

Here We Go!



August 13, 2006

Nikkei:	15,567.02	(June 8)	14,633
Gold:	\$630.50	(June 28)	575.30
Silver:	\$11.91	(June 28)	10.26
Yen:	. 8594	(June 28)	87.06

NB: The first installment of the August report dealt with New York. Sure enough, matters are clarifying themselves everywhere as we continue with our timely analyses and forecasts.

JAPAN:

NB: Please note the Yen commentary at the end of this report, as it contains analysis that is relevant to Japanese equities (over the past weeks, SKC has warned that rates may be raised in Japan "at any time").

Economy (revisited):

The Leading Economic Indicators (LEI) has now fallen to neutral levels, with component indicators lining up precisely where one would expect, given where we are in the cycle. In fact, given the weather in Japan, the numbers have actually been good.

This pause in the economy is refreshing, before an acceleration to the upside in 2007. The pause is emulated in the stock market, where prices had become overheated. The change in the interest rate picture (and anticipated retail tax rate changes) helped cool things off, as the government became concerned about potentially harmful imbalances, due to foreign hedge funds' leverage and speculation.

A sell-off this past week was sparked by lower than expected GDP numbers, which caused investors to fear that full year growth could be in the order of 2.5%. However, corporate sentiment is so positive that full year growth estimates range as high as 4%. Therefore, the GDP growth story is still very much wide open and, as usual, foreigners will underestimate full year Japanese growth.

Further, the next day, machinery orders came in with a happy surprise to the upside (two days, two surprises). This portends another cycle of a self-feeding circle that ends with the retailer consumer, who has scaled back on further items for the home, for now. The enormous pent-up demand in Japan expressed itself with an initial wave of consumption but now has led to a pause in home furnishings, appliances and renovation. The next wave of consumption will accelerate next year, in the face of lower than expected or feared sales tax increases. The government and the people have planned and prepared well, on all levels.

Over the past four years, this isn't the first time that I'll have reported on manufacturing leading retail sales improvements.

Remember: now, more than ever, after this 2006 cycle turning point year, it will be critical to avoid equities with ties in trade to Western markets. Only companies who do business with Japan and the rest of Asia are of interest.

Interest rates:

To understand the interest rate picture in Japan, one must understand the positive effect, as well as the necessity for higher rates.

Increasingly a service economy (I've long since written of Japan's new era as an economy of great wealth), and most certainly a financial services economy, higher rates bode well for banks, insurance companies, and these same institutions that sell money market funds.

The government executed its plans well, in bailing out bank balance sheets (see online 2002 reports). Now, the focus is on resurrecting earnings. Higher rates address that need. As always, foreigners must understand that analyzing Japan requires an opposite mindset to that one employed in analyzing the US.

M&A:

When these pages were still a daily commentary (1999), I forecasted the greatest explosion in mergers and acquisitions activity in the history of financial markets. Such activity continues unabated, as the guys with all the money helped themselves to something that then Prime Minister Hashimoto called Big Bang. Westerners took a while to catch on, but a whole new industry that is swimming in untold sums is feeding a financial system whose secular bull market remains in its infancy.

Bankruptcies:

Remember when I used to report weekly on the increasingly worsening bankruptcies data? Today, there's little to report except that there are always fewer and fewer risks that are apparent, notwithstanding the new-found cleanliness of the Japanese banking system (who would have thunk it?). The bad days are over, for those who have been on an extended cruises.

Technical:

From the July 9, 2006 report:

"I have been warning that the US market may react to Japanese rate movements with great sensitivity. Still, seeing the Nikkei as being in a bottoming phase, the June 8 report analyzed that a possible rally toward 16,000 could be followed by a test of the 14,000 level before advancing further. After rallying to about 15,700, the Nikkei may put in a higher low now. This could coincide with a rate hike. This would also be consistent with a successful test of the recent lows in gold. Of course, one shouldn't try to correlate markets."

Perfect...so far ([note the link immediately hereunder](#)). It is a description of perfection, within the context of the preceding paragraph.

http://bigcharts.marketwatch.com/quickchart/quickchart.asp?symb=jp%3A1804610&sid=0&o_symb=jp%3A1804610

Conclusion:

Particularly as interest rate driven leverage (see Yen at bottom of this report) was and is being squeezed out, the market and economy are preparing for a sustainable advance to new highs next year (19,000 – 21,000, basis Nikkei), which this time leaves the foreigner behind completely. The pain in the Dow will leave him licking his wounds, while Asians will have repatriated their funds to their own backyard and the hottest markets going (ex-exporters to the West). Since European institutions are more sophisticated, they will have a bit more Japanese exposure (than other non-hedge fund foreign institutions).

NEW YORK:

From the July 18, 2006 interim report:

“The Dow put in a 100-point reversal day today. By slightly breaking below 10,700, the VIX spiked up to a point from which it in turn reversed to the downside. Both taken together means that should another multi-hundred-point bounce ensue through these summer months, another option premium bashing event will have taken place.

“This was probably the last (though less significant) tradable event, pre-crash. The next peak may be around 11,000 in the first week of August, or so. If this transpires, then the next decline may not be to 10,200, which is where I had initially placed the next support. In fact, one may more reasonably expect a 3000-point debacle.”

From the August 1, 2006 report:

“Today, the Dow traded as high as 11,219, before closing under 11,200. The VIX reversed to the upside, with implied volatility (option premiums) having tanked to cheap levels, as bears have capitulated. As the quoted interim report above reflects, for a second time the 10,700 level predictably held.

“We went short today (building positions to their highest levels yet) and a full-fledged crash will now get underway.

“There are a number of short-term scenarios, of course. They include a pop up in the morning (Tuesday August 2nd) before reversing, or a 100-point down day right from the opening, before a third leg in this C-wave that merely returns the Dow to about the same levels as today’s highs, probably on the back of the celebration of a rate hike that doesn’t occur next week.

“Not that it matters, but I don’t believe the hike will occur. The economy is decelerating at a faster pace than what people know. Housing numbers came in and they were terrible. As CNBC underscored when the terrible numbers came out, they don’t even include cancellations!”

Well, the rate hike didn’t occur and the Dow, from only slightly higher levels than those of the prior week did turn back. The two recent lows and their forecast time frames and levels have worked. All that remains is a three-thousand-point debacle. Now, we’ll see.

I’ve written before of likely impeachment of the commander-in-chief, and it is very much in my mind that this would be a perfect background story (“political

instability”, currency and gold perturbations) for an already-underway Dow thrashing. Something has come to mind about this scenario, however. A reason for it **not** happening: How do they not impeach the runner-up?

Still, Lebanon served the purpose of making everyone forget Iraq for a while but, still, there’s some PR work to do here. Some goodwill throw-the-dog-a-bone diplomacy won’t hurt, especially since there won’t be a need for reparations (they have all the bombs, and lawyers, too). Dylan’s Masters of War will feed their figurehead to history’s sharks. As George assumes the blood of his father too, hundreds of thousands of lives will resurrect, just like that!

PRECIOUS METALS & DOLLAR:

*The following cash silver chart, along with the blue-highlighted comment that appears immediately under it were initially transmitted in the **June 20, 2006** interim report, days after the precious metals lows, since which time silver rallied about 33%. Gold rallied nearly \$140 per ounce from just over \$540.*



“Investors are 100% long, but trading portions for the Yen, gold and silver may return to all-out buy stances.”

Yet another interim report (June 28, 2006) analyzed soon after:

“Gold and silver have bottomed and any new lows would be minor. Here too rallies could be sharp, violent, and short lived. Many markets are in periods of corrections within corrections.”

The June 28, 2006 report provided the correct analysis, even though the June 20 letter came in at more perfect price lows. As forecast, the drop from \$700 is taking the form of a massive A-B-C correction (in Elliott Wave terms), so as to prepare for an advance to **well over \$1000 per ounce in 2007** and beyond. A larger Wave 2 correction is completing to provide the basis for a launching pad for the next phase of advance. Waves 3 of 3 are the “heartiest” moves (most explosive with best accompanying fundamentals), and such explosions are preceded by larger wave two formations (not minor or intermediate waves two, but, rather, cyclical waves two).

Risk in this scenario is to the \$560 - \$580 area. However, portfolio investors in gold-as-a-currency remain invested 50% of their wealth. Of that, one must determine how much they feel is appropriate for trading. Twenty percent of one’s gold-as-a-currency being earmarked for intermediate or cyclical periods of correction would be aggressive, in my opinion.

*From the **August 1, 2006** report:*

“As for gold, it has come through with SKC’s huge rally within a correction. Simply, I looked for a rally off of the bottom toward \$700, before re-testing the lows. The violent swings are vindicating these timely views. How gold trades from here is uncertain in the very near term now that we have been graced by all this volatility, but the songs remain the same, as regards the intermediate and long term views are concerned. Again, silver timing follows that of gold.”

The Americans have completed their tightening moves. The cycle for rate increases is over (see New York section). The market is factoring in higher rates by yearend or the end of the first quarter of 2007. Don’t count on it. The economic deceleration will have proven to be much worse than initially thought.

With the end of rate hikes comes a green light for gold. Any weakness would be due to the stock market, but de-coupling would make for fascinating viewing. It makes sense that they would de-couple since prior corrections coincided with the spectre of higher rates (yes, they went up together, but that was due to Federal Reserve paper printing).

The **Yen/Dollar rate spread** is set only to widen, as the former increases its rates due to economic strength, while the latter flattens due to economic weakness. The Yen will be the most profitable fiat currency in the world.

Please note how everyone has joined the SKC bandwagon. Last year – and reiterated often at the beginning of this year – I analyzed that Yen rates would

rally due to strength and that this would be an excuse for profit taking, before being used as an excuse to rally the stock market, as a result of those positive fundamentals implied by the higher rates.

The Japanese are the financiers of Asia, much as the Americans had played that role in the West. With emerging markets booming and offering the world's best growth investment, the Japanese currency is the fiat *du jour*. Domestic Demand Oriented Value Stocks (DDOVS) represented a theme that I had created in 2000, as I envisioned the above two paragraphs, within the context of all else that comprises the criteria for these equities, including an Asian focus that is consistent with higher Yen levels.

Conclusion:

I see silver rallying to the **mid-\$20's in 2007**. A short-term correction of 5% - 10% is presently possible.

Gold can now fully retest in wave C, so traders must know their risk to presently be on the downside. The "wave-B rally toward \$700" stopped just under \$680.

The Yen rallied over 8% from the higher June low. Now, it is nearly fully retraced, to a level that has formed quite a base for the Yen. We have come to a crossroads: The Americans have stopped tightening and the Japanese have just started. There is a decelerating US economy (housing crisis?), coupled with accelerating Japanese and emerging market economies (in 2007). The latter repatriate capital for local investment (favourable for **DDOVS**). This is going to continue a forced a stream of swap unwinding. Internally generated US political instability (impeachment).

Strategy: Any or all of these factors again, as in January 2002 makes the Japanese Yen the major fiat currency of choice. It represents half of the half of one's net wealth that is reserved for non-precious metals. The Swiss Franc rounds out the currency portion of the overall approach recommended here. Take note of the respective analyses immediately above, in conjunction within the context of this asset allocation update.

Gold: **50%**
Yen: **25%**
Swiss Franc: **25%**

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