MARKET TRUTH Written by Puru Saxena

BRIDGEWATER

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THE SUMMER OF HOPE???

UPCOMING SEMINAR – For the benefit of those who are not on our database, I am pleased to announce that Bridgewater conducts regular educational seminars covering a wide range of topics such as Market Review, Investment Recommendations, Estate Planning, Retirement Planning and Risk Management. We have great pleasure in inviting you to our next session which is scheduled for 2 August 2003. Please visit our website to obtain details or to reserve a seat -- www.bridge-water.com

CURRENT SENTIMENT – The majority of investors, fund managers, analysts and their brothers are now positioned for advancing stock prices. How do we know? We know because certain items are telling us there is far too much complacency, bullishness and optimism.

Take for example the results of the survey conducted by Investor’s Intelligence. The current reading shows that 56.5% of all advisers are bullish and only 18.5% of advisers are bearish. To put it simply - there are 3 bulls for every single bearish adviser. The current spread is the widest it has been since early October 1987 and we all remember the “infamous” crash of October 1987. Now, I’m not suggesting that history can predict the future, but (contrary to popular belief) you’ll find that history tends to repeat itself.

Another indicator which is making us nervous is the level of the VIX (implied volatility). The reading of the VIX shows the amount of volatility option-writers foresee over the coming days. When the majority of traders become fearful, VIX reading rises, and when complacency reigns, the VIX falls. Since the vast majority of traders are wrong and lose money, it's usually a smart move to go against (counter to) what the VIX “says” the crowd is doing. The VIX is an **INVERSE** indicator, meaning that high readings represent an oversold market (excess of bearishness) and low readings are seen when markets are overbought (excess of bullishness). Over the past 12 months, the market has collapsed each time the VIX has been in the low 20’s and stocks have rallied with the reading close to 50. Over the past 2 months, the VIX has been trading in the low 20’s, suggesting extreme complacency, hope and confidence on the part of traders. This warrants extreme caution – time to be super careful!

On an historical basis, stocks today are ridiculously expensive. Despite 3 years of mind- numbing losses, the current Price/Earning ratio of the S&P is around 33 which is better than double its historical average of 14. So, under no circumstances can stocks be considered “cheap” at current levels. Since October 2000, we’ve avoided US stocks like the plague. Despite the recent rally, we continue to “watch the show” from the sidelines. I have a feeling that the investing public has not participated in the recent rally either – not yet anyway. Retail investors have been too busy licking their wounds after 3 years of horrendous losses… We believe the only punters who’ve taken part in the recent strength are the thousands of equity-fund managers who are always trying to “beat” each other while playing with someone else’s money! Way to go guys, way to go…Needless to say that its always easy to play with someone else’s money…

THE GREAT DEBATE – The stock market seems to be caught in the Inflation/Deflation debate - It can’t seem to decide which way to go.

On one hand we’ve got an inflationary FED which is increasing the money supply like there’s no tomorrow. Over the past 3 weeks alone, the US money supply has increased by a staggering US$ 100 billion! This is monetary inflation pure and simple. The manic Fed is now desperate and is concerned with one thing only – ASSET INFLATION. Greenie is doing everything he can to ensure that the prices of stocks, homes and bonds keep rising forever. The FED knows only too well that declining asset prices will cause havoc on an economy which is upto its eyeballs in debt! Remember, debt isn’t a concern as long as asset prices keep going up indefinitely. It’s when asset values start to decline will we have a major catastrophe on our hands. When asset prices eventually drop, debt will continue to rise and this will cause some serious financial pain to a public which is fully loaded up on debt. Unfortunately, over 200 years of history suggests that nothing can stay up forever and whatever goes up must come down!

On the other end of the spectrum, we’ve got major forces of deflation – global overcapacity and Asian competition. In a nutshell, the world is simply producing too much stuff. End Result - US industry is currently operating at 73% of its total capacity. One in every four factories is lying idle! This is deflationary - Companies are not making fresh capital investment as they continue to meet existing demand quite easily.

More importantly, Asia (China) has now become manufacturer to the world as it produces goods at significantly lower costs when compared to the West. The problem is made worse because Asia then exports the majority of these “cheaply” produced goods to the western world. Due to this stiff competition from Asia, western manufacturers are finding it extremely hard to maintain prices let alone increase them. This, dear readers is extremely deflationary!

So, the stock market is currently “confused” as it continues to dance to the tune of both inflationary and deflationary forces. But, we all know, nobody stays confused forever and in due time the market will make up its mind and act decisively. Our guess is that the latest “shot” of monetary stimulus provided by the FED will “wear off” soon and the market will decline in earnest!

US$ & GOLD - The US dollar, after its long decline from its March high, has stabilised with the Dollar Index recently strengthening against major world currencies. And of course, the dollar is being assisted by Asian countries who are buying US dollars to keep their own currencies down. Competitive devaluations – The new era!

With record-high US current account and budget deficits, it’s a matter of time before the US dollar begins its decline. On a trade weighted basis, the US dollar remains highly overvalued and we believe it will decline considerably over the months ahead. So, if you haven’t switched part of your assets to other currencies yet, utilise the current dollar strength and make the transition without any further delay.

We’ve said it before and we’ll state this again – There is only one genuine bull-market around, and it is the bull-market in gold. Recently, gold has been caught between the global deflationary forces as against the steady surge in liquidity. Over the past 2 years, gold has been “quietly” rising against all major currencies. This, without any media hype and without any participation by the investing public. Gold has been under major accumulation as large, sophisticated interests continue to purchase the yellow metal at what we consider “dirt-cheap” levels.

Below is a medium-term chart of gold with its 200-day moving average. In major bull-markets, an item generally tends to stay above its 200-day moving average.

GOLD (JAN 2001 – PRESENT)

As you can see, gold decisively crossed above its 200-day moving average in August 2001 and ever since, it has dipped below this average only twice and that too for a very brief period of time. Surely (since August 2001) we've had some dramatic corrections in this bull-market, but on every occasion gold has managed to "bounce" off its 200-day moving average. This is typical of a classic bull-market and over time gold will rise to substantially higher levels. Gold is still in the early stages of its bull-market and (somewhere ahead) this bull-market will finally grab the attention of the investing public. This is when gold will rise in a vertical line and become highly speculative. Naturally, the stock prices of gold mining companies will appreciate greatly as this bull-market matures over time. Bearing in mind that the total market capitalisation of gold mining companies is a miniscule US$ 90 billion, it will only take a small percentage of investors' capital to send the price of gold stocks to the "moon"! We have reviewed over 50 gold mining mutual funds and have identified 3 funds with exceptional holdings and track-record. All these funds have produced phenomenal returns over the past 2 years. Please contact us if you require further information.

HEDGE FUNDS – Stocks are extremely expensive, money market yield is historically low and bonds "seem" to be topping-out. Not an easy world to live in! So where should you put your money? We sincerely advise you to take a look at cautious market-neutral hedge funds. Normally, investors "freeze" as soon as someone mentions hedge funds as horror-stories of such funds going bust are much too frequent. Now, there are thousands of hedge fund strategies available and we've done extensive research in this field. After analysing 100's of funds, we have identified and selected 5 funds we are happy to recommend to investors. Please feel free to contact us in order to obtain information on such low-risk strategies which have been producing consistent returns for our clients.

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.

This report does not constitute a recommendation to buy any of the discussed strategies. Bridgewater will not be responsible for any investment decision based purely on opinions expressed in this letter. We strongly advise that you arrange a meeting to understand the risks involved in investment. You may contact us on contact@bridge-water.com or please phone us in order to arrange a meeting. Until next month, Goodbye and Good Luck!

We are pleased to announce that both Stephen Gollop and myself appear regularly on CNBC and Bloomberg television as guests and comment on various topics of interest. Please visit our website in order to obtain further information about our schedule.

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