



SIR "BUBBLEMAN" GREENSPAN!

Issue 9 Volume II

A WORD OF CAUTION - In the previous posting, I had mentioned that we were in a classic bear-market rally and had advised you to use this market strength and get liquid. This summer rally seems to be coming to an end and the bear will return to feast once again. Therefore, for your own safety, we urge you to liquidate your stocks in order to avoid serious financial pain.

SCENARIO EXPLAINED – This is a PRIMARY bear-market. The purpose of bear-markets is to cleanse the euphoria and excesses of the preceding PRIMARY bull-market. Coincidentally, the previous bull-market was one of the biggest speculative asset-bubble in recent times, and naturally the correction or cleansing will also be of a similar magnitude. Take a look at the monthly chart of the Dow Jones Industrials (1981 -2002).



The Dow (monthly) chart shows the 20-month and 40-month moving averages. Between 1980 and 2000, the 20-month moving average was rising continuously and it was always higher than the 40-month moving average. In mid-2000, the 20-month average stopped rising and earlier this year it crossed the 40-month moving average from above.

Therefore, this year, the averages have done something which they have not done for over 20 years! It is an ominously bearish sign and confirms that for the first time in 20 years, the average price of blue-chips over the past 2 years has fallen below the average price of blue-chips over the past 4 years! This demonstrates a dramatic slowdown in price-advances of the 30 biggest blue-chip stocks in the US. The seasoned and knowledgeable investors favour the blue-chips and this slowdown in the advance is evidence that BIG money is waving “goodbye” to this market.

THE GREENSPAN EFFECT: In the previous issues, I have been saying that we felt that the FED would do “anything” in order to fight and tame the primary forces of the market. Let us review its policy. We believe that the FED is engaged in an all-out attempt to re-inflate and reignite the US economy. How is the FED doing this? The Fed is doing this by pumping the system with cheap credit and liquidity. Money supply (M3) is increasing at a (scary) rate of 12% per annum. The Fed (through record-low interest rates) is inducing and encouraging consumers to take on more and more debt. This in the hope that more borrowing will equate to more spending which hopefully will reignite the economy. “Consumer led recovery” – sounds familiar?

There is a small problem with this plan. The problem is that the US consumer is now facing HEAPS of DEBT. In fact, US personal and corporate debt is equal to US\$ 32 trillion. It is highly ironic that the US government itself has run up a huge tab and the Federal debt is around US\$ 6.2 trillion. To put it plainly, the world’s biggest economy is up to its eyeballs in debt. US debt now equates to a staggering 380% of its annual GDP, however the country’s appetite for debt is still increasing.

Since the FED-inspired equity-bubble burst over 2 years ago, American’s have started focussing on property. Hundreds of thousands of Americans have taken “advantage” of low interest rates by purchasing speculative property. Numerous “intelligent” consumers have gone one step further and have refinanced their own homes. The new “theory” is that housing prices NEVER fall. “Refinance your house, buy a new car, go on a holiday, just carry on spending brother...after all, the home prices just keep going up”! Mmmmm...let’s see how long this lasts!!! We firmly believe that US housing is the new speculative “bubble” and it will be punctured within the next 12-18 months.

As the bear-market progresses and stocks decline over the coming months, we will see some serious trouble in corporate America. All it will take is a few more “Enron style” bankruptcies and banks/lending institutions will start panicking and they will demand early repayments of their outstanding loans. Of course, the average American has already “invested” these loans in either the housing market or in durable items such as automobiles. Therefore, when banks and lending institutions demand early repayment of their loans, it will be like your hand coming down hard on a blood-sucking mosquito. In simple terms - it will be messy. Tightening of bank credit, will have a snow-ball effect as there will be numerous additional defaults and perhaps a debt crisis. In this hour of panic, investors will rush for the only form of money which is nobody else’s debt. Of course, I am talking about gold – the only debt-free intrinsic store of value. We have been advising our clients and subscribers to take positions in gold. You don’t have to like gold, just go ahead and buy it as an insurance policy against a faltering financial system.

In the meantime, the FED can manipulate the market, it can lower interest rates to zero, it can flood the financial system with trillions of dollars – At the end of the day, the FED will lose and the PRIMARY forces of this market will prevail!

THE STOCK MARKET– The stock market does not react to yesterday’s economic news. The value of the stock market is the sum total of the combined knowledge, facts, emotions and expectations of all the market participants as far as they can see in the future. At any given point in time, the value of the stock market would have already taken into account and discounted any foreseeable events. Therefore, when Mr. Greenspan came out a few days ago and expressed his concerns about the recovery, the stock market did not react. That’s because Mr. Greenspan’s concerns were already discounted in the existing price structure.

What worries us is the fact that most market participants (investors) continue to remain stubbornly bullish. They continue to believe that the economic recovery is around the corner. Therefore, the present value of the stock market is based on high expectations and optimism about future economic growth. In other words, the market at current levels (Dow 8, 500) has already discounted or taken into account the best possible scenario – A recovery which is “expected” to happen in the 3rd or 4th quarter. What will happen to the level of the Dow if the recovery does not arrive? Yes, you guessed it right! We will have a phase of disappointment, frustration and anger. Market participants have (innocently) continued to believe the bullish propaganda which is expertly being delivered by analysts and con-men of this great industry otherwise known as finance. “Buy and hold for the long-term” is the mantra which has been devised in order to minimise redemptions. “If your portfolio is down 20%, 40% or 60%...who cares, just carry on holding because stocks “always” do well over the long-term”... Most people don’t realise that stocks do well over the long-term, only if you purchase them at low levels.

The market continues to be ridiculously expensive and it does not have any “room” to tolerate any unforeseeable risk. In other words, the market (at current levels) is discounting ONLY good things ahead. However, the risk looming over this market is immense – anyone heard of the Iraq problem before? In bear-markets whatever CAN go wrong normally DOES go wrong. Repeat after me – “In bear-markets whatever CAN go wrong normally DOES go wrong. This is a PRIMARY bear market.”

ULTIMATE BOTTOM: Stocks at low levels are represented by Price/Earnings (P/E) ratios below 10. Over the past century, all major bull-markets have begun with P/E’s below 10. At present, the S&P 500 index trades at 35 times earnings! Our guess is that this historical bear-market will also end with stocks selling at GREAT VALUES, with P/E’s in the 7-10 range. This bear-market will probably last for another 3-4 years. Our advice remains the same – Avoid becoming the bear’s dinner and reduce your losses by liquidating your stock portfolios. This way, at least you would have preserved your capital and will be in a position to take advantage of a “once in a lifetime opportunity” which is probably 3-4 years away!

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.

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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!