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## **NOW THAT THE WAR IS OVER, CAN INVESTORS WIN THE PEACE? -- Ans. PROBABLY NOT!**

### **1.GLOBAL ECONOMY**

**War rally short-lived?  
UK housing to fall.  
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Soybeans look very interesting**

**As predicted last month we have witnessed a strong “victory” and relief rally as the war has progressed relatively smoothly and timely for the allies.** Although sharp, the rally has so far being muted and only consistent with a bear market rally. Markets have risen from 3300 to around 3900 in the UK and 7400 to 8500 on the Dow as a response to the removal of one major uncertainty. But we can't help wondering here at Barmac whether investors can win the peace or will they take fright when they re-focus attention on what is happening in the global economy. After all stocks are still expensive (see below) unemployment is rising, consumer spending is tapped out, house prices are slowing before reversing (already happening in some parts of the south-east UK), companies are still drowning in debt and so is Joe Public.

The only definite bright spot is cheaper oil, which will indeed help stimulate business but probably not to the extent of overcoming the above economic quagmire.

**A UK HOUSING BUST WILL DEVASTATE THE ECONOMY.** According to both the Nationwide and Halifax house prices are still rising in the UK despite evidence to the contrary in the Southeast. The rise in prices and low interest rates have allowed householders to cash out equity at such an unprecedented rate that 6% of High St spending is directly due to debt refinancing. It is self-evident that this is unsustainable over even the medium term and when this trend reverses the hit to the UK economy will be catastrophic. A 6% fall in consumer spending would quickly erode Britain's relative economic out-performance and lead to a slump of 1930's proportion. This is the knife-edge

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On which the “iron Chancellor” finds himself balanced as he joins the borrowing boom to fund largely economically unproductive social(ist) spending, the benefits of which normally prove to be very dubious. It is our suspicion that most Central Govt spending (by any Govt around the world) is ultimately counter productive and only ends up running into the sands of beurocracy and over manning with very little making it’s way to the original target (yes, we are cynical).

Thus Brown’s massive deficit spending (which will get much worse as the tax take tanks along with industry and housing) can only lead to a “tipping point” where the already weakened UK economy collapses under the strain of recession and an overblown Government sector borrowing requirement (PSBR) that could undermine the pound and crucially drive up interest rates, thus killing the housing market.

Because it has only been the housing boom that has sustained Britain’s relative out-performance then Brown must realise that if his reckless policies ultimately drive up long term rates and lead to a higher tax take (stealth or otherwise) then the economy’s only prop will tank.

House prices have more than doubled in real terms (compared with wages) since 1987 and as such could fall an awful long way over the next few years. Just imagine the pain caused by widespread negative equity if housing slumps by 25% or more and the subsequent economic consequences. We believe prices could easily fall by this amount or more.

This vicious circle will destroy the Labour Government as has reckless tax and spend destroyed many others around the world.

## **CORPORATE PROFITS**

The article below by our favourite Austrian economist reprinted from the Daily reckoning highlights why recovery cannot occur until corporate profitability increases. This cannot occur as a result of an over-borrowed consumer sector but via capital investment. As this trend of weak profitability looks unlikely to reverse then both the economy and the stockmarkets look to remain moribund at best.

## **MACRO PROFIT-KILLERS**

**By Kurt Richebächer**

*In our opinion, the breaking of the U.S. economy's last boom had one main cause: a sudden slump in business fixed investment. But then, what exactly triggered this slump? The short answer is a corporate profit carnage that has been lingering for many years, and that has worsened dramatically in the last few years.*

*While Wall Street celebrated a profit miracle, the reality was America's worst profit performance in the whole post-war period. The present U.S. profit carnage started in earnest as early as 1997 - that is, at the height of the economy's boom. In the following four years to 2001, producer prices for finished goods increased altogether by 6.8%, or 1.7% per year. Over the same period, recorded productivity in the non-farm business sector increased by 10%, or 2.5% per year.*

*Under these excellent price and productivity conditions, profits ought to have soared during these years. But even though the economy boomed, nonfinancial profits dived from 6% to 3.3% of GDP, their lowest level in the whole post-war period.*

*After close investigation, we find that structural, profit-impinging influences began to develop in the early 1980s, but that they went to extreme excess during the boom years in the late 1990s. There is a common denominator to all such influences: a gross neglect of capital formation. In the United States, the spending excesses went totally into overspending on consumption, leaving an economy that has become extremely lopsided toward consumption to the detriment of capital investment.*

*The obsession with shareholder value has given rise to virtual anarchy in many fields of economics. One of them is macroeconomics, meaning the study of the economy as a whole. To understand the U.S. economy's deteriorating profit performance during the past few years, one must examine it from a macroeconomic perspective. Applying this perspective boils down to posing and examining one single and simple question to all corporate activities: How do such activities impact business revenues in the aggregate? The emphasis here is on the word aggregate. Changes in spending, saving, investing and, most important, taxing cause changes in profits*

through their effects on certain flows. >From the perspective of a single firm, firing labour, for example, seems a straightforward device to boost a firm's profits as it reduces costs. But looking at the economy as a whole, the lower wage costs mean an equal lowering of consumer incomes, which in further sequence, reduces consumer spending at the expense of other firms' revenue and profits. For the economy as a whole, wage-cutting is clearly self-defeating as a device to increase profits. Keeping this macroeconomic perspective in mind, let us examine the provenance of business revenues. Examined in the aggregate, business revenues have one major source that is generally crucial for profit creation: their own net capital investment. Net capital investment is typically the single most important profit source because - looking at the business sector as a whole - it creates business revenue without generating expenses. The reason is that the investing firms capitalize this spending in their balance sheets. But to the manufacturer who produces and sells the machine, it generates a sale and revenue. No expense is incurred until the first depreciation charge is recorded. A very high correlation between movements of net investment and profits is historically notorious.

As noted earlier, Corporate America's profitability turned ominously bad during the 1980s. As you will remember, the US was famous for its supply-side Reaganomics. In actual fact, there was no supply-side improvement in resource allocation. Fuelled by easy money and wealth effects in the stock market, consumption increased its share of GDP growth over the decade by seven percentage points to 70%. Net non-residential investment, on the other hand, increased modestly between 1980 and 1989 from \$129.2 billion to \$153.4 billion. As a share of GDP, it fell from 4.8% to 2.9%. What actually happened during this decade was an unusual, sudden sharp divergence between gross and net investment, reflecting a massive shift in Corporate America's fixed investment stance towards short-lived investment, mainly high-tech equipment. Gross investment rose by \$252.5 billion over the decade, or 70%, but depreciation charges soared by \$228.3 billion, or close to 100%, leaving very little net investment. Only net investment, however, adds to profits, while depreciation charges add to expenses.

As earlier explained, net business investment is typically the economy's largest profit source. But this profit source literally dried up in the 1980s. In the early 1990s, net business investment performed splendidly - and so did profits. But while net investment didn't turn sharply down again until the great bust - when it crumbled from \$407 billion to \$268 billion in one year - profits began to fall abruptly beginning in 1997. A major culprit behind this downturn was clearly the trade deficit. Over the 1980s and violently toward the end of the 1990s, profits came under heavy attack from the emerging and soaring trade deficit, as consumers began to spend an increasing share of their income on imported goods. The crucial point to keep in mind here is that in the aggregate, all incomes in an economy derive ultimately from business costs. The problem with a big trade deficit is that it diverts domestic spending towards foreign producers.

Conventional opinion holds that the soaring trade deficit squeezes business profits through price effects. It says that cheap foreign competition deprives domestic producers of their pricing power, as reflected in the declining U.S. inflation rates. No doubt, this contributes to the profit squeeze, yet it is not the main cause. By far the greatest part of the economy - services, retail and transportation, apart from airlines - is sheltered against foreign competition.

Nevertheless, we share the view that assigns a key role to the soaring trade deficit in hammering U.S. corporate profitability. But the devil is not in the price effects of the higher dollar. Rather, it is in the massive loss of revenue that American businesses incur due to the outflow of domestic spending to foreign producers. The problem is that much of the money spent on foreign goods comes from the wage expenses of American companies. If it were not for the trade deficit, all this money would return to these companies as Americans purchased domestic products, bolstering domestic revenues and profits. Instead, the trade deficit slashes U.S. business revenues in relation to expenses.

But didn't all the money that exited through the current account promptly return through the capital account, as foreigners bought American assets? Yes, but again, from a macroeconomic perspective, these

*flows match only in the balance of payments, not in the economy. Capital inflows do not invalidate spending outflows. Foreign purchases of U.S. assets may boost asset prices, but they add nothing to U.S. domestic incomes.*

*The steep slide of profits since 1997, happening against the backdrop of extreme monetary looseness, low interest rates and a booming economy, is shocking and indeed, portentous. Altogether, it allows no further doubt that the U.S. economy's protracted profit stress is not cyclical, but of deeper-seated, structural nature. This is a point that we have been emphasizing for years, pointing also to the two major macroeconomic causes - a low rate of net investment and the exploding trade deficit. It has been and still is strict macroeconomic considerations that induced us years ago to flatly disavow the brouhaha about a profit miracle in the United States. And the same considerations suggest to us that there is worse to come for profits and the economy.*

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So the good doctor suspects that worse is yet to come for the US economy and therefore the world as weak corporate profitability will impede any share price recovery.

The following facts perhaps put into perspective some of the above comments by Dr Richebacher

**The US manufacturing sector is in its worst shape in twenty years.** 26.6% of the US factories sit idle today, the lowest utilisation rate since June 1983.

**The US service sector lost 131,000 jobs in the last two months alone.** Service revenues contracted in February at the fastest rate on record ... and sank even further last month, according to the latest Fed survey.

**The US corporate pension crisis is getting worse by the day (see below).** At the end of last year, American companies' shortfall to their employees in defined benefit retirement plans reached an estimated \$300 BILLION.

**The deadly SARS virus is spreading.** According to the World Health Organization and top officials in Singapore and Hong Kong, SARS "... is here to stay." It's not going away.

**Finally, and not wishing to be alarmist but do not underestimate how SARS can impact an economy.**

Right now, it's already gutting Hong Kong, China, Singapore, and most of Southeast Asia. At first, it was mostly the airlines and hotels. Now, entire industries are being shut down.

This virus has already spread to parts of Europe, North America, and South America. If you think the war has put the economy on hold, imagine what this virus could do!

History shows that Malthusian checks are nothing new and the Western world would react much more hysterically (especially the media) to a flu pandemic than it did in 1917/19 to Spanish flu. Thus, we suspect SARS could be a big factor in the winter of 2003/4.

**PENSION CRISIS AFFECTS STOCKS AS WELL AS PEOPLE.**

It is natural to focus on the tragic human-interest consequences of the massive pension shortfalls that are becoming increasingly evident on both sides of the Atlantic. But many have overlooked the dramatic effect these deficits may have on both current and future corporate earnings. Perhaps of even more significance is the effect that mis-reported pension earnings are leading to a misleading picture of corporate PE ratio's. The figures below indicate that yet another reporting scandal exists in equity markets.

In his *GREED & fear* report, Christopher Wood highlights the US pension fund problem. He writes; *This came from the news that Charles Schwab is no longer contributing to its employees<sup>TM</sup> pension plan. In fact, it is only following several other companies which have already made similar announcements. The irony of course is that Charles Schwab was a major promoter of portable 401k pension plans. Another interesting point is that Fidelity has recently decided to lower the assumed return on its pension fund from 7.75% to 7%. This is of note since most corporates are still operating on significantly higher assumed returns and are still, amazingly, being allowed to book these theoretical returns to their profit & loss account.*

*The overall data on how pension fund accounting is distorting corporate profits is worth stating again lest investors forget about this issue in the excitement of seeing a rallying market. Thus Robert Herz,*

chairman of the Financial Accounting Standards Board (FASB), announced this month that FASB plans to look at a new pension accounting proposal. This would be significant. An interesting Bloomberg article last week noted that nine of the largest US companies reported a total US\$8bn gain from their pension funds in 2002 based on an average expected rate of return of 9.2%, while those funds actually lost 9.3% or US\$31bn (see table below). The result of a recent survey by Watson Wyatt also shows that nearly two-thirds of US corporate pension plans were underfunded in 2002, up from 16% in 1998.

**2002 pension earnings of nine of the largest US companies**

US\$bn	Reported	Actual
IBM	0.52	(6.94)
General Electric	1.56	(5.25)
Verizon Communications	2.50	(4.68)
SBC Communications	1.14	(3.40)
Boeing	0.40	(3.27)
Lucent Technologies	0.58	(2.47)
DuPont	0.22	(1.92)
Lockheed Martin	0.16	(1.40)
BellSouth	0.83	(1.28)
<b>TOTAL</b>	<b>7.90</b>	<b>(30.60)</b>

Source: Bloomberg For Greed and Fear report.

The above table provides a shocking insight into the (mis)reporting of company earnings and acts as a cautionary insight as to why all investors should treat the war rally to get out as markets are not cheap. Equities are much more expensive than they appear despite a very “bad” PE of 31 on the S&P (market lows are normally in the 10 to 12 range whilst most historic tops are at 25[ish]) the real number could well be even worse.

**When Bad Becomes Worse... 61% Worse!**

Here's what we mean: The S&P right now is trading at a price-to-earnings ratio of about 31. Based on that number, stocks are more expensive than they were at the stock market peaks in 1929 and the late 1960s. However, according to this week's Barron's magazine, that number is no good...

For example, Cisco's "official" price-to-earnings ratio is 34.6. That's high. But it gets even worse. If

you include employee stock options as an expense, **the true number becomes 71.1**. Ouch! And Cisco is more the rule than the exception when it comes to this - *Barron's* shows that, when *stock option grants* are accounted for, earnings at tech companies would have been **61% lower** than they reported in 2002. There is still amazingly some contention over whether or not granting employee stock options is a compensation expense. Consider the case of Cisco's CEO, John Chambers. Chambers worked for a \$1 salary (compensation) last year - or at least that's what shows on Cisco's books. The poor man... how could he even put food on the table? Why would he accept such a compensation package? Because \$1 in pay was only part of his deal - the rest included 4 million options granted to him last year. When you add it all up, Chambers has been compensated \$280 million over the last five years, and has **\$40+ billion worth of Cisco stock**. Clearly, even on a \$1 salary last year, he gets by. Somehow, Chambers has amassed a \$40 billion fortune in Cisco stock. But it didn't show on 2002's books. Whether you think this is right or not doesn't matter - because it looks like it will change for 2004. Companies must include option grants as an expense starting next year.

**So Stocks Are Even More Expensive Than Many Think.**

Standard & Poor's, keeper of the S&P 500 index, has done a noble job of trying to keep up with shenanigans to get down to what it calls "core" earnings (among other things, S&P counts stock options as an expense when calculating core earnings). S&P says that the price-to-"core" earnings ratio is around 37+.

People debate whether or not S&P's core earnings figure is the right one to use. Whether it is or not, the fact remains that, from what companies tell us, stocks are expensive. And from what they choose not to tell us (about stock option grants to executives and pension shortfalls for example), stocks are an even more expensive.

*Caveat Emptor!*

**DESPITE ALL THE EVIDENCE TO THE CONTRARY THE “CROWD” IS STILL BULLISH**

We wonder what it will take to turn the investment community bearish. Obviously, three years of falling stock prices, still crazy valuations, massive debt and

evidence of a potentially global deflation are not enough.

One of the major reasons we here at Barmac remain bearish is because investor psychology remains determinedly bullish. Is it we wonder because they are talking their book or are they just stupid. Certainly, most investment houses just don't get it. They try to analyse current market conditions in the context of average post-war recessions. They have not grasped the fact that the current bear is not just some cyclical slowdown but a long term and brutal secular bear market. Thus the analysis of equity and bond yields is irrelevant, as the concentration needs to focus upon the wealth destruction caused by falling asset prices.

The following excerpt from DWS' (Europe's largest fund manager) quarterly survey perhaps highlights our above points perfectly;

*We believe that US equity market lows of the last nine months will hold, because even the most conservative approach to stock valuation suggests that stocks now offer a 3-5% premium versus bonds in a variety of markets. At the lows in March, markets as diverse as the UK, Italy, Japan and Australia had dividend yields equal to or in excess of the local government bond yield. Bonds offer only yield in the long run, while stocks generate yield plus the potential for capital growth as compensation for higher risk. In some countries, higher yields for stocks than for bonds will limit forced selling by heavily regulated insurers. The attractiveness of stocks vs. bonds in the long run assumes that the world economy grows modestly over the next decade, without deflation. The risks of deflation will be discussed in more detail in an upcoming special report in Global Strategy, but our core view is that the western world avoids a Japan-style deflationary trap. Assuming that the normalised growth of the global economy plus inflation will be 4-5% over the next 10 years, stocks with high yield become attractive to economic buyers eager to arbitrage the relative value between real and financial assets. Under all but the worst-case scenarios, stocks offer a healthy premium to bonds, especially when trading down to the lows of the range they have been in since last summer.*

The commentary above is typical of 99% of all published commentary at present and therefore confirms that the consensus remains resolutely bullish. Whilst holding a minority contrary opinion does not guarantee making money it at least gives you the chance. The current bullish consensus is intuitively bearish and we continue to advise that all investors remain underweight equities or even gently short.

## INTEREST RATES AND BONDS

- **Further rate cuts still likely**
- **Bond yields look set to rise further.**

**The continuing global recession is almost certain to lead to further rate cuts.** We believe that certainly the Bank of England and the European Central Bank have plenty of scope for further cuts over the coming 12 months. We suspect that we will see no movement until at least the summer but as the economy continues to stagnate then cuts will surely follow.

In the US rates are already miniscule but the Fed may well cut even further when the expected post war rebound turns out to be a damp squibb.

UK and US Governments securities have both seen a dramatic sell-off during the past 6 weeks. Whilst we suspect that this move may be overdone in the short term we expect gilts and Treasuries to remain weak over the longer term on concerns over dramatic supply increases (Browns spending spree etc)

### UK GILT (weekly)



We see Gilts perhaps trading back toward 121 before re-testing the lows whilst the similar key levels for

the US note are 114 and 109 ( a break of which may signal a dramatic move).

### US TREASURY (weekly)



### GLOBAL EQUITY MARKETS.

- **The rule of alternation?**
- **War rally unlikely to have a long-term impact on equity markets.**
- **After the rally – what next?**

**An interesting idea relating to market action is the rule of alternation.** At present many analysts are sure that the victory in Iraq will cause the market to soar. They hold this conviction because in the '91 Gulf war the market soared. QED. Believing that the market will do the same as “last time” is a common error. It is potentially so misleading that Elliott formulated the opposite presumption and called it “the rule of alternation.” In this rule whatever the market did last time is the one thing that it is *least* likely to do this time.

Thus we would not expect the small scale war rally thus witnessed to progress much further than the highs already seen in March/April. Indeed, it would also imply that the war is not going to lead to a new prolonged bull run as it did in '91.

We know not whether this rule works or not but we like its' logic and suspect that it may well be based on good sense. We would not be surprised to see the war rally mark the beginning of a further slide rather than the precursor to a new bull. Let the Gods of the market decide.

**Periodic rallies aside, the macroeconomic problems will continue to limit upside scope for many years.**

Inevitably there are parallels between today's valuations and the early 1990s, which are often cited as justification for long-term bullish views. We're more concerned about the differences. Back then, the world was in the middle of a secular bull market. Today, we are in a secular bear market. Back then, companies were not suffering from a lack of pricing power. Balance sheets were not weighed down with heavy debt burdens in a deflationary environment. Famous and long-enduring companies were not facing bankruptcy. The toll of economic problems related to the biggest bubble in history are likely to result in fabulous bargains in terms of equity valuations, which we last saw in the early 1980s. Back then, the S&P 500 Index yielded 6.21 percent (2Q 1982). Today, it yields 1.61 percent. We believe the S&P 500 Index will yield at least 5 percent before another secular bull market is launched. It will probably take years to get there, through a combination of lower levels for the Index and a very long period of primarily sideways ranging, during which GDP growth is sufficient for companies to raise their dividends perhaps considerably over time. Meanwhile, valuations are sufficiently low for stock markets to experience periodic rallies of medium-term duration, followed by sharp sell offs and lots of sideways ranging. The good news is that in terms of total points lost, we have seen most of the bear market. Unfortunately, many indices could still fall another 25 to 50 percent over the next few years. Overall, we would not be surprised to see many peak to trough falls of approximately 75 percent, similar to all previous secular bear markets. However the first indices to fall that far will almost certainly decline further. For instance Japan although now cheap on a book to sales basis and after a fall of 80% or more could easily halve again.

**Here at Barmac we think the rally (if you hadn't guessed that already) is over.** Indeed we suspect that the worst is about to come with Wall St. potentially poised to lurch suddenly lower. The charts support this view but perhaps most importantly so does recent market behaviour. The latest leg of the rally was unable to make a significant new high beyond the March 21<sup>st</sup> peak. This is a significant

failure considering that the news does not get much better than the fall of Baghdad.

The failure on the 7<sup>th</sup> April also left in place a significant selling spike after the Dow closed up only 30 odd after an initial gain of over 240 points.

A similar pattern was witnessed on most other markets. The US markets then witnessed the toppling of Saddam's statue last week and the Wednesday high coincided exactly with the statues downfall to the minute. This intra-day rally was good for only 70 points illustrating the waning momentum. The war has now ceased to have any hold over the markets and as such stock prices have nothing better to concentrate upon than economic and earnings news.

The chart below illustrates how each bear rally has ended with a key reversal week and quite frequently with an outside down week (Opens higher than previous week but closes lower than low of previous week).

The week ending 11<sup>th</sup> April thus saw the end of the Iraq war, the fall of Baghdad, a selling spike and a key reversal week. All of which would suggest that prices could be about to head lower in the near term.

### S&P weekly chart



If we now look closely at the daily chart of the S&P we can clearly identify the significant selling spike. We suspect that days action marked a climactic collapse in investor optimism and for any bull case to be constructed the spike high would have to be

exceeded. Perhaps more crucially a move below the March 31<sup>st</sup> lows would open the way for a retest of the March 12<sup>th</sup> lows.

### S&P 500 (daily bar)



The FTSE has not experienced the same dramatic spike reversal as witnessed on the US indices and is at present holding above the short-term trend line. Any move 3800 could signal weakness.

### FTSE 100



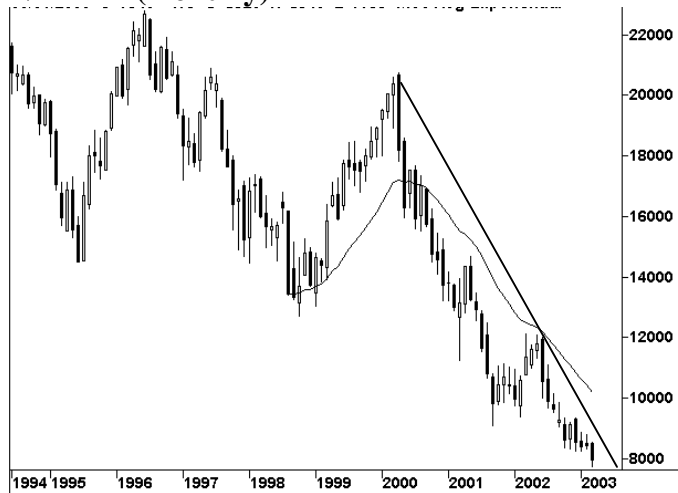
The German Dax (below) and the French CAC track each other and are still stuck within their downtrends. However the March lows do look to have at least near term significance with a clear weekly spike low. This low could hold for quite some time but with potential weakness possible on Wall St then perhaps these lows will be retested. Meanwhile, the index looks set to outperform on the upside if the US market does not decline.

## DAX (weekly)



Oh dear! What can we say about the poor old Nikkei. The market is breaking yet again to multi-year lows as the index slips south along with the deflationary economy. Surely one day a rally will unfold and our own weariness make us wonder if it may well take us all by surprise. At present a move over 9000 and beyond the dominant down trend would provide some initial evidence of a reversal of fortune.

## NIKKEI (monthly)



## FOREX

- **Forex quiet over past month as Euro consolidates gains**
- **Oversold Dollar to rally a little further**
- **Pound also set for rebound**

**The past month has seen most cross rates remain fairly constant.** The declines in the Dollar and the pound have halted whilst the Euro's advance has at

least paused. We suspect that contra-trend moves have begun which may well last for some months in order to unwind the powerful trends that had been in force since the Autumn. This does not mean we believe the Euro's advance is over but merely taking a "breather". The Yen has paused in its recent advance as the market contemplates the implications of the appointment of a new Governor of the BOJ in Fukui.

We suspect that over the longer term the Japanese will finally accept that their only way to avoid the ongoing crippling deflation is for an active policy of devaluation.

This policy will see the Dollar trading above the 98 highs of \$1.49 and could even see yen 200. The pound will also rally strongly once the Japanese actively devalue. However patience is the order of the day as it may be a year or so as yet before the BOJ finally adopts the devaluation policy.

**Why should the euro eventually resume its uptrend against the dollar, when the US economy is so clearly stronger, more adaptable and resilient than Euroland?** There are a number of reasons. Unofficially, the US is happy to see a softer dollar, which will increase the competitiveness of US goods. Geopolitical considerations following 9/11, including the freezing of suspected terrorist organisation funds, has caused a number of Middle Eastern investors to pull out of the US. More importantly, the Federal Reserve continues to rapidly increase the supply of dollars in circulation. This is to avoid Japanese-style deflation, help to finance the current account deficit, fund the war and also global terrorism. Since everyone in the forex markets knows this, it is partially discounted, which is another reason for the euro's present correction. More importantly, with no end to the US's rapid reflation in sight, many central banks with large surpluses will continue to diversify away from the US dollar. Remember, 77 percent of the reserves held by central banks were in US dollars at the beginning of 2002, according to most estimates. That was an overweight position by any definition. It did not make sense. The problem was in finding a viable alternative. Understandably few central banks wanted yen, because of Japan's deflation, which is unlikely to be reversed without an eventual devaluation, if the last 200 year's financial history remains a reliable guide. There is insufficient

liquidity in the Swiss franc and sterling for these currencies to rival the US dollar as significant repositories for central bank reserves.

As for hard money, there is not enough gold available for more than a small diversification into the yellow metal. This leaves the euro by default, despite Euroland's basket-case economies, institutionalised structural rigidities, and a belief among many outside the region that a single currency for an increasing number of culturally and linguistically diverse countries is likely to be a dodo. Aside from the essential issue of liquidity, the euro has another advantage - its supply is increasing far less rapidly than the quantity of additional dollars and yen. And this last fact is perhaps the final bull point for the Euro.

**The Dollar has stopped falling for the first time in over 6 months** and could well range gently higher for a few months. The rebound is unlikely to exceed resistance at 105/107. After the recent falls have been worked off the dollar will likely resume its declines which are due to the Fed's dollar printing.

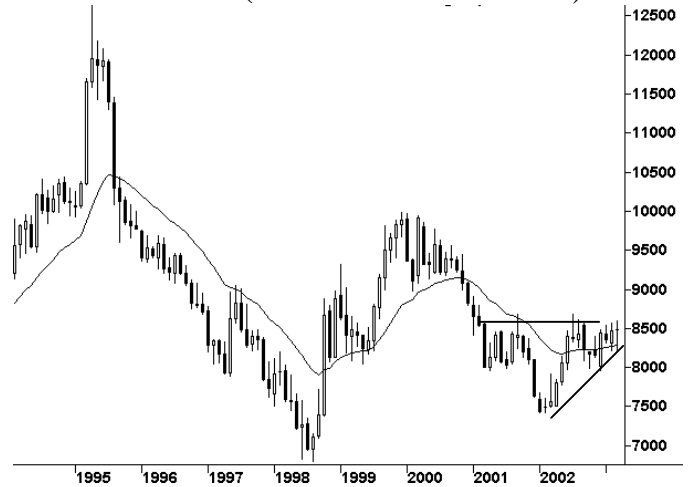
**Dollar Index (weekly)**



**The Dollar has traded broadly sideways** over the past 12 months and a move over 85.00 would complete a potential head and shoulders reversal pattern. Everyone in the market is aware of this pattern and as such we are not convinced the dollar would collapse toward 100 versus the yen if the pattern were to complete but who knows? In the meantime a push below 80.00 would support a period of relative dollar strength, which should be

tradable. As the pattern unfolds the next major moves should become clearer.

**DOLLAR /YEN (INVERSE MONTHLY)**



**The Euro appears to have lost upside momentum against the dollar.** The recent pause in the advance looks set to continue for at least a few more weeks. We will be watching for any sign of a move below 105 that could open the way for a dollar advance to the previous consolidation area of 100 (the likely support area). In the meantime we would stand aside from this cross.

**Euro/Dollar (weekly)**



**The technicals suggest that the pound should bounce against the leading currency crosses.** The chart below against the US unit highlights the divergence between price action and momentum where price is falling to new lows but momentum is no longer confirming this price action. Now we are

not hung up on technical indicators but this simple study leads us to suspect that a short term rally is likely especially as this divergence is evident on the other sterling crosses.

The pound could well trade above the recent downtrend and up towards 1.60/2. We do not at present expect this potential move to be more than a short-term retracement of recent losses.

### Pound/Dollar



The pound euro cross has seen a pause in the euro's strong 6 month advance. A rebound toward 1.50 looks likely with momentum again suggesting a short term reversal of trend is likely. We are cautious of how strong any move may prove to be but would back a small position backing the pound with a stop at 1.44.

### Pound/Euro



**The Japanese Yen** cross is still in a long-term trend but has been extremely choppy lately. The recent move down to 185 has created a small trading range of 185/190 and we would stand aside whilst within this area. However, any further Yen

strength should not exceed 180 where major long-term support should stem any sterling decline. Conversely, a close above 190 may well indicate a challenge of the recent highs.

### Pound/Yen



## COMMODITIES

- **Oil has corrected as predicted as war premium expires**
- **Gold is oversold and may rally prior to further falls.**
- **CRB index may well have peaked**
- **Coffee is still unable to move strongly higher**
- **Soybeans look interesting as cotton confounds bears.**

**Last month we advised speculators to short oil** once the war began as we felt that the price would continue to slide even after the first wave of initial declines. Anyone following this advice should have been able to execute around \$30/32 and should have made a handy profit. We suspect that prices have plenty further to fall yet and expect \$20 to be hit before the summer is over. A move under \$27 (below) could signal the next leg down.

### Oil (Nymex daily)



### Oil (Nymex weekly)



**Gold has eased back to our target area** and may well enjoy a short rebound but we expect prices to remain soft for the near term.

### Gold (weekly)



**The CRB index** (below) appears to have posted a top of at least medium term significance that marks the end of the current bull-run for commodities. The index has seen a move of over 35% from the lows of mid2002. The current pull-back looks capable of extending further over coming months. We will use this as a guide when considering the direction of commodity trades.

Meanwhile, the index could be shorted on a break of the recent lows with a buy stop at 232.

### CRB index (weekly)



**Cocoa's chart shows an ongoing 3 month consolidation** that is currently challenging the lower boundaries of the trading range. As ever we would follow any break out either higher or lower as the "set-up" looks capable of providing a strong move. We wonder if the move will be ultimately higher as thanks to work by our old friend Peter Rhodes the technical price action on the contango/backwardation suggests at present a move higher.

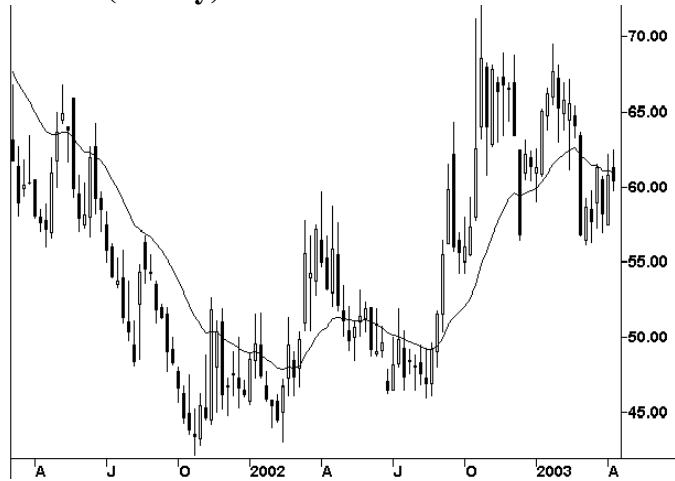
### Cocoa (weekly)



**Coffee appears to be still digesting the gains achieved in late 2002.** This process could well

continue for a while longer as resistance between 65 and 70 looks at present quite formidable. A move below \$55 would suggest a retest of last years lows.

**Coffee (weekly)**



**Last month we felt that the phenomenal run in cotton (first highlighted in Barmac at \$30 over 12 months ago) was drawing to an end.** Despite last months set back cotton has surged on to new highs. The bull looks over-extended to us but cotton has confounded us more than once. A move below \$55 might signal at least the onset of a period of consolidation but for those still long we would take our profits now.

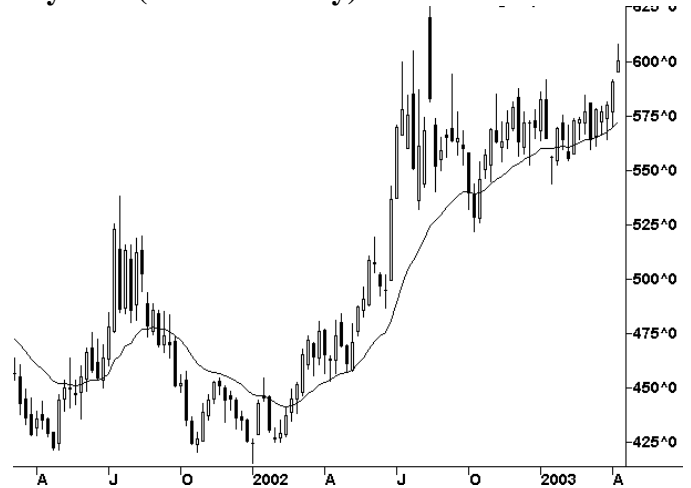
**Cotton (weekly)**



**Soybeans have not always been closely followed in the Barmac, but this month the pattern that appears to be unfolding appears to be of great interest.** The beans had been trading sideways in a range with a rising floor. The chart below clearly illustrates the dramatic nature of the sudden surge

up and out of the previous range. We would suggest that this move could well be bought with a trailing stop at \$5.75. There is some resistance near last years high but if that is overcome prices could possibly run on strongly.

**Soybean ( CBoT. weekly)**



**FINALLY**

**May we apologise for the late production of this months newsletter which was due to various holiday commitments.**

**We wish all our readers a most enjoyable Easter break and hope the unusual spring sunshine lasts a few more days.**

**Regards**

**Andy McCarthy**

**Andrew Bartles**