The Barmac *Journal*
The art of Finance Bartles & McCarthy

Issue No.49

Dec 30th 2005

Monthly Newsletter

Annual Issue Price £250

info@barmacjournal.co.uk

EQUITIES HIT NEW HIGHS ON SANTA RALLY, BUT IS A BULL MARKET IN VOLATILITY DUE IN 2006?

BARMAC MARKET DIRECTIONAL INDICATOR:-
BUY SIGNAL -issued on 2nd Nov
Market up 6% since signal.

1.GLOBAL ECONOMY
Volatility to increase
Blair and EU rebate
Housing and the economy
General Motors teeters

6.INTEREST RATES & BONDS
US rates almost at top
Govt Bonds hold steady

8.EQUITIES
Barmac buy signal
Wall St still a laggard
Ftse holds above key trend
Tokyo blasts off

9.CURRENCIES;
Dollar consolidates
Pound weakens

10.COMMODITIES
Oils boils over
Precious metals fall back.
Copper hits new high
FCOJ flies high
Sugar goes ballistic

Ricardian economics & GavKal

The worlds' global stock markets have continued to rally into the year-end making 2005 an excellent investment year. Here at Barmac we have enjoyed benefiting from the Ftse 700 point (18%) advance. The rise this year has yet again been surprisingly steady with no correction witnessed in excess of 10%. This is the 2nd straight year when we have not had any meaningful setback in equity prices (nearly the 3rd if counting from the March Gulf war low). Unfortunately as a pair of devout pessimists we at Barmac wonder whether this incredible near three year record can be extended to four years!

To put the chances in perspective there has never previously been a three-year period on the Ftse without at least a 10% correction (although from March '95 to October 97 no such correction was witnessed). Thus we enter 2006 with the odds greatly increased that logically the trading year will witness a greater set back than we have seen since the Gulf war lows of March 2003.

The evidence for this possibility is emphasised by the VIX volatility chart (on the next page) that highlights a steady decline towards historic lows in market volatility. Now there is no law stating that this trend cannot persist indefinitely, but logic would dictate that the trend must end sooner or later.

We suggest that investors go long volatility in 2006 both mentally and physically. We certainly believe that stock markets will witness a far greater roller coaster ride than as been seen during the last 2 to 3 years. Thus all investors and traders alike will need to be alert to profit erosion, portfolio protection and major market reversals.

We are not necessarily predicting the end of the current bull run, but we suspect that the quiet advances of the past 33 months are likely to morph into much more tumultuous markets.

AS FAR AS THE EU IS CONCERNED we can barely bring ourselves to speak about Blair's capitulation

Whatever the political persuasion of the incumbent Prime Minister, it was our belief that his/her first duty would be to fight tooth and nail to put Britain's own self-interest above all other considerations. It has not always worked out like that but we do truly believe that Heath genuinely thought joining the Common Market (despite surrendering our fishing grounds and jettisoning our primary trading links with our long established partners in the Commonwealth) was in Britain's best interests (with judgement like that is it any wonder he is probably our worst post-war PM toughing it out with the profligate Attlee/Cripps partnership of the disastrous post war Labour administration).

However Blair has taken the art of negotiation to a new low as he throws away yet more of Britain's taxpayers hard earned brass on an empty promise by the French to "look" at the iniquitous Common Agricultural Policy at the next budget round in 5 or 6 years time!!!

As we have often stated in these pages "**he who pays the piper calls the tune"** and as a major net contributor to EU coffers we should have simply used the simple French tactic of saying non, non, NON!!

If as a consequence no budget was agreed and the EU ran out of money during the next fiscal round, the problem would hit the net recipients and not the UK. We could then perhaps have forced through sensible reform.

After all the best way to force through real hard changes is to create a crisis (especially a financial one) as it concentrates the minds of all those countries with the begging bowls (Greece Ireland, Spain, Italy, Portugal etc.), that is the countries who are also the most enthusiastic Europeans.

We are sure our tactics would not upset our European friends to the point of them stopping the lucrative export of billions of pounds of goods to the UK via our huge trade deficit.

So in reality we have nothing to loose by being obstinate and obstructive and everything to gain including maybe the respect of the other EU members who may have changed their opinion of "soft touch" Britain

Housing and the economy

The UK's relatively strong economic growth (in EU terms) over the past few years has benefited to some large measure from the effect of a booming private sector housing market. In recent years it has been estimated that between 6% and 10% of consumer expenditure has been financed directly from the housing boom.

Money has been flooding into the economy by debt refinancing/consolidation of credit card bills in many households. The dosh has then been spent on holidays, home improvements, cars and general everyday living. Low interest rates and rising house prices have fed this ever-increasing tide of equity release consumer expenditure but it may be grinding to a halt as house prices stall.

The UK property bubble need only to lose air slowly for the excess cash raised via refi to disappear. The resultant slowing in consumer demand will be enough to sling UK plc to the relegation zones of the growth league tables (indeed this process already appears to be occurring). However, the now weakened UK economy would become much more susceptible to any global economic slowdown leading to a far greater likelihood of recession in the UK in the next couple of years.

GENERAL MOTORS UPDATE

General Motors plunges to 23-Year Lows Despite Rally in Dow and S&P 500

They say the rising tide of the stock market lifts all boats. But right now, regardless of the tides, the shares of America's largest automaker are sinking like the Titanic. Just last week, GM crashed through its November low, touching down to its lowest level in 23 years.

Why?
One factor was billionaire investor Kirk Kerkorian. Earlier in the year, he had propped up GM shares by accumulating nearly a 10% stake.

But 12 days ago, he started bailing out: In two large transactions, one on December 15 and the other on December 19, he dumped 12 million GM shares, according to his firm's SEC filing.

Estimated losses on those shares alone: $120 million. Open losses in the balance of his GM holdings: Probably four or five times more. We warned readers in the last issue that Kerkorian was making a huge blunder and was going to get burned. Now that's precisely what's happening. But there's a lot more to this than meets the eye.

GM's Investors Smell Bankruptcy. So They're Running Away — Fast! Back in May, S&P lowered its rating on GM bonds to "junk" and has been downgrading the company step by step ever since, culminating in still another downgrade — to a single B two weeks ago. But a 40-year veteran of bankruptcy forecasting, Professor Edward Altman of NYU's Stern School of Business, says that even GM's already-low B rating is overstated. He believes GM's bonds actually merit a rating of CCC+ — "currently vulnerable to non-payment," according to S&P's definition. The precise reason S&P may be overstating GM's rating is unclear. But we know that major rating agencies often delay downgrades.

Their formulas may have built-in "stabilizers" which prevent drastic changes, even if merited. And they routinely give companies the right to appeal the downgrades before they're published, another factor that can cause delays.

Bottom line: GM may be closer to bankruptcy than the latest S&P rating implies. Plus, here's another factor S&P may not be recognizing: many GM analysts are now saying that a GM bankruptcy would actually be a "reasonable" way to release the company from its burdensome pension costs.

To the degree that management agrees, that adds a new element of danger for investors. It means that the natural incentive GM would normally have to avoid bankruptcy may be offset by the perverse incentive to actually seek bankruptcy in order to renege on employee pension obligations.

> For investors, it smells ... and for the employees that would get shafted, it stinks.

But while GM's decision-making regarding bankruptcy is still obscure, the marketplace is already speaking loud and clear: Kirk Kerkorian is jumping ship. So are other investors. And they're already losing money hand over fist.

To give you a concept of just how much has been lost, consider this fact:

> Only two and a half years ago, General Motors was worth seven times more than Italian automaker Fiat. Today, Fiat is actually worth more than General Motors!

Can you believe that? A once-snubbed, second-tier auto manufacturer in what was recently one of Western Europe's shakiest economies is now worth more than the largest auto company in the world's largest economy! This illustrates, again, the massive

amount of money on the move — a shift that is bound to accelerate in the early part of 2006. Big money will be moving not only out of GM shares, but also out of GM bonds ... not only at GM, but also Ford and similar companies.
The implications are huge for both the stock and bond markets. All we can say is that you have been warned.

GOLD HAS SMASHED THROUGH $500 AN OUNCE.

We bet Gordon (the moron) Brown feels really smart having flogged off a large potion of Britain's gold reserves for $250 an ounce a few years ago at the VERY bottom of the market. Politicians really are not fit to run corner shops let alone countries.

GOLD (WEEKLY)

Gold has exploded up since the summer but a major weekly key reversal last week may cap the advance. Major support remains near last years high at or around $460 mark.

BUT we are left to wonder what this "barbaric relic" may be discounting in the log run. Bill Bonner below relates a very pertinent history of gold during the early C20th and draws some illuminating parallels.

PAYING FOR WAR
by Bill Bonner

Nothing softens money up as fast as war. The shells pound it. The bullets puncture it. Armies march on it. And politicians and central bankers stretch it out to the point that it inevitably breaks.
In July 1914, all the major belligerents were on the gold standard – along with 44 other countries. The system was simple and effective. It had fostered an international financial climate so conducive to the growth of capital and trade that most of the West had never been more prosperous.
Central banks of the various nations held gold in their coffers. The gold was used to back up the paper currencies. If a nation spent too much on external products, its currency flowed to foreign countries. It came back in payment for either goods or services supplied by the home country. In the event of an imbalance, that is to say when a foreign nation found itself with more of the nation's currency than it could spend on goods and services from that nation, the resulting surplus currency was presented to the central bank to be replaced by gold. Every nation's imbalances were settled in the one thing that none of them could print or counterfeit: gold. If a nation ran a persistent trade deficit, it would find its gold pulled away.

This would encourage the central bank to do something to protect it. Usually, interest rates rose, which had the effect of rewarding savings and discouraging the outflow of funds.
The system was neat. It was honest. Which made it ill suited to the needs of war and empire-builders. War, particularly, was distressingly expensive. Politicians noticed—as monarchs had long ago - that people might be enthralled by the cannon fire, but they hated to pay for it.
Typically, according to R. S. Hamilton-Grace, who studied English war financing, about a third of the cost of war had to be covered by borrowing. Gold was famously uncooperative. It yielded neither to flattery nor to technology. You couldn't pretend it was worth more than it was. And you couldn't create more "out of thin air."
Each ounce needed to be dug up out of the earth - at considerable expense. Increasing the money supply - no matter how glorious or worthwhile the cause - was a difficult thing to do. Central banks had only so much gold.
If they wanted more, it had to come from somewhere. It had to be saved, put away, stored. The old expression, "you can't get something for nothing,"

seemed to have been coined to describe the yellow metal. Every ounce of it represented an ounce of thrift, a pound of self-discipline, and a ton of forbearance. It represented money that had not been spent on new clothes, or guns, or food, or entertainment, lodging, tools, roads, or a million other potential uses. Gold was so hard to get that central banks were reluctant to let it go.

Kings used to castrate the keepers of their royal mints if they let the gold slip away, either through chicanery or lack of attention.

Central bankers were naturally careful with the stuff; caution was in their blood. They knew that if they issued too much paper—that is, if they allowed too many claims against their horde of gold - they risked having it taken from them.

On the other hand, war also was a serious matter. And central banks were asked to help finance the war. This difficult position was made even worse in 1914 when the threat of war caused a drop in stock prices—wiping out much of the liquidity that might be sopped up for wartime finance. The European nations needed to borrow vast amounts to cover the war expenses. But each additional unit of currency further reduced the gold cover, or the ability of the borrowing nation to pay its debts with real money.

Readers will be quick to notice the parallels to the global financial system of 2005. The Europeans wanted to increase the consumption of war materiel. Now, Americans and Europeans consume other things as if they were fighting for their lives. Cannons and bullets were not much different from big-screen TVs and automobiles; they were quickly used up with no economic progress to show for it.

From 1914 to 1918, France and Britain needed U.S. financing to conduct war beyond their means. Now, America turns to its principal suppliers in Asia and asks for credit. Without it, the United States cannot continue consuming at its present rate. In 1914, the world's most important supplier was the United States. France, Britain, and Russia (and to a much lesser extent, Germany, early in the war) had to turn to the United States for supplies. But since they consumed more than they earned, they put their gold reserves at risk. France dealt with this problem early on by simply going off the gold standard. Britain remained on the gold standard throughout the war, barely, but only by the grace of U.S. creditors.

Fortunately for Britain, the United States did not force the issue. (Fortunately for America, 90 years later, its major creditors in Asia do not seem to want to force the issue either - at least, not yet. Even without a gold standard, China and Japan could wreak havoc with the dollar any time they chose. For the moment, like America in 1914 to 1916, they are happy to take the orders and increase market share, knowing that their major customer cannot really afford to pay for all that they send her.)

As the war grew more and more grim, not only was the honest money of the gold standard abandoned by most belligerents, the export of gold to settle accounts was expressly forbidden (under cover of fear that the gold would fall into enemy hands). Each nation began increasing its supply of money, issuing more paper currency, borrowing more and more money from foreign (mostly American) and domestic sources, and spending far beyond its means.

France was already heavily in debt when the war began, with a consolidated debt in July 1914 of 27,000 million francs, in arrears already by 967 million. Normally, the French assembly resisted - however weakly – plans to spend more money. But with war cries in their ears and the Huns at the Marne, the peoples' representatives got in the habit of merely rubberstamping any request that came their way. They voted for credits of 22,804.5 million francs in 1915 - an amount that rose every year, reaching 54,537.1 million in 1918. In practice, the government spent far more than the credits that had been voted, using special accounts that we might call "off budget" accounts similar to those used by the Bush administration to pay for the war in Iraq.

In 1920, 30,000 million francs - an amount nearly equal to the nation's entire pre-war debt- passed through the special accounts.

When America entered the war, its expenditures outdid the other combatants, averaging $42.8 million per day from July 1917 until June 1919. Total federal expenditure rose 2,454 percent in the three years 1916 to 1919. The Federal Reserve issued more and more paper notes; the supply rose by 754 percent

between March 1917 and December 1919. The overall money supply increased 60 percent between 1913 and 1918, while GDP increased only 13 percent. The government raised money partly by taxing people much more heavily and partly by borrowing from them. Four “Liberty Loans” were floated during the war years. At the war’s end, a “Victory Loan” was offered.
All of this borrowing, spending, and taxing left the world’s major economies - especially those in Europe - very fragile. After the war was over, they all attempted to return to the pre-war, gold standard that had worked so well for so long. But they were like the farmers going out to plough their fields in northeastern France; they kept hitting unexploded bombs and blowing themselves up.
Wilson’s meddling was disastrous from practically every point of view -except one. The war continued for another 18 months. Not a single major government in Europe survived in its pre-war form. “In 1914, Europe was a single civilized community,” wrote A. J. P. Taylor, “A man could travel across the length and breadth of the Continent without a passport until he reached…Russia and the Ottoman Empire. He could settle in a foreign country for work or leisure without legal formalities…every currency was as good as gold.”
In 1919, European civilization was a wreck, out of which tough new menaces would be hammered - first in Russia, then in Italy and Germany. Nor did any currency buy as much at the end of the war as it did at the beginning.
All the principal belligerents, with the exception of the United States (and Britain belatedly), were forced off the gold standard. The one and only respect in which the war paid off even for America was that it turned the US into an empire.

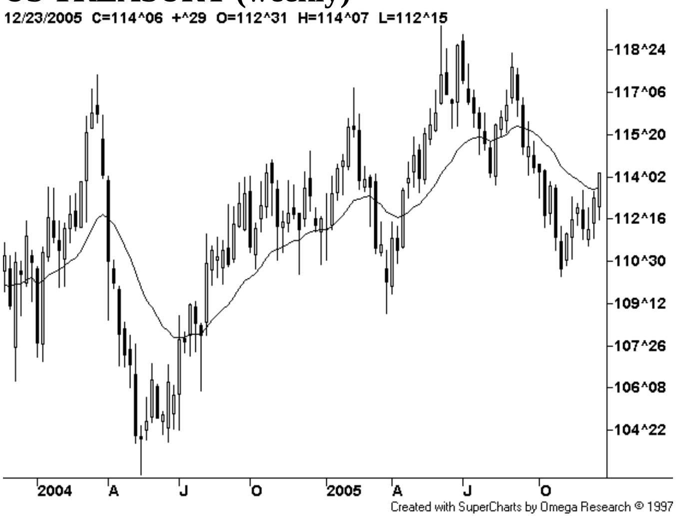
INTEREST RATES & BONDS

- **US rates may creep higher**
- **UK rates likely to remain in the 4 to 5% range in 2006**
- **Govt bonds trade steady but we remain cautious of inverted yield curve.**

Interest rates on both sides of the Atlantic are unlikely to change drastically during at least the first half of ‘06. A soft economy and weak consumer will prevent aggressive rate increases in the US with perhaps two more quarter rises still in the system.
In the UK the B of E is likely to keep a steady hand on the tiller and we suspect that we will witness very little change in rates. We suspect that Mervin King will have an eye on weaker housing and consumer. But he will be fretting about the profligate spending of Brown and potential inflation threats emanating from the multi-year commodity bull and excessive money creation by “helicopter Ben” at the Fed.

UK NOTIONAL GILT (weekly)

US TREASURY (weekly)



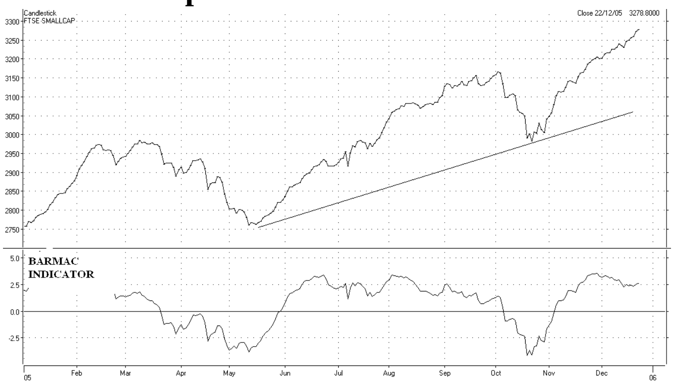
The UK Gilt and US Treasury bond (above) have both enjoyed some recent strength and remain positive whilst they remain above the October lows but a breach could lead to some considerable weakness and a further worrying inversion of the yield curve (where short rates are higher than long). If this occurs we really cannot ignore the real possibility of a US recession as an inverted yield curve has proven to be an extremely reliable predictor.

EQUITIES

- **Barmac re-confirms summer "buy" signal as small-caps rally on.**
- **Ftse remains above long term trend**
- **Wall St still the laggard and Dow still range-bound BUT watch for a sudden surge**
- **Japan just flies away**

Global equities have enjoyed a strong rebound since the sharp but short-lived October sell-off. We have seen European and Far Eastern markets soar to post 2002 highs. This 4th quarter party has only been partly enjoyed by a Wall St that has been a wallflower all year. However, the important aspect for global markets is that Wall St has remained steady. We suspect that markets can continue to rise whilst the US holds steady, but any significant weakness would soon drag most global markets with it.
So the watching brief remains keep an eye on Wall St, invest elsewhere, but run for cover if the Dow takes a dive!

Ftse Small-cap with Barmac Indicator



The Barmac Indicator gave a short-lived "sell" signal in early October and the Small-caps fell 6%. However a strong rebound soon gathered pace and the early summers "buy" signal was re-confirmed by the first week of November and has since advanced by another 5% or so.
The Barmac is generally an excellent lead indicator for all the main market segments and it remains firmly in "buy" at present. We will remain long European markets until the Barmac turns south and will keep our readers informed in the meantime.

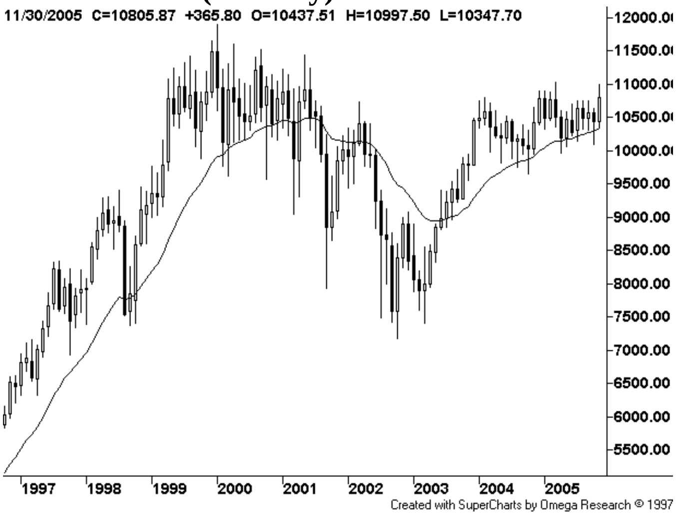
The Ftse100 has maintained a solid uptrend over the past 3 years despite a number small and temporary set backs. As discussed in our lead article the index has not experienced a set back of 10% or more during the past three years, an unprecedented sequence. Additionally, when we look at the monthly Dow chart we see a tight trading range between 10 and 11000 for two years. The Vix is also at record lows.
This combination suggests that there is a strong possibility that at some stage in the next few months a major correction is likely to occur even if the Dow first breaks out of its range to the upside.
The clue that any correction is going to develop into a more serious and pronounced sell-off would come if the key trend line shown on the chart is broken at 5300. A much more serious and deep pull back will follow a breach of this key support trend.

FTSE 100 (last 3 years)

The Dow Jones has been constrained in a trading straightjacket for virtually two full years now. Since December 2003 when the Dow first crossed 9750 it has traded below 11,000 and above 10,000 for 97 weeks. This simply cannot continue for much longer so we expect an explosive move out of this range WILL happen during 2006 and probably in the first half. The incredibly low Vix is pointing the way to a huge surge in market activity, but the question is in which direction?

We don't know but we do know the next move on the Dow will be big, really big!
At least 20% from the break should be expected up or down.
All we have to do is wait and join in once confirmed break of the range occurs. If it is to the bearish side then Wall St will drag all markets with it and it will be time to run for the hills.
So watch and be ready as a huge surge either up or down is long overdue on the Dow and it will affect everything either to the good or bad.

DOW JONES (monthly)



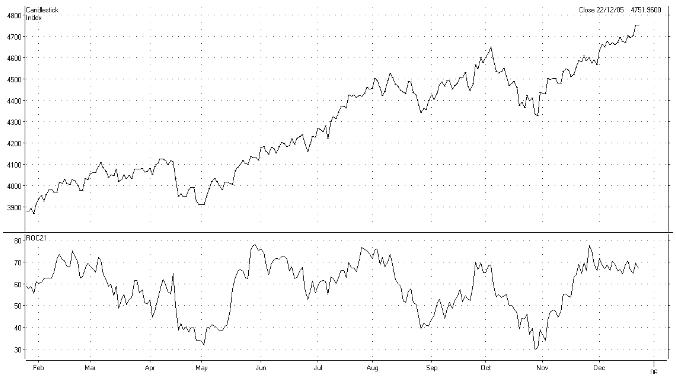
S & P 500 (daily)

The S & P (above) has had a great November but has since paused around 1260. This month-long consolidation should shortly give way soon to trending action. Short-term traders should simply go with the direction of the break for what could be a 30 to 40 point move. It looks to us that the break will be lower but support is around 1230 and this should cushion any downward correction. As yet we see no major reversal pattern on the S & P merely the potential for a short-term pull back.
However any major move is unlikely to occur unless the Dow moves beyond its current trading boundaries discussed above.

NASDAQ (weekly)

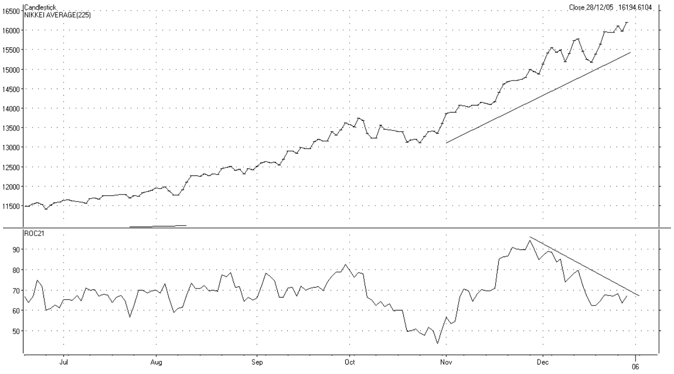
The Nasdaq sports a similar short-term top pattern to the S & P and a breach of 2220 would probably lead to 40 or 50-point decline.

French CAC



The French and German markets sport very similar patterns to each other. They have both advanced consistently since the October setback but the current advance looks to be running out of steam. This is evident when we examine the momentum study at the base of the above chart. Despite consistent new highs for the index the momentum oscillator has consistently failed to confirm the markets advance. This technical divergence implies that a reversal of perhaps only a temporary nature is now overdue. Support is to be found at the October highs that should cushion the declines unless the Dow breaks 10,000. There is no reason to suspect as yet that a final high is in yet although both markets have rallied back to the significant March 2002 rally highs.

NIKKEI



The Nikkei has gone ballistic since August but there are worrying signs that a correction may be immanent. The momentum study shown above has been non-confirming the cash market or 5 or 6 weeks and we would expect this index to consolidate the dramatic gains in the very near future. We expect the index to range for several weeks at least but we should not see any move that carries beyond the October highs.

However, the Japanese markets look to confirm our long held faith. After a 14-year bear market Japan is cheap and stock ownership is extremely low providing the perfect breeding ground for a multi-year advance. But maybe the advance has got slightly ahead of itself at present and an assault on the 20,000 level may have to wait a while.

We would still hold onto core Japanese positions but would lighten any speculative holdings looking to add to weightings on any opportunities created by a decline.

FOREX

- **Dollar rally looks like it could re-commence soon.**
- **Sterling looks in potential trouble on various long-term charts**

The Dollar's global rally of 2005 still looks set to continue as long as 88 is not breached on the Dollar index chart. Many traders and commentators are still bearish the dollar but rising US rates has made shorting the dollar an expensive play. The chart below illustrates the key-supporting trend and as long as this remains in tact we anticipate more gains for he dollar. If the 92 mark is topped we may witness a surge toward the key area around the 98 mark so traders could certainly follow the dollar aggressively above 92.

DOLLAR INDEX (weekly)

Sterling/Dollar

The pound has declined steadily since breaking down from a triangle in April. This decline has completed what looks like a potential huge top. If this proves to be the case than we could see Sterling decline toward the $1.55 levels during 2006. This prognosis becomes more likely when we look at the major sterling crosses against yen and euro.

Indeed our suspicion is that the pound could be in for a tough period with the potential for a good "old fashioned" sterling crisis preventing the B of E from cutting rates this year.

When we look at the Euro cross (below) the last 30 months broadly sideways action looks like a mere consolidation of 2003 downwards thrust. A move below the supporting trend at £1.42 could open the way to a fast move down.

However, we could be a long way from that event at present as the Euro/Sterling cross has traded sideways for over two years and could easily continue to do so for many months. But it is worth being ready to pounce if a truly major breakout were to occur.

In the meantime this cross looks likely to test the lows of the range seen during the summer.

Sterling/Euro

Sterling/Yen

The Yen has steadily declined against the pound since late 2000 but this 5-year decline, which has been orderly throughout maybe tiring. Certainly a spike down through the long-standing major trend line could signal a significant reversal of direction for the yen. This hypothesis is supported by the corrective looking nature of the rally by the pound over the past five years.

We intend watching closely the Yen cross because any evidence of trend reversal will probably signify a long and profitable multi-year rally for the yen.

COMMODITIES

- **CRB continues to rally**
- **Oil bounces on trend support**
- **Precious metals have set-back as industrials rally**
- **Softs follow disparate course**

The CRB index of all commodities continues to hit fresh highs driven of late by the surge in industrial metals. Even as the energy complex has eased back partially the industrial metals have continued to respond to growing Asian demand. The commodity bull is still young and is likely to continue for at least another decade in line with every previous commodity bull cycle of the C20th.

The implications for inflation are clear for all to see.

CRB INDEX (weekly)

The price of crude as well as both petrol and heating oil has retreated significantly since the late summer highs. The decline has probably marked a top of some significance and is likely to hold for many months.

Traders will watch closely to see if the bull trends (marked) are broken to indicate if a more prolonged and deeper corrections are to follow. We suspect that this may prove to be the case but we would not short energy.

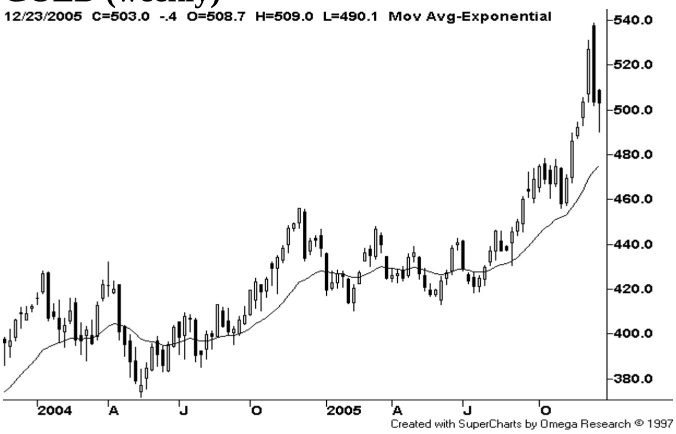
CRUDE OIL (weekly)

HEATING OIL (weekly)

UNLEADED GAS (weekly)

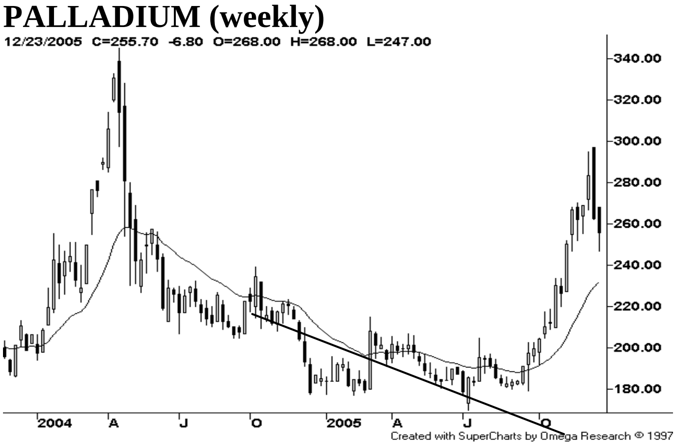
Gold, silver and platinum have all seen a significant set back over the past week but should in the case of gold and silver find support at the October highs. However the recent surge by all three probably is an indication of future gains. The current set back may lead to consolidations that could last a number of months but the next leg up will surely follow and we need to watch for any indication of renewed strength.

GOLD (weekly)



SILVER (weekly)

PALLADIUM (weekly)



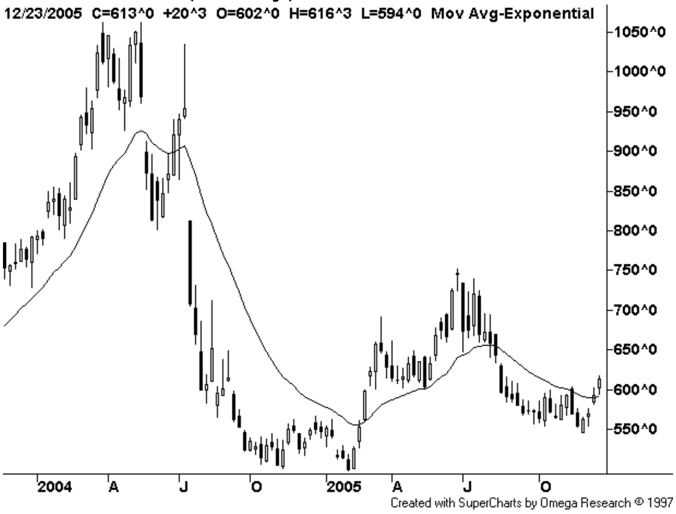
COPPER (weekly)

Dr Copper just keeps climbing as tight supply and surging Asian demand squeeze the price higher. With no sign of demand easing and no short-term possibility of new supply prices will remain historically high but could be due a correction of some speculative excess. Prices should hold above last years range at $1.60 even if a very deep sell-off develops. Prices must correct at sometime but we cannot guess when this soar away metal might fall. Certainly, Dr Copper seems to be saying global growth is strong and likely to continue which has to be good news. Conversely though a major set back in copper could well signal a global slowdown so it is worth watching closely.

ALUMINIUM (weekly)

Aluminium has exploded upwards over the past month and the spring highs at 9500 should cushion any sell-off. Again the reason for the explosion in price can be laid at the feet of rapid Asian industrialisation and is likely to continue until a natural bust occurs to end the current boom. Traders could buy the light metal using 9500 as a stop,

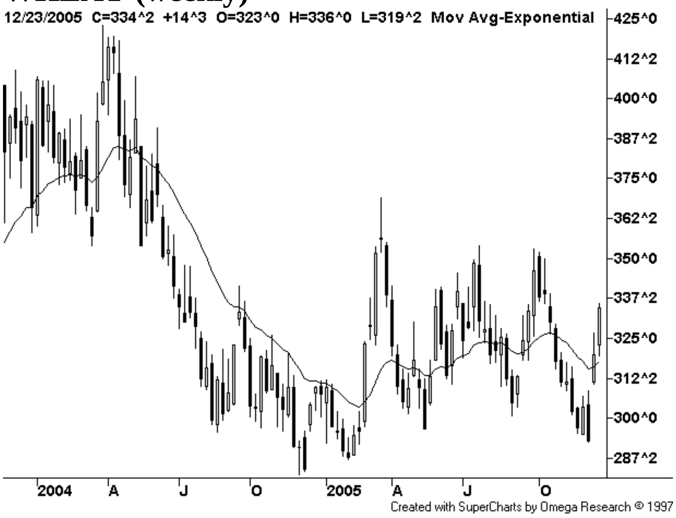
SOYBEANS (weekly)



Soybeans are still historically cheap which is not likely to remain the case for very long as China's growing affluence is increasing demand for various foodstuffs reliant on soya.

Soybeans now look to be accelerating higher out of three-month range as shown on the chart above. A stop at $550 should limit any losses and provide potential to enjoy a rally back to the summer highs.

WHEAT (weekly)



Wheat has ranged throughout 2005 between $3.00 and 3.50 per bushel and we would anticipate that this range should break shortly. We would trade any

break. Indeed we would not be surprised to see a sharp rise in wheat and grain prices as the Asian markets grow with industrialisation.
This story is going to affect all the soft commodities over the next decade and drive up cost-push inflation.

SUGAR #11 (weekly)

Sugar has simply gone ballistic and is hugely overbought. The current acceleration is unsustainable and we would not chase this market higher. We recommended sugar on a break of $9 earlier this year and would now suggest profits are taken.

COFFEE (weekly)

Coffee -:a long-term play of Barmac from $52 in 2002 looks to be completing the year long correction. Once $110 is exceeded we would expect a rally back to the highs seen last year and would set a stop at $100.

ORANGE JUICE (weekly)

Orange juice is flying high on poor crop reports and various agricultural worries. We suspect that prices have moved ahead of fundamentals and would no be surprised to see prices ease back to support at 100.

COTTON (weekly)

Cotton is another old friend of Barmac and is trapped within a triangle and breakouts from these are always profitable. This is simply a watch and wait situation with all traders buying any move over $60.
We would not trade a break down due to the proximity of the 2005 lows at $40.

Regular readers will be well aware of Barmac's economic philosophy, which is broadly based on the works of the Austrian school. Just to prove

that we are not totally partisan we include below a very illuminating and optimistic view of global economic developments based upon GaveKal's Ricardian interpretation of economic growth.
The basic principal of which we have no argument (basically Ricardo argued that rational organization of talent or the economics of comparative advantage would help stimulate global growth in a "free-trade" world) we just think that the world economy is awash with cheap money and not economically totally free. Thus at some point the bull cycle will reverse.

RICCARDIAN ECONOMICS

GaveKal suspects that the economic cycle is "different this time." They begin with the old saying, "History never repeats itself; but it often rhymes" in the introduction of their book "Our Brave New World.

They argue, "This simple fact explains why so many financial analysts, market strategists and portfolio managers like to study past economic cycles and market reactions before taking investment decisions. By studying financial and economic history, market participants are able to anchor beliefs on solid facts and precedents.

"The reason so many analysts drag their feet in admitting that history has failed to rhyme this time around is that it would lead one to the dreaded conclusion that 'things are different this time'. But why is this a dreaded conclusion? Because anyone who has spent ten minutes on a trading floor knows that saying 'things are different this time' is:

1) The easiest way to get laughed out of a room,
2) The most expensive words ever pronounced,
3) The surest way to lose any kind of credibility,

And yet, this is exactly what GaveKal aim to argue in their book.

Arguing that 'things are different this time', they freely admit that they might end up drawing the wrong conclusions, say silly things and establish relationships where there are none. They also realize that some of their more cynical clients (say those sitting in Boston or London) might read the coming chapters and conclude that they have really been drinking the loopy-juice. These are the risks when one ventures into uncharted territory.

They accept these risks gladly, for they are convinced that the first step to successful investing is an understanding of the current world.

"*Unfortunately, History is of little help to this understanding. We have to draw solely on logic, and the help of our friends and clients. With this in mind, we kindly ask that you contact us if you see a flaw in any of the arguments that we present. Again, this is a work in progress, the final aim of which is to help us understand the world we live in so that we can deploy our capital more efficiently*."

So, what makes it different this time? GaveKal suggests a number of things.

First, there is a new business model. Just as industrialists were new in the late 1700s, there is now a new model developing. GaveKal calls this new model "platform companies."

The old model was to design or find something, manufacture it, market it and sell it. (Think Ford, Caterpillar, 3M, oil, mining.) The new model keeps just the high value added parts and ditches the rest. The new model focuses on research and development, treasury, marketing, and the business process and out sources as much of the low margin work as possible. Think Dell, Wal-Mart, IKEA, Li and Fung. Most hotel chains now do not own their properties.

The new model is to "produce nowhere but to sell everywhere....Platform companies know where the clients are and what they want and where the producers are. Platform companies then simply organize the ordering by the clients and the delivery by the producers (and the placing of their logo on the product just before delivery)."

Production is the least profitable of all the processes. It ties up capital, means a lot of volatile (and costly) inventory; it is labour intensive (and subject to all sorts of problems when there is a slowdown [unproductive labour costs] or a quick need for more product and overtime costs). The market does not give manufacturing companies the same investment multiple as they do the platform companies. Platform companies have more stable incomes and profits.

Who would you rather be? The Chinese and other Asian companies that make the iPod at a 2-3% margin or Apple who sells it at a 40% margin?

But this process means manufacturing jobs leave the developed world (the United States, Canada, Old Europe, Australia, New Zealand and Japan) and move to the developing world, primarily Asia and Eastern Europe. This is not seen be many observers as a good thing. Take for instance good friend Marc Faber's recent writing:

"I am fully aware that some observers will argue that it doesn't matter that U.S. companies are increasingly moving their own plants overseas, or outsourcing altogether, because the improved profits that result from the outsourcing accrue to the parent company... However, what about the long term? How beneficial is it going to be for Western industrialized companies if IBM were to lay off 13,000 people over the next twelve months in the US and hire 14,000 in India...I suppose even a non-economist could see that the movement offshore of sophisticated manufacturing and well-paid service jobs has to have some negative macro-economic consequences..."

And indeed jobs have been lost. But more have been found. Some would argue that we are seeing lower paying jobs, but the reality is that tax receipts, at least in the United States, are always and everywhere up, even as the Federal government cut taxes! No one pays more taxes than they absolutely have to. Higher tax receipts mean people are making more money. Not everyone, of course.

Is the platform company model something that will pass or is it the new wave? GaveKal asserts that the model depends upon four things.

1. Free trade, so that products can be produced wherever costs are lowest.
2. Technological progress, especially in communications, which allows a company to decentralize its process.
3. Recurrent overcapacity in most industries, which allows the platform company to never run out of goods to sell.
4. The ability to move goods easily (needed infrastructure like airports, ports and highways).

The above items are all part and parcel of a capitalist economy. "So in a sense, 'platform companies' are the children of the capitalist system."

And where does growth in a capitalistic society come from? It either comes from what is called Ricardian growth (from economist David Ricardo), or the growth that comes from a rational organization of talent, where each person contributes at his best level of skill. Countries that do not allow for free movement and advancement of its workers are less profitable than those that do. How much talent is wasted in countries that do not allow women to work, or do not educate their poor universally? Growth is clearly better when those with the best skills and services are allowed to thrive, free of protectionism. This is true whether it is on a personal level or on a country level. If China can manufacture something cheaper than is the case in the United States, then why should consumers be required to pay more? And if something costs less, then more of it will be bought. Thus Ricardian growth.

Yes, that does result in some workers losing jobs, but in a fluid and free economy, they find others. While some find jobs with less income, as noted above, incomes on average are up. And yes, we have fewer manufacturing jobs, but we are manufacturing more "stuff" than ever. We have become more efficient, as technology has made our manufacturing processes in the developed world more productive.

Then second type of growth is what Schumpeter calls creative destruction.
It is the growth that comes from new ideas and inventions driven by entrepreneurs. New ideas mean new products that create whole new levels of demand. It can also mean that some products become obsolete. There was a time when fax machines hummed all day. Now, we do e-mail. Many people

no longer have a home phone, as we all use cell phones. Things change. They go the way of the buggy whip.
For Ricardian growth you need low trade barriers. For Schumpeterian type growth, you need low regulations, low taxes, access to capital and the ability and right to fail. To the degree which countries encourage such things, they prosper or grow more slowly.

The real danger to the platform model? Governments and protectionism. As they point out, a Dell computer says "Made in China" but it is really more accurate to say assembled in China. It is made from parts and software from a score of countries. Of course, the "trade deficit" is counted as China's. Yet, Senator Schumer regularly bashes China, appealing to his union supporters, but fails to notice things like this. Should we also get upset with Korea and Taiwan and Russia and Sweden and the rest of the countries who contributed? We live in a world where our ability to measure economic reality is becoming more and more limited.

In a world where the U.S. government counts Microsoft physical exports as "plastic" because the disks are plastic and only worth a few dollars at most (Dennis Gartman swears he was told this by a government official who was physically counting export shipping at a port), how can we trust the numbers?

So we thank Gavekal for their insightful and optimistic explanation of economic growth and future prospects based upon the Ricardian model together with their original idea of how platform companies can create growth in the West whilst exporting manufacturing jobs. We suspect Gavekal are at least partly correct and this explains a great deal of the ongoing gravity defying strength of the Anglo-Saxon economies. But we can’t totally shake off our natural scepticism and suspicion that all that liquidity creation of the last decade or so will return to haunt the markets like a ghost Christmas past.

”

May we at Barmac wish all our readers and investors a very happy and prosperous New Year
Regards

Andrew McCarthy &
Andy Bartles

.