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INSIDERS KEEP SELLING, AND THE MARKETS KEEP RISING!

**BARMAC MARKET DIRECTIONAL
INDICATOR:-
SELL SIGNAL issued on 24th Sept.**

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**Insider still selling
Market rally set to stall?
Dollar printing accelerates
Market Ponzi scheme.**

5. INTEREST RATES AND BONDS

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What are we to make of it? We have banged on for over three months now about the level of selling by corporate insiders. This trend has continued throughout August and into September. The ratio of selling in the US has been constantly in excess of three times the normal underlying levels of sales. Additionally, many behavioural consensus surveys are at highs not seen since 1987 (see page 5). Despite all this UK and US equity markets have continued to shine. Indeed, most indices until this week have shown no sign of weakness even during the evil (for equities) month of September. Markets continued to forge ahead fuelled by historically low interest rates and the massive liquidity provided by the Fed, Japan and even China.

So what conclusion can we draw from the above contradiction? We suggest that the answer may be to shrug your shoulders and place strict market stops. But do not expect the rally to last for more than a few months at best. After all corporate insiders represent the "smart money" and if they sell surely we should follow their example. As insider selling is not a great timing indicator, we should watch markets closely especially as the US electoral cycle approaches its zenith. Investors will start to focus on political uncertainty as the election race "hots" up and Bush slides in the polls. Investors should try to keep perspective and remind themselves that this is not a new bull market, but merely a major contra-trend rally within a bear market similar to those witnessed in Tokyo during the past 13 years. Thus "buy and hold" might well prove to be as disastrous for UK investors as it has for Japanese investors.

The market could well be close to an inflection point. Third quarter earnings, and more importantly fourth quarter guidance may well be the resolving factor. At this point the earnings picture remains positive, but mixed. Fourth quarter earnings estimates are even more aggressive than third quarter estimates, but with the credit floodgates wide-open it is hard to bet against (we suspect that it may well be next years Q1 earnings that disappoint, as it becomes apparent that profit growth is stagnant or only achieved via cost cutting). Perhaps, more important is the bond markets determination to push interest rates lower at any hint of financial stress. This in turns lowers borrowing costs throughout the US economy, which sets in motion the American consumer. At some point the market will start questioning the fact that Fed funds are stuck at 1% when GDP is growing 3%, 4%, or even 5% or alternatively when no recovery occurs.

This is the conundrum, which will ultimately end the current equity bull market:-

- (i) Low growth = low interest rates and deflation BUT no recovery.
- (ii) Higher growth = rising rates that will kill off the consumer and recovery

A STAGGERING DEGREE OF DOLLAR PRINTING HAS HAD LITTLE EFFECT DESPITE EQUITY RALLIES.

When we review the anaemic nature of the global economic recovery thus far we should examine the amount of “rocket fuel” the Fed, Japan and other Central Banks have provided. It is a sobering study!



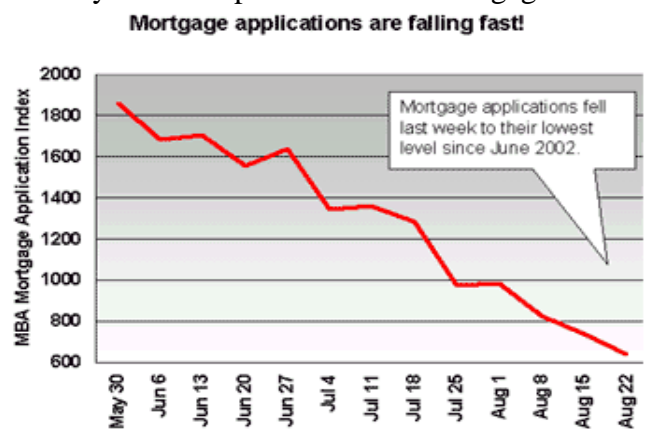
In terms of the American economy itself, the release last week of the Federal Reserve flow of

funds data for the second quarter has provided powerful evidence of the scale of the stimulus unleashed by fiscal and monetary easing. This can be illustrated by the dramatic surge in US domestic non-financial sector borrowings which are quite literally off the charts as can be seen in the chart above (see Figure 1). The line is spiking to such an extent because continued frenzied household borrowing has been joined by a big surge in government and corporate borrowing. This is monetary and fiscal reflation on a massive scale, financed seemingly happily by Asia’s mercantilist central banks. Yet despite all this stimulus there remains little evidence as yet of inflationary pressures rising though it is also true that inflation seems to have stopped falling for now.

If readers now review the chart opposite one more time, we wonder if you are also struck as to why despite an exponential explosion in credit, both growth and inflation have remained subdued. You may well also ponder what will happen when the currently unsustainable credit growth subsides and ceases to stimulate the US and the world’s economies.

OH DEAR! DEBT REFINANCING IS SLOWING AS BOND RATES RISE

The graph below highlights one of the dangers of “crowding out” leading to rising interest rates despite a flat economy. If readers recall it has been estimated that 6% of UK consumer spending is currently generated by debt refi. A similar proportion of the US economy is also dependant on the mortgage boom.



But the worrying trend shown above in new applications might well indicate problems for the US market as consumers stop refinancing their homes or spending on fitting out new properties.

This graph illustrates that mortgage application flow -- an indicator of the future health of the housing industry -- is falling fast. In fact, the index is now a whopping 65.6% down where it stood at the end of May! Both the purchase and refinance components of the index are taking hits.

The outlook? Rising interest rates will continue to discourage people wanting to buy and refinance homes. And that's likely to cool one of the few robust drivers of growth in the US economy -- and the markets.

Bullish sentiment is riding at 1987 levels; tech stocks are leading the way in the reflation rally. What can we say, dear reader, but "oh là là... look out below!"

PONZI ECONOMY

By Kurt Richebächer

Hope and hype are again triumphing over reality. The primary preoccupation in economics worldwide is the U.S. economy's 'recovery', presently hyping the markets.

We note three different views. First, a cocksure bullish consensus; second, doubtful voices, among them the Federal Reserve, stressing the lack of conclusive evidence; and thirdly, a few lonely voices, ours among them, who flatly repudiate the possibility of a full-scale, self-sustaining economic recovery in the United States.

*We see years of Japanese-style sluggish growth for America, if not worse. Yet, the latest American Association of Individual Investors poll showed **71.4% bulls** and a miniscule **8.6% bears**. The gap between the two is **the highest since August 1987**, just weeks before the crash. Merrill Lynch surveys show institutional investors more fully invested than at any time in the past two years, and heavily overweight high tech.*

The case of the bullish community rests crucially on the assumption that the U.S. economy is basically in excellent shape. Fed Chairman Alan Greenspan,

and with him the large bullish community, have actually never seen anything seriously wrong with it.

In their view, its failure to return to normal economic growth is mainly due to a series of exogenous shocks inflicted one after the other on the economy: the stock market crash, the September 11 terrorist attack, the corporate governance scandals and the Iraq war.

Rather, they consider it a sign of health that the economy has not weakened more in the face of this unusual sequence of shocks.

Yet compared to the extraordinary exuberance prevailing in the markets, the Fed has been remarkably hesitant in declaring the economy's impending recovery. In his testimony to Congress, Greenspan acknowledged that the "economy is not yet showing convincing signs of a sustained pickup in growth." In the same vein, Richmond Fed President Alfred Broaddus said a bit later in an interview, "We still don't have a critical mass of hard evidence that the economy is accelerating," defining "hard evidence" as increases in employment, production and capital spending.

Now to our own opinion: after careful analysis both of recent economic data and also of basic micro- and macroeconomic conditions for the resumption of strong economic growth, we have come to two conclusions:

- *First, the U.S. economy neither improved nor accelerated in the second quarter. The reported GDP growth of 2.4% is grossly misleading. From the perspective of quality, it has distinctly deteriorated.*
- ** Second, as we shall explain in detail, the crucial macro- and microeconomic conditions for a self-sustaining and self-reinforcing economic recovery remain flatly missing*

Necessary economic and financial adjustments of past economic and financial excesses implicitly involve pain. But pain is not accepted in the United States. In essence, policymakers are trying to cure past borrowing excesses by more of the same and new excesses.

Trying to assess the U.S. economy's prospects, the first thing to realise is that past cyclical experience offers no guidance to the present downturn because it

has completely different causes and also a completely different pattern.

All past recessions had their main cause in monetary tightening. As soon as the Federal Reserve loosened its shackles, the economy promptly took off again, propelled by pent-up demand. For the first time in history, the U.S. economy went into recession against the backdrop of most rampant money and credit growth. Manifestly, the forces depressing the economy this time are radically different from past experience. The typical, major imbalance in post-war business cycles has usually been in inventories. To correct it, retailers and manufacturers temporarily sold from stock, depressing production. Once the stocks were down to desired levels, production came into its right again. At the heart of the regular V-shaped business cycles was the inventory cycle.

In contrast, the present downturn has its brunt in the combination of a profit and capital-spending crisis. At the same time, there has accumulated an array of economic and financial dislocations that tend to depress the economy in many ways, such as extremely poor profits, badly ravaged balance sheets, a variety of asset bubbles in different stages of development, excessive leverage in the whole financial system and shrinking cash flow. There is nothing normal anymore in the U.S. economy and its financial system.

For the old economists, investment in tangible assets - factories, commercial buildings and machinery - was paramount in creating both economic growth and wealth. It creates demand, employment and income as the capital goods are produced. And with their instalments, all these new buildings, plant and equipment create increased supply along with increasing employment and income with increased productivity.

The United States has always been a low-savings and low-investment economy. Putting it in reverse: a high-consumption economy. But all three went to unprecedented extremes over the past several years. Savings and investment have been run down to atrociously low levels that are typical for underdeveloped countries.

To repeat: Investment in tangible assets is paramount in creating everything that is decisive in generating our wealth and raising our living standards. Given the low levels of saving and

investment in the United States, American policymakers and economists in recent years have elevated productivity growth to the single most important achievement of an economy. But just by itself, productivity growth creates only unemployment. It is the normally associated capital spending that makes for the necessary, simultaneous demand and employment growth.

This simple recognition - gross lack of saving and capital formation - is really at the root of our controversial and highly critical view of the U.S. economy's sanity and vitality. True, its growth rate has been the highest among the industrial countries for years. But it has all the time been economic growth of the most miserable quality. The striking hallmarks of this extremely poor quality were collapsing savings, low rates of business fixed investment, a profit carnage that began at the height of the boom, exploding consumer and business debts and an exploding trade deficit.

Today's economists have at their disposal information in quantity and speed as never before. But reading numerous reports, we have the impression that very few are making use of it. Particularly shocking in this respect were the immediate euphoric reports about growth acceleration in the second quarter.

During the 1960-70s, by the way, the U.S. accumulated on average about 1.5 dollars of additional debt for each dollar of additional GDP. Just extrapolate this escalating relationship between the use of debt and economic activity. And think of it: the GDP growth of today is tomorrow a thing of the past, while the debts incurred remain.

Plainly, Greenspan's policy has collapsed into uncontrolled money and debt creation that has rapidly diminishing returns on economic activity. The late economist Hyman P. Minsky would call this a Ponzi economy, where debt payments on outstanding and soaring indebtedness are no longer met out of current income, but through new borrowing. Soaring unpaid interests become capitalized.

We believe that Dr Richebächer has hit the nail on the head with his explanation of how much new credit is now being created to only produce moderate growth. This diminishing return on debt suggests that sooner or later the growing debt mountain will either

explode into rampant inflation or cause a catastrophic economic deflationary collapse.

Interesting times!

The pension black hole update.

The following is from the Times 24/09/03

“The equity holdings of FTSE 100 pension schemes would have to soar by 35% to plug their black holes according to research by Dresdner, Kleinwort Wassertein, the German investment bank. The research found that pension deficits across FTSE 100 pension schemes have shrunk by 22 per cent since March, with a combined shortfall of £49 billion, compared with £62.4 billion six months earlier. Karen Olney, equity strategist at the bank, said the FTSE 100 would have to rise to 5,678 to clear the deficits.”

So the good news is that the rally has shrunk the deficit but a lot more is still needed. Prospective pensioners must cross their fingers and hope that the markets recover further or either pensions will be cut or company profits will be burdened with payments to bridge the gap.

INTEREST RATES AND BONDS

- Interest rates to remain low
- Key bond market rally but set to stall during the Autumn

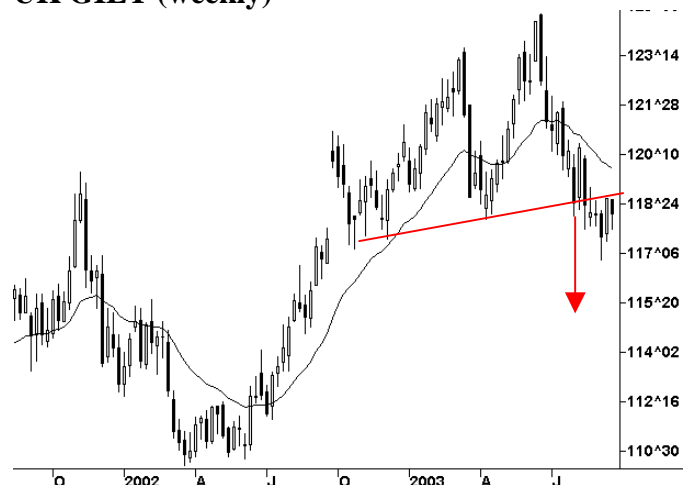
Short-term interest rates stand at generational lows across the Western world and are likely to remain low as recovery remains sluggish. The Central Banks will ensure low rates remain to underpin a depressive underlying economic performance. However as Dr R. above highlights the artificially low rates and massive increase in money supply are having only a subdued response. The global bond markets are already feeling the consequence of this monetary stimulation as they “topped out” during the summer. The rebound evident during the last 6 weeks is purely corrective and unlikely to be sustained in both time and distance by Brown’s and Greenspan’s profligacy.

The US Treasury contract (below) is 6% up since August 6th. This rally lacks dynamism as is clear to even the untutored eye when casually glancing at the chart below. The recent strength will be over once the current trend reverses and breaks 107.

US TREASURY BOND (Dec)



UK GILT (weekly)



The UK Gilt (above) has not enjoyed the significant bounce enjoyed in the US since early August. However, key support at 118 has been broken and whilst the market remains below this level there is danger of a further steep decline toward the spring '02 lows.

GLOBAL EQUITIES

- Markets keep rising-why worry!
- Barmac market indicator gives “sell” signal.

- **Major trend lines are broken**

Here are some of the things that most advisors are not worried about:-

A record number of buying climaxes, record high selling by corporate insiders, intense selling by the S&P commercial hedgers, a low VIX (volatility index which if low implies that the market has no fear), a near-record low in the mutual fund cash-to-assets ratio (everyone is already fully invested) and divergences (that is various markets and indicators are not acting similarly and confirming each others market action) in everything from the Philadelphia Bank Sector index to junk bonds, CAC40 to Dow, NYSE upside volume, new 52-week highs and various upside momentum indicators.

It is said that bull markets climb a “wall of worry.” In order for such a climb to take place, however, *there has to be some worry*. There is none now, and the longer these lists get, the giddier investors become.

Remember that historical precedence highlights that the more bullish the market consensus becomes the more likely markets are ready to decline.

Surveys of traders (Daily Sentiment index and Bullish Consensus), newsletter writers (Investors Intelligence), individual investors (American Association of Individual Investors) and brokerage firm research houses (Ned Davis™ Wall Street Strategists) reveal that *all* classes of market participants (except the savvy “commercials”) have been clinging to optimistic extremes for two to six months. This may in fact prove to be a slope of hope, the bear market counterpoint to a wall of worry, and it has reached monumental proportions.

At 57.4%, the Investors Intelligence percentage of bullish investment advisors is *three times* the number of bears. There have been three bulls for every bear for five of the last six weeks and at least twice as many for 21 straight weeks. At the Dow’s all-time highs in January 2000, there were only twice as many bulls as bears, and that level of bullishness lasted just three weeks. The last time that bullish advisors were even close to being as one-sidedly bullish as they are now was September 1987, when the bulls more than doubled the number

of bears for eight weeks. It was followed by an October crash. Of course, there’s a big difference between 1987 and 2003.

Back in 1987, investors had good reason to celebrate. The market had hit successive all-time highs in more than half of the previous 28 months. This time, the Dow, S&P and NASDAQ have not tasted record highs in well over three years.

The unshakable faith in stocks is also captured by the AAI survey. Back in the bull market, AAI investors were almost never net bullish. But on January 7, 2000, seven days before the Dow’s all-time peak, was “five straight readings [weeks] in which a majority of this historically cautious group was bullish.” Five straight weeks? On September 17, the *20-week* average hit 54%! This is the highest level of sustained bullishness in the history of the survey. The old record of 53% was set on March 23, 2000, the day the S&P reached its all-time high.

The Barmac major market indicator has given a sell signal on all UK equity markets on 24/9 at Ftse level 4236. This negates the “Buy” signal that has been in force since 03/04 when the Ftse 100 stood at 3771.

The signals given by this indicator are relatively infrequent and are a strong indication of market direction with a three to six month view. Unless we witness a speedy reversal it would appear that markets are in for an extremely rough ride.

Major market trendlines break!

As we complete this issue (and rewrite as the market triggers key stop levels) we are witnessing a wholesale break of major market trends (see below). The charts below all display a simultaneous downside dynamic that cannot be ignored, especially when the various technical indicators mentioned above are all at record overbought levels. We believe all the charts tell a story and suggest that all readers keep a very close eye on all national indices. Stops should be tightened and we would not re-enter the market until new highs are established or some other upward dynamic occurs in more than one global index.

DOW JONES



The Dow has broken the key March trend that implies a test of the key 9000 support level, in the near term. Any break of this level would be extremely bearish for the markets medium term direction.

S & P 500



Ditto almost for the S & P with 960 being key support. Again, any violation of this level could unleash a dramatic wave of selling.

NASDAQ COMPOSITE



The Nasdaq has so far only crossed the short-term trend but if the major trend is broken then we suspect that the whole bull rally could be reversed. New highs are needed to negate this risk.

FTSE 100



The Ftse (above) has also broken through key support and the major trend and a test of the June lows looks highly likely at 3950. If the index declines beyond the key support at 3950 then a complete re-tracement of the March gains could follow.

CAC 40 INDEX



The CAC 40 above is representative of virtually all the European markets and it too displays the characteristics already discussed regarding the UK and US. The 3000 level is key support but the trend break evident on the chart looks conclusive and we would expect 3000 to go. This and many of the other markets appear oversold as we complete this issue and a small rebound may be due but, the current market backdrop has globally turned very bearish and a strong rebound to new highs is needed to improve the picture and to reverse the bear signal by the Barmac Market Indicator (BMI).

NIKKEI (weekly)



The bull-run in the Nikkei has experienced the largest reversal in six months and support at 10,000 looks certain to be tested. The key reversal week (19/09) suggests that this market may well find it difficult to achieve new highs for a few months at least with this psychological action capping the market.

FOREX

- Forex is where the fun has been!
- Dollar resumes downtrend

Well we have certainly had some action in the Forex markets over the past few weeks. The resumption of the dollar declines looks terminal for the US unit as Fed supply goes of the scale to avert deflation.

For once nearly all the charts are very clear and are providing great guidance on how to play the current action.

EURO/DOLLAR (weekly)



The chart (above) for the Euro/Dollar highlights the end of the summer correction as the Euro

resumes its advance against the Buck. We suspect new highs (above 120) are almost inevitable for the Euro and would place a stop at 108. In the meantime the initial advance may prove to be choppy as the initial break to the upside is tested by the market.

STERLING/EURO (weekly)



The Euro/Sterling cross is not as yet clear-cut BUT fireworks look set to happen in the near future. We will not second-guess the direction but would expect Britains profligate budget deficit and massive trade gap to weigh heavy on the pound. Watch closely for a strong dynamic move from the above clear pattern.

STERLING/DOLLAR (weekly)



The \$/£ chart (above) is much more messy than Yen or Euro but we would expect new highs for the pound perhaps after a short consolidation of the recent advance. Key support remains way back at \$1.58.

DOLLAR/YEN (weekly)



WOW! Now this looks very exciting with a dramatic leap across major support. The Dollar is in big trouble (and so is Tokyo as a strong Yen will hammer Japanese equities) and although it may be oversold and consequently trade back toward 115 in the short-term it looks set to head back to parity. Any dollar strength should be used to climb on board what should be a very profitable trade.

STERLING/YEN (weekly)



The pound appears to be rolling over versus the Yen. The cracking of the 3-year trend line should prove to be significant and a move toward support at 170 looks on the cards.

Bottom line on forex.

- Sell dollar versus euro and yen
- Pound looks set to weaken also but not as dramatically as dollar.

COMMODITIES

- Oil weakens as gold soars
- Softs provide a mixed picture.

Oil has fallen back toward key support at \$26 as expected and following OPEC production cuts has staged a small rebound to \$28, and we do not expect prices to top \$31 short term. The market generally looks set to fall much further but is susceptible to political shock. If and when prices fall beyond \$26 we would expect a strong decline to gather pace.

CRUDE OIL (Nynex weekly)



Gold has enjoyed all the market uncertainty regarding the dollar and has rallied up to new highs in recent days. However the technicals (overbought and COT report) suggest this move is flagging and we therefore expect gold to struggle to crest \$400

GOLD (spot weekly)



Copper is a key industrial metal and has experienced a gentle uptick over the past year as sluggish economic growth has supported the market. At present the strong trend is still up. We would

merely watch the action and if long place stops at around \$8000 and traders could short at this level.

COPPER (weekly)



COCOA has steadied and a clear move beyond 1800 or 1400 should generate a tradable move. Meantime we would stand aside.

COCOA (weekly)



The weekly coffee chart below appears to be ranging wildly between the 60 and 70 levels so we have enclosed the monthly chart for perspective. Whilst prices are entrapped within the current range speculators should remain sat upon their hands. However, the latent potential for a major rally is clearly illustrated by the monthly chart. From that chart it is clear to all that the gains seen over the last 18 months or so are only a minute proportion of what is feasible if coffee were to set up a new bull market run.

COFFEE (weekly)



COFFEE (monthly)



COTTON (weekly)



Cotton has enjoyed a great run of late and burst through a previous double top \$60. The chart action looks positive apart from the two most recent weeks action where we have witnessed massive indecision illustrated by the weekly candles opening and closing

each week at exactly the same point. Whether this is a pre-cursor to a turn around in sentiment or simply a pause for breath we are unsure. But we would tread cautiously until cotton begins to trend higher again or falls below \$60.

FINALLY

The Iraq situation is tying politicians in knots but we felt the following interview was both fun and illuminating and was conducted by Tunku Varadarajan for The Wall Street Journal. Here's the opening:

PRINCETON, N.J.--The professor leaned forward, his face, briefly, a picture of fun: "Pay attention to the joke," he said. "The joke is the only form of political comment that is authentic in the Middle East--and for the most part uncensored." He then told a joke now doing the rounds in that part of the world: "Two Iranians lament the state of their country. Finally, one says to the other, 'What we need here is a bin Laden.' 'Are you crazy?' his friend gasps. 'No!' the first Iranian says. 'That way the Americans would come and rescue us.'"

The professor, on a roll, then told another joke: "What is the real slogan in the Middle East?" he asked, then paused. "It's 'Yankee go home . . . and take me with you!'"

There you have it--a pithy lesson, worth hours of CNN, in modern Middle Eastern truths.

We hope all our readers find this months issue of interest and would remind all to be cautious of both the Dollar and equities for the next few weeks.

Regards

Andy McCarthy and Andrew Bartles.