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By John Mauldin

This week I probably read over 300 pages of reports, stories, newsletters and such on the economy and investing. Each of those articles is like a single thread in a tapestry. Focusing on just a few threads can give you a very incomplete picture. On e-letter writing day, I try to drop back and describe to you what the actual picture in the tapestry looks like. This week, I need to chronicle some important changes that are happening in our world picture. We are going to look at the world economy and what may be a surprising (and potentially profitable) prediction about the future of the dollar.

I am not going to list the good news/bad news of the last week. It would make this letter much too long. So, let's go to the dollar and then to inflation/deflation.

Long time readers know that I am a great fan of Greg Weldon, an independent research analyst and writer who lives on the beach on Long Island. Every morning, he gets his 6' 10" body out of bed at 2 AM to begin to digest the news from overseas, review economic data and to write four newsletters. Often he writes over 20 pages in one day. By the time I get to my office, I usually have 2 if not 3 of those letters on an amazingly wide variety of topics. He writes different letters focusing on metals, currencies, the international scene and a global macro report, all of which I find useful. As a commodities trader, he frequently makes suggestions for useful trades. His service is $400 per month. He gets read by many major groups, and sometimes I can spot his research in other articles who fail to cite him. You can get one month free by emailing him at gregory.weldon@verizon.net . (I get no commissions for this, but next time I am in New York, it will be his turn to buy dinner.)

This week he has been on a roll. He has given me a lot to think about, especially as I read other sources and see the correlation with his research. For the rest of this letter, if I do not specifically quote another source, assume any data is from him. (The conclusions are mine, so you can't blame him later if I am wrong, although we agree on many things.) We are going to first visit the forces acting on the dollar and then we are going to look at "future inflation".

Off to the Devaluation Raceway

Let's start with a direct quote: "In fact, the VERY LATEST data on global trade provides HARD evidence to support our claims (of a global trade recession which he has been documenting for a long time - JFM). Within today's US trade data, we note the year-year changes posted for US imports from the Far East during May —-

— China … down 1.2% … vs. up 8.6% April … and up 18.2% March
— Korea … down 11.4% … vs. down 4.7% April … down 0.1% in March
— Hong Kong … down 17.6% … vs. down 9.5% … down 5.6% in March
— Taiwan … down 19.2% … vs. down 8.2% April … up 0.2% in March
— Singapore … down 15.5% … vs. down 6.9% … and down 6.6% in March

This is a global trade recession … case closed … if not something more severe in the making."

This week, the headlines were trumpeting the "good news" that the trade deficit has narrowed. But what you didn't read were the above statistics. If you are one of the Asian countries above, our reduction in imports is a disaster. Even Japan has shown the lowest exports to the US in years.

So what are these countries doing to try and sell more products to the US? They are aggressively devaluing their currencies against the dollar. Weldon calls it the Competitive Currency Devaluation Raceway and has been all over this story for over a year. As an example, Thailand, Korea, Singapore and Japan have all seen their currencies drop against the dollar. If you look at a two year comparison chart, when one country "gets ahead", the others race to devalue their currency so they do not lose a competitive edge.

Right now, Thailand, Singapore and Japan are all neck and neck (In NASCAR terms Greg tells us that is an exciting part of the race called "three-wide"), with Korea pulling up the rear.

Even with these countries products being much cheaper, US consumers are still buying less. That is hurting their stock markets. Weldon chronicles these year to date results for world stock markets:

— Hong Kong Hang Seng … down 27.6%
— India Sensex……… down 32.3%
— Japan Nikkei …… down 37.1%
— Singapore STI … down 34.2%
— Taiwan TWI …… down 50.4%
— Thailand SET … down 33.9%

— France CAC … down 18.4%
— Germany DAX … down 17.7%
— Spain General … down 20.4%
— Sweden SWI … down 20.4%
— UK FT-100 … down 22.3%

— Argentina Merval … down 40.9%
— Chile IPS …… down 26.1%
— Brazil Bovespa … down 19.3%
— US S+P 500 …… down 17.8%
— US NASDAQ … down 50.5%

Capacity utilization in the US is at a decade long low and showing no signs of improving. It is just as bad or worse in most of the rest of the world. World trade is slowing down and the US consumer is clearly beginning to buy less from overseas. That means there is a lot of manufacturing capability chasing fewer dollars.

That is why country after country, especially in Asia, is devaluing its currency in an effort to make their products and services cheaper relative to other countries so that they can attract business to keep their factories and production lines going.

That "race" has been partially responsible for keeping the dollar strong. Another part of the strength has been the need for countries to have dollars to buy OPEC oil. With oil so high, they have needed more and more dollars. Further, other countries have not been able to be as aggressive in cutting rates, thereby not stimulating their economies as Greenspan hopes to do with his rate cuts.

That lack of rate cutting ability has hurt the Euro. The European central bank has been worried about inflation and so has not cut rates in concert with the US. But Europe is clearly slowing down as well, so there is fear that without rate cuts, a real recession could develop in Europe, therefore the dollar is stronger as Europeans feel the US may rebound quicker.

Plus, as I wrote about several months ago, there is the coming currency swap in 2002 when all physical European currencies must be exchanged for the new Euro or become worthless. This one time event is creating a black market demand for dollars as those who hold large amounts of physical marks or francs or lira that they may not want to have their tax-hungry governments know about are scrambling to convert these currencies to dollars before the end of the year.

But with the European economy slowing and inflation pressures on the Continent receding, we should see the European central bank start cutting rates later this year. That should have a very positive affect on the Euro. And the "black market" pressures on the Euro will ease off after the drop dead date of February 28 rolls around.

Finally, there is reason to believe that oil prices, while not dropping back to the teens, may settle in the mid-$20's or slightly lower. That reduces the need for dollars.

Dollars to Euros to Won

So, what do we make of it? It is likely the dollar will drop against the Euro before the end of this year. That is actually good for most US companies.

But will Asian currencies go along? It certainly doesn't look that way today. I think they could keep up their efforts to keep their products attractive. Look to watch these currencies continue to drop.

So, the dollar stands to get weaker in terms of the Euro and stronger against Asian currencies. Futures traders can play this by going short the Korean won and long the Euro. Why Korea? Because their economy is weak and getting weaker and their currency is in "last place" on the race track. The charts say they will do their best to "catch up" .

I have a special place in my heart for Korea, as I have twin daughters from Korea who just turned 16 last month, but I fear Korea is in for an even rougher ride in the year ahead.

One more point. I do not expect any major 30% moves. The dollar and the euro should go back closer to parity. The Asian countries don't need to see that big a drop either.
So, visit Europe this fall and Asia next spring.

Inflation? What inflation?

One of my consistent themes for the last year or two has been the deflationary pressures alive in the world. That has been one of the main reasons Greenspan can grow the money supply at huge rates and not spur significant inflation.

As an example, too much excess manufacturing capacity means companies cannot raise prices and remain competitive. Especially when other countries devalue their currencies in conjunction with excess capacity, it puts huge price pressures on US manufacturers. Prices drop when you have too many goods chasing too few dollars.

From time to time, I get (mostly polite) letters asking me where is the deflation? This week, hidden in the details of various economic reports is the beginning of signs that we may in fact start to actually see some of that deflationary pressure in our prices.

Again, from Weldon (I saw these nowhere else in a group like this):

"Non-oil US Import prices dropped a sizable 0.4% in June … the FIFTH consecutive month the US has experienced 'imported' deflation. Indeed, even WITH oil, import prices dropped MORE steeply, down 0.5% for the month, **down every month save one,** (emphasis mine) since September.

"Further details of interest include —-

— Prices from the EU fell for the third time in four months
— prices of imported consumer goods … deflated 0.3%
— prices of imported capital goods … deflated for the tenth time in the last eleven months
— industrial supplies and materials fell a HUGE 1.1% for the month

Within the context of that final bullet, we note the DEFLATION so clearly evident in today's US-PPI data. PPI deflated by 0.4% in the month of June, the largest monthly decline in almost three years. While the record one-month 5.8% decline in natural gas prices … and the 3.7% plunge in gasoline prices, were of interest, we also note the 0.9% drop in prescription drug prices, the largest since Jan-99 … and … that computer prices plummeted 2.8%.

Yet … MORE important are the following PPI facts …

… Non-energy intermediate goods, year-year … a meager 0.3%
… Finished consumer goods yr-yr … 3.0%, down Big from May's 4.7%
… Non-food raw materials yr-yr … minus 7.2%, down from plus 17.7%

A MAJOR swing on that last one … similar to the swing in Energy, which flip-flopped from a 31.3% rate of yr-yr inflation in May, to a minus 5.7% in June."

Space does not allow (maybe next week) but the increasingly serious world wide debt problem has the potential to be very deflationary. This is one of the problems that I hear bumping about in my worry closet at night.

What's the point? Manufacturing capacity utilization is very low both at home and abroad. Therefore, companies are having trouble raising prices. Commodity prices such as copper, zinc and nickel are low. Kevin Klombies writes that the costs for ocean shipping are dropping through the floor. World concrete prices? Aluminum? Steel? Computers? Cars? Etc.?

The price forces that will show up in future inflation numbers are dropping. I know the bond vigilantes are trying to find inflation lurking around every corner. But "around the corner" I see lower inflation.

Couple that with a slowing economy and that is a good environment for bonds. Even if the dollar drops against the Euro, which would normally be bad for bonds, that should be offset by dollar strength against other currencies.

Target 2025 up 13% for the Last 3 Months

And, voila, we are beginning to see bonds move in our direction. After a frustrating first quarter, my favorite bond fund, Target 2025 (BTTRX) is up 13.4% for the last 3 months, and back to only down 1% for the year, after posting 30% gains last year.

Don Peters, my recommended bond timing manager and interest rate guru is looking for a much larger move by the end of this year. Don is in the top 1% of all bond managers in the country for the last 25, 20, 15, 10 and 5 years. If you would be interested in Don managing some of your portfolio (as he does for me) drop me an email with your name, address and phone number and I will send you his track record and a special cassette tape interview I recently did with Don.

Junk Bonds are Still Nuclear Waste

Junk bonds are still nuclear waste. I manage a high yield (junk bond) timing program, so I track these instruments quite regularly. Long time readers know one of the signs I look for to tell me the recession is at the bottom is a recovery in junk bonds. The bond fund I follow, Federated High Yield, (FHIIX) is down over 8% since this time last year. We have

been in cash or another special index fund waiting for junk bonds to turn around. After the last recession, high yield bonds bounced over 70% in three years.

But nothing in the prices says we are near a bottom. So we wait. And watch.

Investor Sentiment

We track positive dollar flow for all NYSE and AMEX stocks. We think of that as investor sentiment. Sometimes you can see some trends which are quite helpful.

The divergence in investor sentiment between the largest institutions and mutual funds is starting to be pronounced. The "Big Boys" were typically 21% of the market trades last year. Now they are only 15-16%. What remains is barely bullish.

On the other hand, the portion of the market that is typically mutual funds has taken up the slack and is very bullish.

If the mutual fund investor ever gets bearish, this market is going to drop and drop fast. On the other hand, if they keep the faith, the market is likely to at least stay in a trading range, and not suffer the average 40% drop we see in recessions. Lately, the dollar inflows to equity mutual funds has been slowing, if not negative. Trimtabs tells us that "U.S. equity funds had redemptions estimated at $2.0 billion in the three days ending Thursday, July 12, for a monthly rate of $14 billion. For all equity funds, m-t-d losses amount to $11.2 billion."

How long will the market hold up if this continues?

Let's leave on a positive note.

As noted, the rest of the world is slipping into recession. This is certainly not good for the US, but it is not as bad you might think at first blush.

The US economic machine is amazing. Our businesses are the best run in the world. Our entrepreneurial management does respond faster than that of other countries. Our infrastructure is the best.

I do not think we are headed for a deep prolonged recession. It may even be quite "mild", as these things go.(Unless it is your job, then it is a depression.)

We will recover faster than most bearish commentators think. Interest rate cuts do matter. As it becomes apparent that inflation is not in the pipeline, long term rates will drop. I continue to think I will get to execute a 30 year mortgage in the 5% range in the next few years.

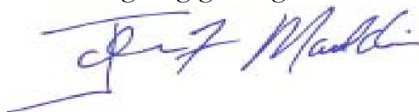
This will be an enormous stimulant to the housing industry and personal consumption as consumers will all have more money each month after they make their house payments. New manufacturing technology is constantly lowering our cost of production and keeping us competitive. New industries we had not even dreamed of 10 years ago will keep employment robust.

I am very optimistic about the long term future. I think we will get back to modest growth next year, and in a year or two 3-4% annual growth is entirely possible.

As we grow, we will pull the world back into growth. If we can avoid the twin demons of trade wars in a recession and growing taxes from our governments, we will find lots of opportunities in the coming decade. I will enjoy writing positive about something besides bonds. Bonds have been good to me, but they are boring to write about.

Enjoy your week. I will be doing my e-letter next Thursday, as I am going to drop down to Puerto Vallarta to spend a long weekend with my wife, who will already be there. I get to "bach it" next week, which really means I will work late most nights. I am trying to get a new fund ready, and am working on a new book project. I am negotiating with publishers to write a popular book on hedge funds. Most books, and there are very few, on hedge funds are very technical, boring and useless. The thrust will be to show investors of all types how they can find, evaluate and invest in hedge funds. Much of the research is done. I am excited about the project and hope to finish it by the end of this year.

Your going golfing with his son tomorrow morning analyst,



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