

Fullermoney

Global Strategy and Investment Trends by David Fuller

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Has gold bottomed? - Have a look at these price charts for perspective ([p&f](#), [monthly](#), [weekly](#) & [daily](#)). Gold has steadied in the last three days (the point & figure chart shown requires a US spot close at \$422.5 today for a 3-box upside reversal) but there has been no upside dynamic to dramatically change sentiment, as we sometimes see at reaction lows. In contrast, note the big downside dynamic on the daily chart when gold fell from its highs on the 8th of December.

However, former delegates to The Chart Seminar ([TCS](#)) will note the failed break beneath the January range and upside mid-point danger line (MDL) violation. Also gold has bounced from the upper side of the pattern that launched the last big rally and the overall uptrend remains intact.

If gold did establish an important reaction low last week, the corrections are getting smaller - approximately \$70 in 2003, \$60 in 2004 and \$50 on this last decline. However, in answer to the headline question above, most analysts/traders will be undecided, based on the price evidence to date. Therefore we will have to look elsewhere for the answer.

Using commonality (in this case, other markets that have a lot in common with gold), let's look first at silver ([weekly](#) & [daily](#)) which I have often described as high-beta gold. Here also the overall uptrend is intact and there was a powerful upside dynamic last Thursday, subsequent upside follow through Friday and again so far today. Rising lows and the additional build-up of underlying support suggest that previous resistance over \$8 will be tested this year, possibly within the next few months.

Now look at platinum ([weekly](#) & [daily](#)), which has often led the bull market in precious metals to date. Although still rangebound, it is currently testing the upper side of the pattern dating back to last August, and there is nothing to suggest that it will not break upwards. Needless to say, a sustained upward break by platinum would be a very good signal for the sector, including this cycle's perennial laggard, palladium ([weekly](#) & [daily](#)).

We should also look at crude oil (NYME) ([weekly](#) & [daily](#)), sometimes described as black gold. I maintain that oil's medium-term correction bottomed just above the \$40 level in December.

Next, we should look at gold shares, which often lead reversals following big moves. Significantly, the AMEX Gold Bugs Index ([weekly](#) & [daily](#)) shows an upside weekly key reversal. On the daily chart you can see the failed break under 200 and upside MDL violation. In total, the rally of the last four days is dynamic, providing evidence that we have probably seen an important

reaction low. The Philadelphia Stock Exchange Gold and Silver Index ([weekly](#) & [daily](#)) shows similar action, as do the world's two largest gold mines - Newmont ([weekly](#) & [daily](#)) and Barrick ([weekly](#) & [daily](#)).

Last but not least, we should look at the US Dollar Index ([weekly](#) & [daily](#)). This has backed away from initial overhead resistance at 85 and remains within an overall downward trend. The daily chart had a small downside key day reversal on Thursday and any further weakness would indicate a failed break above the small amount of lateral trading evident near 84.

Conclusion: Based on commonality evidence, I believe gold bullion bottomed at \$410.40 on 9th February. I now expect it to range sideways to higher, exceeding December's high at \$456 and probably reaching at least \$475 this year. I own and remain a long-term bull of gold funds, shares and futures.

Baby Steps profit taken in silver futures - My silver strategy for the last three years has been to buy on a Baby Steps basis during weakness and to similarly lighten during rallies. Accordingly, I sold some [March](#) silver today at \$7.265, including spread-bet dealing costs, against my purchase at \$7.10 on 8th December. I remain long two units of silver which are now protected with an in-the-money stop.

Nikkei long trades now fully protected with 24-hour in-the-money stops - As subscribers may recall, I am currently long four units of [March](#) Nikkei futures (spot [weekly](#) & [daily](#)). Half were purchased at 11,305 and the remaining two units were bought at 11,445 and 11,535. These positions are now protected with two separate in-the-money stops.

As these stops are tight, there is obviously a high risk that I will be taken out by a small correction. Nevertheless at this stage of the global stock market rally, I would rather not take any further risks. Consequently, if the Nikkei falls back into its recent trading range I will be stopped out at a small profit. Conversely, if today's breakout is extended, I will raise the stops and consider adding to what is currently a medium-sized leveraged position for me.

Platinum: The Noble Metal - My thanks to Sophie Chiew for this informative [article](#) by Ron Struthers, posted on Gold-eagle.com. Here's a section:

You probably are aware that the most platinum production comes from South Africa (S.A.). In 2003, 75% of global supply came from S.A. and 17% from Russia. Three mines, namely Anglo American Platinum (Angloplats), Impala Platinum (Implats) and Lonmin plc Platinum (Lonplats), accounted for 96% of S.A. production. Norilsk Nickel (Norilsk) accounted for 98% of Russia's production and Montana's Stillwater produced 2% of the world's platinum.

Much higher metal prices normally translate into higher production, resulting in lower prices as supply increases. However, since most platinum is mined in

S.A. and mainly by three producers, what is happening here is of importance.

The most important factor, is the main listed PGM producers operating in S.A. have seen the S.A. currency (Rand) appreciate significantly, it has been one of the strongest currencies and this has resulted in operating margins that have actually contracted while platinum prices have skyrocketed!

According to a very recent report by Deutsche Bank, based on their new long-term rand forecast, they have calculated an average marginal cost of production for an "average" Bushveld Igneous Complex operation at US\$700 per ounce. Their modelling shows a range of marginal costs of production of US\$600-850 per ounce on a 3-PGM basis depending on individual circumstances.

This US\$700 cost/ounce is based on a decrease in both their short-term (three-year) Rand/US\$ forecast by 20-25% & importantly, their long-term real rand forecast has decreased by $\pm 22\%$ to R7.10/US\$ (from R9.10/US\$).

You can see that unless platinum prices remain high, S.A. producers will be unable to expand to meet future higher demand. The cost forecast also considers a drop in the rand/US\$ rate. If the rand rises further, so will costs and probably US\$ platinum prices.

There are sufficient platinum reserves if the price is high to meet long-term demand, but delays in planned expansions have resulted in demand outstripping supply since 1998. The most notable example is Angloplats, which announced in 2000 its planned expansion from 2 million platinum ounces/year to 3.5 million by 2006. Every subsequent year it has missed its target and in December 2003 it revised down its target for 2006 by 15% to 2.9 million platinum.

The longer term mining trend looks bullish too, in future more UG2 Reef and less Merensky Reef will be mined, due to a greater depletion of the latter. UG2 has a higher proportion of palladium and less platinum and base metals, which will influence the supply of platinum. The metal ratios in the eastern Bushveld also have more palladium and less platinum and base metals than those in the western Bushveld, where historically the majority of the mining has taken place.

My view - [Platinum \(weekly & daily\)](#) has long been the futures-traded precious metal sector's leader. A break above \$890 which held for more than a day or two would look significant on the charts.

Email of the day (1) - [More on China's central planning](#):

"I would be interested in hearing more discussion on the dichotomy between China's seemingly complete embrace of capitalism, on the one hand, and its stubborn insistence on retention of the communist-style of central planning

(which is also the rejection of democracy) on the other. No other nation in history has ever embraced both ideologies at once. Can it work? Will it work?"

My comment - My perception is that both China and Russia have gone a long way towards loosening the central planning reins. In other words, their governments are effectively signalling that people can turn their energies towards making money as long as they stay out of politics. This works fine, for a while. However at some stage surely the wealth creators will question the legitimacy of appointed and largely unaccountable rulers, in sufficient number to avoid the Yukos/Khodorkovsky fate.

Email of the day (2) - Still more on China:

"Having just noticed the piece on China in Wednesday's Comment of the Day, I don't believe there is such a thing as a little bit of democracy. Tiananmen Square was only 16 years ago when people tried to overturn 40 years of tyranny by the communists.

"Had Zhao Ziyang won the day over Deng Xiaoping, how different the country would be today even with the current economic success. Even now as the EU is falling over backwards to renew arms sales to China, the Chinese government will not admit that Tiananmen was a mistake.

"Communist regimes are by definition corrupt and I feel if daylight gets in all sorts of nasties will be coming out of the woodwork, especially in the banking sector."

My comment - And those of us who live and vote in democracies should never overlook the importance of good governance and personal integrity, without which the system is corrupted and becomes dysfunctional.

Email of the day (3) - On India's population explosion:

"Contrary to many investors I have serious doubts about India because of the lack of family planning and population control. While GDP growth outstrips population growth, in fact what is happening is that GDP growth is cornered by the upper middle class, and population growth is centred on the poorer classes. Therefore per capita income growth of the poorer classes is nil, while their numbers are increasing. Rather than a stable outlook this looks more like a time bomb. Any comments?"

My comment - Is it all that different in the USA, UK or most other large to medium-sized countries? So far, these countries have gained more than they lost through lack of family planning and population control, provided those at the bottom had a chance of upward mobility. And if population growth tails off, we have the opposite demographic problem, touched on in this [article](#) (link kindly provided by Wil Thomas, who I suspect is thoughtfully looking out for my future needs).

Email of the day (4) - [On a strategy for when things do slow down:](#)

"Although it appears that it may take longer for the economies around the world to slow down in consideration of the liquidity in the marketplace, what is your strategy when things do slow down? For example, are you going to overweight commodities even more, are you planning on remaining "long" in regards to any stock markets, are you going to go to cash, etc.? The reasons for my questions are that I am trying to get a feel for what some experienced investors/economists are thinking. My concern is that I have a number of mutual funds that have done quite well over the past five years - even from 2000 to 2002. I am afraid when the day does come and the markets start to struggle, there is going to be no place to hide this next time around but commodities - even commodities scare me to a certain extent because if things slowdown in Asia the demand for raw materials should slow down as well. As a whole, just about every asset class appears to be overvalued."

My comment - [You speak for many of us in asking these questions, for which there are no quick or easy answers, not least because there are always a number of variables to consider. However let's assume that liquidity contracts significantly at some point, as it has done in the past. Having seen how a rising tide of liquidity lifts all boats, we can assume that a receding tide will lower them. Commodities are unlikely to be an exception, unless there are major supply disruptions for some reason.](#)

[Gold might outperform on a relative basis due to its monetary appeal. Yield would have defensive appeal, particularly if inflation was not a concern. During a liquidity contraction, I would certainly want to raise more cash. However I would also want to retain some key strategic holdings, not least because of their perceived merit and uncertainty over the next liquidity contraction's duration. Therefore I might prefer to hedge, albeit probably asymmetrically, by shorting what I perceived to be the most overextend and/or vulnerable markets.](#)

[Whatever, you will always have access to my views and strategies in the Subscriber's Area and Audio, plus the thoughts of others from the reports posted, not to mention the collective wisdom of your fellow subscribers.](#)

[Last week's signups for the Public Comment of the Day - New signups last week, including subscribers and pre-subscribers, currently live in the following locations: Australia, Belgium, Japan, Singapore, UK and USA. Welcome to the Fullermoney global strategy website. Which country topped the list in terms of last week's new signups? It was a tie between the UK and USA.](#)

Tuesday 15th February 2005

[Jonathan Davis' Intelligent Investor - This is the most interesting issue of Intelligent Investor that I can recall, in which Jonathan Davis skilfully interviews \(separately\) Anthony Bolton and Jim Rogers, and distils key points from recent studies by Edward Chancellor and Professor David Wilkie. Here is](#)

a brief portion of the Chancellor section based on his study: "Crunch Time for Credit?":

Doom-mongering about the level of debt in economies is not new, and from a historian's perspective, says Chancellor, has rarely turned out to be justified. One good reason for that is simply that the ratio to debt to GDP, which has risen significantly in the US in recent years, and to a lesser extent in the UK, is not a mean-reverting data series. Debt doomsters often overlook the fact that credit serves a useful function in stimulating economic growth. Hysterical warnings about debt are, in general therefore, "well worth ignoring".

On this occasion, however, the fears of those who warn us against a looming "credit bubble" cannot be dismissed so lightly. The growth in credit that has been experienced in the UK and US in the last few years is, argues Chancellor, both exceptional and unsustainable: it fully justifies being described as a "credit bubble". In fact he argues that the credit binge has "badly corrupted" the economies of the two countries, while the easy money policies of the Federal Reserve have "created moral hazard on a grand scale" in the financial system.

Although it is fashionable these days to rubbish the Austrian School of economists, Chancellor argues that their insights into the effects of a credit-fuelled speculative bubble remain valid in key respects today. The optimism of those who regard the increase in debt as supportable by improved economic performance is misplaced, he believes: what the debt has done is "create an illusory prosperity, while producing profound imbalances in the US and UK economies". Recent experience, for example in Korea since the Asian crisis of 1997-98, underlines the validity of the Austrian School's argument that credit is "no cure for a speculative bust": all it does is generate a succession of bubbles in different asset classes.

My comment - I strongly recommend that subscribers read the full issue of [Intelligent Investor](#). While the main themes will be familiar to you, each of the four sections provides additional perspective.

Email of the day (1) - [On my personal portfolio allocation](#):

"Although every investor has their own risk tolerance, I am curious what the approximate breakdown of your investment portfolio looks like today? For example, what percent is allocated towards commodities, Asian stocks, bonds, European stocks, US stocks, cash, etc?"

My comment - I'm atypical in that I never have a so-called balanced portfolio. This is one good reason why I don't suggest model portfolios - model for whom within my highly diversified subscriber base?

My portfolio consists of unleveraged investment funds and leveraged trading accounts.

The investment funds are mainly in self-administered pension schemes and UK tax-efficient ISAs. The overwhelming majority of these investments are presently divided reasonably equally between Asian and natural resource equities. I invest this capital mainly through funds, investment trusts (closed-end funds), and occasionally individual shares. These positions change infrequently.

As a founding shareholder in Stockcube Plc (the holding company for Stockcube Research Ltd, of which Fullermoney is a division), I also have a substantial stake in this company, which I am not really at liberty to discuss due to reasons of compliance. I also maintain a substantial cash position, just in case.

In terms of tangibles, I prefer art to property, for personal reasons.

I live by my leveraged trading account, which is my main source of income, pays most of the bills and donations, and occasionally tops up the investment side above. I trade futures and occasionally equities through UK tax-efficient spread-betting accounts.

Lastly, as I said at the beginning, this is not a model portfolio, and I'm not proselytising. And as the subscriber's email above stated: "Every investor has their own risk tolerance", to which I would add, and perception of risk. I doubt that any two of my subscribers would feel entirely comfortable with identical portfolio allocations, which is hardly surprising when we think about it.

Martin Spring's [On Target: Risk is a Measure of Investment Potential - This latest issue](#) is devoted almost entirely to a discussion of risk. Here is the opening:

Risk assessment should be the first step when choosing any investment.

You cannot avoid risk entirely, nor should you - it's the price you pay for the prospect of higher returns. Equities generally deliver higher total returns over the long term than bonds because they're riskier. Similarly, bonds deliver more than a savings account at a bank.

Sometimes the type or scale of risk you're taking on is not obvious. In Britain more than a million people suddenly discovered their savings - held through with-profit policies and pension plans - were at risk in Equitable Life, a giant mutual life insurer that was long regarded as one of the most secure.

Equitable got into trouble because it misjudged its risk in guaranteeing future investment returns - an expensive mistake for most of its policyholders.

On the other hand, most investors are too frightened of risk.

Investing in equities can be less risky than it seems, as the longer you hold them, the lower the risk. The US stock market has lost as much as 30 per cent

in a single day, yet over 20-year periods has never failed to deliver a positive real return.

Hedge funds have the reputation of being high-risk, and some are -- yet many are particularly low-risk. They can be effective instruments for reducing the average risk in a portfolio.

My view - A risk understood, and undertaken prudently, is an opportunity. The problem is in understanding the risk. The general perception of risk is much higher at the bottom of a market trend than at the top.

My personal portfolio: Baby Steps purchases in platinum and silver - Having posted charts of platinum ([weekly](#) & [daily](#)) yesterday, plus a bullish report, I decided to make an initial purchase today when the market traded lower following a somewhat bearish [report](#) by Johnson Matthey. I think they underestimate the potential, so I bought July platinum at \$860, including spread-bet dealing costs. I'll probably add to this position if weakens a bit further, but keep the overall bet relatively small, until or unless there is an upside breakout.

With my remaining longs in March silver about to expire, I made a Baby Steps purchase of the May [contract](#) during a setback earlier today, paying \$7.29, including spread-bet dealing costs.

Email of the day (2) - [On contrarian analysts](#):

"Most of the experts that I tend to follow identify themselves as contrarians. I tend to follow them for a reason because I do believe that the best time to buy an asset (typically) is when it is hated and therefore cheap. However, I have come to the realization that most of these pure contrarians are so set on going against the masses that some of their recommendations don't make any sense - they simply fail to recognize that sometimes the masses are right in consideration of other trends. I am curious if you identify yourself as a contrarian and also what your thoughts are on these strategies."

My comment - Today, few investors would admit to not being contrarian thinkers, but many of us would disagree as to which views were actually contrarian. In other words, there are legitimate questions of degree and subjectivity. Similarly, it sounds prudent to say we are value investors (Who would claim to buy rubbish?) but value can be an abstract concept, in the eye of the beholder.

Some friends of mine formed a Contrarian's Club over a decade ago. We had some nice dinners for a few years; many views were expressed, but few agreed that they were contrarian. The problem: crowds move markets and will usually be right in the short term, and sometimes for many months or even years. Additionally, true contrarian extremes are rare.

Perspective is required. For instance, if a market surges up out of a big trading range, sentiment will improve. Does that make it a contrarian sell, or a buy on a pullback? Seldom the former in my view, although the market in question is probably short-term overbought and due for a consolidation.

The best contrarian signals occur after big trends accelerate, driving sentiment to extremes in the process, and momentum then wanes. Consequently we should be suspicious of a clear consensus, especially when the price trend looks overextended in the medium term.

Examples? Think of every bull market top and also bear market bottom that you have experienced. Then ask yourself, when during those moves was the crowd (made up of big players and little players) most bullish and most bearish? And how many market-related magazine covers do you recall coinciding with those extremes of sentiment and price?

Wednesday 16th February 2005

HSBC Global Research: A Ticking Time Bomb - My thanks to Charles Habermacher for this heavyweight [issue](#) of HSBC's Global Insights Report, prepared by Global Economists Stephen King, Janet Henry and colleagues. Here is the introduction:

Tick, tick, tick

Under any plausible scenario, the US current account deficit is likely to get bigger, not smaller, in the months and years ahead. Although the dollar has already fallen some distance - increasingly against a broader range of currencies - the simple truth is that the US economy continues to grow at a rate that will suck in more and more imports. And, with the net external liability position deteriorating rapidly, the deficit will now get larger not just because of a widening trade imbalance but also because of the increasing cost of servicing foreign creditors. As the deficit grows, the US will place a bigger and bigger burden on the world's capital markets.

The bottom line is that the US current account deficit is a bit like a time bomb that, as time progresses, is proving increasingly difficult to defuse. And at the moment, there appears to be little international appetite to confront the situation. In a climate of blame and counter-blame, no consensus is even emerging on why external imbalances have become so large in recent years.

If nothing changes in the next two years, the US will eventually be forced to generate a trade surplus to stabilise the external liability position. In response, the dollar will have to fall further. The US Administration knows this and will happily follow a policy of benign neglect, hoping that dollar adjustment alone will be sufficient to bring the external accounts back in line. Forecasts by HSBC's currency strategists put the euro at USD1.40 by end-2005 and the yen at 98, but there is a clear risk that it could fall beyond these levels.

However, our simulation suggests that there is no level for the dollar that, on its own, would remove external imbalances. Moreover, for the eurozone,

Japan and the rest of Asia, a softer dollar would undermine not just exports but also domestic demand. With few domestic policy levers to adjust, this would leave the world in a sorry state indeed. Therefore, a falling dollar should be seen as only part of the solution; other things must also change to resolve the current account quagmire.

Two solutions

Broadly, we see two possible approaches: a market-led approach and a policy-led approach. The two are essentially intertwined for the simple reason that an increasing amount of funding for the US current account deficit in recent years has come from official capital flows - in the form of central bank currency intervention - rather than from the private capital flows that dominated the funding of the US current account deficit in the late-1990s. Nevertheless, the distinction still holds: If policymakers choose to do nothing, the market will inevitably find its own solution. We think there are three possibilities:

My view - Not to give the game away, but two of their solutions are described as "benign" but unlikely, and the third is "painful". I need to read these reports, and HSBC's is well researched and argued, to remain aware of the risks. This is especially important because I remain of the muddle through school, albeit at the price of future inflation.

And I certainly do not see the US dollar surrendering its reserve currency status to the euro. Inevitably there will be some rebalancing of reserves when the dollar is weak for a lengthy period. We have seen this before; it is an understandable and healthy process.

In addition to the opening economic view, the HSBC report contains many interesting sector reviews.

Japan Falls Into Recession as 4th Qtr GDP Shrinks - [Here's the opening from today's report by Bloomberg](#):

Feb. 16 (Bloomberg) -- Japan's economy unexpectedly fell into recession last year for the fourth time in 13 years as consumer spending declined and exports faltered. The yen weakened.

Gross domestic product contracted at an annual 0.5 percent pace in the quarter to Dec. 31, the Cabinet Office said in a report in Tokyo today. The median forecast of 27 economists surveyed by Bloomberg News was for 0.7 percent growth. Revised figures showed the economy shrank for three straight quarters.

Higher taxes and falling wages may further damp consumer spending, leaving the 503 trillion yen (\$4.8 trillion) economy dependent on exports to China and the U.S. for growth. Finance Minister Sadakazu Tanigaki said the contraction won't change plans for spending cuts and tax increases to curb the world's largest public debt.

“What Japan's economy ultimately needs to achieve stable growth is consumer spending,” said Naoki Iizuka, chief economist at Dai-ichi Life Research Institute, who predicted the contraction. “A premature policy change, such as raising taxes, could cause the economy to falter.”

The report of a Japanese recession comes a day after Germany, the world's third-largest economy, reported a surprise decline in GDP in the fourth quarter and Italy also posted a contraction, dragging down the pace of growth in the 12 nations sharing the euro to half what economists expected.

My view - [If this news keeps tax increases and interest rate hikes at bay, it will be no worse than market neutral for Japan.](#)

GavKal Five Corners: A New US Economic Cycle? - [My thanks to Gabriel Solomon for this non-consensus and iconoclastic report by Charles and Louis-Vincent Gave. It's a partial rebuttal to the HSBC view above and also contains an interesting section on the Chinese RMB. Here is part of a section on the US economy:](#)

The fact that the US consumer has a lot of debt on his balance sheet goes without saying. Not that this keeps a number of financial commentators and publications from saying it over again and again and then again some more! However, all of those who have made it their business over recent years (decades?) to predict the forthcoming demise of the US consumer have been disappointed. So what has gone wrong for the US perma-bears? Is it just a question of timing? Or are we facing a new economic cycle where the adjustments forced onto the Western consumer are much milder?

In the old US economic cycle, the sequence of events was roughly as follows:
industrial

production would slow, the Fed would ease, short rates and long rates would fall, housing starts would pick up (thanks to the low rates) along with consumption, unemployment would start to fall, economic activity would accelerate, companies would start to invest, the trade deficit would deteriorate, the US\$ would weaken, inflation would bottom out and start to rise, the Fed would then tighten, liquidity would shrink, the US\$ would rise, industrial production would slow and...go back to the beginning!

However, if the ideas developed on the previous page are right, then the above cycle (with which investors are familiar) should be replaced by a new economic cycle. And this cycle should work as such: a bust occurs because of a massive misallocation of capital somewhere in the system (i.e.: Asian crisis, TMT crash...). This leads to a fall in prices in the US (as platform companies take advantage of the excess capacity and import cheap goods). The Fed cuts rates. US consumer disposable incomes rises (thanks to lower prices and lower interest payments). Consumption booms. The US trade deficit deteriorates massively. The US\$ falls.... (so far, so very familiar).

But then inflation remains low as platform companies simply start to source their purchases in countries that have not revalued against the dollar (i.e.: China, Malaysia) or even devalued (Mexico). The Fed continues to maintain artificially low interest rates, housing booms, and so does consumption. The FT and the Economist warn us again that it will all end in tears.

The US\$ then falls further. This leads to a great increase in liquidity outside of the US and central bank reserves go through the roof. Housing, stock markets and production (outside of the US) boom. At this stage, wealth in enormous amount is created both in, and out, of the US. Inflation remains low, the US\$ keeps falling, The FT and The Economist...(see above).

However, at some point, US assets in the eyes of foreigners become incredibly cheap. Then the industrialists who have made money selling to platform companies decide that having part of their assets in the US makes sense on a risk adjusted basis. They start buying real estate in Miami, or in New-York. They no longer remit their excess US\$ to their central banks, but instead use them to bid up US assets. The growth of foreign central bank reserves held at the Fed starts to decelerate. The US\$ starts to rise, regardless of what the US current account deficit does. Liquidity outside of the US since the foreign private sector is recycling its earned US\$ back into the US (instead of forcing their central bank to print money). This leads to a global liquidity crunch and the marginal players go bust. Platform companies then come in and tighten the screws on their suppliers.

In this "new cycle" changes in global liquidity occur with the foreigners' perception of the value of US assets; and not with any Fed, BoJ, ECB or PBoC decision. The US trade deficit does not return to equilibrium, but to balance the books, Americans citizens simply sell the family silver; at a price, which for US citizens, in US\$, is extremely satisfactory.

My view - [Read, keep an open mind and watch the charts. And remember, identifying and agreeing with the 'right economic scenario', assuming such a thing exists, is less important for investors than monitoring crowd sentiment as played out in the markets.](#)

Email of the day - [On US Treasury Bonds:](#)

"I would be interested in getting your latest take on why long bond rates in the USA continue to stay so low.

"With the declining dollar, the explosion in the money supply, and the astronomical dual US deficits, why anyone would lend long to the USA at 4% seems incredible to me and very troubling. Other than possible short term trading, why should anyone risk capital today in a long term US bond?

"I have heard some possible explanations, such as the insatiable demand for bonds by Asia, the interest of our trading partners to prop up the dollar, and the possibility that the US economy is not as strong as it may otherwise

appear. But I remain skeptical that these are the real reasons for this situation.

"To me this is the most puzzling aspect of the international markets today.

"Your current view would be appreciated."

My view - There is always the possibility that the US economy is heading for a significant downturn, although I'm not convinced. Theoretically, the Chinese and Japanese governments could buy US Treasuries indefinitely, but I doubt it.

Therefore I agree with you, and maintain that US long-dated government bonds are an accident waiting to happen. However we do know that markets can stay overvalued for a very long time, for a variety of reasons, including liquidity and sentiment.

Japanese government bonds have been ludicrously overvalued for years in my view, despite the mild deflation. I maintain that the next big move in JGBs will be downwards (higher yields). But due to the immutable law of supply and demand, more sellers than buyers are required to make this happen.

Thursday 17th February 2005

ABN AMRO: Force Fed - [My thanks to Ramesh Chandiramani for this report](#) by Robert Lind of ABN AMRO. Here is a section:

The market mantra of the late 1990s was 'don't fight the Fed'. Judging by the market reaction to recent comments from Fed officials, this seems to have become 'ignore the Fed, (what do they know anyway?)'. There have been two consistent themes in the recent rhetoric from senior Fed officials. First, with the economy growing robustly, the Fed has hinted that it might need to become more aggressive in its approach to monetary policy; ie there are upside risks to interest rates. Second, with no sign of an imminent slowdown in domestic demand, the Fed is concerned the current-account deficit will continue to widen, further pushing at the limits of sustainability; ie the dollar will have to fall. In both cases, markets have chosen to ignore the Fed's warnings.

At the start of 2004, most investors were short bonds, in anticipation of a sharp rise in yields, particularly in the US. That didn't happen. The yield on 10-year Treasury bonds was 4.2% at the end of 2004, compared with 4.3% at the start. Yet, investors remain resolutely convinced that yields will rise significantly in 2005. So far, the 10-year yield has tracked lower (it now stands at 4.1%). There are various theories for the fall in yields, ranging from the need for pension funds to buy bonds as part of a long-term asset allocation switch, to the continuing willingness of the Bank of Japan and the People's Bank of China to buy US bonds. As we wrote a few weeks ago, the dollar has also behaved differently from the apparent consensus view at the start of this year. Contrary to widespread expectations of a sharp fall, the dollar has

rallied. Again, there are various arguments for the dollar's unexpected rally (eg a reversal of speculative positions, Mr Greenpan's recent speech).

The Fed has been relatively explicit in its commentary on both bonds and the dollar. Through the final months of 2004, hardly a week went by without a senior Fed official arguing that bond yields would have to rise and the dollar would have to fall. Indeed, the publication of the minutes from the December FOMC gave a clear indication of the Fed's growing hawkishness. Ten days ago, Alan Greenspan spoke on the prospects for the current account, which the markets misinterpreted as an optimistic view. In fact, Mr Greenspan issued a veiled warning the current account might continue to expand, posing a risk for the economy. The markets could be right to ignore the Fed's warnings about interest rates and the dollar. Some have argued that the recent moves in bonds and currencies might reflect a change in fundamentals. But we think there are sound reasons for bond yields to rise and the dollar to fall (see page 2). Indeed, we suspect the Fed could begin to sound more aggressive on the outlook for interest rates. Watch Mr Greenspan's testimony to Congress this Wednesday [yesterday].

My view - This is a good report and timely reminder. I take Fed warnings very seriously but then defer to price action because the Fed is only one factor, albeit a very important one. My latest timing thoughts on T-Bonds and the US dollar are in the daily Subscriber's Audio.

DrKW Global Weekly Strategy: Going heavily overweight government bonds - My thanks to Peter Twaite for this [report](#) by Albert Edwards of DrKW, which takes a rather different view from the one above. Here is the opening paragraph:

We are turning maximum bullish on government bonds. We see the recent move as the start of a further major shift down in yields driven by cyclical developments. In addition, the recent absence of foreign central bank and speculative buying of US bonds may tee us up for an explosive move, if the economy weakens significantly.

Technical review of government bond futures, and implications - [With Alan Greenspan referring to US Treasury bond prices as a "conundrum" in his testimony before the House Banking Committee yesterday and today, a chart review seems appropriate.](#)

10-year Euro-Bunds - [Of the major government bond markets, Euro-Bunds \(weekly & daily\) have had by far the best performance over the last eight months and even pushed above the 2003 peak earlier this month. While still within this period's trend channel, Euro-Bunds have reversed the break above 120 indicating a potentially significant upside failure. Consequently a rally is now required to reaffirm the uptrend.](#)

10-year UK Gilts - A coupon change in December 2004 has distorted the long-term chart for UK Gilts ([weekly](#) & [daily](#)). However without that (try to visualise what the chart would look like without the one-off large drop 15 months ago), the weekly graph would show Gilts losing upside momentum beneath the June 2003 peak. The pattern since late December 2004 indicates at least a medium-term correction and shows potential top formation development.

10-year Australian Government Bonds - Australian bonds ([weekly](#) & [daily](#)) also show potential top formation development, in this instance well beneath the June 2003 peak, and this pattern is more advanced. Note the lower highs in January and also this month to date, and also the recent lower low.

10-year Japanese Government Bonds - JGBs ([weekly](#) & [daily](#)) saw a downward dynamic on the long-term chart last week and a move above 140 is required to revive this tired-looking trend. Note also the daily chart's biggest downside move since Sep/Oct and the recent equal low. A move beneath 138 would suggest that at least a medium-term top had been reached earlier this month.

10-year US Treasuries - US 10-year Treasuries ([weekly](#) & [daily](#)) have been confined to a narrow range since last August but note the lower rally highs on the 10-year chart. The daily graph confirms that resistance has once again been encountered from the upper side of the present trading range.

30-year US Treasuries - US 30-year T-Bonds ([weekly](#) & [daily](#)) broke up out of a similar range earlier this month but have subsequently retraced this move. A further decline beneath 114 would look like a potentially significant upside failure.

Conclusion - I have seen nothing to change my long-term view, expressed repeatedly in Friday's big picture Audios, that the secular bull market for long-dated government bonds ended in June 2003. Additionally, I have maintained throughout that the overall topping out phase was likely to be lengthy, not least because of intense price competition in manufacturing and fear of disinflation (the last cycle) well into a new cycle of gradually rising inflationary pressures fuelled by credit creation.

Therefore I maintain that the big move over the long term will be for government bond prices to fall (yields to rise). Meanwhile, we can expect further medium-term (several month's duration) moves in both directions. A weaker phase for government bond prices appears to have commenced. If so, a medium-term decline in bond futures would have bearish implications for global stock markets.

My personal portfolio: Partial profit taken in silver, corn rolled forward at a loss - Today I sold another Baby Steps position in March [silver](#), receiving \$7.335, including spread-bet dealing costs, against my purchase at \$6.89 on December 9th. I'm hoping that silver will bounce around sufficiently near

current levels for me to continue to replace March contracts with May positions, at somewhat better prices than a straight rollover.

Silver remains my most profitable actively traded vehicle over the last three years, in both total return and percentage of winning versus losing trades. Why? Because silver's role as a volatile proxy for gold has enabled me to buy lightly on weakness (the Baby Steps tactic) and lighten on rallies.

The silver profit above was slightly greater than my loss on an expiring position in March [corn](#), which was sold at 199¢ against the purchase at 215.75¢ on 18th November, including all spread-bet dealing costs. I simultaneously opened a new long position in the July contract at 214.5¢.

This was the second and larger of two consecutive rollover losses in corn, mainly caused by the contango, reflected in the spread between the contract prices shown above. So why do it? The reason is that I want a stake in corn because it is historically cheap, as you can see from this weekly [chart](#) of nominal prices, and corn shows evidence of Type-3 (time and size) base formation development. I'm betting that it will rebound strongly on the first evidence of either increased demand or crop fears.

Investors Insight: Inflation is Always and Everywhere a Monetary Phenomenon - My thanks to Spalding Hall for this useful reference [work](#) by Myles Zyblock. Spalding Hall adds:

"I was going to post this in the Forum but couldn't decide where to put it since the topic of inflation impacts several asset classes. Anyway, I think this article is pretty well thought out. From what I have read, a key to Mr. Schilling's deflation argument is his belief that inflation is essentially a war time phenomenon (mis-allocation of government spending and resources) and that the world is currently at peace. I disagree and think that small and underlying wars are ongoing (Iraq, the war on terror, as well as a belligerent ((and scared)) Iran and North Korea). Then consider possible global tensions between world powers trying to secure scarce resources (your supply in-elasticity trade). In short, I believe that the 'war cycle' as Dr. Faber calls it has, at the very least, turned up!

"Anyway, I like to have confirmation of my long term secular beliefs every now and then, as corrections in markets can always cause me to begin to question those beliefs. (Because I know that I never really KNOW.) Maybe you do as well."

Myles Zyblock's article - This is a must-read item for anyone interested in the causes of inflation - here are a couple of paragraphs:

By our count, the Fed has been printing money at a faster rate than the economy's ability to absorb it since the late-1990s. Too much money chasing too few goods has not yet translated into accelerating inflation. Why? Well, it might be because the excess money is not doing much chasing at all - or, as

an academic would say, the velocity of money is declining. Cash hoarding by corporate America over the past few years in response to a heightened sense of geopolitical and economic uncertainty is evidence that this might indeed be the case. An alternative, and more accurate, explanation is that money metrics are not helpful in forecasting inflationary turning points with precision; rather, they provide a roadmap for what will probably occur at some point within the next few years.

We are convinced that excessive money creation in the US over the past several years will ultimately arrest the 25-year trend decline in inflation, if it has not already done so. We have and will continue to dedicate a good chunk of our thematic research to this topic because it carries the potential to dramatically alter long-term investment strategy. A reversal in trend inflation would spell an end to the secular bull market in bonds, and it would point to trend compression in P/E multiples, the closing stages of the relative performance advantage for interest-sensitive equity sectors (e.g., Financials, Retailers), and the beginning of a long phase dominated by value investing.

My view - Commenting on the above in sequence, I agree with Spalding Hall. And as an aside, we should always question beliefs, if only to keep thinking. And as no one knows for sure, we should always review beliefs, particularly in the context of what is occurring in relevant markets.

Since I've written extensively on inflation (accessible if you use this site's Search facility), I'll be very brief here. Cash hoarding by some companies is a factor in keeping a partial lid on inflation, but I believe it is temporary and by no means the main influence on prices in recent years.

The big factors containing inflation, so far, during a record monetary expansion have been competition in manufacturing due to globalization, and technological innovation which lowers costs while also increasing efficiency. Consequently most companies have had much less pricing power than in previous cycles. And a certain amount of job insecurity related to these factors has prevented an inflationary mentality from taking hold in populations at large.

I believe these factors, not to mention debt problems, will tempt governments to err even more on the side of inflation. Obviously there will be inflationary consequences. They are already evident, as anyone who pays the household bills will be only too aware. Pockets of inflation are appearing much more rapidly than pockets of deflation.

I maintain that we are in the early years of a long-term inflationary cycle. And like most cycles, it will not be linear, at least not until the latter stages, perhaps in ten to fifteen year's time. Fed by central banks, this cycle won't wane significantly, short of a currently unpredictable exogenous shock to the global economy, until governments realise that inflation is once again regarded by the public as the great pariah.

We should invest accordingly.

Friday 18th February 2005

"Gold bugs need a dose of humility" - My thanks to Daniel Kirstein for the link to this [article](#) by Joel Bainerman, posted on 321gold.com. As a bit of a gold bug myself, I found it amusing, in addition to the commonsense merit. Here's the opening:

Judging from the huge responses from the gold bug community to the my article published on January 9th on 321gold, 110 in total and more than 75 in the first 24 hours alone - I feel that I may have released a valve which desperately needs an outlet - and viewpoints that are not the standard pro-gold arguments - from someone that doesn't publish a newsletter or speak at precious metals investment conferences.

First - despite what so many of the people who took the time to respond to my article wrote (Bob, believe me, your site is very well read and must reach every single gold bug from across every time zone) I am not anti-gold - but merely was presenting my conclusions after being a participant this in this investment sector.

I wasn't at all interested in presenting an "anti-gold" viewpoint - but that is what nearly everyone thought I was doing. The knee-jerk reaction to my arguments taught me a lot about how far gold bugs will go to buy their own product. Only about 10% of the responses didn't try and tell me "your wrong" as the first sentence or questioned my motives. Instead of hearing my arguments first - they nearly all assumed I was doing something terribly wrong (i.e., being down on gold) and that it was their duty to inform me of my error.

Allow me to present my observations after going over the more than 100 emails I received in response to my essay:

Observation Number One:

Most gold bugs are extremely arrogant when it comes to the subject of why one should own gold. Even the sound of someone being "not a fervent gold bug" generated a gut reaction to "attack" the viewpoint - just because it was "not pro-gold" not necessarily anti-gold.

My view - [Gold's allure and history puts us in touch with our primal instincts. It is an alternative religion for some.](#)

[As a unique asset, gold has always been a store of wealth. However even the most enduring investments share the same flaw - a fluctuating price.](#)

[Consequently there will inevitably be times when the price of gold is too high relative to most other assets, just as there are times when the price will be too low. After a 21-year bear market, followed by a 3-year recovery to \[date\]\(#\), I maintain that gold is still cheap relative to all financial assets.](#)

Email of the day (1) - Brainteaser on liquidity as an influence on forex trends and government bond yields:

"If a further contraction in liquidity occurs would it be a foregone conclusion that non-US currencies would react negatively? Could the spreads between US govt and foreign debt invert?"

My comment - I don't really feel qualified to comment on this, but that won't stop me from having a go, before respectfully deferring to the subscriber brain trust out there, should anyone else wish to comment.

I'm not sure how much global liquidity has contracted, based on price trends in the various markets, which are usually my first reference point. I also see or hear of other comments on overall liquidity, which I assume is very difficult to measure accurately, so I'm reluctant to draw firm conclusions based on theoretical studies that often disagree.

However I assume that liquidity will contract at some point, due to either less supply from source (central banks) in addition to the somewhat higher cost of money that we have seen in recent months, and/or some other combination concerning a change in the volatility of money or the demand for it. In other words, there are lots of variables.

As for the first question, if one assumes that the US has been the main source of liquidity and now reins some of it in, would that be positive for the US dollar? Yes, all other things being equal, which they seldom are.

Regarding whether spreads between US government and foreign debt invert (move from slightly higher to slightly lower than the equivalent-dated Euro-Bund, for instance), I would say possibly, if all other factors remain constant, which is unlikely to be the case.

From a practical standpoint, while it is good to think and question, as the email above has certainly prompted me to do, rather than try to solve these riddles on the basis of fundamental theory, I would rather look at the price action, which is after all the distillation at any given time of all that is known and felt about the market. And we also know that price takes on its own momentum, for a while, which influences fundamental perceptions.

ChevronTexaco Warns of Global Bidding War - My thanks to Jeff Fisher for this brief item by Deepa Babington for Reuters:

Asia's insatiable appetite for oil coupled with tight supplies has triggered the start of a global bidding war for oil from the Middle East, the head of ChevronTexaco Corp. said on Tuesday.

The rapid growth in energy demand from Asia coupled with difficulties in accessing oil reserves has also resulted in a new energy equation where the

days of cheap oil and gas are numbered, Dave O'Reilly, chief executive of ChevronTexaco, told a Cambridge Energy Research Associates conference.

Asian giants like China and India figure prominently in this new energy equation -- a development that should not go unnoticed by the U.S. government, O'Reilly said, without specifying what exactly Uncle Sam should do about it.

"What I see happening is the beginning of alliances forming between Asian entities and Middle East entities for the long term," O'Reilly told reporters. "And I think it's very important that our government recognizes and understands the implications of that."

The remarks come as the emergence of fast-growing nations like India and China on the global energy scene sparks fears that they may outbid Western oil majors in asset deals or in securing access to a shrinking pool of oil reserves.

"We are seeing the beginnings of a bidding war for Mideast supplies between East and West," O'Reilly said. "The new Asian demand is reshaping the marketplace -- and we're seeing the center of gravity of petroleum markets shift to Asia, and in particular to China and India."

The Asian impact on demand coupled with the lack of easy access to areas of plentiful oil reserves has also meant that oil prices aren't coming down anytime soon, he said.

Oil prices shot up dramatically in the past year thanks to fears of a supply disruption and the spike in demand, prompting a growing crowd within the energy industry to ponder whether sky-high oil prices are here to stay.

"The time when we could count on cheap oil and even cheaper natural gas is clearly ending," O'Reilly told the conference.

Not everyone shares ChevronTexaco's perspective on oil prices.

Exxon Mobil Corp. (NYSE:XOM - news), the world's largest publicly traded company, for example, maintains that there has been no fundamental shift in the energy paradigm and that the oil business is simply one that is characterized by cycles.

My view - Regarding the concluding comment attributed to Exxon Mobil Corp, of course the oil business is characterised by cycles, just like any other. However given the inexorable rise in demand for a vital resource in limited supply, which can only diminish over time, it would be naïve and wishful thinking to conclude that oil will somehow revert to an average price not that far above what we [saw](#) during the 1980s and 1990s.

Cycles can have an upward or downward bias, but for the supply inelasticity markets (my investment theme of the decade since 2003), the cyclical bias

will be upwards until there is a severe global economic contraction, or cheaper substitutes are either found or invented. The question for ongoing debate is: How much higher will prices go? Obviously no one knows but we can monitor the trends.

How will countries pay for more expensive natural resources? With difficulty, eased by increased liquidity created by central banks.

Christopher Wood's *GREED & fear*: Frustrations - This latest [issue](#) is full of insights on Asia. Here is a brief portion of the section on Japan:

The key issue for Japan remains whether the non-performing-loan (NPL) problem has peaked and whether the property market has bottomed out. *GREED & fear* continues to remain bullish on both counts. It is, for example, almost certain that the major banks will achieve the government target of a NPL rate of 4% or lower by the end of March. If these two central premises are wrong, then the whole constructive view on the Japanese stock market is wrong. But if they are right then investors should continue to look at pullbacks in the market on renewed negative sentiment as buying opportunities.

My view - My comments on Japan are in the Subscriber's Audio, covering the big picture, long-term outlook.

Email of the day (2) - On gold and Commitment of Traders (COT) data:

"Adding to your commonality theme on gold bottoming, the commitment of traders for gold appears to be at an important junction. The COT for gold on the 08/02/05 showed Non-Commercials had a net long position of 11,175 contracts (4.38% of open interest). You have to go back to 22/10/02 to find a net number of contracts lower than that (9,462 - 6.10%) and to August 2002 to find a lower percentage. Also on the commercials side you have to go back to August 2002 to find their net short position to be so low.

"As a subscriber to Fullermoney, I'd be interested to know if you take notice of the COT reports and/or analyse them? Do you have any thoughts on their current state?

"Since I'm new to this "game" are there any parallels you could draw between the gold market now and in mid/late 2002 the last time the COT showed similar "net" positions?"

My comment - For someone new to the game, you have certainly focussed an analytical eye on COT data for gold! What you have pointed out has to be relevant and I am pleased to have the information.

Personally, I don't monitor COT data because I don't have the time to follow everything of merit. Fortunately, Fullermoney is now an interactive service, and subscribers' contributions add to our collective knowledge.

My only caution on COT data is that one could be tempted to read significance into every little change, whereas important signals for any market are likely to occur every few months, at most. However we can say the same about most other worthwhile studies.