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DIAGNOSIS - MAD BULL DISEASE!!!

THE PICTURE – Contrary to our own belief, last year turned out to be a whopper for global stock markets. The bulls largely ignored economic issues and celebrated in style. The bear decided to take a rest after 3 years of hard work. So, is the grizzly dead or is he simply doing what he is best at - luring investors back into the market?

Let's not kid ourselves – this stock market advance is nothing more than a liquidity induced rally. The economic "recovery" has been generated on the back of the greatest show of monetary inflation this world has ever seen. Money supply across the globe is rising at a frightening pace. This excessive production of money is putting immense downward pressure on its value. As the value of money declines, asset prices continue to surge. Stocks, commodities, metals and real estate are all soaring! Somewhere ahead, this party will come to an abrupt end. Just like you can't keep a patient on painkillers forever, you simply can't have a sustainable recovery with artificial stimulus. Sure, the stimulus may work for some time but if you really want to cure the patient, the underlying problem has to be addressed. Until now, the US administration has been more concerned about "keeping the party going". After all, this is an election year and the only way Bush & Co. can retain power is by inflating the economy. American leaders and bankers have decided to DELAY the outcome – for now that is! Make no mistake though - ultimately, this bear market will fully express itself and all the problems which plague the economy will surface like open wounds. But for now, let's carry on partying fellas...

In this business, objectivity is essential for one's survivial. So let's try and make sense of what's happening around the globe. The US, which also happens to be the world's growth engine, continues to plunge deeper into debt. Its total debt has now ballooned to US$ 34 trillion which is roughly 3 times its annual GDP. For the first time in its history, consumer debt now exceeds the total after-tax annual income. To make matters worse, the American government's unfunded liabilities (mainly social security and medicare) have soared to US$ 44 trillion. The stark reality is that this debt has to be serviced and ultimately paid-off. Record-low interest rates may provide temporary relief in the form of reduced repayments, but it won't help in getting rid of the problem. The US government is also running a huge budget deficit of roughly US$ 500 billion

– Bush & Co. continue to spend like there's no tomorrow. Despite these huge debts and deficits, last week we heard that the US is going to spend even more as it plans to send a human to Mars!

So you have to ask yourself the following question - "How is the US going to finance these debts and deficits?" Only one logical answer comes to mind - these debts and overspending will be financed by the creation of trillions and trillions of additional dollars. Remember, money creation makes debt less formidable in real-terms. As the Fed continues to pump the system with evergrowing quantities of money, gold - real wealth, will continue to soar.

STOCKS & SENTIMENT – The current rally began with the current price earnings ratio on the S&P 500 at near 28. Every major bull market move of the past has begun with price earnings ratios well under 10. This rally began with the S&P 500 dividend yield at 1.96%. Historically, major bull market advances have begun with the price earnings ratios and the dividend yields being roughly equal. At the 1932 low, the price earnings ratio was roughly 10 and the yield was 10.5%. In 1942, the price earnings ratio was 7.3 while the yield was 8.71% and in 1974 the price earnings ratio was 7.24 while the yield was 5.9%.

This rally began with bullish sentiment readings over 50 percent. Now, we do not have sentiment data going back to 1932, but I can tell you that at the 1974 low, the Investors Intelligence sentiment reading had been below 50 percent for 32 straight weeks. To put it simply – when the market was forming a genuine long-lasting bottom in 1974, the majority of advisers were predominantly bearish. Turn to the current scenario and you'll find that the Investors Intelligence sentiment readings show that over 70 percent of advisers have been bullish for exactly 32 straight weeks. This has NEVER happened in the history of this data going back to 1969. The greatest bull market of all-time ran from 1974 to 2000 and pushed the DJIA up over 10,000 points and NEVER produced this kind of sentiment. Yet, the greatest bear market of all time rolls along and this bear-market rally has managed to produce more bullish sentiment than the entire preceding bull market! What this means is that most investors were afraid as the real bull market climbed the wall of worry. Now, when the real bear market finally comes along, investors are convinced we are in a new bull-market and thus, they have no fear.

It is clear that this isn't a "long-term buy and hold" type of market. Why? Because stocks are selling at ridiculously high valuations, this in the face of the largest deficits and debt any industrialized nation has ever seen! How much further will this market rise? Quite frankly, there is simply no way of knowing. Both the extent and duration of any move can't be predicted in advance. What we do know is that this is a momentum driven market which is being pushed higher by reckless speculation. How do we know if speculation is rampant? Well, all you have to do is take a look at the NYSE margin debt levels. After taking a severe blow between 2000 and 2002, margin debt as represented on the NYSE, now exceeds its 2000-highs. What this shows is that (after licking their wounds) investors have once again started taking risk. History has shown that the majority of investors have always taken on risk at the worst possible time – a sobering thought indeed! We expect the market to continue higher over the coming weeks, however (once a top is in place) you can expect to see some major fireworks to the downside.

COMMODITIES & GOLD – Our clients and long-term readers know that we've been advising positions in gold and precious metals for over 2 years now. This has turned out to be a profitable strategy. Both gold bullion and gold/precious metal funds have registered some astonishing gains. Those who took our advice and acted early are now sitting on huge profits. We still believe we're in the early stages of a multi-year bull-market. If you're having any doubts, simply ask your friends and relatives whether they've got any positions in this sector. The great majority's answer will be negative and this will be your biggest confirmation. As the public continues to ignore and even mistrust this bull-market, sophisticated and seasoned investors continue to accumulate their holdings at what we call "basement prices". How else do you explain gold and silver's mighty rise? There's no question that gold remains undervalued on a historical basis, however silver is even more depressed. Over the past few years, gold has outperformed silver, however recently this trend has changed. Take a look at the Silver/Gold ratio chart below. Since Nov '03, Silver has been outperforming gold. We believe this trend will continue over the coming months but both metals will continue their slow but steady ascent.

How far will gold rise and how should you position yourself? To be honest, it is impossible to make an accurate prediction and much will depend on the state of the world economy over the coming months and years. However, both gold and silver are in a primary bull-market, which like all other previous bull-markets, will end in mass euphoria and complete public involvement. In the meantime, investors are advised to build a position they are comfortable with. Simply decide on a proportion of your total assets you want to commit to this sector, accumulate your positions and then simply sit tight. Short-term trading/market timing is extremely difficult and its best to leave that to the pros. Treat your gold and silver positions as an insurance policy against a faltering financial system. Ignore the daily “noise” and focus on the big picture.

A word of caution – Both gold and silver have enjoyed an amazing run of late and a short-term correction is very likely. Utilise any temporary weakness to build or add to your positions. Similarly, the US dollar has had a relentless decline over the past 4 months and we may get a rally from the present oversold conditions.

INVESTMENT STRATEGY – US and European stocks are grossly overvalued and cash offers a miniscule return. So where should you put your money? Investors may want to consider allocating their portfolios to gold/silver/precious metals, cautious hedge funds denominated in foreign currencies with a sprinkling of select Asian equities. This portfolio may not produce gravity-defying returns, but hey! – you'll get to sleep nights and nothing beats a good night's sleep!

This report does not constitute a recommendation to buy any of the discussed investments. Bridgewater will not be responsible for any investment decision based purely on opinions expressed in this publication. We strongly advise that you arrange a non-obligatory meeting with our team of specialist advisers to fully understand each strategy before investing. 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!