



## Issue 7 Volume II

### THE HEAT IS ON!

**THE BIG PICTURE:** Since August 2000, I have been an advocate of a Primary bear market. Over the past several months, week after week, trillions of hard earned dollars have evaporated in “thin air”. Yet, the degree of hope and optimism prevailing among investors is almost surreal and unbelievable. The NASDAQ has lost over 70% of its value, countless stocks have declined by over 90%, several major corporations have gone bust, many others (like Enron, Xerox and Worldcom) have committed frauds of epic proportions, even the twin towers have fallen...yet, investors are hopeful and optimistic! What will it take for the mass public to turn bearish and fearful? Only time will tell...in the meantime, the greedy bear will continue to dig its claws deeper.

Last month was routine in the course of an ongoing bear-market. Stocks tumbled, major indices declined, more accounting frauds were uncovered and CNBC continued to feed hope and faith! Nothing changes...well, easily anyway. Here is a little secret...*As this bear-market progresses and gains momentum, last month will repeat itself over and over again. This will keep happening until stocks (once again) become GREAT VALUES! We are far from it just yet.*

Take a look at the 22-year chart of the S&P 500 index which gives a true representation of the health of the US economy. Now, take a closer look at the 20-month moving average (higher one) and 50-month moving average (lower one). You will see that the 20-month moving average has just crossed the 50-month moving average from above. In other words, the 20-month moving average has done something which it hasn't done in over 20 years. We would love to explain this in greater detail, however there are more important things to cover in this newsletter. Anyways, this is an extremely bearish sign and clearly indicates that this market is going only one way - DOWN.



**A WORD OF CAUTION:** At current levels the market is extremely oversold. Therefore, we **may** be on the verge of a sharp corrective rally which could last for 2-3 weeks. This rally (if there is one) will present the last selling opportunity to exit without suffering further capital losses. Please do not be fooled as this rally will be nothing more than a classic bear-market trap and the indices will eventually go to much lower levels.

**SCENARIO EXPLAINED:** We have been going on and on about this primary bear-market, so I have decided to make an effort in order to explain why we are so negative about the US economy. I sincerely hope that the majority of you will understand.

We believe that we are facing an extremely fascinating paradox – The battle between inflationary and deflationary forces.

Mr. Greenspan has been pumping the system with liquidity and credit. In fact, last week the money supply (M3) increased by US\$ 38 billion! In other words, last week the Fed created US\$ 38 billion out of thin air. This sort of activity has an inflationary effect on the economy. By definition, inflation is an increase in money supply. The increase in money supply results in abundance of paper money which lowers its true value (remember supply and demand) and this in turn increases the prices of goods.

On the other hand, we have the deflationary forces which are playing out to increase the value of real money. First let us make sure everyone understands what deflation really means. There is a common misconception that deflation occurs when the prices of goods decline. That's not entirely true. Generally price changes are mere reflections of a change in the value of money itself and not the other way around.

The US is a credit based economy and it has been building up heaps of credit during the roaring 1990's. Today, the US owes approximately \$30 trillion in debt which is 3 times the annual GDP. The US success story was dependent on the theory that wide-spread

availability of credit would stimulate production, which in turn would create more jobs and more capital to be reinvested in the economy. This is a logical way of thinking, however the problem has got out of hand. The Federal Reserve has allowed US banks to lend out all their deposits. This money once loaned out is allowed to be reloaned many times over, thereby multiplying the amount of debt. The reality is that the level of credit afloat in the US is several times more than actual money! This is a disastrous situation.

As the stock market continues to decline, production will decrease and more and more people will lose their jobs. Banks will soon realise that there is a shortage of money out there to repay the huge debt and they will panic. This is when the banks will demand repayments of their debt. As more and more bad-debts and bankruptcies occur, these lending banks will become extremely nervous and they will cut back on easy credit. Therefore, non availability of easy credit will increase the value of money and this is what will trigger deflation.

Another cause of deflation is globalisation. In today's world, several countries compete with each other in order to keep their export-markets. As times get tougher, all these countries will then have to devalue their currencies in order to make their goods and services more competitive in the international market. This will also have a deflationary effect on the price of goods and services across the globe.

Cash and real intrinsic money (gold) will become more and more scarce as this drama unfolds. The problem with holding paper money (cash) is that it is under the control of the central banks. Recently, Argentina, Brazil and now Mexico have faced financial nightmares where the banks have not allowed the citizens of these countries to gain access to their own money! Gold on the other hand is outside the financial system. It is an insurance policy in the wake of the current financial situation. Therefore, once again we urge you to allocate at least 15-20% of your assets to gold. You may do this by buying physical gold, paper gold, gold mining stocks and precious metal funds. We strongly believe that we are in the initial accumulation stages of a primary bull-market in gold.

Over the past 4-5 years, various central banks and the Fed have been trying desperately to suppress the price of gold. This is due to the fact that a rising gold price is testament to the faltering financial system and it creates doubts in the minds of investors. Couple of weeks ago, gold went up to \$330 per ounce. On Friday afternoon (28<sup>th</sup> of June 2002), the price of gold was knocked down by over \$8 in less than 15 minutes. Apparently an undisclosed account at JP Morgan had sold over 30, 000 futures contracts at the end of the session. We have seen it happen before. Whenever the price of gold rallies, some major bank or government comes and sells heaps of gold....mmm....smells like manipulation! These institutions can manipulate all they want but I can assure you that (in the end) the primary bullish trend in gold will prevail. As Thatcher once said "You can't buck the market!"

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 treacherous bear-market. Kindly contact us if you would like to arrange a non-obligatory meeting in order to further discuss this issue.

Following the success of our INVESTMENT FORUM which was held on 22<sup>nd</sup> June 2002, we are pleased to announce that we will be conducting another one on the 10<sup>th</sup> of August 2002. The invitation has been included with this newsletter. Kindly contact us or fax us the Reply Slip if you wish to attend. An early response will be appreciated.

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.** Please feel free to contact us if you require assistance in planning your financial future or if you require a complimentary review of your existing portfolio.

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](mailto: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!