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Searching for future trends



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Warning signal for world equities

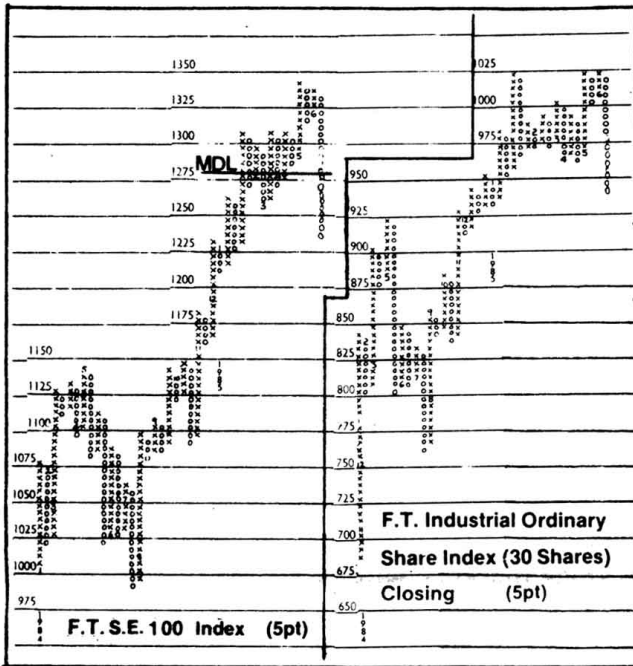
My most reliable pointer to future trends for global equities, the Chart Analysis World Indicator (CAWI), has turned downwards in the first sell signal since February-May 1984. This ended the longest bullish period recorded, following the early August '84 buy signal. Due to the importance of this development I will devote most of this issue to stock markets, while FM15 will focus mainly on currencies, interest rate futures and commodities. (Note: any reversal on the CAWI after a long run is regarded as an important signal.)

Because the CAWI is unweighted it quickly reveals any change in global momentum whether led by Wall Street or not. I warned of a possible correction in FM13 with the front page headline: "More share gains – then a shake-out". I added that "Today's best guess is that most markets will extend the upward acceleration well into June, at least. That would inevitably lead to a correction in proportion to the additional rise". The indicator sell signal means that the overall environment for equities has changed from low risk bullish to high risk bearish for at least the short term. To reverse this signal the indicator must turn upwards once again. For the next reversal to be a buy signal it should occur from either a considerably lower level or reverse the present small reaction and move into new high ground.

Since Wall Street has not provided any bearish leadership, as occurred at the important February '84 sell signal, the trends for world indices are now diverging. This provides FMs with breathing space, enabling you to tighten stops wherever possible. It may be a good idea to sell non-performing shares outright and new purchases should be avoided. I won't adopt a more bearish stance without pattern deterioration among more of the world's leading indices. As this could occur between issues I'll conduct an extensive review of stock markets which will enable you to spot the danger signals. Once you have studied the levels that I have identified on the indices you will have no difficulty spotting the crucial points on any individual share charts not covered by the FM portfolio.

United Kingdom

The UK market has already experienced a decisive downward break following the FTSE 100 Index' inability to maintain the move into new high ground. The subsequent drop back below the mid-point danger line (MDL) at 1280 is especially important due to the size of the January to May trading range that launched the last advance. This large pattern shows us that many shares changed hands at or above today's levels. Most of these positions show



losses, creating a large area of supply that will effectively cap the market as disillusioned bulls seek to reduce exposure on rallies. Short term momentum indicators show an oversold position (see Chart's UK or International publications), but this is unlikely to produce more than a temporary rally. The less important but widely followed FT 30 Share Index never broke above its January peak at 1024 and the decisive break below 950 has damaged sentiment. It would take months to restore confidence and move back through the peak so any rally is a selling opportunity.

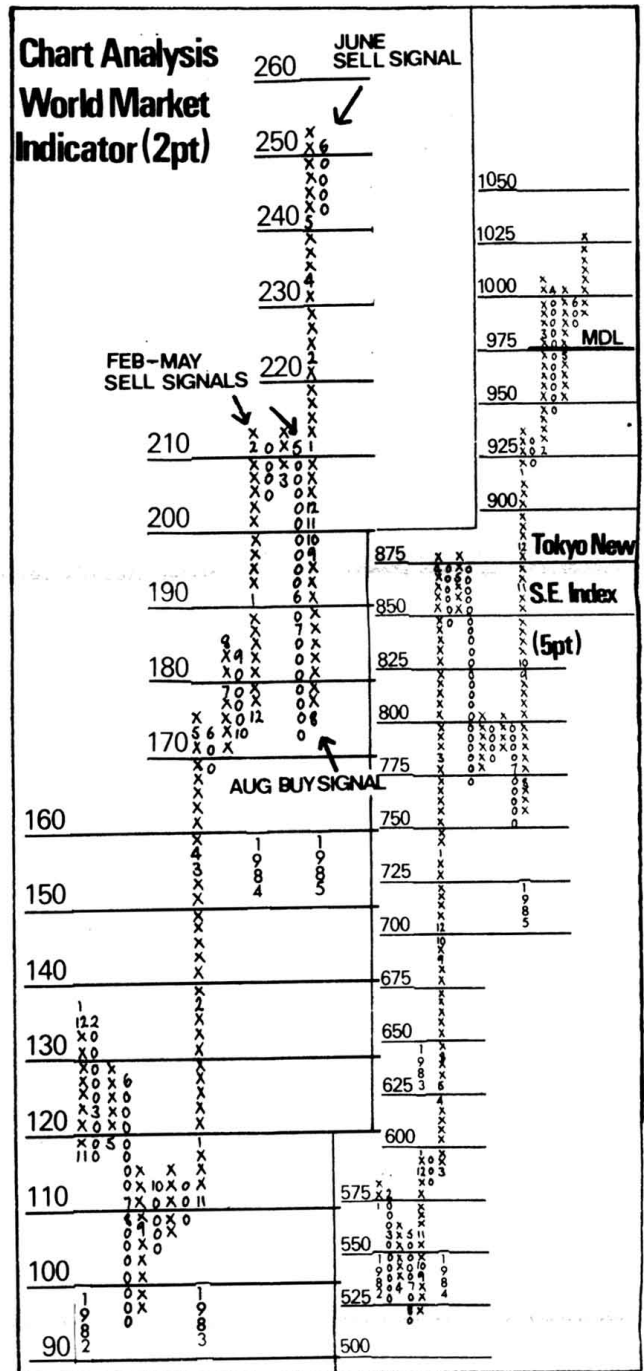
United States

Wall Street's gains have been modest compared to leading European bourses due to the dollar's previous strength. This provided a disincentive for European fund managers while American investors understandably diversified abroad as never before. Consequently Wall Street is less susceptible to profit taking and should improve its performance relative to European markets during the second half of 1985.

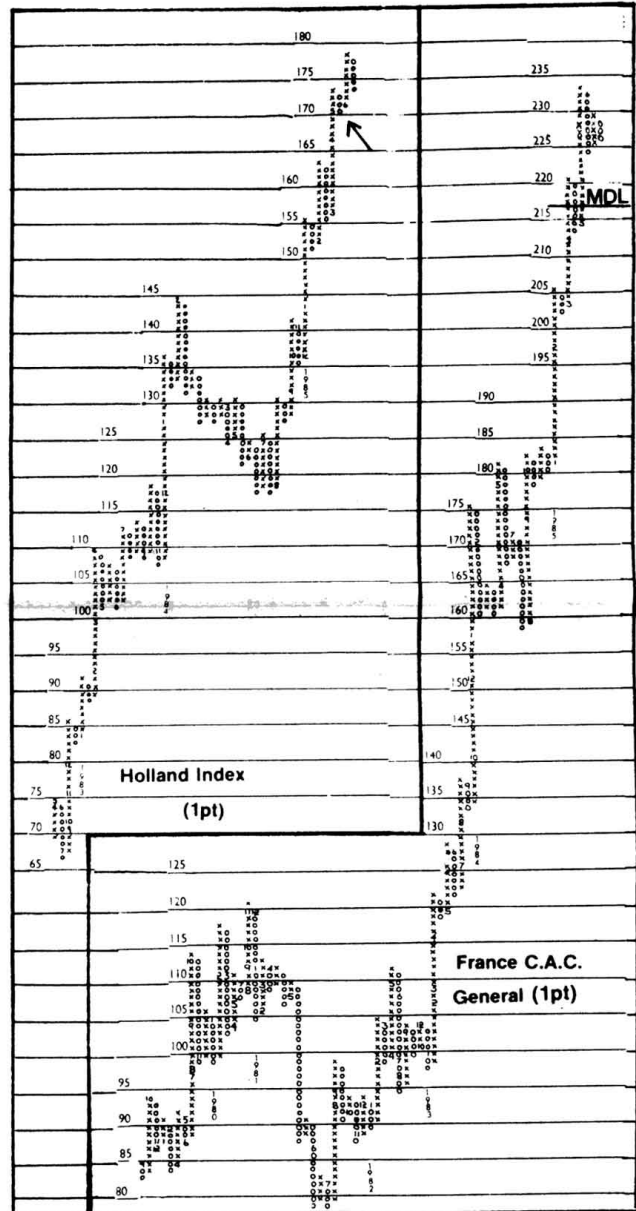
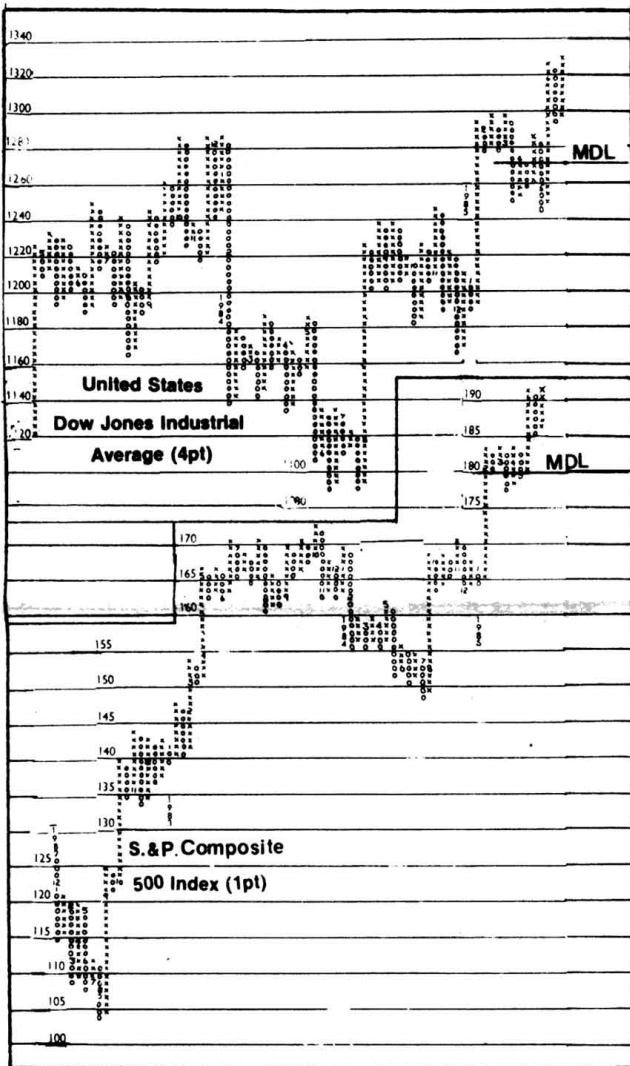
The widely followed DJIA has not dipped significantly below the 1300 break point during the recent consolidation of gains; therefore, the bull market with its broad staircase upward trend remains intact. It would take a move below 1270 to damage the DJIA's pattern, and potential for a substantial advance.

Technical developments on the more representative S + P Composite 500 Index have been exemplary by bull market standards. The upward break during May was decisive and the subsequent consolidation of gains has not dipped into the previous pattern beginning at 183. MDL violation at 180 would be necessary to derail this bull market.

Unlike the first half of this year Wall Street's action over the next few months will be a major influence on other markets. For example, a strong US market would probably limit damage on the better performing continental European bourses to a so called healthy correction. Even a neutral environment in North America would cushion the reaction on overextended markets, but a downward break would pole-axe vulnerable UK shares and high flying markets such as Germany, Holland and France.



The next markets under review perfectly illustrate a message hammered home during my seven city tour with The Chart Seminar: the biggest moves, the ones that make or break fortunes, are the most consistent. This is no coincidence, but a logical, behavioural development due to the conditioning of the crowds that move markets. The extent and speed of a move or other critical aspects of timing have very little to do with the fundamental economic factors that launched the trend. They are technical factors that can be monitored most effectively by the chartist who recognises and understands critical change. Critical change is any unexpected market development, up down or sideways, that interrupts an orderly self-feeding trend. Critical price change leads to widespread reassessment which, in turn, causes people to unwind some of their positions. This checks and can even reverse the prevailing price trend.



Holland

Take the Holland Index, for example, where all moves have been of the orderly staircase variety. The latest stage of this bull market, which began with the rapid and decisive upside MDL violation last August, has been so consistent that every step has been of three column width. Additionally every advance has moved above the previous rally peak and every reaction low has encountered support not only above the previous low, but also at or above the previous step. A technician could not ask for more consistency because any anomaly will stand out on the chart like a beacon. From current levels a clear danger signal would be a move below 170, recording a lower low. The significance of such a move would be that, of the three things a market can do, the odds would have shifted from a further advance to a sideways or declining trend for at least the short term

France

The French C.A.C. General Index was a model of consistency in 1983 until accelerating momentum, the most reliable topping characteristic, led to a year of consolidation in 1984. This year's trend has been extremely consistent so any move below the mid-point of the previous step, currently 217, would spell danger.

Switzerland

The Swiss Bank Corporation Index has been remarkably similar to the French pattern since 1983. A move

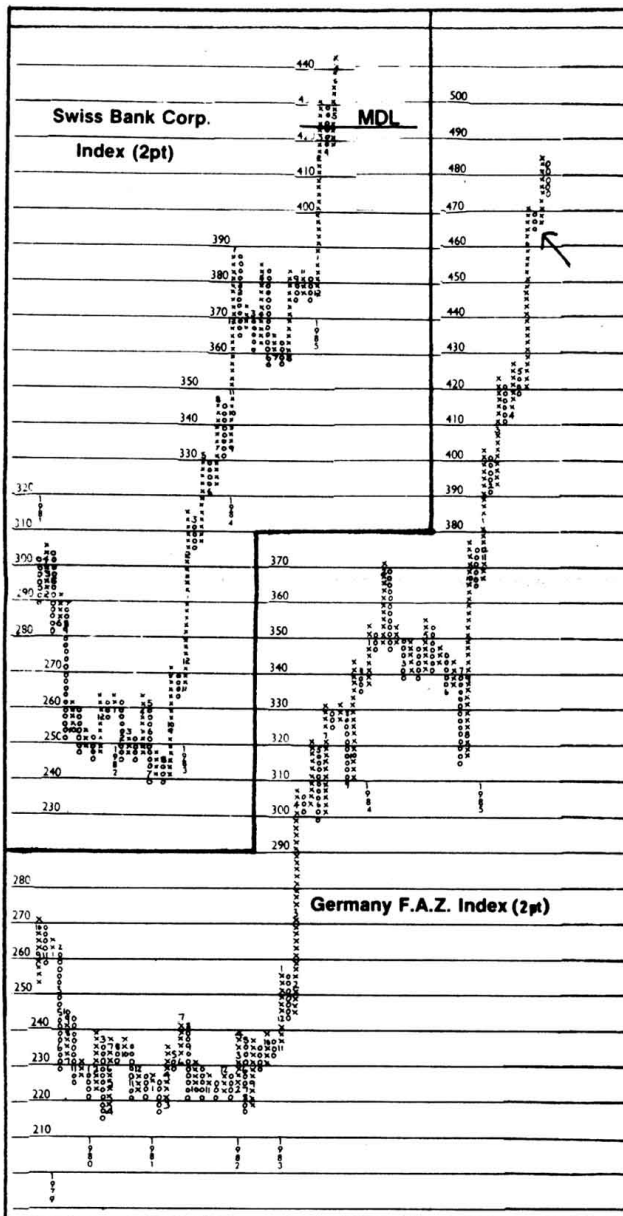
to 422 would represent the first sign of critical change for the worse.

Germany

The German F.A.Z. Index is accelerating at a rate that is unsustainable beyond the short term. Accelerating trends are the most profitable, but quickly overdiscount good news and are inevitably followed by a shake-out. Massive accelerations often cap the best bull markets. To date Germany's acceleration has been moderate, not symptomatic of a euphoric blow-off, for example. A lower low, currently a move to 462 or below, would represent bearish critical change.

Italy

The Italian B.C.I. Index was a technician's dream in terms of consistency throughout the huge 1978 to mid-1981 bull market (partially shown) which carried from 56 to 292 before the first mid-point danger line violation occurred on the move below 280. It took Italy 3 1/2 years to regroup for another strong upward trend. This bull market will remain soundly based provided the MDL at 312 is not crossed.



Belgium

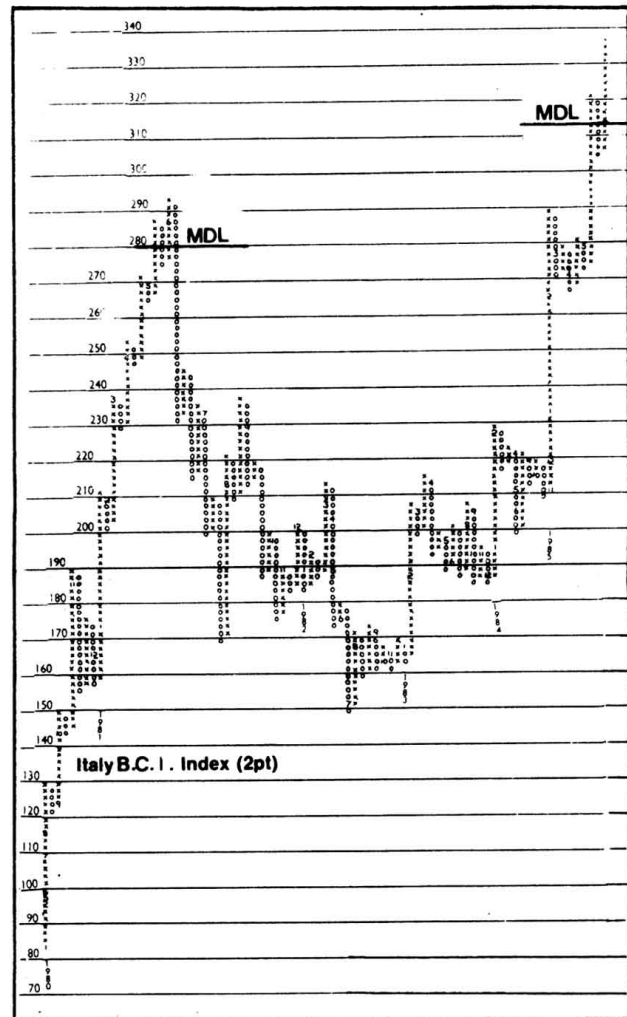
The basis on which the Belgian Index is constructed was changed in January so I have included only six months data, but can add that the Brussels market rose by approximately 60% during 1983-4, before continuing upwards this year. If this Index can hold above 2300 the bull market consistency will be maintained, but a decline below 2250 would reveal critical deterioration. I am not optimistic because Petrofina (not shown), the largest constituent in the Index, shows a large type 3 top formation that would be completed on a break below BFr5600.

Sweden

Sweden is one of 1985's rogue markets as it has declined during a strong global uptrend, falling nearly 100 points since I pointed out the large type 3 top in FM13. The Swedish J + P Index is hovering above the psychologically important roundophobia level of 1300 and could easily collapse. It would take a rally back above 1500 to take Sweden off the critical list.

Denmark

The Danish Index has done well to regain the top area



following last year's big shake-out, but stale bull liquidation may make further gains more difficult to achieve. As we have seen a decisive break above the April-May consolidation pattern, the danger signal would be a move to 187.

Norway

Although the Norwegian O.S.E. Index remains within its broad upward trend, a serious loss of momentum has occurred since February. That makes me extra cautious and I would want to see a break above 350 before forecasting another bull market leg.

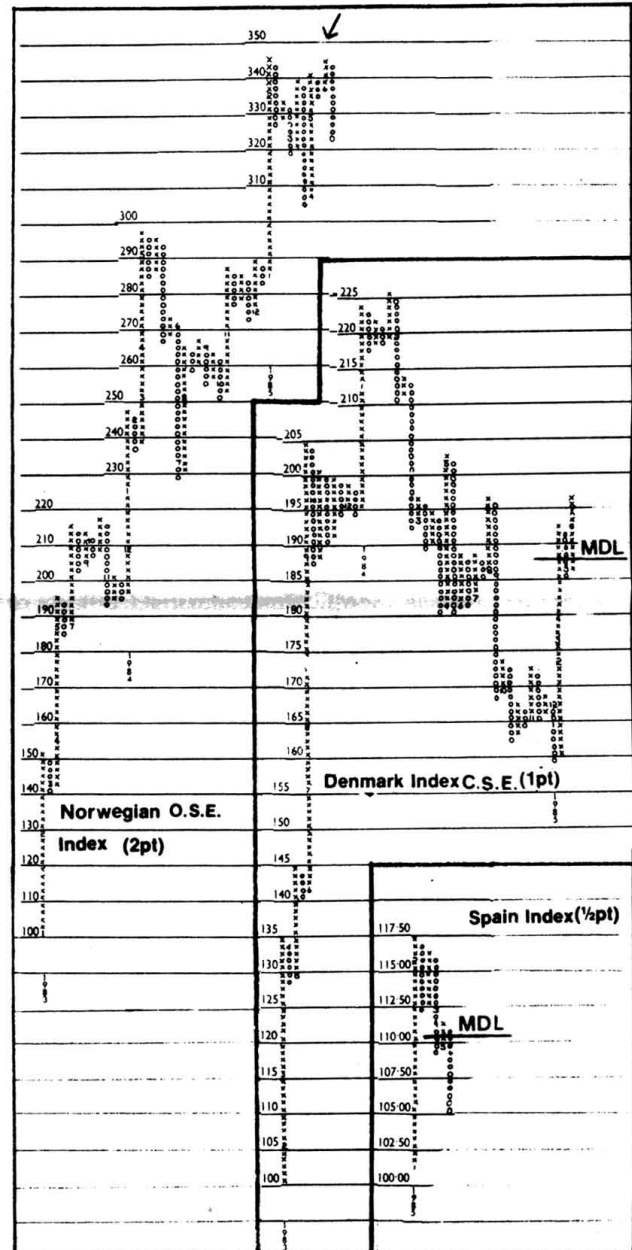
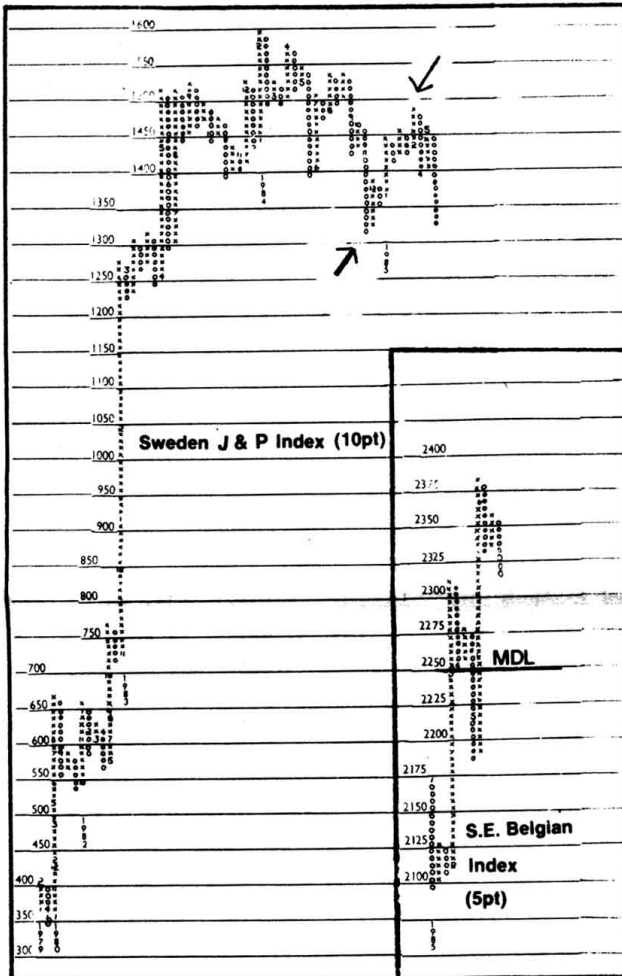
Spain

The Spanish market rose 50% last year (not shown) but a small top developed last February. The minimum rally required to interrupt this year's bearish staircase downward trend would be a move above the MDL at 110.

Japan

The Tokyo New S.E. Index broke decisively into new high ground recently (see page 2 for chart) following a three month pause. That reconfirmed the bull market trend but broad trading ranges, relative to previous sideways steps, are less reliable at this stage of a market cycle – a point I made in FM13 when discussing the UK market's last upward break. Any move below the 1000 roundophobia point would be a warning and a break to 970 would represent critical MDL violation.

The Nikkei Stock Average shows Japan's broad trading range centred on 12500 most clearly. A move



below 12450 would confirm a serious loss of upward momentum and probably derail this bull market.

Hong Kong

FM13 mentioned that "Hong Kong may be overheated in the short term", and a local bank scandal provided the catalyst for a sharp correction. The subsequent bounce from the top of the late January to early April trading range evident below 1430 has been impressive, but inevitably some resistance will be encountered near the May closing peak at 1640. Hong Kong has been a favourite market of mine since I first debunked the widespread "disaster in 1997" stories in FM3, and many individual share patterns have the large type 3 base formations that can support a further advance over the intermediate to longer term. The risk is in the short term and I would not like to see the recent closing low of 1430 penetrated.

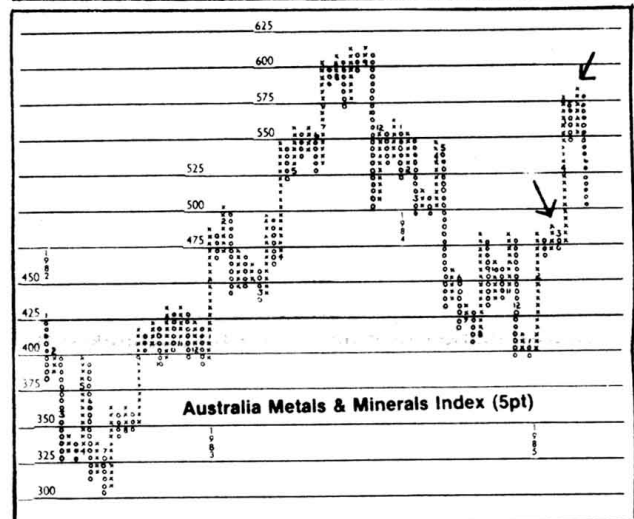
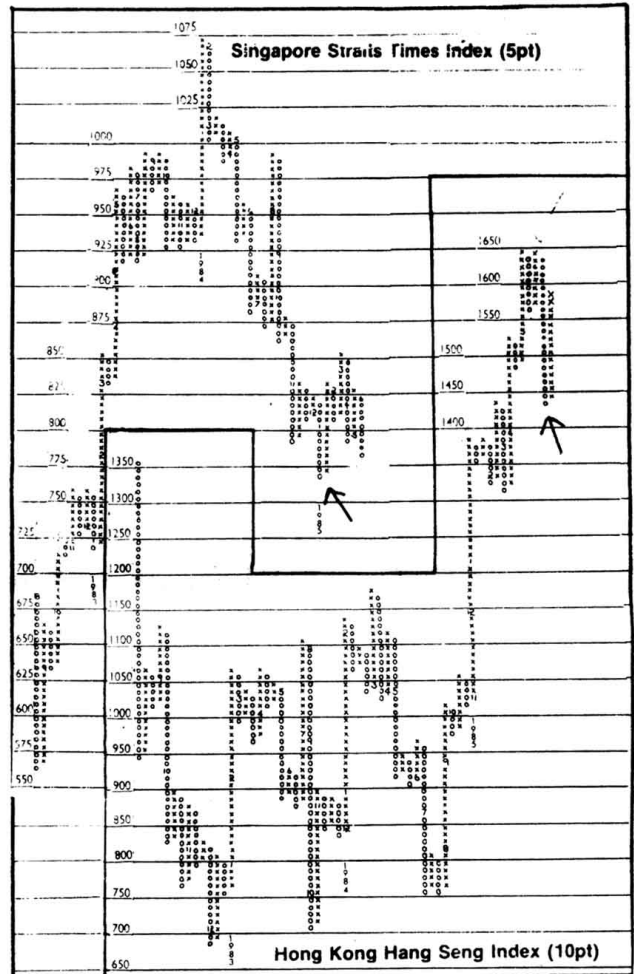
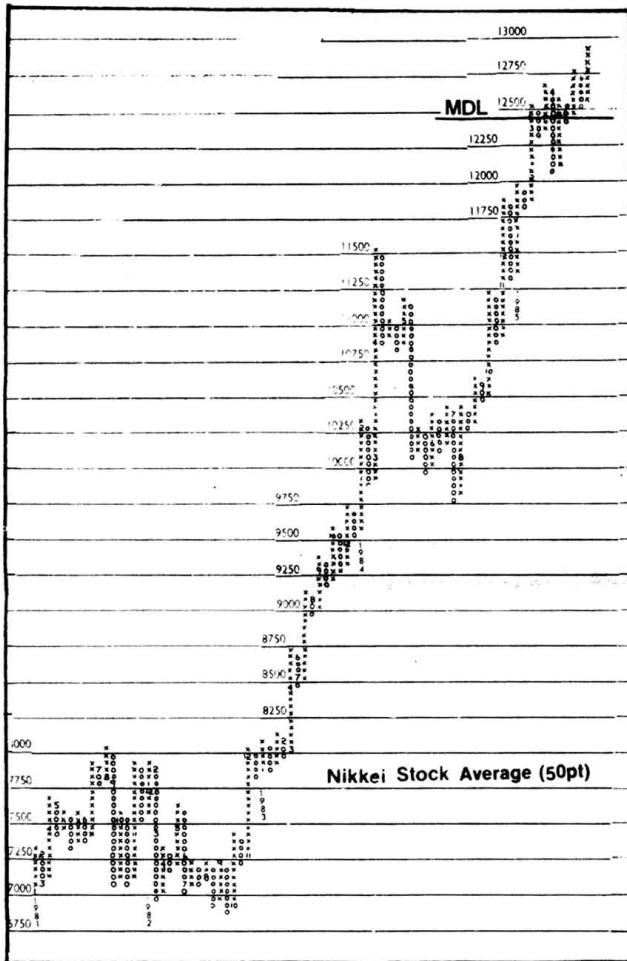
Singapore

Singapore has been a rogue market this year in failing to join the global uptrend. Dips below 800 on the Straits Times Index have predictably produced technical rallies but these have not been maintained to date. Buyers have been put off by financial scandals (mostly in Malaysia), overcapacity in the always cyclical building and hotel industries, the usual funk that permeates sentiment during a recession and most of all, a much too strong Singapore dollar that has been unofficially pegged to the US currency for years.

What Singapore needs the most is a 20% currency devaluation, but I have no reason to believe that such a

move is being even remotely considered in government circles. Therefore the two most bullish developments that will eventually boost Singapore's stock market should occur far away from that tidy, disciplined little island. The next big decline in the US dollar will be the second best thing to an outright devaluation, increasing confidence in the export industries and making Singapore more attractive to foreigners, ranging from fund managers to tourists. An influx of tourists on a scale now evident in Europe, for example, would have a significant effect on Singapore's small economy, increasing profits which, in turn, would cause fund managers everywhere to buy more Singapore shares. The other development that will eventually boost the Singapore stock market will be a strong run on Wall Street. Both markets have suffered due to currency related economic problems and a significant move in US stock prices in either direction should pull Singapore in its wake.

The desire to chase rainbows is part of human nature but in markets the biggest profits are made by those who buy what is out of favour near the turn. The



lower a market goes the more interested we should become. A weak market should arouse our predatory instincts, causing us to salivate in anticipation of the feast at hand. Tighter stops in the uptrending markets and the greater risk of a shake-out should enable FMs to raise cash. Keep some aside for your next pounce in the Singapore stock market which will probably challenge its low before the next significant rally due to the present vulnerable environment for world equities.

Australia

Following its low in early January, the Australian all Ordinaries Index had an unbroken progression of higher lows and higher or equal highs, until the two MDL violations this month. The decline from 904 to 842 was a type 2 (severe reaction against the trend) top characteristic. Therefore the peak should hold for at least the short term and there is no evidence that we have seen the reaction low. The short term trend for the Australian Index should be sideways beneath the peak to lower, but at this stage I do not anticipate a challenge of the very strong support evident below 800. The Australian Metals & Minerals Index has also experienced a sharp downward break. While it may have seen the worst of its decline the chart looks uninteresting.

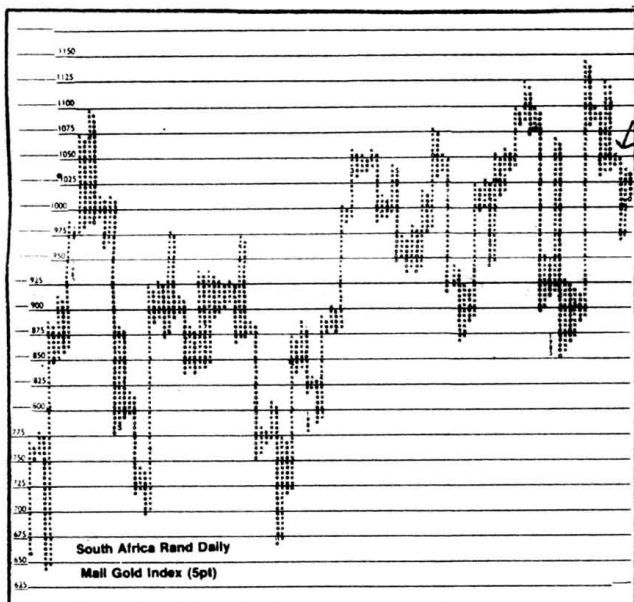
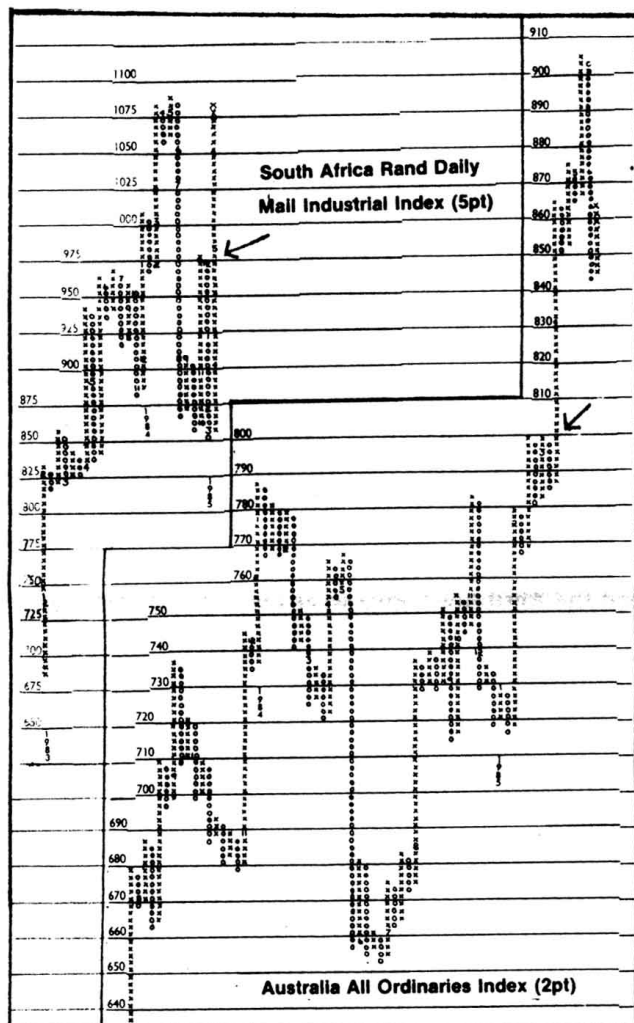
South Africa

The South African Industrial Index moved in a straight line from its March low back to the peak, to the surprise of the "unacceptable political risk" advocates, no doubt. That former peak is an obvious psychological resistance point that is unlikely to be cleared at the first attempt. The risk would increase on a move below

initial support at 975.

The yoyo SA Gold Index has one of those broadening patterns that worry technicians and make forecasts hazardous. Currently in retreat, the Index needs to break back above 1050 to improve the short term outlook. As FMs know, I favour a policy of buying SA golds when they are weak due to their unique bounce back qualities created by the thinness of supply. When bullion looks weak the shares can be hedged with COMEX futures shorts – see Share Portfolio Review.

In conclusion FMs should exercise maximum discipline and caution in stock markets over the next



few weeks until the storm clouds have passed. This extensive review of world indices has shown you where critical deterioration has already occurred and should enable you to spot danger signals in other markets before the crowd. Forewarned is forearmed, and the UK Index serves as a reminder of just how fast markets can deteriorate once MDL violation occurs.

Share portfolio review

A shortage of space in this issue prevents me from showing the share table in the usual manner so I will just list key changes and new closing stop levels. Among the Sept. (FM7) recommendations H.K. Electric was stopped out at the new closing level of HK\$7.70 during the banking scandal reaction, for a profit of 25% before dealing costs. This is vexing because the share bounced straight back up; however, the unexpected bonus was that Cheung Kong (FM12) fell into the recommended buying range. The middle purchase price achieved was HK\$15.00 against today's level of \$16.20. In view of the more dangerous environment for shares I will risk nothing beyond the dealing costs by protecting Cheung Kong with a closing stop at \$15.00. Dunlop, now A\$2.30 against A\$1.87, is currently very steady in a weaker Australian market. Raise the closing stop to A\$2.14. For Skis Rossignol, FF1580 against the purchase price of FF1372xc, raise the closing stop (c/s) to FF1400. Deutsche Bank, DM587 against DM356, has raced ahead so jam the c/s up to DM544. Raise the Nederlandsche Middenstandbank (FL193 against FL149) c/s to FL172.

Of the Oct. (FM8) recommendations, British Telecom was stopped out at 180p against a purchase of 90p (after adjusting all levels up 40p in line with the second cash call) for a profit of 100% before dealing costs. We need a new hedge policy for the SA golds just in case bullion breaks the \$310 support level before the dollar's next big decline. Therefore, if the London bullion quote closes below \$310 for two consecutive days, fully hedge the shares by shorting the October COMEX contract. Protect that short with a market stop at \$326, basis October.

Among the Jan (FM10) positions, raise the General Electric (\$61 3/8 against \$63 5/8) c/s to \$57; McDonald's (\$67 3/8 against \$57 7/8) c/s to \$60; but leave Johnson & Johnson and Merrill Lynch unchanged. My biggest disappointment was in seeing Sony stopped out at a breakeven price after costs of Y3900, as the share had raced to Y5000 in March. Raise the Daimler-Benz (DM829 against DM626) c/s to an ultra tight DM805, and the Ciba Geigy (SF3110 against SF2860) c/s to SF2900.

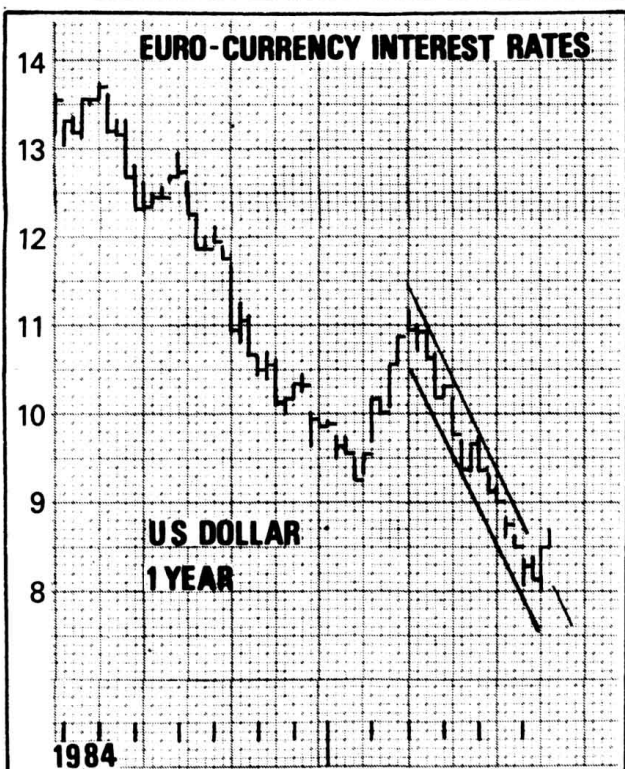
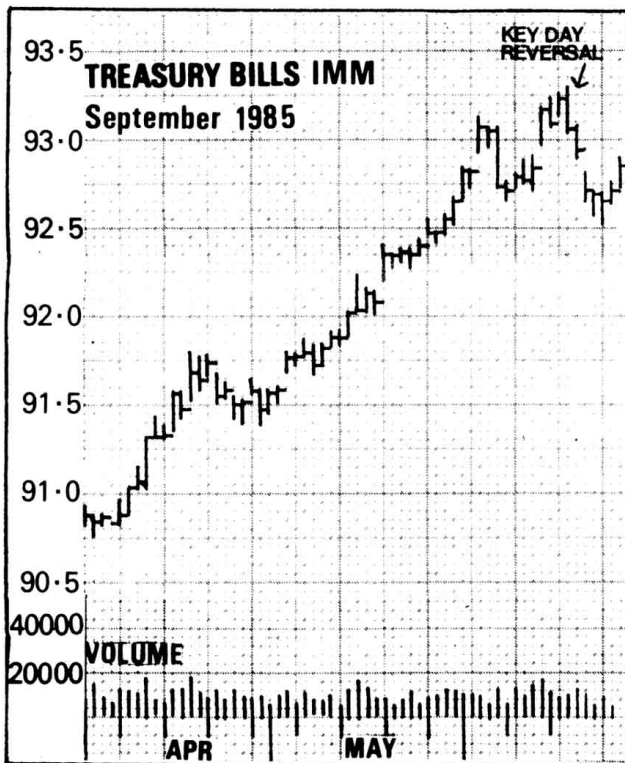
The March (FM11) positions are led by Swiss Reinsurance (SF11,700 against SF9500). Raise the c/s to a tight SF11,250. Safeway's new high (\$34 against \$31 3/4) enables us to raise the c/s to \$31.5, while Gillette (\$59 1/2 against \$58) stays unchanged with a c/s at \$56, but raise the Warner Lambert (\$43 against \$37 3/8) c/s to \$38. The Genting (S\$5.95 against S\$5.75) c/s stays unchanged at S\$5.40 due to the share's volatility.

Among the April (FM12) recommendations, where recently purchased Cheung Kong has already been covered, INCO (\$12 7/8 against \$14) may be a mistake as base metals have fallen, damaging sentiment. Hold INCO for the moment, protected by the c/s at \$11. The other nickel recovery hope, Metals Exploration was stopped out at A50¢ against A60.5¢, for a loss of 17% before commissions.

US interest rate futures boil over

My bullish forecasts for US interest rate futures, Bonds,

Bills, Eurodollars, etc., in FM12 & 13 were rapidly fulfilled in June as markets accelerated upwards. This type one top characteristic is unsustainable beyond the short term and ended in a running key day reversal – an early warning signal featured at The Chart Seminar. The running key occurred on Wednesday June 19th, as I was returning from the Paris venue, but was immediately spotted by Chart's research department, enabling me to provide an up to the minute test case teaching example on Thursday morning at the sell-out London conference. Several delegates who backed this



high probability signal by shorting Eurodollar futures (not shown) that afternoon had paid for the course the following day as prices wilted in the biggest shake-out since February.

That steep decline quickly created an oversold condition but I doubt that rallies over the short term will be able to clear the June peaks which should hold for the next few weeks, at least. Interest rate futures could easily experience another sell-off before the long-term bull trend is resumed. This forecast is supported by the chart of US dollar one year Eurocurrency interest rates which has broken the orderly downward trend, confirming that the decline to 8% has fulfilled short term potential.

Dollar still ranging

FM13 stated that "the dollar is now in the top extension phase that frequently follows accelerating peaks. It will probably range sideways for weeks, possibly months, with most trading occurring in the DM3.25 to DM2.95 region, representing the May high and the April low". Five weeks later the dollar is still ranging sideways in an increasingly narrow pattern with most trading occurring in the DM3.08 to DM3.04 region against the German mark. Activity against other reserve currencies is similarly quiet.

The one bit of drama was a false break below DM3.00 that was reversed the following day. Similarly, sterling had a false break above \$1.30. Those moves could open the door for a challenge of minor resistance at DM3.12 and support at \$1.25 to the pound. A breach of those boundaries would excite the army of currency traders but anyone backing such a move should protect positions with very tight trailing stops because middle of the range break points, what I call levels within levels, are very unreliable.

I will not be buying dollars for a rally but I would probably sell short following a rally, or a false break on the upside, because I believe that the US currency's next significant move will be downwards. The downside crunch points for dollar bulls are DM2.95 and DM2.90.

Stop press

My whistle stop tour of seven cities with The Chart Seminar was a fascinating, amusing, exhausting and exhilarating experience, enabling me to see old friends and make many new ones. I'll share some of the more interesting observations with you next month in FM15. The office has received a number of requests for me to do another two day chart seminar in the autumn in London. At the moment that seems like running the same race just after crossing the finish line, but I haven't ruled it out.

The famous Chart broly will be sent to the first FM who correctly identifies the young woman kneeling behind me in the photograph.

FLASH – CAWI has rallied but not above the previous peak, reducing the immediate danger. A downward reversal to a lower low from here would be a confirmed sell signal – very bearish. Conversely, a new high would constitute a renewed buy signal for global equities. Wall Street's present strength favours the bullish development, marginally, but I prefer not to be too clever by trying to anticipate the next CAWI signal.

Best regards
David Fuller