

So Far, So Perfect



March 31, 2007

JAPAN

Nikkei:

March 4: "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."

As evidenced by the chart below, the Nikkei did indeed fall through to just under 16,600, but held there. Sure enough, it rallied 1000 points. Albeit with greater strength, the Nikkei is tracking the Dow, as major world indices roll over. Exporters everywhere are re-valued due to concerns about slower global economic growth, alongside existent geopolitical risks.

The Nikkei had rallied 500 points higher than I had initially imagined it would, but then identified the peak when it came. That comment's basis was, in large measure, the view that the Dow was imperiling it (the Nikkei).

My forecast was, and remains, that potential is to 14000, though the recent move to slight new highs suggests that 15000 will more likely

be supported. Of course, if it gets really bad, the Nikkei could flush-out to under 14,000 - again, if New York gets really hairy. Either way, two things are true. 14000 Will probably not be approached within 1000 points, or it will be breached with a flush out.

Secondly, we know that the recent move toward 18000 was **countertrend**. That interpretation allowed me to call a top and see that one should not panic when the Nikkei collapses in concert with the New York this year. It will be a **final** decline. See the next chart down.



Still, to more fully appreciate the intermediate term risk, note the following 5-year chart (please scroll down):



And to further consider what may lie in the minefield, let us look at the following chart of the ever-powerful **Shanghai index**. It's not the nosebleed territory that concerns me. After all, they have boomed.

The speed of this advance, however, leaves the 200-week moving average at a level that is only **50% of the index's price, at 1500** (coloured curve). Even a correction within an up-trend, therefore, could be significant.

The distance from this moving average unfailingly exposes markets to susceptibility to profit taking. Any such shock from a much-followed Asian exchange will send waves through to and become another weight on the Nikkei that will also be fending off a Dow decline.

Yet no one is now talking aloud about mid-cap domestic value stocks.....except the hedge fund managers, who seem to have caught on and are catching on more each day. Necessity is the mother of all great ideas, and the pain in New York and the obviously connected Nikkei, has begun the massive diversion of funds toward domestic, as forecast.



On a long term bullish note, Nikkei News Net reported on March 31, 2007 that Sumitomo Realty's FY 2006 operating profit is "seen surging 22% to record level." Real estate was the last group to bottom after 16 years, alongside the banking crisis. All things related will lead the next phase, as from becomes prince.

While this augers well for the market, in the intermediate term, though, it is more important that, after posting higher than expected earnings, 1700 companies were reported to be reluctant to raise forecasts. This is due to falling growth and margins. So...

Domestic Value Stocks:

March 4: "This is true even in the sense that, once again, as we pass March 31, domestic value stocks will shine, led by mid-caps."

Domestic stocks have been strong and will remain so within a freshly commenced 3-year bull cycle. Since the December 3, 2007 letter was written, the 7 stocks recommended therein have **returned 9.0%**. Over the same 4-month period, the **Nikkei** has returned about **5.5%**, and the **Dow 1.1%**.

The out-performance of domestic stocks will **continue and geometrically expand** for several reasons that include those listed at the end of this section.

Immediately below is a chart of the Topix Second Section, as we hone in on mid-caps, now that we have already done a study of the small caps. My timely comments follow it:



The above chart is in a beautiful up-trend, which completed a **full year of profit taking** at the end of the year. **Coupled with this correction's move to a favourable distance from the 200-week moving average** (thus, long-term profit-takers are out of the way), this group of stocks is set to advance much higher.

Domestic stocks in general bottomed in the **2000 – 2002** period. Interestingly, a ratio chart of the Topix Second Section versus the Nikkei (not shown) reflects a low in **2000** and a powerful, unbroken and ongoing up-trend. The place to be, **remains and will be mid-caps, if one had to invest in only one theme for 10 years, on a risk-adjusted and provable major (inter-)trend basis.**

Last year was corrective most of all for the small stocks. At the beginning of the year, I published ratio charts of the JASDAQ versus the Nikkei. Despite a viscous beating, it showed a strong, albeit volatile up-trend up. Versus the Nikkei, it fell a stunning 40%.

Ratio charts [those that correlate one market to another (by dividing one by the other)] reflect true trends. Next month will take a deeper look at various such studies, including the Topix Second Section versus the Nikkei. It leaves little doubt as to the inter-index trend.

It is in as beautiful a trend, as is the outright chart of the Topix Second Section shown this month, but it also clearly shows its low as being **7** years ago in 2000, and that last year's correction was sufficient in magnitude and time (for removing profit takers) in order to launch this new cycle's up-move. The patterns are very clear, as you will see in the next issue with other such studies. In any event, the move is well underway versus the Nikkei, no doubt, and in absolute terms as well, of course.

Why mid-cap value stocks will continue to out-perform the world, while expanding that out-performance appreciably, as it did in 2002:

- The Japanese Yen has reversed, as rates are in a secular up-trend (from 0), and further bolstered by sustainable demand from the unwinding of the renown carry-trade; as well, the Bank of China has begun to address its extreme underweight position in the Yen for reserve purposes, as per official statements. Huge sustainable in-flows.
- The strength in Asia is real and Japan is the region's financier, with now healthy and out-of-crisis banks.
- Another 3-year cycle peak has been completed (1989, 1992, 1995, 1998, 2001, 2004, 2007).
- Hedge funds are springing up in Tokyo, to get a piece of the greatest pie of capital that ever existed there. So, this is an awash-in-capital story, too.
- The group (theme) is historically, consistently and methodically counter-cyclical to the Nikkei and other major markets.
- Capital available from liquidation elsewhere benefits a group that requires only a small portion by comparison to drive it.

Strategy:

No Nikkei, no Dow, no nothing. Load up on mid-cap domestic value stocks. This is a full-fledged buy signal. There are countless screaming buys and others to catch soon in the coming New York drubbing. They are breaking out even as others wither. This will only become more so and the first moves are the easiest/largest. Some will fall in up-trends, only in sympathy with a major index decline. That can cause buying to stall, **but the sellers are all gone!**

Conclusion:

March 31 was the only thing holding back/pulling back stocks and delaying the breakouts; in fact, several stocks that were powering ahead, declined from mid-March. 2 Weeks ago, the 4-month return of the above-referenced December 3, 2007 report was in double-digits, as opposed to 9.0%.

Coupled with the completions of corrections within an already 7-year old bull market against other indices (Topix Second Section and its ratio to Nikkei charts), **these stocks are advancing now and ready to explode into a more powerful phase of advance than the one from 2001-2004.** This is a more advanced phase, as will later be the case for the Nikkei, after completing its correction this year.

NEW YORK

Nothing to add, really. The patterns this week are consistent with the earlier analysis that the Dow would collapse to 12000 in a straight line, hold there, rally to 12,470, and then collapse toward 11,000. Here's the hard part; this last piece has not occurred. To be betrayed, we would have to see a few weeks of basing for the Dow and frustrating Bear who want to see it break 12000. For now, though, the Bears remain in control.

The Colts aren't coming as cavalry this time.

Da Bears!

Strategy: A few points for Dow puts each year, keeps is a portfolio *well-balanced*. Just like certain poisons in certain doses at strategic times is actually healthy. In all seriousness, if appropriate for the investor, with so much profit available for the assumed risk, it is

difficult to ignore. The probabilities of the desired event occurring are greatly superior than that implied by option prices and premiums, if purchases are at timely junctures. We seem to be hitting all the 'junctures' now.

Conclusion: Too many times has Consumer Confidence reversed to bail out the Dow after each took an initial hit. The almost immediate and sudden-like relationship between the two that these pages proved graphically in the past, represents what the true news item of the week was that investors should follow with an eagle eye. The big indicators relate to confidence. Remember that. Everything is about psychology now, in both technical and fundamental analyses. In the 4th quarter, I had forecast that when equity values in homes comes to be known in the new year, Consumer Confidence would collapse along with the Dow that it drags down. That was the real news this week. But, yes, there are always the wild cards, like oil, war, trade-friction and, my own favourite conviction, as readers know (for more than one reason), impeachment. That could follow some more unsavoury goodies. Why would homeowners who are reading all the news about a housing collapse, and who are seeing their new statements, and who are reading everything else, why would they bail out the Confidence indicators now? Negative savings for 2 years and the worst since 1933...with stock prices at a top? What recipe for systemic failure! Insurance time.

PRECIOUS METALS & DOLLAR

Bonus – Oil:

Oil continues strong, consistent with the view at \$56 - \$57 that the lower 50's had been a flush out. The limit target remains \$80 or so, as part of a double top, to complete the bull market in.

Gold and Silver:

There is little to add to previous remarks. The secular trends are up and, so, given the crucial role played by the metals in our portfolios, it is impossible to recommend liquidating. The worst-case scenario under my since-\$500 per ounce mandate, allows for a 50% position. As stated earlier, a sideways correction with a limit of \$600 on the downside during a period of serious equity difficulty is possible.

That said, I have recommended possibilities for creating the volatility one seeks. Scaling back from a 200% silver position was one. The re-test of higher levels in silver just seen was recommended for such

adjustment. Keeping 50% silver and holding 100% gold was another possibility, since the former is more leveraged.

Above all, compensatory leverage was sought from **Golden Star**, in which I had/have advised a strongly overweight position on a number of occasions.

Golden Star:

Is the only non-Japanese stock we own **\$3.25 - \$3.50**. We own it aggressively, since it serves the purpose of providing extensive leverage and safety at the same time, while not being 100% long gold (or owning anything else among the metal stocks now).

The **balance sheet reads like a Japanese value stock**, particularly if viewed as a gold company. Technically, there are long term resistant levels at **\$10 and \$25**. I maintain that both will be seen.



These reports on Golden Star saw the breakout as a matter of course, as I put it, given the base that had been built. Then, when it broke over **\$4.00**, it was plain that the “neckline” over which it had broken would now, and quite typically, be support; a neckline for a stock serves as a springboard, as part of an accelerating pattern. Please see December 3, 2006 and February 17, 2007 letters.

Strategy & Asset Allocation:

For our purposes, we'll assume **50% long gold and silver positions**, while aggressively long **Golden Star**. While gold and silver represent **50%** of our portfolio (in terms of currency denomination), the **Japanese Yen and the Swiss Franc represent the other 50%, 25% each**. These figures assume no partial positions, which is presently and temporarily the case with the precious metals.

Sid Klein

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