

Quarter 1: Act 2

AND SILVER'S LINING



March 2, 2008

JAPAN

Banks:

On January 25 of this year, Nikkei News ran a story headlined, "**INSIDE VIEW: BOJ Must Stop Selling Shareholdings.**"

The story reported that the Bank of Japan (BoJ) had announced last October that it would start selling its publicly traded holdings, despite the unfolding **subprime** calamity. The piece concluded that the market would benefit from a 3-year delay in such sales.

In March 2003 – May 2003, I reported and forecast that the BoJ was buying back publicly traded equities from the banks, which were stuck with unwanted assets. Such purchases, I argued, were occurring during a trumped-up crisis and that, after having bought at the stock market's lows, the BoJ, whose holdings are mostly bonds with hardly any equity, would, in the years to come, sell closer to 20,000 on the Nikkei and, in so doing, negate the losses assumed in the bailout. In

other words, the government was playing the market, as the world's second-largest insider traders (our American friends still take the prize).

Now, it remains for them to step back until the next cycle peak at 22,000 is approached. And they will, just as the reporter above recommended.

A side story worth noting is how differently a country with massive savings may deal with its problems. In Japan, the **subprime** crisis knows a different form.

Due to lowered rate limits for lenders, there has been a drawn-out industry shakeout. Of course, the pain caused to these equities stems largely from a wait-and-see attitude, as regards who will survive.

Moreover, investors haven't chosen the path of patience to see how that plays out and, therefore, even those whose balance sheets were put in good order over prior years have suffered badly...almost as if they really are going out of business. In looking at these highly price-leveraged stocks, another story has emerged.

Reflecting an acceleration of the consolidation in the industry, **SMFG Group is merging 4 non-banks**, as they are known.

These two stories are consistent with what may be referred to as part-2 of the secular bull market that began in the first quarter of 2003 (2001 for the domestic stocks). It makes sense, after all. Domestic Japanese equities have endured a bear market for 3½ years, after a dramatic 3½-year run-up.

Technical (Nikkei):

The Nikkei, Topix, and the banks are ending a **bear** market that began in April 2006. March – April was also the secular turning point (**up**) in 2003. I never thought that post-calendar yearend would yield to such lower lows, if they do indeed occur, despite having held precisely such a forecast for New York.

So, to complete the pattern, a quarter-ending collapse to Nikkei 12,000 (500 lower than January) would be entirely consistent with its overshoot of 14,000, while coinciding with this quarter's debacle in New York.

Remember, however, that the former is ending what the latter is beginning. As Japan's yearend clears, large and small will take-off, as Chinese and American counter-trend rallies commence thereafter.

The chart immediately below clearly marks the big-caps' bear market since April 2006, as mentioned in the second line of this section on page 2. The first leg of the bear market concludes at point-A. Point-B marks the countertrend (albeit the unconfirmed-by-the-Topix new high) peak at 18,000. Thereafter, I wished to dissect wave-C.

The latter, by rule, breaks down into 3 waves. They are marked by points (a), (b) and, finally, (c). And, sub-dividing the latter, wave-(c) breaks down into 5 waves. Therefore, wave-C, wave-(c) and wave-5 all mark the same point, which I have placed out in April.



The 8-year weekly chart immediately below clearly illustrates the impregnable nature of Nikkei 12,000, the massive neckline* support at which the panicked will again yield to Japanese wizardry and deem all financial life hopeless (simply imagine a horizontal line* across 12,000).

Then, with the Westerners shaken out of a market where their trading accounted for a quarter of transactions at the peak, the foreigners will be trapped again – shut out of a party they'll be tripping over themselves to get into at 20,000.



On analyzing the above, one thing further is clear to me, based on 20 years in this market and 25 with technical analysis: Any new low would create a significant momentum divergence (see stochastic at bottom of page) that would yield to a violent spike reversal, to trap the aforementioned dozing bears.

The last chart (at the top of page 5) reflects a short-term up-trend, which underscores that a break below the up-trend line should officially signal the just completed conclusion of the final minor rally (wave-4, at the bottom of page 3), before the final bottom (wave 5 of © of C, in April).



Domestic equities:

From the January 24 report:

“Because of the Nikkei’s activity, high quality low valuation stocks have recently declined as much as 20% in just days or weeks. Not only have they fallen to ridiculous long-term (multi-year) neckline support levels but, aside from that and having more cash than debt in many cases, many have even fallen to price-earnings (PE’s) level between 8 and 13!!! This includes companies at the BEGINNING of earnings cycles; and this is how stocks triple, as opposed to mere 80% mark-ups to more normalized valuations.”

The **technical** analysis that precedes this section describes the psychology and sentiment that developed during this period’s ignored **fundamentals**, insofar as **valuation** is concerned. Clearly, where Japan is involved, the baby has been thrown out with the bathwater.

The massive amounts of capital presently seeking emerging markets underscores the need and demand for alternative investment and, for

now, for some insane reason, the crowd is treating Japan as passé in all respects, forgetting that **it represents the clear majority of both Asia's GDP, as well as its market cap!**

Soon, realizing the significance of the Yen's astonishing turnaround (see Yen below), the search for alternative investment will lead those genius follow-the-crowd managers back to domestic Japan. Be 100% certain of it. This time is no different. In the years to come, the world's 3rd-largest market will regain its status as the 2nd-largest. And yes, I remember when it was #1.

Strategy:

Any strategy that uses Japan as the basis for out-performance – regardless the market – is a winner, both for hedging and pure profit purposes. That has been the case to-date, particularly for well-engineered strategies, and the future will accentuate this reality.

NEW YORK

Dow:

Again from the January 24 letter:

“Anyway, the first stop forecast was for 11,200, en route to 8,800. We got to 11,500. Close enough. In any event, the Dow should pull back after this 1000 point spike up, before rallying to still higher levels as I warned the panicked at the beginning of the week. Thereafter, hell.”

And from the February 4 report entitled, “Debacle Resumes:”

“Simply note the following 1-year chart. The Dow has rallied into neckline resistance and has approached the 200-day moving average, which means that that the resumption of the debacle could occur at any time.”

Please note the comments above and the dates that they were published, in the context of the chart at the top of page 7. Down, then up; then down; then up; then down...all following a like sequence on a bigger scale as well, insofar as the last six months are concerned. The upshot:

When a bear market-ready trader has his day, everything clicks...repeatedly...and for as long as he had had to wait.

(The horizontal line in the following chart is what is referred to as neckline resistance, while the 12,000 level referenced in the Nikkei chart on page 4 represents neckline support.)



VIX

From the January 6 report:

"I have commented and maintain that this new bull market in volatility is defined by the 200-day moving average and this is most obvious by the chart immediately below."

For today's purpose, there is nothing to alter from the above quote, since past again proved to be prologue, as evidenced by the chart on the **next page**. As is quite plain, and as is quite understandable for logical and explainable reasons, the stock market took off to the downside, as soon as the VIX hit its 200-day moving average.

The latter appears on the chart as the upward-trending purple line. When it was hit, the counter-trending-to-the-market VIX spiked upward. We'll see how far it goes this time. The VIX has been a good friend, in timing the market's turns in both directions, so we'll see if this remains the case, as part-2, forecasted for an early April conclusion for the "Dow 2008 1st-quarter hit", manifests.



We conclude with a reprint from the February 4 report:

"Strategy:

Suppose you want to cut your risk in half and double your leverage too, and further suppose that you don't mind profiting only little from a bigger collapse that occurs sooner, as you prefer to err on the side of caution, risk aversion and capital preservation, then an April – March Dow put spread is appropriate. It's a matter of choosing the correct strike price...and the leverage is huge!"

This is precisely what is unfolding.

GOLD

From the November 4, 2007 report:

"At the beginning of the year, I forecast that gold would cross and sail past \$700, perhaps this year, en route to \$1000 with speed. The upside risk is too much to exit without a re-entry plan, and no quality re-entry plan can possibly exist this time.

"We have benefited from another \$150 move up, and the daily chart (immediately below), like the weekly, shows an overbought stochastic (joining other momentum indicators). Note how this thing can take off to \$1000 now, with so much selling pressure gone (institutions needed money). Does the crowd expect it? Are the longs fully long?"

"Forecasting that silver could make a low at \$11.00 (since most investors would wait for \$10.00 after a break of \$12.00), I wrote that the last decline should be used to go 200% long. My reasoning was that silver has and had no reasonable physical chance of dropping to \$5.50-\$6.00.

"I further reasoned that one's investment year is largely made by such a trade that includes a subsequent move to \$20.00, which is where we will be much faster that thought. Indeed, however, that a mere move back to \$15.00 would go a long way toward providing a banner year, too. If 200% long since \$11.50, what are returns even today at \$14.00?"

"...this move up in the metals may simply have been an initial move that merely requires a short term correction, before a yearend eruption to \$1000."

Okay, we didn't get \$1,000 by yearend; call me *pisher*. The mantra in these pages has been: Just stay invested. Period. I could write long analyses like I used to, but there is an instructive discipline to expressed laziness here.

China, India, American monopoly money - yada, yada, yada. At the beginning of 2002 (gold's higher low at \$280), I forecast a secular bull market that will last years and take the precious metals to dramatically higher new all-time highs.

Gold was tradable until \$500, I argued, but that it should not be touched thereafter. This is what we did. http://www.sidklein.com/docs/gold_summary.pdf. (The latter can be linked on any gold or precious metals link on the homepage.)

The adjoining forecast was that bulls would not leave well enough alone on the way up, despite the preceding recommendation. The latter included that gold should represent 50% of one's liquid holdings, upon its crossing \$500 an ounce.



The following longer-term view of this decade shows what a simple investment gold has been, to stay ahead of capital or true wealth erosion. The same has been true of silver.

The timing summarized in the link in this page's second paragraph merely accentuated these facts, and provided what I suspect to be the best performance in the world, precious metals equities excluded.

SILVER

As you can see from this section's quoted excerpt above (in blue), we went 200% long between \$11.00 - \$11.50, before scaling back to 100% long at \$15.29 on January 6.

As forecast in the excerpt above, this trade would in itself be more than enough to make one's investment year. Why fight the simple???

It was repeatedly explained in these pages that there are 3 types of leverage that I am aware of:

Options are fully paid-for instruments that are intrinsically leveraged. Futures are leveraged with implicit borrowing against the notional value of the underlying contract. The 3rd is borrowing in the form of margin.

The latter, I argued, was appropriate for silver, since the possibility of it falling to \$5.00 - \$5.50 was next to zero, given the markets' and earth's fundamentals.

So, 200% long at, say, \$11.25, reduced to 100% long at \$15.29. Today, we're at \$19.82. The return thus far equals: $\{(19.82 - 11.25) + (15.29 - 11.25) \text{ divided by } 11.25\}$

RETURN: 112.09%

SKC covers Japan, New York, gold, silver, select and strategic major currencies, as well as timely special situations. Of course, this includes timing and specialized use of derivatives knowledge.

Realized rather quickly, the return demonstrated above illustrates why SKC might be the most valuable market letter in the world, for global investors.

The 1-year daily and 8-year weekly silver charts that follow on the next page, make clear why executing a single strategy well can provide the returns cited here.



YEN (CURRENCIES)

From the January 24 report:

“In any event, bear this in mind as well: I was bullish the Yen at 117. It went to 123-124. I was told the carry trade would never be unwound because the US authorities were in control.”



Okay, now we know who's in control. Like I wrote through what had seemed to be an eternity: **The free market!**

And the same will have held true of Japanese domestic equities (which follow the Yen over time). As with all markets that defy value or that are manipulated, whether the subject is China, New York or precious metals, etc., no, this time will NOT be different!

The longer fundamentals are ignored, the longer the reverse trend takes hold. Japanese stock investors are reminded of this and their extreme example will have been gold's bull market and the extended bear from which it was born.

Off the bottom, the Yen's bull is already 8 month's old and 16% to the good.

Good fortune to all,

Sid Klein

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