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JAPAN'S POWERFUL UNDERCURRENT FLOWS ON

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<u>JAPAN</u>:

<u>STOCKS</u>:

The balance of margin stock purchases has been reflecting greater strength than any time since mid-summer of last year. More importantly, in the week of Feb. 10 – 14, <u>foreigners were net buyers for the 8th week in a row</u>, advancing an up-trend in the orders for Japanese shares by Americans that took hold in September, the month, not coincidentally, when Domestic Demand Oriented Value Stocks **(DDOVS)** put in their lows. Those bottoms never even fully re-tested their 3-year old lows!

Since the latter part of 2002, the majority of our **DDOVS** have advanced 35 – 40%, with favourite issues actually rallying to peaks representing 100 – 200% returns from their respective lows. This is the very scenario so often discussed in these pages. What will happen when the Nikkei erupts? So far, **DDOVS** have represented risk aversion through troubled times, while offering timely profit potential. The next phase should be utterly explosive across this theme of equities.

The Nov. 24, 2001 market comment reported:

"What is bearish for much of Japan is actually bullish for domestic demand stocks that benefit from more regional (Asian), rather than international-based, Japanese policies, including continued repatriation of the Yen. Value stocks further benefit from managers shunning risk and leaning toward a "play-to-not-lose" approach that actually contains a great deal of price leverage due to the extreme under-valuation of so many such issues.

"Apart from DDOV's, there are (stock) groups that have in the past, and will continue to, benefit from the policy changes ushered in by Big Bang and

the long term reversal of interest rate trends (i.e.--real estate and insurance stocks). To read the papers, one wouldn't know how profoundly well so many equities have done. FORGET THE INDICES. Indices in Japan, unlike the U.S., mean little to the people whose lives have gone on for a decade with a bear market. In Japan, stocks are a tiny percentage of the financial scheme, next to savings and real estate."

The Jan. 25, 2002 missive added that, from the 1998 low:

"…Many equities doubled and tripled as the Nikkei and OTC indices rallied 50% and 400%, respectively. Value stocks bottomed in 2000. The whole period is one of transition and dislocation. Novices can easily lose sight of the bigger picture. The present low is as significant, or more so, than that seen in 1932 in New York. In that market as well, there was deflation, not inflation. The low, nonethesame, was in.

"Interestingly, that was the year GE bought up cheap assets like there was no tomorrow. Now, they're doing it again. This time, GE is doing it in Japan, alone investing double-digits, in the billions."

NB - The average of earnings estimates of certain investment banks reflects anticipated growth in earnings of Nikkei issues of approximately 40 – 45% in fiscal 2003! It is further noteworthy in conjunction with this that, with respect to this Japanese fiscal year ending in 29 days, TSE 2nd Section and JASDAQ (smaller stock indices) stocks are expected to have price-to-earnings ratios (PERs) of about 40% of the level for the Nikkei. This reflects upon the strength of domestic demand oriented (not necessarily value) stocks, particularly those not exposed to unwinding or foreign ownership.

It will be added here that the Nikkei OTC index that quadrupled off of its 1998 low, has not returned to that level. More importantly, within the context of the preceding paragraph, please note the valuations for domestic stocks not generally burdened by debt, crossholdings or foreign ownership. Add to this the anticipated eruption in Nikkei earnings. Mix these together and imagine the power of **DDOVS**.

Insofar as the widely followed Nikkei is concerned, its recent **quintuple** bottom has set the stage for an eruption to the upside, as a break over 9,000 would violate the downtrend line from Nikkei 20,000 that dates back 3 years.

ECONOMY:

Calendar 4th quarter GDP rose for the 4th period in a row. Recession, what recession?

Aided by the recovery in corporate profits and led by powerful exports, real GDP was +.3% for the calendar year and +2.4% for the quarter, year-over-year (y/y). The latter was the best quarterly increase since the 1st quarter of 2001. These figures were shockers for the economic world. SKWC has been forecasting such "surprises" since January 2002.

Consumption was expected to suffer badly but ended up 1.7% y/y. Meanwhile, income rose only .2% y/y. The disparity, in my opinion, may be party attributable to pent-up demand, as per SKWC's oft-reiterated view regarding such demand potential. This disparity may be a major indicator of an unfolding economic driver.

Private capital investment was also stronger than expected and positive y/y for the 1st time since the calendar 2nd quarter of 2001. Exports powered ahead 4.5%. Big surprises included the strength in consumer spending, the positive revisions to private capital investment and the power in both exports and imports.

Fiscal year 2002 GDP may be up as much as 1 ½%! At the end of 2001 and the beginning of 2002, amid the gloom post Sep. 11, SKWC stood out in forecasting that brokerage firms would be forced to **revise 2002 GDP estimates upward by a full percentage point**. This has happened.

On the heels of all this, the January trade surplus declined for the 1st time in a year. Why? Exports roared ahead, only to be surpassed by a spectacular rise in imports! Recession, what recession? This seems to be a powerful economy that is ready to ignite Asia. The talk recently, however, had been about slipping back into recession. My own suspicion is that the brokers will get used to being wrong until ALL the **DDOVS** appreciate 100-200%…and perhaps even then they will still not notice what is going on in the "real" Japanese stock market.

On the deflationary front, the y/y decline in January corporate goods prices (CGP), the heir apparent to the wholesale price index (WPI), narrowed to –1%, the smallest decline since Dec. 2000. Deflationary pressures are lessening as the economy improves, surprising most. Again, pleased refer to Dec. 2001 and Jan. 2002 commentaries, as well as the Jan. 5, 2003 missive, "Net Positive Deflation".

<u>SUMMARY</u>:

SKWC has always been of the view that one should always expect action in Tokyo to be coordinated between politicians, monetary authorities and bureaucrats, despite the fact that the show for Westerners may give the contrary impression. Now, the Japanese are coming out and showing it as the market may be preparing to absolutely erupt, as evidenced by the risk averse **DDOVS**. The "gang" is openly expressing the need and willingness to broaden fiscal and monetary stimulus.

Along with BoJ bank share repurchase programmes, as so often forecast and analyzed as positive by SKWC (despite the contrary and foolish analysis of foreigners), the government appears prepared now to broaden tax cuts and the social safety net, further pushing Japan out of deflation, something from which it is closer to being rescued, much as foreigners don't seem to know it, except, of course, for smart institutional money that is successfully finding safe haven in Japan, as witnessed by the reversal of foreign fund flows.

<u>NEW YORK</u>:

Yet again, it is here reiterated that New York is set to stage a cyclical bull market.

If the indices do so, it would be within a massive secular bear market anyway, thereby implying substantial risk for all but the nimble and capable index players or stock pickers. Further, the extraordinary nature of the 1982 - 2000 bull market suggests that there is always the risk that the Dow continues within a symmetrical bear market, suggesting a one-way drubbing until SKWC's long-term target of Dow 4000 is achieved.

As regards war and politics, there are only 2 investment points that are noteworthy. Firstly, major (not localized) wars occur AFTER a depression, not in the middle or early stages of one, according to the Kondratieff Long Wave Theory, that has been my faithful guiding light for 20 years.

Secondly, the stock market does not respond to the number of casualties, nor even what side to which they belong. This has been the knowledge of powerful families for centuries. The market responds to market related considerations. In this case, that consideration is the price of oil. As investors, SKWC advises focusing on this.

$25 oil may mean Dow 9000, while $18 oil may mean Dow 10,400. At 8,700, SKWC cautioned that a cyclical advance would not be likely to commence before testing 7,800. This has occurred and the situation in Iraq is to be resolved to determine the market's value for oil before any would-be cyclical bull move. Still, this thing is in a massive secular bear market and smart money would therefore focus solely on the secularly emerging themes, namely JDDOVS and gold.

DOLLAR:

US total debt has increased from approximately $12 trillion in 1988 to $32 trillion in 2001. Meanwhile, the US' seasonally adjusted national unemployment rate is about 50% higher than 3 years ago. The prices of assets such as stocks have reversed course, along with international capital flows!

The Swiss Franc, Euro and Yen all made new intermediate term highs in February, the intermediate term lows having been registered in October. The Dollar remains in a massive secular bear market that began a year ago.

For Intermediate and long term gains as recorded by SKWC, please refer to the Feb. 12 Special Report and the Feb. 2 missive, **"Three Days of the Condor"**. The latter is available online, while the former will not be uploaded for another couple of weeks but may be forwarded upon request. As regards the film after which the Feb.2 letter was entitled, for those truly interested in today's war/political backdrop, for a disturbingly insightful yet entertaining perspective, the rental of this 1974 Robert Redford thriller is advised.

GOLD:

The Feb. 2 letter referenced in the DOLLAR section bore the following quote:

"Please bear in mind as well that gold may correct 8% or so from the recent peak…"

The Feb. 12 Special Report followed up with:

"Identifying **every** intermediate term move since turning bullish, our present position is that the maximum downside is now $345, raised from $333".

Well, gold has thus far declined to $344 (close enough) and the Philly Gold and Silver Index (XAU) has fallen to 70. The Special Report discussed 67 as the point of entry for those wishing to buy into the correction. It is reasonable to view 70 as close enough, *n'est-ce pas*? Gold stocks may erupt again and the gold complex, therefore, offers **both** the fearful and greedy a home in which to rest.

This point is here made to underscore previous commentaries in which the warning was issued that a cyclical bull market in New York would not need not be viewed as inconsistent with a major gold advance; in fact, quite the opposite as fund managers would seek those equities that performed well through the 2000 - 2003 period. Moreover, the major gold stocks have so under-performed the metal itself that the money managers would be looking to these more liquid issues in closing the performance gap.

As for the explosive performances in the leveraged-to-gold equities that SKWC always held as favourites (subsequent results in the large, mid and small caps support the views held in these pages through 2002, see previous comments), their major bull markets are set to resume, as per the XAU and gold bullion views expressed above.

Sid Klein