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POLITICAL POSTURING FUNDAMENTAL FOOLERY TECHNICAL TREPIDATION

February 5, 2006

Nikkei: 16,659.64
*April 2003 low: 7,603.76

*- See March 31, May 3, & May 30, 2003 reports linked on homepage.

It has become very much the case that analysis of one asset class or sector, seems to blend in with that of another. Simply put, analysis found in any section below, could just as easily be properly expressed as research into another investment area, whether it be Japan, New York, gold or the currencies. For better or worse, the world is one. As a result, an investor whose focus is more one area than another will find additional coverage of his principal theme of interest in another section within this report.

JAPAN:

FUNDAMENTALS:

As so often forecast, the economy has now provided evidence that a cycle of substantial capital spending has arrived. Specifically, capital spending that leads directly to sales, which in turn boosts consumption, and subsequent improved employment…which in turn improves consumption, which confirms to corporations that they are right in remaining aggressive in their capital spending plans.

Real spending, in fact, was much stronger than anticipated last quarter, turning in a positive 3.2% performance! Meanwhile, the savings rate tanked to a level not seen since 1984, and the job offers ratio is the highest since 1992. Wages and full-time employment continue to increase. Winter bonuses rose 2.3% year-over-year, for the first such December increase in nine years.

To mark the death of deflation (more officially, for those who like to “wait for confirmation”), along with, capital spending, employment and spending indicator turnarounds, the consumer price index (CPI) is in an uptrend that even economists cannot deny (you know, the theorists who turn bullish after the market has doubled, because they were waiting for a particular indicator to make them feel good inside).

SKC identified the low in ALL these indicators at the economy’s lows. See online January 2002 letter, as well as those reports leading up to and following SKC’s officially declared low in the Japanese economy.

When SKC forecasted these events, such ideas weren’t even on the radar four years ago. Countless DDOVS were one-third their subsequent value, earlier this decade, and the Topix banking index also went on to approximately treble from its 2003 low, as well. Still, all anyone saw was everyone getting older and saving. Oh, the vicissitudes of being an economist.

In any event, on a regional basis, with China’s GDP on the rise, but its economy needing to shift from fixed-asset investment to consumption, Japanese companies whose businesses are Asian-based (DDOVS) will surely benefit.

At the same time, Japan seeks to have fifteen free-trade agreements in place by 2010. To appreciate the significance of all this, and the backdrop against which one ought to view these points, please note the comments that appear in the Gold & Dollar section, below.

Taxation:

The ruling party’s tax chairman is considering doubling the consumption tax from 5% to 10%, earlier than most (not us) thought, perhaps in 2007. As readers know, I have looked for this, as the tax will be aimed at dealing with social security concerns.

These reports have reflected the view that this will ultimately be viewed as bullish by the international community, as higher taxes deal with Japan's critical shortfalls. At first, however, the focus will be on lower growth and, as a result, a fundamental reason to sell the market, due to the lofty levels from which it does so. Then, once sufficiently corrected, the market will focus on how the same news item is bullish…and so it goes. Once, again, we're ahead of the curve. Taxes will have been a major theme.

From the December 21, 2005 yearend report:

"<u>Japan's national will supports the removal of the deficit. Therefore, higher taxes are bullish longer term, while providing an excuse for a potentially sharp intermediate term correction</u>."

<u>Liquidity</u>:

Guess what. The last time that investment trusts (mutual funds) had so much capital under management was when the Nikkei peaked at 39,000, sixteen years ago. Since Japanese domestic value stocks (DDOVS) bottomed relatively recently in 2000 and 2001, and since the Nikkei bottomed less than three years ago, we know that this secular bull market is very young and, in fact, should outlive anyone reading this. Let's consider these facts in the context of a cyclically peaking Nikkei, as was the case in December 1989, and we come back to the following excerpt from the December 21, 2005 yearend report.

"Like 2000, the money flow is to DDOVS in 2006, and, in relative terms, away from the Nikkei, which corrects at the same time as the Dow resumes its secular bear market. DDOVS offer far less risk and much greater reward potential. That's where liquidity will re-direct. Investors in DDOVS don't even need that much re-direction."

<u>Real Estate</u>:

Having identified Japanese real estate and property lows, and having made a particular issue of these at the April 2003 lows, due to SKC's forecasted tax changes, in anticipation of which, the condominium market did indeed rally significantly, there is a development at this time that one would be unwise to ignore.

In typically practical, sound and intelligent Japanese planning, elderly Japanese are being supported by the government in any effort to rent condominiums in metropolitan areas, while leasing out their own homes. The condo market has had a large increase in development and, simultaneously, families are finding it difficult to purchase homes that provide more space.

So, elderly, who now actually prefer less space, are being encouraged to lease their homes to families, while renting condos in large cities that more readily offer the services that they require anyway. To reflect the seriousness of this measure, the government is establishing a non-profit organization to help ensure that these moves occur.

One measure that the organization will provide is offering 80% of the proposed rent that an elderly person's home is to be rented for, if a family is not immediately available, so that the move into the condo can be expedited. This is good news for condo developers and property management firms. This action is swift, determined, and presents a clear opportunity for investment into still-undervalued issues, who maintain condo properties in metropolitan areas.

Stocks:

The "foreign hot-money is in neck-deep", as reported in the yearend letter. The Livedoor scandal caused a rush for the exits that was foreseeable after the earlier J-Com scandal. The Livedoor scandal wasn't foreseeable, of course, but foreign reaction was. This was the forecast in these pages after the J-Com scandal, as regards how foreigners would use such an event to panic. Simply, the over-invested foreigners all own the same stuff.

After the Livedoor-related Nikkei low, the shorts ran for cover to create this most recent rally, to very slight new highs in the index. But panic they had. The exchange had had to close for only the second time in its 52-year history.

The foreigner will not add to his large cap investments. In fact, as the Dow tanks, foreigners will withdraw capital from a market that they are not specifically mandated to be invested in. Domestic stocks, however, are another matter. Retail Japanese investors haven't even begun to invest, and are expected to come back in fuller force as yearend (March) approaches.

DDOVS are much higher, in general, than they were in 2000, but only because they corrected from profound undervaluation. That is why I warned, almost daily, that the easy money was about to be made. Now, however, the domestic economy-based (Asia-focused), domestic value stock bull market is set to begin.

CONCLUSION:

Large-cap multi-nationals are out. DDOVS are in.

NEW YORK:

FUNDAMENTALS:

Earnings declines and oil increases are precursors to the crash in consumer confidence (CC), which was only temporarily held up at yearend, erasing what would have been the quarterly reading. The intra-quarter reading that was erased did, nonetheless, show the levels to which it can fall...and just how quickly those readings can get there.

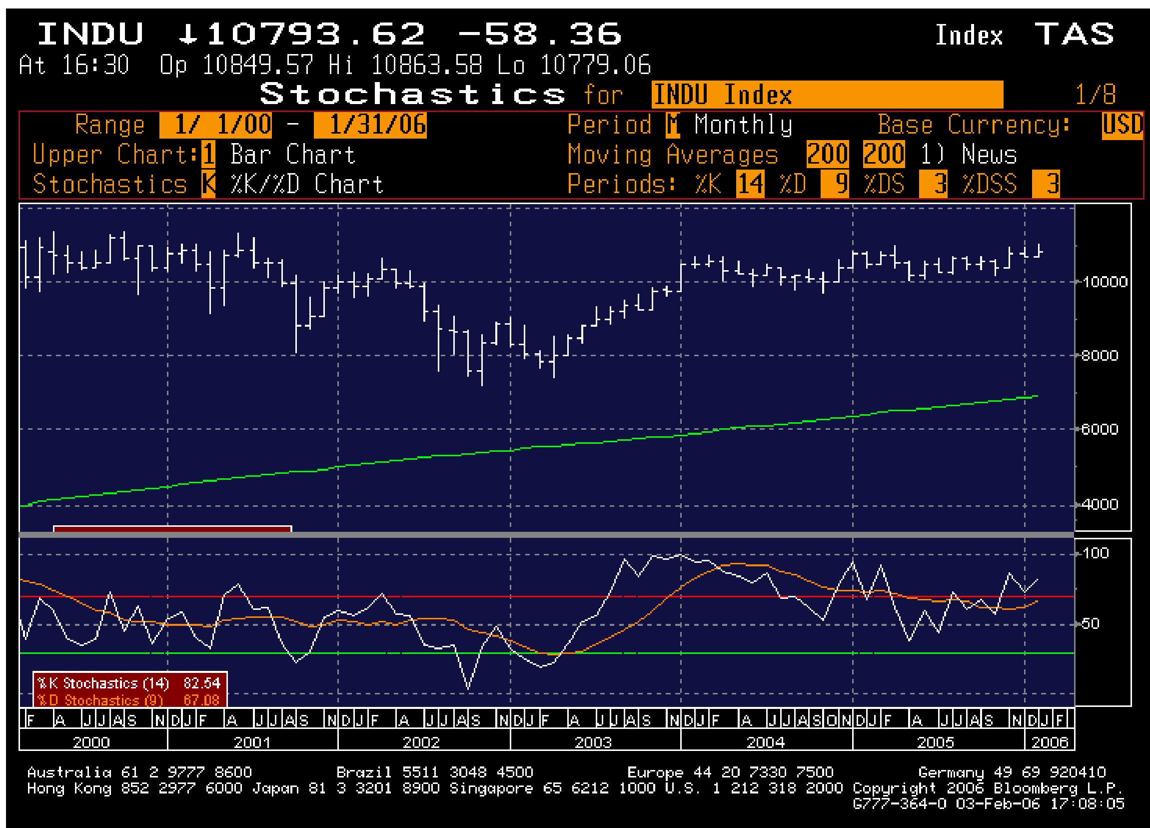
Please note the yearend report, which re-published the consumer confidence and consumer spending (CS) indicators. The combined indicator had harmonized with a Dow level somewhere between 7000 – 8000. So, with oil having seen a key low, with Christmas "denialism" and manipulation behind us, a very swift and stunningly fast return to the intra-fourth quarter levels here cited and previously twice published, is very possible (likely), which would correlate to the 2002 lows in the Dow here mentioned.

Meanwhile, the January 27 government report of dramatically slowing growth in the economy spells disaster for a Dow price-earnings-multiple of over 19, and such a report immediately goes to the heart of confidence and spending, as does any decline in corporate profits and increases in oil.

TECHNICAL:

Oxford defines trepidation as, "tremulous agitation." Let's examine some tremulous agitation in technical indicators of extreme importance.

Courtesy of Bloomberg (see page 6):



The above monthly chart and stochastic indicator reflect the most deadly of all divergences. Of course, I refer again to the much-dreaded triple divergence. A divergence occurs when the security or index makes a new high, while the indicator in question makes a lower high (the reverse holds true for bottoms). If there are three peaks with the indicator making lower highs at each point, a triple divergence is in place.

In this case, we are looking at a monthly Dow chart and its monthly stochastic. A monthly stochastic makes for a “heavy”, long term indicator. Such a signal, in other words, would be seen rarely, and only at extremely stretched points in market exaggeration. Today is a prime example, in terms of the Dow’s to-date non-responsiveness to waning and pathetic momentum.

As we can see above, in 2004, the high in the Dow occurred during the second month after the peak in the Dow’s monthly stochastic. In 2005, the Dow peaked in the third month following the high in the stochastic. We are presently in the third month after the recent high in the stochastic.

Moreover, I am very confident that, at the end of this month, when these points will next be plotted, that the stochastic will again be pointing down, as well.

To provide some additional sense of trepidation, please examine the expanded chart immediately below, which allows a greater look at what lies beneath today’s

Dow level, once the secular bear market resumes. If the chart were to go back to 1982 as opposed to just 1990, then the hankies would have to come out for the nose bleeds. A look back to 1932, the point at which this now-concluding Kondratieff wave began, would offer a better grasp of the political comments made in the Dollar section below, from a technical point of view.

The following chart, courtesy of BigCharts, reflects divergences in the Nasdaq, the secular peak for which was at 5000, one month shy of six years ago.

Over the past year, the advance/decline chart (red graph) has tracked the Nasdaq with lower lows, even as the index has made higher highs.

The unspeakably lengthy list of reasons to be out of and short the US market has truly matured. I recommend review of the December 21, 2005 yearend report, while reading the Financial Times on a daily basis, to see history in the making. Hopefully, having read tomorrow's newspapers yesterday, in these reports, you are well positioned for yet another - but truly unique - lifetime opportunity.

CONCLUSION:

Unless they are precious metal issues, own no stocks. Own lots of long term Dow puts, if appropriate for your portfolio.

See Gold & Dollar section for additional and related commentary.

Nikkei/Dow Ratio:

Since the low, this ratio has erupted 50%, and is nowhere near a secular peak. This means, in brief, that asset re-allocation is confirmed. I am glad that readers and investors were able to benefit, so far ahead of the dozing crowd.

GOLD & DOLLAR:

NOTE: Since turning bullish on gold and bearish on the Dollar in January 2002, I have maintained that one may trade gold until it crossed $500, after which point it would be deemed as a "permanent holding", thereby gaining the same coverage as the Dollar, namely, a lesser one, for shorter term

traders. While SKC reports have provided Yen, Euro and Swiss France intermediate term projections, it was always only for those investors who had not yet converted out of the Dollar, so that they may use preferred entry points. Only once was there a recommendation to partially hold Dollars. That was strategic in global weighting at the time, as well.

Now, similarly, gold is a permanent hold, and projected price levels are for those who have not established their portfolios in the recommended fashion (see below). Readers wishing specific assistance are free to contact me, as written commentaries will rarely recommend levels, but rather treat them more in a theoretical fashion, for the reasons just stated.

Before calling a cyclical peak for the Nikkei, that index doubled since SKC identified its perfect low in April 2003. Now, gold gas doubled, since its higher low at $280 was identified in these pages. This is why SKC's asset allocation model has been unsurpassed for four years. From $280 on, SKC identified every key turning point, going into 2004: *http://www.sidklein.com/comments/Apr12005.doc*.

Then, SKC forecast and identified the key turns in gold at $410 and $455. From the November 6, 2005 report:

"Gold is in the process of being held almost exclusively in the hands of Easterners and there's nothing the West can do about it. It belongs to them, now. SKC felt that $455 would be the worst case scenario. We're there now. $445 wouldn't change a thing. For what it's worth, since January 2002, SKC has forecast spike corrections that stopped on a dime at those levels, at which points we would also warn of what could be the next and meaningless level – that would almost never materialize anyway."

On the **currency** front, Japan and South Korea have determined to increase its swap capability from $7 billion to $15, so as to strengthen Asian trade capacity, by providing superior liquidity.

Note: The Japanese and South Koreans have stated that they will be demanding that the IMF cede greater power to Asian countries, to reflect their increasing economic importance, lest the IMF lose credibility and power to function as the institution it was theoretically set up to be.

The IMF is seen as an American institution by many, the world over, and this event comes at an interesting time. Make no mistake, however. This demand on the IMF was foreseeable, just as the shift in dominance from West to East will surely put the "I" in "IMF". That shift in dominance has been a theme in these pages for a long time, and evidence is now coming from all sides. History has taught that this is how change occurs – from all sides - and this time is no different.

Firstly, in 1999, I wrote that the Japanese were showing their interest in becoming a de facto Asian block currency, by guaranteeing Southeast Asian federal debt that was denominated in Yen. When, in open forum, I asked the new Japanese ambassador to Canada whether this was his government's design (to become a new block currency, as opposed to be acting from post-war kindness). he ignored the question.

Now, let's take a still broader view. The Chinese and Russians do not want the US Dollar to remain as the world reserve currency, as that utility has become one of the tools of economic war and instability. For instance, by printing money like there's no tomorrow, the US government actually got everyone to pay for the invasion and occupation of Iraq, an event which was opposed by the sovereign, democratic free world.

Since the latter is the perception of its allies, the US faces an as-yet unexpressed will, that joins that of Putin and the Chinese leadership (Putin has expressed his desire to see oil denominated in Euros, while the Chinese government actually recommended that its citizens purchase gold). These long term events are, as one might expect, slow in development (by a single human incarnation's standards), but the upshot is that heaven only knows where and when gold will stop when all this is over.

Along side the Kondratieff cycle is how this phase in history breaks down: **First**, there is financial calamity (overvalued stocks collapse). **Then**, the economy crumbles. **Thirdly**, war. The next one (2010 – 2015?) will be the dilly. From the currency side of all this, the US will do everything in its power to not lose its position as the world reserve currency. Why?

Among other things, the devaluation of the USD spells huge profits for the decision makers' foreign asset holdings. Example: Today, the Dollar crumbles, as the currency is printed to pay for the Iraq affair. Meanwhile, foreign holdings soar, in terms of foreign currency denominated valuation, as trade agreements permitted US interests to purchase foreign assets, in historic proportion. Therefore, the trade agreements and the currency standard, are "assets" that will defended at all cost, and by any means deemed necessary. So, while the preceding reflects the risks for confrontation longer term, they also reflect risks to the Dow premium (to other international indices), over these coming five to ten years.

CONCLUSION:

Since **gold** broke out of a contracting triangle above $440, a wave three of three for this move is completing, which should result in the entire move's completion in the $600 area, by quarter-end. Meanwhile, due to momentum, a wave-four correction should be contained by $540.

In deference for the possible effects on precious metals stocks of a steep decline in the Dow, we remain 50% invested in leveraged precious metals stocks. Now, though, I further recommend the cheap stocks of companies that only become profitable at much higher precious metals prices

Over about a year, the Yen has declined about 20%. We are again and still fully long. Our consistently superior asset allocation has been founded every year in the correct recipe of currency mix, which today continues to be: 50% gold, 25% Japanese Yen and 25% Swiss Franc.

Sid Klein

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