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AUGUST NEWSLETTER
What If?

Have you ever wondered just how bad things could get? Well, I've lived long enough and traveled far and wide enough to know that things can always get worse. As most of you are probably tired of hearing by now, I've lived and worked in Peru for the better part of thirty years. During that time I've seen and experienced just about everything imaginable… inflation, terrorism, attempted coup d'etate, self-imposed coup d'etate[1], riots, strikes, war, and corruption. You name it and Peru has experienced it. Here's an example – from 1988 to 1990 we spent twelve hours a day, everyday, without light and water. Then there was the inflation of the late 80's. It was so bad at one point that if you received a check in Inti's at 11 am, then went to the bank and presented it to the teller by 12 noon, it would be worth 1% to 2% less in dollar terms. You want to talk about a bear market in housing? In 1989 people were selling their house for twenty cents on the dollar and glad to get it. Once desperation sets in, no price is too low.

Human beings adapt though and I know I did. To deal with the water and light issue, I built a large cistern tank and bought a 30 kilowatt generator. I wasn't alone either and over time I came to realize that Latin's are rally quite an ingenious people. When then President Alan Garcia decided to impose a two percent tax on all checks written and cashed, it didn't take long to find a loophole. If someone paid you with a check, you simply endorsed that check and used it to pay your own bills. I saw checks with so many endorsements on the back that they had to staple a piece of paper to the back of it in order to hold them all. I saw some checks with as many as fifty endorsements on them. Eventually the government gave up and repealed the tax.

Just when you think you've seen it all, life surprises you and throws a curve ball. When Alan Garcia handed over the reigns of power to Alberto Fujimori in 1990, he left the country in dire social and economic straights. It was so bad that the Central Bank actually had *negative* reserves. That's right, I said negative reserves. Never in all of my years of research and analysis have I heard of, or read of, a similar occurrence. It was so bad that *cashiers checks* from the Bank of the Nation, used to pay the government's bills, would bounce higher than a super ball. As terrible and shocking as all that seemed

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[1] In 1991 then President Alberto Fujimori overthrew his own government. He succeeded and gave Peru the six best years, economically, in its history.

at the time though, it is nothing compared to what I see going on now. As you've probably gathered by now, the worse President in Peru's history was Alan Garcia. He ruled from 1985 to 1990, and when he left power, he handed over a bankrupt country on the brink of revolution. His principal claim to infamy occurred in 1989-1990 when he posted the highest inflation rate in all of Latin American history. If my memory still serves me, it surpassed one million percent. To top it all off, civil disobedience was everywhere. For my money Alana Garcia was not only the worse President in Peruvian history, he was the worse President in Latin American history and that is saying something. How then do you explain the fact that the people of Peru saw fit to vote him back into power just two short months ago? It's beyond me, and he actually ran under the banner which pegged him as "the responsible choice"!

How do you rationalize something like this? It's not easy. I tend to chalk it up to a combination on poor diet, poor education, and a lack of proper medical treatment. When imposed upon a human being from birth, these conditions tend to produce a person with a less than adequate reasoning process. It helps to know that Alan Garcia is the best public speaker this side of Martin Luther King. Also, and this is true everywhere, today's electorate is only capable of choosing someone who tells them precisely what they want to hear. Combine the two and anything is possible. Something like this could only happen in Peru, or could it? Here's some food for thought: what if something similar happens in the United States? The idea that an electorate would sell out to the highest bidder is not particular to Peru. President Bush (Jr.) ran on the premise that he would not raise taxes and would even cut taxes in certain areas. Unlike his father, he has kept his word. The fact that the US currently has over $80 trillion in unfunded liabilities related to Medicare, healthcare, and retirement, or just over US $266,000 for every man, woman, and child in the United States, just doesn't mesh well[2]. The last time I checked the average American comes up a bit shy financially, about US $263,000 give or take a few pennies. These unfunded liabilities do not take into account current deficits, trade deficits, the wars in the Middle East, and a host of other items. The fault doesn't rest with Bush, but with the American people. He was smart enough to figure out what they wanted to hear, and he told them.

Currently we have a government which lied to the American people in order to invade a foreign country. What's more the government continues to lie by telling you that the US presence in Iraq is necessary to battle terrorism. I would take the opposite position; the US presence in Iraq is going to produce even more terrorism. Innocent Iraqis are dying by the hundred everyday in a failed attempt to bring democracy to a country that has no idea of what democracy is. The average American is content to just sit by as long as the war doesn't intrude into his little corner of the world. Meanwhile the US Army is sending dead young American children home on a daily basis. They bring them in in the dead of night and don't allow any TV coverage. Out of sight, out of mind! After all, you wouldn't want to interrupt a rerun of *Survivor*.

Then there is the educational system, or lack of it, in the United States. When I was doing my graduate work in the US back in the early 80's, I had to teach undergraduates Economics 101 (economics for beginners) classes in order to keep my fellowship. I was surprised to see that five students actually couldn't read the book with any comprehension and a majority of the class couldn't do simple math in their head

[2] Source: www.321gold.com in an article entitled "*No Cuts, No Butts, No Coconuts*" by Bill Gross of Pimco

(for example, six times six). At that time, I likened the educational system to a huge baby-sitting service. Recently I was reminded that things haven't improved over the years. Last month a client of mine wanted to hire a young American to do some market analysis for his company. Since I have both a reasonable knowledge of analysis as well as English, he invited me to sit in on the interview process. The Americans had to compete with Latin's, Chinese, and several individuals from India. When it was all said and done, he ended up hiring a young fellow from India who possessed excellent analytical skills and dominated the English language. The Chinese candidates finished a close second and were actually better analytically but lacked the English language skills. The Chinese government is remedying this as they recently made English a requirement for all grade school and high school students. Latin students also did quite well in all phases. The poorest of all were the American candidates and this was in spite of the fact that they had preference going in.

For those of you living in the US, I would ask you to conduct a small survey. Ask all of your friends and relatives if they've read the *US Constitution* at least twice in their lifetime? Most, if they are honest, will admit that they haven't. If they had, they would know that taxes and paper money were unconstitutional. What's more, they would know that the US's action in the Middle East is also illegal. Then there's the Patriot Act. There's a misnomer if there ever was one! It seems that Americans are content to give away little bits and pieces of their freedom for the illusion of security, and that's all it is, an illusion. *From the outside,* it looks as if you have a mindless populace, in a bankrupt country, governed by a small group of individuals attempting to subvert the constitution for there own benefit[3]. I see this every day in my work. I see certain futures prices[4] manipulated on a daily basis by the Federal Reserve in order to maintain the illusion that everything is alright. This price manipulation is illegal and if you or I did it, we would go to jail. Since it is done by a few very large, important institutions for there own benefit, the SEC is content to look the other way. They do so, in part, because these very institutions staff the SEC.

The people in the United States need to stop and take a serious look at where they've been, where they are, and just where it is they think they are going. They also need to take a look at who is leading them and what interests are being served. Case in point: I remember ex-Secretary Colin Powell spouting off about opium production in Afghanistan just after US troops hit the ground there. Something to the effect that we could finally do something about all the supply coming out of that country. Well, we did something about it alright. **It was just announced that opium production rose a staggering 59% in the last year!** It sounds like the boys in Washington found a new way to finance the war effort. Then there is Halliburton. Normally, when any country undertakes a major project involving the investment of billions of dollars of tax payer money, you put the project out to bid. Not Bush! He just walks across the street to Blair House and gives the contract to Chaney so he and the rest of the good old boys can rape the American people for tens of billions of dollars. Great work if you can get it!

In conclusion, the ease with which Americans are willing to give up their freedom is scary. Couple this with their readiness to mindlessly hand over control of their country to a group of individuals who are less than holy, and I have to wonder just how

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[3] Please don't send me a thousand e-mails telling me I don't know what I am talking about. Try to remember that the view from outside is always different than the view from within.

[4] Gold, silver, oil, and the S & P futures just to mention a few

bad it could get. Finally, I look at the current administration's eagerness to engage Iran militarily and I no longer wonder; I know how bad it can get. I caught bits and pieces of Secretary Rumsfeld's speech the other day, comparing the present situation to Nazi Germany in the 1930's, and I have to agree up to a point. Europe is moving to the right, just like 1930, and Latin America is running to the left just like 1930. My only question is who is really wearing the black hat in today's world? I know how bad it can get and that's an area where most of you have little or no expertise. I've also lived long enough to know that it can get worse. I suspect that we are already beyond the point of no return and the only thing left to do is prepare the best that one can. The US is on the verge of standing alone. A nationalistic Europe will not support the US this time around and a leftist Latin America would like nothing better than to stick the knife in a little bit farther. You can also forget about China and Russia as they will tend to their own self interests which do not coincide at all with the US. A morally and economically bankrupt US, standing alone, does not bode well at all.

MARKET COMMENTARY

Just about every market is trending and that includes the DJIA, the bond market, the US dollar, oil, copper, and the CRB Index to name a few. In some cases it is accumulation and in some cases it is distribution. It also appears that the "invisible hand" is hard at work, especially with the dollar, gold, and the S & P's. In every case the primary trend of the market will eventually win out over any and all types of intervention. It always has and it always will. In particular, the **US Dollar** has been the object of a lot of attention the last two weeks. As you look at the *Weekly Chart of the*

US Dollar Index, the first thing that should come to mind is “head-and-shoulders” formation. It’s as close to textbook as you are likely to see. The next thing you should observe is that the 50-wma is trading well below the 200-wma and the actual price is trading below both. Also, both the weekly moving averages are headed down. It’s really hard to find a more bearish scenario.

Back in late May, when the dollar was making a bottom, there were numerous articles proclaiming that the bears had it all wrong and the dollar would be at 104.00 before you knew it. Elliot Wave was used to justify the coming rally and how could you argue with that? Unfortunately for the bulls, the subsequent rally fizzled out at 87.33, producing a considerably lower high and then turned down. For the last couple of weeks we’ve been bouncing around in a fairly tight range from 84.30 on the low side to 85.55 on the high side (basis the September futures contract). Sellers are abundant at the high end and the invisible hand is working his fingers to the bone on the low end. We have strong Fibonacci resistance at 85.30, last week’s high, and again at 85.70, as well as the 50-dma at 85.57. At the low end we have Fibonacci support as well as a trend line coming in at 84.47. Below that we have the old low at 83.27. The dollar is clearly trending down and that won’t change. I expect to see a test of 80.50 by the year’s end. As most of know I have been sort the dollar for months and I see no reason to change.

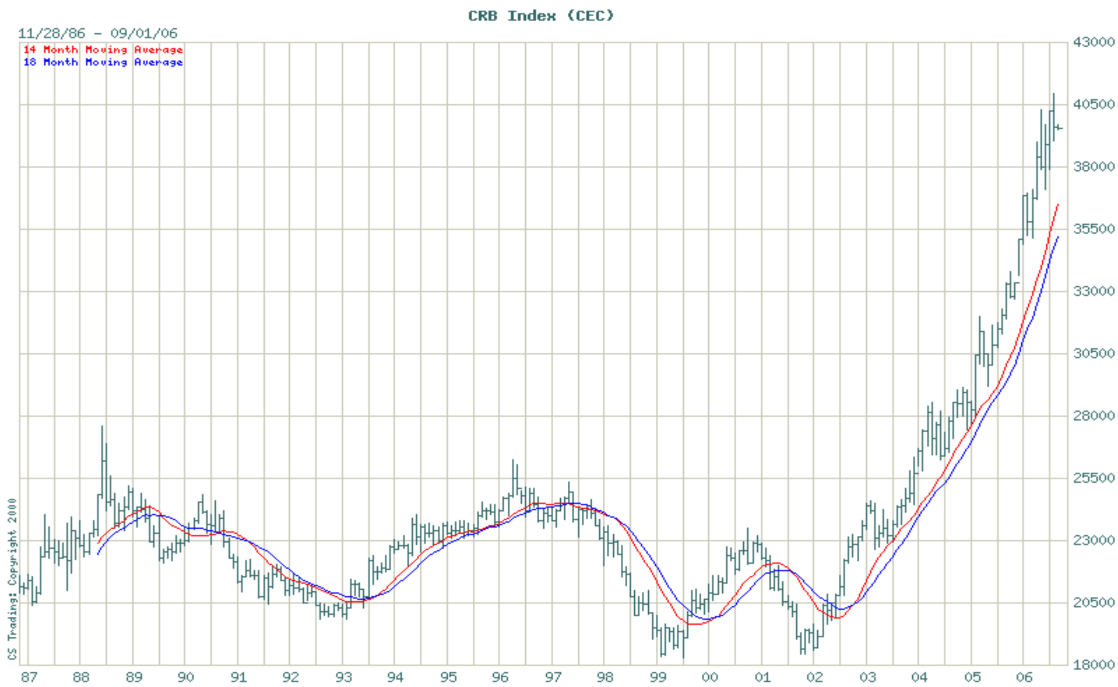
The inverse of the US dollar is the **Swiss Franc**. As far as fiat money goes, this is as good as it will get. It’s the only currency where the word quality truly applies. A look

at the *Weekly Chart of the Swiss Franc* reveals a reverse head-and-shoulders formation and that is quite bullish. Note how both the 50-wma and the 200-wma have turned up and the price is trading above both. The Franc is currently consolidating and must deal with good resistance at .8199 bases the September futures contract. Good support is at .8081. The daily chart (not posted) clearly shows that the Franc is being compressed into a tighter and tighter trading range and, since the primary trend is up, the breakout should follow the trend. I have been long the Swiss Franc since 2001 and see no reason to tamper with a good thing.

Before dealing with the individual commodities, I would like to discuss the **CRB Index** at some length. The interpretation of current conditions and the coming breakout, either up or down, is very important. There are two schools of thought at the moment: we are in a secondary reaction that is quite normal, or, the bull market in commodities is over and we are headed down. There is almost nothing in between. Those that believe the bull market is over base their analysis on the fact that the US economy has rolled over along with the housing market, and demand for raw materials has no where to go but down. On the other hand, the analysts who project another leg up in the CRB are basing their hopes on the demand for raw materials being generated by China, India, and the rest of non-Japan Asia. Just a few years ago, the assumption that Asian demand could produce rising prices in spite of a slowing US economy would have been grounds for commitment in a mental institution. Not so any more. Besides, there is one factor bear market advocates are overlooking and that is the consumer in the US. Take a look at the *Weekly Chart of the Morgan Stanley Consumer Index* and tell me what you see:

Just incase you are wondering, we closed at a new all-time high on Friday, September 1st. That is even more impressive when you realize that the housing market has fallen off of a cliff. The only explanation that comes to mind is that they are wearing the numbers right off of their credit cards.

Take the US consumer, tie it together with Asian growth which shows no signs of slowing down, in fact it's increasing, and you get the following image:



This is a *Historical Chart of the CRB Index*, it is impressive, and there isn't even so much as a hint of a breakdown in this chart. As you can easily see, we are trading well above the fourteen and eighteen month moving averages. Take into consideration that silver, gold, oil, lumber, the grains, and copper have all undergone, or are undergoing, healthy corrections and it is even move impressive.

Although not posted here[5], the daily and weekly charts are both considerably oversold, more so than they have been in many months. The November 06 CRB futures contract closed at 395.60 on Friday, September 1st and is right about in the middle of a trading range that stretches back many weeks. That range extends from 380.00 on the low side on up to 410.00 on the high side and I have to believe that this is nothing more than consolidation as the CRB prepares for an assault on the 419.00 all-time high. In contrast to the naysayers', I believe you'll see new highs before Christmas as oil, copper, gold, and silver, among others drive the CRB on to new highs. Given the chart above, my only path is to stay long the CRB and add on once I see a close above 410.00.

Let's follow our discussion of the CRB with some comments on **oil**. It is probably the heaviest weighted commodity in the index and there is a reason for that; you can find oil and its derivatives in almost everything that touches our lives. Take a look at the following *Weekly Chart for oil*:

It is a bullish scenario although the last high (at 79.86) was suspect as both RSI and MACD failed to confirm. Oil just completed its seventh week down and looks like it is shaping up for a test of the 50-wma at 66.81. Additionally, oil will find considerable support from the 14 month moving average which comes in at 67.00. The major

[5] For these and other charts, you should check out www.stockcharts.com It is an excellent source of free material.

impediment to oil's rise is political in nature and certain forces are doing there best to talk it down. In my opinion, talk won't get it down. Current production isn't sufficient to meet growing demand in Asia and then we have the Middle East question. Nothing has been resolved so far and I am being generous when I say that it wouldn't take much to interrupt supply

It is my opinion that oil will continue to trend sideways for another two to seven weeks, probably within a nine dollar range (66.00 to 75.00), and then make its move to challenge the July 14th all-time high. A look at the chart above still shows a commodity that is somewhat overbought and I believe we need to work that off. The Middle East situation is in a lull now because it is convenient for both sides. Hezbollah wants time to rearm and Israel needs to pause and assess just what went wrong during its recent campaign into Lebanon. Then there is Iran! They won't stop producing nuclear components until there is a dialog, and that is their real strategy. Talk, talk, and more talk. Dialog will not stop production; it is just a ploy to gain time. Bush on the other hand won't talk, and this time I can't blame him. Sanctions won't work because China and Russia won't support it. With everyday that passes Iran grows stronger in the eyes of their neighbors. The US invaded Afghanistan and Iraq with the idea of being the "Good Shepard" and leading the helpless flock down the path to democracy. They are trying to convert Iraqi forces into a good sheep dog. There are wolves along the way, and the problem with having a domesticated sheep dog is that any failure to kill the wolf just may embolden the sheep dog to turn on his master. An undermanned US armed forces is arming thousands of Iraqis whom they just might have to fight some day. Given all of this, oil can only go one way over the long run… and that is up. I expect new highs by year's end and that is why I am long oil and will stay that way.

Copper is another major ingredient found in any number of the things we use on a daily basis. A *Weekly Chart of Copper* paints a healthy picture:

Given what I've said about increasing demand in China and India, copper should be one of the principal beneficiaries. When I look at the above chart, I see a commodity being squeezed into a tighter and tighter range. You can clearly see a lower high and a higher low, and you can also see smaller weekly trading ranges with respect to the last five weeks. Furthermore, we know that we are in a bull market for copper so the next move should be up and through the 394.90 all-time high. On Friday, the September 06 futures contract closed at 347.50 which is just above what was good resistance at 346.27. The key to an upside breakout will be a close above the top band of the trend line passing through 365.00.

I am watching copper and oil carefully as I have been, and am, a nervous proponent of stagflation. I have no doubt that the US economy is slowing, but being a closet deflationist, I continually worry that prices may stop rising. The fact that these up trends are intact is confirmation that my worrying is for nothing. An upside break out would indicate that there is a lot more inflation in the pipeline and I have to believe that will be the case. Therefore I will remain long copper.

I will come right out and say that I am extremely bullish **gold** and **silver** at this point and time. The May 11th high in both metals was followed by a relatively short downside reaction lasting one month and three days. In the initial rally that followed the bottom, gold did all the heavy lifting as silver and gold stocks did little except look on. Gold's July 17th high of 684.70 succumbed to selling that drove the price back down to strong support at 603.10. Since then we've tested the 603.10 level on two more occasions and it has held firm. Take a look at the following *Daily Chart of gold*:

On Friday, gold closed at 625.09 and just under the 50-dma. Note the similarity with the copper chart in that we are making lower highs and higher lows, the last of which was on August 29th. I now believe we are done to the downside and will begin a move up that will take us into February or March of 2007 and, at the very least, reach good resistance at 775.00 and could have the potential to go much higher.

One of the reasons I'm so bullish on gold has to do with the behavior of silver and gold stocks. Normally when gold leads silver and gold stocks up, the rally is labored and/or short lived. Some weeks back I pointed out to my clients that silver looked like it was beginning to take the lead and sure enough last week I saw silver break out ahead of gold. Take a look at the *Daily Chart of silver* below:

Here you see a definite uptrend and the key to the recent break out was the two consecutive closes above 1236.50 which occurred last week. That had been significant resistance for many weeks. Now the next test comes at 1302.90, and once that is overcome, we should be testing the May 11th high of 1518.00 in rather short order. Also notice how both RSI and MACD have turned up in silver whereas gold hasn't yet managed to do that. A quick glance at the *Daily Chart of the HUI* shows a similar bull-

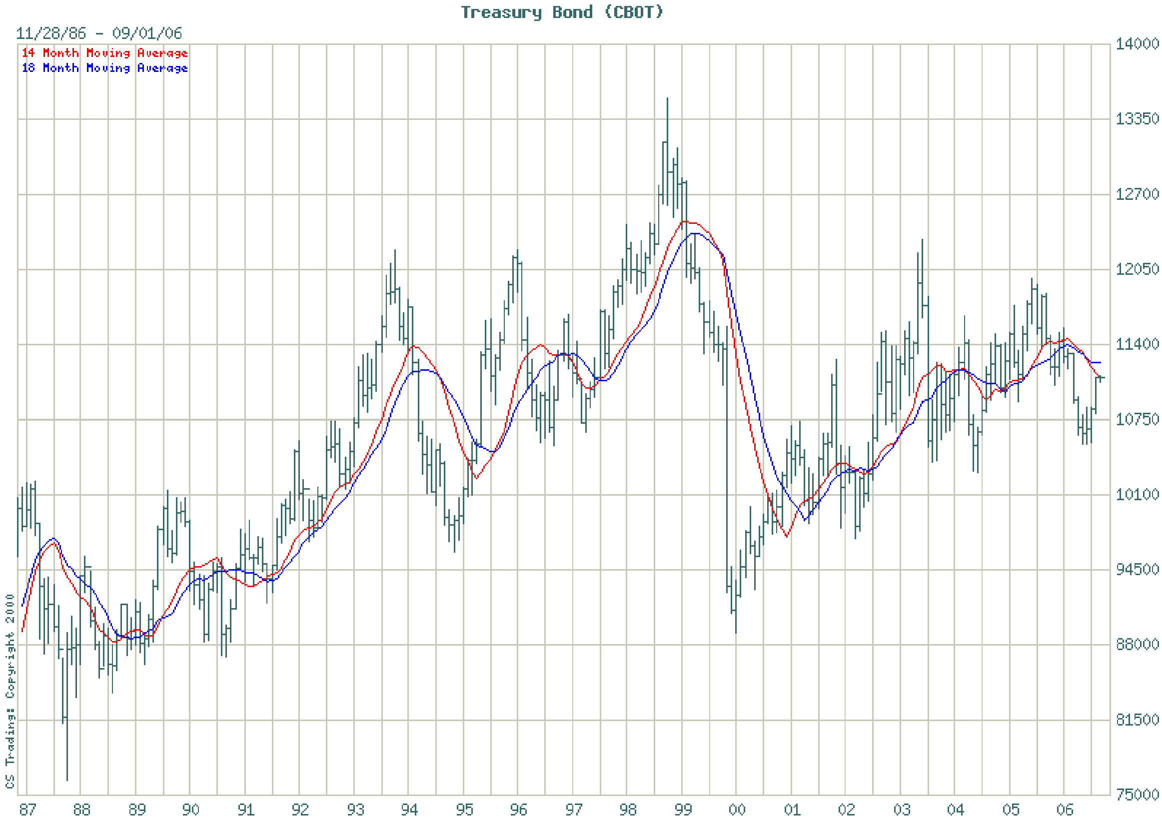
ish breakout that occurred on Friday. I want to see a second consecutive close above 352.00 on Tuesday but, all in all, you can't ask for much more at this stage.

In conclusion, I was a recent purchaser of gold and silver but for different reasons. I bought gold because it held support at 603.10 for the third consecutive time whereas I bought silver on the breakout. In spite of the break out I have not purchased gold stocks because I worry about the effects a declining DJIA could have on the HUI. In any event I am 80% invested and hold the usual suspects, i.e., Buenaventura (BVN), Coeur D'Alene (CDE), Goldcorp (GG), Glamis (GLG), Newmont (NEM), Royal Gold (RGLD), and Silver Wheaton (SLW) and I will not liquidate under any imaginable circumstances.

Now we get down to the complicated stuff. **Bonds** seem to be in a world of their own and I'm not sure there is a simple explanation. Bond prices are driven by interest rates and interest rates reflect inflationary pressures. If you expect inflation, you raise rates, and that drives bond prices down. The same can be said for the inverse. The other side of the coin has do with the economy and whether growth is perceived to be accelerating or declining. Under most circumstances increased growth leads to rising prices and vice versa. The only exception to that rule is stagflation, a condition that embodies slowing growth along with rising prices. I guess you could say that it is the worse of both worlds. Now comes the tough part. The stagflation that is currently gripping the US is complicated by the fact that price increases are being brought about be increased foreign demand for raw materials and finished goods. China and India account for almost three billion people and their standard of living has been improving. They are no different from the rest of the world in that when they have a little more money, they want to live a little bit better. That's human nature. Living better could be highlighted by consumer spending, investment, or even saving more. It just depends on what floats your boat.

The question on everybody's mind is how will the Federal Reserve react to this dilemma? Do you raise rates and fight inflation or do you lower rates and stimulate a slowing economy? When faced with this same problem in 1981, the Fed raised rates well into the double digits. This time around it won't be so cut and dried. Unlike 1981, the US is awash in debt of all shapes and sizes and any significant hike in rates could not only lead to a bad recession, but a full-blown depression. On the other hand if the Fed lowers rates, the world's biggest debtor which just happens to be the US government, won't be able to sell their debt to the rest of the world. You see the rest of the world is already raising rates and that makes their bonds more appealing. Can you see the problem here?

The Federal Reserve is in a bind here with no real way out. It's kind of a damned if you do and damned if you don't thing that wakes you up at 3 am in a cold sweat, and I think the bond market is reflecting that right now. Take a look at the *Historical Chart of the Treasury Bond*:



Bonds were in a bull market for the longest time and that somewhat typical of bonds. Major moves in the bond market often last decades and, Fed problems aside, I believe the bull market is bonds came to an end in 2003 when the rally that began almost four years earlier failed and we made the first of two lower highs. The second lower high came just last year. This particular leg down broke below both the fourteen and eighteen month moving averages and what's more the fourteen month moving average has broken below the eighteen month moving average. That eighteen month moving average is now at 111.08 and I suspect we'll test it before long.

We live in a world where anything is possible and I suppose the Fed *could* lower rates. How would they finance their debt if that were the case? Just like Alan Garcia did! They would crank up the printing press and in essence finance themselves. The end result of such a 'radical' policy would be the destruction of the dollar, then the bonds, and finally the economy itself. On the other hand, if they do raise rates it will destroy the backbone of the US economy which has been and continues to be the housing market. Housing was Alan Greenspan's latest greatest bubble and already appears to be loosing air. Take a look at the *Philadelphia Housing Index* below:

Two lower highs followed by a sharp drop down to the 200-wma is not a good indicator of strength. Over the last month, the index has been drifting sideways with little or no attempt to rally. Since markets are forward looking instruments, I have to believe that if rates were going to drop the index would be headed higher. Instead, it looks to me as if the last of the smart money is heading for the door and we are experiencing distribution. If housing continues to decline the economy will have to go with it. The home has been the only real source of liquidity for a capital starved populace that has been subject to declining real wages and hidden inflation for longer than I can remember.

The ramifications of rising rates will not only be felt in the bond market, but in the stock market as well. We are currently seeing a divergence of interests in the stock market and I'm not just referring to the housing industry. The Transportation Index broke to new lows recently in spite of a rising DJIA. The Dow has been rising as the Federal Reserve wants to continue with the illusion that all is well and will do its best to prop it up regardless of the cost. The average investor opens the newspaper and goes straight to the DJIA. If it's up it's a good day, and if it's down it's a bad day. For the most part, they are unaware that the Transports and Housing indexes even exist. There world is the Dow. The Fed knows this and is fully aware that a mid-term election is coming up, and they will do everything they can to prop it up. The current rally in the DJIA appears to be quite labored to me and I suspect the Fed will come up short. Everyday there is more and more divergence and it will take its toll. Let's take a look:

We have the *Daily Charts for the DJIA and Transports* respectively and it is like looking at two sides of the same coin. When you look at it like this, the divergence that I mentioned early is obvious.

I want to show you one last chart and it's an important one. Two things led the DJIA up over the last three years, the Transports and the Banking Index. I've already

posted the Transport Index and now I'm showing you the *Philadelphia Banking Index.* This index has been as good as money in the bank. A top was registered in early May and tested again in July when the index put in a slightly lower high. Since then the Banking Index has been moving sideways and it is difficult to interpret its intentions. In short, the index has surged with the historically low rates as they made money on the carry trade. I have to believe that if interest rates were going to continue to rise, the carry trade profits would wither on the vine and that should be enough to turn the index down. That begs the question as to whether or not the Banking Index is undergoing distribution or further accumulation. A break and close below 109.00 would be the first indication that it is distribution. If so, the DJIA will probably follow sooner rather than later.

In conclusion, we have the housing and transportation on the skids and banking may be next. The Fed is desperately trying to keep the wheels on until the November elections come and go and I really don't think they'll be able to do it. The market always does what it's supposed to do but never when you want it to and I don't think this will be an exception to the rule. The recent lows in the Transportation Index were unconfirmed by the DJIA just as the recent higher high in the DJIA was not confirmed by the Transportation Index. I envision a scenario whereby the DJIA rallies to a slightly higher high, say around 10,507 or a bit higher and then engage in more distribution until finally turning down. I suspect this will occur in October and then things will get interesting. If I'm right, the Republicans will have a tough row to hoe in November.

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September 1, 2006
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For those of you interested in receiving information on the Funds we manage, please feel free to e-mail us at ebo@dowtheoryanalysis.com and we will respond as soon as possible.