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## **DESPITE THE SPRING SUNSHINE OUR SCRIPT OF A Q2 RALLY HAS SO FAR DISAPPOINTED.**

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**Spring rally has not sprung!**

**Equities still overvalued and dividends are important**

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**METALS Nickel continues to rally**

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**Break out portfolio up 36.3%**

**For at least two months now we have been expecting the equity markets to enjoy a spring rally.** Our script was that such a rally would be based upon the belief that the US economy was about to enjoy a strong recovery. As most readers already know we felt that for a number of reasons (massive corporate debt, the Tech Wreck, over hyped PE ratios, record consumer debt, rising unemployment and fraudulent accounting practises to name but a few) the rally would ultimately fail to hold as it became apparent that any recovery would prove to be anaemic and unable to justify market hopes and expectations. When we look at the charts of the major market indices (S&P, Ftse 100, CAC and Dax) we discover no such move, with only disappointing sideways trading ranges, that may ultimately provide a fantastic break out trading opportunity. We still believe any break will be to the upside (and so complete a classic Elliot three wave corrective rally in an overall bear market), but don't rule out a shock break to the downside.

**US public sentiment towards stocks is poor with Merrill Lynch and many others being investigated by Mr Eliot Spitzer the New York attorney general.** We all suspected that large stockbrokers perhaps acted in their own self interest (are we over cynical?) but the sheer scale and depth of manipulation has both outraged and created deep mistrust in the US public. This antipathy towards stocks is an added factor that will ultimately drive stocks back towards their long-term average historic mean valuation levels. This may well take many years as current valuations are (43 on S&P)

by any standard extremely high. We have discussed the high PE ratios many times but in more circumspect times perhaps people will seek the security of dividends as equity markets return to their long-term historic mean valuation levels.

After all that has happened in the corporate world recently, dividends may be viewed as the only tangible reward for holding stocks. The fashion for boosting reported earnings by leveraging balance sheets with debt and using the proceeds for share buybacks is inevitably changing in the post-bubble environment. Corporations are now endeavouring to reduce debt, and secondary offerings will be part of this process, whenever share prices rally sufficiently. Given the post-Enron uncertainty over what earnings actually are, market reversion to the mean can be monitored more easily by looking at dividends. The DJIA 's yield mean is 4 percent, against 1.76 today. Assuming the market does not collapse, it will take a long time to reach, let alone move temporarily above the dividend mean. Consequently, we maintain that most US and European stock market indices will range beneath their historic highs for years, with bungee-jumping bear markets occurring from the upper boundaries every few years, usually in line with cycles of rising interest rates. As for the NASDAQ, it could take 20 years or more before the 2000 highs are decisively broken, given the extent of its bubble.

The stock market never continues indefinitely in any direction. It is cyclical, and the best part of the current cycle is already over.

- *"You only get to go from double-digit inflation to 2% inflation once, and you only get to go from an Old Economy to a New Economy once,"* says Pimco portfolio manager Paul McCulley in explaining the gigantic bull market of the 1980s and 1990s. In other words, the overwhelmingly favourable macro-economic trends of the last 20 years have exhausted themselves, and the richly priced stock market amply reflects the good things that have already occurred. Looking forward, however, there is no New, New Economy or other major macroeconomic trend standing at the ready to propel stocks even higher...unless the Federal Reserve buys the entire S&P 500.

**The US economy "grew" at 5.8% in Q1 this year as a rebound appears to have begun. Growth is**

**back!** The Recession Is Over!" says analyst Ken Mayland. Talking to USA Today, Mayland suggested, *"The economy is getting back on good growth track, which down the road will mean good things for jobs and companies profits. "If the government's numbers can be trusted, GDP grew an annualised 5.8% in the 1st quarter 2002. Meaning the US economy has not only "emerged from recession," but the slowdown will likely go down as the mildest in US history.* Perhaps. Here at the Barmac, we're not prone to prognostication, but there is one possibility left out of the rosy scenario being lauded in this weekend's press. Namely this: what if, rather than the mildest slowdown in history, we simply haven't begun to feel the effects of a slowdown at all. The second stage of Greenspan's rocket - consumer spending and business investment - could by all intents and purposes burn out in sputtering disappointment. For example, U.S. consumers, whose spending habits make up two-thirds of the US economy, increased spending at 3.5% for the first quarter... but the number has slowed considerably from last Autumn's burn rate. The red-hot 6.1% spending rate of the fourth quarter in 2001 was largely fuelled by 0% interest rate car loans. Meanwhile, consumer sentiment numbers released by the University of Michigan fell more than expected for the month of April.

The US consumer has so far prevented the slowdown from turning into a catastrophe by using the amazingly low interest rates to go on a credit binge fuelled by rocketing house prices (cheap credit always creates new bubbles). The rise in property values has created a "wealth effect" which has offset the hurt caused by falling stock prices. So US and UK homeowners have re-mortgaged and leveraged up yet further to buy new bigger and better homes. Obviously, all this extra credit helps boost demand but with the employment market weak the sustainability of this debt-financed prop is questionable.

In fact, even debt itself has become an asset. Mortgage lenders hawk debt like so many pork bellies...yet that debt is secured by nothing more than paper gains in property values...which are driven mainly by inflated demand that is in turn powered by the availability of further debt to larger groups of clients, with ever more loosely defined

creditworthiness.

Any cash gains in property values...as manifested in large cheques paid out to sellers at settlement...are typically used to buy yet another high-priced ticket to take on more debt (usually in the form of a substantial down payment on another overvalued house).

What if this daisy chain of debt ever starts to unravel, Japanese-style? A decade after that country's last real-estate boom, Japanese banks still have US\$400 billion worth of bad loans on their books. That's four times worse than the S&L crisis in the States, if you account for the different size of the economies.

And if the Enron debacle was all about the quicksand you enter once you start blurring the fine line between debt and assets, the potential for a far more devastating crisis in the debt "industry" is explosive.

And probable.

**The “iron chancellors” budget certainly warrants a close examination of the economic assumptions made by HM treasury.** Much comment in the press has concentrated upon the tax hikes for the long suffering, wealth creating, working population and business. Although we suspect that the economic case for transferring resources from the dynamic private sector to the wasteful, profligate, poorly managed, inefficient and unaccountable black hole of the public sector (whether it is aimed at the NHS or not) is non-existent we would like to highlight the amazing gamble on an increase in hoped for economic growth. Our prudent chancellor has bet that his spending plans will be paid for by the rather bold assumption of an increase in the underlying trend growth rate for the UK economy, despite the obvious current slowdown!

Buried deep in the text of his spring budget was a 0.25% increase in the UK economies underlying growth rate from 2.5%pa to 2.75%pa. This slight of hand allows the Exchequer an extra £9 billion of “spends” by 2005-07. But if the growth assumption is not met then this extra spending commitment will definitely come from the productive sector of the economy—again!

Brown believes his increase is prudent and that the National Audit Office agrees with him. But what

the NAO actually said was that the new figure was “*reasonably cautious but not as cautious as the previous assumption. Given the inevitable uncertainties, the Treasury should continue to review the working of the assumption.*” Or as we would say, “don’t bet the ranch on it” Which is exactly what Brown is doing with the fastest sustained rise in public expenditure since the early seventies.

The chancellor appears to be making the classic mistake of “rear view mirror” economic management. He has assumed that because the UK and more importantly the US had strongly positive growth in the late nineties, that once this inconvenient and paltry little recession has ended, then UK economic growth will resume at the rip-roaring rate witnessed previously. Now the chancellor may well be right (we do not think so however as regular readers know we predict at best below trend growth for a number of years as the economic excesses of the last boom are worked off and an anaemic recovery depresses company earnings performance which will dramatically reduce the Treasuries tax take) but we have to question the use of the word prudent when describing the upward revision of the growth assumptions used in the present climate to underpin the huge increase in Govt spending plans. We cannot help but suspect that we have all been here before and that before too long much higher taxes and huge budget deficits will combine to strangle the lifeblood out of the British economy.

*We agree with economist Roger Nightingale’s comments “Does the Chancellor appreciate the risks he is running? He has seen the British economy outperform those in continental Europe by a full 40% in the last twelve years. Why, in that case, would he now pursue the very policies that are arguably the cause of the latter’s failure? Is he conceited enough to suppose that it was he, rather than the country’s relatively low taxation, that was responsible for the economy’s favourable performance in recent years? Does he think that he, Canute-like, can ward off economic anaemia even while he lifts unaccountable spending on non-productive assets to European levels?”*

As you may have guessed we concur absolutely!

We can already visualise the “funding black hole” headlines.

One potential silver lining will however be far more attractive annuity rates as Govt debt issues push up the supply of gilts and the underlying gilt yields.

## INTEREST RATES AND BONDS

- **Rates will edge higher as the post 9/11 panic recedes but high oil prices will ensure only incremental increases**
- **Bond and gilt yields pause in their uptrend**

Central Banks around the world have been slowly edging rates higher over the last couple of months with Canada and New Zealand adding 25 basis points in the last month. However the two everyone is watching are the US Federal Reserve and the European Central Bank. Greenspan could easily justify lifting rates from their 40-year low of 1.75%, given recent evidence of a recovering economy, albeit patchy, following one of the shallowest recessions in US economic history. However he is concerned about debt levels for consumers and especially corporations, plus the lack of recovery in Euroland and Japan, and most importantly, the recent rise in oil prices on Middle East tensions. The ECB has less reason to hike rates from 3.25 percent, despite inflation above its 2 percent target ceiling, because its projected recovery looks distinctly feeble, especially in Germany. Consequently, central banks will move cautiously in lifting short-term rates, at least until the price of crude oil falls back from its current level of \$26.40 (NYME). While rising energy prices are inflationary initially, the medium-term effect is deflationary because it is an OPEC-imposed tax on consumer and corporate spending. Here in the UK if a recovery does take hold. A combination of an increased PSBR to fund Govt spending plans and increased inflation could result in much higher UK rates with consequences for both the equity and property markets.

As the tensions in the Middle-East has propelled crude higher the rise in treasury and gilt yields has paused. This is likely to be a temporary pause as

crude prices are unlikely to remain at or above current levels unless political conditions deteriorate further. If tension eases then as oil falls the various CB's will again feel able to start edging rates higher. The chart below highlights the recent pause in yield increases over the past month BUT the chart clearly illustrates the failure of the two year rising channel.

### UK GILT 5% 2009



US treasuries below have paused in their downtrends in the past month but a move below 96 would signal a potentially dramatic increase in US long term yields. Slow growth may well delay this for sometime.

### US TREASURY BOND FUTURE (weekly)



## GLOBAL EQUITY MARKETS

- **Ftse, continues to trade very narrowly and this is normally a prelude to real excitement**

- All US markets seem to be losing post 9/11 recovery momentum and are opening up potential for retest of lows
- Far east markets maintain current form as recovery from Asian crisis of 97/98 continues

Oh my what can we say about the Ftse chart that is new at present? We are tired of waiting for something to happen. Yes, we know we are in a long term cyclical bear market as the market returns to the historic valuation mean but in the meantime the market continues to go nowhere for what feels like an absolute age.

THE GOOD NEWS is that this cannot last forever and in our experience the longer a constricted trading range persists the more explosive the move out of the range will be.

We are not now really worried as to which direction any break out may come. We are just poised and ready to trade any move beyond the confines of 5000 to 5350 range band. We would suggest that once a move out occurs it should carry for 300 to 400 points or so with targets of 4600 or 5750. Traders should place stops at 5050 or 5300 depending on whether we are trading an up or a down move. The chart below highlights the current slumber of Ftse perfectly

**FTSE 100 (daily)**



US equity markets have shown some considerable weakness over the past month as corporate earnings numbers continue to disappoint. The worries in the oil states and the continuing TMT debacle have all weighed heavily on sentiment.

Certainly, the NASDAQ has now fallen below the Feb lows at 1700 and needs to rebound quickly back above 1800 to negate the very real threat of further falls to the 9/11 lows at 1400.

**NASDAQ 500**



The S&P has equally dipped below the key Feb lows and now needs to clear 1135 to negate the danger of further falls towards the 9/11 levels. This index is currently very oversold and as such we do not expect a straight line decline. A move over 1175 is required to indicate a period of new strength.

**S&P 500**



The Dow which has until recently being the strongest index, has over the last few weeks crumbled. We asked last month whether the Dow would lead the other markets higher and concluded that it probably wouldn't. The picture has since deteriorated drastically with the Dow now firmly below 10,000 and close to the Feb lows. Support should be encountered at 9,500 but any failure would inflict great technical damage on the index. The Dow would now need to clear 10,350 for the picture to begin to brighten.

### DOW JONES Industrials



Far eastern markets although susceptible to any setbacks in the US have been the form investments over the past six months. These markets were already low long before the tech bubble burst due to the currency crisis in 97/98. These economies are thus not as prone to the dramatic corporate write-downs and inflated valuations currently weighing down US and European markets. Even the Nikkei may be able to stage a further recovery from current levels if the 12,000 (this would suggest a move up to 14,000 as a strong reversal base is built) level is breached although a fall below 11,000 would suggest a retest of the recent lows at 9500.

### NIKKEI (weekly)



The other "tiger" markets are perhaps just perhaps running out of momentum at present after strong recent gains and maybe susceptible to some profit

taking and consolidation. However, any pushes on beyond the recent highs could be actively bought with the usual strategy of trailing stops

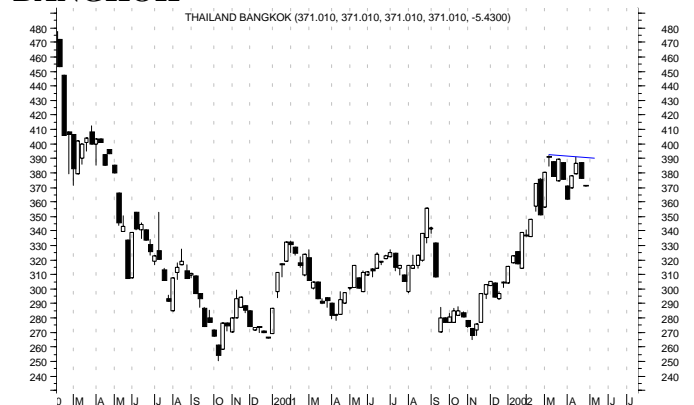
### STRAITS TIMES (weekly)



### TAIWAN



### BANGKOK



Germany and France have seen both their markets succumb to profit taking and have been unable to sustain early spring upside moves. The Dax shown below would now need to break the 5450 level to confirm a new bull run.

## GERMAN DAX weekly



In conclusion we suspect that all the danger lies to the downside on equities and that break-out trades may well occur for the UK. The other markets are all trading well below their recent highs and with the possible exception of the Nikkei look to be stuck in moribund trading patterns.

## CURRENCIES

- **US Dollar is slowly losing upside momentum**
- **Sterling and the Euro strengthen against the Dollar**
- **The Yens current correction is nearing an end**

The Greenback appears to be slowly losing its appeal to international investors for the time being. This is probably due to a combination of historically low US interest rates, sluggish recovery and a reversal of investment money flows as the Tech bubble deflates. The attraction of holding dollars is also reduced by the switching of momentum players to the next “big thing” once the trend appears to run out of steam. We believe that the dollar is likely to under perform all the other reserve currencies except the Yen over the coming few months.

The dollar index has failed to break the 120 level three times over the past couple of years now and a move back to at least 110 looks likely. We do not

expect the world to suddenly swing over to dollar revulsion because what is their to love about either the Euro or the Yen but a weaker dollar could well undermine US bond markets and put even more pressure on equities.

## US Dollar Index: 117 (Weekly)



If we now look at the pound and the Euro we can see how both have strengthened against the Dollar as signalled here last month. The pound finally broke free of the tightening wedge pattern that had strangled the cross rate for many months. Last month we predicted that:

.....“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”

At the time of writing that break has occurred and has carried the cross to 1.465. The move looks slightly over-extended and we would expect some profit taking to occur. However we suspect the trend has turned for the next few months.

## POUND / DOLLAR



The weekly chart for the Euro against the dollar shows very similar characteristics to the above

sterling chart with a clear break out of a descending triangle evident. This move should in the short term at least support a move back to 9200.

**EURO/DOLLAR (weekly)**



The Euro sterling cross continues to tighten and last months comments still hold good. Basically, a move beyond 1.65 and 1.60 should signal an explosive move. All traders should be ready as this really should be a major trade

**EURO / STERLING (weekly)**



The story of the Yen still holds our attention as our most favourable long term trade despite people being less bearish of the yen because other currencies have been ranging against it following their January highs. Sentiment has also improved somewhat following evidence of base development for Japan 's stockmarket, talk of tax cuts and Hayami 's periodic sterilization of liquidity when the yen approaches its lows. Mad Masaru's term at the BoJ doesn't expire until 20th March 2003 and on past form he will try to prevent the yen from

falling until his last breath as Governor. However, judging from the long-term charts, he will have difficulty in preventing a further decline. Meanwhile, the US dollar, euro, sterling, Australian dollar, etc are consolidating in their first step above the base. It often takes months before these patterns are completed and the current tally stands at 4 and counting. Short-term momentum indicators show currencies oversold against the yen as we complete this issue, and Japanese finance ministers have already indicated that they do not want to see the dollar below ¥130. A too strong currency and money supply growth of only 3.8 percent (M2+CD) are the main reasons for Japan 's deflation. We maintain that its elusive economic recovery will not materialise beyond a blip, let alone become sustainable, without a massive reflation. This means flooding the economy with printed money, not recycling it through the banking system, which only leads to the purchase of more Japanese Government Bonds, as we have long seen. While Hayami probably won 't print sufficiently, we suspect someone willing to open the monetary floodgates will replace him in 11 months. Currency markets will anticipate the change. We expect the Pound, Euro, Ausie and New Zealand dollars to lead the next charge against the yen.

The Yen dollar chart below illustrates the recent yen strength as prices rebound with a potential rally back towards .8200 if .8000 (1.25) is cleared

**YEN vs. DOLLAR (weekly) inverse**



The chart below for the Yen pound cross rate illustrates how the Yen has halted temporarily its declines against the pound. However any yen rally

is unlikely to carry beyond the top of the previous chunky trading range at 1.82. Any test of this level is likely to be an attractive level to buy the cross.

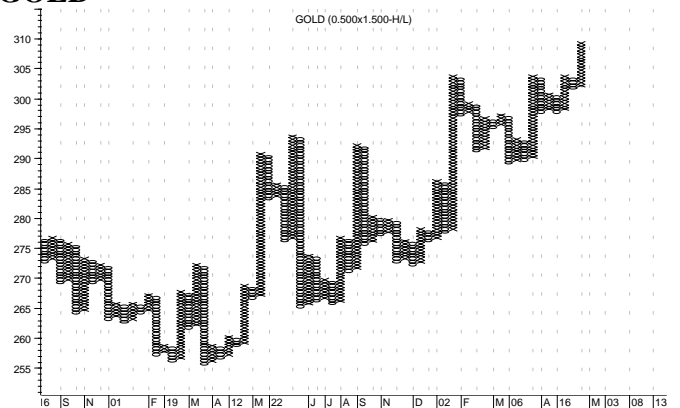
The Euro/yen (not shown) is showing good relative strength and should hold above the key 112 level. At present the current 115.75 represents good value and we would favour trading both the euro and the pound against the yen and switching out of dollar

**YEN vs. POUND (weekly)**



back to the historic mean of just 5. Gold’s recovery this year has been orderly, with gains consolidated along the way. Bullion shows no evidence of trend-ending characteristics South African gold shares have soared but much of that is due to the rand’s slump last year. We thus remain bullish of gold and believe any setback will be temporary and shallow. It would probably take a huge spike upwards or concerted Central Bank selling to end the current trend. The chart below illustrates the latest move to new highs is consistent with the last 18 months action.

**GOLD**



**COMMODITIES**

- **Gold’s bull run is beginning to excite the bugs!**
- **Oil rally hits overhead supply and should decline without further threat of war**
- **Nickel is perhaps overbought and traders should stand aside**
- **Coffee holds above \$50**
- **Wheat still asleep**
- **Oats plummet**

We have remained bullish of gold for six months now and are conscious of the bullish consensus that is building for the yellow metal. We would however want to view any possible overbought condition in context. Gold bullion, has appreciated against all currencies this year but it is hardly a runaway bull trend, especially as the recovery follows a 21-year bear market. The Dow/Gold Ratio (this the value of the Dow divided by the gold price) has declined from 36 to 32 in the last month, but remains way above its highs at the end of two previous super-cycle bull markets for stocks –1929 and 1966, when it reached 18 and 28, respectively, before reverting

**Oil has seen its price boosted over the past month due to the threat of war in Palestine.** However, this has the look of a temporary blip which will reverse if and when tensions ease. We do not believe you can try and play a market based upon political considerations. Therefore, chart wise we would expect overhead supply evident on the chart at \$28 upwards to cap any rally and that oil will subside back to around \$20.

**OIL (nymex) weekly**



Many base metals have seen strong rallies over the past six months. Nickel below has continued to rally beyond the initial pause at \$6000. The metal is perhaps slightly overbought at present and as such we would not chase prices higher for the present time

**NICKEL (weekly)**



Coffee highlighted last month has so far held above the key \$50 level. The long run bear market has seen the price of coffee drop dramatically over the last few years. This trend may now be starting to reverse and tentative longs could be purchased with a stop placed at \$47. Momentum would really start to build if the \$60 level were to be passed.

**COFFEE (weekly)**



Soybean meal (opposite) could be completing a two year flag that has consolidated the gains made in 99. Although a clear signal would not be apparent unless the triangle shape and the downtrend have broken there is interestingly a very strong technical indication that such a move is

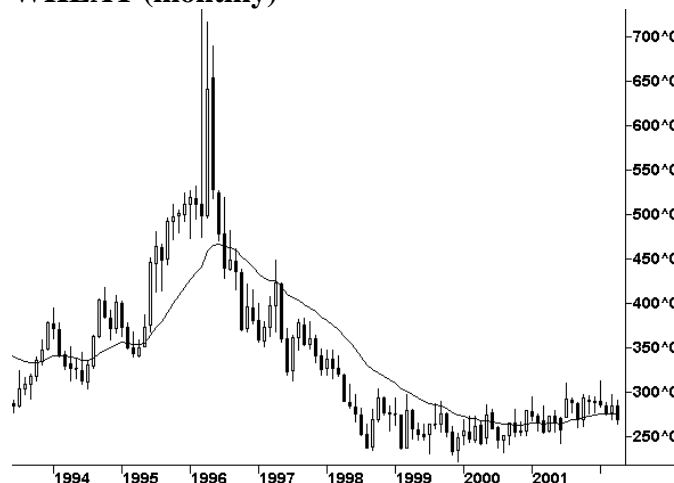
imminent. Our good friend Peter Rhodes who constantly monitors the technical background on most commodities has highlighted a sudden lurch into backwardation for meal. This is generally a strong signal that a strong rally is imminent in any market and may well be an early clue to what could prove to be a powerful second leg in meals bull market

**SOYBEAN MEAL (monthly)**



WHEAT was last highlighted here in November when we said that if it can ever pass the \$300 level then a new major bull market will have begun. As can be seen wheat has recently retreated and as such we may well have to wait patiently for another year or two!

**WHEAT (monthly)**



OATS should have been stopped for a good profit at around \$215. However this grain reversed so quickly and dramatically if that few if any traders took the chance to short as the price crashed out of

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the clear top area at \$187. If anyone is short we suggest covering those shorts now as we would expect a return stroke shortly for oats.

### OATS (weekly)



**Finally**, if you have any comments, queries, questions, observations etc. please do not hesitate to e-mail us as we always welcome and enjoy all our readers interesting and insightful observations

Best Regards

Andy McCarthy & Andrew Bartles