



ENJOYING THE RALLY?

Issue 11 Volume II

RECENT ACTION: In last month's report, I had mentioned that (in our opinion) the recent market rally was likely to last for a few more days, however without the initial intensity we witnessed within the first week off the October lows. Well, we were quite accurate in our analysis since the US market has slowly climbed higher over the past month albeit without much "steam". Okay, okay... we admit that this rally has surprised us in the sense that it has lasted much longer than expected, but that's what Great Bear's regularly do. Bear-markets generate surprise, fear, frustration and finally anger!

Over the past 6 months and especially towards the end of October, speculators had got into a habit of making "quick and easy" profits by shorting the market. So what does Mr. Bear do? He pulls out a "whopper" rally from his hat and (oops!) the shorts get killed! The moral of the story - It isn't easy to make money in this business in the best of times, especially so in a bear-market.

WHERE DO WE GO FROM HERE?: There are numerous factors which are causing analysts and experts to believe that further stock market advances lie ahead. The November-April time period is supposed to be the "good" half of the year. It is taken for granted that stocks generally perform very well between November and April. Secondly, the US Presidential cycle suggests an advance in the stock markets. Finally, the long 20-year cycle is also suggesting that stocks indeed bottomed-out in October 2002. Remember, over the past century bull-markets began in 1942, 1962 and 1982 (all after a 20-year period). Therefore, financial gurus "expect" a major stock market advance to begin somewhere in the current year. Based on historical data this sounds well and good, but these experts are ignoring a vital element and this element is called VALUATIONS. When the equity markets bottomed-out in 1942, 1962 and 1982, stocks were selling at GREAT VALUES. Unfortunately, in 2002 stocks continue to be absurdly priced and extremely overvalued. Therefore, despite the fact that history suggests that October 2002 was indeed the "bottom", we are not convinced and remain highly skeptical.

Don't get us wrong. We firmly believe that this bear-market is far from over yet and the market will decline to much lower levels before a realistic bottom is formed. The real question is the path this market will take in order to get to the final bottom. That is the major mystery we try and muscle with every day.

So let's be positive and assume that the October-low was indeed an important bottom in the ongoing primary bear-market. If this is true then the stage is set for a multi-month advance. At the peak of the current rally (6th of November), the Dow closed at 8,771. For us to turn short-term bullish, we would like to see the DOW better its own 6th November closing of 8, 771. If the Dow can climb and manage to close above 8,771 the present rally will sustain for several more weeks. On the other hand, if the DOW cannot close above 8,771 this rally is over and prepare yourselves for spectacular declines. Mark it down in your diaries, the level to watch is 8,771.

PRIMARY BEAR-MARKETS EXPLAINED: Although everyone speculates in stocks, few understand how primary bear-markets operate and play out. Primary bear-markets just like primary bull-markets are spread out over 3 phases.

During the 1st phase, “smart” investors and speculators begin to understand that the unrealistic expectations and dreams of the previous bull-market will never be fulfilled. In the early stages, stock prices begin to decline as large speculators and institutions begin to take profit by distributing their stock holdings. Meanwhile, completely unaware the general public remains extremely bullish.

The 2nd phase is characterised by a deterioration in the business fabric of the nation. Stock prices decline further as corporate bad news starts to emerge in the form of earnings disappointments and occasional bankruptcies. During most of this phase, the general public remains in denial and hopes to get its money back.

The 3rd or final phase is when the true capitulation takes place. Frustration turns into anger while panic grips the general public. This is the time when investors call their brokers with instructions to dump their stocks at any price. Punters swear that they will never ever buy these wretched stocks again. Of course, this sort of sentiment marks the end of the bear-market.

Currently, we are somewhere in the 2nd phase of this bear-market. Investors are still in denial and continue to hope that somehow, mysteriously they will recover their losses. These days the national anthem is “I am watching the markets closely and will sell as soon as I get my money back”. This tells us that the majority of investors are still hopeful as they remain invested. Hope is a dangerous word in this business and must be avoided at all times. Remember, during bear-markets whatever can go wrong will go wrong.

Regular cash is needed to sustain life and even more cash is required if you have to pay off debts, especially huge debts. Americans are up to their eyeballs in debt and have a negative savings rate. As this bear-market moves on unemployment will rise and the operative word is going to be income. Our American friends will have to find a way to generate income to service their debts. Somewhere along the line the average American will be forced to sell equities in order to generate cash. Good luck to those who continue to “buy and hold”!

US DOLLAR: US annual trade deficit is at record high levels. Recent figures reveal that the deficit is close to USD 500 billion. This year alone, US imports have exceeded its

exports by nearly USD 500 billion. In order to prevent the dollar from weakening further, new capital to the tune of USD 1.9 billion must flow into the US every day. This situation can be compared to a time-bomb which is waiting to blow up. How much longer will foreigners continue to send their hard earned capital back into the US? Our guess – not much longer! Over the past several months, the US dollar declined by approx. 17% against the Euro. Due to the currency link, the Hong Kong dollar also declined by the same degree against the Euro. Those of you who are feeling safe because your money has been sitting in HK/US dollar deposits, think again. Although you may not have lost anything on paper, in reality your capital has been reduced by 17%. Take into equation record low interest rates available on US dollar deposits and you can see how you've done so far.

We are of the view that the US dollar is likely to decline by another 15-20% before the end of 2003. Hong Kong residents, ACT now and protect your capital before it evaporates further!!! Contact us and we'll be happy to help and guide you.

NUCLEUS: Over the past several months, we have been extremely occupied with regards to establishing a genuine solution which will give investors an opportunity to participate in a comprehensive range of asset-classes within a core holding. This baby is the end result of all our hard work, sweat and research. It is a unique concept which is currently unavailable to retail investors. Nucleus is a brand-new exceptional portfolio which will maintain diversification through various assets such as cautious hedge funds, bonds, Asian/emerging equities and gold. An external fund management company has been appointed to actively manage and identify the best performing funds within each sector. We highly recommend you to allocate part of your funds to this portfolio. Please do not hesitate to contact us if you require further information on Nucleus.

SUBSCRIPTION DETAILS: This report is a free service for Bridgewater clients. However, some of you have been receiving this newsletter on a trial basis for over 6 months. The concerned individuals have been sent a subscription form with this letter. Please complete and return it in order to become a paying member if you wish to continue to receive this monthly report. The nominal 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. More recently, we have also introduced a mid-life financial planning course.**

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!