

Graham Dyer's Newsletter

6 Cambuca Crt. Tewantin 4565 – Phone 07 54556289 or 0414 895638
Email: shirleyss@westnet.com.au Website: www.depression2007.com
Subscription enquiries to shirleyss@westnet.com.au
(Email Graham direct at gdyer@depression2007.com)

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PRIMARY WAVE 3 DOWN BEGINS



This newsletter is not intended to constitute investment advice in the legal sense. It is my opinion. It is independent economic and financial market analysis that may assist you in managing your own portfolio. My work is educational in its objective, intended to help you understand the many influences that impact the economy and financial markets, both economic and geopolitical, and, more importantly, sociomic. My aim is to alert you to investment opportunities **and** pitfalls. If you feel you need professional assistance with your portfolio, you should consult a licensed adviser. A license is no guarantee against loss. I choose not to be licensed so my view can be completely independent and objective, with no commission related interest, and not beholden to mainstream industry advice in which I have no confidence. I will let my track record speak for itself. I write generally and cannot determine whether an investment is suitable to your individual needs or circumstances.

The third wave down in the bear market that began two and a half years ago is starting out the same way as the first wave did in October 2007.

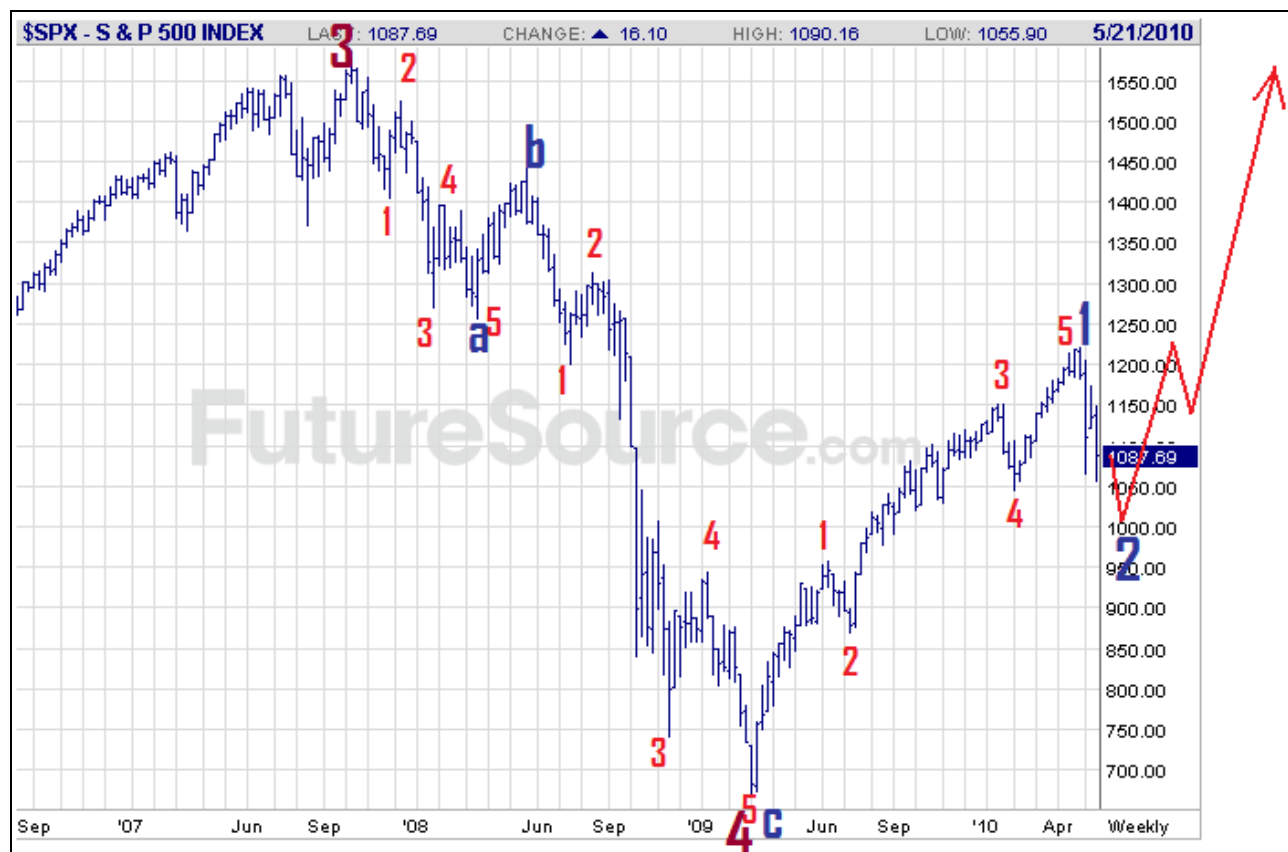
If we are correct in labelling the decline to March 2009 as Primary wave 1 (blue), and the rally to last month as Primary wave 2, then the next phase of the bear market that has just begun should be a monster, as third waves are usually the longest and strongest. At a minimum, the Dow Jones index will fall to a new low below that of March 2009, which was 6,469 points, in this wave. But it should fall a long way further than that. And still we will have waves 4 and 5 to go.

What we don't know, of course, is how long this will take. Wave 1 lasted 17 months, and the wave 2 rally went on for 13 months. One would assume that Primary wave 3 will last for longer than wave 1, but it does not have to.

Could our wave count be wrong?

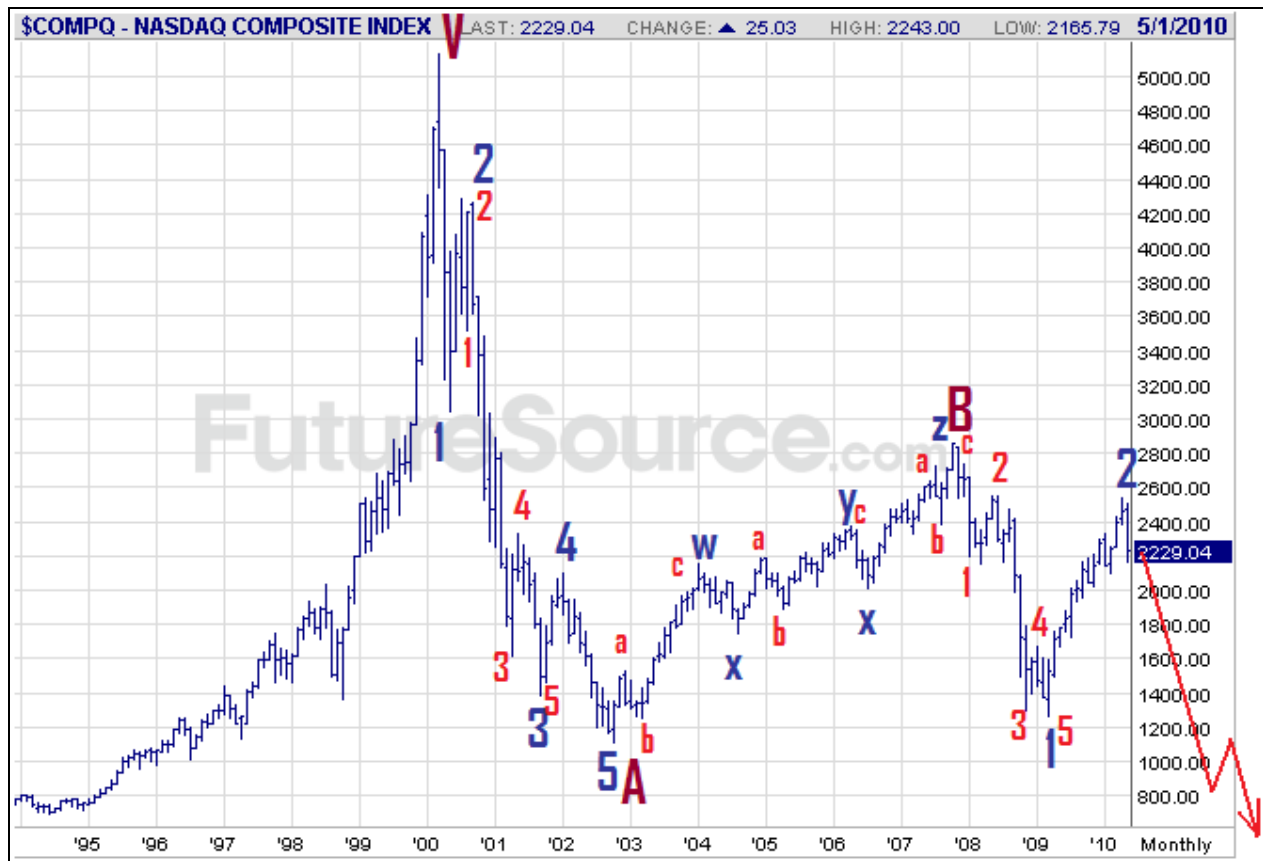
There are many rules and guidelines that we follow in Elliott Wave analysis. I am of the view that pattern recognition is largely a visual thing. When you stare at a screen for 12 hours a day for a decade or two or more, certain patterns jump out at you from the moment you switch on your computer each day. Wave counting is always a matter of judgment, based on not only visual pattern recognition, but also the knowledge and experience of the technician. And there is always more than one way to count a wave pattern. Very often many factors have to be weighed up, and one technician may see the balance of probabilities differently from another.

For example, it is not impossible to interpret the wave structure from October 2007 entirely differently from the way I have been counting it. It is possible to count the decline from October 2007 to March 2009 as an a-b-c, which would be corrective. That would mean that the next move up in the S&P 500 would be a five wave advance to an all time new high. All we have seen so far is the first leg of that larger five wave move. How do we know this is not correct?



We don't. We have to weigh up all the factors we know of that could influence our interpretation.

For one thing, we need to know as much about context as possible. So we look at the bigger picture. Sometimes it is helpful to look at a different but similar index for more clues. In this case I will use the NASDAQ. Its pattern since the major peak in the first quarter of 2000 is different from the Dow and the S&P, though they have moved in sync for more than a decade.



The incredible collapse in the tech index from March 2000 to October 2002 is clearly five waves and clearly impulsive. And in taking a mind boggling 80% off the index, there can be little doubt about the trend until a major reversal occurs. It looks very similar to Japan's Nikkei index a decade earlier. And that market has never recovered.

In October 2002 the NASDAQ bottomed and began a rally. But in contrast to the clear, sharp waves down in the decline that preceded it, the rally that was to last five years, until October 2007, was a slow, grudging, overlapping affair, with few clear impulse moves. Clearly this was not the beginning of a new bull market that was going to take the dotcom index to a new high. It falls nicely into the category of a "B" wave that unfolded as a triple zigzag. I have labelled it as being of Cycle degree (plum). If this count is correct, the next move (after wave B) should be wave C down, which would unfold as a five wave impulse, and take the NASDAQ to a new low, probably back to the level it hovered around in the early 1990s.

Then came the 2007 - 2009 smash, right on cue. It is clearly a five wave impulse, and counts perfectly as Primary wave 1 (blue), the first leg of Cycle wave C (plum) down.

Though the rally from March 2009 retraced a significant portion of the decline that preceded it, it counts perfectly as Primary wave 2 (blue). The sharp decline in the last month or so has come

as no surprise. It is almost certainly the beginning of what should be a huge Primary wave 3 (blue) that will take the NASDAQ down to its lowest level in more than decade.

It is not impossible to count the NASDAQ another way, even to show the pattern as bullish since October 2002, with the hi-tech index on the way (very slowly) to new all time highs. But wave counting is about the **balance of probabilities**. And that alternative is about as probable as the oil spill in the Gulf of Mexico doing no damage to the ecology of southern USA.

The balance of probabilities for the NASDAQ is very clear. It will be less than 1,000 points long before it is ever above 5,000 points again.

Given that the three major Wall Street indexes (the Dow Jones, the S&P 500, and the NASDAQ) are in lock step most of the time, the chances that my preferred count for the Dow and the S&P are wrong are very low.

Was it an Expanded Flat?

Here's another point for conjecture. For years we (that's Elliott Wave International and myself) have viewed January 2000 as the end of the bull market for the Dow that began in 1974 or 1932, depending on how far back or to which degree you want to go. All of the action since then has been what we call an expanded flat correction, where wave B of the correction travels way beyond the peak of the preceding impulse. In this case the October 2007 high was some 2,500 points higher than the January 2000 peak. Yet we still call that new high part of a correction. The expanded flat pattern is very common in Elliott Wave analysis.

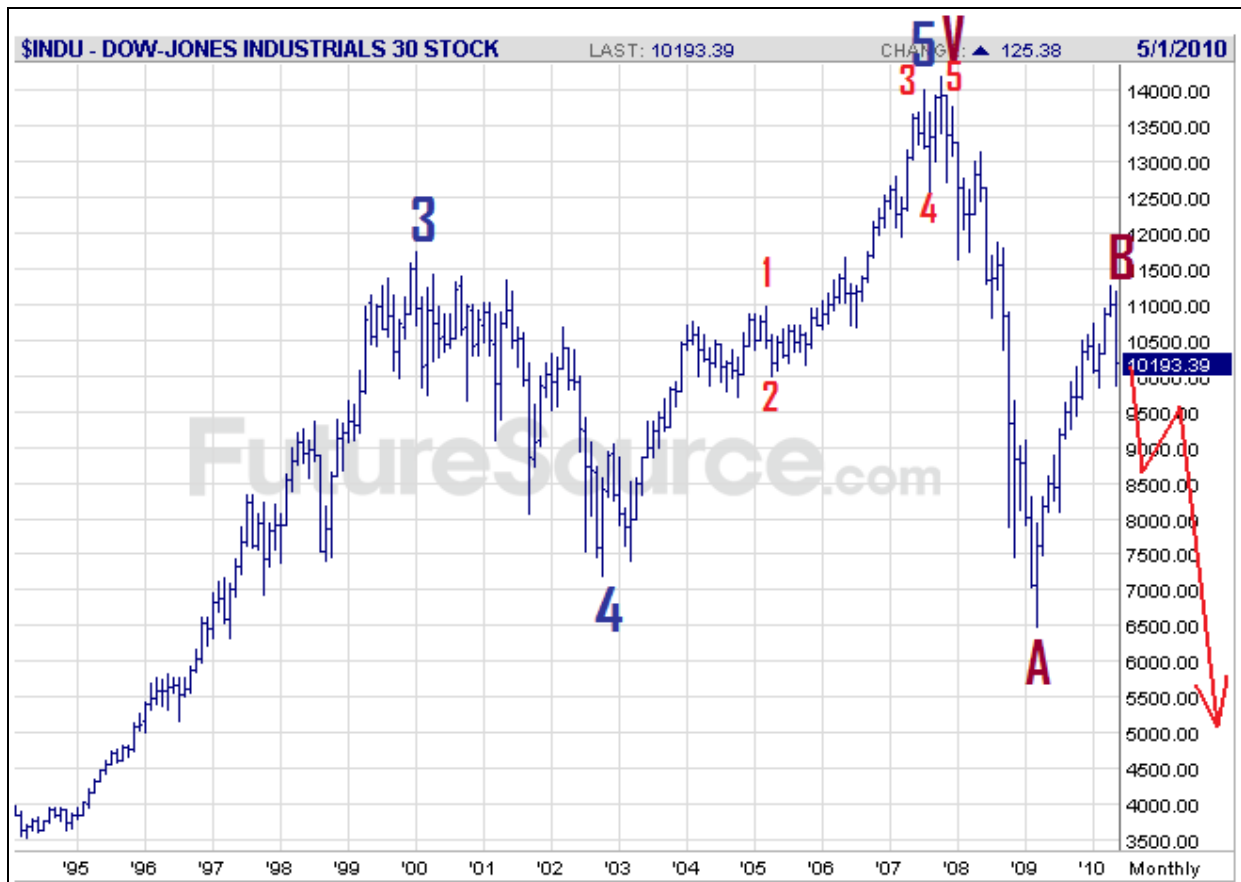


But how do we know that October 2007 was not the end of the bull market (see next chart)?

We don't.

Based on analysis of the subdivisions in the wave count going right back to 1974 and 1932, **on the balance of probabilities** this is the best interpretation. But there is always an alternate count. And in this case labelling the October 2007 high as the end of the bull market is certainly a valid alternative, and is the same way we label the Australian share market. This would make the turning point last month the start of Cycle wave C (plum).

Note that this interpretation makes little difference to the outlook for the near future. In both cases the next move on Wall Street is hard down, to a level below that reached in March 2009, which was 6,469 on the Dow.



The European Influence

Although there are variations on both a short term and a long term basis, US and European stock markets largely move in sync, and most of the rest of the world tends to follow their lead.

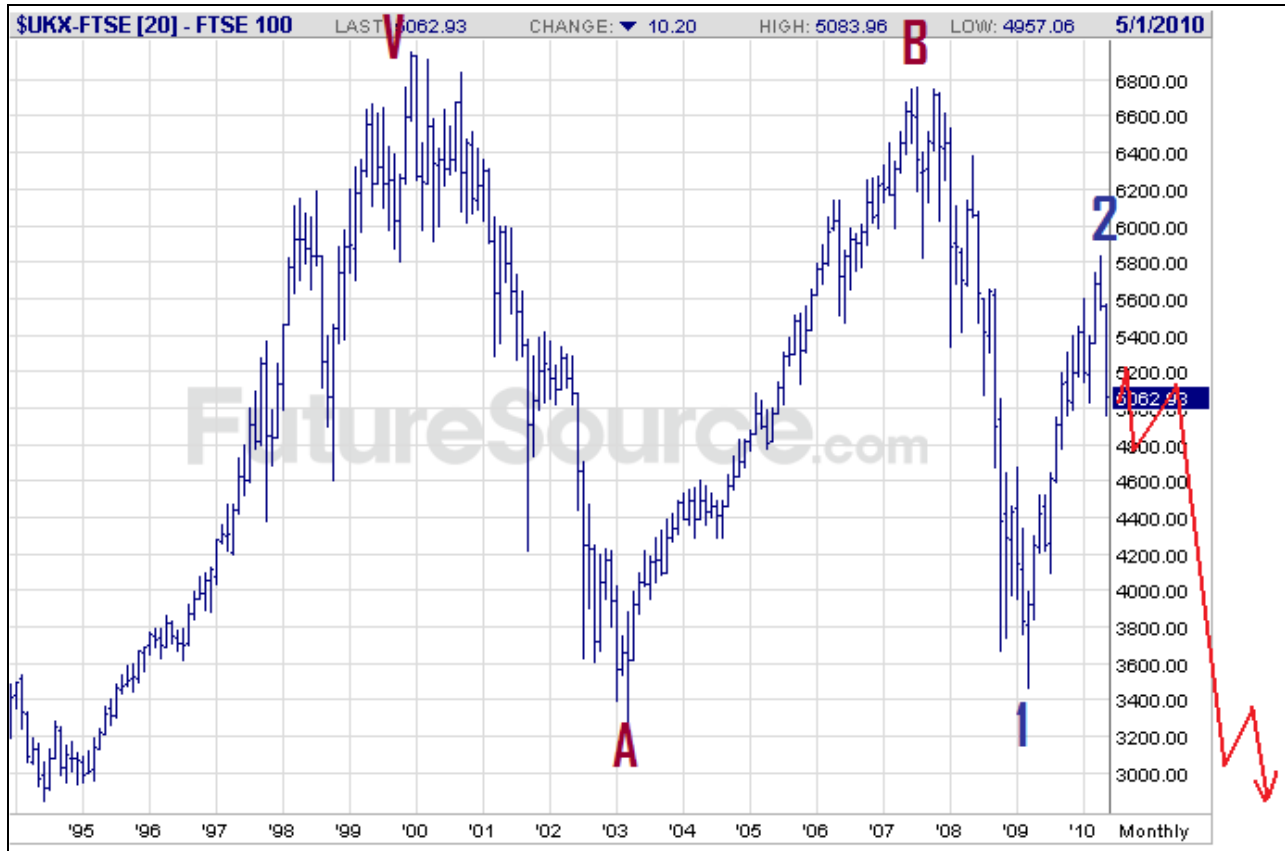
In fact, at all of the major turning points in the last decade or more, European markets have actually led Wall Street, sometimes by only a few days, sometimes weeks. For example, I mentioned that the Dow peaked in January 2000. London's "Footsie" index actually peaked the month before, in December 1999, as you can see on the next chart.

What is interesting from the UK chart is the fact that the October 2007 high did not better the December 1999 high. So, unless the 2007 peak was a very rare truncation, the end of the bull market in Europe was clearly December 1999, which adds weight to the interpretation that Wall Street's bull market peaked in the weeks and months following that.

The corrective pattern underway in the FTSE 100 is what we call a regular flat. In this case wave B retraces a very large proportion of wave A, but does not exceed it, and then wave C

takes the market to a level well below the bottom of wave A. In this case Cycle wave **B** (plum) peaked in June 2007 (note – four months before Wall Street), and the huge decline to March 2009 (the “global financial crisis”) was the first wave of Primary degree (blue). The rally to April 2010 was Primary wave **2**, and a huge third wave down has just begun.

Note how this marries with the interpretation we are using for the Wall Street indices.

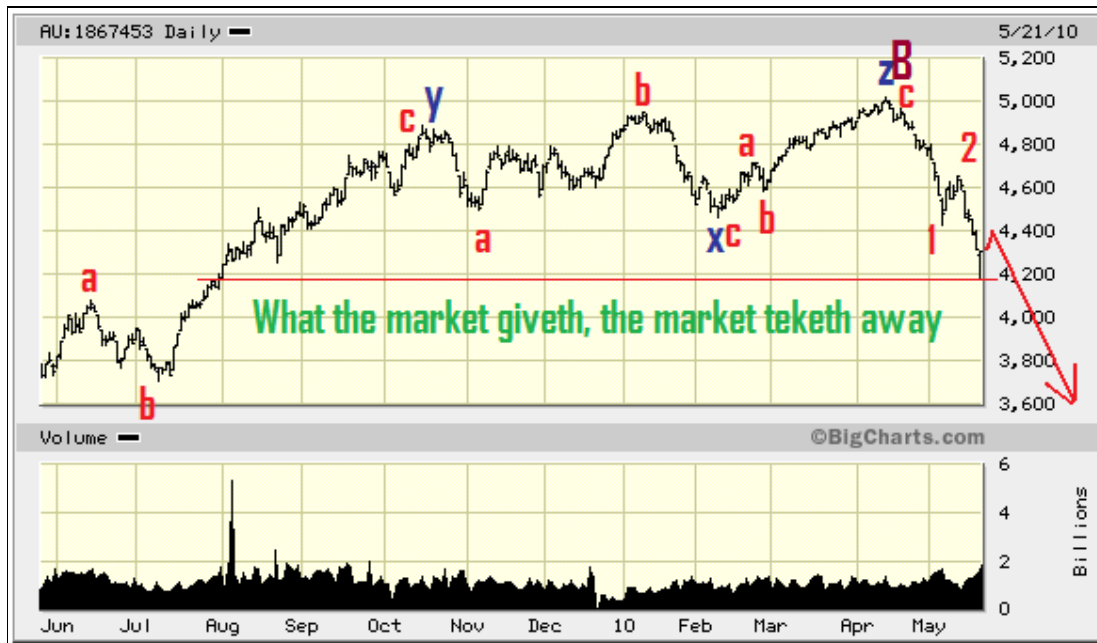


The Australian Share Market



There is little doubt that the bull market in Australia ended on 1 November 2007. The wave count for the ASX 200 has been complex since November 2008, but Cycle wave **B** (plum) appears to have traced out a triple zigzag expanded flat pattern.

The index appeared to peak in October 2009, but found legs to mount a new challenge following a significant fall. It did the same thing in January 2010, but again recovered from an even larger fall to go on and post yet another new rally high. This was frustrating for bears, but did nothing for bulls, as all the gains of the last 10 months have now been given back.



The Australian share market actually turned before any other major market this time (with the exception of Spain). The fall in the ASX 200 from April 15 to May 21 has been 850 points or 17%. The ASX 200 is now at its lowest level since July 2009. Further heavy falls lie ahead.

New Zealand



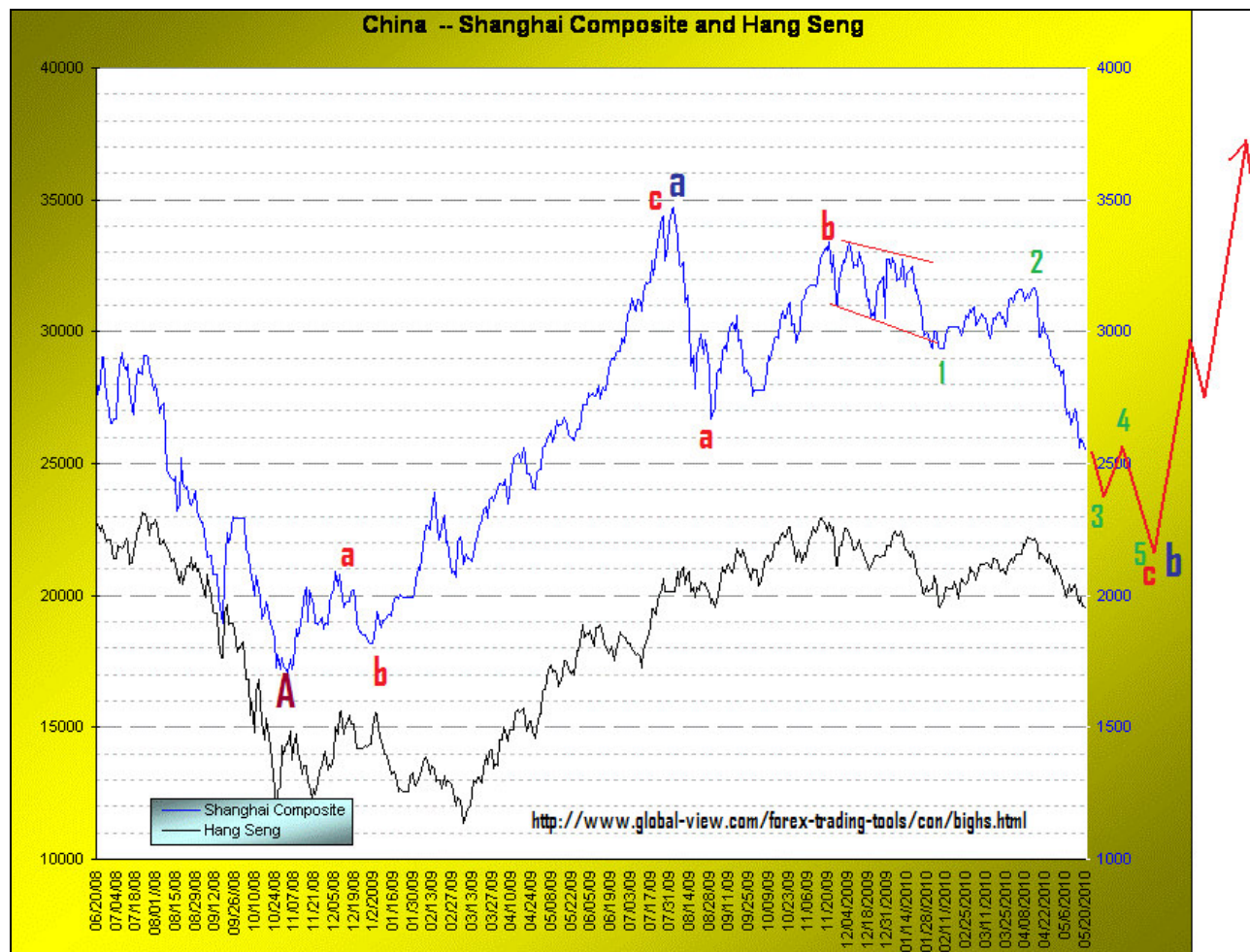
As usual, the Kiwi index has fairly closely tracked the Aussie, although it has not broken through as many barriers yet. Nevertheless, a five wave impulse down appears to have unfolded, so there is a strong likelihood that the trend has changed to down.

China – the elephant in the room

The chart below shows the Hong Kong index against the Shanghai SSE Composite. Notice how the Hang Seng dropped to a new low in March 2009 whereas the SSE did not, bearing out my contention that Hong Kong follows Wall Street more closely than it follows the Chinese market.

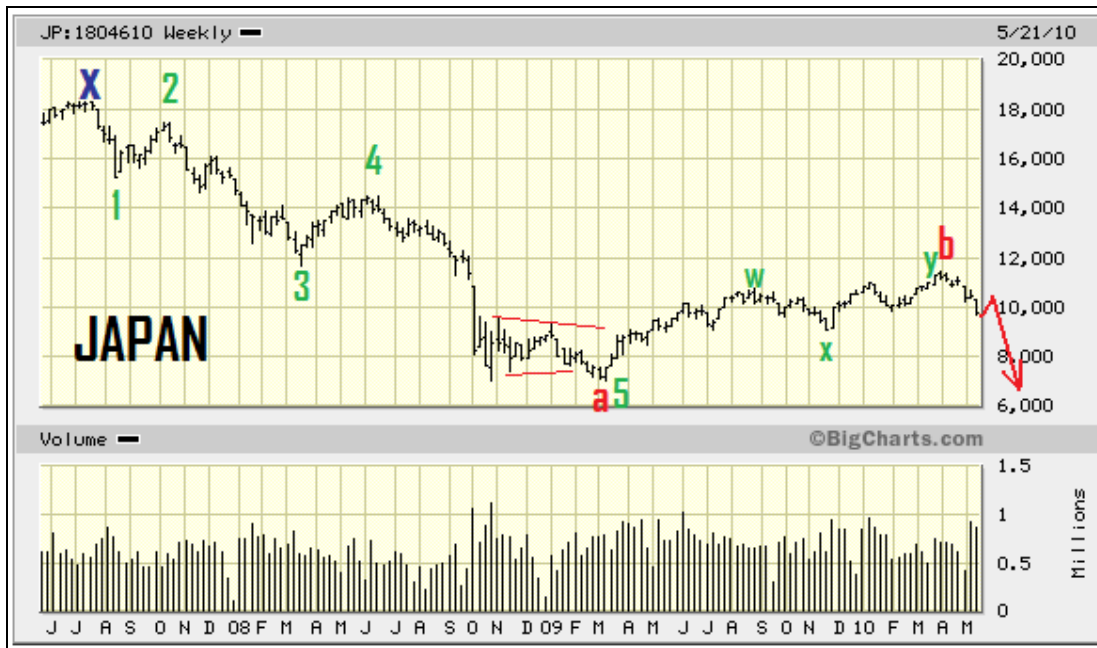
The Shanghai index went into free fall in April, along with the western world, which is unusual. China is an economic disaster waiting to happen (see later). However, I don't think this is the start of "the big one" – yet.

The SSE appears to be in Primary wave **b** (blue) of Cycle wave **B** (plum). The sharp decline in the last month or so is Minor wave **3** (green) of Intermediate wave **c** (red). Once wave **c** is complete, we should see the Shanghai index rocket up to a new rally high in five waves. And **then** "the big one" can begin. This would appear to be many months away.



Japan

Japan has been in depression for so long, it is rarely the frenzied focus of the herd any more. Flavour of the month is Europe. Given the pattern on other major world share markets, the turn down in April would appear to be the beginning of a major decline, which I am labelling Intermediate wave **c** (red).



India

The same could be said for the Mumbai index, which appears to be in the early stages of a major decline, which I have labelled Cycle wave C (plum).



WHAT THE WAVES MEAN

Let us not lose sight of what all these wave patterns mean, and why the share market is such an important barometer.

Notice I have made no mention of economic fundamentals so far. It is not that these are not important. But they are not the "reason" for the current weakness in the share market. The share market is a barometer of crowd mood at the unconscious level. What the share market is

telling us is that the wave of optimism that began more than a year ago is over, and the underlying mood of the herd has now turned to pessimism. That is why they are focussing on things like European debt, a potential Chinese bubble, and slow global growth again. None of these things are new. They never went away. They just weren't a problem while the wave of optimism was in progress. But now it's over, so the frenzied focus of the herd returns to whatever catches their fancy. And the longer the herd remains focussed on these things, the worse they will become, because the collective pessimistic attitude toward all the world's problems (they were not "problems" only months ago) will ensure they become reality.

Neither the media nor the government are the "cause" of these problems. Both are followers, not leaders, contrary to common belief. The media merely **reflects** the mass social mood at any time. It does not shape it, as most people believe. As for the government, that is the ultimate herd. Governments come along long after the horse has bolted and shut the stable door, making it impossible for the horse to get back in even if it returns.

The current frenzied focus of the herd is on Europe, which we foresaw months ago. First it was Greek debt, and the risk of sovereign default. Then came all the other PIIGS. Then came the massive trillion dollar bailout proposal, which sent share markets into the stratosphere for about one day. Then came the questions about where the money would come from. Next came the austerity measures imposed upon debtor countries by the European Union and central bank. Then fears of how this would slow European economic growth and drag the rest of the world back into recession, and protests at the slashing of social benefits guaranteed to Europeans for generations. Now it's the fear that European banks won't be paid the money they lent sovereign governments on bonds, which runs into trillions.

If you would like to watch a clever parody of the European bailout fiasco, check out John Clarke and Bryan Dawe on ABC Television's 7.30 report on May 20.

<http://www.youtube.com/watch?v=5D0VhS8qXT0>

And the herd has a weather eye on the other elephant in the room, which is China. Many experts are of the view that the devastation that will be caused by the bursting of the China bubble will be the worst of all. And the slowdown in Europe brings that likelihood even closer.

China may not be part of the fractional reserve banking system, but their money creation is equally dangerous. A great deal of it is lent to state owned enterprises, which do not have to run at a profit, and spend wildly when money is plentiful, with the Communist government's main focus on creating jobs and avoiding social unrest. Local governments love it, because they collect taxes from all this activity.

When the "global financial crisis" devastated economies in the western world, taking Chinese exporters down, the Chinese government threw an enormous amount of money at the economy in a "stimulus package" that they hoped would head off disaster. Employment was switched from manufacturing for export to construction. But now the Chinese are building many times the number of ships that the world needs, and are pouring money into commercial and residential real estate, creating what many believe is a dangerous bubble. The end result will be a country strewn with white elephants like many neighbouring countries after the "Asian Crisis" in 1997. ABC Television ran an interesting story about this on Foreign Correspondent –

<http://www.abc.net.au/foreign/content/2010/s2903061.htm>

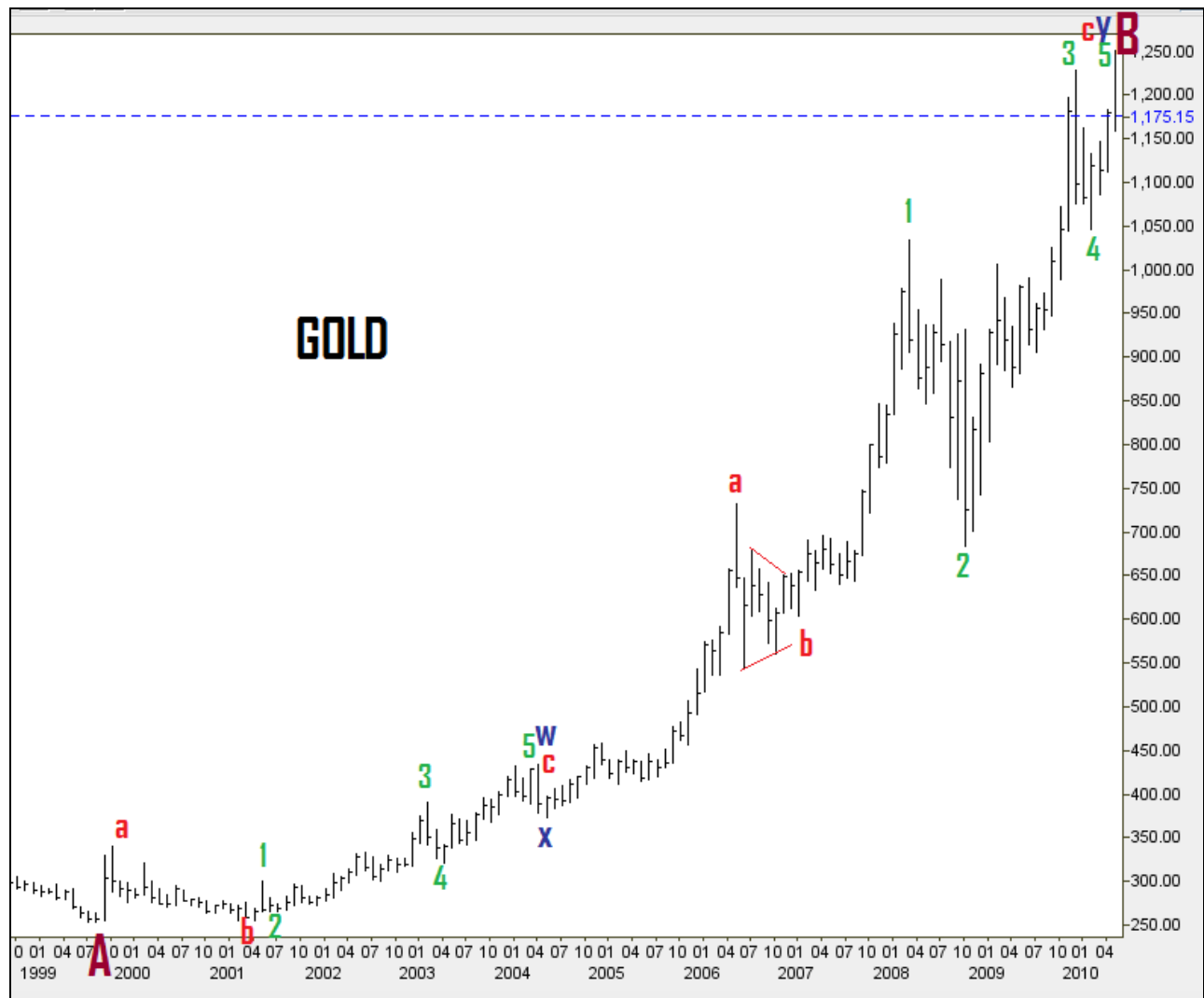
When China no longer has trade surpluses, who will buy US government bonds? So who will prop up America then? It certainly won't be Europe. And it certainly won't be Japan. As the herd

focus becomes more and more pessimistic, all these inevitable economic fundamentals will become realities. While the crowd mood was ebullient, they were all swept under the carpet. But now the mood has changed, the borrow and spend mentality will be reversed, and possibly suddenly, to the other extreme of belt tightening, resulting in economic slowdown and deflation. This will make all the fears expressed by the herd, through the media and other channels, become self fulfilling. Primary wave **3** down is going to be devastating.

And then there's North Korea. And Iran. And ...

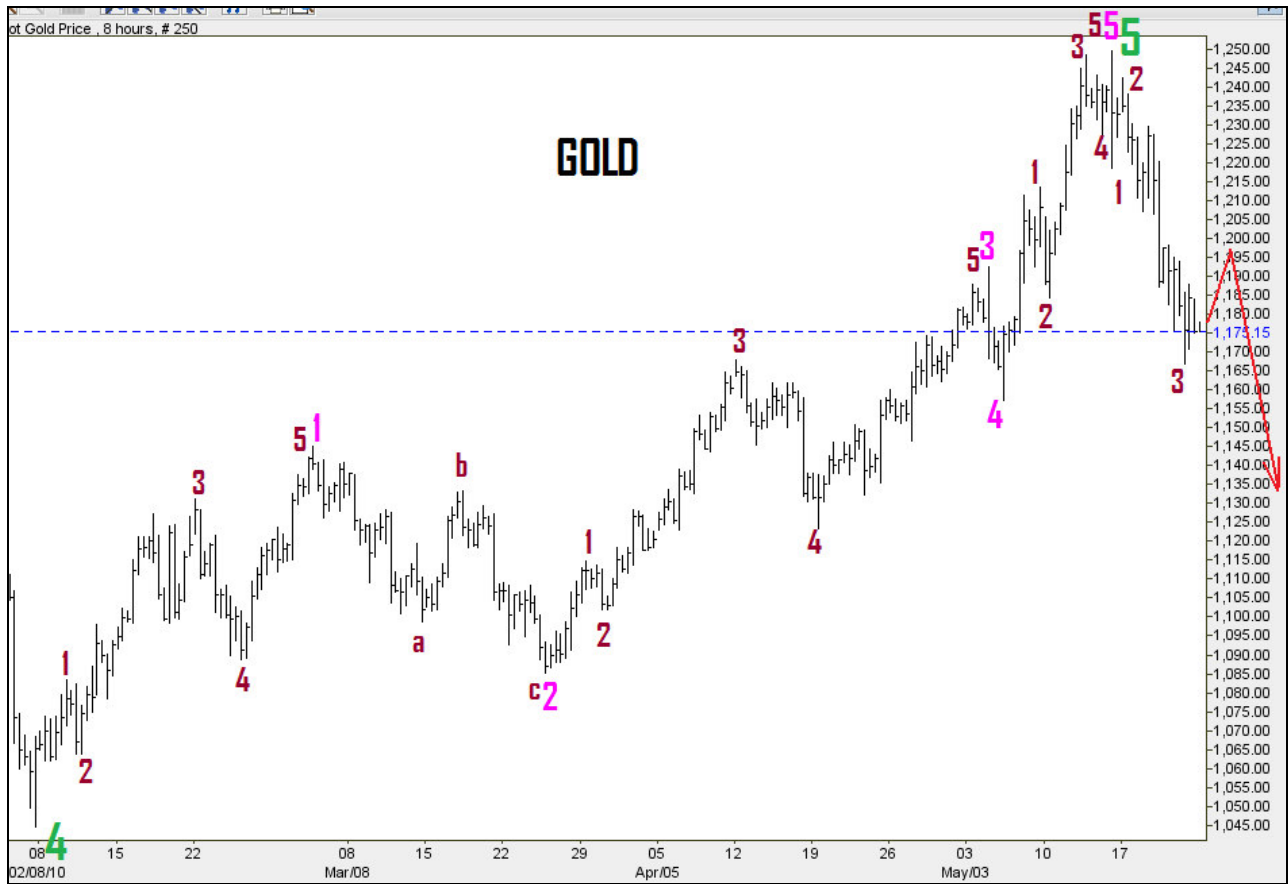
Commodities ...

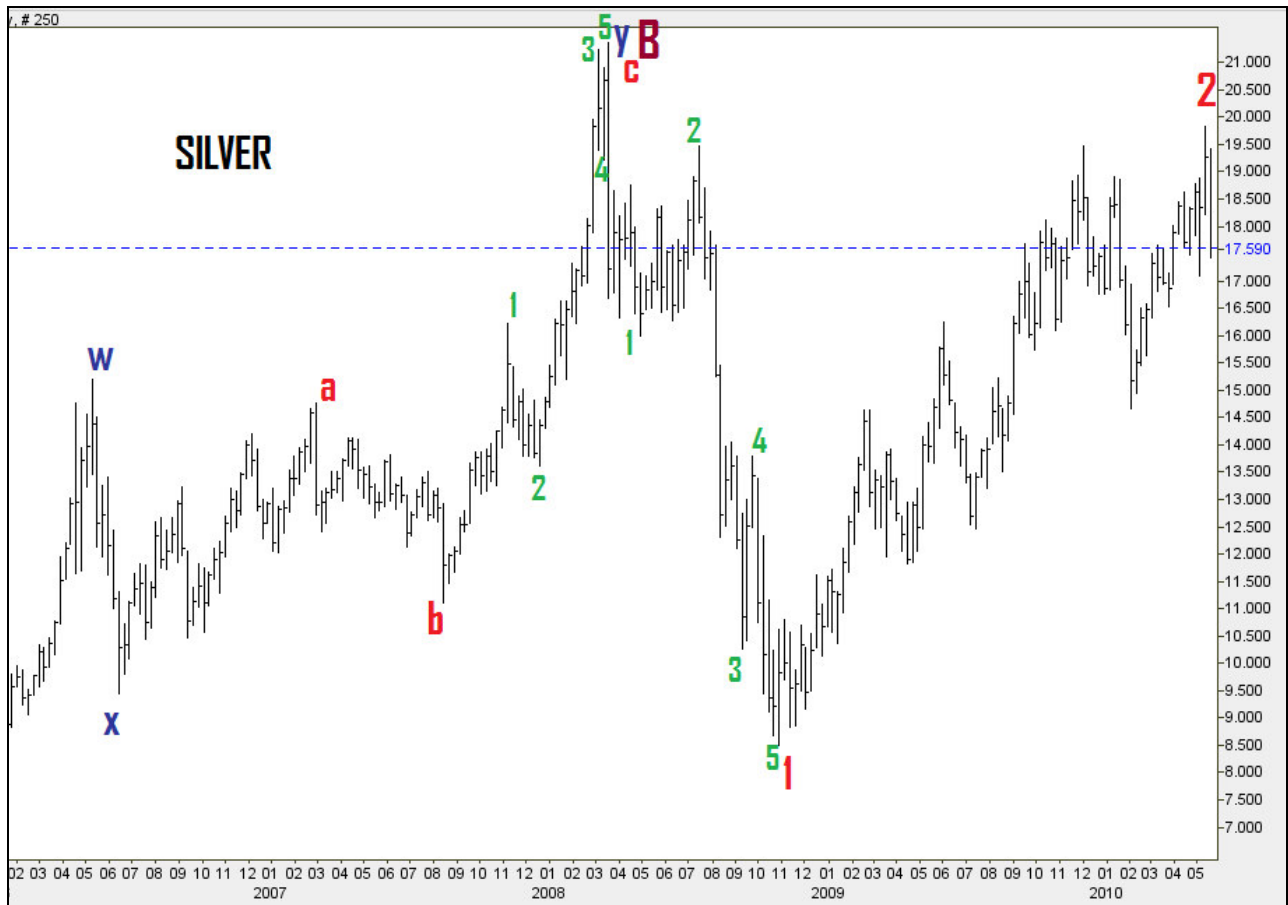
HAVE WE FINALLY SEEN THE PEAK IN GOLD?



The gold price hit a new all time high of \$US1,249 an ounce on May 14 and then promptly fell more than \$80. The new high prompted a recount, which I covered in my daily updates.

We are still looking at the action since January 1980 as an expanded flat correction of at least Cycle degree. The \$255 an ounce low in 1999 was the end of wave **A**. The high on May 14 was likely the end of wave **B**. The first chart (above) shows how we can count it as a double zigzag. The second chart (below) shows how we would count the final fifth wave of Minor degree (green).





It is very early days, but if this count is correct, gold is on the way down to a level that gold bugs could not comprehend at the moment. Ultimately this should be lower than the 1999 low of \$255. This would be in keeping with massive global deflation, which we expect.

The third chart shows the gold price in Australian dollars. You can see the effect of the fall in the Aussie dollar. However, this does not affect the overall wave count.

Silver

If gold has peaked, it is unlikely that silver will see a new rally high. However, it is difficult to count the subdivisions of the wave I have labelled Intermediate wave 2 (red).

Copper

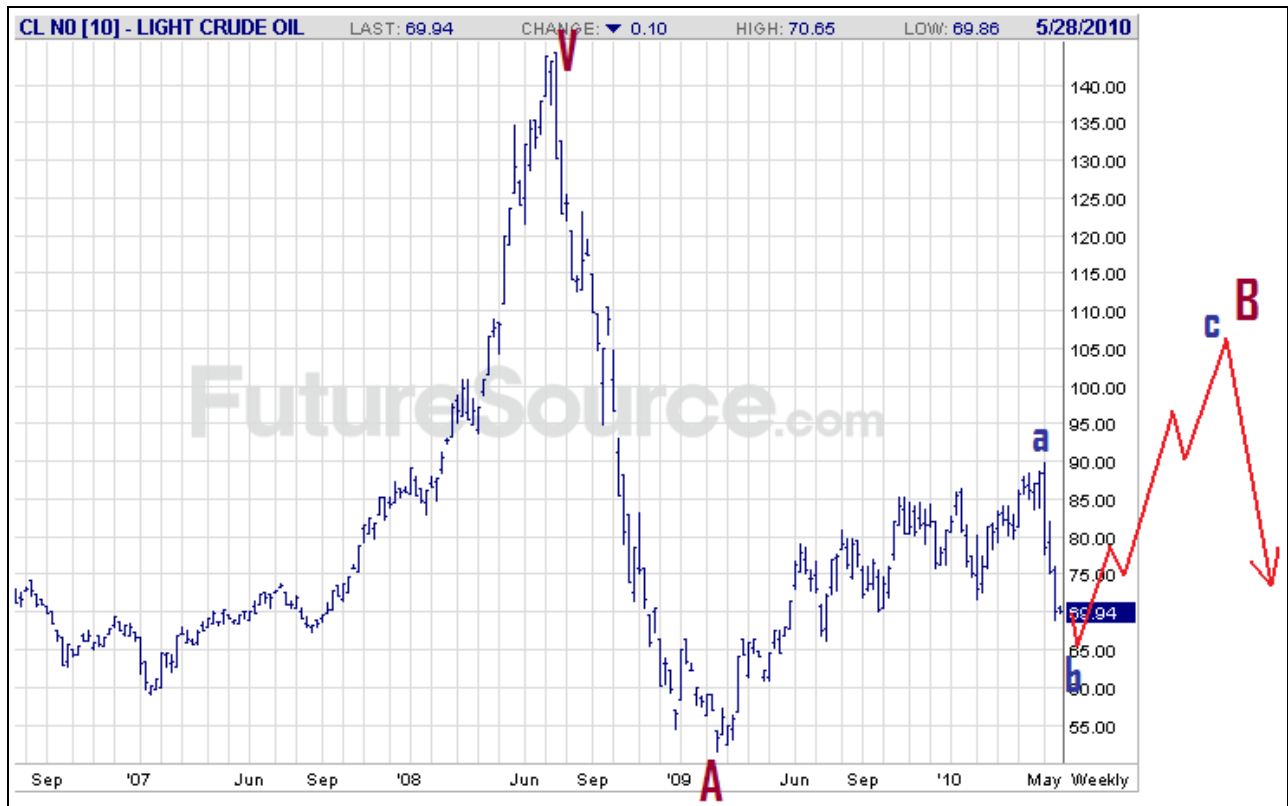
The copper price should have now commenced its massive wave C down. It should finish well below the December 2008 low of around \$US1.30 a pound.

Oil

The oil price remains difficult to predict. The rally from February 2009 to the end of last month has been a choppy, overlapping affair, which is clearly corrective. What is difficult to tell is whether the correction is over or not.

This month the oil price has taken a massive dive, falling 25%. Is this the beginning of a decline in the price of oil that could take it back down to \$10 a barrel? Or is it simply a “b” wave that will give way to further rises, and see the oil price back in triple digits? I confess I am not sure. The outlook for the economy, based on share market falls, makes a decline in the oil price more likely. But price is a function of psychology, not fundamentals, and unfortunately I cannot eliminate the bullish alternative. I will have to sit on my hands for another month.





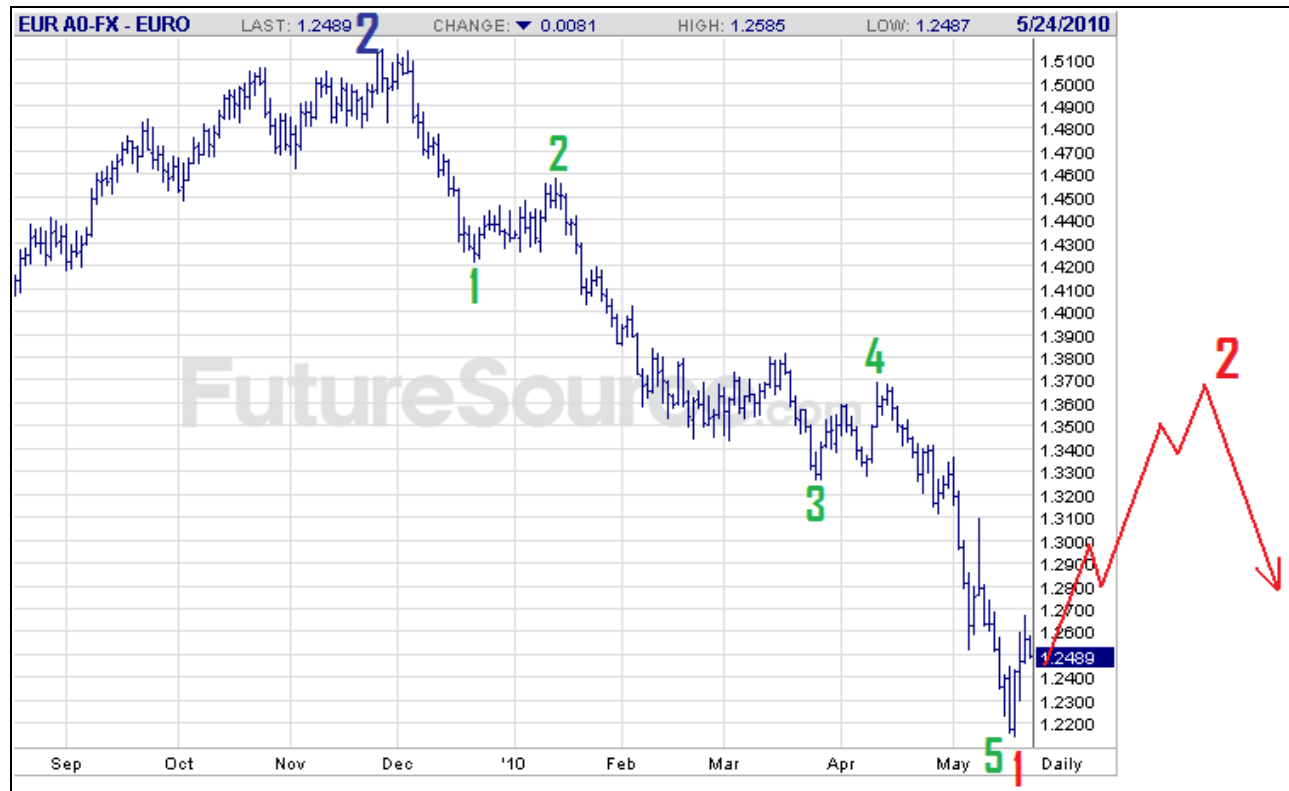
Wheat

As will I with the wheat price. On the balance of probabilities, I think the wheat price will go lower, along with precious metals and other commodities. However, it is not a clear cut wave count, so my call is not with strong conviction. As far as Australian farmers are concerned, the

currency valuation is probably just as important as the wheat price in US dollars. And that is also uncertain at the moment. No doubt clear trends will reassert themselves soon. They always do.

Currencies ...

IS THE RAMPAGING US DOLLAR DUE FOR A BREATHER?



The US dollar has been on a tear against the euro for the last six months, to the point where those who were calling the demise of the “greenback” six months ago are now questioning the survival of the euro.

Six months ago one euro bought more than \$US1.50. Today it buys little more than \$1.20. But a counter trend rally in the euro is now overdue. There is no guarantee it will occur here, but it would be no surprise if the euro now rallied back up as high as \$US1.38.

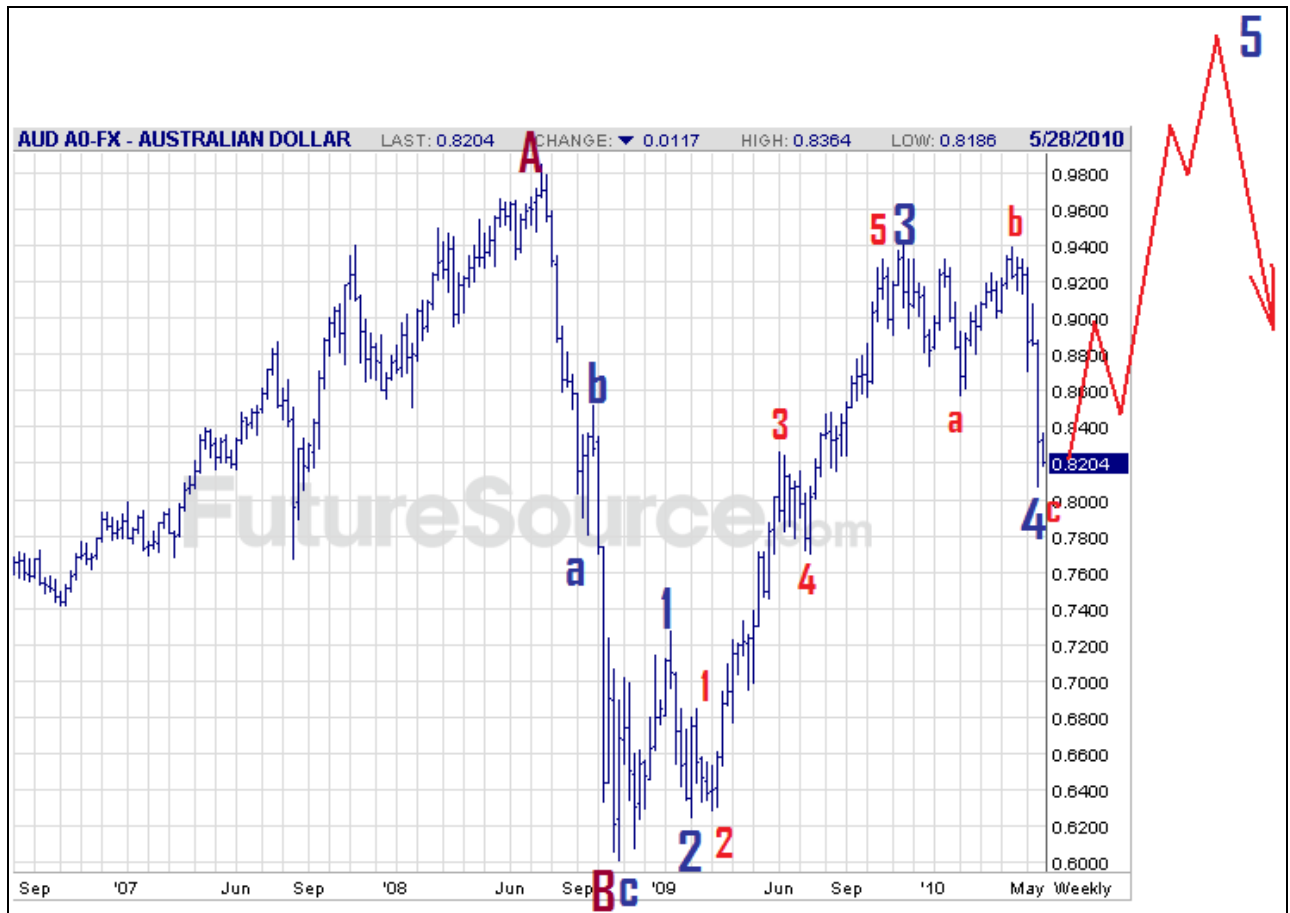
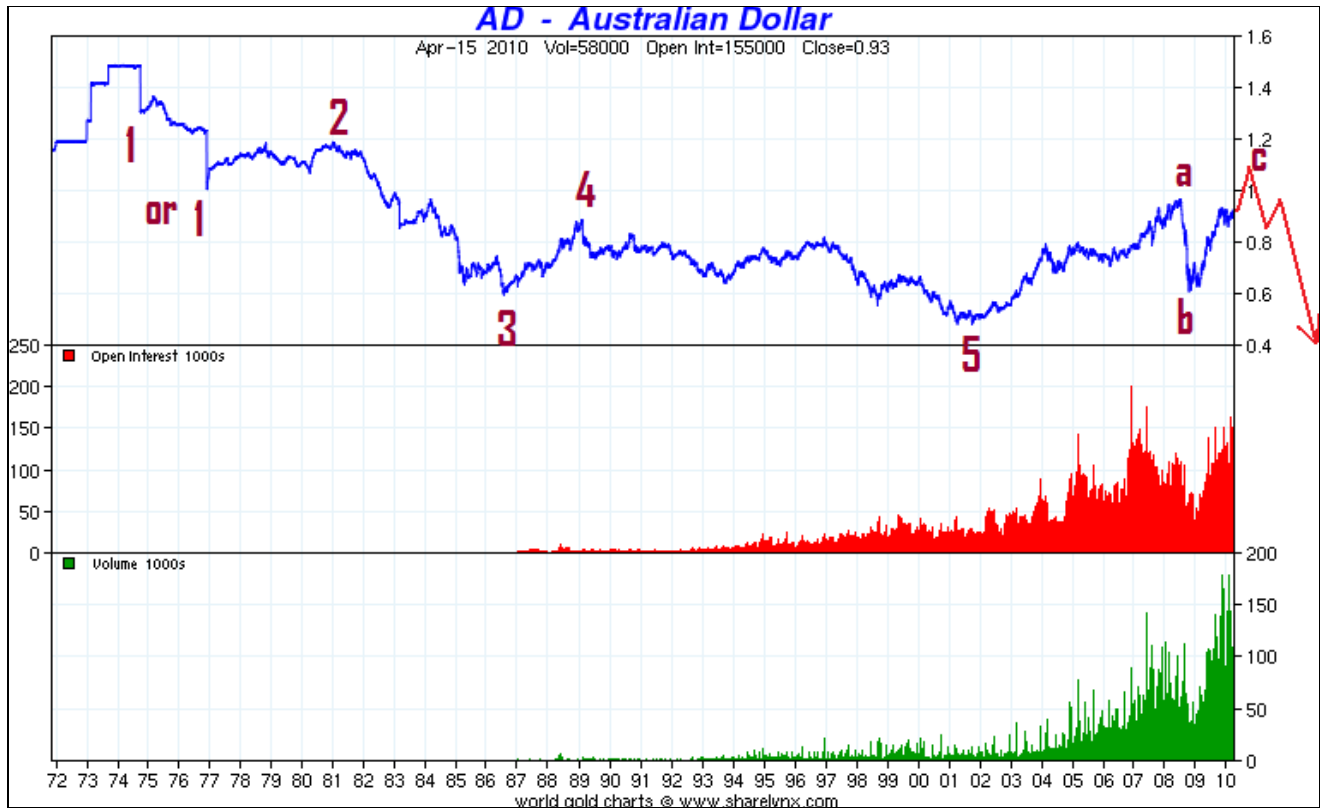
Not that this means the dollar’s rally is over. Far from it. I emphasize that a rally in the euro now would be counter trend. Longer term the euro has a long, long way to fall against the USD.

THE BAFFLING AUSSIE DOLLAR

For months the Aussie dollar has had me baffled. And I am still not sure where it is going.

In my daily updates during the month, I showed you this first chart that goes right back to 1972, when one Australian dollar bought \$US1.50. It can be argued that the entire fall in the AUD over three decades, to the low (less than US48¢) in early 2001, was a five wave decline, and

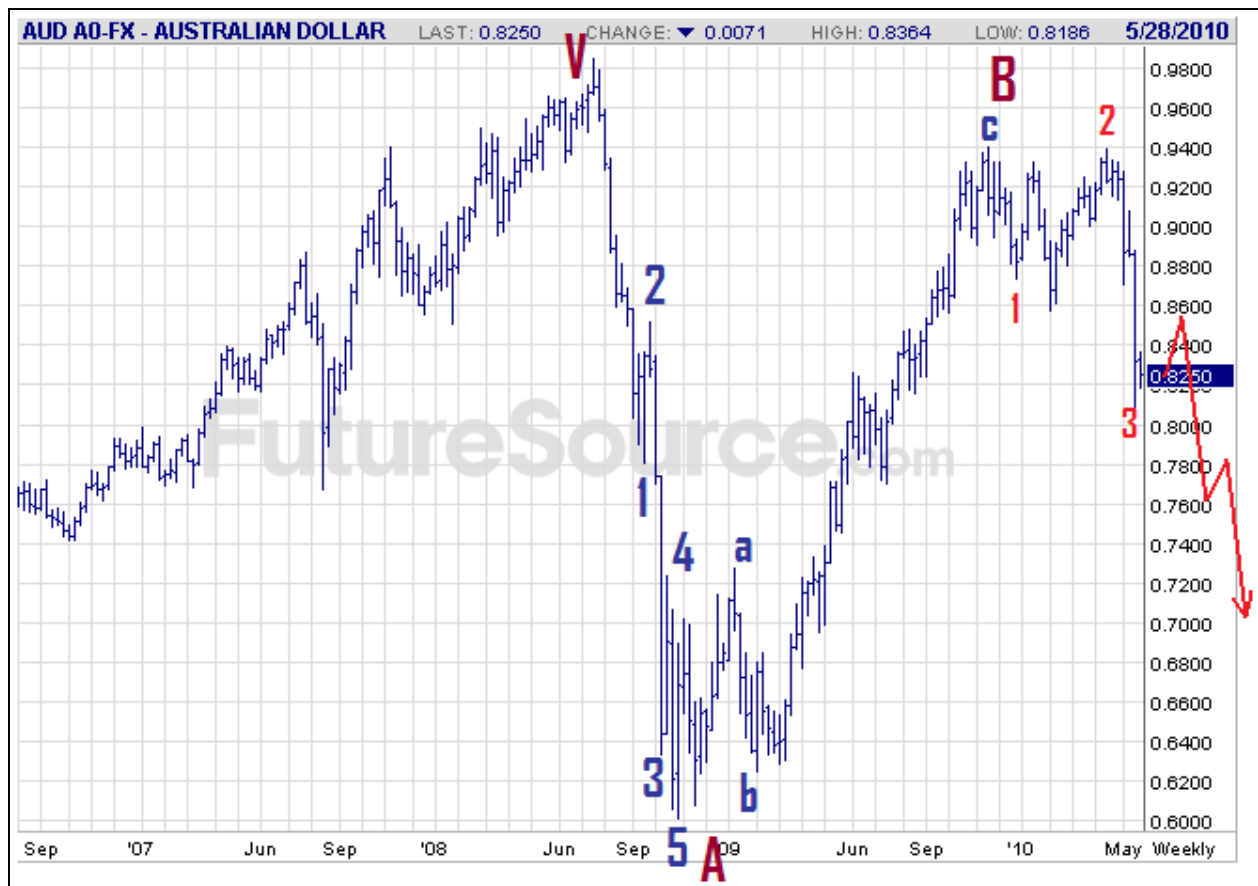
everything since has been part of a corrective rally. We are still in wave c of that rally (see first chart below).



Already this month the Aussie dollar has fallen 13% against the US dollar. Could this still be part of a rally? The second chart above shows how it could. In fact, that is the best wave count at the moment. The May drop is wave **c** of Primary wave **4** (blue), and this should now give way to a rally that will take the Aussie to a multi decade high against the American dollar, almost certainly above parity.

With expectations for a crash in commodity prices, it is difficult to harmonise this with economic fundamentals. But price is a function of psychology, not fundamentals. The waves will do what the waves will do, not what economists or the media think they should do.

Nevertheless, there has to be an alternate count, and the third chart below shows the bearish alternative. Which one will play out? Unfortunately we must stand aside and watch.



New Zealand Dollar

The Kiwi is in exactly the same situation. It has fallen heavily, and looks weak. But, like the Aussie, it could be overtaken by the larger pattern.

WE ARE NOT ALONE

The one economic fundamental that exacerbates all of the global economic and financial problems when crowd mood turns is the deliberately flawed nature of our money creation system. As I have pointed out many times, it has the seeds of its own destruction sewn within it. If you keep on lending \$10 into the economy and taking \$11 out, eventually this system must implode.

More and more people around the world are coming to understand this greatest confidence trick of all time which has been pulled on the public for centuries. Here is an excerpt from a newsletter by James Robertson www.jamesrobertson.com

Why, in modern democracies, should we continue to allow commercial banks to enjoy the privilege of creating the national currency and money supply, instead of transferring responsibility for creating it in the national interest to a public agency?

A draft "Proposed Bank of England Act 2010" to implement this banking and monetary reform is now on the internet at www.bankofenglandact.co.uk. It has been prepared for "a group of economists, lawyers, engineers, former civil servants, university academics and business people who have realised that the root of the instability in the world economy, and huge burden of debt in every country, is due to the fundamental design of the banking system".

This monetary and banking reform will directly help our new government to deal with two of our most urgent economic problems. It will help to ease the burden of paying off our massive public debt - see www.bankofenglandact.co.uk/benefits-of-reform. It will also prevent future banking failures from causing credit booms and busts that result in damaging financial crises.

The reform will transfer the function of creating the money supply to the Bank of England from the commercial banks. The Bank will create the amount of money it decides is necessary to meet the published objectives of monetary policy laid down by the elected government and Parliament. The Bank will give the money it creates to the government, and the government will spend it into circulation on public purposes under normal democratic budgeting procedures. This will be a permanent, more democratic development of the Bank's recent creation of money by "quantitative easing" to support the banks.

The proposed reform will remove the present subsidy to the banks in the form of special profits made by them from being allowed to create the money supply. So, as well as requiring the government to carry out more efficiently its responsibility for a public money system that serves the public interest, the reform will motivate the banks to meet the borrowing and lending needs of the economy more efficiently and less expensively in a more competitive market economy.

More people are now becoming aware that we depend unnecessarily on the commercial banks to provide us with more than 95% of the national money supply; that the banks now create it as bank-account money ('credit') out of nothing, in the form of interest-bearing loans to their customers (profit-making debt); and that less than 5% is now created as banknotes and coins by the Bank of England and the Royal Mint as agencies of the state. Hitherto, very few people have realised that our money supply is created that way. As the numbers grow who realise it, how will they respond to that knowledge in the hardship years ahead?

The "Banking Reform" section of the new government's coalition agreement between the Conservatives and Liberal Democrats - http://news.bbc.co.uk/1/hi/uk_politics/election_2010/8677933.stm - does not mention this more basic commonsense reform. It would, in fact, be a simpler way of dealing with almost all the points covered in the agreement.

Opponents are already complaining that the new government's "Banking Reform" proposals will put UK banks at a competitive disadvantage in favour of other countries' banks, and say that this will reduce the amount of tax the UK banks contribute to the Exchequer and the contribution they make to our economy. The same claim will be made against the simpler and more basic banking and monetary reform discussed in this note.

Those claimed reductions in benefits will almost certainly be greatly offset by the reduction in the present cost of money which every activity in the economy now has to bear - whether in booms or busts or normal times - as a result of the present way of creating it. Unbiased cost/benefit calculations covering the longer-term and shorter-term plusses and minuses (costs and benefits) would no doubt confirm that conclusion. The new government should be encouraged to commission them urgently.

MORE ON THE COMING PROPERTY CRASH

More and more people are also coming to realise that the Australian residential real estate market is a bubble, the bursting of which will be catastrophic for hundreds of thousands of people, not to mention Australian banks. Here is a slide show doing the rounds at the moment

that is worth a look. It is less than perfect in a number of respects, but both entertaining and instructive in others.

<http://www.scribd.com/doc/29520921/How-to-Profit-From-the-Coming-Aussie-Property-Crash-and-Banking-Crisis>

For those who don't have a computer, here are some salient points:

- The property boom in Australia is greater than the one that preceded the US crash.
- There is no shortage of houses in Australia. The figures used by the media and vested interests to push this barrow may be flawed.
- Before house price crashes in Hong Kong, Ireland, UK, California, etc. "experts" warned of "housing shortage."
- Strained banks in the US and UK had around 15% exposure to housing loans. Australian banks, especially CBA and Westpac, have around 50% exposure to housing loans.
- A house price crash in Australia could be devastating for banks.
- According to the RBA, Australian banks have \$13 trillion in off-balance sheet business.

There appears to be some cooling off at house auctions around Australia. But it is too early to call an end to the property boom. I cannot tell you **when** the property crash will come, but I can assure you that **it will come**.

When it does, house prices across Australia will fall back to levels last seen in the early 1990s. This is at least 50% below current levels.

The real estate boom is likely to end suddenly, as the hundreds of thousands of individuals who make up the property market all change their mind at the same time, without realising that everyone else is too. It can be like magic. One week the buying frenzy is in full flight. The next week buyers stay away in droves, never to return. It can be a wonder to behold.

All my comments are about property **investment**. When it comes to your own home, very different factors must be taken into account. Some cannot be measured in dollars and cents.

Happy wave watching

Graham Dyer

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