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TO DATE A SPRING RALLY FAILS TO TAKE HOLD BUT WE FEAR IT MAY ONLY PROVIDE A SELLING OPPORTUNITY

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P E ratios still at record highs
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Watch cotton for break out trade

Break out portfolio up 32.3%

We believe that the early March stock market strength would probably lead to a "spring rally". At present this rally has failed to follow through after positive price action on most markets. Although, most of the gains have been held the major markets have traded very narrowly for the last couple of weeks. The ranging will give way shortly and we suspect that some further strength could well result (but don't bet the ranch on it!).
Assuming the market does indeed move ahead we would use it as an opportunity to lighten all equity portfolios as the much-heralded "economic recovery" is set to disappoint. With equity valuations at historic highs there is no room for any such disappointment and equities will be severely punished. However, most Wall St. analysts are currently heralding the shallowest recession on record whilst asserting that the run down in inventories has ended and that a strong housing boom will keep the good old American consumer spending! This bullish story does not make sense to us and we question the validity of the bull arguments behind the economic recovery.
With market PE's ranging from 40 to over 60 on the S&P 500 (depending on which accounting standard is being used), it is apparent that stocks are not cheap (even if you assume a substantial earnings rebound which has patently not materialised during Q1 reports) on any historic basis of measurement. Regular readers know we think the market expensive, but may be unaware of some of the "fantasy league" style reporting of corporate profitability over the last decade and why as such recession is deeper than appears at first glance.

Recessions are essentially a period of "creative destruction" where the excesses of the previous boom are eradicated. Perhaps the greatest excess occurred in the Enron style move to imaginative accounting practises. Enron was a deliberate fraud but as US Senator Byron Dorgan said, "*This is almost a culture of corruption*". This we believe is an understatement of the new tricks of the accountancy trade as practised in the last 7 years or so. The so called "pro forma" and EBITDA accounting methods have become common practise even for blue-chip companies and have literally allowed companies to omit any expenses it likes and thus report any profit it wants. Strange how many companies were suddenly able to deliver profits to the forecasted last penny. That was until the economy collapsed and drove a coach and horses even through the "fantasy league" balance sheets.

The quantifiable affect of the above lies in the uncertain market PE ratios. Literally which calculation do you take? In 2001 pro forma reckoning, the S&P 500 earned $45 per share giving a market PE of 25. However, by using the generally accepted international accounting GAAP principles earnings were only $28 per share (year to end of Sept.) and the market PE was over 40. Since then the market has risen as profits have declined yet further to inflate PE ratios to unprecedented heights.

The final nail in the "mildest recession in history" argument is to be found in the US commerce departments NIPA (National Income and Product Accounts) figures. The figures show that real profits had stagnated since '97 when at $504 billion before tax they had accounted for 7.6% of national income. If we now see what happens to the proportion that corporate profits represent in subsequent years we are left with a consistent decline in profitability. In 2000 the profit ratio was 6.2% and by third quarter 2001 (before the impact of 9/11) it had declined to 4.7% of US National Income. The decline in profit margins occurred while the economy was booming and company reported earnings were "apparently" growing strongly. We know which figures we trust the most and as such the Tech Wreck and corporate bear market of the last 2years looks logical as profits were falling **not** rising! In fact we have just witnessed the first profitless boom market of all time.

Now if we further review the real corporate balance sheets we notice two significant impostors that will limit the scope for an early and strong recovery – they are debt and "goodwill". Again, we have discussed both at length in previous issues but we should still review some of the facts. During the late 90's mergers and acquisition's went ahead at breakneck pace, despite many having no obvious rational or shareholder value. Indeed a recent study by KPMG showed that only 19% of mergers create a net return to shareholder value over 5 years. So 4 out of 5 are a simple waste of money and resources. A company normally has two simple expansion routes that is, building new capacity via purchasing plant and equipment, or by taking over existing capacity via a purchase of a competitor. Economic rationale would normally dictate that the cheaper route would be the course of action a company would follow. BUT common sense has been turned on it's head as corporations on both sides of the Atlantic purchased existing firms at several times their book values or their costs of reproduction. This idiotic behaviour was compounded by the epidemic of stock buy-backs (another subject we have visited many times over the past year) to increase "shareholder value." Utter lunacy. What are equity markets for other than to raise cheap capital finance for companies? Thus they should not be reducing their equity base to buy back stock even if they have surplus cash (what's wrong with a special dividend or the prudent retention of cash reserves a la Lord Weinstock at GEC in the 80's and 90's ---- most Marconi shareholders would prefer his dull prudence now). The buy backs were however most imprudent with record low yield stocks being repurchased with more expensive borrowed money. We wonder whether this could ever have been done to improve director stock option values --- surely not!

The above actions have gone an awful long way to overburden corporate balance sheets with debt.

"*To get a broad idea of the ravage imparted to corporate balance sheets during these years, just compare the two following figures covering 1995-2000: US business net fixed capital investment edged up $321 billion; indebtedness ballooned by $2,472.7 billion. For each dollar added to net new*

fixed investment, there were 7.7 dollars added to debt. The stunning difference between the two figures essentially reflects the fact that the debt orgy went overwhelmingly into unproductive use, mainly stock buybacks, mergers and acquisitions. Counterpart to the soaring gap between debt growth and net investment growth were bits of paper bearing the pretentious title of "goodwill"."
A fine summary paragraph which we could not possibly better from March issue of The Richebacher newsletter

Thus in conclusion we believe that the prospect for a strong sustainable economic recovery is slim due to the massive overhang of debt and the major decline in US corporate profitability over the past 5 years allied to a massively overpriced stock market. The above will ultimately lead to a slowdown in consumer spending, as jobs are lost and stock portfolio's decline (think of all that money that went to money heaven as the NASDAQ collapsed), capping a strong recovery until the imbalances have been worked away to some considerable degree.

Therefore any fireworks for the worlds equity markets are likely to be limited to a spring rally which will fade out below major market resistance is reached (6000 on Ftse 100).

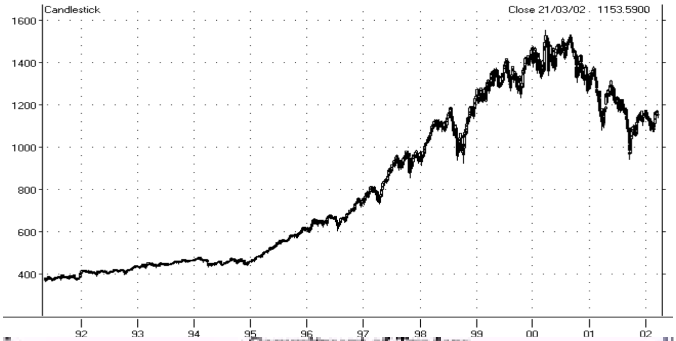
Finally, any stock recovery could well be stopped in its tracks as interest rates rise either to discount growth (maybe only modestly) or due to increased supply as Govt finances are deteriorating quickly.

WHO WOULD YOU BACK? Private traders or professional market hedgers?

The chart below is extremely interesting to all market participants and we would like to thank our friend Daniel Sarna in the US for drawing our attention to the current position of traders on the S&P.

We have at present an all time record long position by private individuals reflecting the fact that they have bought all the way down. Meanwhile the market professionals have a record short position – they have shorted all the way down. The last time such a major imbalance occurred was in '94/95 when the market pro's were long and as such were favourably positioned to benefit from the huge bull break-out witnessed in March '95. Interestingly while the pros were so bullish in '94 the private investor was extremely bearish with a huge net short position.

So we leave you all to draw your own conclusions as to what the implications may turn out to be. However, one thing is for sure market professionals are not in the least bit bullish at present no matter what they say publicly. They have voted with their pocket books and believe the danger is on the downside.



INTEREST RATES AND BONDS

- **A new round of global rate rises has begun**
- **UK & US bond yields start to rise as supply increases and possible recovery**

The US Fed has tipped its stance on monetary policy from accommodative to neutral with a tightening bias not far away with interest rates at 40 year lows. In Sweden and New Zealand short term rates have already been increased by Central Banks and in the UK gilt yields have begun to rise.

Indeed in last months issue we highlighted the range trading UK gilts and US bonds had followed for some significant time. We also suggested that any break of the range was a trading opportunity. Well that break came during March with an attractive short on both Gilts and US bonds. Sadly, we missed it but we hope some of our traders have taken advantage of the move. We suspect that over time the 100 level will be challenged on the UK gilt shown and eventually broken. A stop should be placed at the break out point of 103.75.

UK GILT 5% 2009

A similar confirming break appears to have occurred on the US bond market with the US futures breaking through the lower trend line

US TREASURY BOND (CBOT) weekly

Rates are being driven up not only by Central Banks but good old-fashioned supply and demand, which has no respect for global slowdown and any need for lower accommodative interest rates.

When we highlighted the "smoke and mirrors" nature of the US budget surplus in our January issue we received a great deal of response and interest about the US Treasury website. Several leading UK fund managers commented that they were vaguely aware that the "official" figures were "cooked" but did not realise by how much or that by going to ((www.federalreserve.gov/releases/Z1/current/z1r-3.pdf) *and then scroll down to Table F4. Or, you can call the Federal Reserve at (202) 452-3482 and request that they mail you their Z1-Flow of Funds Accounts. The relevant information is in Table F4, on page 11.)* they could view the correct figures.

The correct figures are very important because when the Federal Govt was running a "surplus" Treasury bond prices surged. This was due to reduced supply and greater demand (simple economics – more demand and less supply = higher prices) as the deficit had shrunk but not as much as the US Govt would have us all believe.

Now, however, all that is reversing. The US Govt.'s deficit is exploding and investors are becoming concerned.

The key factors of concern are;

1. Even using the official numbers, the federal budget has swung sharply from a purported $230 billion "surplus" to an official $14 billion deficit. Worse the US Govt. is forecasting a $106 billion deficit for 2002 and an $80 billion in 2003. (*so we have excess supply concerns for this market).*
2. The official Govt figures have a built-in element wishful thinking. To make their wish come true, they are counting on economic growth of 2.7% in 2002 and 3.8% in 2003.
3. If Social Security Trust Funds (money that is not supposed to be touched) are excluded, then the US Govt's own forecast deficit is $318 billion in 2002 and $337 billion for 2003.

The above points do not constitute the whole picture but they illuminate the reality much more closely than US Govt figures do. Just like many corporations, all governments tuck away the reality in a small footnote, which essentially says: " when we calculate the official budget, we take credit for the income but don't accept responsibility for the expenses!" Enron execs would be envious

The point of all the above is that supply is increasing and despite US Govt wishes to maintain a favourable low interest rate backdrop to any recovery, bonds could suddenly decline when you least expect it.

The same story is true for the UK with the "iron chancellor" running out of pension funds to raid to pay for the massive fiscal largesse being undertaken

by the currently ever more socialist Govt. This expenditure is supposed to be met by increased revenues from a growing UK economy. At present with corporate profits on their knees and any possible recovery not only far from certain but unlikely to be robust, the assumed revenues look like delusional pipedreams.
Profligate spending plans and low growth are a major threat to long dated UK gilts

GLOBAL EQUITY MARKET REVIEW

- **European markets enjoy strong rallies following trend breaks**
- **Ftse fails so far to follow through on early spring trend break**
- **Nikkei rallies as highlighted last month**
- **The Dow leads but will the S&P follow**

As highlighted last month both the Paris CAC and the German DAX did break out last month and hopefully provided all traders with very tasty profits. The move has now paused but a move below 4500 (CAC) and 5250(DAX) is now required to suggest an upside failure.

PARIS CAC weekly

GERMAN DAX weekly

The Ftse has threatened to commence a new post 9/11 up leg but has as yet failed to follow through. The chart below illustrates the uncertainty on ftse quite clearly. Despite our medium term overall bearish view we do feel that most markets including Ftse are due a second post 9/11 up leg to complete a typical ABC bear market rally as per Elliot wave theory.
If and when Ftse clears 5350 we would expect to be able to trade a move of at least 200 points. Conversely, a break below 5000 opens the way to a challenge of the September lows

FTSE 100 (weekly)

The Nikkei has enjoyed a strong rally as suggested last month but the advance has been checked by overhead supply at 12000. A close above this level is required to suggest significantly stronger gains. We would not be surprised to see the advance to continue for a little longer especially if other markets are strong through early April as we initially expect.

NIKKEI (weekly)

The Dow has led the other markets over the past month with a strong surge to 10,600. The move has faltered as overhead supply weighs heavy on the Dow over 10,000 and a move over 10,650 is required to indicate higher prices. Conversely any move below 10,000 would be very bearish.

DOW JONES

The S&P has as yet not enjoyed a "spring fling" like the Dow and has recently bounced off horizontal resistance at the post 9/11 highs at 1175. A move over 1175 would be very positive, whilst a fall back below 1100 would suggest a possible retest of last September's lows.

S and P 500

Strategy for stock markets -Stocks have rallied and chart patterns for indices resemble the V-bottom with right- hand extension base formation. Consequently the window of opportunity during this medium-term recovery for share markets may remain open for a while longer but investors can already see what will close it. A new cycle of higher short-term interest rates has commenced and bond yields have risen sharply, JGBs excepted. Consequently we remain cautious, suspecting that the next downtrend for world stock markets will be considerably bigger than any additional gains from current levels. While in past cycles the lead time between the first rate hikes and a peak in equity prices has been up to 6 months, we suspect it will be much shorter this time, because of all the other uncertainties highlighted earlier.

CURRENCIES

- **Cross rates explode into action**
- **Yen correction is probably over**
- **Euro is slowly strengthening within base**

Last month we rather foolishly bemoaned the total lack of activity on Forex markets. Well we obviously spoke too soon as the Yen exploded into a dramatic contra trend rally. Many of our readers (including us) may well have had some of their stops hit by the Yen's surge. We really should have anticipated a contra move to shake out all the stops that are inevitably jammed up behind the primary trend. The next big move will be signalled by moves to new highs against dollar, pound and euro. Meanwhile current Yen shorts should be lightened on the approach to the previous highs. However we would replace quickly on small reactions, believing that downside risk against the yen near current levels is now limited to small reactions following the earlier shakeout of speculative positions. One other reason for the volatility is Japan 's inclination to manage its currency. Jawboning helped to trigger the stops and concern expressed by many of the same officials over the extent of the correction soon led to a rebound. Aside from Hayami, Japanese officials understandably fear a too strong yen much more than they fear a too weak yen. We'll pay attention when they next talk about the yen "falling too fast ", although as the trend persists, jawboning in its support may have a diminishing effect, as we saw with the ECB, at least until multilateral intervention in September 2000. In any event, short yen remains our Trade Of The Year and it's the only currency position that we are interested in. At the bottom line, it pays to short the yen whenever it stages a decent rally.

YEN vs DOLLAR (weekly)

YEN vs POUND (weekly)

The two charts above illustrate events in the world of the yen perfectly. We have experienced a counter trend move against both currencies that has found support near the major consolidation areas of 2001. The subsequent rebound has fully retraced the break and new yen shorts can be added on a move to new lows for the yen.

The pound is set for a strong move against both the dollar and the euro. We need not second guess the direction but suspect that the euro will strengthen against sterling. The chart below highlights the multi month pattern of a gradually tightening wedge, which will eventually give way and lead to a potentially explosive movement.
The levels to keep an eye on are £1.65 and £1.60 as any break beyond these two levels should be eminently tradable.

STERLING vs EURO

The pound dollar cross is also witnessing a very tight trading range. A break out is likely any day now and we would go with any break. The set-up looks very favourable and we would expect a move to carry at least 5cents in either direction.

DOLLAR vs STERLING

COMMODITIES

- **Gold continues to hold on to most of it's recent gains**
- **Iraq war talk prompts an oil rally**
- **Nickel strengthens further as predicted last month**
- **Coffee is still not quite ready**
- **Cocoa continues it's strong run**
- **Cotton trade is back on!**

Gold's reaction lows have been rising ever since support was encountered above the 1999 low in February and April 2001.Also, if the March 2002 low near $290 continues to hold, gold will have seen its smallest reaction following a rally within the large base. This would provide further evidence of increasing demand relative to supply. The next bullish development would be a sustained push above the psychologically significant $300 level. The timing of base completion is extremely hard to predict, but while the $290 reaction low continues to hold, we'll assume that this pattern is nearing completion. Moreover, we have already seen upside breakouts for gold against the yen and euro. Why, a skeptic might ask, would anyone want to buy gold? Japanese investors have every incentive, because of their weak asset markets, minimal yields and sliding currency. As for the rest of us, gold is cheap, viewed as a store of wealth in times of uncertainty and arguably due for a cyclical recovery. There is a good possibility that investors will be disappointed by stock market returns, while corporate debt default could make bonds less appealing. Among main reserve currencies, the euro and now the yen are unloved and the dollar is overvalued. The only negative factor that we can see, at least until bullion is at considerably higher levels, attracting so-called scrap metal and perhaps more sales by central banks, is the prospect of rising interest rates. However, if/when "gold fever "makes one of its periodic returns, which we haven 't seen for over 20 years, this will outweigh all other considerations while it persists.

GOLD

Crude oil has rallied into the underside of its large top area and natural gas prices have rebounded. This poses a threat to the fledgling global economic recovery, particularly for developing countries, Japan and Euro land, in that order. OPEC resolve and a certain amount of hedge buying, in anticipation of stronger economic growth and a possible US military move against Saddam Hussein, appear to be the main factors behind this rally. However there is no supply shortage, evident by contangoes for most of the futures contracts. Crude oil has rallied to potential resistance from the lower region of its large top area. Therefore we would not be surprised if these gains proved hard to maintain, although charts do not yet indicate that the rally is over.

CRUDE OIL (nynex weekly)

Nickel (below) has indeed moved strongly on from $6200 as suggested last month with the metal now at 6680 after touching 6900 for a gain of at least $300. Nickel looks likely to have another short pause before advancing further.

NICKEL

Tin (below) appears to have found some support at the $3600, however tin could easily fall to new lows and a potential short exists below $3600. Currently we would choose to stand aside on this particular commodity.

TIN

Coffee appears to be attempting to reverse the recent long term declines. The current price above $50 seems to imply that we can expect higher prices over the coming months. Traders can buy coffee with stops placed at around $47. If this turns out to be the beginning of a new bull trend then prices could move forward very quickly.

COFFEE (weekly)

COCOA (weekly)

Cocoa has continued it's strong Bull Run as highlighted last month. The price has surged up above $15.50 and all traders should protect their profits with a protective stop at $14.50

Cotton is back on the agenda after our lovely trade in October. The price per bale has traded between $35 and $40 for about 5 months and looks set to commence a potentially very strong break out move. We would strongly suggest that all traders buy cotton on a move over $40, as the v shaped reversal with right hand extension is a reliable formation. Stops should be placed at $38 assuming a break occurs.

COTTON (weekly)

Finally, if you have any comments, queries, questions, observations etc. please do not hesitate to e-mail us as we always welcome all the many comments we receive

Best Regards

Andy McCarthy & Andrew Bartles