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MARKET VOLATILITY EXPLODES AS INFLATION FEARS CAUSE US RATES TO RISE!

BARMAC MARKET DIRECTIONAL INDICATOR:-
SELL SIGNAL -issued on 12th May
Market down 7% since signal.

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Market volatility
Barmac issues SELL signal
Small and Mid cap out performance to end

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The January issue of Barmac carried the warning that volatility was bound to return in 2006 after an absence of nearly three years since the March '03 low. We highlighted the statistic that equities had advanced for 37 months (to end of April) without a 10% plus consolidation, a sequence not previously experienced by the Ftse since it was first constituted. The Ftse was not alone as most European and US markets had also experienced an unprecedented advance without serious correction

We thus hope our readers were prepared for the sharp correction that commenced on Thursday 11th May.

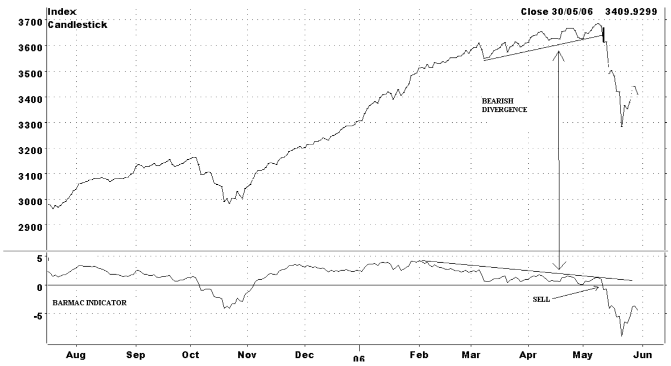
So what has triggered the sudden declines? We suspect the chart below my hold the key to understanding the markets sudden pessimism.

The "discount rate" is the interest rate US banks pay when they borrow from the Fed and is traditionally slightly higher than the more familiar Fed funds base rate.

The discount rate has only risen through 6% on six

previous occasions. As the above chart illustrates on all six occasions the US equity markets soon turned tail and headed lower with a bullet. The declines have all exceeded 20% plus with 1929, 1973, 1987 and 2000 being much more dramatic. Indeed on 4 out of 6 occasions the declines that followed the rate hike to 6% were in excess of 40%.
So we find ourselves at the historic moment where for the seventh time the US discount rate hits 6%. This has happened at the very moment when equity markets have enjoyed an unprecedented unbroken 37 months of advances with no correction greater than 8%. Additionally, the Vix volatility index has been trading as low as a snake's knee for months.
Markets appeared to have cracked right on cue. But here will the declines end soon? Well we do not know the answer to that, but we DO know the odds are not good for a quick rebound.

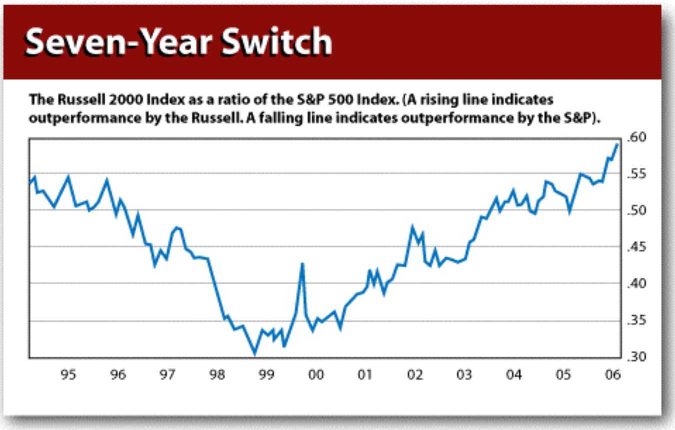
BARMAC INDICATOR ISSUES A SELL SIGNAL ON 12TH MAY



The Barmac indicator finally issued a major market "sell" signal on the morning of Friday 12th May. The UK Ftse smallcap index closed at 3612 on the day completing an advance from 3086 since our last "buy" signal on November 3rd. The index has now fallen to just above 3400 a decline from the highs of 280 points or 8%.
The falls followed a long period of divergence between price action and the indicator (bottom panel) that implied diminishing internal momentum and is frequently an early warning of a trend reversal.
The historical success of this indicator (25 buys since 1996 and only 4 losers the largest being 1.5%) leads us to believe that the current decline could well have further to go with a weak and volatile summer being the likely prospect as prices potentially work lower but we do not expect any sort of crash. Our target is 15 to 25% declines with the small and mid cap indices suffering perhaps the larger percentage falls.

Small & Mid-cap have outperformed on both sides of the Atlantic for several years but is this trend about to end?

The nearby chart depicts the relative performance of the Russell 2000 Index of small and mid-cap stocks, relative to the S&P 500 Index. Over the last seven years, the Russell has nearly doubled, while the S&P 500 has gained a mere 9%.
The Russell's remarkable performance has been mirrored in the UK and throughout the worlds major markets over the same time-frame and has elicited many oohs and ahs, as well as a number of after-the-fact justifications from Wall Street etc.
Small-cap stocks have been strong, the experts explain, because small-cap earnings have been growing faster than those of the big caps, or because investors have been favouring growth stocks, or because interest rates have been low, or because interest rates have been high, or because consumers have been spending, or because consumers have been saving.
We at Barmac have a few vague hunches as to the cause of this of the spectacular small-cap rally of the last several years, but we do have some firm ideas about the resulting effects. Specifically, small-cap stocks have become quite expensive, relative to their large-cap counterparts. Yet, despite their lofty valuations, seven years of straight-up price action has emboldened investors to continue buying them (until this last week or two!). Both of these characteristics suggest that small-caps are closer to a peak than a trough, at least relative to large caps.
We know of no precise reason why small-caps must now begin to falter, but we can think of innumerable reasons why they SHOULD.
For starters, analyst Richard Rhodes, of the Rhodes Report, observes that small-cap stocks tend to perform well over seven-year cycles – or roughly as long as the average spouse behaves him/herself.



Since 1999, Rhodes notes, the Russell 2000/S&P 500 ratio has been going straight up. "Generally," he asserts, "the ratio runs in 7 year cycles, so given we are in the 8th year, perhaps the time has arrived to consider readjusting one's portfolio. In fact, we believe the winds of change are forthcoming...Certainly, this [ratio] should be on everyone's trading radar going forward."

The seven-year cycle is not the only reason to consider lightening up on small caps. Valuation differentials would second the notion. At 41 times trailing annual earnings, the Russell 2000 sells for more than twice the valuation of the S&P 500. And even if we attempt to flatter the Russell by relying on estimated earnings, this pricey index would still sell for more than 26 times earnings, well above the S&P's multiple of 17 times earnings.

Perhaps year eight will prove to be another winner for the small caps, but we'd rather bet on the underdogs.

INTEREST RATES AND BONDS

- **Inflation fears puts pressure on Central banks**
- **UK and US bonds bounce after predicted "sell-off"**

Much vaunted inflationary fears especially in the US has led to increased pressure on US rates. The recent rise in US CPI has led to mounting fears that rising commodity prices, war and fuel will combine to create a robust economic growth that will necessitate the Fed raising interest rates much further than originally anticipated. Many Fed watchers felt that 5% (6% discount rate) would mark the top of the cycle, but markets are fearful that the inflation genie may be hard to re-bottle and that rates could rise much further.

We certainly think US rates deserve to go higher after such profligate money supply growth and the reliance upon deficit spending but we are not yet convinced inflation will rise as much as many expect. A weakening US housing market may just allow the Fed to get away with just one more rise of 25 bips. We believe that the markets are in the balance between inflation and a property decline that would hurt many highly mortgaged up Americans.

However, faced with a choice between being tough on inflation and bankrupting US homeowners the Fed will not raise rates aggressively. So barring accidents US rates should peak this summer near 5.25%.

In Europe the strengthening German economy will lead EU rates higher with as much as 100 points likely to be added to the base rate over the next 12 months.

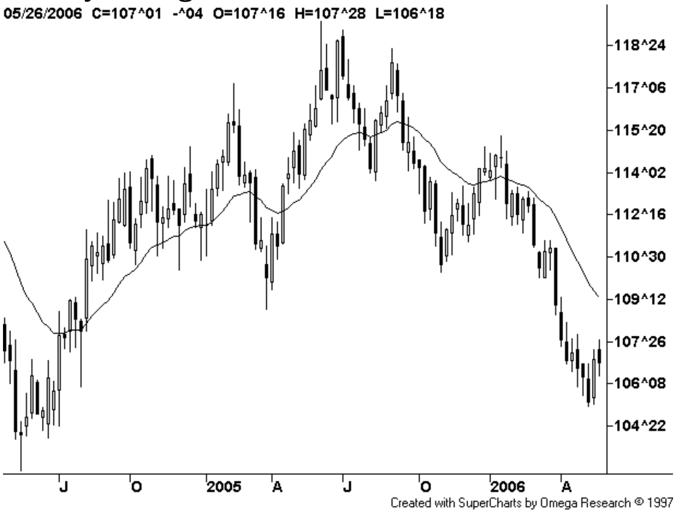
In the UK despite protestations to the contrary the UK housing market remains in the doldrums (turnover is very low, yields uneconomic and sentiment fragile) and still gravely exposed to downward lurch in confidence. Thus although the Bank of England may feel obliged to raise rates by 25 points we suspect old Mervyn will not risk any more unless global circumstances create irresistible pressure.

UK GILT (notional)

The UK gilt has declined steadily to our target levels and has bounced at the spring lows of 108.

The contract is now deeply oversold and a rebound was long overdue. However the strength of the rebound will be weak and constrained by supply, low yields (would you really want to lend money for 30 years at only 5%) and the fear of inflation destroying real yields. Thus we cannot envisage the rally carrying beyond lateral resistance at the autumn lows of 110/111. For that reason we would not advise aggressively trading the current bounce as profit potential is strictly limited.

US 30yr Long Bond



The US long bond has also bounced from oversold levels but any rally is unlikely to exceed the substantial resistance at the October lows of 110.

GLOBAL EQUITIES

- **Historical stats suggest the summer may be tough for equities**
- **Did overheated Asian markets lead the decline and if so where will the falls end?**
- **Despite the falls the bull market major trend lines still hold for now.**

Historical US market stats may help us decide what to expect next after this current sell-off.
By Mark Bail

To get a sense of what declining prices in May means in historical terms -- and what a sell-off in May suggests for the future, I consulted the S&P 500's historical prices from 1970-2005 to search for some possible answers.

The first thing I wanted to find out was how the current drop in the S&P 500 stacks up against prior May sell-offs. Before I go further, I should note that the S&P 500 has suffered a 5.6% decline from its intra-day high of 1326.70 on May 8 to last weeks low of 1252.98.

I evaluated each of the previous thirty-six years in the S&P 500 on the basis of the distance the index fell from the high set in the first four months of the year to the subsequent low registered during the month of May. The only exceptions I made were for the years 1983 and 1999. Those two years were similar to 2006 in that, in both years, the S&P 500 notched new highs in May before subsequently putting in a low in the latter part of the month.

So, just how common is a 5.6% decline in the S&P 500 from a calendar year high to a May low? According to the index's trading history going back to 1970, a setback of that magnitude or greater is very common indeed. In fact, what is not very common is to see a May low less than 5.6%.

In the thirty-six years I studied, the S&P 500 suffered a pull back to a May low in excess of 5.6% thirty-one times. That's better than six out of every seven years! Moreover, the average decline in the S&P 500 from 1970-2005 from a calendar year high to a subsequent May low was 8.6%. In other words, the sell-off we have seen so far is rather mild by the S&P 500's historical standards.

However, the key question to try to answer at this point is, what can we expect next.

To see if my expectation of a further decline has a basis in recent market history, I did some additional searching through the S&P 500's historical data. What I found only confirmed my suspicions -- and what I think the current chart patterns are telling us. Let me share some numbers with you.

Between 1970 and 2005, the S&P 500 violated its May bottom in a subsequent month on twenty-three occasions -- or 63.9% of the time. Thus, the chances are favourable that -- whether we have already seen May's lows or not -- even lower prices await us sometime between now and the end of the year.

That's not all. If the S&P 500 has already marked its low for May, the odds of seeing a lower low sometime between June and December becomes infinitely greater because the current decline is sub-par.

On eleven of the thirteen occasions where the S&P 500's May low marked the low for the remainder of the calendar year (including 2003 and 2005), -- the index had already suffered through a decline greater than the 5.6% we've witnessed so far.

Only in 1993 and 1995 did the index post a modest decline into its May low and then turn up for the rest of the year.

What this means is that -- despite the seeming severity of the recent drop in stock prices -- the worst is yet to come. Whether or not we have seen May's lows, according to the S&P 500's historical trading pattern, odds favour still lower lows for the index.

History doesn't always repeat itself in the same way. But patterns do have a tendency to recur. That's one of the reasons technical analysis can be useful to your trading or investing efforts.

Emerging market falls

The markets most seriously affected by the recent falls have been previously the most exuberant emerging market economies of Russia and Asia as investors have had a growing appetite for risk. But the bulls animal spirits appears to be evaporating and thus we have seen India's Sensex index fall over 20% with market circuit breakers being used to stem the fall of 10% in one day. Russia too has seen similar falls as have many Latin, Asian and emerging countries.

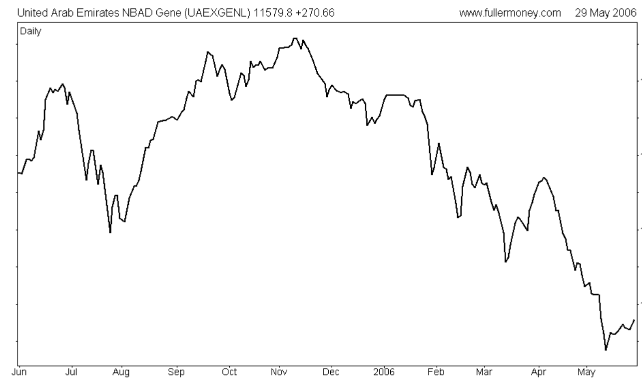
We suspect that this trend of emerging markets underperformance may well persist as investors become more risk averse. Certainly markets such as India's may struggle to exceed its May highs after such a dramatic lurch down. After all barely three weeks ago you could not pick a paper or magazine up without being told how the sub-continent was the investment place to be!

If we look at the chart for the **Indian market** below we can see the dramatic nature of the decline after a near vertical advance. This is classic trend ending acceleration and we would not be surprised to see India retrace the whole advance since last October's lows over the coming months.

INDIA

SAUDI STOCK INDEX

UAE STOCK INDEX



The Middle Eastern markets were among the worlds best performing in 2005 as they roared upwards fuelled by oil cash.

However, the abundant liquidity seems to have disappeared this year and many of the Arab markets have come crashing down (as will the Dubai real estate bubble in the not too distant future – who would in their right mind buy property on the edge of a desert with neighbours such as Iraq, Iran, Israel and the potentially unstable Saudi all lining up to start World War 3).

As can be seen from the two examples above these markets have crashed upwards of 50% in a little over

five months. This severe fall has led some to question as to whether the Arab markets are leading the market cycle and are the first to feel the chill winds of risk aversion and shrinking global liquidity.
We can only hope that this is not the case but their near collapse in a matter of a few months is concerning to all global investors.

The declines in the UK and US markets have been severe but by no means catastrophic as yet. Indeed the two main market indices (FTse 100 and S&P 500 have both bounced on their long term bull trend lines (as shown below). These trends have supported both markets since the March 2003 lows and are important psychological support. We suggested in our last issue that the markets might well trend to this support level if the short-term trend was broken (marked A on the chart of Ftse below). We are both gratified and mesmerised by the power and pinpoint accuracy of charts in helping determine the likely level the falls in the Ftse eventually stopped at.

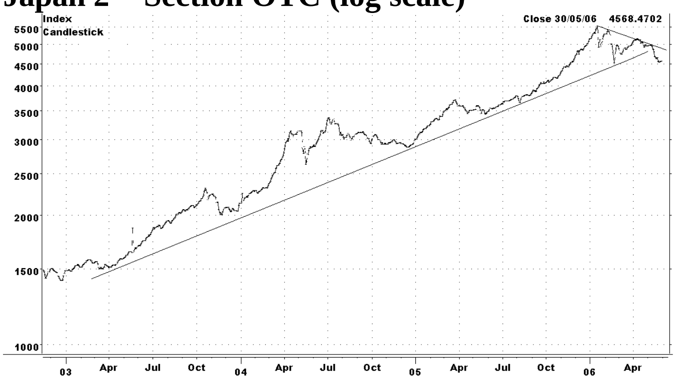
FTSE 100

S & P 500

The two charts above define both a possible trading range and the point at which all traders and investors should start taking drastic action.
Firstly, if the bull trend is about to fail everyone should exit the market as and when the trend is broken with traders shorting the market using the trend as a market stop (currently 5548 on the Ftse). We expect big falls lasting several months if this major trend is broken and confirmed by other key indices such as the Dow and S&P.
The likely short-term scenario is a ranging retracement of at least 2/3rds of the recent declines. This ranging could well last all summer long and it will take new highs to re-confirm the bull. Sentiment has been badly mauled and as such any advance will be tentative.
HOWEVER, if the market does resolve to the downside and break the key bull trend then we suspect that it will become evident quickly and a large move could develop. Initial support lies at the October lows The same is true of Wall St. and so be ready to short the indices if the key bull trend is broken.

Tokyo has hit new lows and has been led all along by the 2nd Section (below) which has now declined over 1000 points (20%) since peaking in February at 5500 (not easy to see on the chart below) just before the Livedoor debacle. Again it appears that the bull markets “animal spirits” appear to be deserting the party, as this index is the high beta speculative cousin of the Nikkei. If this is so then this bodes ill for all Japanese markets.
The key point of the chart is the clear breach of the bull trend and the new low today (May 31st) which implies ongoing weakness unless at least the March highs are exceeded. The Nikkei looks set to follow.

Japan 2nd Section OTC (log scale)



FOREX

- **Dollar slumps out of trading triangle**
- **Euro continues to be the worlds most boring trade as it moves sideways versus Sterling**

Last issue we highlighted the tight wedge pattern bottling up the dollar sterling cross. Well we certainly have had an explosive move out of our wedge from $1.77 to resistance at $1.88. This is typical of a breakout of a tight trading pattern. A great clear trade for all as the pound powered up and past the key $1.78 level.

So where from here? It looks likely that the pound will strengthen further once the current consolidation has run its course and unwound overbought conditions. However, a deeper and longer consolidation would be signalled if last week's lows are breached at $1.86. Stops should be placed at $1.85.

US DOLLAR/STERLING

EURO/STERLING

The Sterling/Euro cross is still just plain boring. This range is slowly tightening but does not look like providing fireworks for sometime yet. A watching brief is all that is required but one day we are sure this range will bust apart and we will witness a dramatic and hugely profitable trade so don't fall asleep or believe politicians if they start to argue that Sterling is a Euro proxy. It is not and will demonstrate that fact at some stage in the next couple of years.

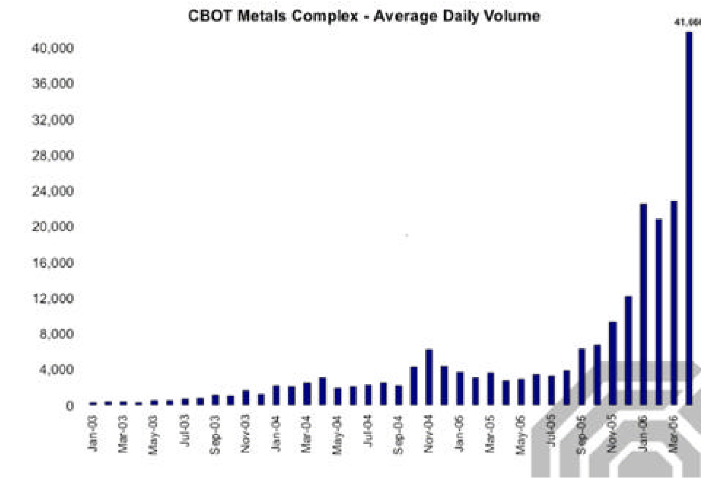
COMMODITIES

- **Massive speculation mania in metals**
- **Oil still above bull trend**
- **Intermediate tops in Gold and Silver.**

METAL MANIA

If we wish to understand why industrial metals have soared over the past few years and why they have reacted so dramatically to recent economic fears then this chart published several weeks ago perhaps provides some perspective of the activity currently being witnessed in the metal exchanges.

We cannot say for certain what the chart below implies, but we are quite certain what it does NOT imply: Commodities are an ignored asset class.



As long-time Barmac readers will be well aware, your editors have been long-time fans of commodities and resource stocks...and so we remain. But we'd be lying if we did not admit to viewing the chart above with some consternation. Trading volumes in metals futures contracts are skyrocketing on the Chicago Board of Trade. Specifically, during the month of April, more than 40,000 metals futures contracts were changing hands every day, on average. That's double the volumes of the prior month and TEN times the volumes of the prior year.

Whenever an asset class becomes this popular this quickly, bad things tend to happen...at least for a while. We suspect that our beloved commodities will be no different.

The sell-off recently witnessed may prove to be a pre-curser to a more dramatic decline or maybe a penultimate top before a major multi-month fall unfolds.

One thing for sure – these commodities are white hot and therefore susceptible to bouts of severe profit taking.

OIL remains around $70+ and is consequently remains a huge tax on growth. Amazingly, global economies have bowled along strongly ignoring the sustained high price of energy. In the meantime the oil chart displays ongoing consistency with the current pullback from the recent highs being consistent with the character of previous consolidations.

Thus with trend consistency in place there is no reason to expect large declines until or unless the character of the market undergoes a change and the key bull trend is broken near $65. The trend is up!

Oil (Nymex weekly)

Petrol prices are back to the October levels, which reflect tight refining capacity as well as high oil prices. The current consolidation looks like a pause or flag rather than a reversal so we would not be surprised to see another leg higher. Support remains at $1.80 and it will look to be moving strongly higher above $2.20.

Unleaded Gas (weekly)

Both Gold and Silver have experienced the largest corrections since the bull began in 2001 (see Barmac issue August 2001 when we urged readers to buy gold at $265). The precious metals have become caught up within speculative excess witnessed by the sudden sexy prominence of metals in all investment bulletins etc.

We think the run-up displayed characteristic trend ending acceleration as a near vertical advance unfolded during April and May. That advance has stopped in its tracks and reversed and despite very small and narrow markets that can make all commodities very volatile we still expect gold to work back to the February highs.

Gold (daily)

We hold a similar view on silver with a decline back to $9.00 not unlikely. We think these markets need to cool and are now very volatile and thus dangerous to trade. Stand aside or be a long-term investor is the only way to play these two.

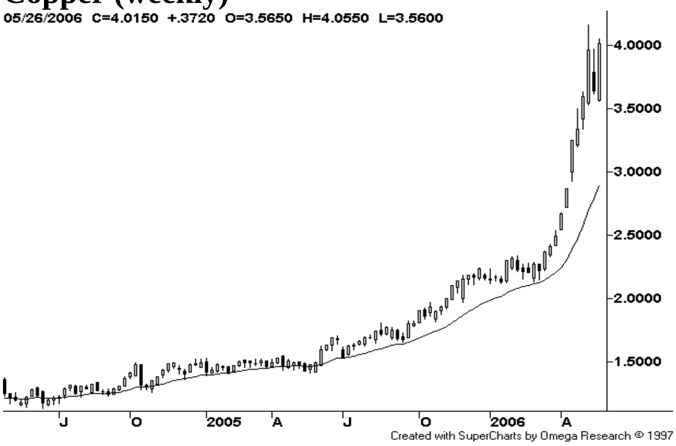
Silver (weekly)

Talking of hot commodities just look at Dr Copper and Aluminium! How can you predict a market that is advancing near vertically? These markets are glowing white-hot and have exceeded our wildest expectations since tipping copper consistently since 2003 at $1.200.

The first major check in the advance was witnessed in late May and this could prove to be the top or at least the penultimate top for both metals. Because metal prices are being driven higher by speculation and not industrial demand they could reverse very quickly.

If you're invested, protect with stops at $3.500 on copper whilst aluminium looks to be reversing. Traders should stand take a deep breath and stand aside and watch the show as this market is looking wild.

Copper (weekly)



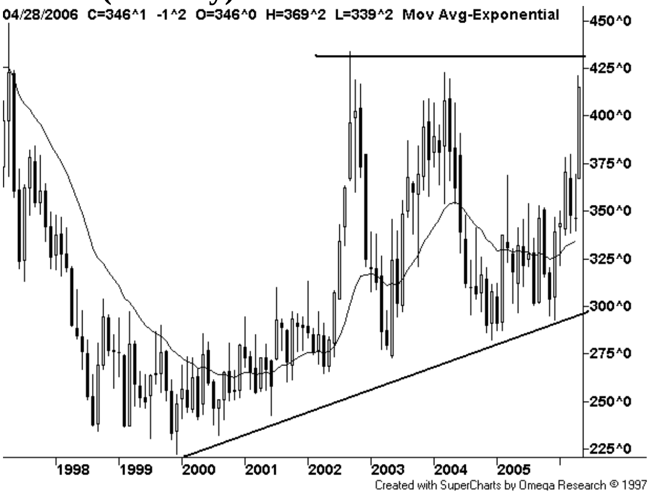
Aluminium (weekly)

Soybeans (weekly)

Soybeans look fascinating, as they have traded narrowly since October. We would watch and wait for action as sooner or later Soybeans will break the trading range and should provide a profitable trade and a safe entry at either $625 (buy) or $550 (short).

In the last four years Wheat has ranged wildly between $2.75 a bushel to $4.25. We are now at the higher resistance levels and we wonder whether we will see a third time break of these highs. If the hedge funds turn to the soft commodities we may see a surge but we would expect prices to at least pause at these levels.

Wheat (monthly)

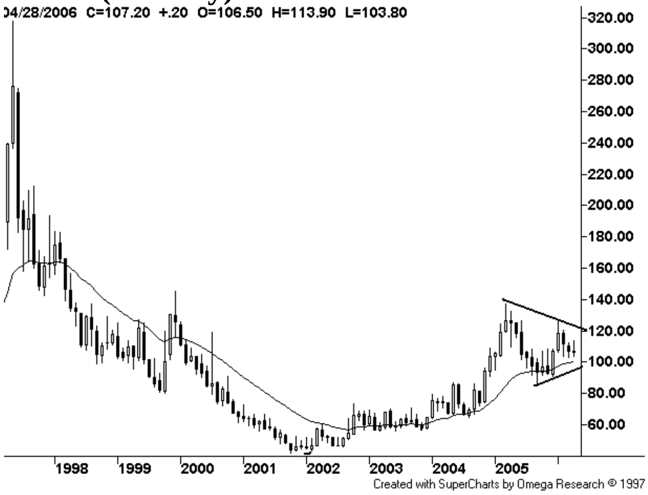


Cotton (weekly)

Cotton appears to be breaking down since cutting through the supporting rising trend at $52 and we would short using the above level as a stop.

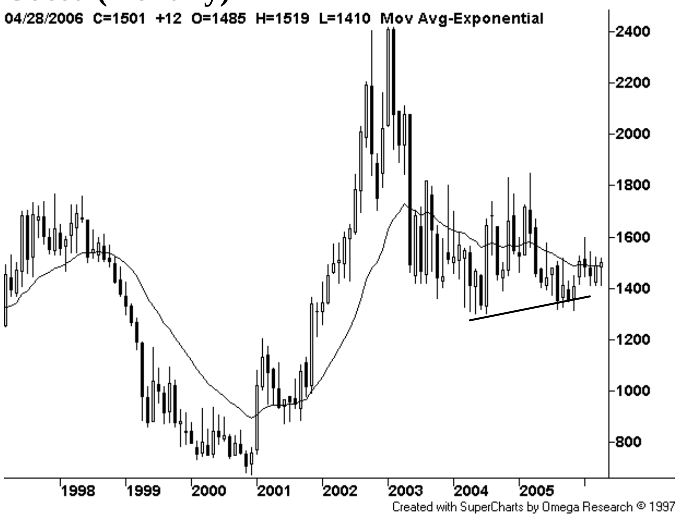
Coffee shown opposite on a monthly basis to give perspective. As can be seen the market has quietly advanced since being tipped here at $55 in 2002 but have stalled recently around $100 and started to build a triangle type consolidation. Long-term investors should use the floor of the triangle as their stop but traders should simply stand aside until price action resolves the pattern and simply trade with the break. Coffee looks like it could be getting close to resolving the pattern so action is likely this summer.

Coffee (monthly)



Cocoa is also shown on a monthly basis and we think the lows around $1350 provide the most interest. If this level is broken then we could anticipate further weakness and would short with a stop at $1400. A break over $1600 would probably negate this possibility and indeed make this commodity look increasingly more positive. Cocoa is definitely worth having on the radar!

Cocoa (monthly)

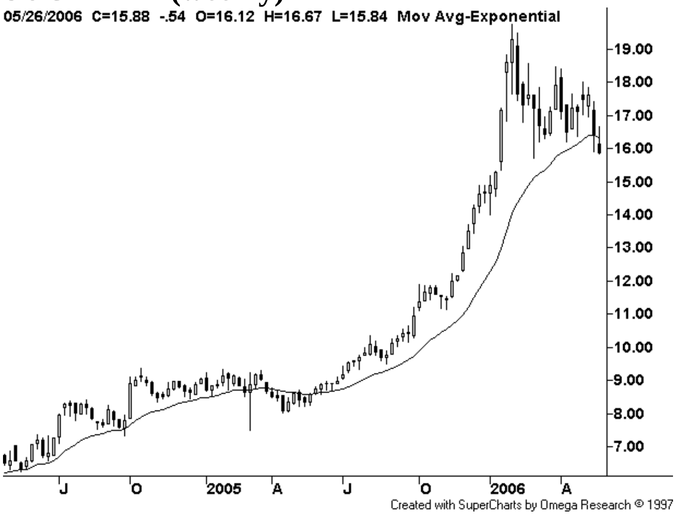


Sugar has enjoyed a ballistic advance in recent months but has crawled to a halt this past few weeks. What we need to decide is whether the current large consolidation is a pause or a top.

Well we think it looks clearly like a top and would be ready to short on a break below $16 and use this level as the subsequent stop. The profit potential could be

substantial as the previous advance was dramatic and the scope for retracement is equally spectacular.
Action; short sugar at $15.50

SUGAR#11 (weekly)



FINALLY

As you know at Barmac we are always looking for a trading opportunity we are currently looking or a bookie to take a bet that the ID card computer system will not delivered 1) on time and 2) on budget.
Given the announcements in recent days about the NHS computer based booking system (which will be at least 2 years overdue and way over budget) and the 2nd year of failure to pay the correct amounts due via working mans tax credit. The Governments track record is clearly consistent in its ineptitude and thus we wish to we think that it is a sue fire bet that ID cards will be late and grossly over budget.
We have already mentally spent our winnings on entering a team into the Dorneywood annual croquet tournament!

Regards

Andy McCarthy
AndrewBartles