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THE FED'S RATE CUTS AND THE NASDAQ PLUNGE CREATE A TWO-WAY STRETCH BUT OPPORTUNITIES ABOUND

INTEREST RATES & BONDS

Rates to be cut globally to offset recession
The Japanese are busy creating the next big play by creating a bubble in JGB's

GLOBAL STOCK MARKETS

Don't fight the FED is still the mantra but the Dow & Ftse will be weighed down by overhead trading range
TMT's are now providing a "once in a lifetime" opportunity

CURRENCIES

It's the Dollar versus the untested and the untrusted
BPR traders should have booked yet more massive profits on Yen shorts

COMMODITIES

OPEC continues to lose control of the oil market despite production cuts
Metals are still falling
Gold is still quiet but may awaken in the next 12 months or so

The current turmoil in equity markets and powerful historic data showing the consistency of new bull market cycles once the FED cuts rates appear to be creating an investment conundrum.

But, I believe that now is probably the best opportunity for at least a decade for shrewd and calm investors. There was never a sell off that did not over- react to create superb value in selective sectors. The key is to identify those sectors/markets and to adopt a clear and sensible low risk strategy for taking advantage of those opportunities.

When I survey the current global dis-array at least two markets scream value at me. Unfortunately value does not necessarily mean that the markets in question will not be better value in a month or two's time, but we can adapt our tactics to take into account the nature of the indiscriminate nature of the falls.

The NASDAQ and possibly Japan are the two I have in mind. The key to playing these markets is to "scale in" over a 2-year period. This way you may not catch the absolute bottom but you should be able to build your position around the lows.

The NASDAQ has now fallen from high (5200) to low (1645) aprox 70%. This fall is reflected in all the other global technology indices and is climactic. It is obvious that the majority of the declines have already occurred. However, the market could still fall yet further but overall declines are unlikely to go beyond 80% so a cautious investment philosophy should pay dividends

Indeed all investors must recognise the fact that the NASDAQ is not going to disappear in a cloud of green smoke. Therefore, all we have to second-guess is the approximate degree of decline and scale in.

With Alan Greenspan cutting rates aggressively and all other Central Banks following his lead the battered Technology stocks are a “no brainer”. We will all look back in 5years and view the current level of the NASDAQ with wonderment.

As for Tokyo very similar arguments apply. Certainly the very deep and prolonged bear market has reduced index levels to a point where logically further declines are going to be limited. I suspect that the next 12months will see the final low for Tokyo with perhaps a final drive to 10000 providing a climactic ending.

Already my favourite “News at Ten” contra-indicator has been highlighting the parlous nature of the Japanese economy and how ruination will rain down on us all unless the Japanese get their act together. All this goes to show is that your average TV journalist is only 10yrs behind the curve on Japanese equities.

I suspect that like the NASDAQ almost all the bad news is in the market and sellers are near exhaustion. Added to this mix is my firm belief that we have already seen the beginning of a massive devaluation of the Yen fuelled by inflationary easing of monetary conditions. A gentle scale in approach to both markets over the next two years should pay dividends

So what will happen to the broader markets as represented by the Dow and the Ftse 100?

The answer is not perhaps so clear cut as it is for the above two markets. Certainly dramatic and deep interest rate cuts will eventually place a floor under the broader markets but much technical damage has already occurred. One of my fears has been that the Tech markets have been leading and as such are a precursor to a broad market collapse.

This fear is compounded when one considers that analysts estimate that as much as 4trillion Dollars have gone to money heaven in the TMT crash (equivalent to a third of US GDP). This negative wealth effect will inevitably spill out into all other markets. The question is how much damage will they inflict and how long will the declines last?

We stated in our November newsletter that recession was inevitable for the US and Europe and we have now been joined by many more forecasters. But we have been surprised by the scale and speed of the declines on the NASDAQ. Thus the collateral damage is greater than we anticipated back in November. The Dow is therefore more likely to remain weak for a longer period and decline further despite prompt rate cuts by the Fed than we at first believed.

The negative wealth effect has put in place a potentially aggressive deflationary spiral as banks stop lending, consumer’s sentiment plunges and redundancies soar.

This spiral down will only be halted when Fed rates are so low as to place a discernable floor under the economy and the TMT stocks begin to lead the recovery. This combination of low rates and evidenced recovery of TMT’s will precurse a sustained rebound in the broader market.

Although I am a firm believer in the maxim of “don’t fight the Fed” I currently believe that too much technical damage has been inflicted on the Dow and FTSE for interest rate cuts to have an early effect The huge overhang of stock traded for the last 2 to 3 years at the 10/12000 mark on the Dow and 6/6800 Ftse will cap any recovery potential for at least the near term. **BUT** a huge set-up opportunity will be created in the midst of this sell-off which will allow investors and speculators alike to buy into equities before the year is out. So keep watching the chart action for clues that the set-up is in place and the recovery has begun.

THE GLOBAL ECONOMY

Markets sense that the ECB is not addressing the risk of a sharp economic slowdown, while the BOJ is only beginning to face reality. Only the Fed has been pressing hard on the monetary accelerator to fend of the four horsemen of the apocalypse – debt, previous rate hikes, OPEC production cuts and slumping stock markets. This is bad news because these are not solely US problems. Yes, the US was host to the NASDAQ bubble but speculators elsewhere joined in and TMT stocks the world over have mirrored the move both up and down. Wall St did not invent corporate leveraging of balance sheets, applauded by business schools everywhere in the 1990's.While the US refined and exported the latest strain, including the issuance of debt rather than equity to finance stock buyback programmes, governments in most other developed countries changed legislation at the behest of their corporate sector, which eagerly embraced the fad. Today there is little of a short term nature that governments can do to counter the recessionary effects of another cut in oil supplies (which may occur considering OPEC's belligerent mood), other than lower taxes, whilst the market will provide the longer term solution (as is always the case with commodities). What CB's could do is address monetary problems but only Greenspan and his Fed colleagues have recognised, let alone tackled the problem so far.

The BOJ's policies in recent years have been ruinous. Governor Hayami encouraged an overvalued Yen during a deflationary slump, kept money supply tight at 2%, interpreted bankruptcy, rising unemployment and economic suicides as evidence of recovery and rationalised the latest deterioration as contagion from the US slowdown. OK, the BOJ is now reflating but the quantitative easing will now need to be massive and the blinkered Hayami hasn't exactly seen the light on his personal road to Damascus (more he has been dragged kicking and screaming down the road of reflation via printed money)

Euroland's central bank is less pathological than the BOJ but it is preoccupied with inflation over 2%. This is a small price to pay for the orderly devaluation in 99/2000, which helped Europe to its best growth for many years. The recovery is now threatened by interest rates that are too high given the US slowdown, Japan's ongoing woes which have impeded Asia generally and with Germany's economy underperforming neighbouring states. In the UK, the Bank of England's Monetary Policy Committee is focused on consumer spending which occurred before the foot and mouth epidemic hit farming and tourism. The current siege and blow to morale can only pare economic growth. In conclusion, there is a clear and present danger that an inevitable global slowdown could turn into a serious recession because most central banks, anxious not to create too much liquidity as occurred in 1998, have fallen behind the curve in today's more dangerous economic environment.

INTEREST RATES AND BONDS

- **Japan's savers pile into JGBs, creating another bubble.**
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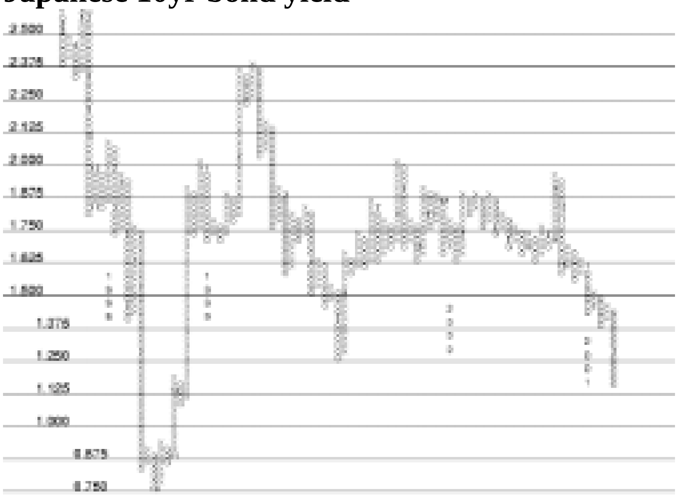
- **Flight to quality will support bonds for time being but once recovery is apparent yields will rise**

T he world's most prodigious savers have had a rough time and it might be about to get even worse! Over the past decade they have suffered from the deflating stock bubble of 1990, whilst simultaneously house prices in Japan became so expensive that families desperate to get onto the property ladder were signing ten-generation mortgages! Property values are still falling today Still seeking safety, the public piled into the government-run postal savings system or stashed the cash under the mattress, metaphorically speaking. In Japan, home safes outsell fridges. Fearing for their future, Japanese citizens have the highest savings rate in the world at 30% of earnings. Unfortunately, the post office just cut savings rates to 0.11%. As a result the public is switching in droves to Chukoku funds, which hold medium term government debt and pay a fixed rate of 0.51%pa currently. The country's more adventurous investors have been piling into 10yr Govt bonds (JGB's) They have been rewarded as yields have fallen 40 basis points this year, providing a gain of 4.3% in 3 months. As more savings are poured into the only game in town yields can fall even lower because the economy remains in a deflationary spiral**. However this can only be a bubble in the making, which will burst as Japan's economy eventually recovers.**

Meanwhile, Japans ballooning debt has reached third world proportions at 130% of GDP> Pressure on the BOJ to reflate out of this mess is intensifying. As it prints money the Yen will fall further with Japan's deflation ultimately replaced by at least mild inflation. As argued here previously a more competitive currency and a surge in money supply will eventually put a floor under the Nikkei, which would then discount an improved economic performance. This will encourage consumer spending by Japanese households, which will feed through to corporations. As Japan finally sustains a significant GDP recovery, interest rates will inevitably rise, driving JGB yields considerably higher. They could easily reach 3.5%, a level not seen in 10 years **providing the most fabulous shorting opportunity….a situation to be watched and stalked over the next year or so until the time to pounce arrives.**

Japanese 10yr bond yield



The decline in JGB yields has steepened and as yet there is no evidence of a floor as yet. Therefore a further test of the 98 lows of 0.75% is likely. For this to be exceeded a fear of accelerating deflation must grip the market. I would not be surprised to see new lows before the bottom is finally evidenced. The people who are buying /holding JGB's today, which includes capitalisation weighted international bond funds, stand to lose an awful lot of money if they do not spot the turn. Astute traders guided by our good selves will spot the turn and then short the market and make a bundle.

US, UK and European bond yields are breaking to new lows/capital highs. We are currently witnessing a flight to quality as investors switch from riskier corporate bonds and stocks. This window of opportunity may not be open long depending upon the nature duration and depth of any recession. Of the three possible economic scripts facing us at present;

1. **Brief economic slowdown**
2. **Stagflation**
3. **Deflationary recession**

The first two are ultimately bearish for bonds as economies and inflation pick up, therefore we should watch the charts closely for timing.

US 10-year bond yield

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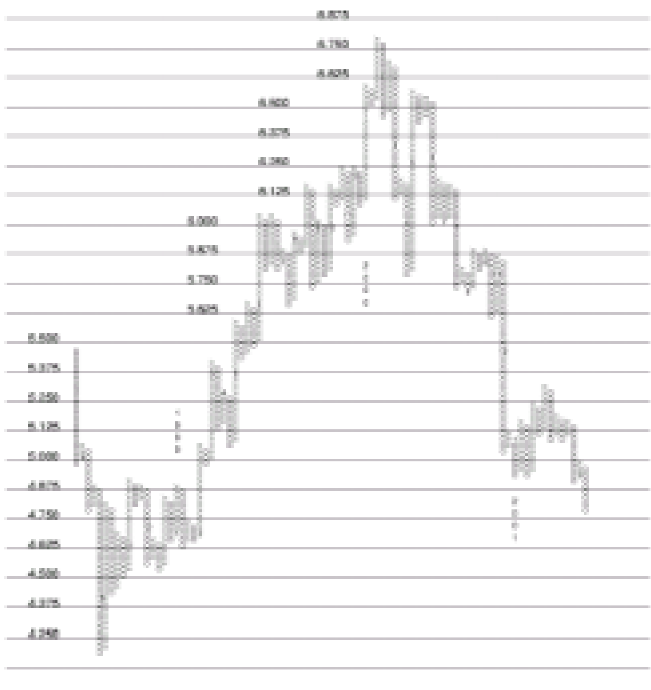


The chart below for the Uk gilt 5% 2009 shows the recent strength in price coupled with a reciprocal fall in yield as investors have fled to Quality. This trend may well persist or even accelerate as the foot and mouth disease crisis weakens the rural economy.

UK GILT 5% 2009

Finally, corporate bonds are offering amazingly attractive yields at present and will prove to be a very good investment unless a very deep and prolonged recession grips the West and smashes corporate America to pieces.

GLOBAL STOCK MARKETS

- **NASDAQ and TMT's are oversold and will lead the recovery**
- **Ftse and Dow will struggle to rally beyond overhead supply at 6000 and 10,000 respectively**
- **Japan will recover one day –perhaps sooner than later**

All is gloom and doom in markets at present but current oversold conditions should support technical rallies at least. Equally the Tech markets is so battered that as mentioned earlier they are now providing attractive buying opportunities for those that are prepared to scale in.

The Dow and Ftse look to be capped for the near term and may well have further to fall before the worst of the bear has ended.

The positive for the broader market is that this slowdown has struck at a time of acute labour shortages in both the US and the UK that will cushion some of the job losses and help to maintain consumer confidence.

Thus we believe that although the major markets will continue to be weak for the next few months weighed down by the tech crash and recession that we are not going to experience a 1930's style depression.

Equally important is the fact that the Central Banks are cutting rates aggressively. This has been highlighted in our last issue showing rate cuts have been good for stock markets in 19 out of 22 rate cut cycles.

CHART REVIEW OF KEY MARKETS

The NASDAQ shown below has suffered an unprecedented decline that has carried the market down almost 70% since last March. Obviously a fall like this cannot go on forever and companies like Microsoft, CISCO, Intel and Dell are not about to place themselves in chapter 11 administration. I suspect we have already seen the low in this market and certainly a short-term rally looks evident with the trendline break evident during the last few days. However few declines spin round on a sixpence so I would advise people to accumulate positions in this market in order to reduce the timing risk.

NASDAQ

The TechMARK has suffered an almost identical fate to the NASDAQ and will probably follow a similar recovery path. However it is worth noting that the TechMARK is more heavily skewed towards smaller companies than it's American cousin.

The TechMARK

The Dow Jones (below) has broken strongly down out of a large trading range and although currently unwinding an oversold position I suspect that the overhead supply evident from 10000 will cap any sustained rally for the short term

If my prognosis proves to be too optimistic for the global economy and the world does slide into deflationary recession then the following long term chart reveals the areas of likely support if the 98 lows were to be broken.

The Ftse (below) is similar to the Dow and I have again illustrated the long-term trend support lines and the channel lines which stretch back to the index' inception back in 1984. These levels are not a prediction but key levels to watch if the markets turn for the worst and break the key '98 lows. I however feel that the 98 levels will provide tremendous support especially as so many trend and support levels converge on the 4800 area.

The shorter-term chart of the Ftse (below) shows that a low of at least medium term importance has been established over the past couple of weeks with a challenge towards the 6000 level currently occurring. At present I do not believe that there is enough upside momentum to carry markets back into the old trading range but if the market does regain these levels then this would be extremely bullish for markets.

Japan's Nikkei

fell below its important 1998/99 floor before rebounding to break the short to medium term trends dominant consistency characteristic – a progression of lower or equal rally highs evident since last September. This is potentially significant and a further rally would confirm a downside failure. As you are aware I believe that the de-facto devaluation of the Yen and BOJ monetary easing will lead to a major new bull market for Japan in the next couple of years.

NIKKEI

Key European Bourse' have been trending down in an orderly manner and as such will give a very clear signal that the bear is over. Simply watch the charts for clues that the markets have broken there

DAX

PARIS

FINALLY I believe that the best profits will be had by buying the technology markets either directly or via good funds as this is probably the best opportunity for a lifetime.

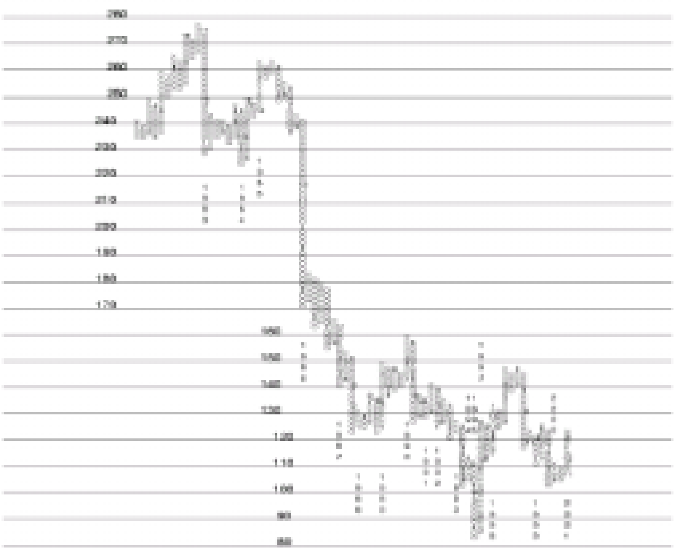
CURRENCIES

- **MASSIVE PROFITS ON YEN SHORTS OVER THE LAST MONTH**
- **For a vulnerable currency the dollar is not doing too badly**
- **Hayami is being isolated by the Cabinet, which appoints members to the BOJ policy board**

Last issue saw the Dollar/Yen rate at 120 and Sterling /Yen at 174 both of these cross rates have rallied strongly to touch 126 and 181 respectively a potential gain of 600 to 700 points. A very profitable months trading which is hopefully a little of what there is to come on this position. As most readers know this has been our "nap" trade for quite some time originally highlighted back in October (see chart below) at 109 and 153 for the Dollar and Sterling crosses.

I suspect we have only seen the start of what will prove to be a major multi-year bear market for the Yen. However, at present a lot of people have joined the trend so be careful of counter trend consolidations that should not carry beyond 6Yen. Such a set back should be a repositioning opportunity.

DOLLAR/YEN since 1983



The above chart illustrates clearly that in historical terms the Dollar is clearly not overpriced against the Yen contrary to popular belief. Interestingly the chart also illustrates the fact that the move has barely begun and has not even completed its base pattern as yet and would have to exceed Y160 to do so.

The dollar versus the untested and untrusted. Six years ago the greenback was reviled for historic reasons. Perceptions changed as the US economy improved dramatically relative to its main trading partners, enabling then Treasury Secretary Robert Rubin to forego competitive devaluation. Fast-forward to 1999 and the Euro – a grand experiment or act of folly depending on your perspective – was launched with such hype that European currencies had appreciated up to October 98. The brand new ECB, which was initially concerned by this strength, was soon able to relax as the Euro glided lower. When the ECB tried to stop the decline nothing happened until co-ordinated Central Bank intervention rescued the currency last September. That prompted a reappraisal and the Euro rallied sharply on forecasts that Eurolands GDP on the way up would pass US growth on the way down. It happened, sort of, only few of the people actually in a position to shift currency (rather than talk about them) believe it will last. Despite reforms, Euroland remains more heavily regulated and taxed than the US. The majority of currency traders are a pragmatic lot who know the Euro has not been tested by a recession, although they suspect one may be around the corner. The ECB, rather than inheriting the Bundesbank's authority has seemed uncertain and reactive. It doesn't help that Wim Duisenberg has become a figure of fun, partly due to that dead sheep on his head. However even he looks a safe pair of hands relative to the BOJ's geriatric governor Hayami, for whom an overvalued Yen is a virility symbol even when the economy is falling apart. Untrusted, the Yen's main support comes from the repatriation of capital by Japanese multinationals that need funds to shore up the parents firm's balance sheet.

Significantly< hayami is being isolated as the cabinet has authority to appoint members to the BOJ,s policy board. The Japanese press is reporting that Hayami clone Eiko Shinotsuka will be replaced by Miyako Suda. Suda who is "only" 52 has said that she does not oppose boosting the money supply, adding that a weak Yen can help support growth.

Sterling / Yen

The above chart illustrates that the pound appears to breaking up and out of the most recent consolidation at 174 to 177. The action would only break down probably temporarily if the 175 level was broken.

The Euro /Sterling cross rate shown below illustrates that the cross rate appears to be trapped within a ranging top area which I suspect will ultimately lead to a further recovery by the Euro. A break below 1.55 would signify the onset of the next leg of the Euros recovery against the pound.

Sterling / Dollar cross (below) is also range bound. The Pound appears to be drifting towards a retest of its lows at 1.40 but a break of the 12month downtrend would indicate an easing of pressure on the pound for some time.

STRATEGY FOR CURRENCIES

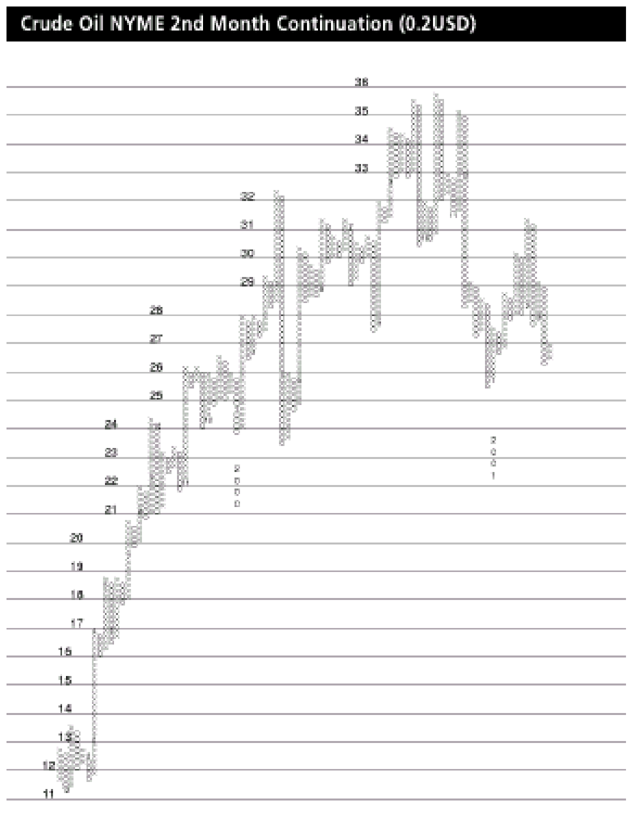
- **Short yen Vs Dollar and perhaps substitute pound or Euro if the above trend line breaks BUT USE TREND RUNNING STOPS for profit protection**

COMMODITIES

OPEC continues to lose control of the oil market despite production cuts

Industrial metals continue to weaken as the global economy slows

With the world economy slowing inventory build up is weighing on prices for most commodities. OPEC is trying to fight the market by reducing supply by a further 1 million barrels a day. This is having little effect as demand is falling. Additionally, while most oil exporting nations had little to lose in honouring production quota cuts when crude traded at $10 in late 98, but it is different today. They know the good times won’t last so there will be cheating on quotas. Moreover, high prices have boosted non-OPEC production considerably, with more due to come on stream while prices remain above $15.
Prices currently appear to be ranging in potentially top development as supplies increase and demand falls. Barring accidents prices appear to be heading lower over the medium term.



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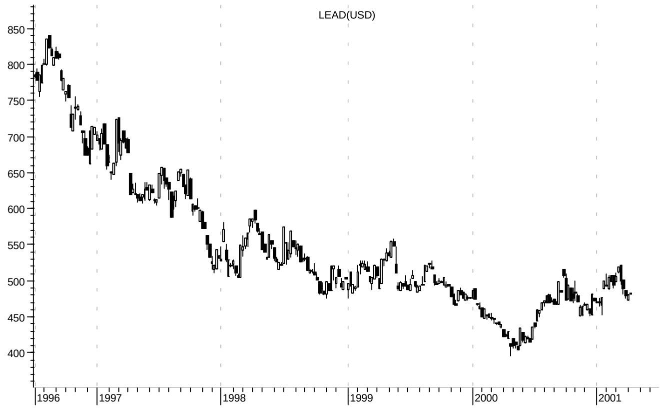
Base metals are unlikely to rally significantly until after global the global economy shows evidence of strengthening again. Many of the metals shown below have experienced long and deep declines and as such may be overdue a bounce but sustained strength is unlikely to be apparent for the medium term

LEAD

The chart below is perhaps the most positive of the base metals with lead appearing to have broken its downtrend and possibly undergoing a phase of base building.



COPPER

Again appears to be locked in a downtrend and any strength may signal only a short term bear rally

NICKEL

This metal has the typical wave like movement that commodities experience and the current downleg is showing little current evidence of bottoming. A short covering rally is overdue, as this move looks oversold in the short term.

PLATINUM AND PALLADIUM

Have both come of their highs quite dramatically and I trust all exited with substantial profits on the run up. I feel that we certainly called the turn down very accurately. For the present I would prefer to stand aside in these markets as I feel we may see downside ranging.

GOLD

Continues to be trapped in the tightening wedge that has been apparent for quite some time. The Gold story will gradually become more interesting as reflation efforts by Japan and other countries increase the supply of money in circulation. In the short term a break out of the current wedge type range should signal a tradable move

FINAL SUMMARY OF KEY TRADES

- **Accumulate a position in NASDAQ and other TMT stocks**
- **Accumulate a position in Japanese stocks**
- **Stalk the JGB's ready to short once signs are clear that the high (low in yield) is in.**
- **Short Yen against Dollar/Sterling/Euro this trend has much further to run.**
- **Don't rush into Ftse / Dow / broader stock market too soon as large trading ranges will limit upside potential for some time**

Thanks to all subscribers who have E-mailed us with comments, observations, questions and thanks for the short Yen!
Please keep them coming we enjoy the interaction and feedback

GOOD HUNTING

BEST REGARDS

Andrew McCarthy & Andrew Bartles