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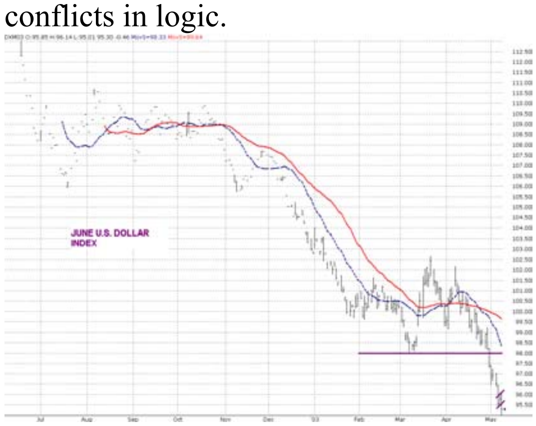
SPECIAL REPORT
FROM THE DESK OF PHILIP GOTTHELF

FED Warns of Deflation

With FED Funds at 1½%, one might conclude the U.S. economy is exposed to inflation. After all, cheap money has always been associated with increasing price levels. Equally important, the U.S. Dollar has sunk to new lows against the Euro Currency to suggest that foreign goods and services are going to cost more in parity differentials. Thus, we have a two-pronged inflation stimulus in the face of concerns over deflation. It is a curious situation with multiple conflicts in logic.



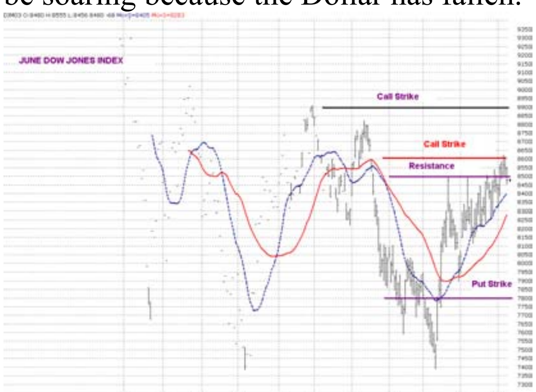
As the Dollar Index spirals below 9500, there is a sense the world is losing confidence in the Greenback at the very moment President Bush appears to be basking in renewed U.S. glory. Understand that the FED has hinted it may cut rates another ¼% next month. The Dollar may not be at its 2003 lows for some time.

With prospective dips in rates, U.S. paper has gained principle value. However, there is no substitution of bonds and notes for stocks… yet. The S&P 500 has managed to maintain an impressive upward channel and analysts have notices that a large majority of S&P 500 issues are above their individual 50-day moving averages. Correlations to past "over 50" environments point to a strengthening uptrend. This has prompted enthusiasm for the broader index despite continuing struggles to maintain profitability by the companies.

With this technical buy signal, we see a narrowing upward channel that foretells a possible stall. At this time, June S&P 500 futures are testing 94000 resistance that appears clearly on the chart. If further price movement is checked by 94000 this week, we could see a consolidation range similar to the November – January period… between 87000 and 94000.

Undoubtedly, the current channel is the most encouraging formation we have seen in more than a year. Yet, if you are a proponent of the "January Effect," your overall forecast is for a decline below last year. The deflation argument adds to the theory that stocks will not make appreciable progress since stocks typically deflate with the economy. Remember 1929?

On the argument's flip side, a weak U.S. Dollar is supposed to translate into more favorable exports. In turn, manufacturers who export should see a boost in sales. Unfortunately, the U.S. does not rely upon exports to support the majority of economic momentum. Assuming the world can afford to buy U.S. food, farmers could see a benefit, but I doubt sales of GM cars abroad will be soaring because the Dollar has fallen.



What do you do under current circumstances? Having compared the indices, June DOW Jones futures appeared to have the highest probability of expiring below its November '02 high just above 8900 while easily maintaining above February/March lows. With premiums fat, we sold the 8900 calls and 7800 puts at 340 points ($3,400.00) for a strangle. When 8500 seemed to offer continuing resistance, I added short 8600 calls and 7600 puts for another 330 points ($3,300.00).

The red line delineates where the second strangle takes on upside exposure above the 8600 strike. However, futures must reach above 8930 before completely wiping out the second strangle premiums. Today, some reality about corporate earnings set in. Traders were interested in taking hard earned profits off the table coming into this weekend.

Gold Raises More Questions

To further illuminate market psychology, consider how gold reacted to FED plans for lower interest rates. Yesterday, gold simply traded within a widened inter-day range. After failing to match Tuesday's high, the Wednesday closing engendered reversal fears. The flag formation was threatened with the dip below 34000.

But, today's reaction to higher oil, lower stocks, and falling interest rates saved the pattern with a breakout above the flag to project as high as 36000... a prior head & shoulders fulcrum.

Why should gold inflate if the FED is combating deflation? For those who have read *The New Precious Metals Market* (McGraw Hill), gold attained its greatest purchasing power parity just before Roosevelt intervened after the Crash of '29 and subsequent deflationary depression. Are we seeing an example of a paper confidence crisis?

There is no panic, but traders are uncertain about which former correlative rule will prove true over the next several months. In the meantime, gold's reluctance to retreat establishes a 5-way arbitrage that some believe is responsible for the current situation. While gold rises in Dollar parity, there is not a 1-to-1 relationship between the Dollar index and gold. The swing in Dollar value as a percentage average value is actually more than gold. Buying gold in Euro Currency does not give the same play as the Dollar. To trade without currency parity risk, the Dollar Index must be hedged.

Deflation au'Natural

Yes, a weak economy is one factor that is responsible for deflation. On the other hand, certain natural parity realignments are having an impact upon consumer prices. Note the energy complex.

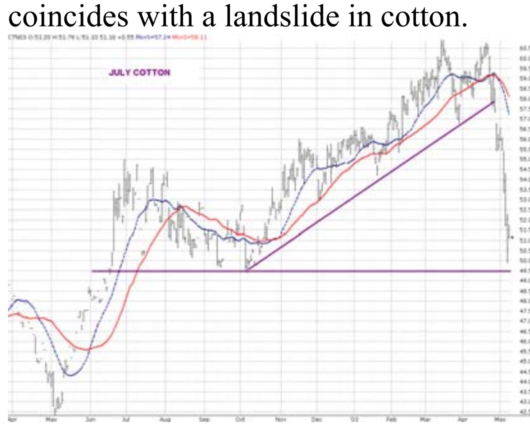
As June crude oil illustrates, prices plunged approximately 29% from a high just under \$35/bbl. To a \$25/bbl. low in less than two months. As mentioned in previous REPORTS, 2825 represents current resistance. Even with today's impressive performance, the high remained shy of the 40-day moving average and is short of resistance.

This cut in energy prices is not a monetarily derived deflation. Rather, it is the result of improved Middle East conditions and prospects for a free flow of Iraqi oil by yearend. The U.S. is pressing hard for lifting U.N. sanctions and dismembering the Food for Oil program. Understandably, the French and Russians would like to keep the program in place since they have been the main beneficiaries. It seems obvious the U.S. position will prevail. My analysis points to crude oil in the teens by the summer. Absent any renewed conflict that threatens Iraq's oil fields, I do not see a way OPEC can maintain quotas and, thus, price levels.

Is Iraq an OPEC member? I reviewed this question last week. The oil industry is shaping up to be far more competitive. The looming danger is a potential price war whereby Saudi Arabia will seek to bankrupt marginal producers by dropping values below production costs. It is a technique that worked extremely well for Japan's electronic and consumer goods industries. Try to find a microwave that is built in the USA.

Statements from Mexico's Oil Minister that the relationship with OPEC is weakening along with incentives to join quotas is a sign of the times. While today's reaction to inventories spooked traders, it is more likely to be a selling opportunity than a signal to get out.

Energy prices are not the only ones tumbling. Consider that a decline in crude also reduces chemical feedstocks for plastics, fibers, fertilizer, tar, and other chemicals. The dip in nylon coincides with a landslide in cotton.



In less than two weeks, July cotton has retraced from double top above 6050 to near 4950 support. This 18% plunge may not be over. Just when cotton farmers thought it was safe to go back into fields, WHAM!

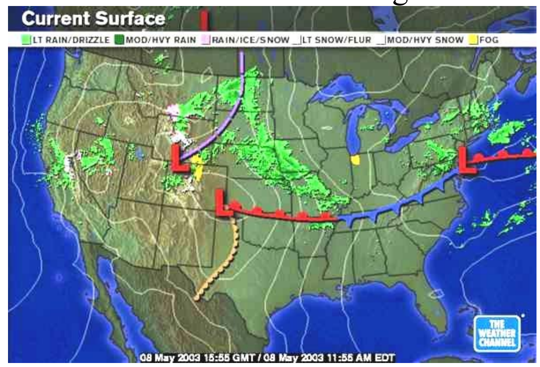
Unfortunately, I was incorrect in my assumption July cotton would climb over December. Poor retail sales for the first quarter represented summer season merchandise. I believed demand for summer supplies would pick up as manufacturers ordered for fall and winter lines. Oops.

Apparently, China has enough fiber to last through the October delivery. Here is another example of deflation unrelated to FED policy. Cheap cotton competes with other natural and man-made fibers. With oil feedstock falling, gray goods (raw material) should move appreciably lower.

Weather

Planting conditions are always a market maker in the spring. This week's storms have left fields too wet to plant in those areas that have not already been tilled and seeded. In some areas, soil has been washed out. The last of the winter wheat remains in fields too wet to harvest.

I would not call these circumstances emergent. We do not face a late planting. However, prospects for unusual summer weather heat up when spring conditions seem unusual. The unseasonably cool conditions through the Northeast Corridor coupled with a series of potent lows in the Midwest suggest drought scares could threaten crops. This week holds more wet weather as two lows converge in the Midwest and South Central regions.



Wheat and corn have picked up on weather concerns, however, higher animal prices have been an incentive to build inventories through the summer. This means domestic feed demand is likely to remain steady to higher.

Corn finally broke out above the 40-day average to present a constructive picture for bullish technicians. The bottoms (all of two) are ascending and it appears July corn will challenge 2.46 resistance.

Notice the length of this resistance line. A pop above this level could be self-fulfilling since so many traders are waiting for this event before jumping in.

If soybeans are an indication, grains have turned the corner (for now). Normally, I don't like to see trends begin in the spring because there is too much room for summer corrections and, hence, volatility. Then, again, the trend is your friend! ☺