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BEWARE THE INVERSE YIELD CURVE & PROPERTY MARKET FALLS!

BARMAC MARKET DIRECTIONAL INDICATOR:-

BUY SIGNAL -issued on 5^h SEPTEMBER
SELL lining up at present **BUT** not given.

1.GLOBAL ECONOMY

Rising interest rates
Property crash
Apocalypse later
“War war” or “bribe bribe”

4. INTEREST RATES AND BONDS

US rates still climbing
Bond demand from pension funds
Bonds defy gravity

5.EQUITIES

Rally loses steam
Volatility to increase?
Tokyo catch-up

6.CURRENCIES;

Dollar weakest link
Bounce for pound back to Jan high

7.COMMODITIES

Commodity bull “only just begun”
Oils bull set to last
Gold due a correction.
Metals set to gain.

“Rising interest rates have been advertised for so long and in so many places that anyone who has not appropriately hedged this position by now obviously is desirous of losing money.”

Greenspan speaking in Frankfurt in November, just after the US Presidential Election.

And on the UK property front line;

The U.K. slowdown is marked by a drop in mortgage approvals, which dipped to a four-year low in November of last year, according to the British Bankers’ Association. Mortgage applications declined because interest rates rose and home values eroded. The synergy of both events likely has quelled housing purchase demand. *“There is little to suggest that mortgage applications will change in the near term, given the noticeable slowdown in the housing market,”* stated David Dooks, director of statistics at the bankers’ association.

The above two economic statements could prove to be the decisive for the prospects of the UK economy over the coming year or so. We witness the world’s most powerful man making it very plain that US short term rates are set to continue rising from the currently “emergency” low levels. This background of rising rates could certainly see increases to 3.5% or even 4% in the US. This presents the spectre of a “reverse yield curve” emerging in the US, echoing the same all be it mild case already apparent in the UK.

So what is a reverse yield curve and what significance does it have? A reverse yield curve occurs when short term rates are higher than long

term investments. Thus at present UK base rates are 4.75% but the 10 year gilt yield is below 4.5%. This relationship is illogical to the casual observer because any investor would wish for a higher return when locking his/her investment up for a much longer and therefore riskier period of time (just think of all the unforeseen and inherent risks associated with long-term fixed interest investment).

So when the yield curve is inversed as it is now (higher short rates than long term rates) the market is telling everyone an important message.

Historically, an inverted yield curve has been a very reliable early warning signal of recession. The track record of this phenomenon is not far off 100%. So we have one market indicator flashing red and about to be joined possibly by the US interest rate markets.

This is a truly major economic development that needs to be monitored closely.

Now added to the above interest rate worry (or because of it) we have a potential housing market slide. Recent mortgage application numbers show declines of upto 60% on last year with statistical evidence of falling prices month on month since September.

It has been argued by the property bulls that a housing crash cannot occur at present because we are near full employment and have above trend economic growth. But as Prof Tim Congden has pointed out the above boom conditions are the very feeding ground of housing market tops. Indeed, all previous cyclical highs in the UK housing market coincided with strong employment growth and economic growth. He also suggests that the UK domestic housing market leads the boom and the bust (a point we have long believed). Additionally, we have always maintained that a housing crash was not necessary to cause economic sluggishness due to the massive scale of debt refi occurring in the UK. A flat market will soon kill off the 6%+pa of cash leaking into the economy via equity release. Thus as property turns down it may well drag the previously strong (and seemingly supportive) economy with it around 6 to 12 months later (witness 1989).

Stephen Roach: The Real Interest Rate Conundrum - This fine piece by the Morgan Stanley economist details the problem that concerns us most. Here is a brief sample:

"Which brings us to the endgame -- how world financial markets and the global economy are weaned from abnormally low real interest rates. This is likely to be a delicate surgical operation, to say the least. Not surprisingly, it all starts with America's Federal Reserve -- the central bank that has nurtured the Asset Economy the most. The task is clear -- to restore the policy rate to a level that is compatible with the Fed's multiple goals of price stability, full employment, and sustained economic growth. The recently released minutes of the FOMC's mid-December policy meeting send a reasonably clear signal that the central bank is about to embark on such a recalibration. By citing two sets of concerns that are goading it into action -- rising inflationary pressures and mounting speculative excesses -- the Fed is threatening to reset the anchor of the world's real interest rate structure. In doing so, I believe that Greenspan & Co. now have their sights set on a policy rate that is in the restrictive zone. Gone are the days when the Fed can afford simply to shoot for "neutrality."

APOCALYPSE LATER

by Kurt Richeächer

Despite all the worried talk about the sliding dollar, both the financial markets and economic forecasters are taking it in stride. Conspicuously, nobody speaks of a dollar crisis at present or in the future. High-riding expectations of a strong year-end rally in the stock markets have been somewhat disappointed. Yet there have been two pleasant major surprises. One is the sharp fall of oil prices, and the other is the resilience of the U.S. bond market, defying not only the dollar's weakness, but also the four rate hikes by the Federal Reserve.

It appears to be a common view that economic growth in the eurozone and Japan is badly faltering again, with both countries flirting with new recessions. In contrast, the forecasts for the U.S. economy remain rather upbeat, hailing the plunges in oil prices and the dollar.

We stick to our diametrically opposite view that the U.S. economy is prone to sharply slower growth. It is

the profligate consumer who has kept the economy afloat since 2000. What kept the consumer afloat is also no secret. It was mainly two events: First, inordinate tax cuts; and second, exploding ultra-cheap borrowing facilities, made available through the Fed's creative bubble strategy and implemented by ultra-low short-term interest rates.

Together, the two have unquestionably contained the fallout from the bursting stock market bubble. They also had respectable effects in terms of U.S. real GDP growth during the second half of 2003 and the first half of 2004. Yet the most important aim of all the monetary and fiscal stimulus - to set in motion a self-sustaining economic recovery - has been flatly missed.

A "self-sustaining" U.S. economic recovery urgently needs accelerating employment and income growth. Just the opposite is happening. During the six months up to last November, real disposable personal income grew just 1%, or 2% annualized. This is down from 3% in the first half of 2004 and 4.8% in the second half of 2003. Taxes and higher inflation rates are taking their toll. Debt-financed spending went to new records. During the third quarter, private households increased their spending by \$139.4 billion, while their earnings increased only \$81.6 billion.

Employment and income growth are the key fundamentals of household finance. According to the reports of the Bureau of Labour Statistics (BLS), they have significantly improved in 2004. But no less than two-thirds of these gains owe their creation to the ominous "net birth/death" computer model of the BLS, designed to estimate employment growth by new business formations.

All that is needed to activate this job creation is a unilateral decision by the BLS that the U.S. economy is in a recovery. Implicitly, the Bureau of Economic Analysis translates these computer-generated additions to employment into corresponding additions to wages and salaries. Considering the persistent, unusual weakness in employment, as documented by the actual surveys, it requires a lot of heroism to assume an employment boom from new business formations.

For November, the BLS reported 112,000 new jobs, as against an expected 200,000. As bad as the report appeared, the reality was even worse. No less than 54,000 of the new jobs had come from the

net birth/death computer model, compared to 30,000 jobs in November last year.

In the third quarter of 2004, consumer spending accounted for 89.2% of real GDP. It is the familiar ruinous growth pattern. A viable economic recovery would require a strong contribution through sharply higher business investment and hiring. Both remain missing, although the recovery is entering its fourth year.

Euroland's Secret Success Story:

"The United States is richer and grows faster than euroland because productivity levels are higher and productivity growth stronger - right? Actually, no. Euroland's inferior GDP performance is attributable to a slower- growing labour force that works shorter hours.

"Euroland's underlying economic performance is better than many commentators portray. Over the past decade, GDP per head has risen virtually at the same rate in euroland as the United States; euroland productivity growth (output per hour) and the rise in the employment rates were slightly faster than in the United States; and to maintain the same growth in GDP per head, U.S. workers have had to work much longer hours than their euroland counterparts."

This subtitle and the above two paragraphs are not ours. They are the introductory remarks to a study about the eurozone economy, written by Kevin Daly and published by Goldman Sachs in January 2004.

Gloomy reports about the eurozone economy always abound. To quote a leading article that appeared in The Financial Times under the headline Two Broken Motors: "The latest economic data leave the eurozone and Japan looking more than ever like two enfeebled old men unable to progress at more than a stagger."

With utter amazement, at the same time, we keep reading that the U.S. expansion remains firmly on track, particularly with sharply improving jobs data. Third-quarter real GDP growth was revised upward to 4% at annual rate, compared with an annualised growth rate of 1.2% for the eurozone. Since the end of 2000, America's output, as measured by real GDP, has grown more than twice as fast as the euro areas.

Quoting the London Economist: "Euro-pessimists see this as further evidence that arthritic economies are being held back by lazy workers and by governments unwilling or unable to carry out reforms. In contrast,

America's more robust recovery, it is often said, reflects its amazing flexibility."

Our view, in contrast, is that the U.S. economy's recovery since 2001 peaked in the first quarter of 2004. This assumption is primarily based on four observations: First, it is the overwhelming message of recent economic data and early indicators; second, the power of egregious fiscal and monetary stimulus has been spent; third, continuous rate hikes by the Fed will prick both the carry trade and the housing bubbles; and fourth, the U.S. economic recovery is of a flatly unsustainable pattern.

To prevent a more painful fallout from the bursting equity bubble in 2000-01, Fed Chairman Alan Greenspan systematically blew three intertwined new credit bubbles: the carry trade bubble in bonds, house price inflation and the mortgage refinancing bubble.

It was the policy of a desperado who did not care at all about adverse consequences in the longer run. In actual fact, the very imbalances that provoked the preceding recession have grossly worsened under the impact of the new asset and credit bubbles.

The good doctor highlights the current conundrum perfectly with a potentially weak housing market, rising rates and weak dollar likely to conspire to provoke a potential economic recession in 2006.

“War on terror” or bribery which might be best?

We are not trying to be disrespectful in any way but a recent calculation published in “The Daily Reckoning” caught our ever-cynical gaze. Apparently the wars in Iraq and Afghanistan have so far cost the US \$10,000 per person in those two countries. We can't help wonder that if the Yanks had simply offered the populations of these two countries the money whether democracy might well have been achieved in a much more amicable manner. Just imagine the goodwill it would have generated! Indeed maybe the same tactic might have proved much more effective against the Viet-Kong also.

INTEREST RATES AND BONDS

- **UK rates to remain on hold as US rates climb**
- **Gilts-the most important factor is pension fund demand.**
- **Bond markets continue to rally: - Are they telling us something?**

The consensus is that UK interest rates are unlikely to be raised further this year and may even begin to fall later in the year as the housing market cools. We normally hate the consensus but can't find any reason at present to object to this benign scenario. Maybe some major shock surprises the authorities or inflation starts to accelerate (WHICH WE WOULD NOT RULE OUT) could blow the consensus apart but we await such developments at present.

What we do know is that UK gilts are being supported by a seemingly insatiable demand from pension funds as they continue to switch from equities to stabilise their liabilities. This demand is probably distorting the bond market and keeping long rates lower than they would normally be.

So are gilts telling us all something or is pension fund demand distorting the message? We are not sure but we are certain that the current status quo will change very soon with potentially highly significant implications for bond and equity markets.

In the US we already know that US base rates will climb steadily back to “normal levels” of around 4%. This assumes the North American economy continues to grow steadily. The bond market rally suggests the surprise this year will be economic weakness not strength (although many have predicted this via twin deficits) and we will watch closely the bond markets as events unfold (again inflation is the main danger). In the meantime US treasuries remain positive above 110.

One thing is for sure bonds are only good value over the long term if you expect ongoing deflationary pressures (not inflationary) because supply is immense and real yields are tiny.

Are we going to witness then a Japan style period of slow and sporadic growth for the Atlantic economies

with record low bond yields despite a huge budget deficits OR a return of inflation and bond markets knocked for six?

We are not sure but we are certain that things will not remain the same so be aware of the dangers in both scenarios for the global economy.

US Treasury Bond (Weekly)



GLOBAL EQUITIES

- Rally in injury time as resistance at 5100/5300 is approached.
- Volatility to increase this year as US lags.
- Tokyo has “catch up” potential

Many UK market segments (smallcap and midcap) have enjoyed a strong start to the year as our long awaited trading range break-out has exerted strong upward pressure since the autumn. Our target for the Ftse was a move to around 5200. We are nearly there now and we suspect the best part of the rally for UK investors may be over. Certainly, the huge trading range evident from 2002 will provide a massive wall of resistance and will almost certainly stop the footsie from trading significantly higher.

This tiring of the current rally will likely reflect in the leaders first such as small and midcap stocks, and indeed they appear to be losing momentum at present. This may well be a reflection of a trend switch to “safer” blue chip stocks following a two

year period of out performance by the high beta small stocks, but is more likely an early warning of a waning in the rallies power.

To protect recent gains we would advocate reasonably tight trailing stops as a sharp reversal could unfold from the current levels.

We do not expect the market to drift gently sideways for the rest of the year. Readers will recall from the work we published last October that quiet, low volatility years, are normally followed by the opposite. So expect a year of extremes. Indeed the Vix has recently hit yet another new multi-year extreme low to a level not previously seen for over a decade. This would imply an extreme in complacency which we would expect to be reversed during '05. After all markets always create panics and stresses and the lack of worry over the past year is highly unusual. Be ready for volatility will return this year. The index could well provide a roller coaster ride as the year progresses.

FTSE 100



European indices are broadly following the same path as Footsie and are likely to experience a similar increase in volatility during the coming year. Meanwhile the rally on the Dax and Cac look due for a period of consolidation just like Footsie.

The US markets have not followed their European counterparts to new highs so far this year. Indeed the fractured nature of the major US indices is concerning. The Nasdaq the high beta leader of last years rally has unlike the Dow and S&P got nowhere near approaching the December highs. This non-confirmation raises the prospect of a potential resumption of the January falls. If this occurs global markets are unlikely too remain immune as they did during January.

A break of the 2040 level could open the prospect of further declines below 2000. The worry eases above 2100 and becomes increasingly bullish if the main trend can be regained.

NASDAQ



The most interesting market could prove to be Japan which has lagged throughout 2004. The Nikkei has been led by the inform 2nd section out of the recent triangle consolidation and looks set to consolidate those gains and press on higher. There is some resistance at 12100 near the April high but we would expect that this level will be tested at the very least.

NIKKEI (Weekly)



FOREX

- Dollar still the weakest link
- Sterling strength unlikely to last
- Euro to rebound
- Yen to strengthen

The whole world watches for signs of weakness in the Dollar due to its pivotal role in the global economy. Certainly, the problems of the twin

deficits look likely to haunt the buck for years and that could easily undermine the global growth story. The dollar story of surging deficits is mirrored by Blair's complacent Britain with the pound bound to follow the Dollar down the slippery slope of sinking valuation.

This reality is revealed by the order of strength as the pound has fallen against the euro over the past couple of years despite climbing versus the dollar.

Over the next week or so the pound (below) looks set to re-challenge the recent high with \$1.89 being the key support level. We are not convinced the current rally will continue beyond the recent highs at present and would not be unduly surprised to see a period of ranging unfold between 1.96 and 1.85.

Dollar/Sterling



Euro//Sterling



The Euro has broken the recent up-trend and looks more than likely to re-test the low at €1.41. The pound has been consistently weak versus the euro over the past year or so but the trend has become increasingly volatile lately, which is a sign that the

current downward move is losing its consistency. We therefore suspect that the recent lows will hold.

Yen/Sterling



The pound/yen has traded broadly sideways in a large ranging pattern for a couple of years now. The current sterling rally is becoming overstretched and is again unlikely to break the recent high at 202. The fact that momentum is failing to confirm the short-term trend lends credence to this view.

Summary

Forex markets appear trapped in a short term trading pattern beneath the early January highs/lows. Major developments and therefore trading opportunities cannot occur until these ranges are broken.

COMMODITIES

- **Commodity bull has only just begun**
- **Oil supply pressures to increase as China industrialises.**
- **Gold looks weaker**
- **Palladium and platinum look interesting**

A great chart conveys at a glance far more useful information than we could put into words. Briefly, inflation-adjusted commodity prices are dirt-cheap and have turned upwards. Consequently we maintain that they have moved from a secular bear to bull market. Supply will be the key variable.

Commodities Near All-time Low



"Hubbert's Curve" is NOT part of the female anatomy...

But it is, nevertheless, a thing of beauty to long-term crude oil investors.

Back in the 1950s, Shell Oil geophysicist, M. King Hubbert, discovered a phenomenon he dubbed, "Hubbert's Curve."

The Shell geophysicist theorized that oil production from a new field would tend to rise until about half the recoverable oil had been produced, then peak and fall off sharply, all along a classic bell-shaped curve.

Furthermore, Hubbert understood that in the real world of crude oil production, the "second half" of the theoretically recoverable reserves would be relatively more difficult - and expensive - to extract, which would prompt oil companies to abandon fields before extracting all "recoverable" reserves.

Based on his theories, therefore, Hubbert predicted in 1956 that U.S. oil production would peak in the 1970s. Most of his contemporaries scoffed at the notion. But his prediction turned out to be surprisingly accurate. U.S. production did indeed peak in 1970.

"Using the same model," writes Jeremy Rifkin, author of the *The Hydrogen Economy*, "Hubbert estimated in 1971 that the middle 80 percent of global oil production will be produced within fifty-eight to sixty-four years, or less than one lifetime."

In other words, 80% of the world's oil would have been produced by 2035...at the latest.

"If M. King Hubbert is proven right once again, the world has either reached or will soon reach peak global production," observes Steve Belmont in a new report entitled, "The Death of Cheap Oil." (Belmont

is the Senior Market Strategist for the Rutsen Meier Belmont Group LLC in Chicago).

"Hubbert's predictions for exploration are also proving to be true," Belmont, continues. "Now that all the cheap sources of oil have been found, oil companies are cutting spending for new exploration. The windfall profits generated by the 3-year run-up in crude prices are not being spent on finding new oil, but on share-buybacks, dividends and/or efforts to purchase already-discovered reserves. Exploration is decreasing because today's smaller, harder-to-drill fields provide less bang for the exploration buck."

"Most geologists agree that there is still plenty of oil left to be discovered," Belmont admits, "but given the cost of extraction, it is not economically feasible at current prices. The world may not be running out of oil. It is, however, running out of cheap oil."

Even the world's largest oil producer may be running low on "cheap oil"...or any kind of oil, for that matter. Saudi Arabia pumps 13% of the world's oil and is responsible for 23% of the globe's reserves, making it the most important player on the supply side, followed by Iran with 11% of the world's reserves and Iraq with 9%.

"According to official Saudi state calculations," says Belmont, "Saudi Arabia could produce at current levels of 10 to 11 million barrels per day for 50 years. However, we view that number with a certain degree of scepticism. Matthew Simmons, chairman of Simmons and Company International - an investment bank specializing in the oil industry says the official Saudi numbers are too high and that Saudi fields are aging much faster...According to Mr. Simmons, the Saudis need to strip water out of nearly every well and this is a sign that Saudi fields are aging much faster than the industry has planned for.

"Almost every oil field sits on top of water," Belmont explains. "New oil wells draw up the crude first and have almost no water content. As a field ages, more and more water gets mixed with the crude oil. Wells that are almost dead will reach a 'water cut' of 40%. According to Nasen Saleri, manager, reservoir management at Saudi Aramco, the 'water cut' for Saudi wells in 2003 was 27%."

In other words, most of the easy-to-get stuff is gone and only the hard-to-get stuff remains.

"Consequently," Belmont's report concludes, "we may have entered an era of perpetual shock where supply and demand are balanced so precariously that the slightest disruption could send prices soaring. The world is currently using 98 percent of its producing capacity; OPEC was pumping flat out in 2004 yet prices remained stubbornly high. This was unprecedented in the short history of crude oil."

So there you have it, folks; demand is climbing as China and India industrialise and supplies are dwindling...At least CHEAP supplies are dwindling. So what's the far-sighted investor to do?

Answer:

Enjoy the commodity bull markets and buy oil stocks etc on every set back. The trend could persist for years and years until replacement energy supplies (nuclear?) come on tap.

OIL (Nymex weekly)



Nymex crude Oil spiked to a significant high in the autumn and is likely to continue ranging in the \$40's for many months. A move below \$40 is unlikely to be sustained for long, whilst a move above \$50 may signal at the least a re-test of the recent highs. We suggest that the oil bull should be played by buying long-term positions in oil stocks and the futures during any sell-offs.

The oil bull is here to stay!

GOLD (weekly)

02/04/2005 C=414.0 -11.8 O=424.5 H=425.0 L=413.7 Mov Avg-Exponential



Gold appears to be gently softening as the autumn rally unwinds. The likely short-term trend is down to \$400 as the price has clearly broken down out of the recent consolidation. We would stand aside for the time being.

COPPER (WEEKLY)

02/04/2005 C=1.4180 -.0445 O=1.4580 H=1.4630 L=1.4000



Copper is making consistent new incremental highs but appears to be losing upside momentum. A fall below \$1400 could herald a more serious setback as the industrial metal market digests the dramatic gains of the last twelve months.

The Huge industrialisation of both China and India remain supportive in the long-run but any market needs time to digest gains.

PLATINUM (weekly)

02/04/2005 C=866.0 -6.3 O=872.3 H=882.0 L=863.0 Mov Avg-Exponential



PALLADIUM (weekly)

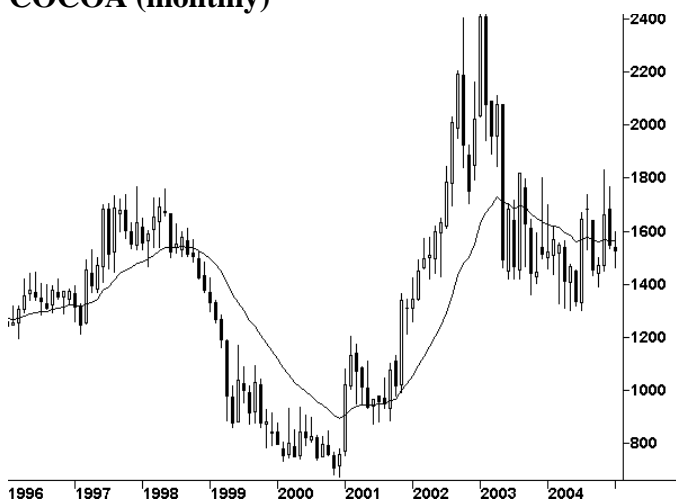
02/04/2005 C=182.05 -10.10 O=190.00 H=193.50 L=181.50



The Platinum and Palladium markets have behaved very differently over the past year but palladium remains a direct and cheap substitute for platinum. Currently both look weak as the current commodity rally pauses for breath (this consolidation could last for several months as fears of a China slowdown checks the advance of industrial metals) but a spread between the two should prove to be profitable, as the price differential looks likely to narrow sharply.

Cocoa (below) is continuing to build a large base above \$1400 after the sharp declines of 2002. Ranging looks likely to continue for some time. Traders should stand aside until either side of the range is broken (\$1400 or \$1800).

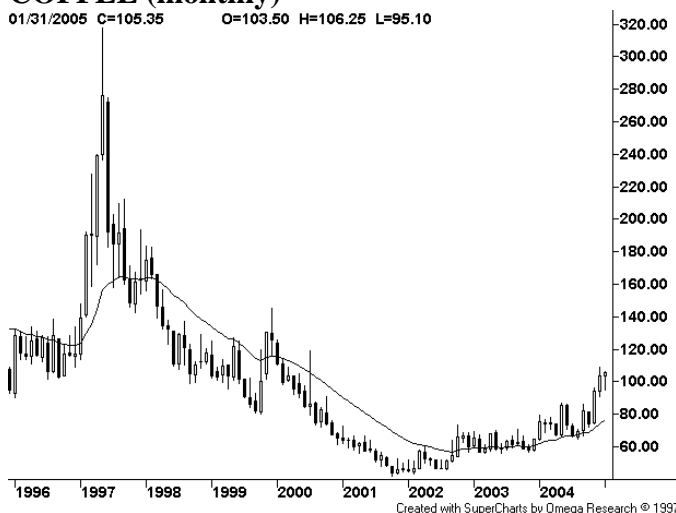
COCOA (monthly)



SOYBEANS (monthly)



COFFEE (monthly)



WHEAT (monthly)



Coffee has rallied strongly since 2002 but the monthly chart above provides perspective of just how far this market could go. We suspect that prices will reach \$120 to 130 in the next year before pausing, with the 1996 consolidation area providing resistance.

Soybeans must have provided the most spectacular market roller coaster of the century so far with prices crashing down by 50% in just a few months. Prices still look capable of testing the multi-year lows of \$450 where plenty of support should cushion the price from any further declines. We would suspect that this would be a market to stand aside from for the foreseeable future until prices have stabilised and a decent base has been built.

Wheat is still struggling after a huge 10 year bear market. Despite signs of life during the past two years the price is slumping back toward the multi-year lows near \$2.50 per bushel. It would take a drive to above 325 to spark interest at present but this remains a key strategic market that all traders should keep a close eye upon.

We would anticipate that the bull market in commodities will finally spread to most agriculturals as China and India urbanise and acquire a more affluent diet and obesity problems.

Already China consumes more meat than the US. Chinese imports of a whole variety of foodstuffs including wheat are set to soar over the coming decade and the feedback into the agri commodities will eventually be spectacular.

ORANGE (weekly)



One of our favourites has always been FOJ ever since we watched “trading places” in the early nineties. The refreshing liquid has enjoyed a healthy rally since last summer but is currently tracing out a large consolidation. We would look to short a break below 78 and buy at 90 (still a historically low level) with every chance that the markets thirst has not yet been quenched (sorry but could not resist pun)

AND FINALLY

We quote Justin A. Urquhart Stewart’s very funny observation of the buy to let market and the timing prowess of our politicians!

“I understand that the Prime Minister has been having some difficulty renting his recently purchased property in London. Financing the burden of a monthly mortgage payment of apparently some £15,000 is no easy task. I understand that the monthly rental fee has to be slashed in order to attract would-be tenants. From a proposed monthly income of £15,600, this has now been reduced to a far more modest £8,000. Ah, the perils of buy to let. I wonder if he should ask the Chancellor for some advice? Maybe not.”

The point should not be lost on all potential investors in property.

Regards

Andrew McCarthy &
Andy Bartles