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Greenspan's Virtual-Reality

Why Inflation is Really Understated - Not Overstated

by *Martin A. Armstrong*

The financial markets are becoming extremely volatile and choppy this year for the most part as they try desperately to guess the next direction of the Federal Reserve. Several Fed members in early September cautioned that inflation could start to breakout while Fed Chairman Greenspan continues to argue that the CPI significantly overstates inflation. So what is going on here? Is inflation going higher or lower?

To begin with, Greenspan is currently laying the foundation for the post-election deal you will desperately find absent from the political media as well as the political debate. The CPI will be cut virtually in half following the elections in an attempt to deal with entitlements without having to confront voters. In other words, entitlement programs are automatically increased from one year to the next according to the rate of inflation as expressed by the CPI (**Consumer Price Index**). If the budget, less interest expenditures, is in excess of \$1 trillion annually,

chopping the CPI in half will save at least \$12.5 billion annually. On a compounded basis, this single act would save almost \$70 billion over the next 5 years - an amount too tempting for Democrats or Republicans alike. The real beauty of this scheme is that social security will be cut without having to call it a cut since only the CPI will be revised directly - not entitlements.

The financial markets remain in a state of constant confusion largely because what we all can see, touch and feel on the street is far from the Greenspan's virtual-reality of low inflation. Just in the past 8 years (**post Reagan era**) where the Fed and the media have proclaimed victory in the war

against inflation, the national debt has risen from \$2 to \$5.2 trillion. State and local budgets (**as well as taxation**) are up in many cases by more than 300% in the past 8 years.



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Sticking with just the federal numbers, we have witnessed a 20% annual increase in the cost of government since 1988. This is a far cry from 2.5% inflation as reported by the CPI and Greenspan's virtual-reality of 1.25%. Total federal spending is currently rising at 4.5% annually and starting in 1997, the growth rate begins to explode. By the government's own projections (**assuming no increase in interest rates or decline in economic growth**), the growth rate in government expenditures will pass 20% annually just beyond the year 2000!

This is part of the root cause behind the growing confusion in the financial markets. We stand silently like a bunch of fools watching every treasury auction increase in size while the media tells us otherwise. To understand how we can be going in two directions simultaneously, we need to look at the design of the CPI a bit closer. The major cause of this aberration is generated by the little known fact that the CPI is exactly what it states - a "**consumer price index**" and **NOT** a "**cost of living index**" nor is it a "**purchasing power index**." If the CPI reflected either of the two latter purposes, then it would require the inclusion of taxation since the average American now spends more on taxes than on housing, food and clothing combined! The CPI is intentionally lacking any government costs to the consumer insofar as property, income and social security taxes are concerned. Simply put, taxation is **NOT** part of anyone's cost of living - it is your obligation.

Because of this major intentional design flaw of ignoring the cost of government in the CPI index, it then becomes possible for inflation to appear in the government sector but not in the private sector in the form of goods and services. Therefore, the economic reality can be quite different from the virtual-reality as reflected by the CPI.

There is one point that is abundantly clear - Perot is right when it comes to the mess we have gotten ourselves into. Washington looks at every issue as if it were a single isolated problem. There is not only an inability to see the entire forest, but Washington has lost all sense of what it has even passed the year before.

There are two key mistakes that have had a dramatic impact upon the decline and fall of the American economy.

1) LBJ's commingling of the once separate and independent trust funds with the general budget was our first big mistake. LBJ simply wanted to hide the cost of the Viet Nam war from the American public by offsetting those costs against Social Security surpluses. This single budget trick served to undermine the entire entitlement process and set in motion a national debt that could rise faster even when the annual "**net**" budget deficit declined. For example, in 1995 the budget surplus for Social Security was about \$50 billion. This is commingled in the general budget according to LBJ practices. Thus, the reported "**net**" deficit declines while the actual "**real**" debt rises by \$50 billion more than the fictitious "**net**" deficit as reported by the media.

2) Jimmy Carter took the United States off the annual zero-based budget system and indexed all programs to inflation. Thus, as inflation rose dramatically during his last year in office, the budgets of most programs and departments were automatically increased by the rate of inflation. This single factor contributed greatly to the explosion in spending under Reagan. You can imagine with a CPI greater than 10%, government spending exploded even though there may not have been a "real" demand for an increase in spending on a parity basis with the CPI. Ever since, spending rises by the CPI on an automatic

pilot basis even when not needed. Departments then strive to spend every last dime or face losing funding the following year. Worse still, Congress may have passed a program 20 years ago which is constantly funded automatically instead of being scrutinized year after year on a zero-based budget system.

These two subtle yet major changes to the budget process, have led us down the garden path to the point that our entire economy is at risk. Entitlements are in danger of moving into default prompting further tax increases starting in 1997. Our national debt has risen from \$1 trillion in 1980 to over \$5 trillion by 1996 not because of Reagan tax cuts, but because of uncontrolled spending. Revenues increased under Reagan proving that it was the uncontrolled spending that led to our problems not a lack of taxation revenue. Consequently, like debt on a credit card, **the annual growth rate for the national debt has been over 10% for the past 16 years!**

The debate over whether or not inflation exists is further complicated by those who love to use the computer example. Here we find that those who constantly argue that inflation is declining, point to the same model computer and how it has declined by 50% in less than 2 years. This, they argue, is evidence that inflation is declining. However, this analogy is like following a 1990 Ford in price down to 1996. Even if the car is never driven, the value of that car still declines due to outdated technology. What is important to note is the constant price of a computer for the latest top-of-the-line product. Here we have actually seen little inflation between 1983 to 1990 as the top-of-the-line seemed to be priced at about \$7,000. After 1990, the price of the top-of-the-line model has actually risen to about \$10,000. Yesterday's model quickly falls in price due to advancements in technology - not due to declining demand.

The low inflation crowd also likes to point out that people are resourceful. They shop looking for sales or travel to discount sales for purchases. Unfortunately, the level of such discount stores as a percent of total sales is not significant enough to warrant cutting the CPI in half. The majority do **NOT** travel to discount outlets. The majority might shop for the best price, but they do not buy goods off the back of a truck.

This latest major proposed revision to the CPI is also nothing new. Over 14 major revisions have been carried out on this index just in the past 30 years. **ALL** revisions to the CPI show one clear purpose - to bring down the appearance of inflation, **NOT** to reflect true changes in our cost of living. The 1983 revision to the CPI illustrates how Congress deals with each issue as if it were an isolated problem. Prior to 1983, housing (real estate) accounted for 40% of the CPI. Due to the fact that real estate was rising sharply throughout the late 1970s and early 1980s, it was then decided that real estate was **NOT** actually part of your cost of living - it was an “**investment**.” Therefore, since a home was an “**investment**” and **NOT** actually part of your living costs, this 40% component was removed from the CPI and replaced by rents. What little real estate influence remained within this new component was then determined by the FHA data. This meant that the real estate component was limited to a maximum consideration of \$100,000. Therefore, during the late 1980s when real estate exploded going into 1987, the CPI rate of inflation remained comparatively steady leading many to proclaim that inflation had been vanquished forever. Well if you take 40% of what used to be in the CPI out, it is hard **NOT** to create a false impression of victory.

The one thing that is clear is the fact that all these continual revisions to the CPI are creating two entirely different perceptions of re-

ality. It has totally politicized the CPI index forever eliminating the usefulness it once had to business and investors alike. This is being reflected in the wage settlements particularly among government employee unions. School teacher contracts right now are demanding a 15% pay increase over the next 3 years on average. That is a wage demand level twice that of the CPI. Clearly, the CPI is starting to have little impact in wage settlements. This is largely due to the fact that taxes are up significantly rising to nearly 40% of total earnings for the average American family. In the end, these tax increases will continue to place pressure on wages in both the public and private sectors.

The consequences of understating inflation can be much more serious to the economy in the final analysis. Instead of constant gradual increases in prices, the danger becomes more of a shock experience in price movement. In other words, the inflation that would have otherwise taken place in a more gradual manner is replaced by surges in price movement within a compressed period of time. For example, the national debt has risen by more than 500% since 1980. The Dow Jones Industrials have also risen a like amount from 964 at the close of 1980 to 5,800 going into 1996. However, there were two bursts in upward price movement between 1984 and 1987 (1211 to 2596) and again between 1994 and 1996 (3834 to 5800). The majority of the remaining periods between 1980 and 1996 were reflected by a steady gradual advance more in a linear manner as compared to the non-linear bursts out of 1984 and 1994.

When one analyzes the price advance of the Dow for the 1980 to 1996 time period, we can easily see that there is a very good correlation between the rise in the national debt (money supply) and the value of the Dow. In effect, the rise in the national debt represents a decline in the pur-

chasing power of the dollar vs assets. Consequently, the Dow rose in nominal terms **NOT** because it was in the midst of a raging bull market in 1929 terms, but rather the price advance in nominal terms reflected assets trying to maintain parity with the rising debt and ultimate depreciation in the purchasing power of the dollar.

This is an important distinction to understand. A bull market is where that particular instrument rises in value against all others. Consequently, if one were to sell that instrument at the peak in prices, you would be able to take that money and buy significantly more assets than you would have been able to do before the bull market. An instrument which rises in nominal terms in harmony with all other assets is **NOT** a bull market at all. Instead, this type of price increase reflects **ONLY** a depreciation in the purchasing power of the underlying unit of monetary value (money). Therefore, if the value of the Dow is 1,000 and a home is 1,000, then if the Dow rises to 5,000 but the home is also now 5,000, then this has been a depreciation in the value of the dollar - not a bull market in “**real**” terms. This is the ultimate definition of “**real**” inflation that prevailed throughout the centuries prior to the floating exchange rate under the paper money standard.

Since the system is never equal and fair, what often happens is that there are leaders and laggards within the entire process during the early stages of a depreciation in the value of a currency. Some sectors in asset values begin to rise in advance of others. Soon, this behavior begins to spread like a virus until virtually all sectors are affected from wages, real estate, equities and ultimately raw commodities. The danger that we now face is in fact that we are on the verge of one of these bursts in price activity.

Looking at crude oil for example, we can see how there is a real potential problem that crude oil will simply begin to explode to the upside. If we take the 1980 price of oil at the peak in inflation (**\$40**) and we use the watered-down version of the CPI to adjust that level into current dollars (**\$82**), we suddenly find that oil prices are incredibly cheap. In fact, oil is running at about 25% of 1980 levels within the price mechanism of the economy as a whole. This suggests prices will burst higher within a compressed period of time largely due to the massive depreciation in the purchasing power of the dollar.

Adjusted for inflation, taxes are up by more than 100% since 1980. In nominal rate terms, federal taxes are up by at least 30% since 1980. Automobile prices in nominal terms are more than double. Even the cost of running Congress is up by nearly

500% since 1980. In the face of almost everything being significantly higher since 1980, it is ridiculous to expect raw commodities from agriculturals to crude oil being maintained at levels well below everything else within the economy. Eventually, this entire sector will explode in a burst of price activity.

Therefore, Greenspan's virtual-reality world where inflation is being overstated is nothing more than a political attempt on his part to try to get government spending down. It has **NOTHING** to do with reality as illustrated by Greenspan's own actions for the past two years. The Fed has raised interest rates 7 times while the CPI has not moved. The press, confused as they usually are, have portrayed the rate hikes of the past several years as "**pre-emptive**" strikes aimed at keeping "**future**" inflation under control while maintaining the current

lies that there is no inflation. This odd scenario painted by the media is confusing and disruptive to the financial marketplace as a whole. Every minor economic statistic is scrutinized so closely in an attempt to see if inflation exists or not, this uncertainty is now creating violent price swings that are so regular, our computer can forecast when a statistic will hit the market without knowing the schedule or what that statistic even reflects! The regularity of violent price swings are simply becoming a routine part of the financial marketplace. This cannot be explained in any other way other than the marketplace senses a problem between reality and Greenspan's virtual-reality. This can only lead to higher volatility and greater risks to the economy as a whole.

Bloomberg - Internet

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Understanding Technology Investment

by *Martin A. Armstrong*

There is always the accompanying hype surrounding new technologies. The Netscape story is certainly at the top of the list of recent boom stories. However, technology developments have always been the life-blood of the stock market since the very dawn of organized marketplace investment. Today's boom, however, is often tomorrow's bust. That bust can come at a moment's notice or more along the lines of a slow dragged out affair often going unnoticed by the best of analysis.

Technology stocks are a very interesting case study by themselves. As the progress of technology has passed through time, we often forget those stocks which were the technology boomers of decades long past. Such prior rising stars have survived to become today's institutional conservative blue chip stocks while others are mere faint shadows of former glories long since past.

The two stories of former glories are railroads and the invention of radio. The railroads burst on the scene during the middle 19th century on the heels of the industrial revolution and the invention of the steam engine. Railroads were the backbone of American millionaires whose family names still live on today. As the railroads soared in price, they too had the booms and busts during the countless panics during the second half of the 1800s. That era of the iron horse actually came to an end with the Panic of 1907. It was the famous panic where the transportation stocks were the blue chips that fell like a stone during that fateful crash. The industrial stocks were not the favored group of investors during that period. A comparison of the Dow Transportation In-

dex vs the Dow Jones Industrial Index bares out this often over-looked fact.

The technology boom of the late 19th century not only peaked in 1907, it was usurped by an even more exciting new technology known as the automobile. Since autos were a durable good which could be sold to the consumer rather than a service purchased by the consumer, the auto stocks entered the Dow Jones Industrial Index. As a result, it was the Industrials that boomed going into 1929 far outpacing the then overshadowed railroads. What is interesting is that for the Panic of 1907, the railroads stocks dropped by as much as 90%. In the 1929 Panic, it was the industrials which dropped by as much as 90%.

There was a third technology that soared in price even during the darkest hours of the Great Depression. That technology was radio and the stock was RCA. In fact, RCA soared in price so much during this period, that a few very smart investors were able to ride out one of the worst depressions in modern history.

No matter how gloomy things may have appeared during the Great Depression, radios were selling rather briskly. People at least wanted to sit around and listen to what was going on. Perhaps many were looking for a broadcast of hope announcing the end of the Depression while others simply passed the time by. FDR even made a radio address the night before the presidential elections in 1933. Truly, RCA was a technology stock that shined in the middle of a dark economic storm.

The importance of these technology shifts provides a good les-

son for today's investor. Railroads once appeared to be the blue chips for the 20th century. All the hype how they would last for centuries providing endless streams of cash was not even questioned by the best analysts of the day. Railroad companies were able to issue 100 year bonds at the start of the 20th century due to such an endless vision of the future that dominated the times. But all those visions soon disappeared with the Panic of 1907.

The final blow to the railroads was certainly the automobile. This was a product that the consumer could not only purchase, but use to go anywhere instead of being restricted to time tables and miles of pre-laid track. That technology shift brought the age of the railroads to an end and the centuries of profits envisioned quickly turned into defaulted bonds.

As we approach yet another new century, there is a technology in its infancy poised to reshape the entire world before us, humbling the former technology boomers of days long since past. At risk are the technology companies we think of as invincible. These are AT&T, Sprint, MCI and other long distance carriers worldwide. With the invention of the Internet and the combination of sound-cards (multimedia), it is now possible to talk toll-free between NY and London via the Internet. While this technology is still far less than the standards acceptable by business, it is a field that could shake the very foundations of how we view the future.

As technology improves, using the Internet for telephone calls over long distance could cut deeply into the revenues of long distance phone companies in the next 10 to 20 years. We could be facing yet an-

other major technology shift which perhaps sounds as impossible to us today as the collapse of the railroads to the bond investors who stood in line in 1899 to buy 100 year bonds. Things change and as they do technology shifts as well reshaping the future we thought would be into something the majority never dreamed possible.

Another important way the Internet is impacting our lives is taxation. I recently testified before the House Way & Means committee of Congress on July 18th (see testimony on our Internet site). One question that surprised me was "How do we deal with the Internet and its impact upon our ability to tax income?"

Government knows only two aspects: 1) Revenue collection 2) How to control the people. Virtually every law passed has to deal with either the raising and methods of collecting revenue or how to restrict behavior by controlling the population. What I was surprised to find was how quickly the Internet technology has captured the concerns of Congress from a revenue collecting perspective. With the ability to encrypt transactions that the government cannot gain access to, the very ability to determine taxation based upon income is at risk in the years ahead. Income can be easily hidden and cash easily transferred without ever being in a position where the government will know about what is taking place. As far out as this might seem, some would argue that the majority of people could not use the Internet to hide their wages. That is correct. But what Congress is worried about are the "rich" who would be in a position to hide income that is NOT derived from a salary.

What if overseas banks begin to tap into the Internet allowing customers in any country to open a numbered account. Transactions made via the Internet in encrypted format could be transferred from one

place to another without even going through the Federal Reserve system. There wouldn't be any way the government could trace that type of transaction.

There is another aspect that has Congress really concerned. While encryption attacks their first power to tax, the second threat attacks their ability to control. The Internet is an open world wide network. It is impossible for Congress to simply pass a law and say that it is illegal to accept encrypted transaction over the Internet. How could such a law be enforced? Any attempt to "control" the Internet would lead to countless offshore banks gaining all the business causing deposits to decline domestically thus impacting interest rates overall. A law passed in the US cannot be legally applied to a business in another country. The only way out would be to outlaw the Internet altogether for American citizens and residents. That would then raise the Constitutional problem of restricting freedom of speech. After all, not all transactions over the Internet have to do with hiding income.

To my surprise, Congress is very smart when it comes to understanding an infringement upon their rights. They may be very slow to act when it comes to their impact upon us, but when you attack their revenue collection ability and their ability to write laws to control society, they become very worried.

We are indeed on the verge of a new technology. Some come and many more go as quickly as they arrived. But this technology has the ability to reshape the world we live in because it also has the ability to undermine government in the two areas it has up to now maintained an unquestionable monopoly.

Tax reform in the US will lead into a move to abolish the income tax. Transactions will no longer be

possible to follow in 10 to 20 years from now. However, a vendor is a vendor and if he sets up shows anywhere in the US, he must deal with a distributor. This is the realization on Capitol Hill and why the retail sales tax is coming whether you believe it or not.

In the end, the two biggest victims of this technology shift will be long distance carriers and government. Your Baby Bells and local phone companies who provide the cable, the hook up and the lines to the new technology age will be the big benefactors. So when you look at technology stocks for the long-term investment, look to see who will be in the position to produce a hardware service, not just software who's life-cycle at best may prove to be that of a fly.

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The screenshot shows a document titled "日経平均トレンドレポート" (Nikkei Average Trend Report) with a sub-header "日経平均株価の動向と見通し" (Trends and Outlook for Nikkei Average Stock Price). The document contains a table with columns for "日経平均株価" (Nikkei Average Stock Price), "日経225指数" (Nikkei 225 Index), and "日経100指数" (Nikkei 100 Index). Below the table, there are three numbered points in Japanese:

1. 日経平均株価は、9月18日の暴落を契機として、急激な下落を遂げた。これは、市場参加者の心理的変化を示唆している。
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3. 日経平均株価は、9月18日の暴落を契機として、急激な下落を遂げた。これは、市場参加者の心理的変化を示唆している。

Government Debt Crisis Revealed

by Bruce Allen
Director PEI UK and Middle East

“We can’t go on like this” screamed the front page headlines of *The Independent* earlier this month - one of the serious national UK newspapers. **“The government is literally bankrupt - with net wealth declining from nearly £20 bn in 1979 to minus £179 bn at the end of last year, according to official figures.”** Had Fleet Street at last woken up to the government debt crisis? The article summarised 17 years of financial decline under the Conservative government. Interest payments on government debt have nearly quadrupled to make up the fourth largest category of expenditure after social security, education and health out of the total government expenditure of £303.9 billion last year. Windfalls such as the tax on North Sea oil and privatisation receipts (£77 bn and £64 bn respectively over the period) have not been enough to cover the spending spree of ever bigger government. The national debt finished the year at £385.5 bn having doubled under Prime Minister John Major’s time in office.

Well, it has all gone quiet again. Perhaps, there was just no other news to report that day.

IMF Watch

The IMF’s annual report has revealed the strain of record lending to Russia and Mexico. The IMF committed \$26 billion during its last financial year compared with \$22 billion in the previous year. Although in real terms this is still less dramatic than the \$20 billion during the 1982-83 debt crisis, the Fund’s uncommitted usable resources are 90% of its liquid liabilities and its liquidity ratio is expected to deteriorate further. A group of 33 countries from the 181 members has agreed in principle to

extend a \$50 billion credit line for another “Mexico” style financial crisis (Canada?) but this has not been ratified yet. Beyond this the IMF needs to raise fresh money to put its “Enhanced structural adjustment facility” (Esaf) program on a permanent basis and find funds for its participation with the World Bank in the joint debt relief initiative for poorer countries.

Of course the Fund will try to increase subscriptions from its members (an international tax rise!) in the longer term to alleviate its position, but a curious turnaround was reported. Mr. Philippe Maystadt, the Belgium finance minister, who previously was driving the proposal to sell some of the IMF gold reserves short term, is now suggesting the extra cash might be provided by bilateral contributions from governments instead. The official view expressed by the first deputy managing director of the Fund, Mr. Stanley Fischer, is that the IMF is closer to agreement on gold sales despite continued German opposition.

Let us hope they are a little more efficient than the Tripartite Gold Commission set up in 1946 by the US, UK and France to restore European countries’ central bank reserves taken by Germany during the war. After 50 years they still have over five tons of gold in the Bank of England awaiting final distribution to the claimant countries.

EU Watch

“EMU is not just about economics, it is fundamentally about politics.”

- Eddie George, Governor of the Bank of England.

Britain is ready to spar once again with the European Union over the BSE (Mad Cow disease) pro-

gram. Agreement had been reached in Florence earlier this year that the export ban on British beef would be lifted over time following a cull of 125,000 British cattle. Fresh scientific evidence forecasts the epidemic will die out by the year 2001 with or without the large scale slaughter of cattle. Germany and France insist the cull must go on to increase consumer confidence at home which has devastated their own beef industry. The British government is expected to tell the EU the cull should be abandoned.

Dunn & Bradstreet Schimmelpfeng forecast bankruptcies should rise 5% this year to 200,000 in the 15 member states of the EU citing governments’ cost cutting to achieve a common currency by 1999 as a contributing factor. Germany is expected to be worst hit with a rise of 17%.

Germany and the European commission have started legal proceedings against each other following the German state of Saxony continuing with “illegal” subsidies granted to Volkswagen to build a new car plant. Without the state aid, VW would not go ahead with the plant which will bring with it much needed new employment in the region. The commission has taken action against Germany as it could not legally file a suit against Saxony.

Rogue dealers? - It couldn’t happen to us.

Deutsche Bank, the German parent of the UK based Morgan Grenfell Asset Management, is now counting the cost of supporting the 90,000 investors in three MGAM funds (market value of £1.1 bn) which have been suspended after the discovery of irregularities and breaches of investment rules. It is reported that a fund manager in the

pursuit of continuing better performance invested in unlisted securities through holding companies set up to disguise the geographical concentration of risk and retained a small financial boutique to rate their market value. A huge proportion of one supposedly Europe-wide fund, was found to be invested in small Scandinavian high tech companies. Unfortunately, it would be impossible to realize the value of these illiquid holdings except at a very large discount.

Morgan Grenfell is not the only fund manager to reveal problems this month. Kleinwort Benson was very successful two years ago in raising cash for a European industry privatisation fund (KEBIT). For some time the managers have realised they were too successful in raising cash and not enough in picking markets that could absorb the funds and perform well. Kleinwort Benson has finally agreed to wind up the fund offering investors cash back at market value or re-investment in a general European fund. The management reportedly felt they had attracted the wrong type of investor who was looking for only short term gains. If anyone knows investors who like to lose 40% of their initial outlay after 2 years please put them in touch.

The Middle East - Here we go again

The Kurdish issue pulling in Iran, Turkey, Iraq, the Gulf states and western powers looks likely to become one more intractable problem in an already unstable area. The Arab-Persian conflict, last shown dramatically in the 1980's Iran-Iraq war, is one of antiquity stretching back at least 3,000 years. The Kurds, like the Palestinians, have been pushed into both internal and external conflict by twentieth century power plays. The fighting between the two major Kurdish factions (once part of the same group) is

more to do with control of fund raising from import duties at border crossings and the funds brought in by humanitarian groups than any difference in political ideals.

The major danger for the western powers, especially the US and Britain, is to be involved in a military action with Iraq which has no achievable military objective and no justification as far as the majority of the United Nations is concerned. Al-

ready there are absurdities in operations. British aircraft are stood down on certain days to allow the Turkish airforce to bomb Kurdish villages which the next day are once again part of the safe haven protected by British aircraft. So far, the only winners appear to be Saddam Hussein's propaganda machine and a few oil traders. The losers as always are the people in the streets of the towns and villages throughout the area.



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The View From Germany

by Harry Groenert
 Director PEI Continental Europe

Made in Germany -
 and the Fear of
 Unemployment ...
 corporate profits surge
 and jobs disappear.

Structural problems, labor costs, taxation and social expenditures are the words used most in Germany these days. What they imply, however, is quite abstract and feeds anxiety throughout the economy. What actually happens is, that corporations announce record earnings as the "Arbeitsamt" announces record unemployment. The "Arbeitsamt" published the number of unemployed at the end of August at a record high with a total of 3,901,700 - 323,500 more than last year, while companies increased their profits and improved their balance sheets.

True, if Germany does not change its course it is heading for a big bang and it is also true, shareholders check their return on capital - but what is going to happen, if simultaneously the number of the workforce is falling?

Currently 10.2% of the workforce is reported to be without a job. The official number does not include all those who gave up registering with the "Arbeitsamt". The IAB (Institute for Job Research) estimates that this number of unregistered unemployed is at least 1,900,000. If one would add also those who retired early, those who attend public sponsored courses for job training

and those who attend government sponsored work schemes one would end up with a figure of 3,100,000 unreported unemployed.

In a recent poll the question was:

Do you think your children will be better off than you as far as living standard and job prospects are concerned?

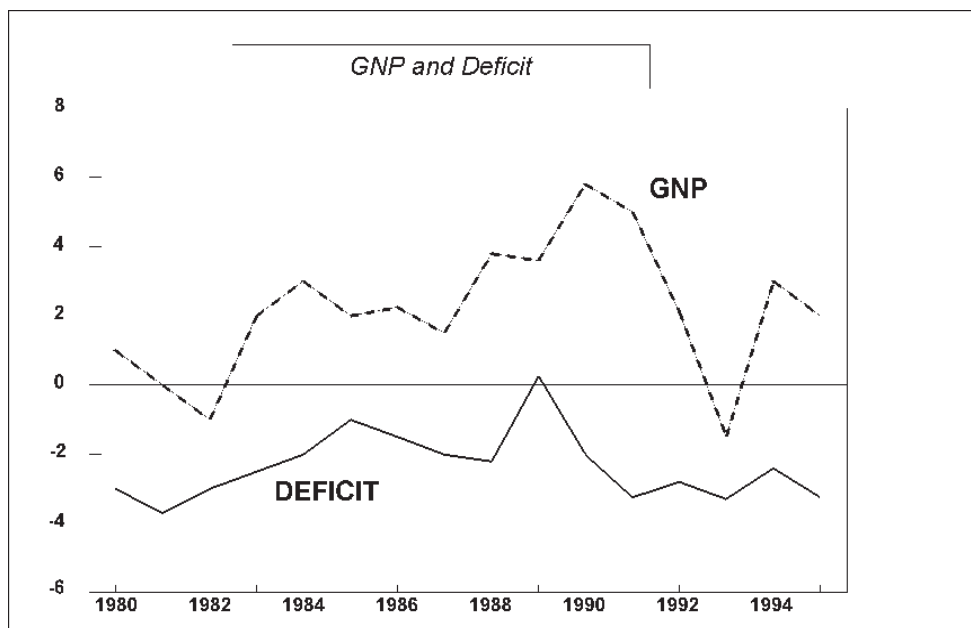
17% think yes, but 48% believe their children will have a worse life than they are having or had and 34% believed there will be no change.

Traditional theories would simply argue with supply and demand factors of the labor market. The cost for labor should fall. A very well known economist for the Deutsche Bank, Professor Walter, suggested recently that everybody should relinquish 20% of his salary. - But that's where the problem started. If you share two apples among two, you are doing fine, but you don't solve the problem of starvation by sharing one apple among 36. It is a vicious circle:

The more unemployed, the higher the social costs, the lower the tax revenues, the lower the domestic demand and that leads to lower sales, leads to lower profit, leads to austerity, leads to redundancies, leads to more unemployed, leads to higher social costs And leads to big trouble.

The German Debt and the Emu

It was not good timing. Just before the Bundesrat (Federal Council), which is controlled by the opposition, could decide on the austerity program it was rumored that the ruling party has already a "Savings-plan II" in the making. Plan II shall help to reduce the effect of the increasing number of unemployed on the budget. A week ago, the labor department received an increase of its budget by 162% per cent, from 4.3 to 11.3 bn. The net increase in the national debt will now increase by almost 70 bn. (see Capital Market Report July, at that time the planned increase was 50 bn).



* Source: Statistische Bundesamt

Today's new debt will be the tax for tomorrow under the assumption that the debt shall be repaid. Not only does an increased demand on the capital market by the government bear the danger of an increase in interest rates but it also dampens the enthusiasm as far as investments are concerned. It remains to be seen how these problems can be solved. The ruling party diverts the attention of the public to the tax reform instead of tackling the real trouble.

The Maastricht single currency criteria of the net deficit ceiling of 3 per cent of gross domestic product might not be achievable by Germany. Mr. Welteke, president of the state central bank of Hesse, said the German public was being misled into believing that the government could prevail with a strict interpretation of the criteria, when the EU leaders decide the issue in 1998.

Mr. Kohl and Mr. Waigl face a paradox here: hard public line on the

Emu criteria when it is apparent that several of the founding members (including Germany and France) are not able to meet the net deficit ceiling of 3 per cent of GNP.

Telekom ...part 2

Telekom wants to receive 15 bn DM through the sale of its shares in November (see Capital Market Report 8). They are now targeting the private investor because the institutional investors have already enough telecommunication shares in their pockets. The marketing budget for going public is estimated at 60 mn DM. Only ten percent of the investors in Germany own shares - so far.

The deal to sell the shares to the average Mr. Mueller on the street is twofold.

- Private investors do receive a discount for the first 300 shares between 1 and 5 percent.

- Investors who hold the shares until the 30th of September 1999 will receive a 10% stock dividend.

The lead underwriters in Germany also agreed, not to charge their minimum commissions to small investors. So, everything is all right. The institutions hold the shares, because they are an important part of the DAX Index and the small guys get their discounts.

You won't find too much of a critical press in Germany despite some concerns which are obvious. Telekom has to pay around 8 bn DM on taxes in 1996. In order to remain profitable, Telekom has to be quite successful in:

- a) cost cutting;
- b) financing of old pension schemes and;
- c) keeping market share when the competitors attack the market in 1998.

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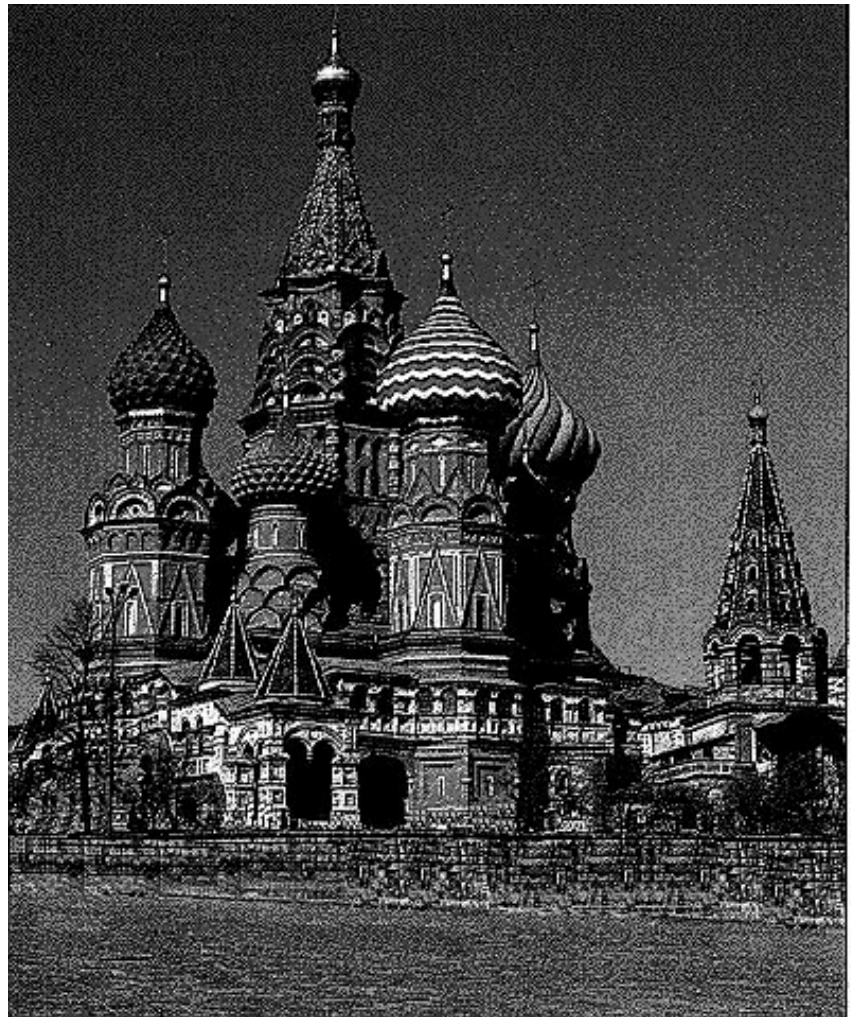
President Yeltsin's Failing Health A Catalyst to Political Meltdown

by Dana Schneider

The potential crisis precipitated by Yeltsin's ailment is drowned out by optimistic economic reviews. Many have hailed the President's disclosure of heart-surgery as reassuring by putting all the cards on the table - further strengthening the political process and the economy. It is difficult to dismiss the seriousness of heart surgery for 65 year-old President Yeltsin. The critical issue is what if the President were to become incapacitated or suffer fatal complications? The President's ill-health may be the catalyst for political meltdown.

Fallout from a political and economic disaster in Russia should be cause for concern to Europe. The catastrophe in Chechnya is the potential crisis put into motion. An estimated 17,000 refugees have fled the region of Chechnya to the surrounding areas. Many of the villages were unable to absorb the refugees worsening the shortages of food, housing and energy.

Historically, Chechnya is not an anomaly in the Russian Federation. Numerous enclaves of ethnically and culturally diverse peoples are spread throughout this region in addition to the 21 recognized autonomous republics. If conditions deteriorate at an accelerated rate, heads of regional or autonomous governments may be more likely to risk policies conflicting with Moscow, increasing the potential for military conflict and spillover. In Chechnya alone, an estimated 30,000 casualties of soldiers and civilians have been reported while some estimates have gone much higher. The Russian military may not measure up to what it once was, but its ability to level destruction is clear while who exactly is calling the shots is not. A



political meltdown could result in military action or a complete bust in the economy - sending millions of refugees into Europe.

The catalysts for Russia to politically implode are present in number and intensity. A successful surgery or recovery for Yeltsin is not guaranteed. Heading off growing pressure from the Parliament and within his government last week, Yeltsin responded to a public call by his Security Chief Alexander Lebed and promised to transfer powers of the presidency to the Prime Minister Viktor Chernomyrdin. Only very recently were remaining powers re-

lating to nuclear weapons transferred. The constitution directs that power be granted to the Prime Minister and that elections be held within three months of a president's death or incapacitation. It is expected that when the President recovers those holding power will also recognize this recovery.

The ability of the opposition to create an opportunity to gain control of the government increased with Yeltsin's illness. Constitutional vagueness opens the door to a sticky confrontation between the Communist majority in the Duma and the Yeltsin's government. The

results of such a situation are bad to worse. If Yeltsin does not recover quickly, the three month time period may encourage the Communist Party to force elections by counting the time elapsed from hospitalization or the promise to transfer power to Viktor Chernomyrdin - giving the president until mid-December. This could create a chance for another round of presidential elections. Without a clear front runner for reform, the opposition is likely to have an advantage.

In the fall of 1993, Yeltsin disbanded the regional legislative bodies and replaced by appointment many of the executive officials. These officials also sit in the upper house of Parliament. Regional executives in 52 of Russia's 89 regions must now face the electors so another political campaign season is underway - giving the opposition another shot to gain control.

Although Anatoly Chubais - Yeltsin's Chief of Staff and former architect of Russia's economic reforms - was brought back into the government to assist with these elections, his hands will be full balancing his interests against those of Lebed and Chernomyrdin. A majority in both houses of Parliament in combination with a weakened government could produce votes of no confidence forcing the government to dissolve. As head of the government, Prime Minister Chernomyrdin could stand to substantially gain from this situation - filling the ministries with allies while disposing of Alexander Lebed who is also a presidential hopeful.

Yeltsin's illness has placed many of his regional appointees and supporters out on a limb. The President will be unable to help direct or coordinate forces to get out the vote for the incumbent or more reform-minded challengers. Many regional officials got out the vote for Yeltsin in the July elections for promises of economic subsidies for their con-

stituents. With Yeltsin's return to the head of government in doubt, previous supporters and appointees will be reassessing their risks and rewards. The political promises from Yeltsin and his government - particularly during his campaign - are now unlikely to be fulfilled if they ever were. Furthermore, the budget-busting campaign and expected economic decline make it more doubtful that money will flow from Moscow to the regions. Hard currency reserves are down as the Central Bank has tried to support the ruble while gold production is down over 13% from this time last year. However, many of these promises have yet to be fulfilled and a backlash could be in the making, particularly in Yeltsin's absence.

The carrot and stick offered to the regional bosses to tow Moscow's line will not be as strong, particularly as the socio-economic conditions are often far worse in the outer lying regions than those immediately surrounding Moscow or industrialized areas. This could especially stoke up the political fires and provoke economic panic as strikes are being threatened by workers' unions - particularly in the energy sectors. The presidential elections showed pro-Yeltsin support to the north and in urban areas while the pro-Communist vote was strongest in the south and rural areas. A decreased dependence on Moscow could stimulate regions or autonomous districts to pursue policies directly opposed to the Kremlin. In the Far Eastern region of Primorskii, the governor flat-out ignored a government decree to raise energy prices. With no clear leader in the Kremlin, the risks and rewards of political brinkmanship and power playing on the federal level as well as on the regional level are dramatically raised.

Even if the regional districts vote in favor of reformers and their representatives resist rogue activities to consolidate their power base, the politics within the Yeltsin govern-

ment threaten stability. Yeltsin has pursued a political strategy that is now threatening the stability of the government in his absence. Instrumental to retaining his power, Yeltsin has sought an environment where his key ministers must build coalitions and leverage their influence against one another in order to gain and maintain power. This protected Yeltsin from unified attacks by his own ministers. Key players are positioning themselves for the next-in-line front runner. Certainly, the rapid pace with which Yeltsin has been changing ministers within the past year or so may indicate a failing strategy in the face of a weakening President.

Political uncertainty is intensified by an unstable economy. In the mix is a recession that has yet to evade the usual fall/winter bust. Unemployment has continued to grow, gross domestic production is down 6% from last year, and the energy sectors are failing. Output of oil and coal is down 2% while reports show a 4% decline in refining. Wage arrears are on the rise. Unpaid wages are reported to be at a high of \$7.4 billion with nation-wide strikes being threatened. Growing energy shortages are expected to get worse as colder weather sets in on top of the usual high prices and food shortages. Expectations of greater IMF aid or a World Bank bailout of the economy if it goes bust - on top of the \$10 bn already pledged - is a big "if" in light of recent disclosures of declining institutional liquidity. Yeltsin's failing health, mixed with a faltering economy, is a combustible mixture for a political meltdown that would prove disastrous to the surrounding regions.

Hong Kong Update

by *Craig Stephens*

As 1997 approaches, speculation that political uncertainty will break the Hong Kong dollar peg is mounting. After rumours last month that George Soros was shorting the Hong Kong dollar, financial secretary Donald Tsang has even gone to the lengths of officially disclosing the considerable reserves backing the peg. However we expect the peg is destined to become a relic of a bygone era, and destined to the history books along with British sovereignty.

Up until now Hong Kong financial assets have been a proxy for US dollar assets. Property and banking assets in fact, have acted like a call option on movements in US interest rates. Under the certainty of the orthodoxy that has maintained the peg, investors have generally viewed Hong Kong dollar assets as risk free. However by definition a change of sovereignty creates greater uncertainty than maintenance of the status quo. The popular proposition that Hong Kong's political risk factor will diminish after 1997 is therefore flawed.

There are many explanations for Hong Kong's success - the British legal system, minimal government intervention and Chinese entrepreneurs. It was not having communist China as a neighbour - but in spite of it. As Hong Kong's economy is absorbed into greater China, closer political integration becomes necessary and inevitable. Eventually investors will demand a premium for the increased political and economic risk of Hong Kong, when at almost no cost they could hold US dollars. Even if the peg does not break immediately, ultimately it will be undermined by the cost of maintaining it.

Politically the peg will also be-

come untenable. After waiting 150 years to get Hong Kong back from Britain, is China willing to surrender sovereignty on monetary policy to the US? Hong Kong's economy is now far less geared to the US than when the peg was founded - conflicts are inevitable and domestic self interest will prevail. Both Chinese and Hong Kong Central Bank officials have vowed to defend the peg with their war chests, US\$60bn and US\$90bn of foreign currency respectively. However while these amounts are undoubtedly impressive, they are no answer to the \$1 trillion traded daily in currency markets. Traders are looking at a win win situation. If the peg goes you win, if it doesn't you need only wait as you hold your US dollars.

Confidence is obviously the key. For an estimated 1.5mn to 2mn Hong Kong inhabitants with foreign passports, it is necessary to hop on a plane to escape if life in the new Special Administrative Region. Foreign capital requires a mere switch of a button. As yet no specific development has created any overwhelming evidence that the handover will cause the peg to break. Rather it will be a series of actions, that little by little will cause lasting change in Hong Kong's political economy. Corruption may increase, along with press censorship - we will need only a high profile case of a connected individual appearing to be above the law to raise doubts on the legal system. Progress remains slow on arrangements between Beijing and London for the handover, although there have been some positive developments. Beijing has signalled it will talk to Hong Kong's elected leaders and Xinhua recently went as far as having a formal audience with members of the previously labelled "subversive" Democratic Party.

There has also been an appar-



ent increase in transparency on the selection procedure for the first Chief Executive of the SAR. Beijing is reported to be dropping its "leftist" policies towards Hong Kong and Taiwan and embracing capitalism. Clearly Beijing wants Hong Kong to be an economic success, but more significantly for the communist leadership, it will want political control. A difficult balancing act and, if a choice has to be made, the communists will inevitably opt for political control. Despite conciliatory gestures, we are seeing every now and again worrying comments emerge; Hong Kong courts will apparently have no jurisdiction over PLA officers who commit crimes in the territory. It is this kind of unpredictability that will ultimately determine confidence in the territory and its currency, rather than the size of currency reserves.

Australia: The Federal Budget



by Nigel Kirwan
Director PEI Australia

If passed in its current form the '96-'97 Federal Budget, brought down on August 20th, should deliver a headline surplus of A\$474 million and an underlying deficit of A\$5.6 billion. That Federal Treasurer Peter Costello has taken the trouble to make a distinction between headline and underlying figures is a refreshing break with the past. In recent years Labor governments have often bragged about budget surpluses or low deficits which in reality were based entirely upon the proceeds of asset sales - Qantas Airways, Commonwealth Bank of Australia, etc. - or the bringing forward of company or provisional tax payments. In other words rather than cut government spending and broaden the tax base to avoid going into debt the country was living off its capital.

In placing the real budgetary position clearly on the table the government plans to enshrine this as a principle of a proposed Charter of Budget Honesty to be enacted via legislation. The Charter among other things will require a Budget update signed off by both the secretaries to the Treasury and the Department of Finance at the commencement of each Federal election campaign. These measures will dovetail with

the government's intention to move all federal government departments to full accrual accounting and suggestions that all "off balance sheet" activities of government via government owned entities be detailed in the budget.

The Budget was generally true to the government's core election commitments and will see the Commonwealth with an underlying balanced budget in 3 years. Most commentators were surprised to see the main beneficiaries being low to middle income families with children and owners of small business. The struggling private health insurance system has been put on a better footing via tax rebates for low to middle income earners who take out private health insurance and tax levies on higher income earners who don't. This may help alleviate some of the pressure on the public hospital system and Medicare with their rising costs and patient queues.

Although heartened by an improved deficit, bigger business wasn't to any extent a beneficiary of this Budget with cuts in R&D tax concessions from 150% to 125% hurting the hi-tech sector. Employment programmes also were severely curtailed with the Commonwealth Employment Service to be corporatised and private employ-

ment agencies contracted to perform some of its roles. The government has emphasised that it sees most potential for delivery of gains to business and unemployed via passage of its Workplace Relations Bills which will deliver far-reaching reform of the labour market. The Senate has to continue to obstruct this bill along with the bill to privatise a third of Telstra Corp.

The Senate and Reform

The Howard government's position in the grid-locked Senate improved somewhat on Budget night with a Labor Senator's resignation from the Labor Party. The Senator's statement that he believed the government had a mandate on certain issues combined with his friendship with another socially conservative independent Senator could make these two the key to negotiating legislation through the chamber. Up to this point Senate leaders have been frustrated and held to ransom by "moon-beam", left-wing, nominally green, Democrat and Green Senators siding with the Labor Party.

If the government continues to be frustrated, then an early double dissolution of the House and Senate and federal election is increasingly on the cards. The one great hope in many quarters if this happens is that reform and simplification of the taxation system will be back on the agenda. This is the one area that disappointed most with the Budget and despite feeling held to election promises not to raise any taxes or to introduce new ones (and therefore being unable to abolish old taxes and preserve the existing revenue base) there are signs that the Howard government is starting to hear calls for a broadbased consumption tax and a lower flattened personal and company tax system.

Outlook on Canada

by *Chris Quigley*

Helms-Burton Update

As we reported in our July issue, Canada was one of the most outspoken opponents of new US legislation aimed at curbing international trade with Cuba and promised legislation to combat Helms-Burton. Canada has made good on its pledge. The Liberals in Ottawa introduced an 'antidote' law to combat the US legislation. The law would block US court judgements against Canadian firms, allow Canadian firms to countersue Americans to recoup penalties and court costs and allow Canadian companies facing US law suits to sue for US court costs even before the case is over. However, the law will not be needed if the existing six-month suspension of Helms-Burton is extended in January. The promised challenge of the law under NAFTA has yet to go forward.

Meanwhile, President Clinton is trying to get Canada and other countries to soften their stance on Helms-Burton. Stuart Eizenstat, special envoy on Cuba, will urge Canadian companies to adopt the Sullivan principles - used during the embargo against South Africa. The Sullivan principles call on corporations to pay their employees directly (instead of through the government) and allow them to organize unions. Eizenstat will also be asking Canada and other countries to adopt five principles aimed at toppling the Castro regime. These principles ask countries to pledge not to help Cuba develop a nuclear reactor, make statements calling for democracy in Cuba, funnel government aid money through Cuban non-government agencies, increase support for inde-

pendent journalists, and end any government subsidies to Cuba. For this first effort to launch a multi-lateral effort, Eizenstat is asking Canada and Mexico to drop their plans to challenge Helms-Burton through NAFTA.

Inter-Provincial Trade Friction

The new interprovincial trade agreement, AIT (Agreement on Internal Trade) is on the verge of collapse after only three months of existence. The deal was finally signed in June after years of negotiating between the provinces and the federal government. It is now about to crumble before resolving its first dispute. At issue is UPS Canada consolidating its operations in New Brunswick, thus taking 900 jobs from British Columbia, Manitoba and Ontario. British Columbia wants to take this dispute to the AIT, however New Brunswick claims UPS agreed to move its operations to New Brunswick in 1994 - before the agreement came into effect. Therefore, the rules of the trade pact do not apply. It appears as if New Brunswick will not participate in the resolution process - which could bring down the whole interprovincial trade pact.

Trade barriers between provinces are hurting the Canadian economy. According to a study released by the Canadian Chamber of Commerce, existing trade barriers between the provinces cost the economy C\$7 billion a year - about one percent of domestic product. While NAFTA, the free trade pact with the US and Mexico has helped Canadian exports surge to a C\$4.58 billion annualized rate in the second quarter, interprovincial exports have

declined in seven out of ten provinces.

Unity and NAFTA

The US Congress will hold hearings on Quebec's potential secession and the impact it would have on NAFTA. The House International Relations Committee will hold hearings centering on "the economic issue, on the possibility of NAFTA falling, if in fact, one of the main signatories to the contract isn't an entity anymore," according to Joel Starr, a spokesman for committee member Representative Tom Campbell. Starr also said that an International Relations sub-committee on the Western Hemisphere "will be looking at the issue of minority rights, specifically in the bilingual area." The hearings, scheduled to begin September 25th, send a clear message to separatists in Québec that the world's capital markets are indeed watching.

Notes

Toronto ranked the highest in city taxes in North America for the fourth year in a row. The CB Commercial Real Estate Canada/Madison Advisory Group survey also placed Montreal, Calgary, London, Ont., and Edmonton in the top 10.

The VSE launched a new, two-hour night session called VISTA (Vancouver International Securities Trading Access) for securities that are either Asian-based or active there. The session starts at 5:30 PM Pacific time and runs Sunday to Thursday.

World Economic Review

UNITED STATES

JOBS GROWTH: Figures from the Labor Department showed an increase in nonfarm employment of 193,000, less than many economists had projected. The jobless rate edged up to 5.4 percent, from 5.3 percent in June. Average earnings fell slightly, reducing worries about upward pressure on inflation.

The employment increase fell well short of an average monthly gain of 273,000 in the second quarter, suggesting an easing of growth. The length of the average factory work week also declined, suggesting output gains will be more modest than in the second quarter when gross domestic product grew at an annualized rate of 4.2 percent.

WHOLESALE PRICES: US wholesale prices were flat in July. The labor department said the producer price index for finished goods was unchanged last month, after a 0.2 percent rise in June. Most Wall Street economists had expected a gain of about 0.2 percent. The annual rate of producer price inflation fell to 2.6 percent from 2.7 percent in June.

Excluding the volatile food and energy components, "core" producer prices were up 0.1 percent after a 0.2 percent gain in June. Prices for intermediate and crude goods (which give advance warning of price trends for finished goods) fell.

HOUSING STARTS: Construction starts on new homes and apartments in the US dropped for a third straight month in July as costlier mortgages put a drag on the housing market, the Commerce Department said.

Total starts dropped 1.3 percent to a seasonally adjusted annual

rate of 1.46m in July, after a revised 0.3 percent fall in June and a 2.2 percent decline in May.

Interest-rate rises that began in the spring appear finally to be slowing down the housing industry by boosting monthly payments to levels that are eliminating some buyers.

Construction starts on single-family homes dropped 5.7 percent in July to a rate of 1.13m — the biggest monthly fall since 12 percent plunge in January 1995 — after a 5 percent rise in June. But starts on apartments were up 17.9 percent to a rate of 322,000 in July, largely reversing an 18.3 percent drop in June.

Previously, the department said June housing starts had risen 1.3 percent to 1.48m but it revised that estimate down sharply. The last time housing starts fell for three months in a row was over a year ago from January to March 1995, the department said.

The National Association of Home Builders said recently its housing market index fell for a third straight month in August.

Total starts in July were 0.3 percent higher than in July 1995, when they were running at a rate of 1.45m a year. While the market may be leveling off, there was no indication it was in sharp decline. Applications for building permits rose 2.6 percent in July to a seasonally adjusted annual rate of 1.45m.

DURABLE GOODS: The commerce department reported that the US durable goods figure for July climbed by 1.6 percent from the previous month compared with economists' consensus forecast of a 0.5 percent increase.

Wall Street is concerned that if the pace of US economic growth seen in the first half of this year continues unchecked, the Federal Reserve will have to push up interest rates to contain the threat of inflation.

The rise in orders was broad based apart from weakness in defense orders, which fell 36.5 percent. Excluding the volatile transportation sector, July orders would have been up by 2.1 percent, compared with 0.2 percent in June and 1.1 percent in May.

LEADING INDICATORS: A key gauge of US economic activity strengthened in June, according to the Conference Board, a business analysis group, despite providing additional signs of slowing in the industrial sector.

The index of leading indicators, designed to forecast economic trends six to nine months ahead, rose by 0.5 percent in June after a revised 0.2 percent increase in May. Higher prices for commodities helped drive the index up, but orders received by factories for durable goods were lower than in May.

The overall monthly gain in the index during June was moderately stronger than anticipated by Wall Street economists who had forecast a 0.3 percent rise.

The leading index measures a basket of economic indicators from unemployment benefit claims to building permits. Six of its 11 components were higher in June while five weakened. The signals of rising activity in June were led by increased commodity prices, slower vendor deliveries, rising consumer expectations and a higher money supply. The average working week was longer and stock prices were higher.

The negative indicators were fewer new orders in June for durable goods and reduced orders for new plant and equipment. Order backlogs also fell.

CONSUMER PRICES: Consumer prices rose 0.3 percent in July reflecting large increases in the cost of food and hotel accommodation. Economists had expected a gain of about 0.2 percent. In the past six months, consumer prices have risen at an annualized 3.5 percent, up sharply from 2.5 percent during 1995 as a whole.

However, the core consumer price index, which excludes food and energy, shows little sign of acceleration. Core prices were up 0.3 percent last month and at an annualized 3 percent in the past six months, in line with last year's increase.

RETAIL SALES: Retail sales rose 0.1 percent, against projections of a 0.2 percent contraction. But for a sharp fall in car sales, which are volatile on a monthly basis, sales would have been up 0.3 percent. Figures for June were revised down to show a fall of 0.5 percent, rather than 0.2 percent.

CONSUMER CONFIDENCE: Consumer confidence in the US hit a six-year high in August. The US Conference Board's Confidence Index rose 2.4 points to a high of 109.4 in August. This sustained growth, following an increase of seven points in July, was a surprise to many American economists, who had expected a decline to about 105 points.

Optimism about current conditions climbed two points, and consumers' expectations for the coming six months rose by three points. Nearly 29 percent described current business conditions as "good" an increase from less than 28 percent in July.

ECONOMIC GROWTH: The US economy grew at an annualized

rate of 4.2 percent in the second quarter, its fastest for two years, the Commerce Department said. The 4.2 percent growth rate exceeded Wall Street expectations and followed revised estimates of 2 percent and 0.3 percent in preceding quarters.

The expansion was broadly based, with consumer spending growing at an annualized rate of 3.7 percent, up from 3.5 in the first three months. Growth was also boosted by a rebuilding of corporate inventories and a rapid rise in government spending. The increase would have been faster but for a slowdown in business capital spending and a widening of the trade deficit.

PURCHASING MANAGERS' REPORT: The Purchasing Managers' index fell to 50.2 percent from 54.3 percent in June, indicating a slowdown in manufacturing last month. Readings of about 50 percent indicate zero growth in factory output.

PERSONAL CONSUMPTION SPENDING: The Commerce Department said personal consumption spending fell 0.2 percent in real terms in June, following a gain of 0.6 percent in May. New orders for manufactured goods were also reported down 0.9 percent in June, after a gain of 2.3 percent in May.

JAPAN

OVERSEAS INVESTMENT: Japanese companies are boosting investment abroad despite the recent weakening of the yen against the dollar and fears that the domestic economy will "hollow out" as a result, a survey shows.

Companies surveyed by the Nihon Keizai Shimbun daily said they would boost capital investment overseas 11.6 percent in the year to March 1997, exceeding a planned 8.9 percent rise in domestic capital

spending.

This compares with a 14.5 percent rise for overseas investment and a 21.9 percent rise in domestic spending in the fiscal year to March 1996. The percentage of the companies' total production done overseas is expected to rise to 13.1 percent 1996-97 (12.1 percent the previous year). Southeast Asia topped the list of sites for planned Japanese corporate investment.

RAIL DEBT: Japan's transport ministry has drawn up a plan to dispose of debts incurred by Japanese National Railways (JNR), the state-run railway group which was broken up into seven companies in 1987.

The plan, which is to be sent to the finance ministry, will include the splitting of debts put at Y28,300bn (\$262bn) held by JNR Settlement, a special entity created to dispose of JNR assets. The move comes amid rising criticism of government delays over the disposals.

The transport ministry had postponed plans to sell former station sites owned by JNR during the asset "bubble" of the late 1980's, fearful of fueling speculation in the property market. Land prices have since plunged. Under the plan, JNR Settlement will be dissolved next year and disposable assets will be shifted to a new fund. Of the Y28,300bn debt, more than Y20,000bn is expected to be paid for by the taxpayer.

PRIVATE CAPITAL SPENDING: Private capital spending in Japan remains on a firmly upward trend in spite of figures indicating a sharp drop in June, the economic planning agency said. Private machinery orders, excluding shipbuilding and electric power, fell by a seasonally adjusted 9.6 percent in June from the previous month, the second straight monthly fall. But the two

declines followed a 26 percent increase in April, the biggest monthly jump in nine years.

"The falls in May and June seem to be just a reaction to the substantial increase in April," said an agency official. Orders for the second quarter overall were up by 10.8 percent on the previous three months.

Compared with a year earlier, orders rose by just 3.2 percent. Manufacturing orders were almost unchanged on a year earlier, while the figures for non-manufacturing showed a slight rise. In the third quarter, the agency expects an 8.2 percent drop in private machinery orders compared with the previous three months, though that would still leave the figures on course for an annual rate of increase of about 8 percent, the best rate of growth for six years.

QUARTERLY ECONOMIC SURVEY: The Bank of Japan's quarterly survey of short-term economic prospects or tankan, showed the first decline in confidence for a year among the country's large manufacturing companies. The tankan is considered by the bank to be among the most reliable indicators of immediate economic prospects and is one of the main influences on monetary policy decision making.

The report revealed that the main diffusion index for business confidence among large manufacturers, the difference between companies saying their business climate was improving against those saying it was deteriorating, dropped from minus 3 in May to minus 7 this month. In May, companies had forecast a gap of zero in August, anticipating rising demand. This has clearly failed to materialize.

Most other indicators in the report suggested the economy was continuing to improve, albeit slowly.

Non-manufacturers reported an improvement in confidence, though it was less pronounced than had been forecast at the time of the last survey. There were also signs of improvements throughout the economy in labor market conditions, in capital investment plans and in liquidity, with little evidence of a resurgence of inflation.

SPENDING REQUESTS:

General account spending requests from Japanese government departments for the fiscal year beginning next April totaled Y81,400bn (\$750bn), finance ministry officials said, 8 percent higher than the current year's initial planned spending total.

The bulk of the increase is the result of a sharp rise in debt servicing costs and tax grants to local authorities. The recession of the early 1990's has forced the government to increase borrowing in the face of rising demand for public spending and falling tax revenues. This year alone, the central government was forced to raise about Y22,000bn through the issue of deficit-financing bonds.

Total debt service costs are expected to rise by 11.6 percent to Y18,270bn next fiscal year. Grants to local authorities will be about Y17,250bn, an increase of 26.8 percent. General expenditures, excluding debt service costs and local authority grants, are expected to rise by about 3.4 percent to Y44,620bn.

TRADE SURPLUS: Japan's trade surplus fell by 37.7 percent in July compared with the same period a year ago, the finance ministry said. It was the 20th consecutive month of year-on-year decline in the overall surplus and the 17th consecutive month of decline in the surplus with the US. The surplus with the US showed only a small decline, 4.5 percent to Y316.7bn (\$3bn), as Japanese car exports shifted into higher gear.

The July surplus — the smallest surplus for the month in 14 years — at Y504bn, reflected strong personal computer and crude oil purchases which were the main factors behind a 35.6 percent rise in imports. The strength of personal computer imports highlights the extent to which many Japanese manufacturers have shifted production overseas. Companies are moving factories offshore to countries with cheaper labor and then bringing the goods back into Japan, also boosting import numbers.

The rise in imports, which has continued for 27 months in a row, has far outweighed a firm increase in exports, which grew for the 12th consecutive month. Exports climbed 17.4 percent on the back of a rise in car and computer exports.

Car sales were the largest contributor to overall export growth, rising 35.5 percent, while exports of personal computers and other office equipment rose 27.6 percent. Crude oil imports rose 48.9 percent, computers 52.7 percent, and scientific and optical products 77.8 percent.

HOUSEHOLD SPENDING:

Household spending in June rose 3.4 percent from a year earlier for the first time in three months, indicating a recovery in consumer confidence. Average monthly household spending in the first half of the year rose 1.5 percent.

UNITED KINGDOM

INCREASED EXPORTS: A hint of an upturn in one corner of British manufacturing emerged after the machine tool industry reported increased exports. The sector, which has been one of the most vibrant parts of UK manufacturing in recent years, saw a sharp increase in export turnover in June, the Office for National Statistics said. This followed several months in which

export turnover had steadily declined.

The increase is likely to fuel hopes that demand in Europe—a significant machine tool market—may be reviving slightly, after slumping in recent months. Measured on a three-monthly basis, the level of exports was a seasonally adjusted 5.9 percent higher than the same period a year before.

INDUSTRIAL OUTPUT: British industry suffered its biggest fall in output for three and a half year in June. Industrial production fell by 1.1 percent in June, the Office for national Statistics said. It was the biggest monthly drop since November 1992 and included falls in factory output, oil and gas extraction and energy production.

The 0.3 percent drop in factory output in June surprised statisticians who had assumed there would be no change when they drew up the estimate of economic growth in the second quarter, published last month.

Recent surveys had suggested factories might be stepping up production again. But manufacturing remains in a technical recession: with output stagnated in the second quarter following falls in the two preceding quarters.

The statistics office estimated for the seventh successive month that the underlying trend in factory output and the broader measure of industrial production were flat.

In manufacturing, output rose in the second quarter in the textiles, chemicals, engineering and food, drink and tobacco industries. But coke, oil refining, nuclear fuels, metals and other manufacturing contracted.

M0 MONEY SUPPLY: The value of notes and coins in circula-

tion grew by a seasonally adjusted 0.6 percent in July, the Bank of England said, following a 0.9 percent rise in June. The annual rate of increase has reached 7.1 percent, the highest since October 1994.

The annual increase in the narrow money supply measure M0 — which also includes banks' balances at the Bank of England — fell slightly from 7.4 to 7.1 percent.

UNEMPLOYMENT: The fall in Britain's unemployment total gathered pace in July. The number of people without work and claiming benefits fell by a seasonally adjusted 24,1000 last month, the Office for national Statistics said. This reduced the total to 2,126,200, its lowest level since early 1991.

Average earnings growth was stronger than City of London economists had predicted, but remains in the 3 to 4 percent band it has occupied for the last three and a half years. Earnings rose by an underlying 3.75 percent in the year to June, with the figure for the previous month revised up by a quarterpoint to the same level.

INTEREST RATE INCREASE SURGED: The Bank of England warned Mr. Kenneth Clarke, the chancellor, will have to raise interest rates and cut government borrowing if he is serious about hitting his inflation target.

In its latest quarterly inflation report the Bank said Mr. Clarke had only about a 40 percent chance of hitting his inflation target in two years without a rise in interest rates. It said the odds had worsened since its last report, largely because the chancellor cut rates in June. The Bank is also worried by the deterioration in public finances revealed in the Treasury's summer forecast.

With domestic spending already accelerating, the Bank expects the pace of economic growth

to rise above its long-run trend of between 2 and 2.5 percent a year through the rest of this year and into 1997. As a result the economy's spare capacity will be eroded and inflation should rise from the middle of next year.

Mr. Mervyn King, the Bank's chief economist, said the question to be asked in the coming months was no longer whether interest rates should be raised, but when. The Bank expects the underlying rate of inflation — which excludes mortgage interest payments — to fall from 2.8 percent to 2.5 percent or below later this year and 2.25 percent in mid-1997.

It believes inflation may be lower if export markets remain sluggish and companies continue running down stocks of unsold goods. But inflation should then start rising as the economy gathers momentum.

CBI INFLATION OUTLOOK: Interest rates will not have to rise until after the general election next year as the government's economic policies deliver strong growth but with low inflation, according to the Confederation of British Industry.

The CBI's latest economic forecast supports the government's hopes of fighting the election amid a low inflation consumer-led recovery. It suggests the CBI believes Mr. Kenneth Clarke, chancellor of the exchequer, will successfully fend off pressure from the Bank of England — the UK's central bank — for higher interest rates ahead of the election, which must be held by the end of May next year.

GROWTH IN RETAIL SALES: The annual growth in retail sales fell to 5.4 percent in July from 7 percent in June because poor weather hit sales of ice cream, soft drinks and summer items, the British Retail Consortium reported.

But the underlying trend remains healthy, with the housing sector in particular reporting steady business. The retail consortium said that the value of sales for "like for like" items remained healthier than the average increase of 4.1 percent in the first four months of this year, and the 2.7 percent annual increase reported since last year. The consortium figures are collected from 75 big retailers, representing about half of all sales.

OUTPUT PRICES: The Office for National Statistics said that output prices fell a seasonally adjusted 0.1 percent in July — the third consecutive monthly fall. This took the annual rate to 2.2 percent.

Excluding the volatile elements of food, drink, tobacco and petroleum, the price level also fell 0.1 percent. This was the first monthly drop for core goods since 1967, and it pushed the annual price increase down to 1.5 percent — also the lowest rate for thirty years. The key factors in the fall were sharp monthly drops in the price of office equipment, base metals, wood products and pulp, paper and publishing.

The price level of raw materials and fuels purchased by industry fell 0.8 percent in the year to July. Excluding volatile items, it fell 6.7 percent in the year. This was the largest fall since 1986. The fall partly reflected the recent strength of sterling. However, the most significant factor was a sharp drop in commodity prices, that has recently reversed the sudden spiral in these prices last year. Goods purchased by the pulp and waste products industry, for example, were 40 percent cheaper in July than a year earlier. Meanwhile while goods for the metal industry were 12.1 percent cheaper, and chemical inputs were 7.2 percent lower.

HOUSE PRICES: House prices in July rose for the seventh month in succession according to

figures published by nationwide, the UK's second largest building society.

The figures confirm that the housing market recovery, unlike in the previous two years, has continued into mid-summer. According to Nationwide, prices on average rose by 0.7 percent last month to BP53,589 (\$83,062). In previous years, prices and sales have improved ahead of the spring, but fallen away as the summer approached.

RETAIL SALES: Shops recorded the biggest fall in retail sales since the beginning of the year. The drop, which followed a large increase in June, was bigger than the City expected, but most economists anticipate growth to resume, at a steady, if not spectacular, rate.

FACTORY SPENDING: Manufacturing investment fell back sharply in the second quarter of the year, official figures showed. Outside manufacturing, other areas of business stepped up their capital expenditure.

Measured overall, the Office for national Statistics said that capital expenditure by the manufacturing sector was a seasonally adjusted 4 percent lower in the second quarter of the year than the first quarter.

Compared with the same period a year before, the spending level was 5 percent lower. The last time that investment was this weak was at the start of 1995.

Most of the quarterly fall stemmed from lower spending on buildings and vehicles. Plant and machinery investment, by contrast, rose slightly in the quarter. But this quarterly rise in spending still left the level of investment in plant and machinery 7.4 percent lower than the same period a year ago.

CAR PRODUCTION: Car

production jumped by 19 percent in July compared with the same month a year ago. While the largest proportion of the increase was destined for export, a year-on-year rise of 8.7 percent in output for the domestic market was hailed by the industry as further evidence of a recovery in the UK new car market.

FACTORY ACTIVITY: Manufacturing activity strengthened again in July for the second month in a row as new orders rose to the highest level since March 1995, a survey showed. But the latest monthly report by the Chartered Institute of Purchasing and Supply painted a less upbeat picture of the manufacturing recovery than other recent surveys.

It confirmed manufacturing was now recovering after recession earlier this year thanks to rising consumer demand by suggested the recovery may be gradual rather than immediate.

Companies laid off staff for the third month in succession. Price competition among suppliers caused the sharpest decline in industrial goods prices since the survey began in 1991.

GOVERNMENT BORROWING: Hopes of UK tax cuts were boosted after government borrowing fell back in July. The fall, triggered by a surge in tax revenues, surprised the City of London. It is likely to fuel political pressure on the chancellor of the exchequer to deliver big tax reductions in the November Budget.

But the Treasury admitted that some of the surge in revenues may have been due to a change in the timing of tax collection. The Office for national Statistics yesterday said the government spent BP1.7bn (\$2.63bn) less last month than it collected in taxes. Last July spending overshot tax revenues by

BP804m. The improvement partly reflected privatization proceeds.

NEW CAR SALES: Growing signs that nearly 500,000 new cars with the latest P registration prefix will be sold in August have raised confidence that the market could top 2m this year — for the first time since 1990. The optimistic forecasts are underpinned by strong indications of returning confidence among private buyers. Their absence had contributed significantly to the poor profitability of many car makers and declining margins among distributors.

INFLATION: A surge in house prices pushed the rate of inflation up to 2.2 percent in July from 2.1 percent the previous month, the government announced. But this was offset by some encouraging trends in the retail sector. Although consumer spending has risen recently, retailers still show no sign of raising their prices. The clothing and footwear sectors reported the sharpest fall in prices for any July sale for forty years.

GERMANY

INFLATION: Inflation edged up again in Germany in July to an annual rate of 1.6 percent, with seasonal price rises for package holidays and hotel accommodation influencing the trend, the federal statistics office said. The July figure compares with 1.4 percent in June, the lowest since pan-German figures were first compiled at the start of 1992. Economists said the slight upturn was expected. July's consumer price index was 0.3 percent higher than in June, which showed a 0.1 percent rise on the May level. In west Germany alone, consumer prices rose 1.3 percent in July over the same month a year ago, against 1.2 percent in June. The east German year-on-year increase was 3 percent (2.6 percent in June), stemming mainly from higher rents and tourism charges.

INTEREST RATE CUT: The Bundesbank cut one of its key interest rates more sharply than expected in an apparent bid to reinforce the German economic recovery and help support the shaky French franc.

The German central bank lowered its securities repurchase (repo) rate, through which it influences the money market, from 3.3 percent to a new low of 3 percent, citing slower growth in the money supply as the main reason for the move.

Mr. Hans Tietmeyer, Bundesbank president, said the reduced July growth rate in the M3, the broad monetary aggregate, announced this week was "decisive" in the rate decision. But low inflation, with no dangers to price stability on the horizon, had also influenced the move.

DRUG SALES: Pharmaceuticals sales in German in the first half of the year rose to DM12.6bn (\$8.5bn), 6.5 percent higher than a year earlier, the VFA industry association reported. Germany is Europe's biggest pharmaceuticals market and third largest in the world after the US and Japan.

The growth rate is below that for Europe as a whole but excludes sales through hospitals. German healthcare reforms of 1993 gave general practitioners budgets which excluded hospital drug sales.

INDUSTRIAL OUTPUT: German industrial output rose by a surprisingly strong 0.6 percent in June, according to the Federal Statistics Office. The increase was underpinned by a strong performance by the manufacturing sector. Although overall the rise was higher than expected, it was still lower than gains in the previous three months.

Ifo, the economic institute,

forecast a rise in economic growth of 0.75 percent for this year, followed by 2 percent in 1997, underlining a consensus that the economic recovery will be slow initially. The 0.6 percent increase in June was made up of a 0.4 percent rise in west Germany and a 1.8 percent gain in the east.

MONETARY RESERVE: German monetary reserves rose DM400m (\$270m) to DM119.6bn in the week to August 7, the Bundesbank said. Foreign liabilities in the week were down DM100m to DM16.5bn.

BUSINESS CONFIDENCE: Business confidence in west Germany increased more than expected in July, according to the monthly index of the Ifo economic research institute. The Ifo business sentiment index rose to 94.1 in July from 90.4 in June, still leaving it lower than in November.

REGIONAL PRICES: German consumer prices have remained stable in August while there appears to have been a slight acceleration in the year-on-year rate of inflation according to early reports from state statistical offices.

North Rhine/Westphalia and Baden-Wurttemberg reported no change in consumer price indices compared with July, while in Hesse prices fell 0.1 percent. However, annual inflation rates quickened to 1.6 percent this month from 1.4 percent in July in North Rhine/Westphalia and to 1.2 percent from 1.1 percent in Hesse and Baden-Wurttemberg, reflecting falling prices in August last year.

GROWTH/EMPLOYMENT: The German economics ministry said industrial orders had risen by a seasonally adjusted 1.1 percent during June, well above market expectations. The rise derived from domestic rather than foreign orders; eastern Germany showed stronger

growth than western Germany.

The apparent recovery has not yet translated into jobs. The Federal Labor Office reported a decline in seasonally adjusted unemployment by only 5,000 to 3.92m during July, equivalent to a fall in the unemployment rate from 10.3 percent to 10.2 percent.

GROWTH FORECAST: The growth rate of the German economy should pick up again next year, but the Ifo economics institute is forecasting a modest 2 percent rise after only 0.75 percent growth this year.

In its latest monthly report, the institute said sustained growth would continue to be heavily dependent on exports as consumer spending and construction remained sluggish. It warned that high unemployment would persist as industry continued to rationalize in a bid to cut costs and boost competitiveness.

The report estimated that growth in the second quarter would more than make up for the seasonally adjusted 0.5 percent fall in the first quarter. The main source of strength in the economy continues to be exports, despite slow economic growth throughout the European Union and frequent complaints that high operating costs are hurting the international competitiveness of German industry. Ifo said German exports would grow a real 3.5 percent this year compared with 1995 and surge to 5 percent next year.

Ifo said the unemployment rate would dip to under 10 percent in the second half of this year, compared with 10.5 percent in the first half, but expected it to rise to 10.5 percent early next year. Consumer spending, dented by fears of unemployment, the heavy tax burden and government plans to introduce saving of DM50bn (\$33bn) next year through social welfare cutbacks,

was set to grow a modest 2 percent this year compared with 1.7 percent last year and a further 2 percent in 1997, Ifo said.

Investment in the construction industry might fall as much as 4 percent this year in west Germany and it believes a boom in east Germany is about to end.

FRANCE

PLANNED SPENDING CUTS: The French government announced plans for substantial cuts in public spending to achieve a planned spending freeze in 1997. The Matignon, the prime minister's office, said it had set "an unprecedented" objective of cutting more than FFr60bn (\$12bn) in real terms from expenditure targets across government departments to ensure that next year's overall target was maintained at this year's level of FFr1,552bn.

CUT IN WORKING HOURS: Legislation designed to encourage businesses to cut employees' working hours to boost employment came into force in France. Employers will be given significant discounts on social security taxes on condition that they cut hours and hire new staff. But employers are skeptical about the proposals.

The legislation, an amendment to a 1993 employment law, came into effect when details were published in the Official Journal. Employers who cut working hours by 15 percent and hire the same proportion of new staff will pay up to 50 percent less social security contribution for the first year and 40 percent less for the following six years. France is seeking new ways to create jobs at a time of high and rising unemployment, currently 12.5 percent, during a period of low economic growth.

The new law is one of the first

significant legislative steps to help encourage a reduction in working hours and boost employment since the former Socialist president Francois Mitterrand cut the legal working week from 40 to 39 hours in 1982, the year after he was first elected.

CONSUMER PRICES: French consumer prices fell 0.2-0.3 percent in July, according to official figures, giving a further sign of the sluggish state of the economy. The national statistical institute said the monthly decline followed a 0.1 percent rise in June; inflation over the past 12 months had been in the range 2.2-2.3 percent. The finance ministry said the decline was a normal seasonal drop, reflecting summer sales and a fall in the price of fresh produce. It also cited cyclical factors, including a fall in petrol prices, railway fares and telephone tariffs. The seasonally adjusted inflation figures for July will be published later this month.

OFFICIAL RESERVES: French official reserves rose by FFr528m (\$105m) in July to FFr303.524bn.

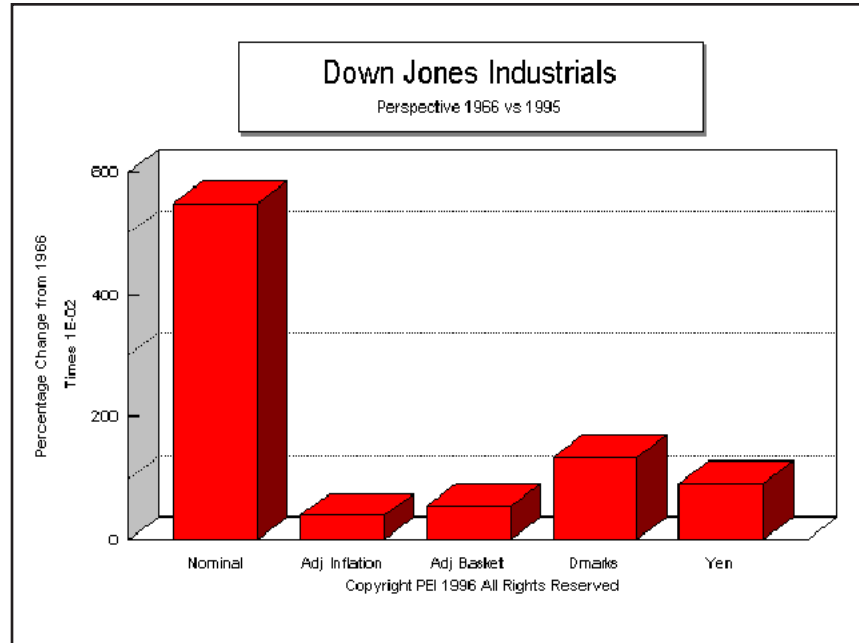
INDUSTRIAL PRODUCTION: France's industrial production, excluding food and energy, rose a seasonally adjusted 0.5 percent in June. Overall industrial production fell 0.2 percent after a revised rise of 0.8 percent in May.

UNEMPLOYMENT: Unemployment in France rose an unadjusted 0.7 percent in June to 3.07m, the second consecutive monthly increase. At the same time, seasonally-adjusted figures from Insee, the national statistical institute, showed the number of unemployed seeking jobs at 3.19m, or 12.5 percent of the working population. This is up from 12.4 percent in May and 11.7 percent in June last year.

Capital Market Review

Precious Metals

Both gold and silver continue to remain extremely weak going into October. Here the major depressing element remains that of pending gold sales on the part of the IMF. The initial stages of a real financial crisis are still forming. The demand for cash among governments is simply rising around the globe keeping a steady supply of "official" gold sales hanging in the wings. However, while this fundamental continues to threaten the short-term, we see that this same fundamental will be the backbone behind an explosive bull market with a target objective coming in around 2003 for the final high. In other words, the selling of gold by the IMF and other central banks is perhaps bearish at this time. However, the long-term implication of this are extremely bullish. The IMF and other central banks would **NOT** be selling gold unless they needed the cash. That is the very foundation from which inflationary pressures build. Look for an initial low in gold and silver going into early October. Key support remains at the \$371-374 area followed by \$368 in gold. We do see that a tar-

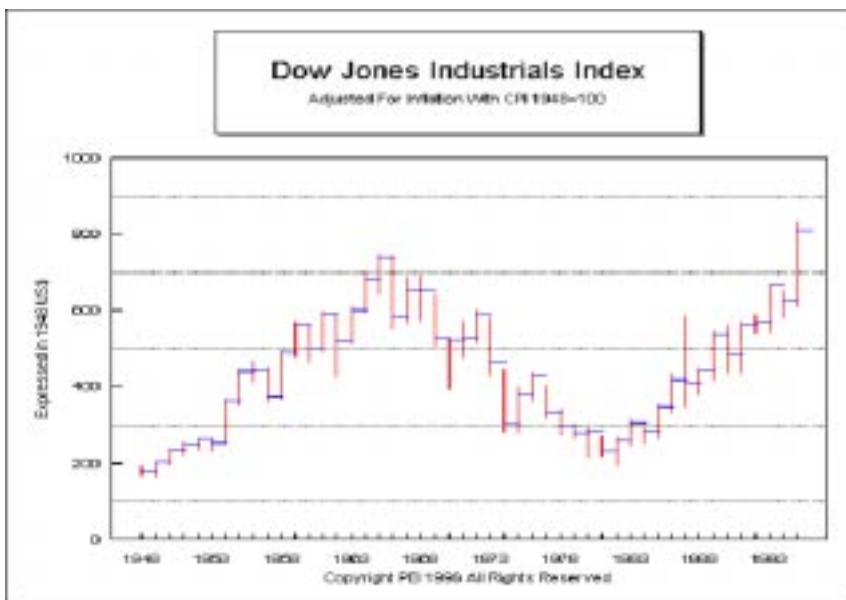


get objective of about \$375 is possible by early October. Silver will be critical to watch. Here we have three important yearly support numbers \$4.62, \$4.52 and \$4.39. If silver closes below \$4.52 at year-end, then we should expect at least a penetration of the \$4 area by June at the latest. However, an year-end closing below \$4.39 would warn that silver is pushing lower straight down to retest the \$3 area. For now, we do see that a reasonable target ob-

jective for early October will be the \$4.62 area.

US Share Market

The US market continues to remain very strong despite the consolidation period that currently prevails. The Dow Jones Industrials are particularly linked with the fate of the dollar at this time. Sharp movements in the dollar will be accompanied by similar volatile moves in the Dow. As the dollar strengthens, this will keep the foreign buying coming into the US market thus providing good underlying support. However, a turn downward in the dollar will lead to a temporary decline for the US share market as well. The big question is whether or not the Dow continues higher into early 1997 or not. We do see that a rally is possible going into early October and new record highs are likely if new lows develop for the dollar as well. Our greatest concern would be to see the Dow continue higher into Jan/Feb reaching the 6300-6500 area. This would then warn that a mini-crash will become possible leading to a 1998 low instead of a high. However, this would also suggest that another leg of the



bull market will develop from a 1998 low taking the Dow to record highs again going into 2003. For now, a rally into October followed by a decline into Jan/Feb should be followed by a strong dollar and US share market leading into a major high near 10,000 for June of 1998.

Nonetheless, the major question of whether or not the Dow is overpriced or underpriced is illustrated by the charts offered here. Clearly, the **NOMINAL** value of the Dow may appear to be way overvalued, but in reality, the Dow is still catching up with the rest of the economy. By this we mean that since 1980, the Dow has risen from 1,000 to 5,800. The national debt has also risen from \$1 trillion to nearly \$5.2 trillion. It is impossible to see the Dow crash by 50% or more as many doomsday forecasters portray. What they are not taking into consideration when comparing current chart patterns with those of the past is the fact that the past represented a stable and single world currency - namely gold. Today, the nominal value of the Dow is actually **NOT** way overvalued given the vast increase in the money supply as a whole.

In summary, the Dow still has a higher probability of reaching 10,000 rather than 2,500. All tangible assets historically rise in nominal value whenever the purchasing power of the underlying currency declines. The FT rallied when the Pound was withdrawn from the ERM and its value declined overnight against all world currencies. The same has been happening here in the US but at a more gradual pace.

Adjusted for inflation, the Dow has finally reached 1966 levels in real terms. However, after taxes, the Dow is still about 40% below the peak of 1966. Consequently, we are far more concerned about the nominal price of the Dow today but nobody seems to be applying the same level of concern about the national

debt being over 500% in 15 years.

According to our computer model, the Dow remains seriously undervalued in global terms. It will be the ultimate turn in the dollar that will spark massive waves of foreign buying. That buying will help propel this market to nearly the 10,000 area for 1998 or certainly by 2003.

US BONDS

The US bond market is still very nervous over the fate of short-term interest rates. The Fed is watching wage prices and union settlements very carefully despite the political talk of the CPI overstating inflation. This speaking out of both sides of the mouth is contributing greatly to the confusion and volatility in this marketplace. We do see the Fed raising rates since wage settlements are running about 15% for 3 year contracts among public sector unions - a group that accounts for over 25% of all labor. Basis the nearest futures, the 30 year bonds have good support in the 103-104 area will major support at 101-102. We suspect that the economy will remain stronger than most expect since our model points to little chance of a recession until mid 1998. Therefore, we should be cautious about the bond market going into year-end. We should expect to see lows for bonds going into as late the week of October 14.

US DOLLAR

While our long-term models continue to suggest that the dollar is going to rally dramatically into 2003, we do see that the potential for one more dollar low during the first half of 1997. Short-term models suggest that we can still see a new high here going into October given several problems ranging from the Middle East to Yeltsin. Nevertheless, the dollar has not quite reached its maximum points of re-

sistance just yet so there is little room on the upside still possible without changing the course of long-term trend at this point. The dollar does remain the weakest on a broader basis against most major continental European currencies, with the noted exception of the pound. Only a monthly closing for the dollar above 15840 on the Dmark would suggest that this forecast is wrong and that the dollar low is in place and that a continued rally is likely in the future. Otherwise, a monthly closing below 13985 for the dollar vs Dmark would suggest that this forecast is correct and that an appropriate hedge position is warranted.

The dollar/yen is a different story. The low for the dollar against the Japanese yen is clearly in place but a reaction back to the par level is not out of the question. Overall, a decline should continue taking the dollar up to 12500 or 14500 level over the next two years. As we stated previously, resistance stands at the *"11300 level and a failure to move above that level by September would also raise the possibility that a retest of support at the 10489-10315 level is likely. A monthly closing below 10315 would then raise the potential for a very sharp decline back to the 10065 area or 9755 at worst."* We do see that the dollar/yen could rally into early October before reversing trend. However, the 11200-11300 level is still very significant resistance that should provide a top at least the first time around.

The Pound/Dmark is one cross rate that appears to be headed higher. Here we continue to forecast that the pound will emerge as the strongest currency with the E.C. A weekly closing above the 23888 area will signal a sharp rally up to the 24400-24700 level in the weeks beyond. Major resistance stands at the 24310 level. A year-end closing above this area will **CONFIRM** that the long-term trend has changed

and at that at least a 2 to 3 years rally is underway with a minimum target objective of 29500-30247.

NIKKEI

The Japanese share market has most likely reached a temporary top in June at the 22750 level. However, important support is now forming at the 19628 and 18896 levels. A monthly closing below 18896 would warn that a retest of long-term support is possible taking this market back to the 15292 zone. A September closing above 21398 would be very bullish warning that a retest of resistance could continue into early Jan/Feb. However, resistance is now starting to form at 21170, 21956 and 22331. Only a monthly closing back above 22331 would signal that a sharp move above the June high will develop. Timing models do warn that a reaction high is possible in early October. Only exceeding the October high would raise the possibility of a continued rally into early 1997. Again, we see that a high in early 1997 warns of a crash unfolding with a decline back down into early 1998 with a target objective of about 10000. Otherwise, an Oct/Nov high with a Jan Feb low will set this market up where a breakout to the upside for 1998 is possible leading to a retest of the 28000-32000 area.

CANADA TSE

The Canadian share market basis the TSE reached a high during May at 52490. Here we see that a correction back to the 48182 to 44867 level is the maximum target objective on the downside. We do see that the timing is similar to that of the US. Only new record highs going into early 1997 would warn of a much more steep decline developing leading into a 1998 low. Otherwise, a reaction rally into mid October followed by a decline into Jan/Feb will still allow for this market to rally into a final high for 1998. Key

support to watch initially will be a monthly closing below 44867. Achieving this signal would warn that a much more serious decline is possible where a sharp drop to the 39307 level would then be possible. We do see that a year-end closing below 43300 would warn that the overall correction could extend into early 1997 before reversing to the upside for new highs going into mid 1998. For now, a weekly closing ABOVE 52420 will signal that new highs are on their way.

LONDON FT

The British share market basis the FT100 is very strong at this time based largely on inter-European capital flow movement. Here new highs seem to be likely. Resistance will stand at the 40035-40324 level basis the cash index. Timing models indicate that a high in this market could extend into late September or early October. If a rally were to continue beyond October, then we are looking at a serious potential for an early 1997 high followed by a crash into a 1998 low. Only a decline into early 1997 would set the stage for an explosive rally into 1998 which could take this market up by as much as 30%- 40% in the face of the pound rising against all other European currencies.

GERMAN DAX

The German share market basis the DAX has been pushing higher in mid September suggesting that a rally into early October is possible. However, there is also a risk that this market could extend higher going into early 1997. This would raise the risk of a major crash rather significantly. Only a decline into early 1997 to retest support would lead to a rally into 1998. For now key target resistance stands at 27170 and 27500 area for Sep/Oct. Exceeding 27500 would warn of a major high becoming possible in early 1997 in the 28500-28900 zone.

FRENCH CAC 40

The French share market continues to lag behind both Germany and Britain. Basis the CAC 40 futures resistance continues to stand at the 22380 level followed by 22620-22765. Here we see that 1996 must close at least above 20252 in order to hold on to any hope that a retest of resistance is possible in the months ahead. A closing below 20252 will leave the possibility that a penetration of the 1995 low could develop in early 1997. Major year-end closing support lies at the 17968 area. Should 1996 close below this level at year-end, then a drop back to the 15750 area will be possible next year.

HONG KONG

The Hang Seng index continues to show the potential to retest the old major high going into early 1997. A monthly closing above 121868 will signal that we could press back to the 1993 high. Our computer is indicating that 1997 will be a Panic Cycle year. This is interesting that our computer model is picking up high volatility for next year without knowing about the change in government on the way. No doubt, a high in early 1997 would set the stage for a sharp sell-off going into the July date. This could also be link to a crack in the HK dollar with its peg to the US. It is unlikely that this peg will hold suggesting that there could be a huge capital flight out of Hong Kong causing volatility to rise in the stock market as well.