MARKET TRUTH *Written by Puru Saxena*

BRIDGEWATER

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THIS WILL BE A BIG ONE !!!

PREPARE YOURSELF: In the previous newsletter, I had mentioned that we were expecting a sharp corrective rally as the markets seemed to be extremely oversold. Well, the market made a “bottom” towards the end of the last month and since then the indices have been generally trending higher. Is this the real thing? Not a chance. The way we see it is that this is yet another bear-market rally and it will fizzle out within a matter of weeks. Here is a word of advice: ***This market is presenting a final opportunity to avoid further financial pain. Use this rally to get liquid, the decline is far from over yet!***

THE BIG PICTURE: This is the mother of all bear-markets. Here are some facts:

- Annual trade deficit in the US is in excess of USD 400 billion.
- S&P 500 is trading at a P/E ratio of 35 while yielding only 1.56%.
- The US government debt is USD 6 trillion!
- US private debt is USD 32 billion!
- There were 1.5 million personal bankruptcies in the US in 2001.
- The Fed has lowered rates 11 times without any positive impact.
- The Dow from its peak has lost 27% of its value.
- The NASDAQ from its peak has lost a staggering 74% of its value.
- The S&P 500 from its peak has lost 40% of its value.

What is shocking is the fact that despite these horrendous numbers, the media doesn’t even recognise this as a bear-market! According to the media, this is a correction which will end in a V shaped recovery which will be powered by the mighty consumer. What they don’t recognise is the fact that the poor consumer is already upto its eyeballs in debt and with falling wages and rising unemployment the poor consumer cannot keep spending forever. USD 8 trillion have already evaporated in “thin air” in the US alone, global stock markets have plummeted, huge companies have gone bust and what is frightening is the fact that the media continues to focus on monthly or quarterly earnings of some individual company. Seems to me that the “gurus” and “experts” are in denial! Wake up!...this bear-market is not about missing estimated earnings by a penny and it is definitely not due to “September the 11th” or Enron or some other scandal. In our opinion, the following is what this monsterous bear-market is all about:

Its about the euphoria of the “New Economy”.

Its about P/E ratios ranging from 50 to infinity.
Its about years of fraudulent “pro-forma” earnings.
Its about “the fed won’t let a bear-market happen”.
Its about “buy and hold for the long-term” (even though you are 70 years old)!
Its about “ your money is safe if its invested in a global-growth mutual fund”.
Its about “you’re not clever if you’re not taking part in the technology revolution”.
Its about trusting bullish “top-name” analysts who don’t have a clue.
Its about gold being a worthless ghost of the past.
Its about “Mr. Greenspan” – The Magician.
Its about millions of investors previously rushing to buy technology IPO listings.

In summary, this bear-market is about the longest list of lies, bullish propoganda and corporate scandals that ever engulfed this market and its about trusting and ignorant investors trying to make their millions by jumping on the bullish express train. A word of caution – this express train has changed direction and its coming directly at you and it hasn’t got any brakes! Therefore, it may be advisable to jump off the tracks!

We believe that this market will begin its final decline shortly after this “fake” rally ends in 4-6 weeks. Towards the end of this rally, the media would have once again managed to convince investors that the “bottom” is in and the ever-trusting public will be fooled yet again. According to our analysis, the final decline will be a crushing blow which will take the market to substantially lower levels.

Several subscribers and investors have asked us the following 2 questions –

How long will this bear-market last?

Answer: We haven’t got a crystal ball, however we do have some general convictions and beliefs. We believe that this bear-market may last until 2006. Historically, every bear-market in the past has lasted at least 35% of the time frame of the previous bull-market. The most recent bull-market of 1982-2000 (which also happened to be the biggest bull-market) lasted for 18 years. Based on this calculation, we expect the present bear-market to last for 6 years. The bear-market began in 2000 and therefore we expect it to bottom-out by 2006.

How low can this market go?

Answer: Historically, bear-markets have always bottomed with major indices selling at 10 times earnings. A market with a P/E ratio of 10 represents an undervalued market and implies that stocks are selling at great values. A P/E ratio of 15 represents fair-value and it is the historical mean.

At present levels, the S&P 500 is trading at 871 with a P/E ratio of 35. Bearing in mind current earnings, a Price/Earnings ratio of 15 would bring the S&P 500 down to 370. At this level, the market would represent fair-value. If the S&P 500 were to trade at an undervalued level with a P/E ratio of 10, then the S&P 500 would have to decline to 247.

From the present level, this still represents a loss of 70%! Of course, we don't know for sure whether the market will decline to such an extent, however we have no doubt in our minds that we still have a long way to go!

DEFLATION: This may turn out to be the most important piece I have ever written, so read on carefully. After spending numerous hours thinking and carrying out a comprehensive research in this area, we have come to the following extremely critical conclusion: **The US is heading towards a Japanese-style deflation.** The most conclusive evidence came last week, when the government figures revealed that the Producers Price Index (PPI) "unexpectedly" fell by 0.2%.

You may remember that in the previous newsletter I had mentioned that I believed that there is tremendous deflationary pressure on the US economy. This pressure comes from over-capacity and globalisation which has resulted in stiff cut-throat competition amongst various countries exporting to the US. These countries have no alternative but to reduce the price of their produce in order to retain their market share. Therefore, manufacturers and producers are finding it extremely difficult to even "hold" the price of their produce.

The last thing that Mr. Greenspan wants is Deflation. This must be his worst nightmare. Remember, that the Fed can check inflation by increasing interest rates, however it has no answer to deflation. That is why the Fed is engaged in a mighty attempt of re-inflating the US economy. It is attempting to do so by pumping the system with liquidity and the availability of easy credit. Last week, the money supply (M3) increased by $ 44 billion!

The reason why the Fed does not want deflation is due to the fact that it will become impossible to service the existing mountain of DEBT. Deflation means a decrease in money supply which in turn would increase the REAL VALUE of the dollar. An increase in the real value of the dollar would make it impossible for the debtors to repay their loans and borrowing. This would result in a debt-meltdown as hundreds of corporations will have no option but to file for bankruptcy. This may never happen, but this is how we see and forecast the future of corporate America.

We have been advising investors to allocate part of their assets to gold. The precious metal is still in its correction phase and it may take some time before the next bull-run commences. However, if a debt-meltdown were to happen, then the price of gold "will go to the moon". This is due to the fact that gold is the only store of value which is not someone else's debt. Gold is outside the financial system. We strongly advise you to allocate at least 10-15% of your portfolio to this precious metal as an insurance policy against a faltering financial system.

Once again, we sincerely advise you to liquidate or reduce your equity holdings in order to avoid financial pain. There are several strategies which will allow you to protect your capital and even profit from this long and treachorous bear-market. Kindly contact us if you would like to arrange a non-obligatory meeting in order to further discuss this issue.

SUBSCRIPTION DETAILS: Some of you have been receiving this newsletter on a trial basis for over 6 months. All good things come to an end and so is this trial period! (The concerned individuals will be receiving a letter in the post). A lot of time, effort and funding goes into producing this letter. Therefore, we request you to become a paying member if you wish to continue to receive this monthly report. The annual fee of HK$ 300 will provide you with 12 monthly issues.

Bridgewater is an SFC registered investment adviser. The directors Stephen Gollop, Edward Cheung and myself have gained over 30 years experience in financial planning. **We are proud to announce that working in conjunction with the BPHR department of the Asian Development Bank, Bridgewater is employed as an external consultant to provide training and guidance to professional staff preparing for retirement.** Bridgewater will not be responsible for any investment decisions made based on this letter alone. We strongly advise that you arrange a meeting to understand the risk/reward profile before investing. You may contact us on contact@bridge-water.com or please contact Ms. Pooja Balani on 2525 3639 if you would like to arrange a meeting. We hope this information proves useful to you and once again we wish to thank you for your continued support and positive feedback. Until next month, Goodbye and Good Luck!