



**22 MAY 2003**

**DEFLATION – GREENIE’S NIGHTMARE!**

**CRYSTAL** - We have great pleasure in announcing the launch of **CRYSTAL**, which revolutionizes the concept of Wealth Management. **CRYSTAL** is a unique and exclusive club created specifically for high-net worth individuals and corporate clients.

Our independent status has allowed us to unveil this unique discretionary Wealth Management service. Investors have access to a wide range of asset-classes in all major markets combined with complete transparency in terms of extremely low fee and charges.

Bridgewater manages **CRYSTAL** portfolios purely on a fee basis and receives ZERO commission while trading. In order to become a member of this club, minimum portfolio size must be equal to USD 2 million. Please feel free to contact us in order to obtain further information or visit our website [www.bridgewater.com](http://www.bridgewater.com)

**BIG PICTURE** – Over the past few months, we have been warning about deflation. It’s only recently that Greenie came out and voiced his concerns about declining inflation or shall we say deflation! At Bridgewater, we firmly believe deflation is going to become a serious menace on a global scale.

Let’s first take a moment and explain deflation. In simple terms, deflation is a decrease in the money supply. As the money supply shrinks, money becomes scarce which causes its value to rise in real terms. The same amount of money is now able to buy more and more goods as people put off buying in anticipation of even lower prices ahead. This sort of sentiment plays havoc on consumer spending and corporate profitability. Business suffers immensely as consumers cut back on their spending and start saving. In order to survive, companies are forced to lay-off more workers which further adds fuel to the fire. In deflation, debt becomes extremely hard to service. To put it simply, deflation is the biggest nightmare any country can face - Japan anyone? The Fed is well aware of this problem and (led by Greenie) it is fighting deflation with all its might!!!

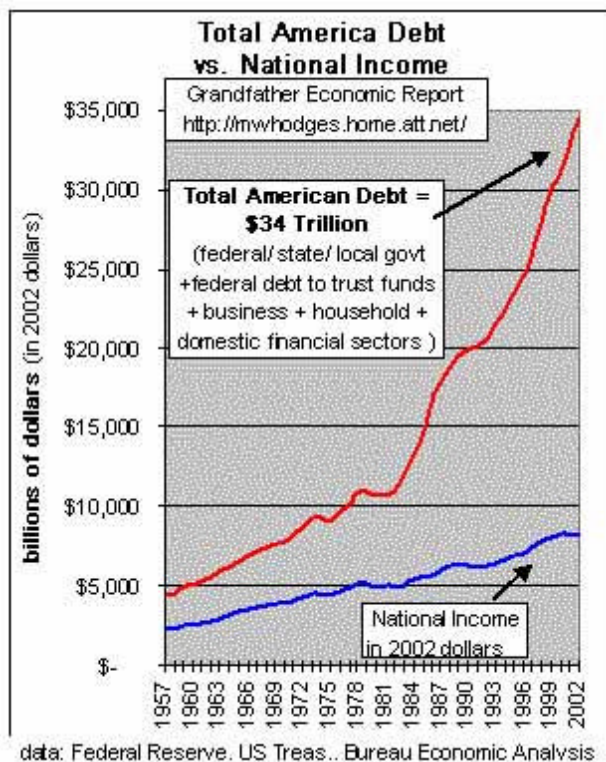
**FED & INFLATION** – Back in November 2000, I had clearly stated that I strongly felt the US would eventually face “Japanese style” deflation. I had also mentioned that the Fed would fight deflation with its entire ammunition. Over the past 29 months, the Fed has done exactly that! By lowering interest rates to a 40-year low, it has encouraged both consumers and companies to borrow. The Fed motto – “Carry on borrowing and spending

brother, just keep increasing the money supply”!!! In all honesty, the Fed has done a great job trying to re-inflate the US economy. Over the past 2 weeks, US money supply (M-3) has increased by US\$ 83 billion. At this pace money supply is increasing by US\$2.1 trillion a year...With total M-3 at \$8.67 trillion, Greenie is now increasing the broad money supply at a mind-blowing annualized rate of almost 25%! No question, Greenie is winning the inflationary battle now, but trouble may lie ahead.

Today we have the world's second and third largest economies, Japan and Germany, in recession -- and the US on the verge of deflation. The central banks of the world have only one solution -- inflate, drop interest rates, and inflate some more.

So what have the frantic inflationary efforts of the Fed done? They have created a housing bubble in the US. Cheap mortgage rates, easy credit and unbelievably good refinancing deals have lured investors to park their life savings in property. The new mantra – Property prices never go down! Unfortunately, all bubbles eventually burst and when the housing bubble bursts, it will not be a pretty pop!

**QUESTION** -So why do we think deflation is around the corner?



**ANSWER** – Asia (China?) is exporting deflation to the Western World. Due to its low cost of production and cheap labour, China is able to produce goods at incredibly low prices. China then sells these goods to developed nations. In a nutshell, China is killing the developed economies and their manufactures have totally lost their pricing power. This has forced US manufacturers to transfer billions of dollars worth of manufacturing facilities overseas while at the same time firing thousands of US workers. These are not just jobs temporarily shut down, they are jobs that are permanently lost.

Overcapacity is a serious problem. The US is currently using less than 75% of its production capacity. Historically, the long-term average is 82%. There is little incentive for companies to invest in new production lines when they can meet consumer demand now with their existing facilities. This will seriously continue to hamper new investment/spending by companies over the foreseeable future.

Internet- The great invention continues to cause serious problems for the world economy. Now, at the click of a button, consumers are able to compare the prices offered by

numerous discount stores. They are then free to buy from the cheapest store. This “convenience” is highly deflationary as manufacturers can’t afford to raise prices.

The US faces mountains of debt. Every section of the US economy is upto it’s eyeballs in debt. The total debt is close to US\$ 34 trillion!!! Yes, that’s around 350% of annual GDP! Houston we have a problem - This debt has to be serviced and ultimately paid off. As more and more qualified Americans continue to lose their jobs to the “cheaper” Asian work force, the US will have a real “income squeeze”. When this happens, it will be like your shoe coming down hard on an overripe tomato. In simple terms, it will be messy!

Interest rates have been pulled down and down, the money supply has been blown up. But what if the banks can't find borrowers, and what if manufacturers are already producing too much in the way of goods, and what if manufacturers don't want to borrow and what if commercial and industrial loans keep sinking (which they are)?

Well if all the above materializes (and it is), then money turnover or velocity sinks and it becomes almost impossible to "re-inflate" the economy. Just a thought, just a thought!

**BACK TO THE MARKETS** –Over the past 2 months the market has rallied and analysts are now convinced that a new bull-market has begun. This in the face of the S&P 500 selling at 34 times earnings, this in the face of US stocks throwing off a miniscule yield of 1.76%, this in the face of constant investor bullishness and optimism. We have covered this on many occasions, but for the sake of our new readers we will go through this again –

We expect a new bull-market to begin with the S&P 500 selling at P/E ratios below 10.  
We expect a new bull-market to begin with US stocks yielding more than 5%.  
Close to the final bottom, we expect black pessimism amongst the investing public.

Based on the above criteria we couldn’t be further away from the final bottom.

We are still in a primary bear-market, we know that. What we don’t know is the path this market will take in order to get to its ultimate bear-market low. Based on the market action of the past 2 months, the market is now overbought, we know that. This market, like all other markets will correct and we know that. How big a correction? We don’t know that. We expect the correction to start fairly quickly – very likely within a week.

We closely follow a contrary indicator which shows the percentage of bullish advisers as well as the percentage of bearish advisers. Now, we have a very wide spread between bullish advisers and bearish advisers with bullish advisers above 55% and bearish advisers down in the mid 20s. This just shows that most advisers/investors are now positioned for advancing stock prices. There seems to be too much complacency and optimism on the part of advisers. Time to be careful, super careful!

**GOLD & DOLLAR** – This from last month’s report - “Yes, we still believe that the bull-market in gold is still intact. No doubt that gold has been in a severe decline over the past 2 months, but this is normal healthy correction in any bull-market. Utilise such declines and add to your positions.”

There is only one bull-market at present and it is the bull-market in gold. Like it or not, but gold is still in the early stages of its bull-market Over the past month gold has risen from \$332/ounce to \$359/ounce. Gold is now looking overbought over the short-term and we expect a mild correction over the coming days. Utilise such weaknesses and add to your positions.

Remember, gold is real money and its supply can’t be manipulated by central banks around the world. Several paper currencies have come and gone but the yellow metal has been around for 5, 000 years. With the Fed pumping the system with more and more worthless dollars every day, gold can only go up over time. Every investor “should” hold at least 15% of his/her portfolio in gold. And, don’t look at actively trading, just let the bull-market do all the work for you.

We have been bearish about the US dollar over the past 18 months. The dollar is in a freefall and is declining severely against all major currencies. There’s no surprise here, just take a look at US trade deficit which is close to USD 500 billion per annum. There is no doubt in our minds that the US dollar is indeed in a long-term bear market. A word of caution though – the dollar may be getting close to an important intermediate-term low. Once such a low is in place, we can expect the dollar to rally for 3-4 months. There is no way of telling how long such a bear-market rally will last or how high the dollar will go. However, once this bear-market rally is over, we expect the dollar to drop to considerably lower levels against the Euro.

Bridgewater is an SFC registered independent investment adviser. The directors have gained over 33 years experience in the financial services industry.

**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](mailto:contact@bridge-water.com) or please phone us in order to arrange a meeting. Until next month, Goodbye and Good Luck!