The Barmac *Journal*
The art of Finance Bartles & McCarthy

Issue No.15

December 19th, 2001

Monthly Newsletter

Annual Issue Price £250

info@barmacjournal.co.uk

THE YEN'S BREAKOUT HAS BEEN DRAMATIC SO FAR, BUT THERE IS STILL PLENTY MORE TO COME!

1.GLOBAL ECONOMY
The YEN has commenced the2nd phase of its devaluation
Deflation threat is receding BUT vigilance is necessary
Equities are not cheap

4. INTEREST RATES AND BONDS
Rates could go even lower in Europe
Bonds are starting to discount recovery and may be topping out

5.EQUITIES
Markets are due to retrace some of recent rallies
Deflation to stalk certain sectors and countries
All downtrends are still in place
Equities may stay locked in trading ranges for years

7.CURRENCIES;
YEN has broken out and a dramatic devaluation may follow
The pound is trading sideways against both Dollar and Euro
Euro should rally as "black economy" transactions end
9.COMMODITIES
OIL –consolidates at lows
METALS production cuts stem price falls
SOFTS Cotton trade ready to move further
SILVER hits $430 but overall trend still down.

Well what a fantastic month for all who have been following our "nap" trade for 2001 and have been consequently trading the Yen. In the last 3 weeks the Yen has fallen to 186 from 175 vs. the pound. As all readers will know we have been very bearish of the Yen since our first issue in October 2000. At that point it stood at 155 to the pound compared with 186 today! THAT IS A MOVE OF OVER 3000 BASIS POINTS.

Last month we stated that the yen was "*coming towards the end of its current trading range and a break-out is imminent*"(also chart of the week 9/12/01). Well we have had our "break-out" now against pound, dollar and Euro and although the recent ballistic move has been dramatic we believe that the move will continue for some time to come.

If we re-examine the reasons behind the Yens collapse it becomes obvious that the Yen has much further to fall! Japan has seen a decade of economic disaster following the bursting of a huge speculative bubble in 1989/90. The disastrous macho "strong yen policies" pursued by the BoJ has recently seen the economy mired in the third recession in ten years despite near zero interest rates. The average Japanese consumer has been on a buying strike (with private safes outselling refrigerators) deflation is endemic and the property market having experienced falls of up to 80% since 1990.

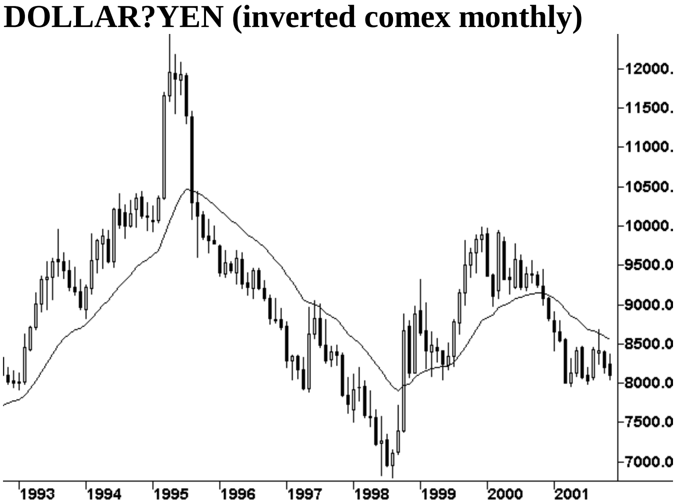
With Japan's sovereign debt recently downgraded to the level enjoyed by most third world countries due to its huge ballooning levels there is no scope for reflation via further Govt borrowing.

Thus in our view Yen devaluation has long been the only option to kick start the economy.

Over the last 3 months Japan has started to actively seek a controlled devaluation with the blessing of the US treasury. This blessing is vital as the US has a long history of being sensitive to an over-competitive Japan. The US now however fears a depression in Japan and all its international ramifications more than it does cheap Japanese imports. Thus the US has been encouraging the BoJ to target exchange rates and to print money to get the economy moving. Additionally, Forex intervention by the BoJ has recently remained unsterilised (ie it is allowed to increase money supply) and although money supply growth remains painfully inadequate, if “the house” (both Central banks that is) is publicly seeking a lower Yen then who are we not to follow their lead and short the Yen all the way down!

If the Yen falls far enough over the next few years it will potentially revitalise the Japanese economy. The lower Yen will stimulate Japans great export industries. This in turn will stimulate some moderate inflation and as such may tempt Japanese consumers to start spending instead of saving. Another potential benefit would be the effect on the Govts debts as their “real” value is eroded by inflation and as such consequently easier to repay and manage (at the cost of higher future interest rates). As devaluation is Japan’s only option it will surely happen and the only questions left are when and by how much? It looks that when appears to be happening now but remember that it will not be a straight line decline as recoveries and contra-trend rallies are bound to test the resolve of most traders.

DOLLAR?YEN (inverted comex monthly)



However, we believe the chart above highlights that the Yen has only being consolidating last Dec/Jan’s 1st leg advance for the last 11 months and that the new 2nd leg break-out is a prelude to a test of the ’98 highs of **Y68** (147 $/Y).

This prognosis is supported by consolidation theory, which indicates that if a market consolidates at an extreme (at the high or low) then the market will normally continue the move on break out. The above chart now supports this with the latest price being Y78. Also our theory gives us a target of approx Y68 with the recent consolidation being a half way staging post. We suspect however that the Yen will not stop ultimately at the ‘98 lows and may well move much further after overcoming resistance at those levels. However speculating on what may happen then is currently academic as at present our main thoughts have to be concentrated on running a truly significant and profitable trend towards the target area.

PE ratios for the Nasdaq, Dow, S&P and Ftse have actually risen since the so-called “bubble” valuations of late ’99. This has occurred because despite falls in share prices, earnings have collapsed even more quickly. Thus markets are theoretically extremely expensive. Many will argue that earnings are overly depressed and that a sharp rebound in earnings will restore some normality. That may well be the case in part but markets are <u>not cheap now!</u> Maybe markets have already discounted an earnings rebound for 2002 in part or full (the old buy the rumour adage) but if recovery disappoints valuations could prove to be vulnerable. Additionally, if recovery does prove to be reasonably strong (sell the fact the second couplet of our adage). Whither interest rates? Whither inflation? Greenspan may have aborted his fight against inflation for now but strong recovery would surely prompt much higher rates.

Thus we are sure that equities will struggle to make any substantial progress for some time with no chance of a strong sustained multi-year bull for three basic reasons;

1. Historically high PE ratio’s
2. Recovery already discounted and may disappoint
3. If a strong recovery occurs this will prompt the marching of interest rates back up the hill-hardly a conducive background to attractive equity returns

Is it any wonder that master financier George Soros has reportedly taken all of his money out of stocks!

Deflation is main threat to economic recovery.

Japan has suffered from the effects of deflation for a decade now as the over leveraged speculative 1980's equity and property bubble has unwound. The crash in stock and property prices in Japan has crippled the economy with banks technically insolvent due to the billions of Yen in debts, that can never be repaid. This deflation has spread to nearly every aspect of Japanese life with mundane articles such as hamburgers and clothing falling 20% or more over the last year.

Deflation is not confined to Japan alone with many of the Asian "tigers" also suffering. Malaysia, Singapore and Taiwan have all seen exports plunge by as much as one third and as a result prices are being slashed, production cut and GDP plummeting by as much as 10%.

In Latin America the picture is equally perilous with traditionally triple digit inflationary Brazil seeing a dramatic shift that is characterised by falling property prices and dramatic discounting (new VW passat only £5000!). Argentina is the true basket case. In a move that sent shock waves throughout the world, the government of Argentina has called a national moratorium on all cash withdrawals from banks above $250 per week. The government's drastic steps temporarily stopped a panic run on the banks. But it doomed the economy - already in its fourth year of depression into an even steeper plunge.

Now, Argentina has two and only two options: Devalue the currency, collapse the national banking structure, and bring on political chaos. Or, abandon the Argentine peso, switch to the dollar, drive the economy into an even deeper depression, and bring on still more political chaos. Either way, the impact on the US and other world markets is unquantifiable.

So a deflationary environment is pressing globally with Europe and the US potentially vulnerable to these pressures. Exports to and from these countries are getting flattened and if the US does not recover quickly as the "consumer of last resort" the global trading system could collapse in debt deflation (falling prices erode pricing power and erode asset values creating crippling negative equity). At present the Fed has cut rates drastically, whilst pumping billions of dollars of liquidity into the economy. "*The odds are in favour that this massive inflation will offset a deflationary spiral*" but this outcome is by no means guaranteed.

We need to be aware of the symptoms of deflation and be wary of isolated sectors spreading their infection to other areas of the western economy.

The pernicious touch of deflation is quiet and subtle but it is far more destructive than the scourge of the 70's and 80's –inflation. Do not believe the baloney that will be peddled about cost cutting as deflation is like cancer and is very aggressive. For every pound of cost reduction, the typical business suffers £2, £3, or £4 in profit losses due to deflation.

Example: Last year, a company that makes computer servers sold an average of 1,000 units per month for £4,000 each. Total monthly sales: £4 million.

But this year, due to the recession, it's selling only 700 units per month, a 30% drop from last year's rate.

That's bad enough. Now, adding insult to injury, the company is also battered by a 50% decline in the price of each unit to £2,000 each.

Result: Revenues get slaughtered -- from £4 million to a meagre £1.4 million. Admittedly, the cost of components has declined. But marketing and overhead costs will have barely changed:

Last year, when they were selling the servers for £4,000, the company's total expenses per unit were £3,500 -- a profit of £500 each. Now, although they're selling them for £2,000, the per-unit expenses are still running at about £3,000 -- a £1,000 loss on each sale. The more business they do, the more they lose. This is typical of what's going on in the tech industry today. Indeed, this kind of deflation-driven profit squeeze is one of the key reasons why:

- We've just seen the worst collapse in corporate profits since the Great Depression. Every penny of the *total* profits earned by the 4,000-plus Nasdaq companies since mid-1994 has been wiped out.

- Just one company, JDS Uniphase, has recorded the largest single loss in the history of civilization.

- In the Nasdaq alone, investors lost over $5 trillion in wealth in just 11 months, long before the September 11 attacks.

- Enron, the seventh largest US company in revenues, has gone belly-up. Its stock has collapsed from $90 to a low of 25 cents -- wiping out more than $65 billion in invested capital, almost every single penny invested by 58,920 investors.

As you can see, deflation has been the nightmare of the tech industry for nearly two years. Now, is it on the way to becoming a nightmare for other industries as well? The same exact deflation-driven profit squeeze you saw at the computer server company could repeat itself for autos, appliances, housing, and even services.

In the world commodity markets, prices are also collapsing. Crude oil plunged 24% in a mere 10 days in October. Since the beginning of this year, copper is down over 12%; zinc, down 28%; and nickel down 14%. Natural gas hit $11 per million BTUs back in December of last year. Now it lingers a hair above $2.

Until recently, this kind of deflation had been mostly overseas or limited to certain sectors. Now, it's lapping at our shores and beginning to spread rapidly.

Deflation Will Sink The Value Of Collectibles

The brightest rising stars in times of inflation -- art, antiques, rare coins, and collectibles of all kinds -- are the most wretched dogs in times of deflation. After the crash of '87, art and antiques at major auctions fell as much as 30%, even 50%. The plunge didn't last very long. But it illustrated how susceptible those items are to deflation. As deflation takes hold, this is bound to happen again, knocking down prices with little regard for the factors that normally prop up values -- rarity, beauty, and intrinsic values

Already, at Sotheby's, auction revenues for the first nine months of 2001 have fallen 12% from last year -- a telltale warning sign of actual price declines in antiques, paintings, jewellery, and decorative arts, which are their specialty. Right now, the big buyers of the highest priced items -- including the wealthy in America, Japan, Hong Kong, and the Middle East -- are just beginning to feel the impact of a falling global economy. When deflation strikes their businesses and other assets, watch out! Bidding for collectibles will dry up, and a torrent of items will come out of the woodwork for auction. If you have a nice chunk of money tied up in these illiquid items, don't wait for the barrage of selling. Put them up for auction now, price them aggressively, and get your cash out as soon as humanly possible. Then, sit back and watch prices collapse. With the right amount of patience, you'll be able to buy back some of the most desirable pieces the world has to offer -- for a small fraction of their current value.

In conclusion, we reiterate our view that the dramatic rate cuts and huge fiscal stimulus by the Fed this year will probably head a deflationary spiral off at the pass. BUT it will be a close run thing with pockets of deflation throughout various sectors of the western economies. However, we must remain ever watchful as a debt led credit crunch could still emerge and tip the global economy into a wicked deflation.

Even if we are right the background for equities is hardly joyous as interest rates will surely start rising

Perhaps the key market to watch for signs of a deflationary tailspin is property (commercial and residential). If prices begin to fall the vast percentage of personal and commercial credit secured on property could default and cripple the banking system prompting a credit strike.

SO PROPERTY IS TO BE OUR BELL WEATHER FOR DEFLATION.

INTEREST RATES AND BONDS

- **UK and Euro rates may edge down further**
- **The cycle for lower short term interest rates is drawing to a close**
- **US and UK bonds may well have topped out for this cycle**

US rates have now fallen to such a point that like Japan there is little gain to be had by cutting

further. A massive 475 basis points have been shed by Greenspan since January to give the US the lowest rates since Notts Forrest last won the cup (1959)! Along with huge fiscal stimulus the Fed will sit back and wait to see if this is enough to kick start the US economy and fret as to whether it may also trigger an inflationary spike. If it doesn't then the economy will certainly be in a parlous condition.
In Europe and the UK rates are still at 3.25% and 4%, respectively, and further cuts are very likely. With zero interest rates, Japan is dependant on monetary reflation to check its destructive deflation.

US and UK bonds have both suffered serious corrections in the last month that suggest that their bull markets are over. The main Govt bond markets have fallen on a combination of divergent economic fears. Markets at present are probably discounting an economic recovery in 2002 and an up tick of inflation that may well be combined with greater supply. This increased issuance would be a result of higher Govt spending in both the US and the UK together with falling tax revenues resulting from the economic slowdown.
Ironically, bonds may well perform badly even if a deflationary environment takes hold. This paradox evident in the 1930's, is due to the devastating affect deflation has on Govt finances.

US 10yr bond (weekly)

UK Treasury 5% 2009

Going forward we would only recommend holding short dated securities and corporate bonds for higher yield and capital appreciation as confidence should improve if a US led economic recovery takes hold in 2002.

GLOBAL EQUITY MARKETS

- **Overhead supply will make further gains difficult to maintain but the Sept lows should hold during a consolidation phase**
- **Long-term outlook for equities is unexciting. Equities to "muddle through"**
- **Deflation will stalk certain sectors.**

Two months following 21st September, most stock market indices have registered bull market advances, defined by some as a minimum 20 percent recovery from a low, which the DJIA achieved on 19th November. However most indices have seen much larger gains, partly because they fell considerably further from their 2000 peaks than the Dow. Many have now rallied over 30 percent, led by the German DAX at 47 percent. Perhaps we should be asking if the bull market is nearly over? The short answer is no, although we suspect we have now seen most of the initial recovery. Panic selling followed by short covering produced a V-shaped low, giving way to a more gradual, ranging upward extension Hedge funds and futures traders probably dominated September 's V-portion of the reversal. However other institutional investors have been moving steadily back into the market since late October. Consequently cash reserves will have been reduced and most leading shares have rallied back into overhead resistance. Confidence only two months following a major bear market low is ephemeral. Investors will find much to worry about: corporate profits, valuations, the extent and sustainability of economic recovery in 2002, the crises in Argentina and Japan, not to mention the next and more controversial stage of the war against terrorism following Afghanistan. In conclusion, any additional near-term gains by stock market indices should prove difficult to maintain. We expect them to spill over into corrections before long, during which at least one-third of the rallies are retraced in base extension phases. Nevertheless given all the liquidity sloshing around and the impressive technical action recently, the 21st September lows should hold, assuming we are not nuked in al-Qaeda 's dying fling. Thereafter base extensions should support somewhat higher levels in 2002 until investors start to discount the next rise in interest rates.

As for the longer term we believe that the super cycle bull market ended in 99/2000. Therefore new all time highs of consequence for indices are unlikely over the next few years or more. Instead we expect to see a series of medium term bull and bear markets within broad trading bands. These would likely coincide with monetary cycles as occurred in the late 1960's and 70's.

The worrying aspect of the above scenario is that it represents our optimistic viewpoint! The above unexciting prospect of global equities muddling through for the next few years whilst avoiding the worst of a deflationary meltdown is the most likely outcome of the current recession. But as we have warned elsewhere be on your guard for signs that even this less than rosy scenario is breaking down due to deflationary pressures.

We would certainly expect a number of countries to succumb to the ravages of deflation (Argentina, many Asian tigers and Japan of course) and maybe a number of sectors too. If this shows any signs of spreading to the UK or US then equities will get creamed with new lows on both sides of the Atlantic.

MARKET REVIEW

Dow Jones (monthly)

We show the Dow on a monthly candlestick chart to gain perspective and presently the chart suggests that further progress from current levels will be slow and difficult. Additionally, the current level (around 10000) is an area of resistance and it would be no surprise to see the Dow pause at this level.

NASDAQ (daily)

The Nasdaq has enjoyed a consistent and persistent recovery trend since Sept 21.It is now overbought and due to retrace. Overhead resistance to 2300 is likely to slow any advance in the short term. Any move below 1900 would probably signal a 50% retracement of recent gains.

Ftse 100 (daily)

The market is still below the dominant trend line and lateral resistance at 5400 and has traded sideways for the last few weeks. A move above 5400 would probably signal a rally back to 6000 region. The 6000 level would probably then prove to be insurmountable. However we suspect that ranging is likely to continue for a few more weeks.

NIKKEI (monthly bars)

The monthly bar chart clearly illustrates the dire condition of the Japanese equity market. As is clearly apparent the Nikkei has delivered nothing but heartache for all investors over the past 24 months. A break above the channel line at around 11000 is needed to indicate perhaps a fledgling rally/recovery. Conversely, a fall back below 10,000 will probably lead to a further share price slide as deflation eats this market alive.

PARIS (weekly)

Paris is typical of the main European markets in that the recovery has slowed as resistance from both the downtrend and overhead supply are encountered. A clear break of the downtrend would be a major positive for this market and extremely tradable. The same is true for the Dax and Ftse.

Strategy for equities

On the break of any of the major trendlines we would suggest buying with stops placed tightly behind the trend line break. As most markets have already completed the first stage of progress may be much slower now. These are probably traders markets now with individual stock picking being more important than being in the right market. Look for relative strength and use a rigid stop loss strategy for all trades

FOREX MARKETS.

- **The YEN *is* the only game in town**
- **Pound is trading sideways against both dollar and Euro**

Although not wishing to become repetitive we believe the only game in town at the moment is short Yen. Now that we have at long last had our desired break out we can hopefully run Yen shorts versus Dollar, Pound and Euro for some considerable time. We believe this second leg (remember last Dec/Feb when readers of this column caught the first leg from 155 to 178 a staggering 2300 basis points) will prove to be equally powerful as the first . If that proves to be the case then we should see the Yen trading at

Y200 against the pound and Y147 against the dollar.
We suggest that a core position of short Yen should be held in all three main reserve currencies and that after each retracement this can be increased. If and when the Yen position has accelerated then we suggest easing back exposure again back to your basic core position

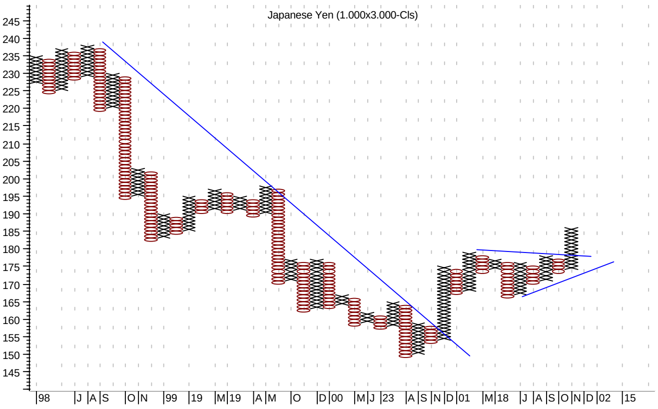
Rule #1 Short on each pull back

Rule #2 Ease and take some profits on strong moves

Rule #3 maintain at all times a core position and do not allow yourself to be shaken out!

MAKE NO MISTAKE THIS IS THE PRIMARY TRADING OPPORTUNITY OF THE YEAR SO ENSURE IT IS NOT WASTED AND THAT YOU TRADE IT BOTH AGGRESSIVELY AND SENSIBLY.

YEN Vs STERLING



The above point and figure chart captures both the clarity of the current break out perfectly and also highlights the scope for further gains over the coming months. As the chart illustrates the pound had fallen from around Y235 to Y150 over the last 3 years until the clear trendline break signalled a fundamental reversal. It is our belief that the Yen will ultimately retest the '98 levels of Y235. This would obviously be a hugely profitable trade for all sterling investors.

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, which is currently rifting towards the lower side of its pattern against the US dollar. Any further near-term weakness, should it occur, is very unlikely to exceed the $0.86 to $0.84 region and few traders will want to be short euros just prior to the new paper's availability. We expect it to at least test resistance in the $0.95 to $0.96 region next year and would not be surprised if it even moved briefly above parity at $1.00. However, aside from the important factors of price transparency and the removal of currency conversion costs among Euroland member states, there is no other certain advantage for the euro, which has yet to win the hearts and minds of the public. There are obvious disadvantages, including a single monetary policy regardless of individual country economic performance, a stability pact designed for good times only and a charter for the ECB that focuses only on prices. The US economy will recover before Euroland and this coupled with rising US interest rates in the second half of 2002 should strengthen the dollar once again.

Dollar/Euro

The pound has seen broadly sideways trading against both the Dollar and the Euro over recent months. The two charts below highlight then boundaries of the trading action and we would council a wait and see approach for the time being. If the pound was to break out of either of the two tightening wedges we would trade the break. For the time being we have no clear view which direction the break may come though suspect it could be to the downside.
So simply watch and wait and only trade a break of the trends shown on the chart.

EURO /POUND(daily)

US DOLLAR/ POUND (daily)

COMMODITIES

- **Oil steadies near lows**
- **Silver rallies but remains in bear trend**
- **Base metals flop back after rallies**
- **Some softs look very interesting**
- **Cotton more profits for our subscribers?**

Oil has steadied near the lows at around $18. Whether these lows hold or not is debatable but we suspect that any rallies will peter out at $22. New lows could signal a move down to $14 but the market looks oversold and we feel the market is likely to trade sideways to gently higher for the next few weeks.

OIL (comex daily)

Silver has suffered a contra-trend rally that has carried the price back up beyond our stop at $4200. However we feel that this rally will prove to be short lived and will look for a reversal day to time a re-entry on the short side.

SILVER (comex weekly)

Base metal prices have been an inevitable casualty of the global economic slowdown. Last month I mentioned that Phelps Dodge was lowering its production of copper. Subsequently, other metal producers have announced that they are cutting output, as we have seen on previous occasions when prices are historically depressed. This action is more a matter of necessity than the formation of a cartel. Mining and refining companies cannot go on producing if they are losing money. It would make more sense for them to buy and stockpile their own metal. Futures prices spiked upwards on the news, breaking their medium-term downtrends. Those initial rallies are not holding, because demand is low, but base metals appear to have commenced the bottoming out and base building process, prior to a further recovery as the global economy improves.

COPPER (weekly)

TIN (weekly)

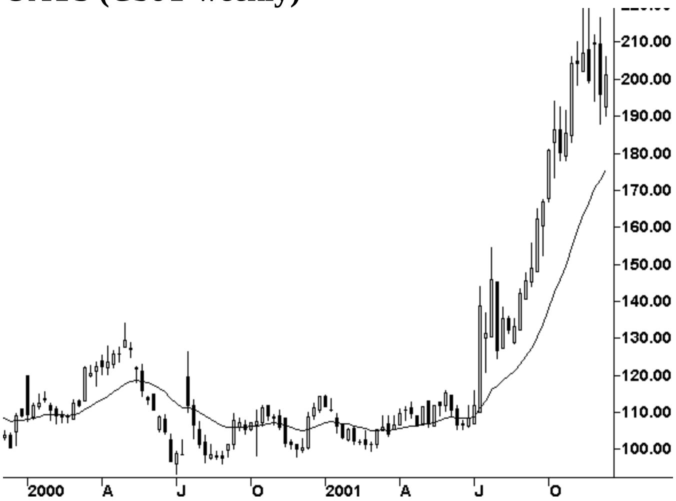
NICKEL (weekly)

Various soft commodities have been making interesting runs recently. Cocoa below has paused in its dramatic uptrend and traders should stay long with a stop placed at $12000. We have just had a weekly engulfing candle which would seem to indicate stronger prices in the next few weeks.

COCOA (weekly)

The chart for oats below has had a strong move that has met resistance at 200. This consolidation looks likely to continue for a few more weeks but traders could short on a break of 190.

OATS (CboT weekly)



We believe that the chart for Pork Bellies provides the "set up" for two potential trades. Although the chart suggests failure at current levels we would not short unless $73 is breached. Longs could be instituted on any move above $80

PORK BELLIES (DAILY)

Sugar #11 is looking positive still. We feel that the candle action suggests higher prices with confirmation on a move above $1300. A stop should be placed at $12000 where traders could square and reverse as this is a good entry for shorts.

SUGAR #11 (weekly)

Since we first suggested buying cotton in October at $28 the market has staged a strong rally. This rally has now slowed into a downward consolidation pattern that we would expect to break to the upside. We would suggest that longs can be taken as the market passes through the $38 mark with a stop at $35

COTTON (daily)

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 1.285 (up 28.5% since Oct 3rd 2000) and we would like to reiterate that the key to all our trading successes is tight stop loss strategy together with money control at all times. If traders follow these simple rules they will make money in any markets.

WE WOULD LIKE TO WISH ALL OUR READERS A TRULY PROSPEROUS NEW YEAR.

REGARDS

A McCARTHY

A BARTLES