

Mr. K: 1931–1936



August 31, 2006

JAPAN:

Okay. So someone tells you that there are going to be spending cuts and the removal of tax breaks, against a backdrop of already-bottomed interest rates. Do you conclude bullishly or bearishly? Why, bullishly, of course. Why? Because this is Japan and understanding it – or attempting to – cannot be achieved through Western eyes, since the Western paradigm is debt-ridden. It's different when you've got about 40% of the world's savings and enjoy greater monetary clout than the US. Really.

The opposite of the above was true through a thirteen-year bear market, so why be afraid of the opposite as also being bearish. I forecast these economic events at a time when it was all considered fantasy (this decade) and the point was that if these events could be forecasted in advance as bullish events, well, that should make us feel warm and fuzzy.

In June, an interim Japan special trading advisory recommended purchase on the way toward 14,000. After it was touched, the following appeared in the June 28, 2006 report:

“The Nikkei has a strong floor at 14,000 and investors may be expected to front-run that level. Therefore, any new short term low would not be by much. In the first quarter, my stance had been that taxes and higher rates would be the focus of attention as an excuse to deflate excess foreign hedge fund buying and fund buying. Everyone owned the same stuff. But I also felt that the subsequent correction would create major buying opportunities, in this cycle turning point year for markets.”

I had felt that a rally would only take the Nikkei up to the 16,000 area, before falling into yearend due to a terrible US market.

With the Nikkei now at 16,000, some cash should be raised. Even DDOVS are being affected by the fact that the Yen’s bull market has stalled. While the latter remains intact, the fact nonetheless remains that DDOVS will move up in earnest once the Yen takes off. This happened earlier this decade and will again. In fact, the DDOVS up-move preceded the Yen advance, and this time should be no different.

Condo stocks in particular will benefit next year, as the Japanese government puts into place measures that will have moved elderly from their rural homes into urban condos. Other property management stocks are also cheap. I recommend Dynacity and Hunet. The former got plastered by one-time events, which exacerbated a seemingly chronic problem. Through 2007 and 2008, both stocks should double to triple, regardless the macro picture. Other cheap stocks of companies with either special fundamentals or situations include Gakken and Tokyo Kikai Seisaku.

With market corrections due at any time, the specific timing for purchase may be at any time, according to the equity. Yes, that was a disclaimer, since there isn’t any specific fundamental coverage offered here, but I am always available for consultation on these points.

We’ll review economic and market fundamentals as we go further into the quarter. SKC doesn’t report developments; it forecasts them.

NEW YORK:

Fundamentals:

In the fourth quarter of 2005, I published the University of Michigan chart below that I had taken from the Financial Times. The reason I am publishing it again, as opposed to offering an updated version is simple:

This chart uses quarterly data but, intra-quarter, it uses the most recent month’s data. As a consequence, the data points on the chart below do NOT appear on

any updated chart, since the data had fully recouped losses by yearend. With consumer confidence presently at the lowest level since a month after the chart below was published, barring a wild rebound in confidence again, consumer spending should now come into line

My point and observations at the end of the year had been that consumer spending follows consumer confidence on only a one-month lag, and that if that should remain intact, spending would line up with about 7500 on the Dow (simply add two zeros to the left grid, as funny as that may appear – there is a logical explanation). Confidence is crashing and if it does not IMMEDIATELY improve (rebound) as it did last year, look for spending to shadow confidence on hardly any lag (see chart).

If looking to Europe's largest economy for a further clue, German investor confidence has crashed to its lowest level in five years. Nischt goot. (Like I keep on reporting: Stick to Asia-focused investment only.)

I have reported more times than I can count that we are approaching the next phase of the Long Wave Economic Cycle, otherwise known as the Kondratieff Cycle or, simply, the K-Wave. At this stage of the cycle – where Bull morphs into Bear – there are three phases. I will reiterate them here:

The first phase is financial demise, due to overvaluation. The second one (beginning NOW!) is economic demise. The third phase is non-regional war. In the last cycle, the financial demise and massive rally occurred during the 1929 – 1931 period. The Dow then fell to 40 (1932) as the Depression swept over the US economy. It lasted until 1935 – 1936, based on commodity prices. We're there now. This time, confidence won't get off the floor.

Adjustable rate mortgages (ARMs) have been tapped to the point of draining ordinary citizens of their basic equity. This is so to the point where we may see housing prices decline for the first time since the Depression.

While the Dollar's bear market may actually recommence after the Dow's decline, the Dollar Bear will restrict the Fed's capacity to lower rates. Why were the Japanese able to lower rates to zero? They've got all the money. Why won't Western nations be able to lower rates? Because there is a massive shift of power and wealth to the East, as so often harped on in these pages.

In any event, please examine the confidence and spending chart. It is a story of the second stage of this Long Wave Cycle's phase. Unlike the thirties when the US was a creditor nation (and wealth and power was shifting from Britain to the US), this Depression will be so vile that one should expect violent expressions of anarchy over the years to come. We're not quite at that point yet, but Bush's impeachment will have been part of that backdrop. If he isn't impeached, that

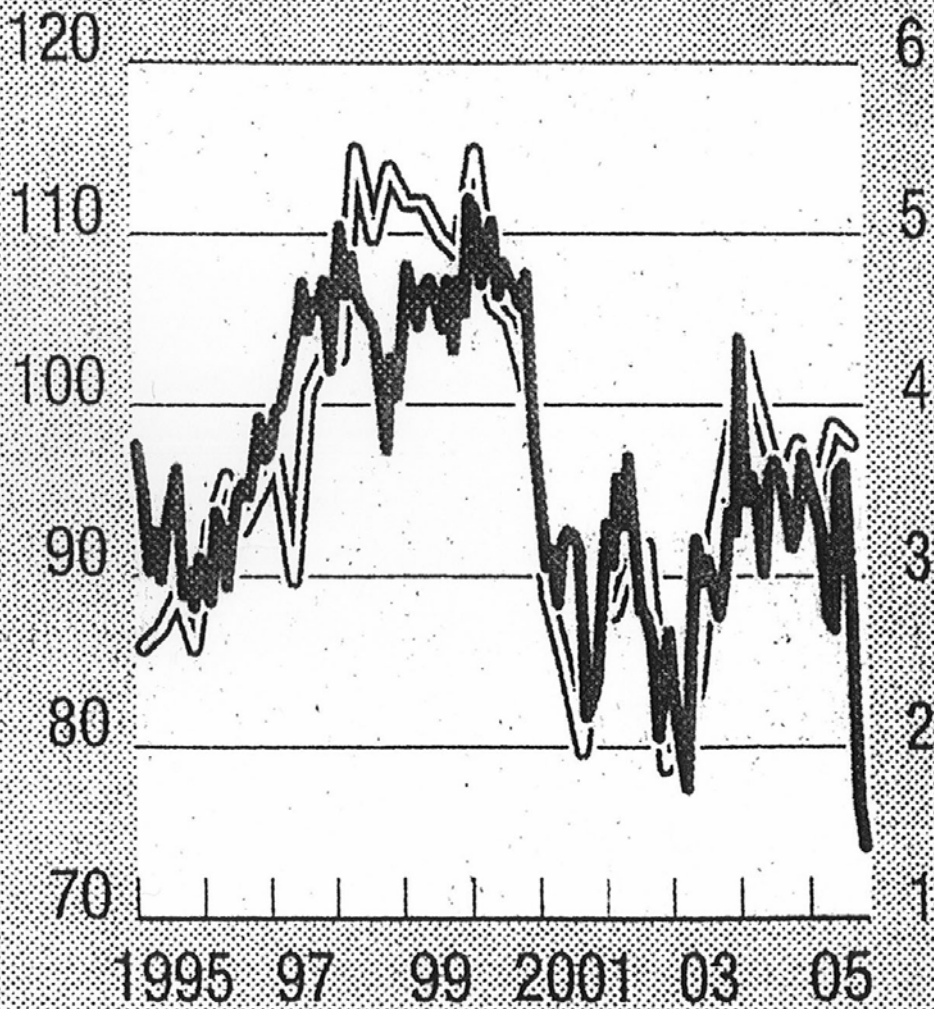
US confidence and spending

University of Michigan
consumer sentiment

Real personal
consumption

Indicator —
(Q1 1966=100)

— spending
(annual % change)



Source: Thomson Datastream

could make American sentiment even worse, particularly if there are any stunning revelations about 9/11 or anything related to it that followed.

At the end of last year, the black line (confidence) above disappeared, so, with that immediate rebound in sentiment, spending never came into line on the downside. This time, the Grinch WILL steal Christmas.

Technical:

The following chart of the S&P volatility is clear. Connection of the lows creates a slight up-trend channel. The chart erupted in a five-wave fashion out of an apex, before correcting to this unbelievably low level (the low of 10 was itself a 13-year re-test). The meaning is significant.

Firstly, this chart runs counter to the market and is a forerunner of market activity. It also means that put premiums are cheap. In fact, if one had bought puts months before the Dow's peak based on this chart but then saw the Dow rally several hundred points, despite the passage of time, the eventual spike in volatility and decline in the Dow bailed out those put-holders.



Strategy:

In other words, this is again a preferred entry point. The 18-month puts we once purchased have 3 months remaining and we very recently added the June 2007 puts. For readers, I recommend the December 2007 Dow 100 puts. This equates to Dow 10,000. It is stunning how much “play” there is in the price, just based on the level of volatility. With a double-whammy from the market (market down,

while volatility up), profits will run into the percentile stratosphere. Pros artful at timing and writing short-term premiums against these longer dated puts could run up profits sizably (with a cool head). Remember, while retailers buy short term puts, the lowest annualized premiums are the longer-dated ones, which provide a vista of strategic possibilities.

PRECIOUS METALS & DOLLAR:

After having broken support, silver, as with gold when it had collapsed to \$550, hit major cyclical lows in June. Then, I published charts on our two metals at screaming buy points. On the **28th of June**, SKC turned bullish for intermediate trading accounts, while always having remained bullish for long-term investment, which never shifted from my “permanent” asset allocation stance (see August 13 report). Gold at the time was **575.30**, while silver had closed at **10.26**.

Cash silver is already pushing \$13.00 again and gold, as forecast here, has pulled back after a “correction within a correction” that had taken the metal up toward \$680. Now, this near term gold pullback has not corrected to the \$580 area as previously considered but, rather, has bounced from the \$605 - \$610 zone. The news background today was the Goldcorp merger but that’s unimportant for me.

The long-term perspective and strategy is again the only one of importance and, in that specific light, all systems are “go” from here. This summer’s cyclical correction – with its corrections within corrections – is now a thing of my concern’s past. It’s too dangerous to not be bullish now.

As for paper money, the Swiss Franc has held strongly, compared to the Yen, which I believe still has the greatest profit potential. The Yen keeps re-testing higher lows, while the Swiss Franc has neckline and 200-day moving average support around 80, basis the nearby futures contract. One can see why we hold as much Swiss Francs as Yen; the former is a fiat play on gold with relatively little “stock” (paper) outstanding.

Our asset allocation model remains unchanged, as it is geared for this brutal phase of Mr. K’s Cycle, his second of *a three-part opera most tragic*. Grow old with me; the worst is yet to be.

Sid Klein

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