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BEWARE A GLOBAL CREDIT CRUNCH COULD BE DEVELOPING OUT OF THE TECH-WRECK.

INTEREST RATES & BONDS

Rates to be cut further despite inflation fears
 Fear of inflation makes yields rise
 The JGB is not ready to short yet

GLOBAL STOCK MARKETS

Beware of stock collapse due to credit crunch
 Many markets will hit new lows
 P. E ratios are still climbing despite stock price falls
 Corporate earnings will continue to collapse until mid 2002

CURRENCIES

Dollar ready to resume its rally against the Yen.
 Euro to rebound vs Dollar
 Pound may begin technical rally vs Dollar

COMMODITIES

Oil tests support
 Tin & Nickel fall despite backwardation.
 Gold retraces all of recent gains
 Silver to fall to multi year lows.
 Soybeans rally continues

The global economy could face it's biggest threat yet as the unwinding of the biggest speculative orgy of modern times has come to a screeching halt.

It is our view that the NEXT 3 MONTHS will determine whether the current stock market falls are an opportunity or a prelude to something much worse. We are certain any credit crunch will become apparent within that timescale and if no such calamity occurs then market falls will be opportunistic. The opportunity cost of delaying investment decisions until October is unlikely to be too great as the Ftse.100 will probably be capped at 6000 for sometime (see chart review later). The NASDAQ and TechMark may rally during this delay but their recovery potential (assuming no credit crunch) will not be exhausted due to our caution. After all in bear markets cash really is king and time is on our side.

SO WHY A CREDIT CRUNCH?

Firstly, this is not a prediction but a warning, as we believe that there is perhaps a 1 in 3 chance of a significant and prolonged contraction in global GDP brought about by a collapse in bank lending and liquidity.

This potential collapse in liquidity is a direct result of the TMT meltdown and the ongoing consequences of \$4 trillion going to money heaven (40% of US GDP via the NASDAQ alone). The US economy has never had such a massive deflationary shock and its after effects may be hard to evaluate. Certainly, new lending criteria will tighten as loans granted in the late 90's go bad. Many US banks

Could find their capital base eroded badly because of the following reasons;

- 1) Huge losses from their own speculative forays into Tech boom. As the boom was cresting many banks were loading up to the gizzards with \$400 billion invested in venture capital in 1999 by US banks according to Fed Governor Laurence Meyer. Look at what has already happened to the likes of Amazon, Dr. Koop. Priceline, etc. Many stocks have declined 90% or disappeared altogether. This alone could emerge as a big hit to bank earnings...and make it more difficult for banks to act as a source of capital for loans and or equity.
- 2) Mergers and Acquisitions activity in the 90's was mostly debt financed at the height of the boom. In 1980 corporate debt represented 30% of US GDP by 2000 this had risen 50% to 44% of GDP. Some of the acquisitions this raft of debt has been used to finance are beginning to look pretty sick (Time Warner/AOL, Deutsche Telecom with VoiceStream and Vodafone with Mannesman. KPMG looked at the 700 highest priced deals between 1996 and 1998 and found only 17% increased shareholder value and Business Week concluded after studying 150 major deals between 90 and 95 that over 50% actually lost money for shareholders.
- 3) Corporation's worldwide leveraged up their balance sheets with share buy backs and debt financed growth. This is how it worked: The company repurchases a big chunk of its own shares. This reduces the supply and simultaneously enhances earnings per share boosting the share price (remember many CEO's are remunerated on share price performance via bonus or options). As long as the company can continue financing these buy backs the share price continues upwards. This over inflated stock valuation is then used in cashless (paper) mergers with other companies. Now armed with a stronger currency (their own overvalued shares) they are ready to go after even bigger targets and "pay" a lot more than it would under normal

(cash) circumstances. In 1999 AT&T spent \$4 billion on share buybacks and then went on to spend \$52 billion on TeleCommunications and \$55 billion on MediaOne Group Inc.

- 4) Derivative trading exposure is \$37 trillion (over 530 times all US banks profits for 1999). According to the strangely named "office of the comptroller of the currency" the worlds largest bank—J.P.Morgan/Chase--have \$8.17 in credit risk from derivatives per \$ of risk adjusted capital. Thus only one eighth of its positions need to turn sour to wipe out the whole of the banks capital base. So in simple terms Morgan/Chase would go bankrupt.
- 5) Finally, the US consumer has been positively Trojan over the last few years at keeping the global economy ticking along at a fair old clip. Most recovery-based scenarios rely on US consumer demand holding up in the face of job losses and recession thanks to tax and interest rate cuts. But the spending binge of the last 5 years or so has largely been debt financed. The average credit card debt per US household is \$8123 and is triple the level of ten years ago. In 1970 only 15% of Americans had a credit card. Today, there are four cards for every man, women and child in the US. Personal debt has soared with three out of five American families spending more than there after tax income leading to a negative savings rate of -0.7%. In April alone US consumers spent \$50 billion more than they earned. 32 million US families run an annual deficit of over \$8000. They are running down their assets to service this excess. In 1985 US homeowners owned on average 73% of their property. That has fallen to a record low of only 56%. All this indebtedness was great while the NASDAQ was rising but suddenly investment portfolios have had a hammering and cannot be relied upon to offset expenditure. **Thus US consumers will have to stop spending and many are headed towards personal bankruptcy. Who owns the credit card companies? The banks**

So for all the above reasons US banks could find themselves unable to provide credit just when the economy needs it most. Thus a credit squeeze could send many already troubled companies to the wall.

DANGER OF DEBT DEFLATION AND DEEP RECESSION.

Recession is a fact for most western economies now but most believe that it will be short lived and mild. The comments above highlight some of the key threats to bank stability, which could cause a financial crisis, but we will now examine the economic backdrop to weakening bank balance sheets and why it could get out of hand.

Corporate profits

The NASDAQ has fallen roughly 60% over the past 15 months but the PE ratio has actually risen to an unbelievable 130x earnings. Even the Dow has seen PE ratios rise since January to over 24 from 20 despite the index trading sideways. How can that be so? The answer lies in the fact that corporate earnings are dropping off the edge of a cliff. For the markets to regain some composure and fair value earnings have to rebound over 400% for Tech stocks and yet Intel announced last week falls in profits of 72%

These earnings collapses put ever more pressure on companies to service the interest charges on their over leveraged balance sheets. As a result many companies will either go bust or “downsize”. The negative multiplier effect this may have on the US economy together with the affect on consumer confidence could be seismic. After all it is only the prodigious US consumer who has kept the whole merry-go-round spinning.

US CONSUMER CONFIDENCE

As stated above if the economy slows and unemployment does become problematical confidence and spending is bound to fall with dire consequences. However the US consumer faces further erosion of self-belief via the stock markets. We have already highlighted the high levels of consumer debt and the problems a slowing economy may cause, if we then throw in savings/asset erosion for good measure we could witness a dramatic collapse in consumer confidence. Many Americans have their savings in stocks especially the NASDAQ and have watched those savings swallow dive. If the markets began to

fall further due to yet lower profits brought about by lower consumer spending brought about by job and equity losses bringing on more lay-off's and so on and on.

As we have seen the conditions are in place for a US consumer strike before we factor in the most crucial and killing possibility of all.....

IF DUE TO THE PROBLEMS OUTLINED IN THIS ARTICLE CORPORATE EARNINGS CONTINUE TO SLIDE THEN AS NIGHT FOLLOWS DAY THE DOW JONES, THE S&P AND THE NASDAQ WILL COLLAPSE.

We could see declines equal to those witnessed in the Thirties with the Dow falling by more than half and the Nasdaq perhaps halving again.

Should these indices resume their declines then a full-scale credit crunch will occur with consumers sidelined for the duration. This final coup de gras would lead to the irony of a declining economy with massive interest rate hikes (as corporate bonds crash and scarcity of capital allied with heightened credit risk leads to ever higher costs of capital). This final act of any credit crunch is the most devastating as it unleashes a final tsunami of high profile corporate and personal financial collapses. This was last seen in Japan in the 90's and the US during the panic and “Bank Holiday” of 1933.

So there we have our Doomsday scenario. We believe that the markets will indicate if such a meltdown is occurring. However modern economics are so complicated and inter-related that Greenspan's rate cuts and Bush's tax cuts could well avert the worst excesses by engendering a return in confidence and a rebound in corporate profitability. Even if our caution proves to be groundless pessimism, we believe that the exercise of examining the nature of the current financial slowdown can provide a valuable insight into what may be the more interesting and lucrative investment opportunities of the next upturn.

Finally watch the US indices and for any evidence of a slowdown in consumer spending as the lead indicators of a looming credit crunch.

INTEREST RATES and BONDS

- **Further cuts in short term rates are likely**

- **UK, US and European bonds trade sideways to lower**
- **Japan bonds are not ready to short yet**

Greenspan will err on the side of monetary easing. The Fed will attempt to cut as long as it can to offset the TMT declines. Despite dramatic cuts since the turn of the year the Fed will cut further if it feels that the economy is still not reacting favourably to the fiscal stimuli. The Fed Chairman will not wish to see consumer confidence sag in the face of weak corporate profits, rising unemployment and the sharpest US slowdown in decades. Moreover, with the ECB way behind the curve of declining growth and Japans economy slumping once again, only the US is capable of leading the world out of the slowdown, and a widespread improvement may not occur until mid 2002.

As the charts show below the charts for UK and US long bonds are trading slightly sideways to lower. This is due to the current concerns of a possible stagflation scenario as highlighted last month following relatively higher energy prices over the last 18 months.

Currently, we would only wish to hold short dated Gilts over upto 3-year maturities. The long dated stocks will become more interesting if the March lows hold on the stockmarkets and the threat of aggressive interest rate easing and it's potentially inflationary consequences dissipate. Inflation is unlikely to be a problem for the UK or the US once the current oil spike has worked through the system over the next 12 to 18 months.

UK gilt Tr 6% 2028



U.S. TREASURY (Cbot) weekly



Japan's bond market is paradoxically the world's best performer at present. This is being driven by deflation and BoJ's purchases and because that even at 1.175% the yield on JGB's is preferable to that on deposit. Moreover, the BoJ is a big buyer in an attempt to reflate the Japanese economy. Whilst Japan is now entering it's fourth recession in 11 years and the worlds other major economies slow we would certainly not entertain shorting Japanese bonds. We believe that conditions for what will be a truly great multi year position will not be in place for perhaps another 12 months. In the meantime masterly inactivity is called for as we stalk our major bond market play for the early 21st century.

GLOBAL STOCK MARKETS

- **Weak corporate profits versus interest rate cuts**
- **Chart review of main markets as bears grip tightens**

Lower rates are usually bullish for stocks and we have already described earlier some of the sobering background to the current economic slowdown. In 19 cycles of interest rate cuts since 1914 the Dow has shown a 12 month gain in all but two occasions both during the Great Depression of the thirties. We have listed the historic gains in two previous issues and the evidence is compelling for a rebound. However, there is a risk that the current cycle may disappoint due to concern over valuations and corporate profits. Just before the Fed's first cut on 3rd Jan the Dow stood at 10646. To date it has

mainly traded below that level and many other indices have fared much worse. We maintain that if the Dow is not higher by 2nd Jan 2002, then the global economy, not just the US, will be in a mess. Since markets usually improve at least 6 months before their economies, the key question is have we passed the inflection point where investors are looking beyond the current slowdown and focusing on recovery following the interest rate cuts.

As yet there is little evidence to support this view and if the March April lows are broken then any recent base building activity will be destroyed. Generally, we have hedged much of our market exposure via individual stock options and futures although presently we will not short unless the March lows are broken.

CHART REVIEW

Dow Jones Industrial has probably been the strongest of all the indices this year. It has continued to trade within a trading range centred upon the 10500 level. This range looks like top formation but as yet no sustained break has occurred. The chart below clearly illustrates the very tight congestion area built up over the last 3 years. A break out would be a very powerful move and could be in either direction. However the Dow is not to be traded whilst it is stuck in its current range.

DOW JONES log scale



The **S&P** index has been under performing the Dow since last summer. This broad index looks likely to challenge the March lows at 1100. If the index rebounds and can exceed 1300 then we may well have a strong buy signal but below 1100 and the market looks likely to drift away

S&P 500 index



The **NASDAQ** recovery rally was checked by initial resistance at 2300. A move over this level is required to offset prospects for a potentially lengthy base extension, including a test of the April trough. **NASDAQ last 6 months**



The **NIKKEI 225** has plunged back down through the March lows and a sharp rebound is now required to question the current outlook for at best a lengthy phase of base extension. The market has growing pessimism due to renewed recession. Over the very long term although Tokyo currently looks desperate it probably represents the best value of the Western markets.

The long declines on this market have seemingly no end with the high of 40,000 set way back in Dec 1989. The terminal economic problems are unlikely to be helped by the US slowdown but after a near 75% fall the low can't be too far away. This market is perhaps a lesson for Wall ST perennial bulls!

NIKKEI 225 (weekly)



Most of the European markets are trapped in downtrends and pressuring their lows. The 3year trading range evident above 6000 firstly caps the FTSE 100 as shown below. This level will act as a lid on any recovery. Secondly, the index is now in a bear market decline with no evidence of a bottom as yet with the recent March lows likely to be broken. The market may well push down to test the 98 lows of 4800 as frequently predicted here over the past 6 months.

The 1st chart below is the long term Log chart that illustrates that the FTSE has broken its long-term trend line evident since launch in 1984. Also shown is the “Investors Chronicle” Coppock indicator, which indicates a bear market when it falls below the zero line. As can be seen from the chart this indicator is determinedly calling for a period of price weakness on the index.

FTSE 100 & Coppock indicator (log)



The much shorter-term chart below highlights the powerful effect of the key 6000 level and the dominant downtrend that is now in place.

The weakness of the rallies implies that this market has not established a floor as yet. The first sign of a sustainable reversal would be if the downtrend line was broken (5750 at present) and a double bottom established at the 5300 level. Then a tentative buy may be possible especially if other markets were confirming the floor.

FTSE 100



The Techmark makes even more depressing viewing than the Ftse and the NASDAQ as it has lost 75% of its value in 15 months. What is worse however is that the index is still continuously hitting new lows and showing no sign of bottoming.

The TechMARK 100



The other main European indices are similar to Ftse and are all pressuring their March lows. The trend lines drawn indicate the consistency of the declines. As the chart for Paris shows below the CAC is pressing the March low of 4800. If the index finds support at this level we would then await a break of the trend line before considering entering a trade on the long side (tight stop needed).

CAC (weekly)



The **DAX** is even more orderly than either of the above two markets and the same comments hold true with the key levels being the low of 5400 and the trend line at around 6000.

Xetra DAX (weekly)



The only European market that is not all gloom and doom at present is Dublin, which is still defying the global falls. Although the index looks like it may be rolling over at present no real technical damage would be occur unless falls carry it beyond 5900

Dublin ISEQ



We include a collection of world markets below which on the whole are all displaying a similar pattern of decline. Nearly all markets are approaching the key March lows and a global rebound of these levels may be the first tentative positive for some time and may herald a period of firmer prices.

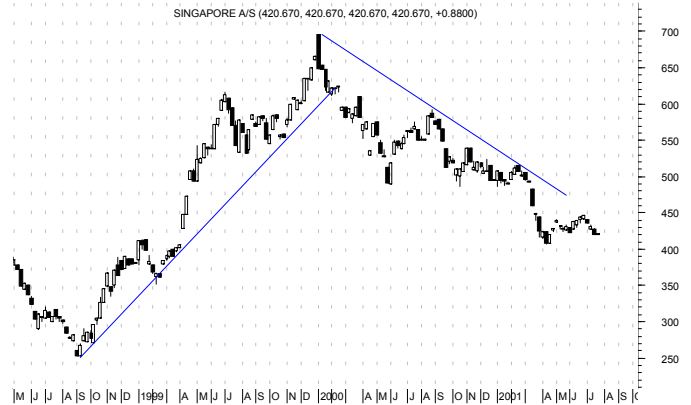
HANG SENG



MALAYSIA KLSE



SINGAPORE ALL SHARE



TACTICS FOR STOCKMARKETS

We suspect that a short term rebound will arrive at the March lows. However much the more interesting trade would occur if the markets should then slump back down through these lows. If that should happen we have the perfect set up.

- **On any fall back through the lows after an initial bounce SHORT the index with a stop at around 5400 on the ftse (similar area on all other index)**

Alternatively

If markets steady, then meet a strong buying response and go on to break the downtrend then cautious buying could be undertaken with a stop placed just below the trend line break.

CURRENCIES

- **The Yen has completed its contra-trend rally and the BoJ will have to flood the market with liquidity**
- **One off cash transactions have weakened the Euro but support may be found near the lows.**
- **Sterling is struggling within its downtrend against the mighty Dollar.**

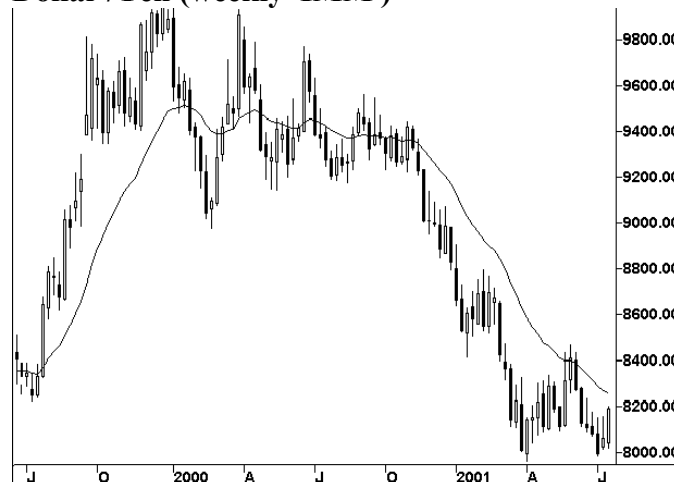
The Yen's bear market will run for years but it will be punctuated by many 6 to 8 Yen rallies against the Dollar. Multi-year trends are produced by major changes in fundamental economic factors. For the Yen, the most important has been the chronic deflationary slump that has hit the economy during the 90's. Japan can only escape via massive reflation due to its Govt debt and virtually zero interest rates. We have covered these reasons in depth recently. However the biggest moves occur following an overreaction of extreme proportions. In 1995 the yen hit a high of 79 against the Dollar as talk of the "Pacific century" created one of the great overshoots. As currency movements are a "zero sum game" chronic overvaluation of one currency necessitates chronic undervaluation of another. In this case the Dollar. Today, those who believe the dollar is high at 124, such as lobbyists for US manufacturing, should look at the very long-term chart below. Thirty years ago the dollars high was 357. It last crested 250 in 1985. By this measure, the dollar is extremely cheap

US Dollar / Japanese Yen (Quarterly) from 1971



The chart above will only confirm the completion of a base on a break above 160. The short-term chart below provides convincing evidence that we have seen the low for a medium term correction, which commenced in April. If so a move under 122 (over 84 on inverse scale) is required to question this hypothesis, no more than temporary resistance is likely to be encountered between current levels and the April high before the overall up trend continues for the Dollar.

Dollar /Yen (weekly IMM)



Sterling / Dollar has seen an ongoing sterling decline for 6 months or more. However the pound has not maintained its break below \$1.40. A move beyond \$1.43 would break this year's progression of lower rally highs, providing further evidence of an important downside failure, in which case sterling would probably range somewhat closer to its January high of \$1.50.



The Euro /Dollar chart below suggests that the Euro has found at least temporary support at last years lows against the Dollar. The rebound looks capable of propelling the Euro somewhat higher over the next few months. Interestingly both lows were signalled by weekly “doji” crosses. We suspect that the Euro may well test its spring high against the Dollar before perhaps running out of steam. A failure would occur if the lows were exceeded and a fine “set up” to short the Euro would be in place with a stop \$0.86

Dollar /Euro (weekly)



Euro/ Sterling remains basically rangebound. The fundamental key areas are in the mid 1.70’s and the 1.55 area. A break below E1.60 would probably signal a test of the lows of 1.55. We think such a move would be very tradable (place a stop at 1.61 if such a break were to occur)..

Sterling / Euro



FOREX SUMMARY

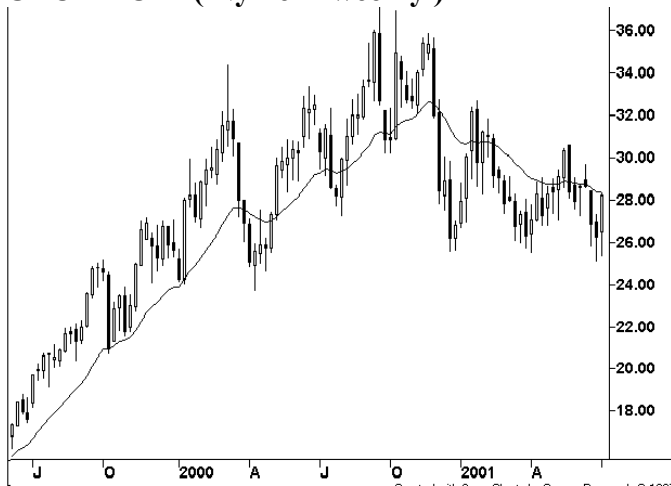
1. Short Yen vs Dollar
2. As Euro and Sterling may be about to see temporary relative strength short Yen against these two for diversification (the “carry” is equally as positive as it is for the Dollar).
3. Short Sterling against Euro if 1.60 level breached
4. Buy Sterling vs Dollar if \$1.43 level exceeded for move towards \$1.50

COMMODITIES

- Prices for crude oil is testing support.
- Silver is breaking to new lows
- Gold is base building

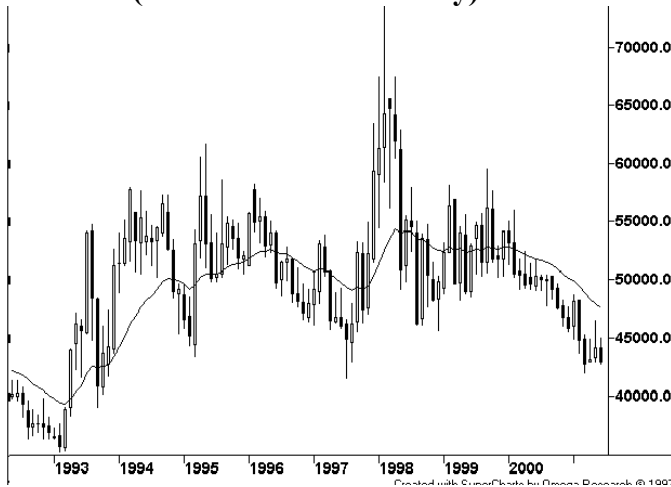
OPEC is slowly losing control of the oil market. The global slowdown has reduced demand and production from Iraq and other sources has increased, including above quota leaks from the Cartel. Lows for the broad trading bands date back to Jan 2000 are being tested by both gasoline and crude. These patterns have looked like developing top formations for many months. The main question has been will OPEC summon up enough resolve to keep prices above these key levels. Nevertheless all cartels fail over the long run so that any rebound from the current lows may prove only to be temporary.

CRUDE OIL (Nymex weekly)



SILVER seems to breaking down through its multi year lows. Sentiment in this market is being blown apart by reduced industrial use. Kodak just announced demand for silver halide film is plunging due to new technology. Silver is bouncing gently on multi year lows around \$4.20 per ounce but looks likely to plunge down to \$4.00 and perhaps on to \$3.75.

SILVER (comex 5000 oz monthly)



Nickel and Tin have plunged despite backwardation as predicted here last month. The markets are both so oversold in the short term that technical short covering rallies may be due but presently both these metals along with most of the other industrials looks unlikely to mount a sustained recovery.

TIN (weekly)



Nickel (weekly)



SOYBEAN MEAL has pushed on yet further providing windfall profits for many subscribers. We first highlighted soybeans at 162 and since we have seen prices nudge 180 – a gain of almost 2000 basis points. We would raise any stops upto 170 if you are still trading this one.



GOLD

Blips aside, we could be years away from another inflationary cycle but events are moving

in that direction. The money supply is being pumped up to offset recessionary fears both in the US and Japan. Additionally, the public psyche has changed to one of fear of deflation not inflation . This is an important generational sea change that will have profound effect on gold prices over the next 10 years. Meanwhile, gold could benefit as a store of wealth if our doomsday scenario unfolds. However, gold's retracement of the May rally suggests that a lengthy additional period of base formation extension is likely

GOLD (weekly)



REMEMBER

Our doomsday scenario was a warning not a prediction based on the current imbalances in the world economies. However we do feel that it would be prudent if investors sat on their hands for the next 2 to 3 months to see if any financial shocks (like LFCM in 98) crawl out of the woodwork.

FINALLY

As ever we welcome all your comments and e-mails and any investment or trading stories.

GOOD HUNTING

BEST REGARDS

Andrew McCarthy & Andrew Bartles