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U.S POSTWAR RECESSIONS LAST ON AVERAGE 11 MONTHS THEREFORE RECOVERY IS DUE THIS SPRING!

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Recessions are not about counting on your fingers

Slowdown looks to be stubborn

Equities are not cheap

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YEN has completed first leg of devaluation and is now pausing for breath

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Break out portfolio up 30.7%

Economics and market timing is as simple as counting on your fingers to eleven. This startling revelation has had a dramatic effect on our view of the markets and our methodologies. Business Week (Dec 10th 2001) stated in a highly sophisticated fashion *“The downturns since W.W.II have ranged between 6 and 18 months, with an average of 11. This one is now 9 months old. The recession would be the longest in the post-war era for recovery to be delayed past the middle of 2002. That’s unlikely because the policy response during the slump has been faster and larger than average”*.

So that’s all right then, we had better get back into the market and buy, buy, buy ready for the recovery.

In fact the above market analysis has been repeated widely by both the third estate and all the major investment houses on both sides of the Atlantic and used as the reason why you should buy now while stocks are cheap!

The optimists state that with US interest rates at 40 year lows and inflation running at around 2%pa the US will quickly spend both itself and the rest of the world out of recession. Additionally, the optimists point out that money supply growth over the last year has been running at an extremely buoyant 13.5%, providing yet more powerful evidence of an impending rebound in US economic activity and company profits.

Thus, the logic of the above accommodative monetary background would lead one to assume that a dramatic and typical (in post war recession terms) rebound in growth, output, stock prices and interest rates was imminent.

Indeed, the logical conclusion of the above argument would be incontrovertible if we had just witnessed a typical post war recession. However, we have NOT.

Perhaps we should explain why we believe this current slowdown is not typical of the last 60yrs of economic history.

Since '45 every recession that has occurred followed Fed fiscal and monetary tightening in order to choke off excess demand and inflation. The effect of the tighter monetary conditions was to cool demand and choke credit creation (as it costs more). This normally leads to a classical recessionary period, which has only ended by the interest rate cycle turning 360 degrees back to monetary easing, rate cuts and a supportive monetary background. Obviously there are various lags and a number of variations in each post-war recession cycle but essentially the story has remained the same----- excess demand ----- leading to inflationary pressures-----to higher interest rates ----economic slowdown-----credit reduction--- recession -----lower interest rates ----- recovery.

Although the above is an extreme simplification of the standard recessionary cycle it does contain all the essential elements (1989 rates raised to dampen demand1980 rates raised to offset inflation ...1973 oil shock led to higher inflation and higher interest rates etc. etc. etc.).

The current recession.

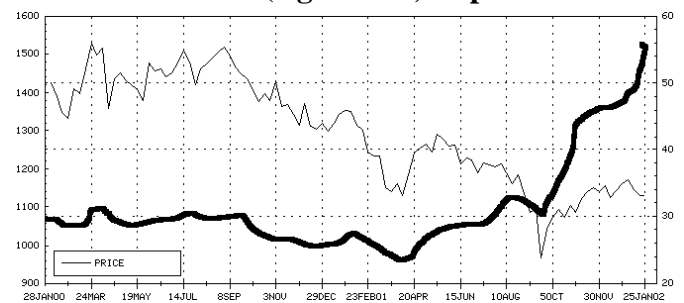
If we then examine the effects of the Fed's policy response it becomes ever more apparent that something different is occurring this time. We have quoted many times over the past 12 months the statistic that since 1918 every time the Fed commenced more than one rate cut the stock market is considerably higher within 12 months. The exceptions to this rule being rather ominously 1930 and now 2001. Obviously, this could be simply an unfortunate co-incidence but we suspect it maybe a reflection of a deeper problem in the US economy (the lack of rally in stocks is a problem in itself, as higher prices create confidence and a sense of financial well being which is normally a contributory factor to recovery).

Observing the US economies slide from growth of 5.7% in Q2 2000 to -1.3% in Q3 2001 we were

most concerned by the collapse in corporate profits. Profit margins are now the lowest since the 1930's Moreover, there is nothing in sight that might reverse this profit implosion as the profit-depressing influences remain in full force. Company CEO's have responded by a savage curtailment of investment spending. This, in turn, is progressively curbing employment, consumer incomes and consumer spending. This may appear to contradict the great hope that the battered U.S. consumer will rescue the economy by maintaining his borrowing and spending habits, funded by remaining gains in homes and stocks. That is they hope for a return of the bubble!

Profits are the key problem preventing a rapid recovery especially when one considers the record PE ratios evident on most US indicies. *The reason for this is that the profit miracle that everyone celebrated only took place in the heavily cooked books that accountants allowed companies to report in the late 90's.* In marked contrast the US Govt's national income statistics have confirmed that the profit performance was in reality a lot worse, in fact it was the worst profit growth in any post war boom period (as a percentage of national income). Thus, when the economy slowed in 2001 the poor profit performance turned into an outright collapse (all NASDAQ accumulated profits since '95 were wiped out in the losses of the last 18 months). Firms slashing their investments and private households that stopped to dissave are the major negative influences on profits.

S&P 500 PE ratio (right scale) vs price



We make no apology for publishing this table for the second month running.

In 1995 Q3 post-tax profits of non-financials were \$324 billion, in 2001 it had fallen to \$242 billion (a fall of 25% in 6 years of so called record growth). At the same time the S&P 500 had risen from 580 to over 1100. Thus the great bull has been an almost

exclusive phenomenon of re-rating and not earnings growth. Corporations are even mortgaging the future to pay dividends with \$78 billion of 2001's \$320 billion being payed out of borrowed money.

The slowdown in earnings is likely to be bashed even further as often-bogus "goodwill" is finally written off. During the boom if a company paid \$10 billion for a dot-com with \$1 billion in assets, the balance was booked as goodwill. That was supposed to represent the value of the company's customer lists, its "great ideas" etc. This has now come home to roost after Enron and companies are suddenly crawling out of the woodwork with huge write-downs that will again allow billions to leak out of the system to "money heaven". These "one time charges" are huge. In 1989, these one-time charges to earnings among the S&P500 totalled \$10 billion. That was considered huge and prompted much comment about M&A excesses in the late '80's. In 2001, these charges amounted to \$360 billion. That is THIRTY SIX times more than 1989! This is only the start as at present there is \$1000 billion of goodwill still in S&P 500 companies, much of which will have to be written off.

Already, AOL-Time Warner has warned of a whopping \$40 to \$60 billion charge against earnings due to "impaired assets." Tyco has \$30 billion of goodwill but refuses to disclose the details. There is also the mass of corporate debt which was used to buy non-existent assets. These companies are going to launch rights issues to repair balance sheets(as ICI, BT, etc.have) or simply sink like C&W, Energis, Telewest and so on, as the reality of their asset backing and corporate profitability become more apparent. Be careful some of the biggest write-offs have been a prelude to major bankruptcies.

We thus conclude that corporate earnings are not only unlikely to recover for some time but were really much weaker than reported in the 90's.

Money growth and low interest rates would normally stimulate recovery but as stated before this recession was not caused by tight money. The low interest rates have had an interesting effect over the last 18 months. High on the list of sectors that typically lead the economy out of recession is homebuilding. Being largely credit-financed, in recessions of old it has regularly plummeted when the Fed tightened the credit conditions. The same is

true of consumer durables. Once the Fed loosened the shackles from the credit machine, the two interest sensitive sectors rebounded dramatically, propelling the ensuing recovery.

It cannot and will not happen this time. In the absence of any monetary tightening, housing and vehicle sales were effectively spared their usual sharp downturn. Doing so, they have cushioned the downturn, but this has a troubling flip side: The two have little or no upside potential from their given record levels for a long time to come, even with the easiest and loosest money.

Finally the bulls have one main argument and that is 13.5% money growth. This, the only point that makes any sense and in their view the post 21/09 rally has essentially been liquidity driven. However we do witness the paradox of a bear market for stocks over the past 18 months with skyrocketing money supply growth.

We suspect that old classical economics solves this apparent anomaly. The theory that the "quality" of money is as important as the quantity of its creation. That is if the growth in money supply is not being directed to capital investment then its effect on the growth rates of the real economy will be negligible.

Schumpeter stated, "*Credit creation does not produce economically determined effects. These are contingent upon the use to which newly created credit is applied and the way they take through the economic organism.*" So we must distinguish between "good" money growth and "irrelevant" growth. The "good" is bank lending; the other is the creation of money market funds. "*During 2001, money creation via bank lending in the US virtually stopped. Total loans and leases of the banking system increased by merely \$50.5 billion, or only 1.3%*". Source The Richebacher letter Feb 2002.

In other words the vast majority of M3 money growth was directed to money market funds to enable the purchase and creation of short-term highly liquid credit papers. As this money does not circulate within the economy it has no part in the "multiplier effect" and has no visible effect on the economy. Thus we believe that the oft-cited growth in money supply will provide the fuel for a liquidity fuelled bull run to be erroneous.

Conclusion

The US economy and therefore the global economy are unlikely to experience more than an extremely modest recovery because of;

1. Massive corporate and personal debt
2. Weak profit growth
3. Overvalued markets
4. Mis-directed money supply growth
5. Corporate excess
6. Demand for homes and durables already high and no scope to lead rebound.

In a way the stock market and economic response to the aggressive interest rate cuts of 2001 were like the “dog that didn’t bark” in Sherlock Holmes. That is the lack of a positive response by markets told us that declines were not interest rate sensitive but something more deep-seated and structural. The reality of this assumption will unfold during the next 12 months where we suspect the optimists will unfortunately be disappointed by anaemic recoveries if one should occur.

INTEREST RATES AND BONDS

- **European rates could fall if recovery falters during Q3**
- **US rates probably at lows even if no recovery**
- **Gilts and US bonds trade sideways for present**

Nowhere is the uncertain nature of the potential recovery more apparent than in the major bond markets. The ECB and the UK’s Bank of England have both put rate cuts on hold as the CB’s await developments. Both authorities are hopeful that economic recovery will materialise following the rate cuts already made. Indeed both Banks are concerned that they may have gone too far and potentially stoked up future inflation. The hawks are keen to ensure this cannot happen but in the meantime the long hoped for recovery is awaited. The European Banks still however have some dry powder if the recession proves to be more protracted than originally feared and we believe that rates could be lowered on both sides of the channel if necessary. However, we do not think this will occur before April at the earliest even if the economies remain moribund.

Any increase in rates would also be left until much later in the year to ensure any economic recovery has had chance to take a strong hold. We view the possibility of UK rates rising by a max of 0.25% this year as the most likely outcome even if there is a robust recovery by the autumn (something we doubt will happen as an anaemic recovery is our favoured scenario). A very similar outcome is likely for the EU with dim Wim unlikely to move rates aggressively higher until unequivocal evidence emerges confirming robust growth.

Thus, we can all look forward to stable rates for the next 9 to 12 months with the potential to a downside surprise if recovery falters.

The Fed’s position is dictated by the lack of scope for possible rate cuts, as rates are so low already. US rates could be cut again if a new crisis occurred and Greenspan would be prepared to do so. However the law of diminishing returns suggests any further cuts would be both small and short-lived. US rates are likely to remain at current levels until the end of the year unless there is a strong recovery in which case rates may bob back up to 2.5 to 3% by year end.

UK Gilts and most other bond markets are currently trading quietly awaiting economic developments, which will ultimately decide whether a break out of the current range is likely to occur. In the meantime traders could short gilts on any break of the lower range band with a tight stop at 105.00.

UK GILT 5% 2009



GLOBAL EQUITY MARKETS

1. **Ftse, TechMARK, S&P and NASDAQ all trade below their post 21/9 highs**
2. **Dow shows relative strength but could hit resistance at 10500**

3. Dax and CAC still below bear trend
4. The Nikkei hovers near its lows
5. Many famous stocks are virtually wiped out by the bear ---beware a famous name is no protection from the falls.

Global stock markets have traded quietly for once over the past month as investors patiently await the much-heralded recovery. Currently, investors are afraid to buy and scared to sell, as they are frankly unsure of the timing and strength of any recovery. Markets reflect this indecision clearly with most national indices trading sideways just below the recent rally highs. We suspect that quiet trading will resolve itself shortly with co-ordinated breakouts in one direction or another.

Even though we have an overall bearish stance we would not be surprised to see a further up leg that carries markets beyond recent highs but tops out during the early summer.

Perhaps such a move represents the most dangerous scenario as any strong rally carrying the Ftse to say 5900 for example, (with similar rallies elsewhere) would probably create a very euphoric bull mood. The investment fraternity and the press, sucking many investors back into the market near the tops, could fan this gung-ho attitude. If as we fear this should prove to be a suckers rally falls could well be rapid and calamitous.

Traders who use charts, as their guide should be able to avoid any such pitfall by adopting carefully placed and managed stop-loss policies.

Ftse 100 index (below) is still trading sideways within a range of 5000 to 5350 established since late October. We suspect a move out of this range is imminent. Any such break out will be fast and powerful propelling the market like a sling shot 300 points or more in either direction. A move over 5250 will probably indicate the move is underway. We suspect that any rally will pause at resistance at 5600 and ultimately 6000. This move if it unfolds could be extremely profitable but a cautious trailing stop should be held behind the move.

If the index breaks down (which at present we suspect it will not) below 5000 again trailing stops should be used for profit protection on shorts.

Traders should buy any break over 5250 and short a break below 5000. Don't anticipate any move before it happens!



TechMARK 100



NASDAQ



Both the Techmark and the Nasdaq have fallen consistently since the New Year. An initial indication that these declines may be ending would be a break of the steep trend lines controlling the moves. Rallies on both markets could possibly

carry as far as 1400 and 1900 respectively (Dec lows).

S&P 500



The S&P appears to be readying itself for a rally, which would be confirmed above 1120 (stops should as ever be placed just behind the break at 1110). If such a move gets underway a move to the post 21/9 highs should be the least to expect.

DOW JONES IND.



As most readers know we don't like the Dow as an index, as its construction is so unrepresentative of actual stock movements (like the old FT30) but all commentators seem obsessed by its behaviour (give us the S&P anytime!). Anyhow, the Dow has been the strongest performing index since 21/9 lows and looks set to move on to set a post attack high (above 10500) in the next few sessions. However, overhead supply (evident above 10500) should inhibit the power of any advance. At present sellers should keep their powder dry, as the logical shorting level is a long way away at present at 9500.

The NIKKEI



The long ongoing turmoil in the Japanese economy appears to be never ending and could end in total calamity. As the chart above illustrates the index has fallen consistently since April 2000. However, the Nikkei has steadied over the last 4 months or so. Whether this is simply a pause before a further slump we cannot know **but any move over 11,000 could be traded (very carefully) with the usual trailing stop strategy.** The Japanese market is certainly overdue a strong rally as markets simply cannot and do not fall (or rise) in one uninterrupted straight line.

PARIS-CAC & GERMAN DAX



The two above markets are almost identical and have followed each other consistently over the past two years or so. On both markets a major buy signal

would occur if and when the dominant down trend were to be broken. We suspect that the two will at least challenge the post 21/9 highs.

MAJOR WIPE OUTS

Just because a company is high profile and well known does not mean that it will not ultimately endure a bear market or indeed go bust! If you look at the following list of miscreants they have all been either in the Ftse100 at one time or are extremely high profile. If you had followed our three simple rules none of these stocks would have hurt your pocket during their dramatic declines. We have not included Enron, Enrgis, K Mart etc. as that would be cheap. But we could have picked any number of stocks that have fallen 90,95 or 99% from high to low over the last two years.

The key rules to avoid wipeouts are as follows;

- 1. Always use a trailing stop loss of between 10 and 20% --- that way you limit your loss.*
- 2. Always sell on a profit warning as they are like buses --- they do not tend to come singularly!*
- 3. If companies start to announce major review of accounting procedures or write downs of "goodwill" --- sell.*

Three simple rules that should keep us all out of the desperate trouble and injury to wealth the following selection of very high profile companies could have inflicted upon us all.

MARCONI (ex Ftse down 98%)



BT (down only 85%)



PSION (ex Ftse down 95%)



MAN UTD (down 75% high profile – no protection)



BALTIMORE TECH(ex Ftse down 99%)



VODAFONE (down 70%)



SO THE LESSON OF THE ABOVE STOCKS AND MANY OTHERS LIKE THEM IS BEWARE!

CURRENCIES

- Very quiet month on all crosses
- Yen still consolidating recent falls
- Euro still in need of 10,000 volts to provide some life

When you look at the charts of the entire range of cross rates you would be forgiven for thinking we have not updated them from last month. The Forex markets have basically had a month off with all crosses continuing to trade in their already established ranges

Any movements that have occurred have done nothing to alter the overall picture outlined last month. The markets are simply pausing before the next frenzy of activity, which will be all the more dynamic as a result of the recent slumber.

The short Yen position remains our trade of choice and the current trading range has helped define the key break out points more clearly.

DOLLAR Vs YEN (inverse imm weekly)



The above illustrates how the Dollar has paused at the 132-to-135 range and that new Yen shorts should be placed on a move beyond the 135 levels.

STERLING Vs YEN



Again the yen is trapped in a tight range of approx 188 to 192 and new yen shorts should be placed on a break beyond the 192 level. At present we are maintaining light short yen positions awaiting the opportunity to load in on any break out. All position should be protected with a stop of 187 on the pound and 131 versus the dollar.

As you are aware we are also short yen versus the Euro and are awaiting a break out above 117.5 on that particular stop.

DOLLAR Vs STERLING



The long-term trend for the pound remains down but over the past 8 months the cross has traded in a tightening triangle with a floor of around 1.40 and the ceiling at 1.45. Any upside break would probably support prices of at least 1.50 whilst any downside break could see at least a 500-point move. As always when confronted by trading ranges our advice is don't jump the gun. Await developments and trade with the break with your stop placed near the original break out level. We think a good fast move is imminent on this one so keep a close eye on the ceefax spot rates to time your entry.

EURO Vs POUND



Well we are yet again confronted by yet another trading range, which is slowly edging towards a break out point. As can be seen from the above chart the cross rate has been trading tighter and tighter for eighteen months now. Our view is to sell Euro at a move over 1.65 for a 500-point move to 1.70. Conversely, any downside move of at least 500 ticks would be heralded on a break of 1.60. If you were prepared to be extra aggressive then a

mini break of the sub-trend line at 1.63 could used as an entry for long Euro down to the 1.60 level.

As ever on all trades do not rush in until the market indicates where it wants to go. Then all you need do is go with the market. There is no need to anticipate if one has already identified one's long and short levels. Just sit and wait patiently until the market indicates that the time has arrived for you to make some money.

COMMODITIES

- **Gold has shown relative strength as Japanese flee the Yen**
- **Oil remains weak in trading range**
- **Base metals fluctuate with each economic survey**
- **Cocoa and Oats are big winners from last months issue**
- **Coffee is still not ready for new longs as yet.**

GOLD



With a politician's perfect timing "iron chancellor" Brown managed to sell millions of pounds worth of Britain's gold reserves at the low early last year. Gold which has suffered a near twenty-year bear market has been showing signs of life for sometime and we have highlighted its prospects quite frequently. However gold is always liable to disappoint so careful trading is the way ahead. Gold shares are perhaps the best way to play any gold rally. We suspect that a ranging recovery is underway and if prices hold above \$300 for a month or so then we may well see some spectacular gains over the next year. The new strength has

come from worried investors who have been forced to realise that gold is money after all. These investors are stuck with Argentine Peso's or Japanese yen deposits and wish to find a rock solid home for their savings in case bank defaults ruin their financial health. The latest move in bullion has come on the back of mainly Japanese domestic buying with plenty of apocryphal tales of people in Tokyo buying more bullion than they can easily carry home.

A move over \$320 would indicate a major move to the upside is underway with the potential of achieving \$400.

OIL (nymex daily)

Oil has rallied during Feb within a range of \$18 to \$20 and now looks susceptible to correcting back to the lows at \$18. At present we would stand aside but would be especially interested in any break to the lower level.



TIN (below) is retesting the recent lows and perhaps reflects currently weak industrial demand.



NICKEL (weekly)



Nickel's recent strength has so far only partially corrected a massive bear market and nickel is currently pausing to digest the gains made so far. Traders could buy Nickel on a move over 6300.

COCOA



Last month we told readers to buy cocoa on a move over \$14.00 and that purchase should have paid back handsomely for all traders. The chart seems to be gathering more momentum and we are expecting higher prices from here. Any new positions should be protected with a stop at \$14.00

COFFEE (weekly)



Coffee is perhaps starting to show some signs of life but not enough as yet to prompt new longs. However, a careful watching brief should be maintained for any move over \$50, as a powerful contra-trend move is long overdue.

OATS (daily)



ANOTHER WINNER from last month!

The Barmac last month suggested longs on a move over \$215. The move upto\$230 has been explosive and stops should be moved upto \$215 to protect capital.

UPDATE ON THE BARMAC BREAK-OUT SERVICE

The portfolio is now up 30.7% since launch on Oct 3rd 2000 whilst the Ftse has fallen 21%. If you would like details on how to subscribe to this service please just e-mail us for information.

Best Regards

Andy McCarthy

Andy Bartles