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IS THE DOLLAR COLLAPSE AMERICA'S REVENGE ON FRANCE AND GERMANY?

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We at Barmac believe a full and comprehensive understanding of history is the single most important discipline any politician, general, scientist, student and investor can possibly have. History is the great teacher and its lessons can provide an insight into the future and help prevent hubris. Sadly the discipline is somewhat undervalued in modern society, not helped by philistine comments by Henry Ford and Government education policies that treat children with all the humanity, humour and soul of a VAT inspector on mogadon

The current state of the dollar reminds us of previous periods of historic turmoil in the forex markets. In the depression years of the 1930's the gold standard was abandoned by GB and most other major economies as a deliberate policy of "beggar thy neighbour" became de-facto in the foreign currency markets. Nation after nation sought competitive advantage via active devaluation of their currency. The nation states hoped that a cheaper currency may stimulate their economies in order to offset the global slowdown. This cunning plan unfortunately had two basic flaws, which were overlooked by the politicians. Firstly, the simple Newtonian law that "every action has an equal and opposite reaction" applies equally to economics as it does to physics. Thus country (a) will only gain a short term advantage via a currency devaluation (imports become relatively more expensive and exports more competitive) and this gain is at the expense of other competitor countries whose own less competitive industries will experience an increased downturn. This will limit that countries demand for products and services from country (a).

Thus the benefit of the Devaluation is short lived as foreign demand slumps and prices are cut.

The second major problem with the plan is the simple fact that other Governments will retaliate by devaluing their own currencies leading to a spiral of competing devaluations destroying international co-operation and trust.

This scenario may be playing out at present as the US Fed prints money and quietly allows the dollar to slide 25% against the Euro over the past year. The Euro is unable to retaliate at present because the ECB is rigidly bound by inflation rules imposed by Maastricht etc. Many Americans may well believe that the French and Germans deserve their uncompetitive Euro but as the EU slides ever deeper into the economic mire consumer demand in Europe is collapsing. The death rattle of the EU economy will have serious consequences for the global economy just as Japan's has over the last decade.

The dollars slide looks overstretched right now and we suspect that the dollar may turn higher toward at least 1.05 euros over the next 3 or 4 months. However, the long-term trend for the buck is down as supply creates a world awash with dollars and new supply continues to outstrip demand.

STOCK EARNINGS

With nearly 90% of the S&P 500 membership having reported their first-quarter results, ISI Group observes, the year-over-year rise in earnings stands at a hefty 14.7%. If we assume that accounting gimmickry is a thing of the past and that the reported earnings are squeaky clean. Even granting that dubious assumption, the 14.7% earnings growth reported by the S&P 500 is far less robust than it would appear.

Barron's points out, *"the overall S&P 500 numbers got a big boost from energy companies, whose profits swelled by more than 200% over the prior year, thanks to the ramps in oil and natural-gas prices, which have already subsided. The second boost, was the salutary impact of the sinking dollar on the books of multinational companies. By some estimates, the benefit of translating euros and yen into dollars at a favourable exchange rate was responsible for virtually all of the top-line growth evidenced by large companies so far this year."*

Net-net, the "strong" quarter owes its entire strength to a rising oil price and a falling dollar.

Hmmm...that does not exactly seem like a textbook formula for strong earnings growth, much less for sustainable economic growth.

INSIDERS SELLING.

Wall Street would love for you to think that the next bull market is right around the corner. But the people who really know what's going on -- company insiders -- know this is nothing more than a bear market rally. Here's proof: They're SELLING their own company's shares hand-over-fist -- not buying!

In fact, roughly seven out of every 10 recent insider transactions are "sell" orders, according to Market Profile Theorems. That means the "smart" money -- people with inside working knowledge -- are getting out fast! If this were a real bull market, insiders would be buying like crazy, not getting out at record numbers.

In April, there were 31% more companies filing for insider sales than buys, according to InsiderInsights.com.

- Only 664 companies had insiders who bought shares in April. That's the smallest number since InsiderInsights began keeping records in the mid-90s!
- Insider buying plunged 40% from March to \$70 million, according to Thomson Financial. This is just the third time since 1998 that insider buying has fallen below \$100 million.
- Ted Turner -- the biggest shareholder in AOL Time Warner -- just dumped an astonishing 60 million shares of AOL stock worth \$784 million. That's more than half his holdings in the company. And it shows that America's corporate elite are getting out, too!

The fact is insiders are getting out because they know the recent market action is not the start of a new bull market and may well be nothing more than a bull trap.

SPECULATIVE FROTH!

Do you know which stock traded at the highest volume on the Dow on the 8th May?

Ans. Lucent Technology...

It's been two years since Lucent traded above \$10. And over three since it began its spectacular decline from a peak of \$51. The stock closed at a little over \$2. Yet Lucent was the most actively traded stock on the NYSE... trading over 60 million shares.

Isn't this incredible? Three years after the burst of the tech-bubble... in the midst of an historic bear market... investors are still mindlessly speculating in losing stocks with little hope of recovery.

Here at Barnac we remain deeply sceptical of the current rally and suspect it may all end in tears.

What would the late, great economist F.A. Hayek have to say about the economic mess we're in? If he were inclined to gloat, suggests Apogee Research's Andrew Kashdan, he'd have good reason to say, "I told you so."

HAYEK, THE FED and THE DOUBLE DIP

By Andrew Kashdan

To even the most casual observer of the stock market and economy over the past 3 years, the failure of the Keynesian "print-and-spend" approach to curing a business cycle downturn has become glaringly evident.

Regardless, most people will continue to believe in it, of course, but a few are groping for a better explanation of how we got into our current rut, and why we're having so much trouble getting out of it.

Today we offer an explanation put forth more than 70 years ago by F.A. Hayek, because for the most part, his basic insights hold up as well in today's market as they did following the Great Crash.

Building on the monetary theory of Ludwig von Mises, Hayek would later receive the Nobel Prize. Reason enough, we think, to look for guidance in one of his perhaps forgotten tomes like "Prices and Production," which Hayek wrote in the depression year of 1931.

Attempts to cope with the Great Depression caused Hayek's contemporaries to ask: Doesn't the existence of unused resources in the economy justify

the expansion of the money supply? To which Hayek responded "no", explaining that all monetary expansion distorts the structure of production. Similarly, today, Hayek's response explains why Fed easing and seemingly strong consumer spending hasn't gotten us out of the slump.

Far from being the answer to our problems, Hayek argued: "[I]t should be fairly clear that the granting of credit to consumers, which has recently been so strongly advocated as a cure for depression, would in fact have quite the contrary effect; a relative increase of the demand for consumers' goods could only make matters worse." The reason, in brief, is that the structure of production - that is, the economy's particular use of capital goods - must be adapted to the true savings preferences of consumers, as opposed to the distorted consumption and investment decisions prompted by monetary expansion. In other words, notwithstanding the sage advice of Dallas Fed President Robert McTeer, our economy would not be better off if every American rushed out to buy an SUV.

For those who consider Hayek's stance too dogmatic, it is interesting to note that he actually acknowledged the theoretical possibility of a beneficial monetary expansion that favoured producers (as opposed to consumers), if it occurred at the beginning of a downturn. But the emphasis is on "theoretical", for such an expansion would have to be so carefully regulated and then withdrawn that Hayek admitted, "Frankly, I do not see how the banks can ever be in a position to keep credit within these limits." He concluded by arguing against "the well-meaning but dangerous proposals to fight depression by 'a little inflation.'" Sound familiar?

Furthermore, while Mr. Greenspan tells us that nothing could have been done during the boom to prevent the bust, and now all he can do is address its after-effects, Hayek held the exact opposite view: "[W]e arrive at results which only confirm the old truth that we may perhaps prevent a crisis by checking expansion in time, but that we can do nothing to get out of it before its natural end, once it has come."

Yet, not all the blame for post-boom economic distress should be put on the regulators of the monetary system.

Capitol Hill deserves its proper share of blame as well. "Certain kinds of State action," Hayek said at the end of his book, "by causing a shift in demand from producers' goods to consumers' goods, may cause...prolonged stagnation.

This may be true of increased public expenditure in general or of particular forms of taxation or particular forms of public expenditure." So where does all this leave us? In short, with many investments that still need to be liquidated before a healthy and sustainable expansion can begin. Such a process is difficult in the best of times, and unfortunately war and vastly expanded government spending will only divert resources away from economically productive uses, no matter how much "stimulus" it appears to bring.

The symptoms of the continuing post-bubble adjustment are all around us. There is weakness in retail sales, consumer confidence, business investment and employment, to name but a few areas of malaise. The eternal optimists among us are quick to blame "temporary" factors like oil prices, "geopolitics" and cold weather as the culprits. We would point out, however, that this is merely what happens when growth is weak and the economy is vulnerable to an external shock. It hardly matters which particular event triggers another downturn. The good news so far is that oil prices have not spiked further - a sustained increase would certainly send us back into recession. But a tour of recent economic indicators makes it clear that we have indeed hit another "soft patch" (to use the soothing words favoured by the Fed chairman). First, let's consider the labour market. As everyone has heard repeatedly, the employment situation is a lagging indicator. But what was a convenient excuse at the beginning of the recession has now become evidence that the recovery never quite got on track after all.

As the Fed's Beige Book for the first few months of the year puts it: "Business spending remained very soft as geopolitical concerns and uncertainty over the strength of demand continued to constrain spending and hiring plans."

Stephen Roach, crack Morgan Stanley economist, goes straight for the jugular when he blames the deterioration in the labour market for the "high and rising" odds of recession. Other indicators also

bring into sharp relief the recent setback in the economy. For instance, although industrial production growth has rebounded from negative territory, it hardly compares to previous recovery periods, and already appears to be levelling off.

The manufacturing industry will certainly not find it any more comforting to hear that GDP growth is still positive. The Institute for Supply Management's index tumbled to 46.2 in March, below the expansion level, and down from 50.5 in February and 53.9 in January - now the lowest since right after September 11. ISM survey chairman Norbert Ore was correct last month when he observed that the drop seemed to be more than a temporary blip. The ISM survey also showed that jobs in the manufacturing sector continue to disappear. And after it looked like they might finally be moving in the right direction, jobless claims are heading higher once again.

Indicative of the investment overhang, non-residential private construction remains very weak, down 15% from a year ago, and 30% from its peak in 2000. How long will low interest rates continue to boost the residential market? Not forever is our unhelpful guess. Housing starts are already declining, and the inventory of unsold homes has risen sharply since the beginning of the year.

Of course, all this could change if the removal of Saddam Hussein really is the answer to all of our economic problems. We're just not betting on it. If there is one benefit to all the troubles we find ourselves in, perhaps it is the learning of some very old lessons.

War is never good for the economy, and when it comes to monetary policy, there still ain't no free lunch.

We fully endorse all Andrew Kashdan comments and remain big fans of the Hayek school of economics due to the simple common sense notion that the size of the hangover is commensurate to how much you had to drink. Thus the post bubble environment is likely to remain bilious for some while yet.

Bull market in Government?

We wonder whether UK citizens will get a referendum on the new nightmare EU constitution

being promoted by the distinctly shady and allegedly corrupt diamond Lill (Valerie Giscard d'Estaing). Big communist/fascist style government is alive and kicking and ready to suck the lifeblood out of the UK and Europe with yet more bureaucrats. Whether the UK was right or wrong to attack Iraq, at least our elected representatives had the choice. Not any more if the new Napoleons, Hitler's and uncle Joe Stalins' of the EU have their merry little way.

It is a vote Blair knows he will lose, like he would the Euro, so will he do a Ted Heath and railroad Britons into a new anti-American superstate?

After all Government is in a bull market globally at present, as people forget the lessons of Eastern Europe and the terrible '70's. Each generation has to relearn that Government intervention no matter how well intentioned, is normally counter productive. Politicians understanding of economics, free enterprise and business could be written on the back of a postage stamp. Thus, it makes no sense whatever to promote an interventionist Government that will ultimately only waste our money. But, sadly we never learn. The same tendencies are also present in the US.

"*Is Big Government Back?*" asked Tom Gallagher in a talk he delivered on March 24 before the National Association of Business Economics. "*For the better part of the last 20 years,*" writes Gallagher, Washington analyst for the ISI Group, "*the prevailing approach to solving problems was to reduce the role of government. Now I think we are on a trend in which the predominant approach to solving problems will involve an expanded role for government...*"

PIMCO's Paul McCulley seconds the notion that a bull market in government is underway. As McCulley points out in a recent interview with Welling@Weeden, "*There are a number of things that capitalism really can't do very well. The top two on the list, I think, are dealing with deflation risk and providing national security. The upshot is that we've had a profound one-two punch for a bull market in government...*"

"*A bull market in capitalism was good for a tripling of the P/E multiple during the 1980s and '90s - the tripling of the P/E ratio was what the whole bull market in stocks was about. It certainly wasn't about real earnings growth, merely a revaluation of*

earnings...[But] if you start with the premise that capitalism is in retreat and that we have started a new bull market in government in which markets don't necessarily dominate, but sovereign nations enforce their wills, that doesn't at first blush tell you that P/E multiples on stocks are likely to go up. But it does tell you that the equity risk premium is too damn skinny.... What it tells you is that the starting point valuation is a residual of the bull market in capitalism - and is not necessarily what you would ideally sketch out at the beginning point for a bull market in government.

"*The most pleasant thing that could happen,*" McCulley winds up, "*would be for stocks to meander around where they are for a long, long time.*"

Something we find of interest is the correlation between a growth in the nanny state and the social mood of the world. As long term economic downturns set in, so do politicians with yet more intervention (1930's, 1960/70's and now). The irony is that social intervention by Government is so counter-productive that it inevitably prevents the process of creative destruction and the phoenix like recovery of laissez-faire economies.

PROPERTY

CAN YOU AFFORD YOUR OWN HOME?

Readers will be well aware of our skepticism about UK domestic property prices. We wrote last month about how prices have more than doubled in real terms over the past fifteen years (using wage inflation), a period that includes the bust of the early nineties.

However we recently spotted a great little article on Yahoo that we felt encapsulated how overpriced property may be.

Under the headline "***CAN YOU AFFORD YOUR OWN HOME?***" they simply came up with the standard mortgage formula to calculate how overpriced property may have become relative to when it was purchased.

Firstly times your current salary by 3.5 and add your spouses income. Add 10% to this total to see if you could buy your own home today.

Obviously, you do need to have lived in your current abode for more than a year or two for this to be

relevant but those who have not moved for some while might be surprised by the answer.

INTEREST RATES AND BONDS

- Interest rates are still headed lower
- Bonds stage a strong rally but it may be posting a significant high.

Despite the upbeat nature of equities lately the economic news has remained weak. Indeed the risk of deflation has steadily increased with Germany perhaps already in its deadly grip. Thus despite historically low interest rates panicky Central Banks are likely to cut rates again. The ECB has plenty of scope to cut further and is close to absolute panic as the Euro's strength cripples exports and all pricing power. We believe that euro rates will fall 100 basis points before the year is out. In the UK as property price inflation eases the BoE will be forced to cut rates to stimulate the economy by 50 bps during the summer.

Even the US with interest rates already at diddly-squat will cut rates as Greenspan and Co. increasingly fret about the developing threat of deflation in the US.

Bond markets have staged a spectacular rally in the US and a decent run here in the UK. This is despite the growing threat of an overwhelming tsunami of supply as Brown desperately seeks funds to fill his funding gap due to overspending and collapsing tax revenues. A similar tale is playing out in the States and we feel the current rallies will fail in the next week or so and a deep correction will follow.

Support for the gilt future is at 118 but a break would leave an ugly "head and shoulders" top that could force prices much lower.

The US Treasury bond future has had an astounding rally during the spring despite dollar concerns and growing supply. The current run looks over-extended and has become near vertical of late which suggests that this unsustainable advance is likely to reverse in the next few trading sessions.

We would suggest that investors hold only short dated stock or even short US bond futures as the correction sets in.

Junk bond spreads have narrowed dramatically over the past few months but that outperformance could soon end as deflation creates an increasingly difficult business environment for those companies laden down with excessive debt. We would suggest

reducing exposure to junk status corporate debt as the forces of global deflation devours corporate pricing power.

GILT (weekly candle)



US TREASURY (daily bar)



GLOBAL EQUITY MARKETS.

- Baghdad bounce over?
- Reversion to mean to continue.

The comments in the Break-out issued on 13th May (attached) still hold good and we include the two key charts relating to the Dow and Ftse.

The view that the current rally is running out of steam is supported by a variety of sentiment indicators. The American Association of Individual Investors weekly poll of its membership latest survey shows 62.8% bulls, which is a historically high level of positive sentiment. Another important detail is that more investors are neutral than pessimistic toward stocks. The bearish reading of 16.3% is the lowest

bearish level since March 21. This is the complacency we were talking about on Wednesday. The chart combines the two readings to give a 46.5 bulls-minus-bears figure. This is the highest reading since December 2001 when the NASDAQ reached a peak of 2065 (just 33 points from its January 2002) and the rally from the lows of September 2001 started to peak out. The February reading of -36.8 bulls-minus-bears shows that the bear market to date has created some underlying wariness on the part of investors, but they have clearly cast those concerns aside on the rally from March 12, even as the market laboured to gain just over 200 points from March 21 to Monday's high. Given the fact that the AAI did sustain readings of 50% bullish until December 1999, this picture is a portrait of an extremely bearish short and intermediate-term outlook for stocks.

The 10-day Daily Sentiment Index (Courtesy of MBH Commodity Advisors, 847-446-0800) has continued to run above the 70% level and this makes 10 straight 70+% trading sessions, which means the current run exceeds the string of 9 at the peak in March 2002. Today's (Friday) likely to register one more for good measure as the five-day put-calls fell to .65, which is low enough to support a strong decline. Until recent days, the put-calls were running a bit high, but they have come in line with other sentiment readings in recent days.

The charts below highlight the key support levels for the current advance and the bearish divergence to the rate of change momentum indicators that have fallen as markets climb. As such all traders should be ready to exit the market or short stocks on a break below 8550 (Dow) and 3900 (Ftse).

DOW



FTSE



The Dax (below) displays a similar loss of momentum and a move below support at 2900 would confirm a trend line break and should lead to a considerable retracement of the recent advance. The late March low of 2400 is an obvious target if a sell-off gathers strength.

DAX



The Nikkei (below) appears to be continuing its long lonely march south which currently shows no sign of coming to an end. The bear market has continued for nearly fourteen years despite 3 or 4 substantial rallies and its move to a post bubble revaluation is still not complete. We still believe that Japan is the blueprint for markets during the coming decade as reversion to mean drives equity valuations to below their long-term average.

In the short-term a move above 8750 is needed to provide evidence of a rally that could potentially advance toward the 11/12,000 levels.

NIKKEI (weekly)



Bottom line stocks look very vulnerable to a sharp correction in the short term.
lottie is the best isn't she

FOREX

- Dollar oversold
- Euro overbought.

So where do we go from here as the only two facts worth considering at present are the two sides of the same coin listed above. When will the Dollar turn and can the Euro rally further. Certainly the decline of the US unit certainly looks calamitous and appears to display a classic trend ending blow-off characteristic. We thus suspect that this decline is approaching a low of near term significance. We will watch for evidence of a reversal that could propel prices back toward 105 during the next few months.

DOLLAR INDEX (WEEKLY)



The over-extended move against the Euro is perhaps best put in context by examining the cross against the Swiss Franc. The long term context this provides for the dollar decline suggests that medium term resistance is imminent and that the Euro's advance will pause for some months. However, the way the Fed is printing dollars we are sure that by year end the dollar will resume its trend back toward the 1995 levels (approx \$1.30/40 against the Euro). This will of course decimate the German and Benelux manufacturing industry.

DOLLAR/SWISSY (monthly)



Sterling's precipitous decline began with the clear break of support at the turn of the year. Since then a Fibonacci 21 week advance has seen the Euro hit £1.39. This area was our oft-repeated long term target area. However we never expected the advance to achieve this point so quickly and directly. We do feel however, that the move is overdone and that Sterling is likely to retrace a proportion of the declines experienced over the past few months. If the pound breaks the current down trend then a counter trend move could unfold rapidly. A return to the mid 140's looks likely and we suspect that the pound will trace out a similar path as the dollar over the coming months versus the Euro.

The pound is trading very choppy against the Yen (below) between 185 and 192 at present. A move out of this range is needed to signal a concerted advance/decline and at present we would remain neutral whilst the cross remains rangebound.

EURO/STERLING



STERLING/YEN



Bottom line on currencies. The Dollar decline/Euro advance looks overdone and we would look to trade the dollar index on the upside.

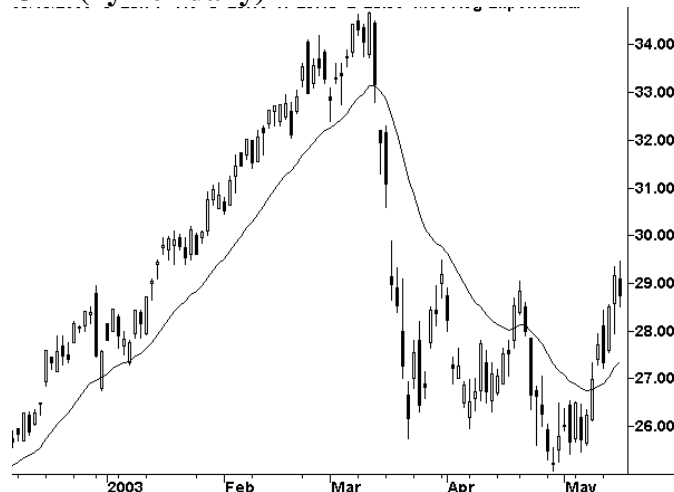
COMMODITIES

- Oil trades back to resistance
- Gold rally looks to be tiring.
- Coffee is hot as cotton unravels
- Wheat and Soybeans surge

Since the shooting started in Iraq oil has by a third. The recent bounce has carried the black stuff back to resistance in the \$29 area. A portion of the rally is due to dollar depreciation but we find oil now at a crucial level. The previously cited resistance at \$29 should cap the advance and we would expect prices to ease back down to the lower levels recently experienced around \$26. Much will

depend upon US strategic reserves and if global terrorism creates a nervy spike in oil prices. Over the very long term (3 to 5 years) we see a gradually tightening supply picture as growth in demand outpaces production leading to long term bull conditions.

OIL (nymex daily)



Gold's recent advance has hit resistance at 360/5 and looks overbought. The advance looks susceptible to profit taking after a 50% retracement of the recent falls from the February high. A break of the clear upward trend would signal the commencement of the falls.

GOLD



Coffee is hot again (sorry) as it has advanced back toward overhead resistance at \$70. The beverage is in a nascent bull market and subject to choppy trading as the new bull establishes itself. The current advance could stall again whilst base building continues but

once the base completes on a clear move over \$70 then coffee could fly.

COFFEE (daily)



The Cocoa chart (below) has two key levels \$1800 and \$2100 both of which if breached are likely to signal a move toward either new highs or a serious decline. So stops are paramount.

COCOA (weekly)



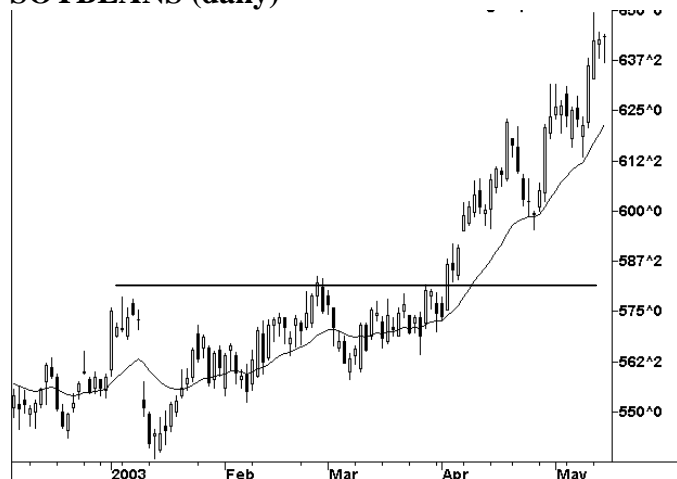
We warned last month that cottons volatile advance was looking overbought but we did not anticipate the speed of decline that has unfolded during the past few weeks. With a 50% retracement of the recent decline in place we would expect cotton to retest the early May lows during the next few weeks. A break of these lows may herald a more serious decline.

COTTON (daily)



In March we identified the potential for a strong break out move by Soybeans. We are pleased with how the advance has gone to plan so far and would advise placing stops at 612.

SOYBEANS (daily)



The dramatic lift off in wheat prices during the past fortnight from long term support would suggest that once any short term profit taking has finished then this baby could move on up much further. The explosive nature of the advance would make any bears very wary and will have created a very positive psychological backdrop. This commodity could well enjoy a sustained bull run and we suggest stops at \$290.

WHEAT (daily)



FINALLY

It is strange how frequently persistent trends in a number of markets often come to a point of inflection simultaneously, as we are seeing at present. The equity, gold, oil and the dollar markets are all at potential turning points and we suspect that the next week or so could see at least a short term reversal of the current market trends.

Regards

**Andy McCarthy
Andrew Bartles**