

Annual Issue Price £250

info@barmacjournal.co.uk

EQUITIES SLOWLY LOSE MOMENTUM AND WILL TOP DURING 2004 WHEN THE BEAR RESUMES.

BARMAC MARKET DIRECTIONAL INDICATOR:-

BUY SIGNAL re-issued on 2nd Oct. and still in force

1.GLOBAL ECONOMY

Global rally likely to end in04

Reversion to the mean

John Templeton on housing

Economics of comparative advantage.

5. INTEREST RATES AND BONDS

Govt short-term rates turn up

Long-term bonds to remain under pressure

6.EQUITIES

Break-out in 250

Easy money from Fed to help equities in what maybe a roller-coaster ride.

Dollar erodes market gains

8.CURRENCIES;

Dollar reverses

Euro and Yen strengthen

9.COMMODITIES

Gold hits high's but looks vulnerable

Oil holds above \$32.

Palladium our nap for 2004

Cotton to fall.

Global equity markets have enjoyed a universally strong advance since March this year but these advances have clearly slowed of late. Gains on markets have become choppy and incremental since August with the Dow (allowing for the dollars decline), S&P and Ftse making gains of only a few percent since the summer.

The press however would have you believe we have witnessed a run away bull during the last few months. Various commentators are now predicting the birth of a new bull market and the end of the market falls. They point to the up tick in US growth to 8% pa during Q3, whilst extrapolating this growth rate forward. However, the US rebound has been historically weak compared with previous post-war recoveries. This relative weakness is even more noticeable considering the Fed has driven rates down to 50-year lows and the US consumer has had massive tax rebates during the late summer. Indeed a huge sledgehammer of fiscal stimulus has produced only a proportionately small nut of recovery.

The current overall bullish consensus has now surpassed any prior period in history. The American Association of Individual Investors weekly survey has passed 50% more bulls over bears for 21 weeks straight, a new record in the 40 year history of the survey (old one 11 straight weeks). The latest reading of 69.7% bullish is the third highest figure on record with the all time high coming in Jan 2000! The stability of bullish opinion is despite the fact that markets are still way down on 2000 levels and insiders continue to sell heavily for the seventh consecutive month. Indeed, despite the weakness in real gains since August, investors have felt better

about the prospects for stocks longer than they did at any time during the bubble mania. This positive attitude signals a heightened vulnerability to an unforeseen decline.

Due to the supportive stance of the Fed during this the election year we suspect that equities will broadly range in a roller coaster ride. We cannot foresee UK equities gaining a foothold above massive resistance above 5000 and expect a period of weakness to test support at 4100. This year will need some cute market timing but investors should look over the horizon at the potential horrors that may be looming in '05.

We re-iterate our stance that the bear is not over, merely slumbering through this liquidity-fuelled rally. It may re-awaken at anytime, though perhaps not for a few months yet. Watch charts for signs of weakness.

Insiders

It feels like everybody is buying the market. Yet two groups have so far steadfastly refused — insiders and legends. **The insider sell-to-buy ratio recently hit 7-to-1**, a new all-time record. As we've said previously, there are many reasons why an insider, a person with the most intimate knowledge of a company's financial prospects, would want to sell his or her shares. It could be for tax planning purposes, or possibly for portfolio diversification. But we can guarantee that one of the reasons they are selling is not because they think the price of their stock is going to skyrocket. The other "group" that refuses to chase the market is what we call the "legends." Specifically, seasoned investors such as John Templeton and Warren Buffett have at various points over the past year expressed their strong reluctance to commit money to a stock market as overvalued as the US. Could it get more overvalued? There is nothing to prevent this. But it is no accident that these people have accumulated long-term wealth by "buying low and selling high." They are not buying now.

Last month we highlighted the growing non-confirmation of new market highs by the various momentum indicators. This pattern has continued with the latest incremental new highs that have again not been confirmed by the technical momentum indicators. This weakening of internal

strength normally gives way to a correction at some point.

With the presidential election cycle moving into top gear we expect the Fed to remain supportive in 2004 but, markets will inevitably start to focus beyond the election and upon the various imbalances which the new President WILL address in 2005 (budget and trade deficits). Thus markets will increasingly focus upon the inevitable tax hikes and spending cuts in 2005 and may run scared during the second half of '04.

Thus our current roadmap has equities slowly manoeuvring to a cyclical bull top in the next few months before the resumption of the long-term secular bear market.

BEAR RALLIES AND REVERSION TO THE MEAN

An interesting study re the U.S. by David Schwartz, the market historian backs up our suspicion that major secular bull markets do not unwind after a mere 3 years with still historically high PE ratio's. David Schwartz states there have been 25 occasions when, over 15 year periods, markets have shown major rises, to beyond two standard deviations from the long term mean, of which the end 2000s' bubble must be about the largest. On 24 such occasions, the market was lower 15 years later. OK there will be (modest) dividends - but also, quite possibly, 15 years of inflation to diminish real value. So is this a new bull market? No that looks most unlikely.

It seems likely to us at Barmac that by 2015 a 100% record will be established with the 25th mean reversion event complete.

Other longer-term (regrettable) reminders:

1) Never has the S&P index shown investors a profit 10 years later when bought at a (GAAP) 23 PER or over. It is well over that now.

2) Mean reversion after a 2 standard deviation event, across all 28 asset classes analysed in a study, occurred 100% of the time. The late 2000s' equity bubble was well over a 2 standard deviation event.



Mean reversion for Global markets could see PE ratios halve on Wall St, let alone the concerning tendency for markets to overshoot. This perhaps could take PE's down to single figures as happened in the late '70's/80's and the '30's, now that would be bothersome!

HOUSING AND BEAR MARKETS

Legendary investor John Templeton, was recently interviewed in Equities Magazine and as usual had many most interesting comments on current economic events: *"It would be unlikely that the bear market is over when the American stock market is only down about 30%, when in the biggest boom ever, it had been up 10 times over where it had been years earlier... Following such a large increase, a 30% decrease is small."*

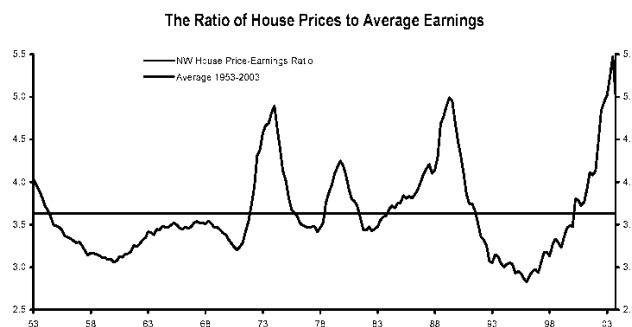
"Every previous major bear market has been accompanied by a bear market in home prices... This time, home prices have gone up 20%, and this represents a very dangerous situation. When home prices do start down, they will fall remarkably far. In Japan, home prices are down to less than half what they were at the stock market peak. A home price decline of as little as 20% would put a lot of people in bankruptcy."

"Emphasize in your magazine how big the debt is... The total debt of America is now \$31 trillion. That is three times the GNP of the U.S. That is unprecedented in a major nation. No nation has ever had such a big debt as America has, and it's

bigger than it was at the peak of the stock market boom. Think of the dangers involved. Almost everyone has a home mortgage, and some are 89% of the value of the home (and yes, some are more). If home prices start down, there will be bankruptcies, and in bankruptcy, houses are sold at lower prices, pushing home prices down further. After home prices go down to one-tenth of the highest price homeowners paid, then buy."

Certainly, the legendary market guru Mr Templeton is bearish to the extreme.

If you think a housing bubble exists in the UK, then the chart below gives a taste of the similar state of affairs in the US (however US asset prices in global terms have not advanced so far due to the dramatic dollar declines).



Courtesy Capital Economics

The graph above is similar in the UK and illustrates how inflated house prices have become when related the average earnings. Affordability measures are not so overstretched but we all must realise that over time interest rates will rise from the current generational lows. Rate rises would destroy the housing market stone dead.

If housing was to wobble the implications are vast as 90% of personal wealth is held in peoples own homes. The Refi market would collapse leading to a catastrophic drop in consumer spending.

The economics of comparative advantage, Norwich Union and the EU constitution.

The liberalisation and globalisation of the world economic system should and would allow the laws of comparative advantage come to the fore. Thus if the costs of production are lower in one country than

another then production should migrate to the lower cost producer. This after all is a fundamental law of economics and benefits all consumers and producers via lower cost product and services.

If labour costs are the main advantage of one location over another the laws of supply and demand will eventually neutralise any advantage (this may be painful, slow and politically unacceptable but inevitable). This is currently a hot topic thanks to Norwich Unions decision to switch 2500 "call centre" jobs to the Indian sub-continent. The NU is only following a trend that has been apparent for several years. This trend can only accelerate if the anti-business EU labour laws spread to the UK. The insidious spread of regulation has already strangled France/Germany and thanks to UK unions and the misguided pro-EU constitutionalists could soon be the status quo in Britain.

The only answer the EU can offer to the real world of a competitive global economy and the economics of comparative advantage is to dump yet more regulation on business and yet more tax (well that will help won't it).

The EU may ultimately resort to the nuclear option of protecting jobs via protectionism (in line with the long-term French and German mercantilist past,). Indeed, this was the route European powers took in the 30's when faced by a competitive world.

That was a disaster as no one benefits from trade barriers and there is no reason to think that an uncompetitive fortress Europe would achieve any better results this time round.

The UK still has time to repel both the new EU constitution from being introduced via the backdoor and the euro in order to stand any chance of resisting the tide of euro sclerosis (even if the current Government shows little stomach for putting the UK first) whilst ignoring the siren calls for trade barriers coming from the continent.

Protectionism is the refuge of popular political opportunists (often wrapped in nationalism) and the mob and almost by definition is ill thought out and self-defeating. The worry is that the politically bankrupt EU will busily attempt to protect the workforce in burdensome and uncompetitive labour laws and resort to market protection strategies to keep its high cost labour force insulated from the chill competitive winds blowing from Asia.

When France's own problems are mentioned in public, the reaction is electric. The hot book in France just now is "La France qui tombe" ("France Falling") by the lawyer and political scientist Nicolas Baverez (which was first published as an essay in the prestigious quarterly *Commentaire* last spring). Baverez--who opposed the American invasion of Iraq in a clear-eyed way--blames France's current predicament on the country's preference for stabilising its institutions over adjusting to the world as it is. This is not a momentary loss of will but a tendency that has been entrenched in French culture since the Industrial Revolution, and it leaves France in "undeniable decline, even in the context of a Europe that is itself decadent."

Legislation passed by the Socialist government in 1998--amidst a great deal of continental philosophising about "the end of work"--produced a statutory work-week of 35 hours. Baverez keenly notes that in the 1930s, France's left-wing Popular Front passed a similar *réduction du temps de travail*. Indeed, its association with the Popular Front gave a powerful boost to the 35-hour work-week during the debates five years ago. (The otherwise admirable tendency of the French to root for underdogs has led them to look at the Popular Front's defeat at the hands of domestic--and later foreign--fascism as evidence of its superior morality, not of its inferior strength.)

The short week was meant to spread limited jobs around; but it wound up doing the opposite, serving as what Baverez calls a "weapon of mass destruction for industrial production and employment." Today France has the highest youth unemployment in Europe, at 26 percent; only 37 percent of its over-55 population works, a world low. Its employment rate of 58 percent is at the bottom of the developed world. (The figure is 62 percent in the European Union and 75 percent in the United States.) And this grim employment picture is worsened--some would even say caused--by a political inequity. Over the past decade, public-sector employees have been able to enrich themselves in ways that private sector ones cannot. Government employees can retire after 37.5 years on the job, versus 40 for private workers; they get 75 percent of their salary as a pension, versus 62 percent in the private sector; and the salary in this calculation is based on the best-paid six months for government workers, versus an average of their last

25 years for workers in private industry. So the latter wind up subsidizing the former.

The above inequalities will sound oddly familiar to UK workers who are no doubt aware of the feather-bedded pension arrangements public sector employees enjoy and paid for by the 20 million private sector wealth producing workers. With 20 million supporting 40 million (UK population being approx 60 million) via their taxes, the pyramid is already heavily inverted in Britain without any further assistance from the EU and its labour laws.

GOLD

With the ongoing decline in the Dollar and the potential for both overpriced equities and oversupplied gilts to decline the current bull trend in gold has caught the imagination. We suspect that although gold may well perform relatively well over the next few years it may be overcooked at present. However since investors are not allowed to own gold bullion direct, they can now gain gold exposure for their portfolio's following the launch of the new gold security on the LSE.

The new security is a great new vehicle for investors and portfolio managers alike.

The following is an excerpt from the FT

Gold Bullion Securities (GBS) plans to list on the London Stock Exchange, giving UK investors the opportunity to buy gold without having to worry about storage, insurance or transporting the metal. Simon Village, GBS joint managing director, said the new vehicle would reduce the cost of acquiring gold for private investors, who face transaction costs of up to seven per cent for buying physical gold.

Transaction costs for buying or selling the gold-backed securities issued by GBS would be less than 0.5 per cent.

Jim Burton, chief executive of the World Gold Council, which is a backer of GBS, said investors have been calling for lower cost access to gold. "We hope this is a landmark day for the gold industry. Gold has been trading in London for the past 250 years. This initiative should make gold more accessible to more investors."

Until now, UK investors wanting exposure to gold had to buy shares in a gold mining company, most

of which are listed on exchanges in Canada, Australia, South Africa and the US.

Alternatively, they could buy gold options and futures, which both carry the risk of margin calls if the gold price goes the wrong way, or they could buy physical gold.

The launch of the long-awaited gold-backed security came on the day that bullion prices reached \$405.55 a troy ounce, their highest level since March 1996.

The World Gold Council also hopes to list similar gold investment vehicles on other large stock exchanges. It is currently awaiting a decision from the Securities and Exchange Commission (SEC) on its plans to list a gold-backed security on the New York Stock Exchange.

GBS is, in effect, the issuer of gold securities, each of which comprises a secured note with a nominal value attached with entitlement to gold bullion. The LSE-listed security will be priced in US dollars. There is also the option to redeem the security into physical gold. However, this option is restricted to approved holders such as professional bullion dealing firms.

The UK-listed product comes with currency exposure. Gold's 16 per cent rise this year in US dollar terms translates into only an 8.5 per cent gain in sterling following the pound's gain against the dollar this year.

The London listing is modelled on Gold Bullion Limited, which listed on the Australian Stock Exchange in March. The Melbourne-based company has since sold gold-backed securities representing about \$100m in gold sales, or eight tonnes of the metal.

The World Gold Council will own two-thirds of the management company that will operate GBS.

Our view - This is a good idea, long overdue. It can only increase investor interest and awareness of gold as well as allowing portfolio's to hold some gold direct

INTEREST RATES AND BONDS

- **Interest rates to remain low in first half.**
- **Govt bonds will remain under pressure**

Despite the recent rate rise in the UK we do not expect rates to rise significantly this side of the US election. The Fed will not risk unsettling the US

voting public ahead of the November polls and unless the dollar goes into freefall there is little likelihood of a rate hike. In Euroland rates may incrementally rise but any increases will be modest and in the UK below market expectations. The ECB and the B of E will take no chances with growth still below par. Inflation remains benign with China providing ever cheaper manufactured goods (dollar currency peg is making China even more competitive in European terms) thus pressure to increase rates will only stem from the overheating housing and consumer credit numbers. We feel the BoE will largely ignore this pressure and only incrementally raise rates at worst.

Bond markets will almost certainly end the year lower unless the global economy collapses! This comforting thought leads us to believe that Govt bonds are probably to be avoided due to the massive increase in supply via UK and US budget deficits together with the fear of future inflation due to ever increasing printing of money as promised by the Fed.

UK GILT 5% 2009



As can be seen from the above chart UK gilts have had a miserable 6 months and look likely to test support from spring '02. If these lows are broken then further capital erosion is highly likely.

The US Treasury (below)has barely steadied above 106 since the dramatic summer sell-off. Any move below 106 could open the way for a move to below 100. If prices exceed 112 then the next leg down may be delayed for a short period.

US TREASURY BOND (weekly)



Bottom line for '04

Medium and long term Government bonds are in a new secular bear market and will only cause capital losses for all investors during 04.

EQUITIES

- Mid 250 will indicate timing and strength of the next/current rally.
- 04 to be a roller-coaster with an accommodative Fed but below par economy.
- US gains don't exist!

We will start this section with a review of the Ftse Mid 250 (below) We like this index because it is not totally dominated by the futures market or 3 major stocks (Vodafone, BP and Shell) like the FT100. We believe that it is a broadly based indicator of overall market direction and as can be seen below it has been stuck in a sideways range since late August (Ft Small Cap is similar). Thus the latest move by the FT100 is not at present being confirmed by the smaller cap indices. This is not necessarily a problem but we expect the FT100 and the mid cap to fall back into line with either the FT100 rally failing or the mid cap breaking to new recovery highs. The resolution of this conundrum will be a major guide to UK market direction for the next few months.

FTSE mid 250



The Mid 250 will help guide our short term (0-3 months) trading so traders can buy the UK on a break out above the 5850 level, but run for cover if 5600 is breached. We feel that the upward move looks more likely with a strong first quarter likely to follow.

The prospects for global stock markets for '04 are not great but neither are they disastrous.

Despite overvalued markets and reversion to mean which will act as a huge drag upon markets we are going to see a Fed that will be absolutely determined to support the economy in this an election year. At present it looks like Bush will win. Historically, incumbent Republican winning Presidents has been hugely positive during the election year with average gains in excess of 14% during the 20th century. Therefore, we would suspect that '04 might well be slightly schizophrenic due to the above opposite forces being at play. It may well prove to be a positive first half with the second becoming choppy as investors focus on the likelihood of tax hikes, public spending cuts and interest rate rises during '05. Reversion to mean will likely re-assert its influence later in the year, as the Fed has no powder left to add to the very stimulative policies pursued in '03 (tax cuts, increased public spending and lower interest rates). So investors should proceed with caution this year with one eye on the charts to watch for any sign of weakness (watch for lower lows, and lower highs to indicate a trend change) especially later in the year.

The Dow and S&P are no higher now than they were during June for European investors. The recent rally witnessed on the US blue chip indices have seen the Dow rise from 9320 on 18th June to around 10400 currently whilst the S&P has gained 100 points to 1120 over the same period.

This seemingly 10% advance has been largely eroded by the dramatic dollar decline from \$1.65 to \$1.80 versus the pound over the last six months. This 10% currency decline has wiped most of the market gains witnessed in late '03. We have only seen a currency adjusted stagnation on the key US market which may well partially account for the stagnation witnessed on many key UK indices since September (Techmark, Small-Cap and Mid 250). The same is true incidentally when the gold rally is considered in sterling terms. Look at the dollar chart in the forex section to see the scale of the declines since the late summer.

DOW JONES



NASDAQ



The two above charts for the Dow and Nasdaq both show continuing advances that will remain in tact as long as the key supporting trend lines are not

breached. On the Dow the advancing line is around 10,000 and the Nasdaq trend support level is around 1950. A move below these levels would imply a serious loss of momentum and probably signal a prolonged period of lateral action at best.

On the above charts we have also shown a simple momentum indicator that highlights the currently overbought nature of many markets at present. Thus in the very short term investors should be ready for a bout of profit taking.

The Ftse 100 has recently broken above resistance at 4400 and looks likely to advance further. However there may be some very short-term weakness to work off the current overbought condition. A trade back to the top of the previous trading range may well reflect this at 4400 to “kiss goodbye”. A move below 4400 would become on a technical basis increasingly problematical as we would then have a failed upside break from a trading range. This deterioration of trading technicals would be heightened if the long-term trend support line at 4380 were to be also breached. As ever keep an eye upon the charts for signs of market failure.

FTSE 100



The Nikkei probably saw its reaction low in November and a move below key support at 10,000 is required to offset scope for a test of the October high of 13,000. If this level were to be surpassed then we may well witness a further run onto around the 15,000 levels. Japan is very cheap in global terms but investor sentiment is still below basement level.

NIKKEI



Most of the Asian markets have had great runs of late and the Hang Seng is no different. The recent consolidation at 12,000 has now been overcome and we would expect the market to run up to multi-year resistance at 14,000. Any weakness beyond the recent lows of 12,000 would be serious for the market strength and traders should be aware of this key market level.

HANG SENG



BOTTOM LINE

Equities look likely to trade broadly higher certainly through Q1 and Q2 as fuelled by cheap money from the Fed. **BUT** the bear is not over and as the current stimulative package and liquidity wanes the bear will resume at some stage this year or Q1 2005 at the latest. Investors and traders alike should be very wary of any profit erosion.

FOREX

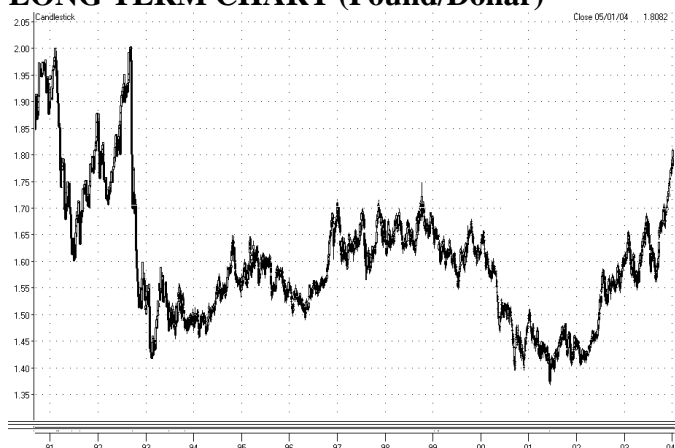
- Dollar is oversold and the decline is accelerating
- Euro pound remains trapped
- Yen declines along the Dollar

The world appears to currently have two currency polls with the Yen and dollar trapped together whilst the pound and euro also acting as one. We are currently witnessing a dramatic acceleration in Dollar declines together with Joe Public finally starting to take notice; therefore the current sell-off must be nearing a low of at least medium term significance.

If we look at the two Dollar pound charts below we can see how the dollar is in almost freefall and this is unsustainable despite a Fed that seem unconcerned. The Sterling highs of the early 90's should cap the dollar's decline if the current move does not end somewhere in the mid 80's.

The current dollar decline is unlikely to continue much longer and "jawboning" from the ECB is likely to coincide with the end of the current trend. We anticipate a multi-month correction by the dollar before falls resume. Thus any traders currently short the dollar should run with a trailing stop of perhaps 3 cents which, should avoid being shaken out unless we see a larger correction than we have seen the last few months.

LONG TERM CHART (Pound/Dollar)



POUND/DOLLAR (last 12 months)



The euro remains the least ugly of three reserve currencies in the eyes of forex traders. While no country wants a strong currency, as we mentioned above, some are willing to do more to prevent it than others. The ECB has done very little to halt currency appreciation, relative to what we have seen from the US in recent years and from Japan over a longer period. Until this changes, it will continue to trump all other factors, including Euroland's comparatively modest GDP growth.

In the meantime the pound appears to be stuck in a ranging lateral pattern with the euro at present and until this range is broken we would stand aside.

EURO/POUND (weekly)



The Yen has fallen sharply along with the dollar versus sterling. This despite massive intervention by the BoJ who have bought over 200 billion dollars over the past few months. The yen is approaching the significant 200 yen level versus the pound. Interestingly the momentum at present is not

confirming the move and it may be a pointer to the fact that sterling strength is likely to abate for the short term at least.

YEN POUND



Bottom line: Current trends are overcooked beware of a trend reversal. Long term we expect further dollar weakness but only after a countertrend rally.

COMMODITIES

- **Gold bull run overbought?**
- **Oil to fall before summer**
- **Palladium our nap for 2004-01-13**

Gold simply continues to climb despite being overbought and having an amazing bullish consensus. As regular readers will be aware we are long-term bulls of the yellow metal as it emerges from a twenty year bear market. However, we have been surprised by the recent strength as we felt that a consolidation of the recent gains was overdue. We still reluctantly hold this logical view but fear we might well have yet more egg on our faces!

Long term we are sure gold will more than exceed the all time highs of over \$800 in 1980 due to the global printing of paper money and huge budget deficits. We also think that the "Iron Chancellor" issued the greatest buy signal of all time when he sold a large portion of Great Britain's gold reserves at the bottom (\$252) in '01.

Such stupendous crass stupidity is the prerogative of politicians and provides all traders and investors alike both a great contra indicator as well as an insight to the conceit and hubris of politicians.

We would like nothing more than all our readers to make substantial gains out of gold just so we can chuckle to ourselves over Brown's actions.

In fairness the value of gold has not advanced recently so spectacularly in Sterling terms but, we feel that it definitely constitutes a hedge against uncertain economic events.

Currently, we still expect a short-term pull back that may well see prices dip back below \$400 for a short while. But with supply finite and demand growing dramatically across the globe we can envisage a rampant bull market for the next 5 to 10 years.

The greatest obstacle in the path of higher gold prices is central bank sales. Since 1999 European central banks have sold over 1594 tonnes of bullion from their reserves under the WAG (world agreement on gold sales). The biggest sellers, according to the World Gold Council, have been the Swiss National Bank (871 tonnes) and the Bank of England (345 tonnes), with this latter amount offloaded near the lows. Sales from non-European central banks have been small, and some have been buyers, notably from Asia. The WAG expires in September 2004, but is likely to be renewed, albeit with some changes. Commenting at a recent gold conference in Dubai, Giacomo Panizzutti, who retired last year as the secretariat supervising the WAG said, "I strongly believe the agreement will be extended, probably for a slightly larger amount of around 2,300 to 2,400 tonnes, and for another five years. Such an increase of about 300 to 400 tonnes should not be a problem and should be easily absorbed as long as the market remains as well supported as it is just now". This is probably correct although some potential buyers of gold may be cautious until a new WAG is reached. Additionally, stronger prices beforehand would probably lead to a higher tonnage agreement, and vice versa. Should the WAG not be renewed, the price of gold would be susceptible to a potentially significant, albeit temporary correction, due to supply fears.

Meanwhile, it is generally acknowledged that the WAG's fifteen European member countries, which still hold approximately half of official reserves at 14,000 tonnes, would like to sell more gold. Among other countries with large bullion reserves, the US and Japan agreed not to sell shortly after the WAG was announced in 1999. Any moderate increase in

gold sales by the WAG fifteen are more than likely to be offset by purchases from Asian central banks, some of which maintain a small fixed proportion of their reserves in bullion.

GOLD (weekly)



OIL (Nymex weekly)



Oil has continued to surprise many by remaining well above \$30 a barrel. The current sideways to higher action following last spring's sell-off, appears to be corrective and we would not be surprised to see oil weaken below \$30 as the winter peak in demand subsides. A break below \$32 would be the first hint that prices may be set to decline.

POTENTIAL METAL TRADE OF THE YEAR?

The two charts below of Platinum and Palladium are based upon the time period. As can be clearly seen that whilst Platinum has nearly doubled since

the spring of '02, Palladium has halved in price. This is despite the fact that the semi-precious metal Palladium, can easily be used as a substitute for Platinum in catalytic converters.

We think a **MAJOR OPPORTUNITY** has arisen in the Palladium market, as we feel sure a catch-up move is likely to occur as the price disparity makes Platinum un-economic.

We think there is two possible ways of playing the potential move.

1. **Convergence trade** with a short on Platinum and a long on Palladium. The advantages of this approach is that timing is not so important and also if the price differential is closed by a straight fall in the price of Platinum then the position is still a winner. The potential drawbacks are that both prices may rise in tandem and provide little or no profit plus there is the additional cost of carrying both contracts
2. **Palladium longs** could be taken but we would caution speculators to await a break above \$215 and a stop is required below the recent trading range at around \$180. The main drawback of this approach is that we are reliant upon the convergence occurring via a catch-up move by Palladium.

In our view we think Palladium will indeed rise to close the price differential, but suspect that the move may well be volatile. We would advise traders to await a break above the \$215 level but suspect that this may well occur sooner than later.

PLATINUM (weekly)



PALLADIUM (weekly)



Cotton has long been a favourite trade of ours ever since tipping it in 2001 at \$29. The recent spike high looks trend ending and climactic and as such we would be tempted to short the contract on a fall below \$70. We certainly would not trust the current weak return rally and would expect a failure below \$80.

COTTON (weekly)



FINALLY

A footnote on valuation

This is a very sound article by Bill Fleckenstein of MSN Money. Here's a section:

“Assuming a Dow P/E of 21, if we were to acquire the entire index, we'd get our money back in 21 years. (Along the way, we'd also get a dividend of

about 2%, barely enough to keep up with even the Fed's low definition of inflation.)

That 21 years assumes no growth of earnings and no diminution of same. The break-even time would obviously be a bit longer for the S&P, and nearly an eternity for Nasdaq. I'll leave it to you to decide what you think the growth in earnings would be, but even Warren Buffett has said recently that he finds little value today. For those who assume that low interest rates necessarily result in high P/E's, I say look at Japan. If rates are low because business is poor, higher P/E's compound the risks.

Taking a slightly different approach, we could look at the entire stock market capitalization as a percentage of gross domestic product. The percentage is now about 105% of GDP. That number alone doesn't mean anything. But what if I were to tell you that, before the bubble began in 1995, the highest the percentage had ever been was 80%? You could see that if we just traded back to the highest previous level, we would experience a decline of 25% in the Dow. Likewise, if I told you that, for the last 75 years or so, the stock market's total capitalization has averaged about 55% of GDP, you could see that to get back to the average level we've traded at would imply a decline of about 50%. We won't even discuss what would happen if we were to trade back to lower levels of valuation.”

We would remind all readers that although we are currently following the current rally, it is our belief that it is a mere bear rally and that a vicious downtrend will resume sooner or later, probably not before the summer in all likely hood. But the charts will warn us when the trend cracks.

We would like to take this opportunity wish our readers a very happy, healthy and prosperous New Year.

Regards

Andy McCarthy & Andy Bartles