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IF THE BOND MARKET CONTINUES TO FALL, THERE CAN BE NO RECOVERY.

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Debt markets the world over were slaughtered during July. US Treasuries fell over 10% with yields rising by as much as 120 basis points and seemingly imperilling economic recovery. Many have posed the question what frightened the horses? We refuse to answer that question, but we are interested in what the aftermath might indicate about the global economic prospects.

Our interest is focused upon the conundrum that if bonds rally back then this implies deflation and a weakening economy. Conversely, an ongoing bear in bonds would lead to rising rates that could choke off any nascent recovery. Hmmm.

US Mortgage refinancing applications

US mortgage refinancing application index



Source: Mortgage Bankers Association of America

The dangers associated with rising rates are hard to exaggerate as both the US and UK economies have been heavily dependant upon consumer spending with mortgage refinancing providing the fuel to keep the High St and the car lots buzzing during the last year or two. Indeed 6% of UK consumer spending has been attributed directly to monies released via refi. If this spigot were to be switched off there would be serious repercussions upon consumer spending. The above chart demonstrates the sensitive relationship between refi and interest

rates. Note how dramatically new applications tanked as mortgage rates rose during July in the US. This potentially dramatic turnaround in debt financing is a warning shot across the bows of recovery. It may well prove to be an uncomfortable recovery if any economic strength and or yet more Government borrowing causes generationally low interest rates to increase, thus killing consumer spending!

As night follows day

In the late 70's and early 80's Anglo Saxon interest rates were at a historic peak in the teens. Although, it was difficult to recognise that fact at the time it was a fantastic time to buy bonds.

We have now turned full circle with rates at historic lows. Yes, rates may well go lower still if we have a depression over the next few years but, we will make a 100% cast iron guarantee that over the next 10 to 20 years bonds will fall dramatically and rates will be much higher. So for long term investors now is the time to sell bonds.

As to where the bond market goes from here, our advice is to ignore the economists and listen to the traders. It's been our experience that huge market moves like this have little to do with fundamentals and much more to do with market technicals and trading dynamics. The very concept of "fair value" is utterly meaningless at times like this. Even so, we can't help but note that long-term real interest rates of 2.2% (as measured by the 10-year TIPS) are still well below average (3.5%) for a recovering economy with outsize budget deficits. In other words, even if we've there is no recovery, the economics suggests that there's still plenty of upside to yields from current levels.

But here's where we defer to the traders. Their tone is starting to sound very similar to that which was evident some nine years ago, during the '94 bear. As was the case back then, there's great concern today over selling pressures stemming from mortgage "convexity." And yet today's US economy is actually far more dependent on the infrastructure of home mortgage financing and refinancing than it was in 1994. According to Federal Reserve data, mortgage debt outstanding is currently about 67% of GDP; by contrast, in 1994, the ratio was 48%. If anything, that suggests there

could be an even more powerful convexity-related unwind this time around. The traders today are telling us exactly what they did back then -- the more rates back up, the more the long end gets hammered by an unwinding of mortgage-related hedging. It's a warning we have to take seriously.

But that's not all. One of our most seasoned trader compatriots has always warned that a yield curve which "steepens in a downtrade" is emblematic of the most virulent of bear markets. And that's exactly what is going on today. The spread between 2s and 10s in the Treasury market hit 259 bp at the close on 21 July -- equalling the yield gap last seen in 1992. The traders are telling us that this "bear spasm" is now at risk of feeding on itself -- until or unless it is stopped by an unexpected weakening in the economy or by direct intervention by the authorities.

This is hardly an outcome that the Fed would deem desirable in the current climate. It runs the very real risk of spilling over into other asset markets -- especially given the mounting potential for a further sell-off in the US dollar as part and parcel of America's long overdue current-account adjustment. Moreover, a sharp additional back-up in long rates poses a serious threat to a nascent recovery (as mentioned earlier) in the US economy -- not only crimping the credit-sensitive sectors of homebuilding, capital spending, and consumer durables but also aborting the home mortgage refinancing cycle that has been so supportive of consumer demand. We tend to forget that the US economy is still closer to the brink of deflation than inflation. Wouldn't it be ironic -- and tragic -- if the perils of deflation were compounded by a rout in the bond market?

This view was supported by none other than the famous **John Bollinger (of Bollinger bands fame)** who warned that (Bloomberg TV 12/08) negative convexity of the yield curve likely means that US mortgage rates become hyper sensitive to rising bond rates and he therefore predicts a massive financial dislocation and bear market in bonds, leading to a bear/sideways in equities over the next few years.

We suspect his analysis is correct but agree with his view that equities are likely to be "juiced up" higher over the next few months.

In our view, all this is indicative of what happens when deflationary risks of post-bubble economies take monetary policy into uncharted waters. As short-term nominal interest rates approach zero, central banks start to lose control of financial markets and the real economy. That's precisely what has happened in Japan under the BOJ's zero-interest-rate regime. And the rout in America's bond market may well be a warning sign of a similar fate for the Fed.

A golden age ending?

During the 19th century until 1914 the world financial system revolved around Britain's massive trade deficit with the Empire (so just who was exploiting who?) and surplus with Europe. This system arose as Britain exported capital (the pound was the world's currency of exchange with Britain on the gold standard) and imported materials and basic goods from the Empire, whilst enjoying a huge manufacturing surplus with the rest of the world to balance the books. This ensured that the UK was the world's most important export market much as the US is today.

After 1918 the US has taken up the baton of export market of last resort. But until recently the US balanced the books much as Britain had.

However, for an entire generation, Americans have been the happy beneficiaries of a unique monetary system... in which the world took American dollar bills in return for their work. The more dollars the US exported... the more the world bussed and schlepped to get them.

It was a little like the discovery of gold in America by the Spanish in the 16th century. All of a sudden, the Spaniards were the richest people in the world - for they had the world's money!

Money came in from the New World; it was as if the Spanish had a printing press in the basement and could print up as many dollars as they wanted. Even the word 'dollar' comes from that period, as Spanish money was known the world over. As the money supply increased in Spain, the first effect was inflation. Prices rose. But the second effect was the one that hurt. Rather than develop their own economy, the Spanish exported their dollars in exchange for the goods they wanted.

The Spanish thought they were rich. And, for a

while, they lived rich. They were the 'world's mouth,' the leading consumers of the 16th century.

But soon the money ran out. And its overseas adventures became cost-centres, rather than sources of booty. And then the Spanish discovered something important: the easy money had been a curse; it deprived Spain of the development needed to become a prosperous country.

After good old Franny Drake and the boys defeated the Spanish Armada, in 1588, Spain fell into a slump. It was the 'sick man of Europe' for the next 4 centuries.

And now it is America that is cursed by good fortune. It has become 'the world's mouth.' The US is following a long tradition of empires that have become the consumer of last resort (Egypt, Greece, Rome, Byzantium, Spain, Vauban France, Great Britain and now the US) and all on the above list consumed their way into inevitable decline and decay. Because they all used their wealth and power to export manufacturing and import goods.

The US though has one advantage its predecessors did not possess. The printing press. The forerunners all paid ultimately with a hard currency, gold. But the US has no such impediment. As long as it has a printing press in its basement, Americans believe, they will never go hungry.

But we ask what happens when no one wants devalued dollars anymore? A repetition of history.

RICHBACHER

AN OPEN MOUTH

By Kurt Richebächer

The people who expect a double dip or worse in the United States certainly represent a small minority. Among policymakers and economists in America, it is a virtual consensus view that the Great Depression of the 1930s as well as Japan's present, protracted economic quagmire have their decisive cause in one crucial policy mistake: both central banks were much too slow in lowering their interest rates when the economies began to weaken.

All this really boils down to one key question: When do central banks make their decisive mistake? Is it during the boom and the bubble? Or is it in their aftermath?

Convinced he had learned from history, Mr.

Greenspan slashed the Fed's federal funds rate with unprecedented speed from 6.5% to just 1%. Establishing thereby a steeply sloped yield curve, his aggressive rate cuts had sweeping effects also on long-term rates, as investors and speculators stampeded into highly leveraged purchases of higher-yielding longer-term bonds.

In principle, central banks have but two instruments at their disposal to influence money and credit growth with the ultimate aim to curtail or to stimulate economic activity: adjustments in bank reserves through open market operations; and adjustments in its key short-term rate or rates.

Yet there is still a third, unconventional instrument of which central bankers have made very different or no use of at all. It has sometimes been called a central bank's open-mouth policy. Mr. Greenspan is definitely the world's one central banker who has practiced this extraordinary tool with unusual abundance and aggressiveness. He, apparently, regards it as perfectly legitimate for a central banker to bend expectations in the economy and the markets in a direction he wants.

During America's boom and bubble years, Greenspan was effectively the most prominent and also the most pronounced New Era Apostle. In various speeches, he developed arguments or "theories" plainly rationalizing and fanning the euphoria in the stock market.

In his famous Boca Raton, Fla., speech on Oct. 28, 1999, just a few months before the stock market's crash, he suggested that the unprecedented equity valuations seemed to be the appropriate response of investors to the economy's advanced information technology:

"The rise in the availability of real-time information has reduced the uncertainties and thereby lowered the variances that we employ to guide portfolio decisions. At least part of the observed fall in equity premiums in our economy and others over the past years does not appear to be the result of ephemeral changes in perceptions. It is presumably the result of a permanent technology-driven increase in information availability, which by definition

reduces uncertainty and therefore risk premiums. The decline is most evident in equity risk premiums.

"But how long can we expect this remarkable period of innovation to continue? Many, if not most, of you will argue it is still in its early stages. Lou Gerstner (IBM) testified before Congress a few months ago that we are only five years into a thirty-year cycle of technological change. I have no reason to dispute that."

Having learned nothing from his past blunders, Mr. Greenspan is at it again. To quote Fed mandarin Vincent Reinhart: "The Federal Reserve has always appreciated the importance of correctly aligning market expectations." Putting it rather more bluntly, the Fed endeavours "to manipulate market expectations in the direction that the Fed desires."

During the late 1990s, Mr. Greenspan was keen to foster the stock market bubble by aggressively manipulating both market rates and market perceptions. After the equity crash of 2000, he has become keen to foster the three new bubbles he kindled in fighting the burst of the stock market bubble - the house price bubble, the mortgage refinancing bubble and the bond bubble.

Together, these bubbles are plainly indispensable for maintaining some zip in consumer spending.

But among the three bubbles, one is of crucial importance because it drives the other two. That is the (now hard-pressed) bond bubble. Refinancing activity tends to pick up significantly whenever mortgage rates drop below previous lows. Importantly, Treasury yields guide the movements of mortgage rates. In essence, it was the sharp drop of Treasury yields over the past two years that led the simultaneous, steep decline of mortgage rates. The recent, renewed sharp drop in Treasury yields gave mortgage refinancing another strong boost.

Within barely six weeks, 10-year Treasury yields plunged from close to 4% to close to 3%. In sympathy, mortgage rates fell to 5.21%, the lowest rate in more than four decades.

The astonishing thing about this sudden decline in market interest rates was that it happened at a time when the stock market was, on the contrary, being

carried upward by spreading hopes for the economy's imminent recovery. What happened to make this new, sharp decline of longer-term interest rates possible?

In its May 29 editorial, The Wall Street Journal praised the Fed chairman for his wily gamesmanship. "Merely by talking about deflation, he's made the markets anticipate easier money; long-term interest rates have fallen accordingly, helping to keep housing prices afloat and to spur one more round of home mortgage-refinancing. This in turn feeds consumer confidence and helps keep the post-bubble economy growing. As a monetary gambit, uttering the word deflation has so far been a great tactical success. We suppose that's worth the price of scaring people about an economic threat that isn't very likely."

In short, being assured by Mr. Greenspan and other Fed members that there would be no interest rate hike as far as the eye can see, investors and speculators, desperately hungry for big profits, stampeded into heavily leveraged bond purchases, giving through the sliding yield a new strong boost to mortgage refinancing. Closer to the truth: In the guise of worrying about the evil of deflation, Mr. Greenspan signalled to the marketplace his determination to accommodate unlimited leveraged bond purchases. Investors and speculators complied with enthusiasm, giving long-term rates another sharp downward tick. Implicitly, in a country with negative national savings, any decline in market interest rates can only come from financial leveraging.

In this way, the last bit of restraint on financial leverage and speculative excess in the markets was effectively removed. Endless liquidity is available for the taking by the speculating financial community. The obvious result is a credit and bond bubble that meanwhile has vastly outpaced the excesses of the equity bubble.

The fundamental dilemma today is that - by every method available - the Greenspan Fed and Wall Street are making desperate efforts to sustain unsustainable bubbles. Of these, the belaboured bond bubble is now our greatest fear. Its influences

have pervaded the whole economy and the whole financial system, and its bursting may have apocalyptic consequences.

Regards,

Kurt Richebächer

P.S. Nobody questions the need for action. But it should be clear that easy money can only be the cure for tight money, not for any other causes depressing the economy. For us, the real and disturbing story about the U.S. economy is that with all its imbalances it has reached the stage where it requires permanent, massive monetary and fiscal stimulus to garner just a tepid economic response - and to prevent the various bubbles from deflating. All this is definitely not prone to create a healthy economy being capable of self-sustaining growth.

Dr. Kurt Richebächer's articles appear regularly in The Wall Street Journal, Strategic Investment and other respected financial publications..

Insider selling continues

In the last two issues we have highlighted the high levels of insider selling and despite some apparently decent second-quarter earnings reports from much of corporate America, the earnings reports out of the technology sector have been conspicuously underwhelming. Not surprisingly, therefore, few investors are rushing to add to their holdings of richly valued tech stocks.

Nor are corporate insiders adding to their holdings of overvalued stocks. To the contrary, America's CEO's and CFO's last month bought a paltry \$73 million worth of their own shares. At the same time, they unloaded a whopping \$2.4 billion worth. In other words, insiders sold \$32.21 worth of stock for every \$1 worth of stock purchased. The typical sell-buy dollar ratio is 15 to 1, according to Thomson Financial.

Thomson's insider sell-buy index has been stuck in historically bearish territory for three months running, Barron's Alan Abelson's reports. "Over the decade, there's been only one similar stretch," says Abelson, "and that was in the three months from July

to September 2000. In the 12 months that followed, the S&P declined a mere 28% - the worst one-year return in the past 10 years.” It may not make you bearish, but it should make you think. As we've observed before, no one ever sold a stock because he thought it was going up.

Large selling by index insiders as well!

The chart below reproduced from Elliott Wave International backs up the above picture and reveals what is happening on the S&P futures market. The weekly report chronicles the position of three groups of traders. The chart displays the net position of the commercials (red line) and the large speculators (green line), the two most important groups at the moment.

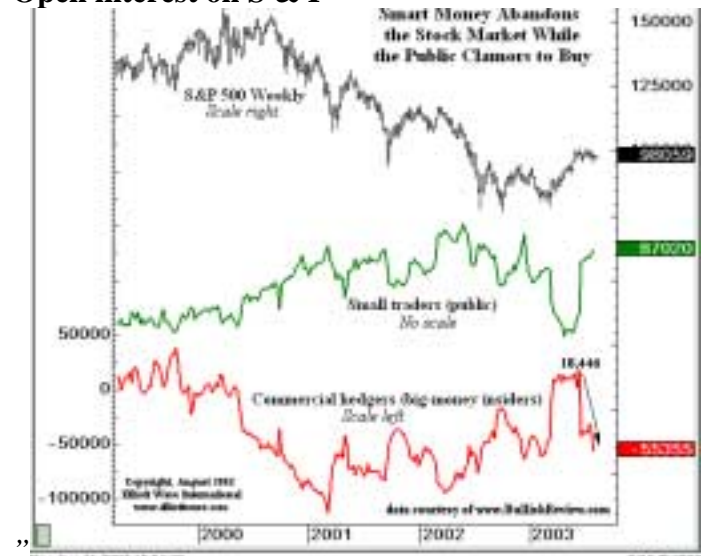
Elliott’s commentary runs; *“The smart-money commercial hedgers moved from a net long position of 18,446 contracts at the June 17 high to a net-short position of -55,355 contracts as of last Tuesday, when the data was collected. This net swing of 73,801 contracts represents the most concentrated insider selling in such a short amount of time (seven weeks) since the March 2000 all-time high. Who were the insiders selling to? The public, as seen by the sharp rise in the green line on this chart.”*

We would simply ask the question. Who is most likely to be right, the smart money insiders and pros or the public? We leave subscribers to draw their own conclusions.

Markets are “juiced up”

Despite insider selling and overly bullish sentiment we suspect that equity markets may well be poised for one last hurrah before the bear resumes. The extremely cheap money policy and presidential election cycle would suggest that markets may well squeeze higher maybe 10% before the longer term bearish influences come back to prowl around markets.

Open interest on S & P



INTEREST RATES AND BONDS

- Short term rates are at a generational low
- Both US and UK bond markets are oversold and due a consolidation

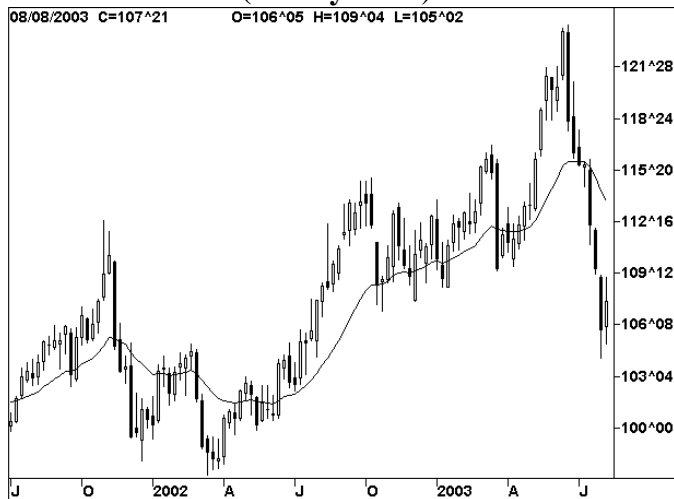
UK short term rates could fall further along with European rates

but we think that this is less likely as bond supply continues. The UK housing market will limit the Bof E scope for further cuts. In the US the low is probably now in with rates only likely to creep up from here maybe to protect the dollar.

As discussed above we suspect that the interest cycle is at its nadir and although the current trough in rates may well last some considerable time depending on inflationary influences, we expect bonds to fall and rates to rise inexorably over the coming decade.

The two charts below for both the US and UK bond futures markets illustrates the dramatic nature of the July declines. This now looks overcooked for the moment and would expect prices to steady near current levels. If support at 117 is breached for the UK gilt further weakness is likely to follow. The US unit has considerable support around 100.

US TREASURY (weekly Cbot)



UK NOTIONAL GILT.(weekly Liffe)



EQUITY MARKETS

- **Insiders sell and bullish consensus makes this a dangerous market**
- **One last push out of the trading range?**

The current market technicals have and remain unsupportive at present. We have historically high bullish consensus (see last months Barmac page 2) and consistently strong insider selling. However, cheap money and excess liquidity are supporting prices at present. We are watching the market play off these conflicting forces at present resulting in a stalemate. But, we suspect that although ultimately the bear forces will overwhelm the bull (when bonds next sell off and the dollar resumes its decline later in the year) in the meantime Mr Market may just suck more players

into the game with one last hurrah. Such a surge would certainly lead to a boiling over of bullish enthusiasm and create the perfect “set up” for a sustained decline.

Market review

Thus when reviewing the major US and UK indices we might expect a short-term break-out to the upside of 5 to 10%.

Simply watch the trading ranges on the markets shown below (Dow, S & P, Russell and Nasdaq). The Ftse (not shown) needs to break and hold above 4230 for a break out to be confirmed with a target of 4600. The Dow should be good for the roundaphobia level of 10,000 whilst the S&P should hit 1150.

If technology continues to lead we could see the Nasdaq ramp beyond the 2000 level.

The small caps have done well lately and we would expect the Russell to outperform any gains in the major indices.

DOW JONES IND.



S & P 500



RUSSELL 2000 (weekly)



NASDAQ(daily)



The European markets such as the Dax have continued to recover but may be soon approaching resistance between 3500 and 3750 and as such the recovery scope is perhaps limited.

DAX (weekly)



The Nikkei continues to be the best value and we would buy on any move over 10,000.

NIKKEI (weekly)



FOREX

- **Dollar continues to unwind oversold condition whilst the Euro digests recent gains.**
- **Sterling stages slight recovery**

As discussed in the last two issues the dollar continues to unwind the oversold position created by the dramatic declines leading into June/July. This consolidation is mainly against the Euro that enjoyed the majority of the gains amongst the key reserve currencies.

Sterling has remained weak and has so far only staged a very moderate recovery against the Euro. We suspect that the pound will meekly follow the dollar and will act as a proxy.

Dollar index

As suspected, the dollar has now paused for breath and now appears to be tracing out a sideward consolidation after its hectic move from 92 up to 98. This is the type of action we would expect to see and is a good sign for any short-term recovery in the greenback. We still believe the dollar is heading up to at least 102. The dollar may retrace a little more of its recent gains before resuming its recovery

DOLLAR INDEX (weekly)



The Dollar/Euro chart once again reflects the dollar index in that it too appears to be establishing a sideward consolidation. As stated previously, we expect the Euro to fall towards the 1.05 mark (no pun intended) over the coming months as the dollar has a well-deserved respite from its recent falls. We still prefer the dollar index as a means of trading this short-term dollar strength.

Dollar Sterling (opposite) remains above the two-year trend although a break of £1.58 would indicate further sterling weakness.

DOLLAR/EURO (weekly)



Dollar/Sterling (daily)



The pound, has only managed an anaemic recovery to date but a move from the current triangle could signal a strong move perhaps beyond £1.45

Sterling/Euro(daily)



Yen/Dollar

No change here as the sparring continues unabated to see which currency will become the weakest over the coming years. The consolidation area continues to build between 84.00 and 86.00 on the inverse IMM futures (for those who prefer dollar terms the range is still 117 and 120). A break out of this consolidation in either direction will be interesting and – we suggest go long the dollar if it breaks 120 and short it if it breaks below 116. Stops on either of these moves can be placed tightly at these levels.

YEN/DOLLAR(monthly)



OIL (Nymex weekly)



COMMODITIES

- **Oil's recent strength should end soon.**
- **Gold builds a triangle**
- **Copper off the lows.**
- **Wheat looks set to recover further and other agri's look interesting.**

It looks like oil's strength is drawing toward a temporary end and traders should be careful. There has been a very visible Doji Star (open and close at same level at the culmination of a move) last week that is a warning that the move has ended or is about to end. There could still be political shocks which could cause further short term strength – witness further US and now British casualties in Iraq and apparent increasing instability in Saudi Arabia, but from the chart it now appears oil is running out of steam.

Gold has continued to range sideways and is carving out a large triangle. We would stand aside for the present and await developments and follow the trend in whichever direction the break comes.

GOLD (weekly)



COPPER (monthly)



Copper (above) appears to have established a base at 6000 with a rising floor. The move over 8000 looks likely to lead to yet higher prices and we would suggest a stop at \$7250.

Wheat

Last month we advised to sit tight and wait until wheat broke out above \$3.50. Well it has so the eagle eyed among you will already be in ready for a move towards the \$4.30 area. Stops should be placed at \$3.25 and as and if the move gathers strength a trailing stop should be employed to protect profits.

WHEAT (weekly)



Soybeans

The downward plummet continues. For those of you who are short, a trailing stop should be employed to protect profits and this should now be set at \$560.

SOYBEANS (weekly)



Cocoa

After its dramatic fall (predicted here), cocoa is now entering into a mini-consolidation phase. Nothing unusual here, as we say at Barmac as markets don't go down in straight lines! This gives

traders an opportunity to tighten their trailing stop loss. We would now suggest this stop is placed at \$1550.

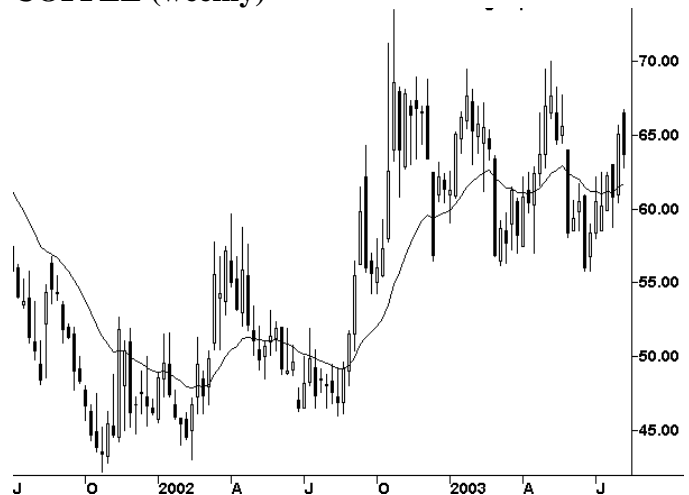
COCOA (weekly)



Coffee

The coffee market fails to wake up. It is still trapped in a trading range between 58 and 70. However as you well know here at Barmac we say quiet markets are the ones to watch. So keep your eye on this one because a break out in either direction will probably unleash some healthy profits. In the meantime it is the old story of masterful inactivity.

COFFEE (weekly)



Sugar

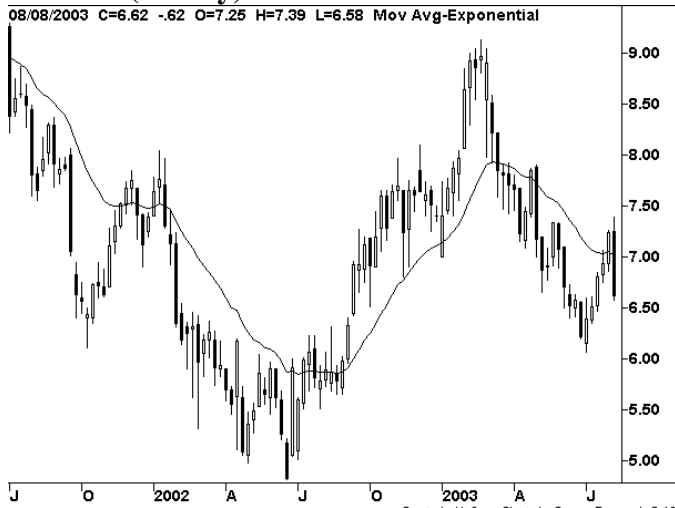
Clearly people aren't drinking much coffee with sugar in it. Sugar had looked to break up from its recent low but we have had a nasty reversal candle

which appears to have called an end to this move. We suggest short sugar with a protective stop at around the \$7.25 level, and if the recent lows are taken out then sugar should go on to challenge last year's lows.

We as always look forward to your interesting e-mails.

Regards
Andy and Andy

SUGAR (weekly)



FINALLY

After the debate ignited by e-mail linked to our "what if" article about Britain joining in with the French in 1914 we thought we might throw another googly at our readers.

The recent hot weather has prompted the usual media hysteria about global warming. It appears to be obvious to most detached observers that any warming which may be occurring is nothing unusual at all when one examines the climate history of the green ball (especially during the recent inter-glacial periods). Indeed, in only the 13th century the climate in the UK was much warmer with vineyards in Yorkshire. The Black Death of 1348 and subsequent pandemics are linked to a period of global cooling.

The Earth is currently approaching the expected mid-point between ice ages and judging by the last half dozen inter-glacial periods temperatures should peak within the next thousand years.

The control freak left obviously are not keen on the simple historic record of climate change as it would not allow them to bully and cajole the rest of society and fun lovers, with their so called eco-friendly self righteousness.