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THE "IRON CHANCELLOR" GETS HIS SUMS WRONG AND BORROWS £20 BILLION TO PLUG "BLACK HOLE"

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SURPRISE! The Government has to borrow extra monies to plug a financial hole. As trailed in this publication last April the "Iron Chancellor" who promised no more "boom and bust" recklessly increased UK growth assumptions from 2.5%pa to 2.75% despite the worst global slowdown since the 70's. But our master of post-classical economic theory(?) decreed that he was being "prudent." Perhaps he was being very Keynesian and indulging in a bit of contra-cyclical spending but we wonder why he felt he had to hide this policy if it is deliberate. More likely the Treasury was making assumptions in the usual manner using a rear view mirror and has simply grossly misjudged the degree of the slowdown. But matters are likely to get much worse! The lack of profits being generated by companies struggling to find any pricing power in a deflationary environment means an even smaller tax-take. Experian's latest corporate health check to June '02 reveals 13 consecutive quarters of falling profits. The average return on capital across the industrial economy fell from 10.4% to 7.6% over the twelve-month period to June 02. Profitability peaked in early 1999 at 14.2% and has since tumbled 47%. Worryingly, for the UK and Brown is that there appears to be no sign of recovery. Indeed the rate of decline between Q1 and Q2 was the fastest seen since the 13-quarter sequence of decline began. The current 7.6% return on capital is now lower than that "enjoyed" when the economy slid into recession in the early 90's.

With an economy slowing and a house price boom boiling over we are left to wonder how employment levels are to be maintained. Certainly, companies

Have no incentive at present to hire labour (hardly helped by Browns tax on jobs via NI changes due in April). Resultantly tax revenues from both employers and employees are likely to fall much further (as unemployment claims rise?) and blow the "Iron chancellors" prudent budgeting to pieces. So more tax and/or more borrowing is sure to follow as yet another Labour chancellor heads full steam towards the rocks of reckless spending.

PROPERTY

Since the bubble burst in Japan, the average house price has fallen in half, reports the Singapore Straits Times. Stock market losses are trivial in comparison, with \$17 trillion in lost value from property an amount equal to twice the nation's entire GDP!

In the UK we are reliably informed that house prices in London and the south-east (where over 120,000 city jobs have been lost in the last twelve months) are finally starting to ease, a trend that will no doubt spread geographically. The implications for the UK economy could be disastrous, as we believe that the relative out-performance of the British economy has been due to consumer confidence spawned by rising house prices. Thus the UK homeowner has been cushioned from stock price falls and has continued spending. Indeed, recent research suggests that record levels of refinancing have contributed an extra 6% to total consumer spending during 2001/02. Thus 6p in the pound represents Mr & Mrs UK literally spending the equity in their houses one brick at a time. Another startling fact that should set alarm bells ringing throughout the land is the level of re-mortgage financing that now represents 43% of all new advances during November. This is astronomical and unsustainable.

Whilst house prices climbed this "refi" posed no danger and actually helped bolster economic activity. BUT if prices begin to ease UK plc is faced by the unpalatable prospect of a housing "double whammy" consisting of negative equity and all the problems and hardships that entails, together with the evaporation of consumer confidence/spending as the 6% "refi" spending dries up. Thus, the UK economy could swing dramatically from international relative strength to

one of weakness as the housing whammy cripples any hopes of economic recovery.

BABY BOOMERS, DEBT AND PENSIONS

Over the last 20 years a generation of Americans and Brits- the baby boomers - leveraged their personal balance sheets to a degree without precedent in the history of economics. At the same time, they represent an enormous future pension liability for both governments. In the following essay Porter Stansberry of Pirate investor previews this looming economic crisis...one that will likely concern any observer of the Anglo-Saxon financial system.

Throughout history, even the most important and self-evident trends are often completely ignored because the changes they foreshadow are simply unthinkable...

Examples of big, problematic trends that the "elite" missed are too numerous to list here with any authority.

But consider: did the massive inflation of the 1970s come without significant warning early in the decade? No one said much when Nixon untied the dollar from its gold peg in 1971. There wasn't a huge outcry in the mass media against his price controls in 1972. And the rapid escalation of social spending coming from Johnson's "War on Poverty" went without critical analysis until the mid-1980s. Why did so few people see clearly what were huge and obvious warning signs of an enormous inflation?

*Not all trends are bad, of course. But many still go unnoticed. Take the bull market of the 1990s, for example. The Netscape IPO that launched the mania occurred in the spring of 1995...five years before the market's peak. Few people understood what was likely to happen. In his 1994 book, *The Road Ahead*, about the future of computer technologies, Bill Gates, doesn't even mention the word "Internet."*

The biggest trend we see in place right now can easily be captured in one word: debt. Since 1992, there's been an ominous shift in debt from the public to the private sector. Federal borrowing

rates have declined, while private borrowing has grown at a rate never seen before in America.

In 1992, the government borrowed around \$300 billion; private industry borrowed \$200 billion. Since then, private borrowing has increased every year except 2000 and now tallies over \$1 trillion per year. Federal borrowing, as you know, declined until mid-2000 and was actually negative for a few years (indicating a Federal surplus). But, overall net debts - private and Federal combined - increased during the whole period, moving from around \$500 billion per year in new debt to over \$1 trillion per year in net debt addition.

A high rate of debt growth, by itself, is not necessarily a problem. If these funds are invested wisely, if they spur new economic opportunities, then, as a percentage of the national balance sheet, these debts could remain sanguine. But that's not what has happened. Instead, since the 1960s, each new dollar of debt has added less than a dollar to economic growth. This indicates the economy is suffering from systematic declining returns. Today, each new dollar of debt adds about \$0.54 to economic growth (that's assuming the U.S. economy is growing at 2.5% a year - which it may not be).

The vast majority of the debts added in the 1990s were used to fuel massive financial speculation in corporations and home mortgages. As these financial assets begin to deflate, the debt remains, causing the debt to loom higher and higher as a percentage of assets. Total debt, as a percentage of GDP, has grown from around 150% in 1982 to nearly 300% today.

Unfortunately, not even this high debt load tells the whole story of future obligations.

As the bear market has ravaged the stock market, the assets of U.S. (and UK) pension funds were annihilated. State and local pension funds - whose figures are a matter of public record - have fallen in value from \$80 billion in 2000 to \$25 billion today...a 70% decline. Although I don't have complete figures for U.S. corporate pension funds, those numbers won't look much different from the state and local government accounts (which often use the same pension fund managers).

Meanwhile, news of enormous future charges to earnings based on the mandatory contributions to their sagging pension funds are filling the pages of the financial media. (Again much the same pension

problems are becoming apparent in the UK as witnessed by the recent "Panorama" programme on 24th Nov) For example, SBC announced this week it would take a \$2 billion charge against earnings next year to begin repairing its pension plan. Raytheon says it must pay \$500 million towards its pension fund over the next two years. Right now, Wall Street estimates that 10% of the S&P 500's earnings next year will go towards under funded pensions.

There is, of course, an even bigger under funded pension plan out there - Social Security. But describing the future impact of these costs requires more too much space and detail than available here.

Suffice it to say, there are two components to private debts - corporate debts and personal debts. The rise of personal debt isn't hard to figure out: who doesn't like to live beyond his means? On the other hand, understanding why companies have abandoned all fiscal responsibility isn't that easy. Corporate managers have leveraged their balance sheets and used debt to manipulate earnings in order to increase profits, 'grow' earnings and augment the value of their stock in the short term. Stock option compensation gives managers an incentive to take big risks. If the risks work, the managers receive windfall profits. If they don't, managers can walk away unscathed.

The worst abusers of shareholder trust aren't hard to find. Just look at America's biggest and most respected companies. IBM bought back \$9 billion worth of stock while issuing \$20 billion in new debt during Lou Gerstner's reign as CEO from 1993-2000. Why would you issue debt that costs you 8-12% in interest when your stock only pays a 1% dividend? The only reason you'd do this is to juice earnings in the short term. In the long term, you're only adding risk and shrinking your future profit margins.

But what did Lou care? He received 500 million stock options (all of which he sold when he retired in 2000). There's no doubt that Lou Gerstner leveraged IBM's balance sheet to increase its operating margin. That's not against the law...but it's not the way great companies are built. It's the way great companies are devoured. Since Gerstner's departure, IBM also admitted to booking asset sales as operating revenue - a common

accounting trick to hit earnings forecasts. Selling assets is also another way to leverage your balance sheet. Within one year of Lou's retirement, his replacement had taken huge billion-dollar charges, sold off major under performing businesses (hard drives) and closed non-performing (but long held) businesses like PCs.

Unbelievably, Gerstner wrote a self-congratulatory book about his tenure at IBM.

Or how about GE, perhaps the most respected company of all time? Since 1992, GE has been a net borrower. How could America's best company be a net borrower for ten years? Well, look at what the company is doing to make money, and it's easy to figure out.

About 50% of the company's total debt is in the form of short-term paper - the 90-day commercial paper market it can access thanks to an AAA rating by Moody's. The company uses this debt, which carries a low interest rate, to finance credit cards, which carry a high interest rate. If you walk into J.C. Penney or Macy's and take out a credit card, chances are pretty good that you're on the hook to GE. In total, GE Capital has spent \$43 billion on buying such receivables in the last three years alone.

And here's the scary part. Fifteen times since 1997, the company has sold a large batch of these securities (at a loss?) less than three weeks before the end of a quarter. That's how the company is able to match its earnings forecasts so precisely. Meanwhile, GE's debts have mounted. Today, its balance sheet stands precariously at four times debt to equity. Why take such risks? Because these debt-laden acquisitions accounted for 40% of GE's revenue growth from 1985 to 2000, according to Merrill Lynch analyst Jeanne Terrile (who retired immediately after publishing her study of GE's use of debt).

Again...these are America's best companies. As profit margins slipped in the '80s and '90s, corporations leveraged their balance sheets to make profits look better. More sophisticated companies played more sophisticated games. And the whole time, fundamentals continued to deteriorate without any clearly discernible warning.

Since 1975, capital expenditures have exceeded cash flow, meaning that corporations have been

raising debt or equity faster than profits. This game catches up to you as demand slowly declines. Eventually, capacity utilization rates begin to fall on everything from computers to credit cards, indicating a broad surplus of goods and services in the economy. And that's what we see was slowly happening, starting as early as 1985 and accelerating with amazing rapidity over the last two years.

Across the board in the US economy, capacity utilization has fallen from around 85-90% in 1985 to below 75% today, according to the Board of Governors of the Federal Reserve System. The data makes sense: areas of our economy that had the biggest investment boom show the biggest decline in capacity utilization today. Capacity utilization in electronics, for example, has declined from 90% in 1999 to under 65% today.

This rapid decline in capacity utilization is one of the symptoms of a credit bubble bursting.

A healthy economy is driven by savings-fuelled demand. When savings and investment become badly maladjusted, there will be problems. If you think of these problems in the abstract, they're easier to understand. Imagine your own family's balance sheet. What would happen if you maxed out every available credit source over the next six months? Your rate of consumption would soar, you'd place great demands on the economy and, eventually, your needs would slowly decline. You'd be left with few wants...and a lot of debts. You'd stop buying anything for a long time, until you were able to repair your family's balance sheet.

That's essentially what has gone on in America over the last ten years. The savings rate here declined from around 5% (which is weak) all the way to a negative figure in the late 1990s. People were spending more than they made each year, mostly by tapping into home equity loans (sounds familiar ed). Now we've reached the point where most people (and most corporations) are close to tapped out.

The amount of money people have borrowed against the value of their homes is unprecedented. Since 1992, quarterly adds to home mortgage debt have increased from around \$200 billion per quarter in 1992 to over \$600 billion in the most recent quarter. This is an amazing amount of debt.

Take a look at the data we have on consumer credit, which includes auto leases and home equity loans.

Back in 1992, consumer credit as a percentage of disposable personal income stood close to 16%. Today it's over 25%. And that means an overwhelming majority of people's income today is going towards taxes, interest and paying down debts.

Future demand is going to be weak...and could be for a surprisingly long time.

JAPAN and the US

Is history repeating itself?" asked a headline at CNNMONEY. The mainstream financial press is beginning to notice the similarities between Japan and the U.S.

Between '71 and '85 Japanese stocks rose 500%. Then in the next 5 years, they went up at an even faster rate - tripling again by the end of the decade.

Ten years later, Wall Street followed, with stocks up about 500% from '81 to '95, and then tripling in the 5 years, '95-'00.

In January of '90, the Japanese stock market headed down and had lost 30% of its value 18 months later.

In January (depending on what measure you use) '00, U.S. stocks entered a bear market. They were down about 30% 18 months later. Japanese householders never went so deeply into debt as their American (or British) counterparts, but the trend lines headed in the same direction. Savings rates in Japan fell 10 points during the boom, from about 20% down to 10%. In America, they fell 10 points too, but from near 10% down to near zero (a very similar story for UK savings rates which hit a low of 2% last year).

In both countries, businesses and individuals borrowed more than ever before.

The President and the Fed have urged Americans to spend, spend, spend, Viv Nicholson style, in order to keep the economy going. Bad advice or what! After all you don't throw a drowning man a bucket of water. You get rich by saving, not by spending. You produce something in order to gain revenue and you spend money in order to live and do your work. The difference is what makes you rich.

We could all go out and borrow a million. And if we spent it, our standard of living will shoot to the stars. But when we have to pay it back, our own personal debt deflation will kill our living standards...

Many Americans are now at the stage where they're going to have to pay some back. In both Japan and America, the bubbles were accompanied by all the usual rational explanations and hogwash.

The Japanese were all business geniuses in 1989.

Ten years later, Jack Welch, Ken Lay, Jeff Bezos, Kozlowski and Michael Saylor were the geniuses and people who had bought their stocks thought they were better investors than Warren Buffett. In both instances, neither the public nor the experts were prepared for what happened next. 'It is just a temporary slowdown,' said the experts on Japan in 1991. 'It will all be over by summer,' said the experts on America in 2001. But stocks did not go straight down and stay there. Instead, the two stock markets staged a series of alluring rallies - each one helping to convince investors to stay in stocks a while longer. When you look at the charts of almost any of these post-bubble price movements, you find the same pattern, of seemingly convincing rallies giving way to more falls. The high that will be hit sooner or later during the current rally might prove to be the high for the next 10 years.

The Dollar and the Mississippi bubble

At the height of "the bubble," just when the wheels started to come off, Mississippi John Law (a great account of both the Mississippi scheme and the South Sea Bubble can be found in the must read "popular delusions and the madness of crowds" by Charles Mackay published 1841) came up with a cunning plan to save his company and the Banque Royale. The year was 1720. Paris, over the previous three years and by virtue of Law's financial innovations, had become the largest and richest city in Europe. Law's "innovation" was paper money. At the outset of The Mississippi Scheme, Law had demanded, on the pain of death, that his banker's not print more money than could be redeemed in gold from their own reserves. The strict backing of the currency - what was essentially the world's first gold standard - gave investors of the day such confidence that the currency actually traded at a premium.

But there was a problem. Law's bank existed by virtue of a deal with the Regent of France, the Duc d'Orleans. The finances of the government in France following the reign of Louis XIV, his wars

and the building of Versailles, were a mess. Seeing how much value was being placed in the new bank notes of the Banque Royale, the Regent set another precedent modern readers will recognise: he decided to print his way out of debt. He suggested Law issue currency up to 80 times what the bank held in redeemable gold reserves. Law, being rather preoccupied with the power and prestige the Scheme had bestowed on him, ignored his previous warnings, and let the printing begin.

The new notes flooded into the market and for a while held the value they had gained with solid gold backing. So many people got rich, the Aristocracy of the time coined a new term to describe the: "millionaires". Stories of commoners making so much money fired the imaginations of thousands and thousands more investors and the frenzy got out of hand.

When people started getting wind of the fact that there was nothing backing Law's currency but rumours of future profits to be reaped in the New World, they started losing confidence in the new currency. Law trying to keep up appearances just a little longer rounded up all the beggars, bums and thieves in Paris, furnished them with picks and shovels, and marched them through Paris ostensibly on their way to New Orleans... and the mines of Mississippi. The quiet hiss of air leaking out of the bubble soon became a screeching "whoosh!" when the same old dirty faces began appearing in the same old dirty doorways and alleys.

In 1971, the almighty dollar was the last modern currency to be officially removed from the gold standard. Since that day, no one – not even the president of France- can redeem his or her paper money for gold. And the value of the dollar is largely determined by the confidence investors around the world foresee in future success of US economy.

Doing his part last month to keep up appearances just a little longer, Alan Greenspan lowered the Fed funds rate another 50 basis points.

And now Fed member Bernanke states that the Fed will print as much as is necessary to ensure that deflation is beaten. We believe him so maybe we will get a little bit of deflation and asset deflation before the printing press is cranked up to full speed and the inflationary forces let loose. Remember it is usually very hard to target a little bit of inflation.

Once that Jeanie is out of the bottle it is nigh on impossible to pop it back in. Watch the Dollar for signs of cracking under the strain.

WE HAVE ALL BEEN WARNED AND TAKEN NOTE!

INTEREST RATES AND BONDS

- **UK rates may well come down despite house price inflation**
- **EU rates cut “too little too late”**
- **T Bonds and Gilts may find temporary support at current levels.**

UK interest rates have been held at 4% for twelve months now. The Bank of England would surely have cut rates further by now as industry has slumped but the inflationary danger of the housing market has kept the bank very hawkish. Rates in the UK can only fall if the bank judges housing to be cooling. This may prove to be sooner than expected. At present the B of E has contented itself that if the US rate cuts do stimulate the US economy then most of the UK's industrial problems may well be solved without it having to act unilaterally. This cunning plan is undoubtedly valid but we suspect that the US will not recover and we will see new lows in UK rates in the forthcoming months.

The appointment of the hawkish Mr. King as “steady Eddies” successor will mean that inflation will always be targeted but at least any chance of the UK joining the fiasco that is the Euro is now more unlikely.

The ECB has no problems with inflation in Germany (quite the contrary) but the ludicrous “one size fits all” straight-jacket that is the Euro, has meant that rates were not cut because of fear of rising prices in other European countries.

Germany appears to be careering toward the economic abyss that Japan tumbled into 13 years ago. With chaotically sclerotic labour markets, massive budget deficits, high tax rates, unaffordable feather-bedded state pension arrangements and overly strong restrictive unions Germany desperately needs to kick start the economy before a deflationary spiral destroys the economy. But the ECB will not allow it. Of course as rates come down it could prove to be a case of “too little too

late". Europe will likely flirt with Japanese style levels of interest rates.

Meanwhile the yields on the world's key bond markets have been backing up since the end of September with both the notional US Treasury future seeing yields jump 75 basis points from 3.56%. The falls may come to a temporary end in the short term if the stock market begins to fall again as a flight to quality boosts demand for bonds. This is exactly what happened in September as investors fled the plunging Nasdaq and bought bonds creating an overbought bond market as stock markets were oversold!

US TREASURY BOND(weekly)



The US bond is likely to find support above 107 and rally back toward 112. However, we suspect the late September high will not be exceeded. Long term if the Fed keeps its word and prints money then US yields will rise and bonds will plummet in a worst of all worlds scenario.

UK GILT (weekly)



The UK gilt (above) looks set to find support above 117 as the gilt market consolidates the summer's gains. If inflation and Govt. borrowing becomes an issue we would expect the gilt future to eventually break below 117.

STOCKMARKETS

- **Defaults on bonds raise the costs of capital despite interest base rate cuts.**
- **Bear market has a long way to go.**
- **Major trend line break rallies to come to an end?**

Global corporate debt default continues to soar.

"Annual Global Corporate Defaulting Debt Amount", according to Standard & Poors, was all but non-existent in the early 1980s, before edging up to about \$8bn in 1989, before jumping over \$20bn during the recession years of 1990 and 1991. It then subsided for most of the decade before jumping to a record of nearly \$40bn in 1999. That figure was marginally exceeded in 2000 but defaults really soared in 2001, nearly reaching \$120bn. The 2002 tally to date, presumably through September, was nearly \$140bn. To pose the rhetorical question, after 4 consecutive records for annual corporate debt defaults, does anyone expect this problem to end soon?



Corporate debt defaults increase the borrowing costs for other firms, which lowers profits in a slow-growth environment, contributing to deflationary pressures. Equally as corporate yields continue to be historically high they impose an excessively deflationary burden on business. Thus despite interest rate cuts on both sides of the Atlantic the real costs of capital to business continue to climb and squeeze profits.

The 8-week rally on global equity markets has led to a return of “irrational exuberance.” After nearly three years of a deflating bubble it has taken only two months for many analysts to declare that the bear is over. The market sentiment indicators have turned excessively bullish with readings that are comparable to the March 2000 highs. This would lead us to believe that the market is due a turn lower and this weeks (Barmac break out readers will have seen the bear fund recommendation on 2nd Dec) weakness will probably follow through for few weeks.

Stocks such as Intel and Maxim have led the rally in the US as investors have traded the old speculative TMT stocks. PE ratios on such stocks are still well over 50 and are an indication of the purely speculative nature of the recent strength. Bear markets end when the last stock anyone would wish to purchase has a high beta. Speculators still have not given up the ghost so the final low is still not close by as yet. This bear has many more twists and turns along the road to the long-term mean valuation (below?) before buy and hold will become the order of the day once more.

The recent up-trends have been broken and suggest at least a partial re-test of October’s low. However, we believe that if support is found at or near the recent lows it may well prove to be a temporary respite. Both the Ftse and the Dow/S&P demonstrate the same confirmatory pattern and will probably rally back toward the underside of the recent trend break before “kissing goodbye” and heading south.

FTSE 100



DOW JONES



The Dow may find some temporary support at 8400 region.

NASDAQ



The move beyond the August high on the Nasdaq has reflected the highly speculative nature of the recent rally. The break of the recent up trend is extremely clear and should lead to a move to at least 1300.

NIKKEI



The Japanese market still demonstrates little sign of reversing the 13yr bear market. The first sign of a

revival would come with a move above the 3year down trend. The Japanese authorities have promised to buy equities to underpin a recovery but it may prove to be yet another false dawn. Certainly, no significant rally has begun and if any buying plan were to be a success we would have expected a move in advance. Sadly, the Japanese bear still seems as relentless as ever.

FOREX

- **Yen weakness resumes**
- **Dollar declines as supply soars**
- **Short the yen and dollar against pound and euro**
- **Euro to strengthen against sterling.**

Japan's bureaucrats are showing a new sense of urgency. They may not be achieving much but activity has increased. Unfortunately, it's mostly bickering rather than any quantum leap in deflation fighting, as consensus-favouring Japan remains unable to agree on policies. Hayami and Co at the BoJ are dead set against an inflation target, which Koizumi and the MoF favour. Hayami says this would push up bond yields and damage the central bank's credibility - as if it had any credibility to lose after four consecutive years of deflation on his watch as BoJ governor. 10-year JGB yields of just over 1 percent can only mean that monetary policy is deficient. It may not improve until Hayami is replaced on 20th March, when his term expires. The BoJ is printing lots of money, but it is being recycled through the commercial banks, which plough it straight back into JGBs. This buys up government paper but is of little help to the private economy. Meanwhile, Hayami 'sterilizes' (mops up) any liquidity that leaks into the economy, because he is trying to prevent the MoF from weakening the yen.

There are rumours that he has also told commercial banks to sell overseas investments rather than domestic shares or bonds, should they need additional capital. This would increase repatriation, providing further support for Japan's currency. Judging from the charts, it would only slow the yen's devaluation. International investors continue to pull money out of Japanese stocks, which have under performed US and even European equities in recent weeks. Forex traders prefer most other

developed country currencies to the yen on yield considerations, and the dollar because of the US's better growth potential. Additionally, recent calls in Japan for big tax cuts and much more fiscal spending can only mean another jump in government debt, necessitating further printing of money by the BoJ.

DOLLAR/YEN (weekly inverse)



As long as the dollar remains below 84 (above 119) there is potential for further dollar gains. A move beyond 86 would signal a major reversal in dollar fortunes.

YEN/POUND



Both the euro and the pound have firstly broken out from a 9 month trading range and since broken out of the recent autumnal consolidation. The scale of the base looks capable of supporting substantially higher prices and our preferred trade is short yen long sterling or euro. Protective stops should be placed at 121 euros and 190 sterling.

The dollar index has recommenced the dramatic declines that first began in early October. After first moving below key support (red trend line) the index fell to 104 before rallying back to kiss it goodbye (yes it is common). The major reversal day witnessed on 4/12 signals the onset of what may well turn out to be dramatic declines towards the 100 level.

Any dollar shorts should have a stop of 107.5, 97.5 against the euro (below) and perhaps £1.55 against sterling. We would favour using the dollar index on all shorts.

DOLLAR INDEX (daily)



DOLLAR/EURO



The most intriguing chart is perhaps the euro/sterling cross. The euro is again challenging the £1.55/6 levels and we suspect that this attempt could prove to be successful with potential for a surge in the euro. Traders should watch for any

move below 1.55 and short the pound with a stop at 1.58. Obviously, the euro may well back off once again so we would not advise traders to jump the gun.

EURO STERLING



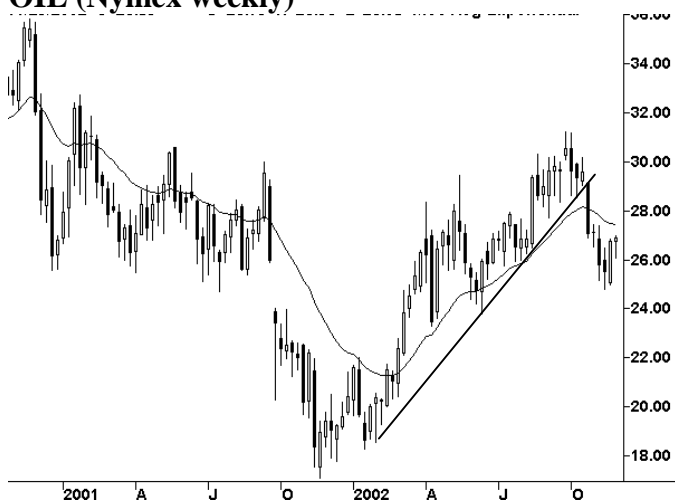
COMMODITIES

- **Oil war premium is eroded**
- **Gold completes a triangle and we await the breakout.**
- **Cotton and sugar strengthens as wheat loses momentum.**

Oil prices have found support at around \$25. Oil is likely to remain above this level while the threat of war in Iraq is present. The recent easing of tensions, which prompted the declines from \$30, could very quickly reverse. If and when war becomes imminent we expect new highs for oil futures that will further depress global economic activity. Meanwhile, support is evident at \$24 and a move below could open the way to significantly lower prices but we suspect prices may work their way back up toward the broken trend-line at \$30.

We would re-iterate our view that unless you have no choice then we would not attempt to trade oil as the potential high volatility is being driven by politics and not fundamentals. The charts are a guide but they will be unable to signal sudden changes in the political landscape. Options are the only way to back a view as once any war is over (or even begun) prices will plunge.

OIL (Nymex weekly)



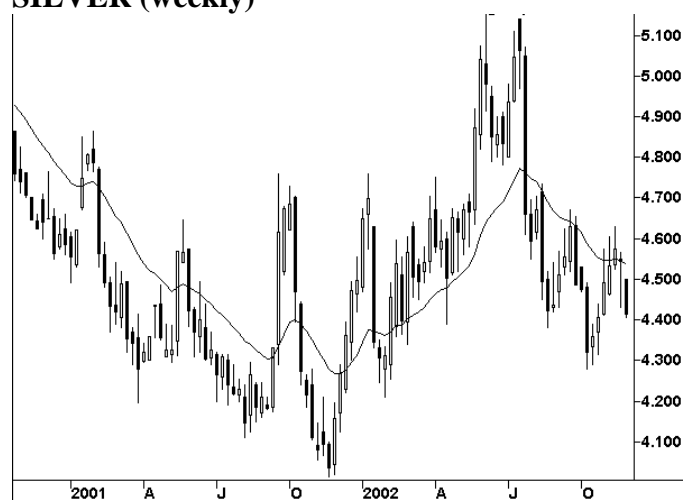
Gold is building an intriguing pattern at present that will herald a dramatic move. The question is in which direction! The key levels to watch are \$330 and \$315. Any move beyond these bounds will likely signify a powerful move of \$20/30 or more. Wait for the break and trade with the direction.

GOLD(weekly)



Silver is often seen as a high beta proxy for gold. However, the charts have no comparison at present as one glance at the chart below illustrates. This probably because the long-term fundamentals for silver are so bad as digital camera technology destroys the main industrial demand for the metal. If silver were to break below \$4.30 we would advise taking a short position, as war is unlikely to affect silver prices.

SILVER (weekly)



Wheat has lost momentum and is pressuring support at \$370. We would stand aside at present and perhaps go short if support is broken. Technically, support has been lost, as backwardation has been eroded over the past month. A move over \$410 is now needed to re-establish the bull case.

WHEAT (weekly)



Coffee has been a great success story for Barmac. We believe that we are only in the early stages of a major multi-year bull market and would advise investors to await another buying set-up before re-entering the market. At present prices are ranging around the \$68 level having been rejected from the \$75 level decisively by a major weekly key reversal candle. The downward pressure exerted by this price action is likely to last for some weeks to come and consequently would not be surprised to see lower price levels in the weeks to come. We would not trust any rallies in the short

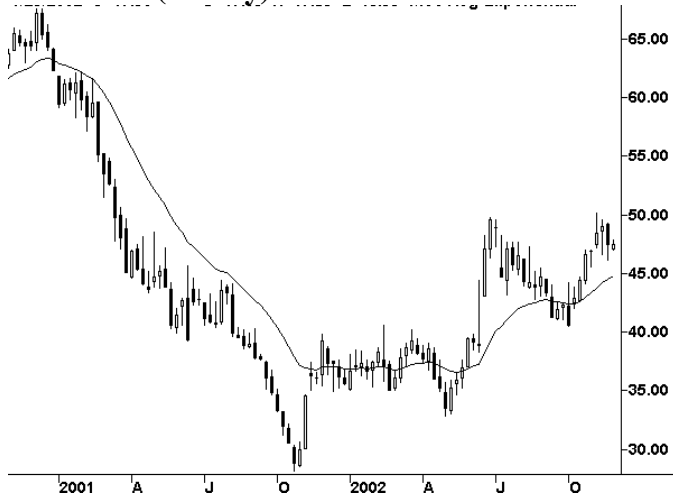
term as backwardation has narrowed, and unless prices exceed the \$75 mark

COFFEE (weekly)



Last month we advised buying cotton at \$47.50 with a stop of \$42.50. This has proven a profitable strategy and prices look set to move yet higher. Once \$50 is cleared prices could run very strongly. At present we would move the protective stop to \$45.

COTTON (weekly)



Sugar's advance has at present stalled at last month's levels of \$7.5/8.00 We were unfortunately stopped at the \$7.00 level but are keen to re-enter the position. The technicals remain positive with backwardation still present on the front month futures. We would suggest buying new longs at \$8.00 with a protective stop at \$7.25. We obviously

run the risk of being stopped out yet again but that is the only way to play volatile markets.

SUGAR (weekly)



FINALLY.

Many thanks for all your comments and feedback keep it coming as it is always stimulating and thought provoking. The next Barmac will be published during the first week in January.

May we wish all our readers a very merry Christmas and prosperous New Year.

Regards
Andrew McCarthy
Andrew Bartles