savings. It will shock them. The crucial difference to see is that Europeans are primarily savers, while people in Anglo-Saxon countries are primarily borrowers.

Consumption-driven bubble economies reveal themselves at first through sharply falling personal savings. Their second typical, yet spectacular, hallmark is large trade deficits.

In the end, the main question is, of course, what happens when a housing bubble expires. As to be expected, Mr. Greenspan and the bullish consensus deny the possibility of a hard landing. A little logic says that such a landing is inevitable.

An illuminating case in this respect is the very recent experience in the Netherlands. While traditionally a country highly conservative in its finances, it developed a housing bubble in 1998-99, after years of strong economic growth. House prices and credit growth soared at double-digit rates. As homeowners cashing in on their burgeoning home equity went on a spending spree, the household savings rate plunged from 12.9% of disposable income in 1998 to 6.8% just two years later.

As the Dutch central bank raised its short-term rate from 2.5% to 4.5% from 1999-2000, house price inflation came to an abrupt halt. Household borrowing and mortgage equity withdrawal slumped sharply.
Being deprived of their "wealth effects," the Dutch people returned to saving from their current income. Within just three years, the personal savings ratio was back to 12%, driving the Dutch economy into the worst recession among the industrialized countries. The growth rate of consumer spending sagged in a straight line from 4.7% in 1999 to minus 1.2% in 2003.

We have recalled this episode to emphasize one point of greatest importance, yet one that is widely ignored. The Dutch example confirms that for consumer spending to slump in the wake of a fading housing bubble, house prices do not need to fall at all. It is sufficient that they stop rising, thereby depriving households of new wealth effects and the associated borrowing facilities.

Therefore, major housing bubbles imperatively end in a hard landing. A second major adverse influence on economic growth implicitly arises from the sudden cessation of the building boom. Yet the worst looming problem is always the potential damage to the banking system through escalating bad loans.

On Dec. 5, 1996, when Alan Greenspan made his famous remark about possible "irrational exuberance" in the stock market, he asked a rhetorical question: "How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions, as they have in Japan over the past decade?"

For a central banker, that is really a most astonishing question. With some knowledge in macroeconomics, bubble economies - in the sense that asset bubbles impact the economy - are most easily identifiable. Consider that last year, the United States had recorded an overall credit expansion of $2,718.6 billion, versus virtually zero national saving. As you can see, the simple clue is in the relationship between soaring credit and collapsing savings.

As the good doctor rightly points out a property bubble is invisible to Alan Greenspan but as the air seeps out (as is clearly happening in the UK) the economy and the consumer feels the chill.

London bombings and markets

We at Barmac were like everyone appalled by the abhorrent actions of the criminal few and we hope all concerned are rounded up quickly and dealt with severely by the authorities.

We extend our sympathy and sorrow to all those who lost friends and family and to all those simply terrified by the actions of the criminally insane fanatics who perpetrated the bomb attacks.
Our beat is finance and it is apparent to us that whatever the bombers do the global financial markets are becoming inured to such atrocities as they did to the IRA bombing campaign.
This growing realisation that markets are unlikely to be affected by terrorist action has helped fuel the latest rally as markets have increasingly shed the fear discount apparent since 9/11.

INTEREST RATES & BONDS

- **UK rates at peak?**
- **US perhaps just an extra 25 to 50 points.**
- **Gilts and bonds fall back to short tern support.**

The widely held market belief that UK rates have peaked is almost certainly correct with the B of E expected to start cutting rates at the August meeting. The weak housing market and a recession in manufacturing has given the Bank both the scope and the excuse to commence rate cuts. With reported inflation remaining subdued the Bank could shave upto 75 basis points by next spring in order to stimulate some growth.
The Governor however remains concerned by the growth of money and that may well inhibit the pace of cuts during the next 6 months. We suspect that next year rates may well fall yet further if the economy weakens as we anticipate but inflation would need to remain subdued.
The ECB has held rates steady for what seems like a couple of millennium and despite a growing pressure to cut rates to offset Franco/German recession we would not be surprised to see yet more inactivity. However, with rates at 2% any cut would probably have little or no additional effect.

In the US rates may well creep slightly higher but we believe that again the consensus is right that short-term rates will peak in early autumn and could begin to decline during the spring. The only real threat to this scenario is if reported inflation climbed on the back of commodity inflation to a point where the Fed felt it was unable reduce rates.

UK Notional GILT

UK gilts have had a strong run since March but have stalled twice at 105 with potential support at 103 being challenged for the second time in just a few weeks. If this support is broken then conceivably prices could decline toward the 100 zone that marked the early spring low. Such declines if they occur, would provide a mild headwind for equity markets and as such needs monitoring.

30 yr TREASURY BOND (weekly)

The US bond market displays a similar pattern to the gilt market and we again have a small double top in place. If prices fall below 115 then they could easily run down to the spring lows. A stop at 115 would enable traders to short bonds reasonably safely.

GLOBAL EQUITIES

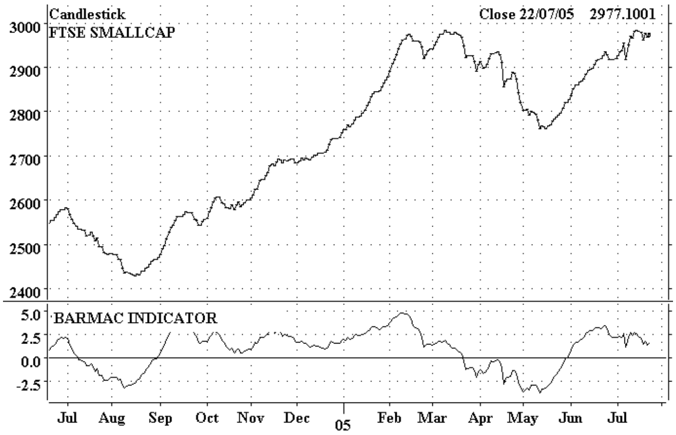
- **Global liquidity lifts all ships.**
- **Barmac buy signal holds good since May as small caps hit new highs**
- **European blue chips rally strongly**
- **Wall St still lags**
- **Tokyo approaches key 12000 zone**

A global surge in liquidity appears to be simultaneously lifting all markets. We wonder if the Gann enthusiasts are going to be proven correct when they stated at the start of the year that all years ending with 5 are super positive. Well despite our dubiousness it is holding broadly true so far.

The Barmac Indicator gave a “buy” signal (2850) in late May after quitting the market in March at 2925 ish. The small-cap has progressed steadily and looks likely to exceed the late February highs and emulate the various European “blue chip” indices completing a picture of “commonality”. We believe that commonality is a great market indicator that is often overlooked by market analysts.

The positive outlook would deteriorate if 2900 was pierced and the Barmac indicator near this level would probably signal a major reversal. At present however small cap stocks look set to climb higher for the present.

BARMAC INDICATOR



The three charts below showing the Ftse 100, the German DAX and the Dow Jones all show the long-term picture and display a number of common features that may help us identify how far the current market rally will carry to.

The long-term charts lend perspective and it becomes clear that the current 2 year old Bull Run is approaching a series of key chart resistance levels.
When we look at the Ftse there is a key consolidation area created in late 2001 and early 2002 that stretches as high as 5350. The lower part of the range has already been encountered and we await evidence that the area of potential resistance has any effect. If the Ftse is able to surmount this initial target area then the huge multi-year trading range evident over 6000 will probably halt any advance for a considerable period of time.

FTSE 100

The Dax is likewise just entering a key resistance zone created in 2001/02 and we suspect that the German blue chip advance will be at least held-up in the target zone.

DAX

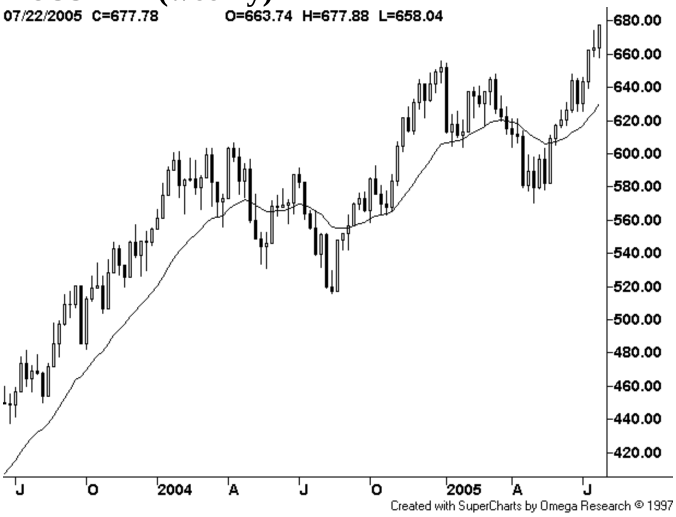
The Dow Jones has a slightly different pattern but exhibits certain similarities to the Dax and Ftse. So far this year the Dow has failed to emulate them and hit new post 2003 highs but, the dollar rally has lifted the market 7% or so in euro terms during the year. We would not be surprised to see the Dow push to new post 2003 highs to comply with commonality.
However when we study the Dow's chart we can see why it has paused so long at the current levels as a huge multi-year trading range from 98 to 2001 is acting as resistance and making progress very tortuous. Whether this resistance will be overcome is not clear-cut and despite the lead from many small and mid-cap indices that are at all-time highs now, progress for the Dow may well prove slow and painful.

DOW JONES (monthly for perspective)

NASDAQ (weekly)

The Nasdaq (above) appears poised to attempt a break-out over 2200 as a third assault on this level is now at the upper boundary of a two-year trading range**.** A sustained move above 2200 is possible if the Europeans and small-caps maintain their leadership. We would recommend long positions with a stop at 2200 if and when the break-out is confirmed but be careful of a false break-out which for some reason the US markets seem prone to do.

RUSSELL (weekly)



We have included the above chart for the Russell 2000 to illustrate that in the US the small-cap sector is leading the blue-chips higher.

NIKKEI(weekly)

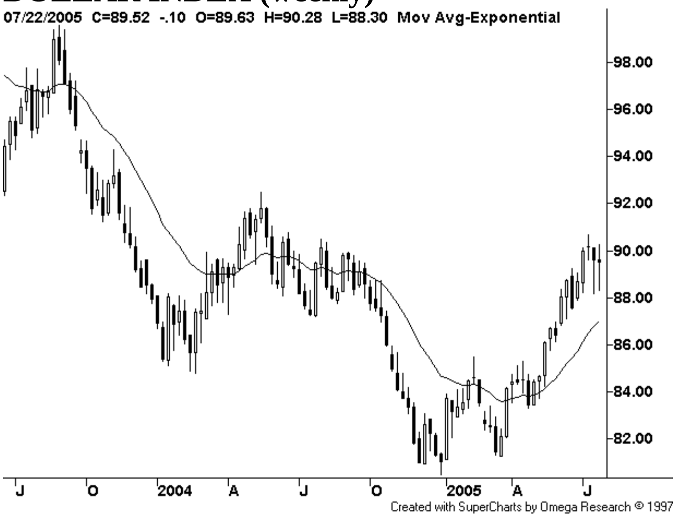
The Nikkei is looking extremely interesting with the index trading in along-term range just below 12000. We await with great anticipation a breach of this level that could well lead to a strong upward thrust**.** Again commonality would suggest that the index is likely to follow other markets and sectors (Tokyo 2nd section) higher. We would suggest a long position above 12,000 with a stop at 11,750 and then trail gently higher behind the index if and when the break-out happens.

FOREX

- **The dollar rally may be ready to pause for breath**
- **Sterling weakens across the board and tests key levels against Euro.**

The dollars rally during 2005 has carried the index back to resistance from last summer in the 90 region. The previous trading range will likely cap any further progress by the greenback for some while. This is doubly so as the ramp the dollar has enjoyed since April is over-extended and susceptible to profit taking. Thus it remains likely that the dollar is due a consolidation for several months.

DOLLAR INDEX (weekly)



The Sterling dollar cross has seen the pound tumble from $1.90 to $1.70's during the dollars recent strength. The pound's excessive weakness (it fell further and harder than most other currencies during the dollars rally) suggests that sterling could be starting to buckle under a perception that a slowing UK economy will be forced to cut rates and increase taxes.

The chart below highlights the precipitous nature of the recent decline and suggests that any rally from a small double bottom may only carry back to long term resistance in the $1.76 to $1.78 region of last years lows. Long term the pound is starting to look vulnerable but a bounce from current levels is likely over the next month or two.

STERLING/DOLLAR

STERLING/EURO

The Sterling/Euro chart (above) sees the pound trading at the lower end of a near two-year trading range. Sterling last traded in a range against the Euro in 2000 to late 2002 and then quickly fell to £1.40. We will carefully watch very carefully the current trading range for any change in circumstance. There remains considerable resistance above the current trading range that would inhibit any real progress if the pound broke up and as such we have a sneaking suspicion that the pound may eventually break the range to the downside.

As always our advice to traders when faced with a trading range is sit tight and await the end of the range and then use a tight stop near the break-out level. For the moment there is no need to act.

COMMODITIES

- **Oil and gas drives the CRB back to the highs.**
- **Precious metals are poised for action**
- **Dr Copper hits new highs**
- **O.J. revisited**

The CRB index appears to be just backing off from its recent highs for a second time as oil and gas consolidate recent gains. As can be clearly seen a major bull market has occurred in commodities over the past few years and as yet reported inflation has remained subdued on both sides of the Atlantic. We suspect that the reported CPI numbers are completely skewed and bogus but unless reported inflation starts to accelerate interest rates will remain historically low. The key is to maintain a close watch on the CRB and the CPI for any signs of an uptick and get the hell out of financial markets if inflation unexpectedly becomes a problem.

CRB INDEX (weekly)

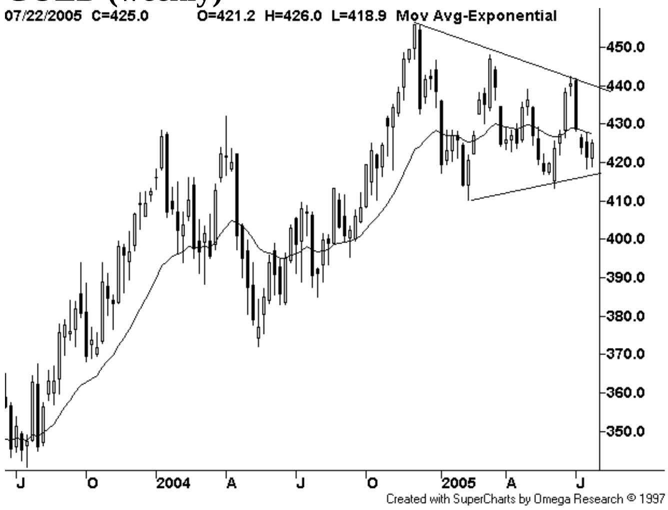
Crude oil hit new dollar highs during the summer that were even more marked in Europe due to currency weakness. Gasoline contracts confirmed

crude oil's action, as the whole energy sector remains caught in a strong bull run. Whether this price strength will continue is the awkward question despite the ongoing background of a growing long-term global oil shortage due to peaking of production (Hubbard theory discussed in various previous issues) and booming Chinese/Indian demand.
The charts for both contracts (below) suggest that uptrends remain intact but perhaps at least a period of consolidation is due. Oil could easily fall back to $50 and not disturb the overall bull trend but a break of spring lows would suggest that a top of at least medium term significance was in place. In conjunction with commonality $1.40 is highly significant for gasoline.

OIL (Nynex crude weekly)

UNLEADED GAS (weekly)

GOLD (weekly)

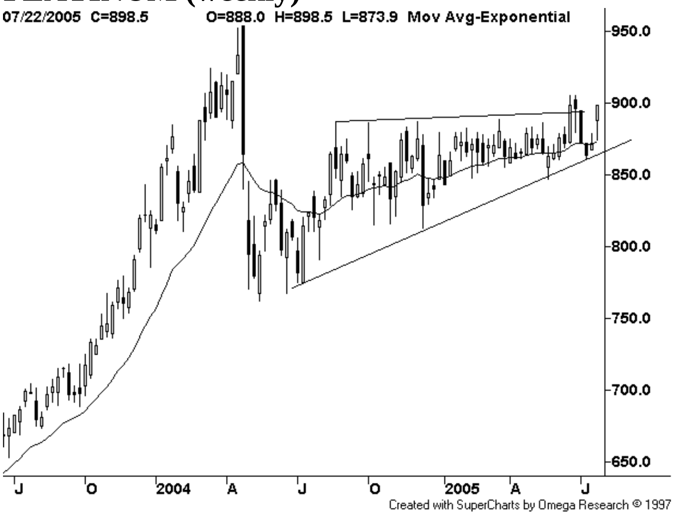


Gold continues to trace out a ranging multi-month triangular consolidation pattern and we would stand aside until this range resolves itself. But we would institute a position with the direction of any break using the pattern boundaries as our stop-loss. Any correction would probably be contained by the spring '04 lows of $375. Over the longer term we suspect that gold will ultimately head much higher as investors seek a haven from inflation and the gross printing of dollars (not to mention the politically unstable €uro).

SILVER (weekly)

Silver has crawled along the key uptrend for well over twelve months. A decline below $6.75 could herald a sustained period of weakness with the possibility of last springs $5.50 level being tested. We would place a stop at $7 if and when a downward dynamic occurs. In the meantime it would need the price to exceed $7.50 to open the way for a bullish stance to be adopted.

PLATINUM (weekly)

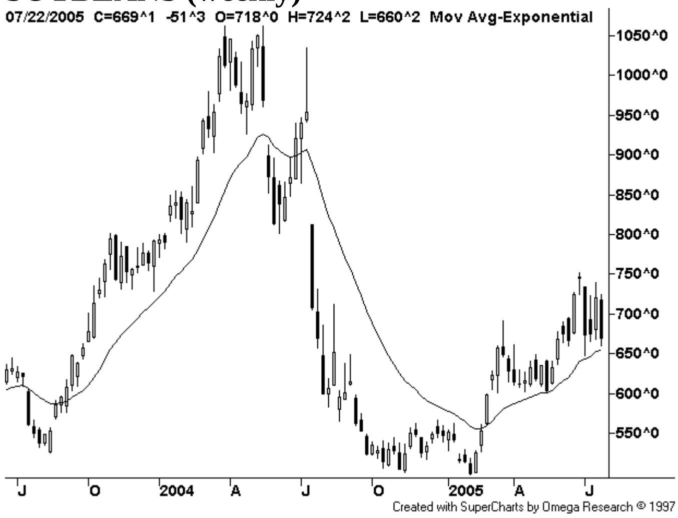


What a strange chart! The very tight triangle appears to be ready to end. Quite clearly any resolution to the current trading range could provide a very interesting trading opportunity. Suffice it to be said but we would suggest that we trade with the break-out with a stop back inside the old range.

COPPER (weekly)

Dr Copper has shown yet another strong upward dynamic above the multi-month trading range at $1.50. If this break is held then we would expect prices to run on further driven by Far eastern demand. We would use $1.45 as our stop level on any long positions. Interestingly the global economy does not appear to be slowing according to the analysis of good doctor copper. Obviously, China and India just keep on growing.

SOYBEANS (weekly)



Soybeans are holding on to the spring gains at present and appear to be completing a second step above the multi-year lows. As long as the price holds above $650 (use as a stop) we would expect prices to firm as Asian demand increases along with industrialisation

COFFEE (weekly)

Coffee's meteoric rise seems to have been followed by an equally precipitous fall but should find some support near the significant rounda-phobia $100 level. As regular readers are aware we have been major bulls of coffee for three years and first bought at $52. We expect the current correction to be over before year-end and would re-purchase on a break of the downtrend shown on the chart above. Meanwhile watch for a potential upward dynamic and support at $100.

ORANGE JUICE (weekly)

Frozen concentrated orange juice futures (FCOJ) have long been one of our favourites since watching "trading places" with Eddie Murphy in the late 80's. We highlighted FCOJ in July last year as the clear downtrend was smashed. The Bull Run that has followed from historic lows is still intact. However, with the price hovering around the significant $100 zone and no longer historically cheap we would use the uptrend line drawn on the chart as a potential stop loss. The market however still looks capable of moving higher in the near term so we would advocate maintaining and running current profitable long positions until and if the above mentioned trend line is broken.

AND FINALLY

Another amusing and pithy observation by Mr Justin Urquart-stewart.

"Property has never been a strong suit for the Blairs. After missing out on the property boom of Islington after being elected in 1997 (advice from Mr Mandelson, I understand), we had the controversial student flats in Bristol (advice from a fraudulent adviser here) and, to cap it all, we have had the purchase of a modest dwelling in Connaught Square for £3.65 million. As indicators for the property market the Blair investment policy is a clear contrary indicator. By way of illustration, the most
recent purchase works out at an eye watering £822 per square foot ! Pity that one across the Square has just gone for a mere £600 per square foot ?
Tear-making for some, I expect"

Regards

Andrew McCarthy &
Andy Bartles

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