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## **WHEN PROPERTY FINALLY TOPS THE WHOLE ECONOMY COULD GO WITH IT!**

### **BARMAC MARKET DIRECTIONAL INDICATOR:-**

**Has oscillated between positive and negative over past month since buy in October 2003.**

#### **1.GLOBAL ECONOMY**

**House price madness**

**Policy traction**

**EU let GB reclaim her pride**

**Insiders still selling**

#### **6. INTEREST RATES AND BONDS**

**Govt short-term rates turn up**

**Bonds-Bear back on the prowl**

#### **6.EQUITIES**

**China crisis?**

**Global markets lose momentum**

#### **9.CURRENCIES;**

**Dollar short term overbought**

**Sterling at key juncture with Euro**

#### **10.COMMODITIES**

**CRB has dramatic fall.**

**Gold & Silver and metals all crash**

**Softs also look interesting**

**The importance of the UK housing market to the general health and well being of the UK economy is hard to over-exaggerate.** Over 70% of UK households own their own homes and as a store of wealth the equity held in domestic property dwarfs that held in pension funds and the stock markets. Indeed it was recently calculated that the net average worth of each UK citizen had now reached £87,000 due solely to residential house price appreciation.

In February '03 we highlighted the fact that 6% of UK consumer spending was directly as a result of debt refi and equity release. However, a recent update of these numbers presents an even scarier picture.

According to the Motley fool *“One reason why the UK economy is doing better than its European counterparts is that UK consumers are in the midst of a serious spending binge. According to the Financial Services Authority, the UK's financial regulator, we are spending £100 for every £90 we earn.*

*So, where are we finding this extra tenner?*

*In an ideal world, it would come from savings - but this is a far-from-ideal world! Debt statistics show that this extra spending is coming from debt: bigger mortgages, more personal loans and larger credit-card bills.” In fact, according to the Bank of England, mortgage equity withdrawal (capital taken out of our homes that isn't re-invested into property) hit £53 billion last year. This means that we increased our mortgage debt as a nation by £53 billion and then spent this money elsewhere.”*

Interestingly this figure is roughly equal to the UK domestic household total interest bill for 2003. So debts are being serviced at present out of capital

growth!!

Worryingly, in the last quarter of 2003, we withdrew a sum equal to a twelfth of our post-tax income (8.3%) - the highest on record. Buoyed by the UK's *apparently* unstoppable house-price boom, homeowners are spending tomorrow's money today - and like never before. The problem is that house prices are largely a matter of opinion, and are governed by numerous factors. Debt, however, is harsh reality - as the 660,590 homeowners whose homes were repossessed over the last twenty years will confirm!

So the die is cast the UK consumer is at present living on the notional capital appreciation of his or her home. The UK economy is therefore shackled to this spending boom driven by property price inflation. If property were to falter then the implications for consumer spending and by default the UK economy would be desperate.

**A self-feeding cycle of decline** may follow a break in house price appreciation. The potential loss of upto 10% of total consumer spending would be devastating to domestic demand. The scale of devastation could be visualised if one relates economic well being to UK trend growth of 2.75%pa. If we were to see a potential slump in consumer demand of 3%, 4%, 5% or more in the UK, it is not hard to imagine that the economy would suffer a dramatic and catastrophic collapse. This collapse would inevitably lead to pressure on employment and feedback to further falls for house prices.

These pressures are building in the US also and explain the reluctance of the Fed to move interest rates up from the "emergency/panic low" rate of 1%. If the global economy was in such great shape (as they keep telling us) and recovering we would not need to have US rates at 1930's depression levels.

This conundrum leaves the FED in a bind as they have caused an asset (houses) and consumer spending bubble by lowering rates to offset the 2002 recession and if they start edging rates higher (which they may have to with inflation creeping higher) they risk a collapse in property prices and consumer spending.

Thus the Fed may well have "set up" far more dangerous conditions by encouraging consumers to spend their way out of recession. The credit binge

will in the end have to be paid for and the timing of the hangover will coincide with the slowing of the housing bubble on both sides of the Atlantic.

The point is this: low rates are puffing up the stock market, lifting share prices over and above the true fair value of the assets they represent. When the artificial stimulus is removed... when rates rise, as they must eventually... stocks will fall. Bonds and house prices, too. Both of those markets are trading near all-time highs. And who owns these assets? Joe public. our friendly indebted consumer...

The fall-out for both the Atlantic economies will be disastrous.

**Despite record stimulus, record low interest rates and a record budget deficit, the US economy has experienced only a sub-par recovery.** This lack of policy traction is a warning of the fundamental weakness of the global recovery and an insight into what might occur if and when the favourable stimulus is removed. This will occur soon, probably after the US Presidential election. The amazing lack of response to unprecedented fiscal and monetary stimulus is discussed below by the good Dr Richebacher from an article produced in March for the Daily Reckoning.

### ***POLICY TRACTION*** ***By Kurt Richebacher***

*"Policy traction" is an expression that lately has come into fashion. In essence, it is about the relationship between the size of the monetary and fiscal stimulus injected into an economy... and their effect on economic growth and employment.*

*In the past three years America has experienced an interest rate collapse, a record fiscal stimulus and the loosest monetary policy imaginable fuelling money and credit creation at a scale that has no precedent in history. Has it really worked?*

*Well, in one way it had fabulous traction. It engendered the greatest credit and debt bubble in history. Total outstanding debt, financial and non-financial, in the United States has ballooned by almost \$6,500 billion since 2000, as against GDP*

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growth of \$1,238 billion. For each dollar added to GDP, there were about six dollars added to indebtedness.

And it had fabulous traction in a second way: The runaway money and credit creation went with a vengeance into asset markets -- stocks, bonds and housing. When the equity bubble popped in early 2000, the consumer simply moved on to the housing bubble that had been waiting in the wings, helped by the Fed-inspired bond bubble driving mortgage rates sharply downward.

Their joint result was the unprecedented mortgage finance excess. While businesses were slashing the consumer's income growth, he offset this income loss largely by stepping up his borrowing.

Yet in the course of 2002 it became clear that the lowest short-term interest rates in nearly half a century were failing to create the customary strong economic recovery. In June, the Fed cut its interest rate for the 13th time, to 1%, a 45-year low. In the following month, it admitted in its report to Congress the fact that the economic performance during the first half of the year had remained sub-par.

On the other hand, however, the Fed stressed the success of its easing by mentioning the recent rise in stock prices, the sharp narrowing of credit spreads on corporate debt, the strong housing and mortgage refinancing market and rising consumer sentiment.

What, in fact, had emerged was an unprecedented dichotomy in the effects of the Fed's most aggressive monetary easing between economy and financial markets. Instead of jump-starting consumer and business spending, the extreme monetary looseness and rock bottom short-term interest rates generated multiple, price bubbles in the stock, bond, mortgage and housing market.

Without great discussion, the U.S. economy has been shifting to a growth model that radically differs from past experience. In the old model that has ruled for centuries, monetary easing was conceived to work directly on the real economy,

and it could be counted on to promptly do so. But it was a world with low debts and strong employment and income growth.

Most importantly, it was a world in which financial systems of very limited size principally served as mere conduits for channelling savings into capital investment, creating national wealth in the form of productive plant and equipment, and commercial and residential buildings.

Faced with an economy that responded poorly to its aggressive monetary easing, and with very little scope for further cuts in short-term interest rates, a desperate Fed reacted in an unconventional way. Internally, it was obviously considering an attempt to increase policy traction by bringing long-term rates down as well.

Wanting to avoid direct intervention, it apparently decided to put America's highly vigilant, huge, financial and speculative community before the cart, by using nothing more than simple opportune rhetoric. Repeated public talk by Mr. Greenspan and other Fed members of looming deflation in the economy was one bit of bait. Simultaneous talk of two new policy considerations was the other.

The first idea, was to repeat in public an explicit commitment to maintain the existing rock-bottom short-term rate peg of 1% as far "as the eye can see"; and the other one, was public hints that "unconventional" measures, like direct purchases in the market, were being considered to push long-term rates further down as well.

It was really an unreserved invitation to investors and speculators around the world for greater engagement in playing America's yield curve with heavily leveraged carry trade. Many heard and acted promptly. In just six weeks, U.S. 10-year yields fell from 3.9% to 3.1%.

It should, by the way, be clear that this manipulated indirect intervention vastly outdid what the Fed could have possibly done with direct purchases. We have no idea about the scale of the purchases that suddenly flooded the U.S. bond market, but it was without question in the range of several hundred billion dollars.

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*What followed is well known: A frenzied stampede of the financial community into the highly leveraged bond carry trade sent bond yields plummeting, pulling in their wake highly correlated mortgage rates sharply downward with them. In the same vein, the loose money helped to boost house prices.*

*Given in addition extremely aggressive mortgage lending institutions, eager to lend prodigiously against rising house prices, consumer borrowing just went parabolic.*

*All in all, four interrelated bubbles have kept the U.S. economy going after the bursting of the stock market bubble in 2000:*

*Rising house prices, falling bond yields and mortgage rates, and soaring mortgage loans feeding the consumer-spending binge. Yet the key role fell manifestly to the bond bubble. By pulling mortgage rates precipitously down, it provided the big bait that lured house owners to capture the offered big savings in current interest rate service by refinancing and increasing their mortgage.*

*U.S. economic growth, therefore, is no longer based on saving and investment. Its essence is that credit excess provides soaring collateral for still more credit excess creating still more asset inflation for still more borrowing and spending excess. It seems like a perpetual motion machine that just goes on cranking out wealth and spending.*

*The traction that these policies have so far achieved, and its probable economic and financial effects in the longer run, has therefore become the most important issue in the current development in the United States.*

*The true name of this game is bubble-driven growth... and all bubbles end by bursting.*

*Note: Former Fed Chairman Paul Volcker once said: "Sometimes I think that the job of central bankers is to prove Kurt Richebächer wrong." A regular contributor to The Wall Street Journal, Strategic Investment and several other respected financial publications, Dr. Richebächer's insightful analysis stems from the Austrian School of economics. France's Le Figaro magazine has done*

*a feature story on him as "the man who predicted the Asian crisis."*

### **European referendums**

"He who pays the piper calls the tune" is an old and very pertinent maxim to bear in mind as the spin begins to bully the British electorate into a "yes" vote.

Currently Britain "enjoys" the benefit of around £3 billion worth of EU spending a year. All those European development zones are wonderful and we should be grateful for such generosity. But before we become too overwhelmed by such benevolence we should consider the sobering fact that for every £1 Britain contributes only a measly 48p is allocated back to Britain costing the UK a net £3 to £4 billion a year.

Great deal eh!

Now with the EU set to grow with accession of ten new members contributing a 20% increase in EU population but only a 5% increase in GDP we can anticipate yet more subsidies pouring out of the UK to the east.

The "spinners" will argue that a "no vote" will mean the isolation and withdrawal of poor little Britain.

What utter rubbish. GB has a huge trade deficit with Europe and is also kind enough to be one of only two members who has been a consistent NET contributor to EU funds. So does anyone truly believe that the EU would turn their back on this highly profitable relationship for our European partners?

People can therefore vote for what they feel is right because the EU has no big stick to beat the UK with. In fact it is Britain that has the power and maybe this vote may lead to GB following the De Gaulle line of vetoing everything that we don't like. Europe might not like it but that's politics.

### **INSIDERS STILL SELLING**

We know what the dumb money is doing... refinancing houses in order to buy 4x4's, conservatories, holidays and tech stocks at 100 times earnings. But what's the smart money doing? Thomson Financial reports that corporate insiders continued to sell their own stock last month. For every share they bought, they sold more than 28 shares - bringing to 11 the number of consecutive

months sporting a sales-to-purchases ratio greater than 20 to 1. People who follow these things said they had never seen such extreme selling.

Why would insiders sell?

Often, they are the people who started the business. At some point in their lives, they have had enough. Or they get sick... or divorced. There can be a lot of reasons for selling your own stock. But, typically, the ratio of sales to purchases remains around 2.25 to 1. At 28 to 1, something is different. Either people who run corporations are dropping dead at an alarming rate, or many of them figure that the "lumps" are making a mistake: they're bidding more for corporate stock than the people who know it best think it is worth.

## INTEREST RATES & BONDS

- Yields rise as Fed hints at rate rises
- Bond markets resume their bear trends

**The Bear market in bonds resumed during the last few weeks.** In the UK the benchmark yield on 10 year gilts is within a whisker of 5%. This is significant as the driver behind mortgage rates and annuities are gilt yields. So regardless of the Bank of England's tinkering with base rates the general direction of real rates in the UK is pointing strongly higher.

This is the result of fear of rising inflation together with excessive supply due to Gordon Browns profligate spending plans. The UK budget deficit could top £40 billion during the current fiscal year. This total represents a huge reverse from the budget surplus of 2001/02 and this surge in Govt debt has to find a home. The laws of supply and demand dictate lower prices and higher yields. The Gilt market is especially vulnerable to extra supply with current interest rates at generational lows and the potential threat of an increase of the inflation rate likely over the coming months.

**In the US Greenspan's recent testimony** has hinted at higher rates to normalise the US market rates. The US bond market has thus seen yields rise from 3.6% to 4.4% over the last few weeks as investors run scared of a US CPI that appears to be accelerating. Indeed the last three months CPI is indicating a potential annualised inflation rate of

around 5%. With short-term money at 1% it does not take rocket science to envisage sharply higher rates. The timing of rises in the US is uncertain with Greenspan keen to delay to perhaps next year if possible.

**The UK and US bond markets have both fallen sharply over the past month as we suggested they might over the past few issues.** We suspect that the current declines are only the start of deep and long-term declines as the global bond market struggles through a major bear that will see yields back above the long-term average.

### UK Treasury 8% 2013 Gilt



### US TREASURY (weekly)



## GLOBAL EQUITIES

- China bubble bursts?
- Japan still strong

- **Global loss of momentum affects Ftse and S&P**

A major driver of the equity bull rally over the past year has been the growing emergence of China as a global economic superpower. Indeed later in this publication we talk about China's affect upon various commodity markets. China has been the main beneficiary of much of the US fiscal stimulus (exporting all kinds of widgets to the US via Walmart) and has had growth rates of 9,10 per cent or more over the past few years. This growth has spread all around the various Far Eastern markets such as Japan and Hong Kong. This has helped drive equity valuations higher around the world as companies have re-located production to the PRC.

However, China's boom has led to overheating and a huge speculative investment bubble (witness last months "erection index feature on the worlds newest tallest building) and the Chinese authorities have now decided they have to "cool" the economy. The various China "plays have had a "right shellacking" as the JP Morgan China investment Trust below has given back in just a couple of weeks half the gains made over the previous year. This kind of dramatic downward dynamic is a major warning to the western markets, which have been struggling on waning momentum for several months.

**CHINA Investment Trust (JPMorgan)**



The Hang Seng (below) has been a classic "china play" and has been a very strong market over the past twelve months. However, it has too succumbed to the dramatic change in monetary conditions in

the PRC and retraced 30% of the advance. This index may well trade sideways to higher for the short term but any decisive break of the 12,000 level could well lead to further steep declines.

**HANG SENG**



Currently, the Japanese market for once appears to be serenely sailing along on smooth waters. But it too could be vulnerable to a correction emanating out of the Peoples Republic. However, the trading range of late autumn should cushion any correction.

**TOPIX**



The Ftse 100 is clearly decelerating as can be seen by a casual glance at the chart below. Additionally the advance has become less orderly with sharper corrections starting to occur. This is normally consistent with a change of trend and despite relatively loose money from the US it would appear that global liquidity is waning with the PRC perhaps the most obvious and highly leveraged indicator of global market health. A move below 4300 for Ftse

would likely lead to a major crack in the bull mentality and lead to falls towards the 4000 area.

### FTSE 100



**The S&P 500 has hit horizontal resistance at 1150** and appears to be struggling to make any further headway. We certainly believe that the best of the advance is already behind us and a crack of the March low would be a major downside failure and open the door to a deeper correction. We are not sure whether the bear will return fully in this an election year but the storm clouds are gathering.

China is tightening monetary conditions, after the election the US will have to address the twin deficits and housing booms are likely to crumble as bond yields rise.

### S&P500



**Bottom line. Equities appear to be running out of steam are increasingly susceptible to a major correction. KEEP A SHARP WATCH ON THE march lows. If they are broken then a major correction may well be underway**

### FOREX

- **The Dollar rally is now becoming overbought.**
- **Therefore the Euro looks set for a bounce.**
- **Sterling caught in the middle**
- **Yen; B of J stopping sales**

As predicted in February and March the Dollar has staged an impressive contra-trend rally. The rally looks to have legs as yet in both time and price but short term the Dollar's rally against all currencies illustrated below is becoming slightly overheated. Although we expect the Dollar index to reach at least 95 we suspect that there may be a pull back before any further meaningful advance is achieved. We also suspect that after nearly three years of declines the dollar needs to spend at least six months ranging higher to unwind the deeply oversold conditions apparent in January.

The Dollar/Euro story remains the dominant story in the Forex markets with all other currencies acting as satellites to the fall-out from these two. At present Sterling is simply stronger the euro but weaker the dollar as the cross currents between the big two unwind last years huge speculative dollar declines. Longer term we expect the US economies massive twin deficits to weigh the dollar down way beyond the January lows but not until at least the autumn.

### DOLLAR INDEX (weekly)



Sterling appears to have just breached the neckline of a large "head and shoulders" top. Thus apart from some temporary strength as the break is

perhaps re-tested it would appear that sterling is to stair step lower over the coming months.

Traders could short the pound with a stop at \$1.81 on any sterling strength with a potential target of \$1.70 the highs of last summer

### Sterling/Dollar



**The Sterling /Euro chart is approaching a key juncture.** The recent rally has carried prices back toward the underside of the massive multi-year trading range of 2000 to 2003 at £1.53 and the falling trend drawn down through the falling highs created during the first few years of the decade. This area could likely cap sterling's advance and perhaps kick in a period of relative sterling weakness versus all currencies. Speculative traders should reduce any short euro positions at current levels and watch for a downward dynamic for sterling.

### Sterling/Euro



**With the BoJ ceasing to intervene in the forex markets it is likely that over the medium term the Yen will strengthen.** The Japanese had almost

single-handed supported the dollar last year. This lack of yen selling will surely feed through to all yen crosses. The sterling /yen cross has seen sterling fall from over 204 to 194 and we suspect that prices could head lower if 192 is breached.

### Sterling/Yen



## COMMODITIES

- Major breaks in speculative trends on many markets
- Gold and Silver post important highs.
- Oil hits new high
- Palladium creates huge profit but sees major set back
- Many Softs are at important junctures

**Commodity markets have been on a tear over the past year or so as the Commodity Research Bureau (CRB) index highlights below.** The huge rally across many commodity markets has been by driven by a combination of a weak dollar, global growth (the rise of China), loose money and restricted supply.

The rally appears to have hit a brick wall during the past month with a major correction that has retraced 33% of the gains of the last year in two weeks. This dynamic is likely to mark a significant top (but not a final top) in the commodity markets and may reflect a subtle change in global conditions. Certainly the dollar rally will have had a drag on prices but perhaps the potential of the brakes being applied on an overheating Chinese economy is having a dramatic emotional effect on many industrial metals. The China factor is hard to underestimate, as it has become the major swing buyer in the commodity

markets. Indeed many commentators suspect that China represents 60% of the global growth in commodity demand over the past two years as a huge construction and output boom rips through the PRC.

The CRB is unlikely to hit a new peak for at least a few months, as a ranging consolidation is likely to follow the current correction. With global interest rates slowly heading higher and the zenith of US monetary stimulation being already past, then the global rates of growth are likely to slow over the next year easing demand growth pressures on the CRB.

### CRB INDEX (weekly)



**We hate to say “we told you so” but the dramatic tops and subsequent decline in Gold and Silver do not come as a surprise to our readers.** The nature of the blow-off top in silver implies that the silver market will have a severe hangover for many months to come. Gold too has seen a top of intermediate significance and we suspect prices will work lower over the months to come. That does not mean we are not long, long term bulls of gold but we suspect gold will not move strongly until a global fear of deflation reappears in a year or two. Meanwhile we would look to short gold on any strength above \$400. We would stand aside on the wildly gyrating silver market for the present.

### GOLD(weekly)

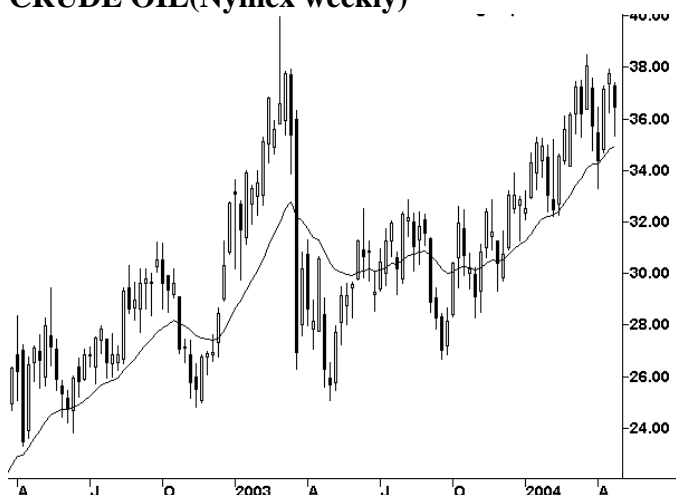


### SILVER(weekly)



**So far OIL has not joined the global commodity sell off.** As regular readers are aware we have not expected oil to continue to trade so strongly and had been awaiting a break of the sequence of rising lows. That remains our stance so we will stand aside until and if \$34 was breached signalling a deeper correction than any witnessed since September last year. Clearly with crude trading back at levels seen during the pre-Iraq war levels one would expect prices to ease. Certainly, current levels are acting as a brake upon global growth.

### CRUDE OIL(Nymex weekly)



### 50% gain in Palladium since January!

**Platinum and Palladium have both suffered from the recent declines in metals but our catch-up trade in Palladium has performed well.** The rally looks to be over for the present and although we expect palladium to continue to outperform platinum we would take profits now if you haven't already. We reco'd palladium at \$215 and saw it shoot to a high of \$340 in only three months, so even if you have suffered some profit erosion during the last week or two it has still proven to be a great position.

When we look at both charts (below) we do not expect the recent highs to be exceeded for sometime. These metals have both been caught in the general commodity sell-off sweeping through over the past month as China tries to cool its economy.

### PLATINUM (weekly)



### PALLADIUM (weekly)



**Wheat has rallied throughout the last twelve months** but now finds itself crawling just upon the rising trend support. Any breach could indicate a final failure of positive momentum and present a potential shorting opportunity. Currently, the \$375 area looks crucial and a breach below this level signals a shorting opportunity. Any new position should have a stop placed around the key roundaphobia level of \$400

### WHEAT (weekly)



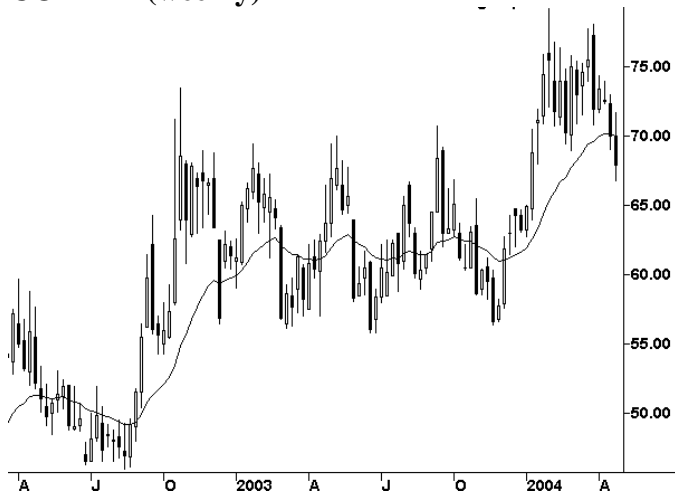
**Cocoa's bull peaked late last year and has since built a shelf of support at \$1400.** Interestingly that shelf is under pressure at present and appears to be giving way. Traders could short cocoa with a relatively tight stop just above \$1400 if the shelf of support has been breached.

### COCOA(weekly)



**Coffee is proving to be a very choppy market at present with no consistent trend in force at present.** An apparent step up above the key \$70 tops occurred late last year but this strength has failed to be maintained and recent weakness has seen the price slither back into last years trading range. This market at present does not appear to be offering little to speculative traders at present and we would stand aside until a clear trend begins to emerge.

### COFFEE (weekly)



**Now that's what we call a bear market!** We have at present nothing concrete to act upon with FOJ but the rate of decline does appear to be slowing. The massively oversold conditions could easily lead to a dramatic short closing rally and we suspect that such a rally is perhaps not that far off. A move over \$63 could signal the start of such a move as the

downtrend line would be breached and would probably place a small buy order above the market at \$63.

### ORANGE JUICE (weekly)



### FINALLY

As ever we welcome your feedback and if you have any comments we would be delighted to hear from you

Regards

Andy McCarthy & Andrew Bartles