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## US RATES ARE RISING AND ARE INCREASING THE RISK OF GLOBAL RECESSION IN 2006

**BARMAC MARKET DIRECTIONAL INDICATOR:-  
SELL SIGNAL -issued on 22<sup>ND</sup> MARCH**

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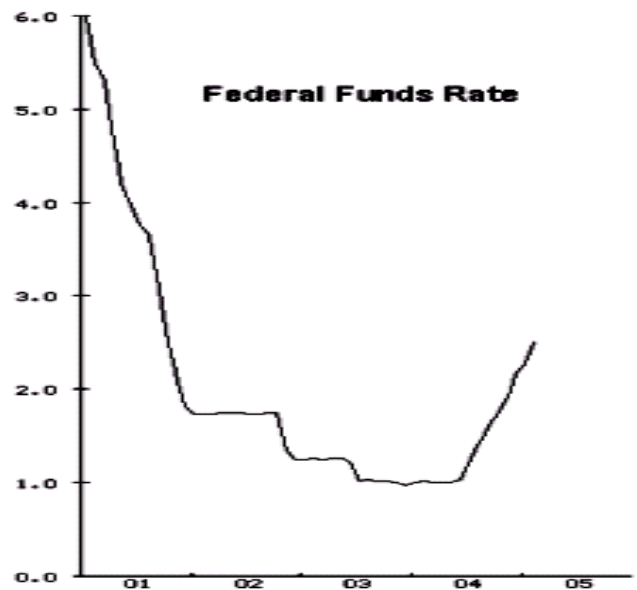
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Just a few weeks ago, the Fed governors met and raised their key Fed funds rate from 2.5% to 2.75%; and just two weeks from now, they may well do it AGAIN, possibly at an even faster clip. Already, this puts the Fed funds rate at nearly TRIPLE its level of just a year ago. And already, other interest rates -- on 30-year fixed mortgages, credit cards, auto loans, and commercial loans -- are rising.

*But is this just the beginning.*



So how high can US rates go? For starters, just take a glance -- back in time -- to see how high they came from.

How far back in time? You don't have to look all the way back to the 1980s. You don't even have to refer to the 1990s. Just plot the Fed funds rate starting from, say, January 2001 (as above).

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So what is so significant about the above chart?

First, the *magnitude!* The decline was from 6% to 1%. That's FIVE full percentage points. But the rise is just from 1% to 2.75%. That's only 1.75 percentage points or about one THIRD the magnitude of the decline -- SO FAR!

*Second, the timing!* The decline started only about four years ago. So we're not talking about a long-ago historic period when the structure of the US economy and financial markets were radically different from today.

Third the *CONDITIONS!* Think back. What were the conditions back then which corresponded to the 6% Fed funds rate? Was the federal budget deficit going haywire?

Was the US trade deficit going berserk?

No.

Were oil and gasoline prices surging to their highest levels in history?

No.

But they are today?

Yes.

Then with all this going on, how can anyone in their right mind justify the Fed funds rate sitting all the way down at 2.75%? How can you have them at less than HALF the level they were at just four years ... despite the fact that all the pressures for higher interest rates are FAR more powerful today than they were four years ago?

So how high can they go?

But before you ask how high they can GO, you should really ask how high they should normally BE right now.

The Fed funds rate should be at least DOUBLE today's level. At five and three quarters percent. And we're not talking about next year. So how do we get that figure? We first took the current inflation rate, 3%, and then you tack on to that the average historical difference between the inflation rate and the Fed funds rate -- 2.75 percentage points. Add those two and what do you get?

5.75%

More than DOUBLE today's rate. But that's just your STARTING point. On top of that figure, you have to add on a couple of percentage points to cover any *worsening* of inflation ... a few percentage points to account for the burgeoning money demand from the Treasury to finance its

deficit ... and still more points to help offset any further decline in the dollar due to the trade deficit.

Conclusion?

Interest rates are abnormally low and therefore unstable. The Fed is keeping them low as it fears an economic collapse if it returns to normal rates. The build up of other economic pressures however (twin deficits etc), partly as a result of low rates, will eventually lead to this policy becoming unsustainable. Interest rates could fly out of control.

In all western economies this could spell disaster with the US consumer and housing boom likely to be a major casualty of higher rates with dramatic implications for the rest of the world and especially property boomville Britain.

### **Mugabe a gentleman and a scholar?**

Just to show you that deceit and humbug are as much in evidence in Africa as in Britain, Mugabe was just awarded an honorary doctorate from Zimbabwe's Open University. The country is very fertile and extremely productive. It used to be the "breadbasket" of Southern Africa, as its economy exported tons and tons of food to the rest of the continent. But Mugabe decided to steal the land of white farmers and redistribute it to his cronies and political allies. The white farmers left and the new landowners who took their places had little interest in farming. In a few years, half a million African farm workers were destitute. Inflation rose to an annual rate of 800%...four out of five workers are unemployed. And millions of people now face starvation. So, what discipline do you suppose Mugabe's honorary degree is in? Agriculture, of course.

### **LESSONS IN JAPANESE**

Japan has suffered the worst property bust in modern history. According to Dr. Sjuggerud's painstaking research, prior to the great crash, house prices in Japan went up every year since 1950, with the exception of 1975.

"Land can never go down in value," the Japanese must've been thinking as they bid up prices until the land under Tokyo was worth as much as all of the

land in the U.S.A., according to one newspaper's calculation.

In 1991 alone, says another source, the year the bubble burst, 12 leading Japanese banks poured \$470 billion in loans into the property sector, equal to a quarter of the total loans made in the year.



But since 1991, prices have only gone down. Now the converse is true, they all must think: "Prices can only go DOWN."

"Once you kill the animal spirits (after a bubble pops) it takes a whole new generation to pass before anyone has the stomach for risk and speculation," said Dan Denning in the Daily Reckoning. "

Perhaps the Japanese property market should act as a warning from the grave to all those investors who foolishly believe property "always goes up." It plainly doesn't and UK house falls of around 35% between 1988 and 1995 re-enforces this risible conviction.

And when property goes, so does the UK economy.

## **STRUCUTRAL DRAGS**

By Dr. Kurt Richebächer

*From the macro perspective, U.S. business profits received their main boost from two flows in recent years. One was the phenomenal decline of personal*

*saving, and the other was the soaring budget deficit accruing from tax cuts and higher spending.*

*Saving is the unspent part of personal income. To this extent, wage earners reduce total business receipts in relation to total expenses incurred. The net result is a corresponding fall in profits. Conversely, when households run down their saving, business revenues rise in relation to expenses incurred. The net result is higher profits.*

*In this way, the phenomenal collapse of personal saving in the past few years has been Corporate America's main profit bonanza. This was far more important than the direct and indirect revenue flows from the soaring budget deficit.*

*But the trouble is that the soaring U.S. trade deficit in recent years has been diverting a rapidly growing share of such spending and its inherent profit creation to foreign producers. In essence, the trade deficit directly transfers spending and profits from domestic to foreign producers, leaving American producers with the wage expenses, which their employees spend on foreign goods. As we have stressed many times, the trade deficit is the greatest profit killer in the U.S. economy.*

*We come to the most important macroeconomic profit source in a healthy economy. Apparently unknown to most American economists, this is net capital investment. John M. Keynes expressed it with great simplicity and precision: There are two streams of money flowing to the entrepreneurs, namely, the part of their incomes that the public spends on consumption and the expenditures of businesses on net capital investment.*

*Economists, in general, are completely unaware of the crucial importance of business investment for business revenues and profits. This has a particular and peculiar reason. From the perspective of the business sector as a whole, investment spending creates business revenue without generating business expense.*

*What seems mysterious has, in reality, a simple explanation. Investing firms capitalize their investment expenditures. No expense is incurred until the first depreciation charge is recorded. For the producers of the capital goods, on the other hand, it involves a sale, producing immediate revenue.*

*Due to this particular treatment in accounting, net fixed investment is typically the business sector's most important profit source. But in the United*

States, this profit source has dramatically collapsed in the past few years, as rising depreciations have overtaken gross new investment.

In 2003, net fixed investment amounted to \$154.5 billion, after \$404.8 billion in 2000. This implies, first of all, a rapidly shrinking capital stock; and second, a disastrous drag on business profits, because depreciations are expensive.

Answering the question of aggregate profit prospects for the U.S. economy in 2005 requires a macro perspective focusing on changes in four aggregates: personal saving, budget deficit, trade deficit and net business investment.

Our crucial assumption is that negative profit influences will grossly outweigh positive influences, suggesting in their wake lower business investment. If the consumer starts to save out of current income, the U.S. economy will slump.

We have characterized the U.S. economy as a bubble economy in the sense that asset appreciation has become its main engine of growth. Courtesy of the prolonged sharp rise in house prices, the American consumer has been willing and able to maintain his spending despite a protracted recession in employment and wage incomes.

But we see a variety of influences tempering the bubble climate. For the time being, the whole set of asset bubbles finds strong support from still exceptionally low short-term rates, still extremely loose money and credit, and high-riding expectations about strong U.S. economic growth and low inflation rates in 2005. Much economic data warn of impending strong disappointment on both counts that will prick the bubbles. Not to ignore, moreover, the Fed's commitment to further rate hikes.

Yet the refusal of long-term rates to rise in response to the Fed's serial exertions to raise short-term rates further is perplexing. Mr. Greenspan himself spoke of a "conundrum." A reported inflation rate above 3% would, by past experience, imply a federal funds rate of at least 5%. But a rate of 3.5% would already be enough to wreck the bond bubble, and in its wake, the stock and housing bubbles.

For sure, the financial community is fully aware of this immense policy risk, strictly limiting the Fed's scope for further rate hikes. The amazing stability of long-term rates suggests the financial community has not only refused to unwind, but has even

continued to add to existing carry-trade positions. They are still far too profitable to be abandoned before the Fed makes them unsustainable.

As no one is taking the Fed seriously, it may have to do more than it wants. The frightening point to see is that, given the U.S. economy's heavy dependence on consumer spending for the housing bubble, a mere levelling of house prices would be enough to slash consumer spending and economic growth. We expect worse than price stagnation.

**It ought to be realized that a rise in long-term rates by only 1-2 percentage points would rapidly play havoc with all existing asset bubbles - bonds, stocks, housing - and in consequence, with economic growth. Within a matter of months, there would be deep recession.**

A crucial question is the inherent impact on personal saving. Voluntarily or involuntarily, private households will sharply restrain their borrowing and return to old-fashioned saving out of their current income. That this will badly depress consumer spending needs no explanation. Unfortunately, when consumption declines, fragile business and housing investment will fall as well.

Most people inside and outside of America have yet to realize two things: First, that among industrial countries, the U.S. economy has by far the worst structural fundamentals; and second, that it is far more vulnerable today than in the first two years of the decade.

Of course, American policymakers and economists have been trumpeting the opposite for years. Having realized their complete disregard of macroeconomics, we are sure that they earnestly believe this fairy tale. With this in mind, we recently, with great interest, read a report from Morgan Stanley about a meeting with customers in late January.

About global economic prospects for 2005, it said: "There was little doubt as to who would take the baton in a post-U.S.-centric world - it would be another encore for America. There was deep conviction that no one comes close to having such an ideal system - especially in terms of technology, the work force and America's unique risk-taking culture. Market depth and flexibility - in both the financial and the nonfinancial realms - was depicted as the icing on the cake for yet another run of U.S.-centric global growth."

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*Later, it stated, "Europe, which has none of these qualities, is the last place where productivity could take off."*

*For us, this is typical Wall Street trash, bare of any serious macroeconomic thought. It used to be an elementary truism among economists that a healthy economy is rich in savings, rich in productive investment and rich in profits. The U.S. economy is extremely poor in all three. But it is extremely rich in financial speculation and corporate malfeasance. To be sure, the enormous structural deficiencies are increasingly impairing U.S. economic growth. For the past three years, unprecedented monetary and fiscal profligacy has been able to overpower their depressant influence through the bubble-driven consumer borrowing-and-spending spree. Yet the "structural drags" are finally gaining the upper hand over the weakening bubble impetus. The U.S. economy's famous resilience had more to do with clever statistics and unprecedented monetary looseness than with true economic strength.*

**So the good Doctor highlights the fact that US growth is dependant on loose money and that sooner or later loose money will become tight. At that point we suspect that a major global recession will unfold made worse by being delayed by artificially low interest rates.**

**General Election. All parties have their collective heads in the sand!**

**Yawn!** Although we should show a great interest in the forthcoming election we still only see politicians who are still trying to outbid each other to buy votes. No party is prepared to tackle "Big Government" or seriously address the major problems caused by an aging population and the pensions "black hole"

These issues are so important that all parties have chosen to pretend that they do not exist and instead argue about shuffling the order of the deckchairs on the Titanic instead.

Still though there are no votes in pension planning, prudence, saving, de-regulation, competing with emerging economies and cutting Government expenditure.

Maybe it is because we are the world's fourth richest country and can/should provide a wonderful cradle to grave welfare state that all rich and civilised societies should enjoy.

But Rome was once the richest country in the world. As was Greece, China, India, Spain, France, Byzantium, Egypt, Iraq and of course Britain. The one thing all these countries had in common is that they all fell from grace once they became bloated and corpulent becoming unable to compete with the new "kid on the block." By common consent the US is cresting at best at present.

Thus the smug assertion that Britain is the fourth richest country in the world and can thus afford to "gold plate" all types of Government provided services and benefits is flawed. The "dead hand of the State" which now accounts for 41% of GDP will ensure Britain's ongoing relative demise as all incentive for enterprise and efficient economic allocation of resources is squashed by "Statist" policies. The 50year decline of Rover/BL/Leyland/Austin/Morris/etc. etc etc is the sad metaphor for Britain and the realisation of desperate politicians ongoing market distortions and interference.

Thus until we hear a politician addressing the real issues facing Britain we will continue to look forward to "The Ashes" instead!

## **GLOBAL EQUITIES**

- **Equities lose momentum**
- **Nasdaq and Russell lose their attraction**
- **Barmac small-cap indicator gives sell signal**

**The state of play as we write is that European stock markets still maintain uptrends, the US is holding above the March and January lows, Japan is pulling back from the highs and the developing world is attempting to recover from a significant correction.**

**The further development of March stumble is now delicately poised.**

The possibilities are that we will rally from here, markets could range or they could fall.

If markets range they could do so for a considerable period, maybe weeks or even months. If they fall we envisage three signals to be alert for.

Treasuries are currently meeting some stiff resistance at 112. If they were to break the lows set in December and March on more than a short-term move, this would be a stronger headwind for equities.

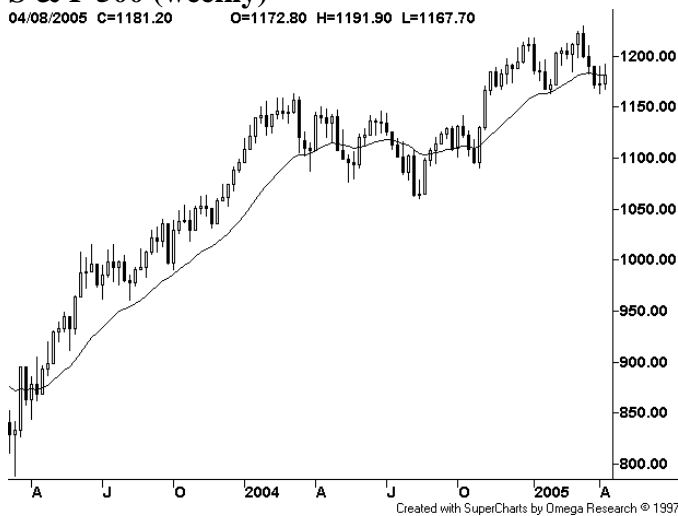
The Nasdaq and Russell have been the laggards since January. They are the best proxy to judge the appetite for risk in the market. If they break down this will be another signal that equities are headed for a general correction. Both the Nasdaq and the Russell 2000 failed to confirm the March high in the Dow/S&P and this fractured market implies an increase in risk aversion. This is a bearish factor.

If the S&P500 breaks support at 1160, this will be another signal that we are entering a bearish environment for equities.

If we do not see these signals, then the US market could go sideways in this difficult choppy pattern for some time. This would allow developing markets to perform relatively well and for Europe to maintain its uptrend.

One thing for sure the momentum of the key US markets has waned substantially during the past quarter and although this does not preclude another rally phase it does imply the market is tiring and the post March 2003 bear rally maybe nearing its final juncture.

### S & P 500 (weekly)



### NASDAQ (weekly)



### RUSSELL 2000 (WEEKLY)



**The Ftse 100 (below) remains barely positive whilst it still trades above 4880 and prospects would improve considerably above 5000.** However, a move below 4880 would create a lower low and generate a new downtrend with little or no support until 4750 and then 4600.

The European markets have generally de-coupled of late to some degree from the US and we could see a favourable relative performance as long as Wall St does not collapse. So the new highs being seen in France (also below) could continue across the continent if the Atlantic environment remains benign. However the first substantive sign of a correction would be a break of the trendline shown below. If this were to happen major support exists at the November highs (CAC 3900).

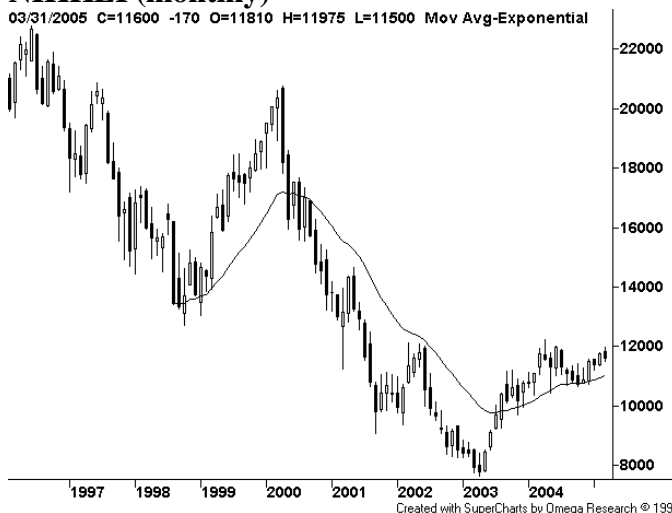
## Ftse 100



## CAC



## NIKKEI (monthly)



In order to gain some perspective we have shown the monthly chart of the Nikkei. The multi-year bear is clear with the rally of the last couple of years looking quite puny. This rally has stalled at the key 12,000 level more than once and a decisive

break of this level is required to open up the possibility of substantive gains towards 15,000 or higher. We advise a watching brief until and if 12,000 is cleared.

## BARMAC INDICATOR

It says SELL.



The Ftse Small-cap has had a great run since August and outperformed the Blue-chips dramatically. However, we have recently seen a sharp correction that has tipped the Barmac Indicator into “sell” territory. This could be quite significant for both the small-cap sector and the major market in general.

Firstly, this very reliable timing indicator could simply be calling for a pause in the breathtaking ascent of smaller companies and may in a month or two flip back to buy as small-caps gain a second wind (watch for new highs above 3000 on the index). However it could also be a reflection of events in the Russell/Nasdaq where the appetite for risk is reducing. If this is the case then small-caps may well have topped out. This is likely to imply that the “animal spirits” of the UK’s two year equity rally is evaporating, with the implication that perhaps the big cap blue chips may well have little upside left. After all the best periods of advance for the Ftse have normally co-incided with a strong broad market. While the Barmac remains in negative territory we will treat UK equities with extreme caution.

## INTEREST RATES & BONDS-

- **Corporate bond spreads are dangerously narrow.**
- **GM becomes junk.**
- **US rates set to go higher**
- **Gilts and bonds still look susceptible to further declines**

**General Motors issued the largest single chunk of corporate debt a couple of years ago.** Around \$50 billion was raised to plug its pension deficit, not to invest in new product or capacity. Only in January the CEO was projecting a profit of \$2billion. In March a **loss** of \$5billion was announced and GM debt spread has widened to 450 basis points over US Treasuries. GM is now *de-facto* junk. As we complete this edition Ford appears to be following a very similar trajectory.

However, what these two massive corporate debtors highlight is the current mortal danger lying in wait in the corporate bond market.

Since 2002 debt spreads (the difference in yield between the two asset categories) between all corporate debt grades and Treasuries (gilts in UK) have narrowed dramatically to the point where investment grade corporates (companies whose debt is rated as secure by the various rating agencies) yield barely 100 basis points over Government securities. This is the narrowest debt spread ever and does not represent the risk inherent in corporate debt (as highlighted above by GM) versus Government securities.

It is surely obvious to all that the scope for the spread to narrow further does not exist and therefore logic dictates that during the natural business cycle this yield spread is set to widen significantly over the next year or so.

Investors in corporate bond funds beware!

**As discussed in our lead article we believe that US rates are headed higher and the rate of increase is the only debatable issue.** To offset the various bubbles and to return to “normality” US rates have to go higher during the next year or so. Despite our worries that the Fed may quicken the pace of increase it would not be a complete surprise if they “talked tough” but continued to drag their feet. Either way it is clear that the Fed feels the US

economy is SO WEAK that it has persisted with emergency low rates for three years now and frightened to death of the consequences of a return to a normal interest rate environment.

The implications of this view are dramatic and imply that the current façade of economic stability is extremely fragile and is merely an effort to delay an inevitable and painful re-adjustment of the Anglo-Saxon economies to economic reality. The current US policy perhaps echoes Japans record low rates of the past decade. The outcome could well be the same!

### US BOND (daily)



### UK GOVT Securities index



**The above two charts illustrate the latest action in the bond markets.** Both have recently steadied after a quick decline and they need to remain above the latest lows if an accelerating increase in rates is not to occur (and if the equity markets are to remain steady). If the inflationary pressures continue to build then we expect these lows to be busted and a vicious move may well unfold. However, there remains

plenty of support at the lows that should cushion and delay any break for some considerable time.

## FOREX

- **Dollar bottoms**
- **Sterling trades sideways versus Dollar BUT up against Euro**

The Dollar index appears to have established a low of at least medium term significance. The completion of the possible double-bottom and break of the dominant down trend would occur above 85.5. If this should occur we expect a multi-month correction that could carry the dollar considerably higher and perhaps challenge the consolidation zone centred around 89.00 over the next couple of quarters.

### DOLLAR INDEX (weekly)



The last six months have seen the pound range in a tightening wedge or triangle type consolidation pattern versus the dollar. This ranging looks likely to continue for a little longer before any break out. We expect a strong move if and when the break occurs and would trade the break aggressively. The direction of the break is hard to call due to the confusing crossfire caused between the dollar and the euro and so it is best to sit and wait.

Long term however we remain bears of the US unit.

### US Dollar / Sterling



The pound has been steadily advancing against the euro since the turn of the year. Over the past six months a large base has been completed and sterling is breaking to the upside. If this break is maintained a rally beyond £1.50 at least is likely. The Euro has come under increasing pressure as the dollar has bottomed and global currency speculators use the dollar/euro cross as the main medium to exploit the dollar's strength or weakness. This speculative money could have a negative effect on the euro for the next few months as the dollars counter-trend rally runs its course. Traders should place a stop at £1.43 and hedgers could sit back and allow the pound to rise.

### EURO / STERLING



## COMMODITIES

- **Oil's run boils over**
- **Gold looks susceptible to further declines**
- **Industrials still very strong**

The fabulous run enjoyed by oil year to date may well have boiled over. Although we remain long-term bulls the recent action appears to have got well ahead of itself. The chart below illustrates a weekly key reversal at a level slightly above the late '04 high. The reversal looks likely to mark a top of intermediate significance that could well last for at least 3 to 4 months or more and maybe longer. We do not believe the crude bull is over but perhaps this first phase has ended. We would become interested back in the lower 40's especially with a weekly key or some other chart reversal action.

### OIL NYMEX(weekly)

04/08/2005 C=53.32 -3.95 O=57.80 H=58.20 L=52.70 Mov Avg-Exponential



Petroleum has also suffered a key reversal as has all the oil complex and we expect the current correction to test support in the recent consolidation near \$1.30.

### UNLEADED GAS (weekly)

04/08/2005 C=1.5365 -1544 O=1.7350 H=1.7400 L=1.5100



Gold and Silver (both below) appear to have both turned lower with lower highs set in recent weeks. A break below the Jan lows could well signify a much deeper correction. We would suggest instituting shorts on a break of the recent lows with stops at \$420 on gold and \$7.00 on silver.

### GOLD (weekly)

04/08/2005 C=426.9 O=426.0 H=428.5 L=422.7 Mov Avg-Exponential



### SILVER (weekly)

04/08/2005 C=7.165 O=7.000 H=7.175 L=6.920 Mov Avg-Exponential



Copper is known as the metal with a PHD as it appears to call the direction of the global economy very accurately. Despite extremely strong advances over the past twelve months or so we suspect that a reversal is around the corner for this intelligent metal. Our suspicions have been aroused by the dramatic slowing in momentum over the past few months with only a series of incremental new highs, together with a very bearish "rising wedge" chart consolidation pattern clearly emerging. We would not be surprised to see a sustained downward break and would short

the metal below the lower trend line of the wedge at \$1.40.

### **COPPER (weekly)**

04/08/2005 C=1.5235

O=1.4860 H=1.5250 L=1.4800



Regards

Andrew McCarthy &  
Andy Bartles

### **STOP PRESS**

**Further to our comments about equities on page 7 we note that many of the key support levels noted have now been breached. This is very bearish for the equity markets and if no sustained rebound materialises in the next week or so could well signal the end of the two year bear market rally.**

### **AND FINALLY**

**Another amusing and pithy observation by Mr Justin Urquart-stewart.**

*"I note the cost of Government has gone up again. In our world of apparent low inflation it is surprising to note that despite the comments of Government on cost control, the running costs of the Department of Environment, Food and Rural Affairs and the Department of Culture Media and Sport have both risen by 30%. Additionally the Cabinet Office costs have risen by 16% - excellent value, I am sure.*

*As we are talking of cost controls, I also read that a further 6,000 jobs have been created in the first quarter for the Civil Service - this is in the same year that the Chancellor said he was looking to cut 100,000 Whitehall jobs. Little comfort for Rover employees but whatever you may have thought of the prospects for Rover, at least you can say they produced, exported and created wealth. I wonder what wealth the new 6,000 Civil Service jobs will create?"*

**Ho! Ho! Ho! Please excuse our laughter at yet another crass example of how our wonderful politicians try to delude the populace (and probably themselves).**