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## **EQUITIES SLAUGHTERED AS SHORT TERM LOW ESTABLISHED BUT GLOBAL ECONOMY SLIDES**

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**Last month we posed the question is the US the new Japan? We believe the parallels are so great that the answer is yes. Thus the recent market lows are unlikely to be the final bottom (but may well be a medium term low of significance). In issue 21 we explained that our basic market framework was based upon the assumption that the UK and US had entered a “super-cycle” bear market in early 2000. In common with previous super-cycles (66 to 82, 29 to 48 etc see last months list) and Japan since ‘90 we would expect apparently cataclysmic falls to be punctuated by potentially explosive rallies. These rallies could last many, many months (e.g. Japan 98 to March 2000 when market rose over 60%) and will feel like full blown new bull markets. This is where the dangerous bit occurs. Once the market has sucked people back into stocks the next leg of the down cycle will begin with falls to fresh lows.**

**This cycle of wealth destruction could proceed for many years until all investors have reached the point of “equity revulsion.” This was last seen in 1979 when Barrons heralded the death of the equity as an investment (a good contra trend indicator less than 3 years before the start of the great super bull of 82 to 2000). Interestingly, in the ‘66 to ‘82 super bear on Wall St. the absolute low was hit in 74 but the low in PE ratios was not attained until ‘81 (7x earnings on the S&P – now that is a bear market low on a PE ratio!). The comparison with other super-bears reflect the above picture with stocks hitting an absolute low in 1932 but PE ratio’s sliding to their lows in the 1940’s.**

So why do we believe that last Wednesday's falls (3600 on the Ftse and 7500 on the Dow) did not signify the bear market low? Well firstly we cannot be sure but we suspect that all the evidence suggests that the long slow erosion of valuations has only just begun as stocks inevitably work their way back towards and perhaps beyond their long term historic mean valuation (PE of around 15 on S&P and Ftse). However markets usually overshoot and the long-term mean may well be exceeded with valuations perhaps falling to beyond so-called "fair value".

One thing for sure current valuations are not cheap on a historical basis despite the falls. They are only cheaper on a relative basis. The current S&P ratio of around 30 is still above the PE of 29 that marked the 1929 high!

Equally significant -can anyone really trust the "E" element of PE. As we all know by now many accounting sleights of hand have exaggerated earnings (not counting straight forward fraud).

For all equity investors there will be more shocks, defaults and frauds over the next few months but we see a short to medium term rebound perhaps into Autumn with new market lows possibly banished until next year.

The bad news is that the stock market might continue to reflect the struggling economy...and therein lies the real problem. The prospects aren't terrific.

- *"On April 1, US earnings growth in the third quarter was projected to reach 20.7%," Barron's reports. "By July 1 that had slid to 16.6%, and by Friday third-quarter profit improvement was forecast at 13.5%...Among tech companies, the dissipation of analyst euphoria has been more dramatic, with projected tech earnings growth tumbling from 96% in April to 81% July 1, to 66% now."*

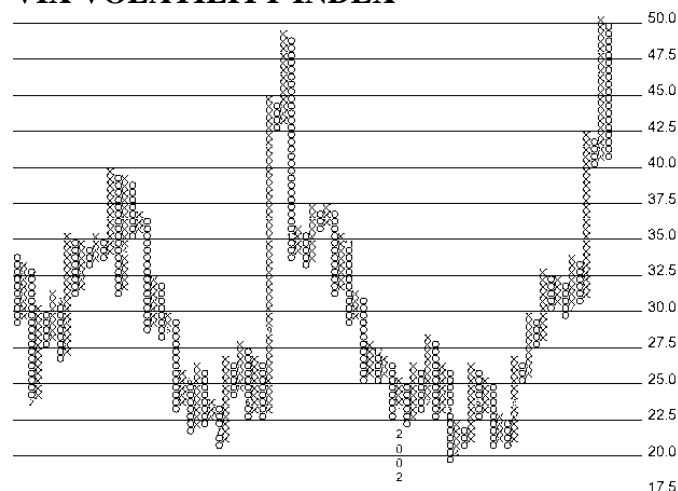
- 66% growth wouldn't be too shabby, except that at 20-plus times projected earnings and based on deeply depressed previous reported profits - stocks aren't cheap.

- *"There's been a growing recognition that the proposed, or hoped-for, fixes for the current corporate- credibility crisis will have the effect of reducing reported earnings for years to come," Barron's correctly observes. "Expensing stock options against earnings, eliminating earnings-management abuses and forcing CEOs to*

*personally vouch for the veracity of results likely will all act as a drag on stated earnings growth. Another possible hit to earnings may come from companies reducing the assumed rates of return on their pension-fund assets."*

- All in all, corporate profits face a severe headwind. Ditto, the stock market. Trading rally? Yes. New bull market? Doubtful.

## VIX VOLATILITY INDEX



The above indicator implies that equities reached such a deep level of depression that it equalled the level attained after 9/11. Thus we would expect markets to rebound strongly for a few months to come with perhaps a 20% move from low to high on all indexes. Thus we may have already enjoyed 50% of the rebound. Time however, is important in this recovery process and we expect the Ftse to trade in the mid 4000's for a good few months.

The only short-term risk to this prognosis is a surprise attack on Iraq that would halve markets overnight if it ever happens (this event has not been discounted as yet and oil would at least double and possibly treble to \$75 as any attack would lack coalition support).

So it may appear that the bear could go on vacation for a few weeks at least.

## CONSUMER CREDIT

The great US consumer who we are reliably told accounts for over 70% of the US economy and who is also the consumer of the last resort for the whole globe is seen as key to avoiding a second dip into recession. We have marvelled at his resilience over

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the past year as he has stoically spent every last penny of his pay cheque and then some. This negative saving in the US and UK has worried us here at Barmac for some time but not wishing to spoil the fun we have only occasionally commented on such folly. We believe now is the time to revisit the recent consumer confidence and credit numbers coming out of Whitehall and the US.

After the recent stock price falls, corporate bankruptcies and job losses we are unsurprised to see consumer confidence indicators on both sides of the Atlantic subside. Additionally, the actual levels of spending have topped out as a negative wealth effect sweeps through the Anglo-Saxon world. Indeed in the UK recent figures showed the worrying trend of lower new credit consumption but higher levels of outstanding debt. In other words spending is slowing but credit card bills are not being repaid and at anything upto 25%+ interest rates those debts will grow rapido. It is beginning to look like the consumer has finally realised that he simply cannot continue to spend, spend, spend and is about to retrench. If this proves to be the case then we could see real problems for the UK and US economies. A double dip or as Richbacher predicts a “double deep” recession would become inevitable.

## **PROPERTY**

The above comments concerning the consumer are very applicable towards the domestic property markets. Prices have ballooned towards sky-high levels over the past few years fuelled recently by low interest rates and falling stock markets. Indeed, consumer confidence has probably only held up due to the comforting sight of accumulating paper profits on our homes. Whilst house prices have risen we have dismissed from our minds the slump in our pensions, endowments and investment portfolio's. Not only have we ignored these falls in our spending plans but have refinanced and consolidated credit card debt and mortgages to provide more free spendable lucre. This massive increase in long-term borrowing will top soon enough and at that point house prices will begin to slump (ignore the shortage argument as it is amazing how demand can melt away when prices fall). This will be the inevitable corollary of

unaffordability, job losses and a return to a positive savings ratio.

Next month we show all our readers how you can protect yourself from falling house prices in the what may prove to be a bear market for houses in 2003/4.

If you wish for a previous roadmap of how this may unfold simply look to our old friend and trendsetter in the Pacific. Japan's property slump did not begin until 3 years after the Nikkei first slumped as the Japanese changed from being the world's great consumers to the undisputed savings champions of the world.

As is usually the case the reaction to the current problem of negative saving will be a dramatic swing to excessive saving that acts as a brake on the potential of any economic recovery

## **BRAZIL**

They may have been crowned the new world champions of football but their economy is as sick as the proverbial parrot. Whilst everyone has been watching the various stock markets, no one has paid attention to the lethal virus spreading from Argentina to the largest economy in Latin America. “The crisis will not overflow into Brazil this time” they insisted as Argentina slid down the pan in December. And they were right for a while. Now, however, Brazil is sinking into the quagmire that despite any differences with Argentina, threatens to produce the same results for world banks and investors: Huge losses.

The alarm bells of serious debt troubles are now ringing so loudly that even central bankers might hear them. But we know what they will do; they'll grant another huge IMF loan that will merely defer the default for a few more months. Recently, Brazilian debt has had to service bond yields 17 full percentage points higher than US Treasury rates. This needless to say is unsustainable and at sometime in the next 6 months Brazil will slip into the deflationary spiral that Argentina finds itself in. The currency already severely weakened will collapse along with the economy as the world's largest default will trigger global panic (especially in Mexico which will then be viewed as the next domino with huge US implications). So maybe next year we could see a major debt panic spreading to all the major global banks. This will lead to yet

more global deflation as the world credit crunch ratchets up another notch.

### INTEREST RATES AND BONDS

- After recent market turmoil rates can only go lower
- Bond yields have fallen as flight to quality and reduced fear of inflation boosts bond prices
- Gilts for depression?

**Europe's GDP growth is slowing.** For Euroland and the UK, economic risks are on the downside and have been made worse by complacency on growth and the ECB's rigid charter on inflation. In the UK, fiscal spending has kept some sectors of the economy reasonably firm but manufacturing is in recession. The arguments for rate cuts are compelling. In the US Greenspan has stated that while he expects evidence of recovery before year end (he'll be lucky) any pick-up may be sub-normal and/or delayed. Believing risks remain on the downside, he will cut rates again by upto 75 basis points if necessary.

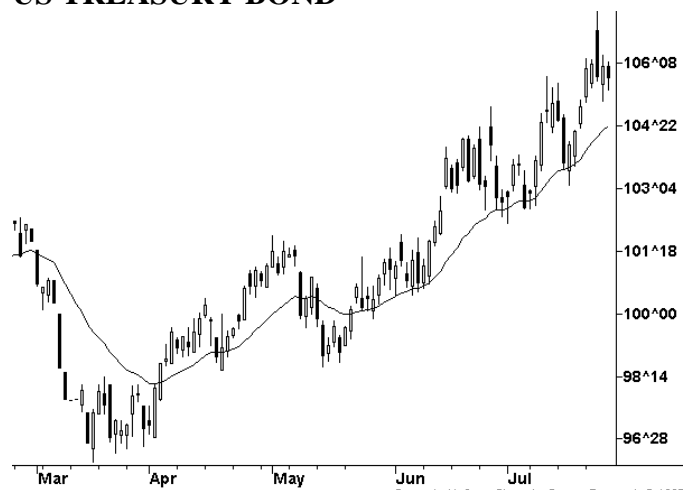
The belief that growth could slow yet further together with the cooling housing market has made any residual fear of inflation recede

This view is born out below as both UK and US bond markets have rallied strongly over the past month or so. Clearly market meltdown has banished the threat of inflation for bond investors.

### UK GILT (WEEKLY)



### US TREASURY BOND



**If a full blown depression were to occur in the UK and US** then bonds could well be the place to be. If we look at the historical record of bonds in the thirties and Japan since 1990 a very powerful story emerges.

As economies slide the tax take slumps and benefit payments go through the roof so supply rockets. Normally, this course of events would lead to a slump in bond prices. But during a depression the flight to quality and the effects of deflation make Govt bonds highly attractive. In the thirties Gilts and US Treasuries were star performers providing dramatic capital gains and good income (incidentally during the "great depression of 1872-90 also saw UK consols outperform most other investments). More recently we have witnessed Japanese J bond yields fall to less than 1.5% from over 6% despite monumental supply. The capital gains have been spectacular and could be mimicked here over the next decade if we witness sub-par growth and deflation.

### GLOBAL EQUITIES

- The outlook for corporate profits has seldom been more uncertain.
- Global GDP growth in 2003 is likely to be lower than generally expected.
- The double-edged sword of leveraged balance sheets is taking its toll.
- A bull point for investors - markets are currently oversold and interest rates are low.

**Corporate “surprises” during a post super-cycle bull market environment are almost always negative.** First we saw the reckless borrowing and spending, including takeovers that have added little value in most instances. More recently, we have seen the corporate fraud, scams and dodgy accounting. While the worst examples have come from the US, corporate foolishness and shenanigans have certainly not been limited to that country. We assume there is more to be revealed, as companies move towards honest and prudent disclosure, if only to avoid the courts.

Unfortunately, the bad news will not cease with improving standards of boardroom integrity. While one assumes that there is a limit to excesses and that the majority of companies are honest (and isn't it outrageous that we even have to say this), few CEOs have any experience of the post super-cycle bull market environment, which will probably intensify some of the deflationary pressures. Governments, economists, financial analysts and corporate management are likely to underestimate economic problems. Most talk of a rebound in 2003 but this is likely to be much less than what is hoped for and needed.

There is no engine for global growth. The US economy still leads but only because of military spending. Data on consumer spending may bounce around a bit but the trend will be downward as households increase savings. Asia may appear somewhat more healthy than the West, if only because savings rates in the region are higher and it has already gone through many of the problems experienced elsewhere today. However Japan is still in no position to lead a global recovery and could easily fall back into recession due to the yen's rally. Asia's former little tigers have done comparatively well recently but are heavily dependant on exports to the US. These will decline due to slow GDP growth and a weaker dollar. No other country or region is in a position to take up the running.

**Technical conditions for a rally are falling into place.**

Stock markets have accelerated downwards in climactic fashion. There is clear evidence of capitulation selling. Sentiment is grim. Press headlines are uniformly bearish and feature the

corporate scandal du jour. The CBOE OEX Volatility Index, known as VIX, (see earlier) surged to over 50 during July, the highest and therefore most bullish reading since the 21st September peak of 57.31. Last but not least, there is technical evidence that the Fed has been intervening recently. Consequently markets should have established a medium-term low. Could this be THE low? We don't think so. Valuations are not low enough for a reversion to the mean overshoot, which is all the more likely now that the well of public confidence in the stock market has been poisoned by scandal. We continue to expect a series of medium-term recoveries, such as we saw from late September to January, followed by bigger sell offs. This pattern could last for years. We maintain we won't see the secular low until big-cap stocks sell around 10 times earnings and yield 4 to 6 percent.

**Debt will weigh on corporate profits for years.** In the late 1990s, when the self-serving fashion was to leverage balance sheets, often to use borrowings for stock repurchases to kite earnings and enable CEOs to cash in their options, this publication stated the obvious - leverage is a two-edged sword and companies would suffer in the next economic slowdown, let alone a recession. These debt chickens have come home to roost.

How do you climb out from under a debt mountain? Bankruptcy and default is the only quick way, which does no favours for shareholders and bondholders. Selling non-core assets is a popular route but these change hands for less than they are worth in a depressed market. Today, most companies would be delighted if they could float more shares to pay down debt, but how can they get a good price in this market? Restructuring helps, and the US has an advantage over the more heavily regulated Europe in this process. You can earn your way out of debt but this takes years. Of course not all companies are burdened with debt, but many are, and this doesn't help the business environment.

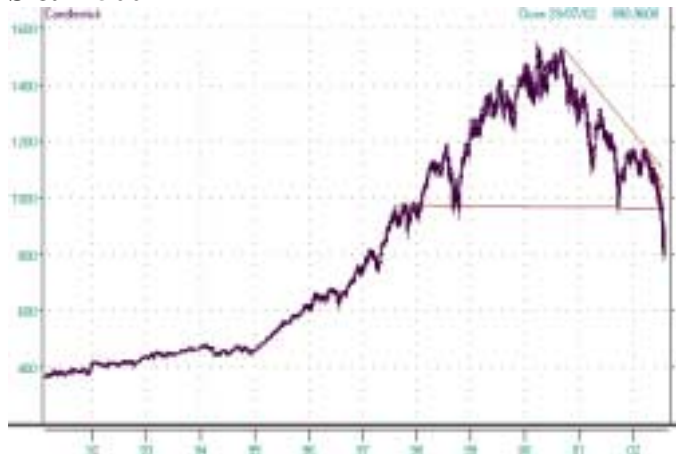
**The Ftse 100 below has descended to climactic lows at the significant 3600 level.** The dramatic weekly spike reversal looks capable of supporting higher prices for several months to come. We would expect a rally back to falter below 5000 and pause at around 4500/4600.

## FTSE 100 (weekly)



There has been much comment about a huge “head and shoulders” on the S&P. Whether, this pattern will fulfill its potential or not, it is great to see the FT converted to technical analysis. The neckline is around 1000 and we would expect a return stroke to this level before the declines resume. Thus our 20% target rally would be completed.

## S & P 500



The Dow (below) accelerated to dramatic lows last week. These falls were dramatically reversed in one day when the index started down over 180 points but ended the day up nearly 500! Such a dramatic reversal day accompanied by record volume and after such overall bearish sentiment should support market for several months at least. We expect the Dow to trade at least to 9000 when temporary resistance will be encountered but if that is overcome then a move to below the last trading range at 9500 looks possible.

## DOW JONES



Europe’s markets have also witnessed a dramatic reversal and as long as an Iraq attack does not occur will rally similarly to Anglo-Saxon markets. The Paris CAC below could rally all the way back to the major trend at around 4200 if resistance at the 9/11 lows can be overcome.

## PARIS CAC (weekly)



Well what can we say about Japan. Despite over 11 years of falls the index remains mired at the 15 year lows. The chart below at 9400 is under threat yet again as the index charts out a huge channel. We believe the Japanese index will struggle to make any real headway until the Yen finally trades at more competitive and realistic level.

The index now needs to move above 12000 to complete a base capable of substantially higher prices. Indeed such a base completion could propel prices to beyond 16000. However, a downside break would signify yet further weakness and new lows to beyond the current 75% decline.

## NIKKEI DOW (weekly)



The Malaysian market is a good representative of many of the Tiger economies. Although, they have suffered like all other markets lately this reversal has come after a strong recovery through 2001 and a test of the May high looks likely.

## MALAYSIAN KLSE (weekly)



## EQUITY SUMMARY

Major lows were established last week and we expect the lows to hold for many months. The current rally should prove to be highly tradable over the next few months. However, the rallies should be used for offloading equity holdings, as we do not believe that the bear is over by a long way.

## CURRENCIES

- **The euro is consolidating earlier gains but currency flows, particularly from central banks, will continue to favour the single currency over the medium term.**
- **Japan's government will continue to fight the appreciation of its currency and charts suggest they will succeed.**

**What percentage of global central bank reserves remains in US dollars?** There is a big lag in Bank for International Settlements statistics but we suspect the figure is not far off 70 percent. This is obviously high, even though the dollar will remain the basis for most international settlements. What should the percentage be? It certainly won't fall anywhere near US GDP, which is less than 25 percent of the global total. The key variable is confidence in alternatives to the dollar. With Japan's economy still in crisis and the Government wanting a weaker yen, there is only one viable alternative - the euro. While the Swiss franc, sterling and the Australian dollar have all been firm recently; these are not sufficiently liquid to absorb central bank diversification from dollars. The euro wins by default and we maintain it will rally to at least the \$1.10 to \$1.15 region against the greenback, if not quickly, within the next year or two. However there is a catch. Euroland and the ECB will not be happy with that additional gain, particularly if it occurs within the next few months, as this would compound the region's problems of slow economic growth. Moreover Europe's corporate regulation would delay restructuring, weighing on corporate profits, while government budget deficits would rise due to the fall in tax receipts. Conversely, a weaker US dollar will provide an additional boost to the US economy, already helped by the lowest interest rates for 40 years and high fiscal spending due to the necessary war against terrorism. Consequently, we also maintain that the dollar's decline is cyclical, rather than secular.

Meanwhile, the Bush Administration's justified criticism of CEO and accountancy firm ethics, which will lead to improved standards, is paradoxically hastening the flow of funds away from US assets.

**Japan remains the most interventionist country in terms of its currency.** Bank of Japan, acting on the Ministry of Finance's instructions, has intervened on numerous occasions during the last few years, mostly to prevent the yen from appreciating but also to halt the currency's more rapid declines. However with a chronic deflation problem, Japan fears yen strength more than weakness. The yen has been strong recently,

prompting intervention and considerable jawboning, with little success to date. Efforts have not been helped by a series of contradictory statements from the MoF's hapless Governor, Masajuro Shiokawa, who has become the laughing stock of foreign exchange. Additionally, BoJ Governor Masaru Hayami, while paying lip service to the hazards of an appreciating yen for export earnings, has at least partially sterilised recent intervention. Meanwhile currency traders, who are very good at running short-term trends, feel they have the MoF on the run and are extrapolating trends, which on longer-term data show the major currencies approaching or already in probable support from their bases against the yen. A Bloomberg report on 14th July was headlined, "Japan wants yen at 125-130", against the dollar. While markets can do anything in the very short term, we would not want to bet against the MoF, given its track record in managing the yen's level during recent years. Judging from the comments, it will continue to intervene until it succeeds.

**The dollar has seen falls against most currencies** over the past couple of months. The chart of the dollar index below shows the dramatic nature of recent weakness. The falls should be cushioned between 104 and 100, the old trading range in the late 90's. The dollar is unlikely to stage a strong sustainable recovery for some time although a temporary rally is overdue.

**US DOLLAR INDEX (monthly)**



**DOLLAR EURO (daily)**



The dollar looks set to extend its recent reversal against the euro with a move beyond .9800 likely to signal a move to .9400. However, we feel that the Euro will probably resume its relative strength sooner or later and move to new highs.

**DOLLAR YEN (weekly inverse)**



The dollar had a "doji" reversal last week at the 86-resistance level and looks set to resume its bull trend towards yen80 (128/30). With the Central bank on its side one would expect the yen to fall even against the relatively weak dollar

## DOLLAR POUND



The dollar looks to be also reversing recent weakness against the resurgent pound. The break of the strong uptrend suggests that the dollar could carry as far as 1.52. Confirmation of the reversal came not just via the candle action but also on the rate of change (ROC) momentum oscillator. The most recent highs by the pound over the past month were not confirmed by the ROC. This non-confirmation is an early warning of waning momentum and a strong confirmatory indicator of a reversal.

## STERLING EURO



The pound's form against the euro may carry a little further following the completion of the double bottom at 1.5750. The move will probably top out at around 161/162 resistance level. We would then expect euro strength to resume.

## STERLING YEN



The pound appears to have confirmed a rebound from the 180 support level. We expect the pound to now move on toward the 192 high where some resistance may be encountered. The interesting trade will occur on a break out above 192, which should signify a dramatic move for sterling.

## COMMODITIES

- **OPEC supply restrictions keeps oil high**
- **Gold corrects as expected**
- **Softs look soft**
- **WHEAT IS A BUY**

**Petroleum traders expect OPEC to hold quotas at their lowest level in 11 years.** They could be right but this seems unduly pessimistic to us. We've long maintained that high prices in 2000 provided such a boost to production capability, especially outside OPEC, that any rally in prices above the Cartel's publicly stated target of approximately \$25 for a barrel of crude would be unsustainable beyond the short term, as it would soon attract additional supplies. However, there are other factors. OPEC, off the record, would like a price nearer \$30, especially following the dollar's decline. Oil is also sometimes used as an instrument of foreign policy for the Middle East's producers. Western dealers are holding more supplies than usual, just in case the eventual toppling of Saddam causes temporary chaos. The US has been replenishing its strategic reserves. The demand for gasoline in the West is greater during summer months. The price for gas

unleaded (NYME) is pushing above 82.5¢ - an upside breakout. At current levels, petroleum prices are a negative factor for global GDP growth, especially in developing economies.

The chart below illustrates how oil has traded between \$24 and \$28 for the last few months. Whilst supply is tight and tensions remain in the Arab world we cannot foresee short-term weakness. Obviously, any attack on Iraq would lead to stratospheric prices but as yet the oil price is giving no early warning.

**.OIL (Nymex weekly)**



Gold has corrected recent massively overbought conditions where everyman and his dog were tipping the yellow metal. The correction to the key \$300 levels looks to be sufficient to unwind weak holdings but perhaps a little more backing and filling might yet be experienced.

**GOLD (weekly)**



**Coffee** is becoming tedious as we sit and await a potential turnaround in the long savage bear. As regular readers are aware we suspect that a major rally or even a new bull may well occur soon and we would tentatively enter new longs at \$55 with a completed reversal signaled above \$60.

**COFFEE (weekly)**



**Cocoa** was around \$1600 last month and we suggested that traders should keep stops tight but let the market run. It duly has run and we would now bring stops up to \$1700 to protect some good profits.

**COCOA (weekly)**



**Wheat** has long been highlighted as a “sleeper” in this publication. We first highlighted the potential

of any break above \$3.00 a bushel back in summer 2001 with a second focus in March this year.

As the long term chart shows wheat has been in decline for six years. Now however, with half the US on fire, silo stocks down to multi-year lows and famine in Africa the fundamental background for a rally in wheat is in place.

We now have a technical confirmation with a dramatic break out of the multi-year trading range. **The move over \$3.00 is significant and should herald a major bull market in the grain. We would suggest that all new positions should be protected with a very loose stop at \$3.00 a bushel.**

### WHEAT (monthly)



### FINALLY

As ever good luck with all your trading and please don't hesitate to e-mail us with your comments and observations.

Regards

Andrew McCarthy & Andrew Bartles