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Major Cycle Yen, Dow Turning Points Perfected, at Last

Japan Asia Investments Canada

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Recent reports have been heavily weighted toward technical analysis. The reason is that we have been in the last phase of an up-cycle.

In the initial cycle, which is predictive of major cycle change, there is extensive fundamental analysis that is not reported or interpreted in the same manner at the time elsewhere. As things progress, the nature of our focus morphs, until, finally, the final stage, which is purely psychological. The madness of crowds, and such matters.

The study of market psychology is technical analysis. My basic thesis has been that Japan is in a massive secular bull market, which is underscored by this corrective phase's move up to new highs. This is extremely bullish. Still, this move up is within a corrective cycle, which implies a peak, with *potential* to 14,000. A key driver has been the Nikkei's correlation to the Dow, since both benefit from a weak Yen as this large-cap index is weighted with multi-nationals.

Hence, the position here has been that the Dow is at death's door, which represents a key threat to the Nikkei. With respect to New York, every conceivable bearish argument has been made in these pages

(well, the ones I consider really important or ignored or misinterpreted, anyway). So, I have been reporting, that all the bearish arguments (and I do mean all) are already known in the marketplace.

However, monies that were committed as of September have driven the US indices. Therefore, fundamentals are suspended since committed money has to be spent. I added and remind that this is what happened in Japan in the 4th quarter of 1989. Exactly! Hence, the coverage is technical.

A key theme has been that as the markets fall, the excuses will be things that have been in the market. Such is and will be the case. However, there is almost ALWAYS an event that occurs at the initial move down, so that the market can choose to ignore the beginning of the decline This is aided by the effect of a short covering rally that is mis-reported as being due to the relaxation of the mis-identified bearish threat. This time, it was China. But,...

JAPAN

Nikkei: We already reported that the Japanese were making matters tighter for Federal Reserve and that China was taking a different, financial, economic and politically strategic approach, as regards the currency. For me, the key event that was smoke-screened to a degree as regards its relative impact on markets this week was the Yen, which we have been writing is the key turning point event for virtually ALL markets. As an aside, events in these markets (charts below) also underscored the enormous risks of investing in China, particularly if looking for counter-cyclical safe haven.

The correction of the under-valuation in domestic mid-cap value stocks (their bottom) began in 2000. Economic indicators turned bullish in 2001 and, I then added, the general economy bottomed in January 2002. This was perceived more than a year later, only because the banking crisis was technically resolved (the plans had already been "in the drawer") along with the Nikkei, which made its low in March 2003. With the resolution of the banking crisis came the new dawn of foreign and domestic lending and investment. Who would have thought it, eh?

At the same time, enormous legislative changes to the tax code triggered the beginning of what will have been a transfer of hundreds of billions of dollars to demand-hungry younger generations, who are further *incentivized* (encouraged) to spend and invest. And while the profit growth story in firmly entrenched in the secular sense, the following might sum it up. Start-up profits have only grown for a long time, so, if you're only as strong as your weakest player, then you're on the right team.

These major drivers were the spark for and are the ongoing drivers behind this secular economic and financial bull market. Like all bull markets there are corrections and shifts in dominance within asset themes, industries, ect.

All quotes below (in blue) are from last month's February 4th issue.

"Admittedly, the major spark will come from the Yen. This will shift asset allocation to more Yen-based equity investment. The spark could be sharp, due to the extremes from which the Yen and domestic stocks are coming, although the latter have been firm since yearend.

Regarding the resumption of the Yen's secular bull market, it means an influx of capital into Yen-based investments of all kinds. As regards the following paragraph, the upshot is that the Dow's extension to the upside helped the Nikkei along, as US investors' wealth-effect was felt. Then, when diversifying with Japanese stocks, bolstered foreign investors, who have been strong purchasers, reach for the Nikkei.

"I'm surprised by the Nikkei's last 500 points up. It has rallied and it has done so on the back of the same type of news that has recently driven the multi-nationals in New York, namely, "good earnings." The extent of the rally doesn't change my interpretation for the intermediate term, but it does re-confirm the larger bullish trend as being secular, since the Nikkei is poised to complete a corrective period and pattern that is consistent with a primary up-trend."

Simply, the Nikkei has been dragged by the Dow's (US stock market's) wealth effect and has potential to 14,000, to complete a corrective cycle. This particular decline just-commenced may well be over, but when viewing the 2nd and longer-term Nikkei chart below, it becomes evident how 14,000 could (not likely) happen with a collapse in the Dow to under 9000, to which I assign a high probability (see Dow below).

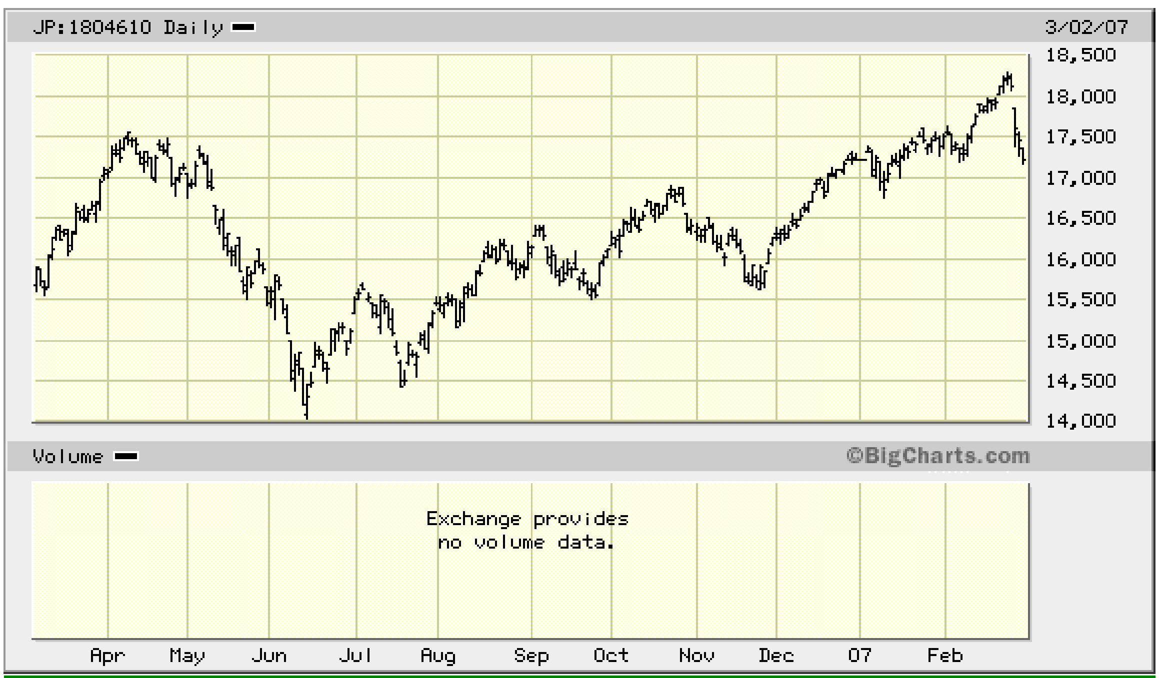
Strategy: "25% of our holdings are in Yen. Domestic stocks are the most levered and contrarian way of investing against New York and the Nikkei on Asia's major exchange."

Above all, it invests in a country of over-abundant capital and demand as far as the eye can see. Profit growth will continue to accompany in this next phase of broader domestic stock profits, followed by the Nikkei, in the coming more advanced and profitable leg of the Japanese bull market, which began in 2000, 2002 or 2003, depending on what you're looking at (for me, it began in 2000; there are 3-year cycles in

all cases). Domestic stocks are the off-cycle levered-value approach at this time, bolstered by the Yen, which tends to bottom two months ahead of a general reversal/blast-off in these equities.

Conclusion: "An interesting thing has occurred with the Nikkei's rally to a level a few points over its previous high. Particularly when simultaneously revisiting the Nikkei/Dow ratio chart (published last month), one can conclude that the Nikkei has "ample room to fall", to accommodate a significant and swift beating in New York."

Investments purchased last, particularly if of foreign content for diversification purposes, are the first sold. This is a driver for the Nikkei decline being timed with the Dow, even if they are in different secular cycles. The sum of all this is that hedge funds will lead the way into domestic Japanese stocks as the Yen powers forward, while foreign institutional and retail investors dump their Nikkei exposure, against the backdrop of their own spiraling markets.



In the near term, the Nikkei has probably bottomed, with a worst-case around 16,500, though I doubt it. But after a rally, as per the next chart, the room to fall is more evident.

<u>NEW YORK</u>

Please, remember: I have often warned of this cycle's most unusual phenomena.

The Dow (not only) has stopped being predictive and falls once the bad news is already in the market. This has two powerful effects: Firstly, it lulls investors into doubting or even disbelieving what they had rationally thought and what later will appear as have having been obvious. All the false starts hypnotize the investor into, "I'll wait for one more rally." This time the rally doesn't come. With all the risk to the downside, with so little to the upside, the investor later bangs his head against the wall.

Secondly, and most important, the collapse comes, as I have always put it, "all at once." This is calamitous in the markets (compacted/speedy bear market which also over-shoots), while spelling a lifetime opportunity, as well.

I'm too aware that this peak is 3 years to the month after the date I had forecast for the peak, at the October 2002 low. Most important is that I'm using the same market interpretation and methodology to arrive at my conclusions. So, I have continued to make my US exposure a small percent of total wealth in 1-year Dow puts at strategic intervals, both in terms of market analysis, as well as premium and strike targeting.

This is the technique for nailing the most significant extremes in markets, from which the largest profits are made, fastest as well, when it's a market peak. Declines are vicious and this is the scenario from hell for the markets and the opportunity for dramatic profits. Only two or three even reasonably-placed manipulations, even with 1-year puts, could dramatically improve on gains that would exceed 1000%, which could be reasonably expected, even if held straight through to target levels (see Strategy below).

"The American savings rate is now negative for 2 years running and is at its lowest level since 1933, the time of the Crash and Depression. We're at the opposite end of where this secular bull market began which, in my opinion, was at 786 in 1982 (I joined the industry a month earlier). The savings rate could not possibly be more strained, if likened to 1933!

"As home prices decline, those declines are not marked-to-market, as regards the mortgages of home equity loans. He wondered what would happen in the New Year when the effected public would receive their yearend statements. Their mortgage payments never increased (with equities, one would have to post margin to maintain equity).

"The effect is seeing declines in home equity to desperate levels, and desperation could set in, particularly as many assumptions for retirement purposes are for higher real estate and equity prices."

Combining the savings rate story with the latter 2 paragraphs that was inspired by an online commentator (whose name regrettably escapes me), provides all the excuse the market needs for a crash, as the trigger to the spending collapse which is, in turn, the most obvious trigger to a Dow crash, despite the fact that all the news has been that there's no end in sight for consumer spending.

Liquidity: "The story is that as long as investors can borrow cheap Yen and buy US assets, liquidity will be ample. It's a funny thing. I've believed that ever since the new bull market in the Yen was signaled and began, that the Yen has been kept down artificially to allow the carry trades to unwind in a more orderly fashion. The next rate hike in Japan may well be the trigger and cyclical take-offs in the Yen are often first-day explosions. For all the markets covered in these reports, directly or indirectly, the turn in the Yen is the single largest story at this time." As per the Yen section below, the Yen turned precisely where recently recommended, at the extreme point of Yen bearishness [as finance ministers were meeting (to allow Europeans a chance to vent)].

Technical: "**Squiggles isn't a Bear's pet. It's a nuisance that has as its most irritating feature that it reminds the investor of the memories of being disappointed for so long. Still, the following 1-year Dow chart reflects how quickly the Dow can lose 1500 - 2000 points, within a 6-week period or so.**

"…a few assumptions may be made….This type of formation necessarily corrects to its point of origin with speed, days. The point of origin for the 5th and final move is 12,000."

Lending credence and confidence to last month's interpretation, quoted immediately above, please note the Dow charts at the end of this section. A straight line down since last month's report.

I reiterate that we are seeing a replay of 2000. The following will repeat (available online):

"Peak for Dow, Japanese tech stocks; low for Japanese value stocks:

"January 13, 2000: Happy Millennium. Now let us begin. The forecast Y2K short squeeze is over and the bear market in New York is free to begin. Japan will pull back with it on a lag as Westerners do the margin call thing. Its bull market vs. New York will accelerate, however, and many cheap Japanese equities in certain groups will actually rise (rotation) as the Nikkei is dragged down by the tech sector. For appropriate accounts, we are buying calendar put spreads (March/February) in New York…."

"Tech out, value in:

"April 14, 2000: …It certainly is not good for hot stocks that, sure enough, have been deflated by margin calls needing to be met. This latter phenomenon has also hit Japan. We now see why I have consistently cautioned to shun the Softbanks of the World and stick to "domestic demand, undervalued, under-owned, non-new-economy Japan". Especially with March 31st year-end out of the way, we are seeing the results…"

This is true even in the sense that, once again, as we pass March 31, domestic value stocks will shine, led by mid-caps.

Strategy: "They won't go far, it won't last long, and it'll reverse with speed." That was our forecast, so the SKC strategy was once again to buy 1-year puts. As you can see from the first chart below, the Dow might just be about finished on the downside, with a spike up toward 12,470, or so, possible. The pursuant chart shows that after a possible spike up, the Dow could easily fall to 11,000, or so, to completely satisfy last month's forecast (if the market continues straight through from here, then the picture is extremely bad for anyone trying to sell any US stocks). So, newcomers can wait for better put prices. A spike reversal up in the Dow and down in put option premiums and time premiums is possible, <u>but it's just as likely that it would reverse on a dime and give only those who are the most prepared a chance to buy puts at good prices.</u>

PRECIOUS METALS & DOLLAR

Bonus – Oil

"...The 3-leg correction is now complete...$65 is price resistance and the 200-day moving average.

Conclusion: We've hit resistance, just as the precious metals have reached their short-term highs. En route toward $80, oil is set to correct now.

Gold:

"Insofar as forecasting this year is concerned, however, some humility isn't a bad idea. Gold may stall when the Dow falls apart, particularly if oil's high is put in..."

This week, it seemed that gold and silver had peaked with a sharp correction of its own possible. But it couldn't even wait for the weekend report. For those who want to trade some minority portion of their position, one could wait for a bounce to $660, say, and then see if the metal re-tests $600.

A reason for taking such a stance is that it gives a chance to see if it maintains its historical correlation to the Dow, at the beginning of the latter's fall. The risk, though, is always to the upside. If one wanted to trade, it would be better to use the over-invested portion of the silver position (below). A reason against is simply that risk is always to the upside during a secular bull trend and one should determine honestly what role the position plays in one's holdings.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Silver:
Just above $12.00, as had been planned, the opportunity to recommend a 200% position became possible (50% margin on an ETF, say). The thought was that extraordinary gains would be enjoyed even at $20, which could be achieved in short order with a break over $15. Well, we already had a lower test of the $15 peak and have quickly spiked lower.

In deference to and in context of the gold comment above, one should sell the over-invested (margin) portion, or, simply put, part of one's silver position, since it is the more volatile. Still, gold is a much bigger position on the books, so sell a trading position (minority) around $660, or so. In any event, be alert for a bounce back to the $13.75 area.

Yen:
The big story in the world was the big news out of Asia and SKC covered both involved countries (Japan and China) in recent issues, including last month (below). Forecasting a price turn is good, but getting the story right and forecasting it too, lends further confidence about both the big picture and timing. Given very recent events, please consider the following from last month, through today's eyes and within the context of the pursuant additional comments.

"The Japanese Yen's slight new low looks a lot like oil's new low into the 50's. In both cases, the moves broke through a neckline resistance (oil chart down, Yen chart up, the latter representing a price decline). This may not be an accident. In any event, oil has reversed. Is the Yen right behind it? I continue to believe that the moves in the other currencies, such as the Swiss Franc and Euro, are forerunners to the Yen's advance.

"The Yen will enjoy extraneous drivers, apart from interest rates and the effects thereof (carry trade reversal). The Bank of China is badly underweight Yen and, rather predictably, has expressed the need to diversify from the USD (the Chinese have already long-since declared the need and wish to diversify from USD into gold and other assets).

"I have often reported the emergence of the Yen as Asia's block currency. Even a pro-Chinese argument regarding currency is a major buy-Yen story. Again, they have to put their money somewhere (and holding each other's bonds forges political associations)."

Strategy & conclusion: "Given the role our Yen position plays in our asset allocation, there is nothing to do. Like oil, with which it shares a similar chart, reversal can occur at any time, so why tinker? The issue

of the resumption of the Yen's bull market is most significant. Firstly, it will alter the equity theme in Japan from multi-nationals (Nikkei) to domestic issues."

After the above-forecasted sharp Yen reversal and turning point took place, the Yen turned back down sharply on the re-hashed news that Bank of Japan would only move rates slowly. But note that interest rates have nothing to do with it. My analysis above does**. The Chinese and Japanese are re-weighting their portfolios and that's the best interpretation of recent events. Particularly since it isn't in the news.**

In any event, the Dollar has recommenced its secular bear market, though it now enjoys support around 115 versus the Yen. Still, to reiterate, the picture is very bad for the Dollar versus the Yen, which will now outperform all currencies, including the precious metals.

Strategy & Asset Allocation:
My asset allocation continues to be 50% gold (or 40% gold + 10% silver), 25% Swiss Franc and 25% Japanese Yen. The change in the status quo depends on whether the above sell zone(s) is/are achieved. I recommend immediate vigilance, and selling into (near term) sharp rallies, since the precious metals are in a secular up-trend, after all. Only if the price is right.

On another note: I've continually been bang on with precious metals, the Nikkei and, finally, the Yen again. In covering as much as this report does, it is easy to get something wrong. But even there, one may consider the track record of reversal, after being wrong for a while. A track record of explosive gains, after perfectly identified turning points to get back in sync with that market (index or stocks). In any event, all the cyclical turns previously forecast our now in place, with lots of room to run. All are on-board.

Sid Klein

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