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STOCK MARKET INDICES HAVE COMPLETED MOST OF THEIR CURRENT UPWARD LEG, AS MUCH OF THE GOOD NEWS HAS BEEN DISCOUNTED

1.GLOBAL ECONOMY

Lower oil should support global GDP

Afghan war is no longer a threat

Optimism has replaced pessimism

Deflation threat is receding

2. INTEREST RATES AND BONDS

Rates could go even lower in Europe

Bonds are starting to discount recovery

3.EQUITIES

Markets are due to retrace some of recent rallies

Much good news already discounted

All downtrends are still in place

Equities may stay locked in trading ranges for a couple of years

4.CURRENCIES;

DOLLAR looks set to advance against Yen

YEN is coming towards the end of its current trading range a break out is imminent

The Euro should strengthen as hot money transactions dry up ahead of January

5.COMMODITIES

OIL –OPEC cartel is broken and oil prices will support the global economy from now on

METALS production cuts stem price falls

SOFTS Cotton rallies and looks positive

SILVER hits new lows but bouncing of \$400 support level.

The recovery in global markets has unfolded as expected with markets correcting massively oversold conditions via “snap back” rallies. The behaviour of equities when at least a partial retracement of the recent gains occurs will provide clues as to whether we saw the bear market low or not in September. Until recently, the rallies have been impressive with gains in excess of 20% from the 21st Sept lows on some markets. However most markets are still below their bear trends and have considerable overhead resistance, which may cap the scope for further gains in the short term.

A considerable amount of good news, including further cuts in interest rates, a steep decline in the price of crude oil, a US led recovery in 2002, a successful war and no further terrorist attacks have been discounted. There is only the capture or elimination of “gooner” bin Laden left on investors Xmas wish list.

Investor confidence however, is still fragile and susceptible to any potential setbacks. It is not hard to find sources of concern with record PE ratio's, Argentinean bond defaults and high profile corporate bankruptcies all of which make it likely that current overbought conditions will yield to a correction of some of the recent gains.

Watch for reactions in excess of small 2 to 4 day pull backs that we have seen to date. A larger decline will indicate that stock markets have completed their first upward leg, which should be followed by a retracement of at least a third of the gains since September's lows. *It is the reaction to this sell off that will provide the evidence as to whether the bear in equities has ended or not.*

MARKETS ARE SOON TO BE TESTED BY DISAPPOINTMENTS.

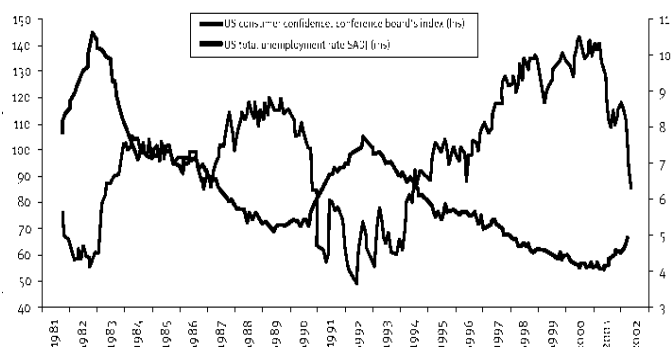
As discussed above it is the reaction to news and the subsequent price action that best indicates the health of any market. At present we have only witnessed an upward recovery trend since 21/9 and although this may continue for a little while yet the next setback will be of great technical significance. We do not believe that equities are out of the woods yet despite the current “blue sky” story emanating from Wall St brokerage houses. They are keen to remind everyone that equity valuations are attractive against bonds, financial markets are awash with liquidity, and there will be an inevitable recovery in corporate earnings next year as demand picks up. Using this years’ depressed earnings for comparison, next years’ year on year earnings growth figures may be very attractive leading to a sustained market rally! Indeed the Oct/Nov gains were not based on fundamentals (which remain bad) but on optimism of an inevitable economic and stock market recovery, fuelled by loose fiscal and monetary policy. However, a sober assessment of this “blue sky” scenario may point to the significant bond market gains of recent years heralding an ice age of low inflation and low growth. The record spread between low-grade corporate bond yields over Treasuries may convey a more accurate assessment of the problems facing companies than the stock market does. Thus the only attractive equity indicator (bond vs. equity ratio) is perhaps providing a false reading if inflation is dead.

DEFLATION

Despite tax cuts, rate cuts, huge fiscal stimulus and plunging oil prices there are still potential dangers for the world economy, with deflation top of the list. If the “blue sky” and currently majority view is to hold sway then the US must not slide into a deflationary environment as this would kill the all important US consumer (see below). Consumer sentiment at present is naturally poor due to rising unemployment, the tech wreck and a residual shock after Sept 11. Added to this mix are collapsing corporate earnings, deflation in Japan, global recession and the possibility of a major international debt default.

We have all witnessed the devastating effect a persistent and chronic deflationary environment can have on an economy as Japan has laboured under

US consumer confidence and the labour market



Source: Zinnov

this yoke for a decade or more. Once prices begin to fall, especially asset prices (property, art, stocks etc.), then whole economies become mired by a spending strike (why buy now when prices will be lower next year), low profits (lack of producer pricing power) and a chronic debt problem. The most dangerous aspect is caused by asset deflation. Most assets in the US are heavily indebted (corporate and personal debt is running at record levels as discussed in previous issues) and if values were to fall as has happened in Japan then many of these borrowings would inevitably default, as negative equity became a problem.

The threat of a potentially dangerous deflationary spiral is very real as all the world’s major economic zones slide into recession. This is a potentially volatile situation with no copper bottomed guarantee that an economic recovery will arrive with enough vigour to re-create the robust growth of the nineties.

We suspect that whatever recovery is experienced in the US next year, will prove to be anaemic and lead to slow growth, pockets of deflation, corporate collapses and subdued stock market growth. We cannot foresee markets experiencing double digit compound growth over the next few years as we saw in the 80’s and 90’s. The combination of low inflation and low interest rates will be reflected in single digit stock advances.

THE EURO.... “SHOULD I STAY OR SHOULD I GO”

The Clash’s famous punk ditty seems to sum up Blair and Browns funk over the Euro. Famously

President Tony would like to follow in the footsteps of other “great leaders” and leave his mark in history by leading Europe, sorry Britain into the Euro. As all other European leaders know the Euro is a Trojan horse that is designed to create a single unified European state. Many may well agree with this goal (as did Attila, Charlemagne, the Habsburgs, Louis xiv, Boney, Kaiser Bill, Hitler, uncle Joe Stalin and worst of all Ted Heath) but an honest open discussion of the implications would be welcome.

The Euro goes live in January and undoubtedly after a few teething problems, will work successfully as a medium of exchange. When we travel to Europe we will all marvel how easy it is to cross borders and trade and travel in the new Euroland. It will be great boon on foreign holidays no doubt about it. Both of these convenience factors will be heavily utilised to persuade GB to join. After all isn't a currency simply a medium of exchange! And hey, for all those little Englanders we will put the Queens head on all British “regional” Euro notes and coins. So that is fine and dandy.

However the debate is surely much more subtle and complicated. As dedicated free traders we can see the many great advantages of a single currency across Europe, but believe the total collapse in UK sovereignty is **not** a price worth paying.

The first bone of contention will be the discussion of entry level. Obviously, if you are going to join a fixed exchange rate mechanism (the ERM, Bretton Woods and the Gold Standard—nothing new under the sun here!), the level of conversion is vital to all (not just export industries and multinational companies). Firstly, the UK could try and enter at current exchange rates. This would fossilise the “uncompetitive” pound and cripple industry so we are told. We will all be told repeatedly how the high pound is costing jobs by various “captains of industry” in the FT and on the BBC. This will part of a bullying tactic to soften up the British public into agreeing to entry. However the pound is not strong against the Dollar, the Yen or the Swiss Franc. It is actually the Euro that is very weak due to sclerotic economic policies, slow growth and the dis-united ECB who may have the French crook Trichet as the next chairman.

The exchange rate is really the only economic test Blair will use. He will not enter currently as big business friends and Union bosses would not wear an uncompetitive exchange rate. They desire a low wage currency subsidised economy where old economy manufacturing industry would be protected. This is despite the relative success of UK plc. over the past decade. The deregulation of the labour markets (although this is slowly being rolled back by the slow march of Socialism) has allowed the UK to outperform economically virtually all our European rivals despite the so-called handicap of a high pound.

However at conversion a high pound would be very favourable to all those Britons with some degree of savings and saleable assets (houses?), as they will simply end up with more Euros' and as such be richer in European terms! Therefore to enter the Euro at a lower rate would in effect be an act of larceny and betrayal on these investors.

Pensions are another key area at risk should the UK join. We have got the more money put aside to pay pensions than the rest of Europe put together! Most EU member states have public pensions that are not sustainable in the long term and which their Governments are not able to change. When Germany tries to make the finest of adjustments, people are out on the streets. That means that at some stage pensions either won't be paid or money will have to be borrowed. The borrowing will have to be substantial and will blow the Maastricht restrictions apart.

The borrowing will result in a significant rise in interest rates and if we are in the single currency we will have to suffer these high rates and mortgages.

It means that British people will have paid for their pensions twice, once via their contributions and secondly bailing out EU countries that have made no adequate provision for their profligate and overblown pension benefits.

However this will not stop the Govt from trying to talk the pound down to facilitate entry. So you pay's your money and makes your choice!

The effect of a truly single European market would be dramatic. A single currency will soon highlight all kinds of pricing anomalies from one state to another. These would soon be eradicated on all tradable goods. This is attractive in its own right

but it does disguise a potential radical undermining of individual state indirect tax policy. This would undoubtedly lead to the EU setting “fair and level” tax rates. Now don’t get us wrong, we have no love of taxes, especially unfair taxation, but we do believe that democratic countries should have the right and ability to tax as it sees fit and many argue a tax on spending is more equitable than income tax! We believe all Govt’s have the right to choose.

But it will not stop there, because pricing is also a function of the costs of labour and capital. Therefore if one individual state has lower corporation tax levels, NI rates and perhaps generous location grants etc. then that state would be decreed to be enjoying an unfair advantage. This advantage would have to go in the interests of fairness. ***Thus both indirect taxation and corporate taxation policy would have to be centrally controlled by the EU.***

So ignoring all the old arguments over handing over gold reserves, pension funds, setting interest rates etc. we can see that a single currency will inevitably lead to a de-facto single European state. The ability to set tax and fiscal policy, welfare policy, pension policy, and ultimately foreign policy will be gone forever. This would render Westminster an irrelevance and allow the ultimate regionalisation of England. Now Tony may well support this new world order we just wish he would be open and honest about it.

As currency traders we would mourn the loss of the pound to bet on, but in the meantime the Dollar might be a safe haven for UK savers as the pound is driven down to allow entry to the Euro.

Taxation is back on the agenda again. We are now to be told by our leaders that more tax is good for us (we’re sorry but hasn’t the tax take risen to 40% of GDP from 37% since ’97!). The old “tax and spend” policies of Labour are back with a vengeance. We are greatly comforted to know that our wonderful politicians are able to spend our money much more wisely and less wastefully than we possibly could.

INTEREST RATES AND BONDS

- **Some further rate cuts are likely, especially in Europe.**
- **Deflationary pressures are favorable for long-dated government debt but much of this has been discounted and bond prices often move inversely to stocks.**

Waning inflation leaves central banks room for further rate cuts. Lower prices for petroleum products and the global economic slowdown have ended the late-1999 to early-2001 inflationary blip. This is good news for central banks, which should err on the side of leniency in establishing monetary policy over the next few months, because economic risks remain on the downside. We maintain that the European Central Bank and the Bank of England’s Monetary Policy Committee are still behind the curve of events. Consequently they have the most scope and likely cause for making additional cuts. The US is near the bottom of its rate-cutting cycle but it would probably require a blistering stock market fall from current levels to make Greenspan shave another 25 to 50 basis points off the Federal Funds Rate, which he has already reduced this year from 6.5% to 2% in ten steps. He will be concerned about the economic effects of rising unemployment and blows to consumer and business confidence due to terrorist attacksrecent and feared.

Long dated bond yields could move lower but it is now late in the cycle. UK gilts briefly breached the March highs (yield lows) in November but have since corrected back within the gentle upward sloping channel. This implies that the market believes that currently long term interest rates are near their lows. The long-term channel is so well defined that if there were to be any break out of the boundaries, then a significant move should occur. Indeed, any upward break would probably signal depression and deflation, whilst a downward move suggests a recovery along with a degree of inflation. As yet there is no discernable clue as to which is the more likely scenario, although in the short-term gilts are slightly oversold.

UK GILT 6q% 2010



GLOBAL EQUITY MARKETS

- **High price/earnings ratio's matter less in a well established bear market**
- **Markets are overbought and due to correct.**
- **Is the bear over?**

Earnings warnings by companies are becoming old hat. In the waning days of the last bull market, investors had become so accustomed to announcements of corporate profits above consensus expectations, that anything less was a disappointment. Many knew the figures were massaged by creative accounting and stock buybacks but it didn't matter because the US economy would boom forever, or so people hoped, boosting GDP growth everywhere else. Even as petroleum prices surged and the Federal Reserve moved to curb an overheating US economy, we were told that tech was interest rate and recession proof, not that a serious slowdown was seen as remotely possible by believers in the new paradigm. When profit downgrades commenced, the offending stocks were punished by juries of investors as seldom before. These corporate offences were doubly heinous because every other company was doing so well, or so it seemed. Today, bad news is the norm. It still has an effect but we see far fewer of the downdraughts, which were so frequent last year. Since bad news has become the norm, it is at least partially discounted by the bear market. Investors accept that earnings will generally be

worse following the atrocities on 11th September. Moreover, this is a convenient excuse for companies to write off everything but the kitchen sink in Q3 and Q4 2001. Stock markets will probably take this in stride, provided there are no further horrendous attacks by terrorists. This hypothesis alarms some fundamental analysts, especially as the price/earnings ratio for the Standard & Poors 500 Index has never been higher.

Write offs in Q3 and Q4 2001 should mean higher earnings for the same period in 2002, even if the recession has not ended. Few corporate treasurers will squander an opportunity to redress any previous accounting excesses in an economic downturn, especially now that they can blame bad news on terrorist attacks. Consequently, earnings for the remainder of this year are likely to be so bad that a rebound is assured in Q3 and Q4 2002, regardless of whether or not the world is in recession. Furthermore, the inevitable layoffs still to come will lower overheads and increase productivity, as will lower interest rates. Stock markets have already begun to discount the improved outlook for earnings during the second half of 2002 (YoY). However, assuming this script is correct, higher earnings next year could prove difficult to sustain in an environment of moderate global growth.

Markets such as the Ftse are looking tired at present and ready for a set back. Even if (and we mean if) we are in a new bull, then advances will never be linear. Thus at present when reviewing markets it becomes apparent that the recent rallies have carried too far too fast and are susceptible to profit taking. The nature of any such falls will help define the nature of the 21/9 low and provide the necessary base building needed to support higher prices in the medium term.

GLOBAL MARKET REVIEW (is the bear over?).

This month we intend to use this section to examine the technical picture of each market. In order to determine whether we can tell if markets have ended their bears' or not and to identify the technical criteria required to confirm this.

The Dow Jones has perhaps been the most resilient index globally. It has only fallen by 30% to the low and has recovered half this loss already. When we look at the long-term chart below two key **DOW JONES (last 8 yrs)**



features are immediately visible. Firstly, the dominant bull trend stretching back to '95, which was significantly broken earlier this year. As many are aware this is technically very weak action and perhaps we have not witnessed the level of fall such a key break would normally warrant. However support was found at a logical point at the 97/98 consolidation levels.

Secondly, the multi month consolidation visible between 10,000 and 12,000 levels. This trading belt will probably provide considerable resistance to any market advances. A new bull for the Dow really could not be declared until this resistance band is cleared. Despite all this the rebound from the 21/9 low is powerful and looks likely to hold unless there is a calamitous collapse in the global economy.

S&P 500 short term



The S&P is similar to the Dow in that the low looks to be of a climactic nature with support again found at the '98 low. This is a very powerful support level and is unlikely to be broken at least in the medium term (3 to 6 months). However, the S&P is still trading below the primary bear trend and a break of this trend is important psychologically for traders to feel confident enough to trade aggressively. In the very short term the index is hitting the underside of this trend and is overbought (ROC above 75) and looks likely to retrace perhaps a third of the recent advance.

This index is still technically in bear mode until the major trend is broken. *A break of this trend line will provide a superb trading opportunity, as we will be able to harness a strong technical advance with a logical and tight stop loss.*

NASDAQ

The technology market bubble in many ways led the bear market so may well lead the bull. This index is still below the primary bear trend despite a rally of 30%. A sustained move above 2000 is required for the technical picture to confirm a final low on 21/9. The index is overbought and hitting overhead resistance at present and is likely to retrace perhaps a third of recent advances. However any new bull market will struggle to reach previous highs and this index may well have a series of mini bull and bear markets over the next few years as the overblown sector sorts out its overcapacity problems.

NASDAQ



The UK's FTse looks very similar to that of the S&P. The index has rallied back to considerable overhead supply and the primary bear trend. A pullback towards 5000 looks likely but the technical

picture would only deteriorate below 4900. The index has however got considerable resistance to overcome at around 5400 and 6000 together with the oppressive downtrend. We suspect that the Ftse "bull" will be contained by volatile range trading between 5000 and 6000. The 6000 "concrete cap" looks formidable and makes the index look like a traders market. The lows of 21/9 look solid and climactic with only economic depression and deflation in 2002 capable of causing new lows.

Ftse 100



The declines witnessed on the two main European markets have been dramatic. The Dax has fallen from 8000 down to below 4000 during the past 18 months. For most of this period of decline the falls were very consistent and orderly. As the events of September unfolded this orderly decline turned into a rout and demonstrated a trend ending acceleration. We suspect the lows will hold but the March lows and the dominant downtrend will slow the further recovery of this market.

XETRA DAX



Japan has as ever followed it's own agenda and set new post 1990 lows. Japan is a warning as to

what may occur if deflation is allowed to grip markets. The index has followed the global markets down setting yet another 16 year low. The October/November recovery has been muted and a slide back below 10,000 could signal even further falls. The Nikkei probably cannot stage a cohesive recovery until the Yen is allowed to fall and monetary policy becomes truly stimulative. All that said the index is massively oversold and unloved and as such capable of staging a "surprise" surge back toward resistance from 12800 upwards.

NIKKEI



CONCLUSION ON STOCK MARKETS.

We suspect that market lows are in unless recession turns into deflationary depression. Markets are only likely to make ranging recoveries capped by overhead supply, low rates of inflation and low growth leading to a series of mini "bull" and "Bear" markets.

CURRENCIES.

- The trading consolidations against the Yen are ready to explode.....be prepared for windfall profits
- Euro will enjoy relative strength as January approaches.

The trouble with base extensions is that they can take a long time to complete. While no one is bullish of the Yen, because it yields nothing and the Japanese economic crisis is worsening, not many people are short because the currency remains range bound. There are two main reasons for this - capital repatriation by Japanese companies to shore up their balance sheets and an insufficient supply of

yen in circulation, judging from money supply growth of only 3.6 percent (M2+CD) Japanese firms are liquidating overseas assets, from property to bonds, because they need the money. Meanwhile, Bank of Japan Governor Masaru Hayami is operating a disastrous monetary policy, despite zero short-term interest rates, for an economy experiencing a deflationary spiral. The same thing happened in the US, only worse, following Wall Street's crash in 1929. America's economy did not break out of its deflation and start to recover until the dollar was devalued against gold in 1934. Today there is no gold standard and the yen is a freely floating currency, but it too will have to be devalued before Japan can sustain an economic recovery. This will eventually occur regardless of what the BoJ does, because on Japan's present course bankruptcies will eventually trigger a capital flight. However the sensible policy would be for the central bank to announce an inflation target and print money until it is achieved. Hayami has said that he will not do this and his term does not expire until 20th March 2003. Judging from the charts, the yen will resume its decline against reserve currencies well before then and possibly within the next several weeks, perhaps coinciding with an improvement in the euro's relative performance. Currently, the Swiss franc, and US dollar are trading close to their 2001 highs against the yen. The euro and sterling are likely to follow their lead. Confirming breakouts will indicate commencement of a major advance against the Japanese currency. *So be ready to fill your boots on the first sign of a break out.*

The euro is friendless at the moment, aside from Tony Blair, but the next significant move will be upwards. Traders haven't liked the chart because the single currency has drifted lower. Economists don't know when there will be an economic uptrend for Euroland because Germany is leading the region into recession. No one has any confidence in the European Central Bank, which has been consistently wrong on forecasts, slow to cut interest rates and arrogant in its pronouncements. Meanwhile, the main reason for the single currency's recent weakness is the one-off cashing in of Europe's national currency notes prior to the release of euro paper on 1st January. Many billions

in paper money from criminal activity, the black economy, East European hoardings and tourist cash continues to be converted mainly into US dollars, plus some Swiss francs and a little sterling. These people do not want to deposit their notes in bank accounts and they cannot yet acquire euro paper. However, this cash flow reverses from euro-negative to euro-positive in the New Year. No one knows how heavy the flow will be because there are few precedents and none on a remotely similar scale, but it should contribute to a steadier euro in the first half of 2002. Charts support this hypothesis, showing developing bases for the euro.

STERLING/YEN



The above chart highlights perfectly the "set up" visible on all the Yen charts.

*The key levels to watch are 178/180 vs Sterling
125/126 vs US dollar
113/114 vs Euro*

STERLING/EURO

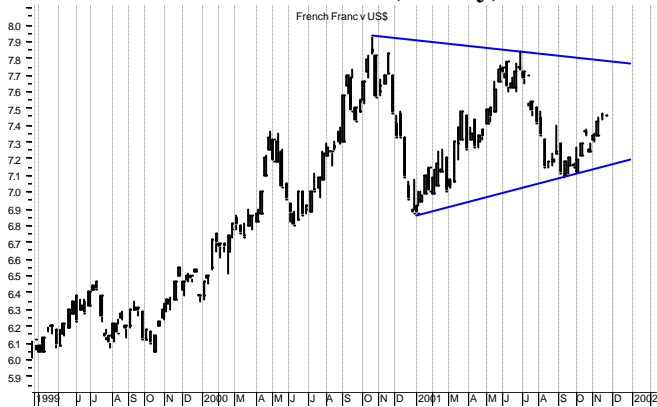


The Euro is trading within a tightening wedge and traders could probably make reasonable profits on trading a break out in either direction with a tight stop placed behind the break out point. *The next*

move could prove to be quite explosive as the triangular pattern has formed over the past two years

The Euro Dollar pattern is similar to the above but not so tightly formed. As a consequence we would not position trade Dollar /Euro (French Franc chart shown below as Euro proxy) because it would be hard to select an appropriate stop loss level.

FRENCH FRANC/DOLLAR (weekly)



The Sterling Dollar chart below shows the pound falling back towards the summer lows. Some support should be found here and indeed a strong “doji” reversal was witnessed on 23/11. This will probably support a rally back towards 1.45. The pound however looks set to continue its slow but overall downtrend that has been in place since late '98.

The overall chart pattern has been characterised by lower rally highs and new lows. Thus any pound strength that may be seen in the next few weeks is likely to be short-lived until and unless this downward sequence is broken by a rally beyond the 1.50 level.

STERLING/DOLLAR (short term)



STERLING/DOLLAR (long term)



COMMODITIES

- OPEC oil price control has collapsed
- Base metals rally on short covering and production cuts
- Cotton rallies as predicted last month
- Silver falls to new lows.

OPEC has lost all pretence of control of the oil price. Certainly all cartels always fall apart but this one faced the added pressure of 60% of global production being outside the cartel. With Russia now becoming the most influential swing producer not playing ball as far as production cuts are concerned the price is set to remain weak, as the bull in oil is dead.

CRUDE OIL (nynex)



Prices have moved quickly but with the background of a global economic slowdown they are unlikely to

bounce even if we have a severe winter. We believe that oil will trade in the \$15 to \$20 band, at least until traders have cause to fear supply disruptions from the politically unstable Middle East.

The significance of oil under \$20 a barrel cannot be overemphasised, because no other factor contributed more to the global economic slowdown than OPEC supply cuts. Thus lower oil prices are a powerful underpin to global GDP and should prevent a further slowdown.

The industrial metals have all rallied from historic lows as predicted last month. Many metal producers have followed Phelps Dodge's announcement that it was cutting copper production and cut their own metal output. This action is a matter of necessity, as companies cannot go on producing metal at a loss. Many futures prices have spiked upwards as a result breaking their downtrends (as predicted last month). These initial rallies will probably not hold for long, as industrial demand is low. However base metals do appear to have commenced the bottoming out process, prior to a further recovery as the global economy improves.

TIN (weekly)



ZINC (weekly)



NICKEL (weekly)



Last month we highlighted the price action occurring in the cotton market. We felt that the dramatically oversold conditions present might well provide the springboard for a rally of some magnitude. The chart below illustrates the dramatic nature of the rally witnessed in this market during the last month. The latest break out from a two-week consolidation seems to suggest that prices could push up yet further. The commodity now offers a second chance to climb aboard what may be a volatile but profitable move with long positions protected by a stop at just below \$33 a bale.

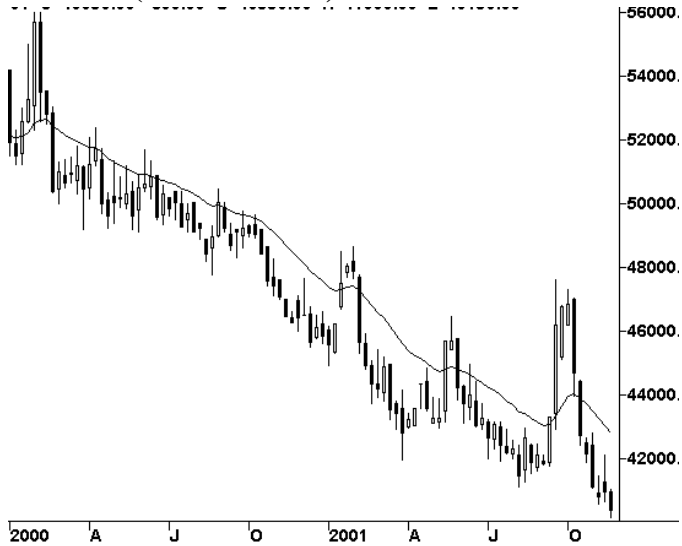
COTTON



SILVER has fallen to new lows in the past couple of weeks and is challenging the key \$400.00. The move is becoming quite volatile at present with the "round phobia" level of \$400 acting as support. However, we maintain that the fundamentals for silver are so poor with digital cameras destroying industrial demand for silver,

that an eventual decline well beyond \$400 will occur. We first highlighted this position in June with silver trading at \$423 so stops should now move to this level now.

SILVER (comex 5000oz)



FINALLY

Many thanks for all your comments regarding the new web site and format please keep them coming. Much comment has been made about the break out portfolio which is now standing at 1.265 (up 26.5% since Oct 3rd 2000) and we would like to reiterate that the key to its and all our other trading successes is tight stop loss strategy and money control at all times. If traders follow these simple rules they will make money in all markets.

REGARDS

A McARTHUR

A BARTLES