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This week we will start with a letter from a reader who asks an important question that is on your mind (not to mention mine). From there we will piece together some odd bits of data, some of which I picked up from the hedge fund conference I attended in Bermuda and see what type of forest we are wandering around in.

The Question of the Day

Fellow wanderer Sam Lee writes: "…I think that you are in a zone like Prechter was for a while in the late 80's. Every good hitter has his hot streaks, and I'm betting that you are on one now. The main thing that worries me about you is that you are married to certain indicators and from time to time indicators have all failed-p/e, p/d, trend lines, non conformations, a/d ratios, new highs vs new lows, volume indicators- I mean if there were 1 or 2 or 3 that were infallible then everyone would follow them and get rich.

"So tell me why I am wrong. Why will your indicators be correct and all the bulls in Barron's be wrong?"

This is a question I worry about every day. I know it will be a matter of time before I miss a major call. That is part of the business. I have seen to many writers get hot and then go down in flames to get too cocky. They key is to admit it as soon as possible instead of being stubborn. It is why I read and study so much. Because one day the trends will change, and reliance upon just one trend or even a few trends will eventually get you in trouble. It is why I like to drop back and look at patterns in which I can discern some currently macro-economic rational basis.

Let's take the Three Amigos. Historically, they have been pretty good at calling economic bottoms. That is because those indicators are directly tied to economic performance. Generally, the stock market also bottoms about that time. But will they this time?

I can think of one good reason why they won't. For the last 18 years, investors have been taught to "buy the dips". I think that is what is happening now. Let's say the economy and the Three Amigos start to turn around in December, in advance of my current predictions. It is quite possible that the market will have not gone back down to test new lows in the next month ("We" continue to buy the dips.). As investors begin to come back into the market in December with the comfort that the economy is on the rebound, the market just continues to go up. As usual, there will be some turbulence, but the markets at that point would be unlikely to go back down to test September lows.

So why am I not jumping back in the market now? Because, as we will see, this economy is not yet on a rebound, and there is considerable concern, at least in my mind, that it will be able to rebound in the next month or so. At some point, the economy has to confirm this market rebound. If it does not, I would think the market will go back down.

But my internal data says investor psychology/sentiment is in new territory. My logic may not be the prevailing thought.

I could very well miss a 5% or more run in the markets. But I think the risk is a lot more than 5%. I would rather wait and be cautious. Experience has taught me there will always be another deal if I miss this one. Further, if another bull market starts, then missing the first few points will not be that big a deal in a year or two, except for bragging rights.

Secondly, Sam, most of the indicators you mention above are measures of the market itself. I readily admit these are patently unreliable indicators. It is like predicting the future speed of a car by measuring various factors that are derived from the speed of the car itself.

It is only when you know the nature of the driver, where the car is going and what type of roads the car is on that you can predict the speed of the car.

In the short term, the technical indicators can be useful as there are patterns in them, but they tell you nothing about the long term direction of the markets. The only indicator you mention I find useful for the longer term is P/E ratios, and that ratio is not very useful for the short term.

P/E ratios are useful, because they contain a measure of the economy: earnings. Ultimately, earnings do drive the market. P/E ratios are not useful short term predictors, but over a period of many years they have shown to be very reliable. P/E ratios always return to trend. There are a number of reasons for this, which I will not go into here. While it may take years for the trend to assert itself, fighting the trend is ultimately pointless.

My belief is that, in general, **when the economy is growing** I want to have an allocation of some part of the stock market in my portfolio. What percentage is right for any one person depends upon individual needs. There is no one size fits all. Remember, we can look to the yield curve to give us some warning for major bear markets and crashes. So far, it has been 100% spot on. Will it be wrong some day? Probably. Do I want to fight a 100% (so far) indicator? Not with my money, or yours.

Unfortunately, the yield curve is not very useful for telling us when to get back into the market

When it is time to be in the stock market, I choose what area (mid-cap, value, growth, etc.) of the stock market to be in by looking at the current conditions. Some years it will be growth stocks and some years it will be value. Sometimes it will be large caps and sometimes it will be small caps. I use historical trends to ascertain my allocation.

That does not keep me from having some volatility in my portfolio, but the trend and the economy will be in my favor.

The mistake I am most likely to make is to be too cautious about getting back into the stock market. There, I said it and now I feel better.

The Bermuda Triangle

One of the more brilliant minds in the economic world is Martin Barnes of Bank Credit Analyst. I am a big fan.I consider myself fortunate to have been able to spend some time with him last week. I will give you a brief synopsis of his presentation.

His biggest concern is unemployment, as employment and consumer confidence have a direct connection. " Lower equity prices have dealt a major blow to household net worth. The ratio of net

worth to income is back to 1997 first quarter levels and the drop in net worth has exceeded that of any or recession in the post WWII period. This adds to the case for a spending retrenchment." (Major comment on that later.)

His charts showed, contrary to the cheerleaders on TV and in Barron's, that the ratio of information technology inventory to actual shipments is continuing to rise. He thinks they have not hit bottom. "The weak profit picture implies more cutbacks to capital spending."

"US Imports have already declined at an 18% annualized pace in the six months ended July." The picture will not get any better this quarter.

That being said, he does not expect a serious recession, and he finds no evidence debt has reached a crisis level. The ratio of total non-financial debt to GDP has shown little change since the mid-1980s The high level of debt is generally the one specter that the most ardent bears cite as a reason for a coming depression. He does note that non-federal debt is at an all-time high relative to GDP.

He does make one somewhat positive observation I have seen nowhere else. Much of the excess capacity build-up in the last few years has been in information technology. "Regular" manufacturing has not been nearly as aggressive. Long story short, a recovery in the non-tech sectors will probably happen sooner. The non-tech area is a much larger part of the economy.

Interestingly, he closed with the point that that he does not see much capital gains potential in bonds but he wants to own a lot of bonds. He wants to wait until January or February to see what the stock market does. He would rather be late than get in too early.

Is Deflation a Threat?

His short answer: "It could be, but the Fed will not let that happen. They can create inflation if they want to."

I was surprised at his serious public denunciation of the Japanese government. Privately, he agreed with me they were a disaster. But his public term for their central bank was "economic nuthouse". (More later.)

And finally, he is confident the economy will turn because it always does. But when asked by your brazen analyst what would be the spark that ignites our economy in the light of a global world recession and deflation, he didn't really have an answer.

Dragging the World Down

Some of you ask why I write about Japan so much. The simple reason is that they are the world's second largest economy. What happens to them will effect us. Let me give you an example.

The "call rate" in Japan (what banks charge each other to borrow money overnight) is.001%. That is 1/1000th of 1 percent. **Essentially, it is free money. But the Wall Street Journal in a great lead article on Thursday documents clearly how Japanese banks cannot get their best customers to borrow money. They stubbornly insist on paying back loans. Outstanding bank loans have fallen for 45 straight months by an amount that is more than Canada's total annual output.**

This is called a liquidity trap and is a major problem. When economists talk about pushing on a string, this is the phenomenon they are talking about. You and I cannot imagine not borrowing money at 1%. We would just ell out banker to back up the truck and give us all he could. But if

prices are dropping faster than 1%, then you wait to buy. If your land and home value is dropping, you get nervous. You want cash. Bank deposits have risen by $78 billion in Japan, although rates there for savings accounts are only .2%,which means it takes 3,500 years for your money to double. That is why so much money is leaving Japan.

Only 9% of businesses in one survey planned to borrow money. Much of the borrowing that is done is to invest overseas.

Last week, I sat in an office and listened in amazement as a Bermudian insurance agent showed me the most amazing numbers. He had a wealthy US client who was planning to borrow $5 million from a Bermuda bank at 1%. The loan was denominated in yen. The bank was only paying .1% for the money from a Japanese bank. He would then use the proceeds to buy a life insurance policy which would pay a much higher fixed rate for – get this — $25 million. The policy would pay off the loan over time. He was putting up $1,000,000 in cash plus guaranteeing the yen value of the loan. His only real risk was the dollar falling against the yen, which I assume he will hedge out.

For $1 million and some risk he creates an estate of $25 million for his family and heirs, all because he can get 1% money.

Japanese consumer confidence is at an all time low. Greg Weldon notes that Japanese imports have declined for the first time in three years. Their exports are in double digit decline.

The WSJ talks about one middle class couple, presumably now typical in Japan, that instead of using tap water for their garden uses bath water and water hauled from a nearby stream to save money. They are saving every penny they can for retirement, and now expect no growth in their money from the bank or the stock market. Think about that. They have to save every penny they will need in the future, and they are behind schedule.

What if you felt you could not count on a reasonable return on your investments for your retirement? We all plan on 8% on 10% as "reasonable". So did the Japanese a few years ago. Now, they consume less and less today in an effort to be sure they can live somewhat comfortably in the future.

That is what deflation does. What will happen to consumer patterns (and the economy) here and in the world if we ever start to think we will not get a 15% long term return on our money? Or 10%? Or what about 5%?

We stop borrowing and pay down loans. We save more. And that is when we start talking about "liquidity traps" in the US.

That is why Martin Barnes and others talk about an "economic nuthouse". Ultimately, I agree with Barnes. The Fed will not allow deflation for any length of time. They will inflate, because the alternative is too damn scary. Right now, they are not in a panic. They are trying to get the economy going again without creating inflation. But they will risk it if they have to. But they can let long term rates drop a lot more in the process.

What will the Japanese do? They have dropped rates as low as possible, and nobody wants to borrow money. The only thing they can do is destroy their currency in an effort to re-inflate. They will buy dollars and euros. The yen is going down, down, down.

Other Economic News

Sales of existing homes dropped 11.7%. Last week, the number of people applying for a mortgage to buy a house fell to its lowest level since last year.

The Meyers Group says "Unsold existing home inventory rose 13% during the month to 5.4 months of supply. We expect unsold existing home inventory to continue to rise because buyers are more likely to offer prices that are less than the asking price."

They state there is a consensus among homebuilders that "Job losses will grow and housing sales will slow until February or March. Activity in April and May will determine whether the recovery is likely to be quick or slow."

Greg Weldon delves into the National Association of Realtors and notes that "In other words, the median sales price of an existing home in the US has fallen by $6,600 in just the last two months." He also writes that the inventory of unsold homes has risen by 17% over the last year even though mortgage rates have dropped 1% in that time. That is not a good trend as we are all taught that falling rates are supposed to stop that type of thing.

U.S. corporate earnings tumbled for a third straight quarter by 21.2% as a slump in computer-related sales deepened and consumers spent less. Many analysts and investors are now predicting earnings declines through the first quarter of 2002. The last time earnings fell five straight quarters was in 1969-70, according to Thomson Financial/First Call.

Jobless claims are now over 500,000 per week and are at levels not seen since 1992. "There will be further rounds of layoffs," predicted Michael K. Evans, the chief economist of the American Economics Group.

" We are in a global, synchronized recession," said Lakshman Achuthan, the managing director of the Economic Cycle Research Institute in New York. "Those are really hard to get out of," Mr. Achuthan added, because companies cannot shift their resources to economies that are still growing. The last recession to be so widespread occurred in the mid-1970's and lasted for almost a year and a half." (NY Times)

I will close with one final quote from Greg Weldon's latest bulletin. He writes 3-4 newsletters a day. His newsletter is the single most valuable information source I know of. It is pricey, at $400 per month, but if you are a serious trader, investment analyst or major business, it is worth it. You can get a free trial sample by writing him at gregory.weldon@verizon.net. Tell him I sent you.

Now to his quote. He is making a case for the continued rise in bonds and that the current stock market rise is a bear market rally:

"Consider the following … extracted from, 'the week that just was' —-
— New LOW price for industrial metals, like copper, nickel, and aluminum
— New LOW price for other industrial commodities, like cotton and rubber
— STEEP sell off in Gold
— NEW LOW in US industrial economy
— NEW LOW in Singapore Industrial economy
— NEW LOW in Singapore Dollar
— NEW LOW in Hong Kong trade
— NEW LOW in global trade
— SHARP slide in US bank shares
— NEW LOW in US Railcar Loadings
— BREAKDOWN in US house prices
— COLLAPSE to NEW LOW in German Business Confidence

— NEW LOW in European credit creation
— MASSIVE Monthly DEFLATION in German State CPI
— NEW LOW in Italian Consumer Confidence
— NEW LOW in UK Export order books
— NEW LOW in Japanese Bank Index
— NEW LOW in Japanese income
— NEW LOW in Japanese consumption
— NEW LOW in Japanese confidence
— and of COURSE … NEW LOWS FOR BOND YIELDS."

He argues that the recent and massive surge in foreign investment in US bonds, especially from the Japanese ($28 billion in just the last 3 weeks), is providing liquidity to the US markets. We both agree that the world economy is accelerating to the downside and that central banks are clueless as to what to do, except to keep their currency weak against the dollar and hope the US consumer will return. I note that Martin Barnes was pessimistic about the dollar but even more pessimistic about the rest of the world.

Add in anthrax, Afghanistan and more economic uncertainty and you can see why I remain cautious about this stock market. I hear that bear market growling.

Afghanistan Update

Ed Artis and crew are now in Afghanistan. He is taking 60 tons of food into Jebul Seraj, a city only 40 miles from Kabul. He can buy and deliver a ton of food for only $1,000. If you are in the media, I can put you in touch with him by satellite phone. **They need more money, of course.** Winter is coming and he writes the situation is really desperate. Pray for this team, as I am sure they can hear the bombs from where they will soon be.

My middle son turns 13 today. He is the 6th of my children to do so, with only one more to get to that magical age. At the wise suggestion of my wife, I intend to give him money to start a savings account. Hopefully, we will figure out how he can grow his cash at better than 1%. Maybe that will encourage him to let up on me on the golf course tomorrow, but I doubt it.

Bermuda was beautiful. I love the island. You can stay at the SouthHampton Princess Resort (a Fairmont property) for 50% off this winter. There are a lot of good buys out there. I will be in New York Monday, November 5 somewhere in Mid-town if you would like to visit.

By the way, I read every letter sent to me, and try to answer as many as I can. I enjoy reading your comments. They mean a lot, and let me know what you want me to write about.

Your enjoying his bond position analyst,

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