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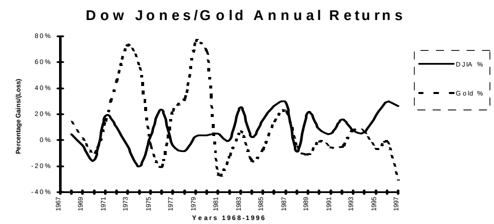

& Technology Stocks

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Dr. Robert McHugh, Chartist, Gold Bull

Your editor was greatly impressed by an insightful article I found on the Internet titled, *"The Feds Are at It Again. What Do They Fear?"* It was written by Dr. Robert McHugh.

Robert is one of the few people I know who has been a part of the establishment's money creating machine and understands the virtues of gold as money. That factor, along with his strong analytical skills and his exceptional quest for objective truth—enhanced, I believe, by his strong Christian faith—makes Dr. McHugh a very interesting and valuable addition to our growing list of noteworthy interviewees. We are very thankful to Dr. McHugh for graciously granting us more than 1½ hours on July 5, 2005, to talk about the markets and for his permission to pass along those insights to you this month. We trust you will enjoy our discussion and not only profit from this interview but also take advantage of his free one-month trial subscription offer as outlined below, at the end of the interview.

TAYLOR: Could you explain for the benefit of our readers how money is magically created out of thin air?

McHUGH: There are two ways to create money. The first is where the Federal Reserve directly "prints" it and puts it directly into the economy by purchasing anything really, but usually by way of purchasing U.S. Treasuries. But more to your question, the second method is that the banking system can create money out of thin air. And the way it is done is simply by the bank making a loan. A bank loan results in a spanking brand new deposit that never before existed in the economy. The loan disbursement either gets deposited in the bank—thus the loan becomes a deposit—or it is spent, and the merchant that receives that money deposits it in his bank. So that is how you have a new deposit that has been born.

TAYLOR: So what you are saying is that the Fed initiates a deposit in say the large money market banks in New York, or even smaller banks I suppose, by buying bonds that those banks may hold or by buying bonds that anyone might hold. The seller of those bonds then places those dollars in a deposit with their bank that can then be used to make a new loan. Then that multiplies out by an infinite number of times, I guess?

McHUGH: Yes, if you look at the multiplication or velocity of money, the way that would work is when the same deposit is lent over and over again by different banks over a short period of time. For example, if $1,000 is loaned by Bank "A," that $1,000 remains a deposit at Bank "A," but that loan also becomes a new deposit at Bank "B," which received the loan proceeds from the borrower. And then if Bank "B" lends that same $1,000, it becomes a third deposit at Bank "C." Thus through the process of two loans, deposits in the monetary system have grown from an initial $1,000, to $3,000. In effect, the initial deposit has grown "baby" and "grandbaby" dollars. Faster velocity means that more lending is going on or more spending associated with those loans. Lower velocity means the loans are being repaid by reducing deposits, thus spending slows. Because of reserve requirements, there is a limit to how much money is created in this fashion, but the money multiplier is a powerful money growth agent.

TAYLOR: Before we finish talking about velocity, I would like to ask you what the reserve requirements are these days. As I recall, in the old days, banks had to keep something like 5 percent or 8 percent of the deposit. Do you know what if any such reserve requirements are in place now?

McHUGH: It is a complicated formula where for up to the first $7.0 million of net transaction accounts in a bank, none are required, from $7.0 million to $47.6 million, 3 percent are required, and above $47.6 million, 10 percent. There are no requirements to reserve for non-personal time deposits. They really lightened up the requirements. In the old days, you couldn't loan 3 percent of a much larger percentage of your checking accounts, which had to be locked up. That reduced the potential velocity of money because there were 3 percent of deposits that could not be loaned. A lower percentage of deposits was required as reserves for savings accounts, and an even lower percentage for CDs. They liberalized these rules because they were trying to increase the money supply.

TAYLOR: So a higher reserve requirement would lower the money supply and a lower reserve requirement would increase the money supply, all other things being equal.

McHUGH: That's right.

TAYLOR: Okay, so back to then, I think we have the understanding that if more lending takes place within a given time, that means we have higher velocity, and if less lending takes place during that same time frame, then we have a slower velocity. Could you give our readers some idea of what faster and slower velocities would mean for the economy?

McHUGH: With a faster velocity you have a lot of lending going on, a lot of deposits being created, and therefore you have a rapid growth in the money supply. Rapid growth of the money supply is inflationary and forces interest rates up. But actually it is a self-fulfilling prophecy because if interest rates continue to rise, it will eventually slow the economy. And the opposite happens with velocity declining. People are not borrowing as much. They are not spending as much. Asset values are not going up as much and so you have less inflation and possibly even deflation. And it is a contracting force on the economy.

TAYLOR: Money is measured in different ways. We have MZM, M-1, M-2, M-3. Could you define for our readers those various terms of money and tell us which ones you think are the most important and which ones we should therefore focus on?

McHUGH: I will try to keep it as simple as possible. A precise definition is available on the Federal Reserve Web site. The narrowest measure is M-1. It is essentially currency plus checking accounts. It excludes savings accounts. It excludes CD. That is the narrowest definition of money. It makes a distinction between a savings account and a checking account. M-2 would be M-1 plus savings accounts and it also includes small time deposits and small CDs less than $100,000, but it excludes IRAs. M-2 also includes some retail money markets from retail clients. M-3 is the broadest definition and that equals M-2 plus all balances and institutional money market funds to capture money market funds that are in non banks, as well as large CDs, time deposits over $100,000, repurchase agreements, and euro dollars. So M-3 is really checking accounts, savings accounts, CDs, plus institutional money market funds and U.S. Treasury repurchase agreements and euro dollars. M-3 is the broadest definition of money but I think it is also the truest because if a banker has a CD, he can lend that out just as equally as he can a checking account. So I think if we are looking at the power of money supply, its availability for velocity, its impact on inflation, I like M-3.

MZM is an odd definition of money. It really means all measures of money that does not have a term attached to it. But again, if a banker gets a one-year CD, he is glad to have it. He will just simply make a longer loan with that money.

TAYLOR: So MZM would be the most liquid measure of money then?

McHUGH: Yes, the most liquid.

TAYLOR: The Federal Reserve has been increasing interest rates at a "measured pace." Yet as you point out, the supply of money has been exploding during the past several weeks. Isn't the act of creating huge amounts of money inconsistent with raising short-term rates? How do they manage to raise the short-term rates if they are increasing the supply of money? Shouldn't an increase in supply result in a lower price for money, which of course is what interest is—the price of money.

McHUGH: I find this one of the most fascinating aspects of Federal Reserve behavior right now. They are kind of doing one thing with the left hand and the opposite with the right. They can actually do both. The act of raising interest rates and the effect on money supply is mutually exclusive from the act of pumping huge amounts of money into the system. What's happening here is the Fed is tightening with one of their four tools at their disposal to manipulate the money. They are tightening with one of those tools, the raising of short-term interest rates. That discourages people from borrowing money and as such reduces the velocity of money. But while they are dong that—and that is what is getting all the hype in our financial media—simultaneously, they are taking their right hand and loosening money through open market operations. Here is where they buy anything they want—but most commonly, Treasuries. They are buying them in the market and exchanging them for money that they have created "in the back room," electronically. They send money into the economy when they take securities out.

Or they are lending money to foreign central banks that then acquire these Treasuries and in effect pump money into the system for the Fed.

Or they can simply sit back and not do their job of pulling money out of the system when they should, because the velocity of money is creating money. So in effect money supply continues to grow under their control and in accordance with their wishes. They have full control of what is out there through the open market operation. So even though they are tightening on the short end, they want an accommodative monetary policy out there. So they are not really using their open market operations to skim off money, as they should be doing.

TAYLOR: Why do you think the Fed is being so accommodative?

McHUGH: M-3 has grown 9.4 percent over the past month on an annualized basis. It has grown 8.0 percent during the past three months. These rates of growth are very high. They are far in excess of GDP, which has recently been reported at 3.8 percent, which you would think would be the maximum rate of money growth the economy would need to sustain that pace. And these rates are far greater than the reported inflation rate of less than 3 percent. These are historically high rates of monetary growth. What this tells me is, obviously, for the Fed to be this accommodative and to pump this much liquidity into what their jargon and rhetoric suggests is a so-called strong economic recovery, well, it simply means that there is something out there that is scaring the Fed. There must be a risk out there that they don't like.

The Fed is a very secretive organization. For example, they make bankers sign confidentiality agreements that the Fed's examination reports cannot be shared. They do this because the Fed cannot have people knowing when they are putting pressure on bankers to slow lending (in other words, people would find out the Fed is slowing the velocity of money through the power of the bank examination process). That's why nobody can understand what the Maestro, Alan Greenspan, is saying half the time. He doesn't want anyone to understand him. His views and thoughts are a big secret. So, in order to understand what the Fed is thinking, you have to look at their actions. And their actions, pumping extraordinary levels of liquidity into the system at this time, suggest they fear something. I don't know what that fear would be, but a good possibility might be the derivatives risk because we have heard certain Fed governors voice their concern about the derivatives bubble. It could be a fear that the risk of a collapse has risen beyond their comfort level. So they are funneling liquidity into the system, just in case. There could be a ton of other fears. Maybe the Fed has been clued in by the Federal government—the CIA, the FBI—about some political or terrorist risk out there.

TAYLOR: And the Fed, which is a private corporation, would have the knowledge that we wouldn't know.

McHUGH: That's right. So they are doing what they think is the right thing to do, based upon their risk assessments.

TAYLOR: I think in your June 19 report, you suggested that we might well have had a crash during the April 2004 time frame and you wrote, ***"At that time the technical landscape was horrid, including a rare and ominous Hindenburg Omen, as Kennedy Gammage noted back then. The pumping of money through June 2004 led to the rally from August 2004 through year-end, including the post-election rally. But the pause in M-3 growth from June 2004 through October 2004 subsequently permitted the Dow Industrials decline from March 7 through April 20. The recent rally from April 20 was fueled by the liquidity pumping that the Fed initiated from October 2004 through now."***

Most people have been trained to think that Alan Greenspan and a host of policy makers are gods who can manipulate markets for our common good. And you mentioned how, by simply printing money, the Fed has been able to stop market slides. John Hathaway, who manages the Tocqueville Gold Fund, recently remarked that the turning point for paper money and for gold would come when it becomes apparent that printing more money will no longer serve to keep equity and bond markets from crashing.

Do you see any reason why the Fed may not be able, at some point in the future, to continue managing and manipulating the economy to avoid a collapse of the equity and bond markets and to keep a devastating depression from taking place?

McHUGH: Yes I do. I think the Fed is smart enough to understand that they are not as all powerful as they want people to think they are. So they aim to nip these crises in the bud. They try to over-liquidate the supply of money as soon as they get the first inkling of a crisis, because they know that once something gets started it can spiral out of control very quickly and they could become powerless to do much about it.

TAYLOR: So that is why they have always been erring on the side of liquidity?

McHUGH: Yes, I think so. The Fed Chairman is a student of the Japan deflation, and I think it scared him beyond belief, so he has really gone overboard to make sure that does not happen again here. But the truth of the matter is that once the foreign holders of our dollars, bonds, and stocks—and they are becoming a larger and larger percentage of the ownership of our financial assets—lose confidence and decide to sell those assets for whatever reason, the Fed is not going to be able to pump enough money supply into the system to offset what is going out the door, because as you get a big wave of selling from foreign securities holders, it is going drop asset values sharply lower. They will be wiping out trillions of dollars of financial wealth. And I think once something like that happens, the Fed will see that they are standing under an avalanche. What are they going to do? Pump 100 percent money growth to try to make up a 30 percent or 50 percent drop in asset values? The numbers would be ludicrous. So I think that their strategy is to err on the side of liquidity so that no avalanche gets started.

TAYLOR: But in so doing, they are increasing the money supply drastically. I like to say, "Debt is the raw material from which money is manufactured in a fiat currency system. And so as I look at the charts of debt growth, I see debt growing almost exponentially, with GDP growing at 2 percent or 3 percent. It seems to me that at some point, something has to give.

McHUGH: Yes, we almost have a parabolic spike in the growth of debt. As you just said, it is taking more and more debt dollars to generate a dollar of GDP. That is a very scary situation. What you want debt creation to generate is income, not asset appreciation. But we have the opposite.

TAYLOR: So "How will debt be serviced?" is the question that is central in my mind. If the Fed always errs on the side of safety, they are creating more debt in the economy. It certainly seems to be true that debt is growing much more rapidly than income. If that is true, what happens when the foreigners decide that they have enough dollars and they stop buying (or at least stop buying Treasuries), and we start seeing a spike in interest rates? How will that debt be serviced? If the answer is printing more money, it seems to me to be a self-defeating exercise of the longer run, given that debt keeps growing much, much faster than income.

McHUGH: If a corporation or a person has too much debt, the way to get rid of debt is to either generate more income or push higher asset values onto another debt holder. But the asset value approach doesn't reduce aggregate debt, it just shifts higher debt loads onto others, exacerbating a tenuous situation. No, what we need here is a huge increase in income to get rid of the debt we have now.

TAYLOR: Or debt repudiation through massive bankruptcies?

McHUGH: Yes. Repudiation is an interesting concept.

TAYLOR: Repudiation through inflation or bankruptcy.

McHUGH: Or just a declaration by the government.

TAYLOR: In your July issue you noted that the Fed is printing money much faster than people realize and you offered this as one reason that the long bond has remained so strong and why there seems to be so much stealth liquidity sloshing around. Then you suggested that the Fed may be manipulating these long rates lower in this manner to allow the banks to get out of their Freddie Mac and Fannie Mae paper, to book a profit before interest rates begin to rise. Do you think the Fed is fearful of a housing crash or a mortgage crash and massive losses for those owners of mortgages?

McHUGH: Yes, I think the Fed is very concerned about the real estate bubble, which ironically was created by them. But I think even worse, or more importantly from their perspective, I think they are concerned about the health of the banking system above all else. After all, that is really what the Fed's primary role is—to protect the banking system and keep it going. And I think the biggest risk they see now to the banking system is the mortgage backed security—the Freddie and Fannie paper held in bank portfolios, including preferred trust paper. I think they want banks to lighten their holdings of these securities. Systemically, the Fed would rather see non-bank entities carrying these mortgage backed securities and trust preferred risks. Traditionally, banks are really loaded heavily with mortgaged backed securities (Freddie and Fannie paper), because it had a quasi-government guarantee with a nice high yield over Treasuries. They had AAA rating. They had good yields. It was a good place to park money. The collateralized mortgage obligations gave you liquidity. So a lot of banks and other financial institutions are loaded with these securities. And the trust preferreds appealed for similar reasons. Now all of a sudden you have rising risk levels for government sponsored agencies.

The Fed has quietly gone into these banks and told them they need to lighten up on these mortgage backed and trust preferred securities. And in order for this to happen, the Fed needs a bond market that is rising, so that interest rates stay low, so that banks that put this paper on their books in this low interest rate environment can get out with gains, or at least break even, so they don't jeopardize their capital as they dump this paper. I think the bond conundrum has been solved. The Fed needed a bond market rally to help the banking system to lighten up on Freddie and Fannie paper.

TAYLOR: If I recall properly, with the S&L crisis of the early 1990s, the Fed also seemed to go in and fool around with the money supply so as to drop funding costs for banks and thus give the banks huge amounts of capital.

McHUGH: Yes it did. Absolutely. The Fed remains very active in preserving capital. They do what they can from their end to make sure that the banking system does not jeopardize the economy.

TAYLOR: Well if the Fed wants the banks in the system to lay off this paper, who are the lucky people that get to buy it? The pension funds or who?

McHUGH: That's a great question. Whoever is buying this stuff is assuming the risk. I think it is a question of who will be stuck holding the old maid—that is, who will be holding the Freddie and Fannie paper when rates begin to rise? But the Federal Reserve banking system is only a small fraction of all purchasers of securities. The Fed would like to see this risk be spread out or diversified throughout the economy rather than have it concentrated in the banking system.

TAYLOR: So get the banks to get more liquid now? Go down the yield curve?

McHUGH: And then they have to replace Freddie and Fannie paper with something else. That will be the next challenge.

TAYLOR: Any notion what the next bubble will be?

McHUGH: I believe the real estate bubble will be around longer than most believe. It is the only ticket for safe passage out of town for this administration, so they will do all they can to keep it going through 2008. There is just too much debt and not enough income to allow it to dissolve. To keep real estate floating, money supply must grow and grow. That means gold and precious metals should take off.

TAYLOR: I think it is interesting that high profile people like Stephen Roach and Bill Gross have helped the Fed drive down interest rates recently by switching from a bearish to bullish posture on bonds.

McHUGH: They have. Maybe they end up being right. But I think the Fed knows that someone has to harbor the old maid, and they would just prefer it not be the banking system.

TAYLOR: As I look back at a long-term chart of the 30-year bond chart, it looks to me like we are still in a long-term bond bull market.

McHUGH: I know. I expected bonds to drop a year or two ago when the economy began to pull out of what we have been through. But the way the bond markets have rallied the last six months or so, it makes you wonder if it has had some Master Planner help. But you know, you can never quite put your finger on a manipulation.

TAYLOR: Robert, you are a very strong technical analyst. What are your views in the short and long term on the long bond?

McHUGH: Well, if you look at the charts, the long bond is bearish. In the short run, we have identified what we call a Megaphone Top, which is a pattern with expanding higher highs and also expanding lower lows, giving it the shape of a megaphone. That is a bearish pattern. That suggests that in the short to medium term, bonds prices should fall and rates should rise. And in a longer term, I still believe we have another pattern that is very bearish. We have a double top or even a head and shoulders pattern, and those patterns also foresee prices dropping.

The megaphone is fairly new. It is only about six months old. But the larger tops, the head and shoulders, have been there for quite a while, which was one of the reasons I expected bond prices to drop. Greenspan himself used the word "conundrum" because the Fed said it was expecting bond prices to drop. Prices didn't, and I think happily so. The Master Planners' desire is for long interest rates to remain low, so there may be a little help there behind the scenes. I mean the Fed can buy long-term bonds to keep the rates down. They don't have to tell anyone what they are doing.

TAYLOR: In fact, is there some evidence that the Fed may have recently been monetizing some debt by buying some of the bonds the Chinese and Japanese were possibly buying in prior months? It seems to me I saw a chart, which was brought to my attention by a friend Warren Pollock, who pointed out a decline in purchase of Treasuries that coincided with a rise in buying from the Cayman Islands which may have represented a step up in buying by the Fed.

McHUGH: I think so, too. I really do.

TAYLOR: So from a purely technical basis you are very bearish on bonds.

McHUGH: From a purely technical point of view, yes, but here is the thing: This market can be manipulated very easily by the Federal Reserve via the monetization system that is in place. It is not illegal. They can do it. It is very legal for the Fed to buy bonds. So with the risks they see out there, they buy bonds. They can delay the decline of bond prices by pushing them back up, keeping them in a trading range, where they are now, for an extended period of time, say six months to a year.

TAYLOR: What are your views in the short and long term on the dollar?

McHUGH: The dollar should fall short term. Should rise intermediate term.

TAYLOR: And by "short term," I believe you usually define that as couple of weeks.

McHUGH: Yes, like the next month or so. And then it should rally. But in the long term I see it falling hard. The Fundamentals are just lousy. Since the start of the year, the dollar has been in a bear market correction. Corrections usually start in three waves. A up, B down, and C up. It looks like the "A" portion of that correction is complete. The dollar is overbought. It is ready to drop in the short run. So in the next month or so, there should be a correction in the dollar that brings it down. And then there should be one more thrust higher that would take the dollar to as high, perhaps, as 95. And then at that point, the corrective retrace of the decline in the dollar from 120 to 80 should be complete, which would be about a 38 percent retrace. And then the dollar should start falling very hard. I think that is where the fundamentals are.

TAYLOR: If you look at 82, isn't that a strong support for the dollar index? And if it broke there, where would the next stop be?

McHUGH: Probably 80, where we bottomed before. But once you get below 80, that is where the trend line kicks back in. Then you are talking about 70, or even 60, for the next major decline.

TAYLOR: But are we not really looking at fiat currencies against each other, all of which are sinking? It's just that some sink faster than others?

McHUGH: That's what is happening right now. Everyone is printing like mad. I have said in the past that the first country to back their currency with gold will be the winner.

TAYLOR: But, of course, the IMF prohibits countries from backing their currency if they want to be a part of the respectable world community and if they want to work with that global institution.

McHUGH: Or, how about this? A one-world currency coming out of the G-8? Their attempt to diminish gold. But those not participating could back their currency with gold, anyway.

TAYLOR: Who might that be—the Chinese?

McHUGH: I would expect the Chinese.

TAYLOR: Speaking of gold, do you see gold being dependent on a weak dollar to rise?

McHUGH: No, because gold is being bought enthusiastically by foreign interests. As the euro has had trouble, foreigners have bought gold. The Chinese have a strong interest in gold. But I think gold has enough demand outside of the U.S. in non-dollar currencies that there is going to be a force there to drive it higher.

TAYLOR: At some point in time, gold will rise against all the currencies, as it has the last couple of weeks.

McHUGH: Yes; in recent weeks people have been somewhat shaken by the concurrent move in gold and the dollar together. But there is a symmetrical triangle pattern on the gold charts that suggests gold needs another short-term rally. If this pattern plays out as it should, gold should rise above $450—perhaps to $475–$500, if it really gets some legs. I have it in the fifth wave of a higher degree fifth long-term topping pattern. So I'm bullish on gold over the next month to six weeks if this pattern holds up—and it usually does, because it's a pretty clean pattern. It has nice support at its 50- and 200-day moving average area, and it is not anywhere near overbought, so there is room for it to rise. And then at some point here we'll see a top in gold—six weeks or so—it's hard to tell the timing. As Richard Russell likes to say, "We know where markets are going, we just don't know when."

TAYLOR: That's the problem, isn't it?

McHUGH: It really is. But I see gold rising for six weeks, then I see it starting an intermediate "A" down, "B" up, "C" down correction, which could last quite awhile, perhaps a year or so.

TAYLOR: What do you see as the ultimate low for gold on the next wave down?

McHUGH: I don't think more than about to $375.

TAYLOR: That will shake some people up, though.

McHUGH: It will shake them up, but it will be an awfully nice buying opportunity for people interested in getting back in.

TAYLOR: Doesn't seem to me as I walk the streets of New York that there are very many people who want to get back into gold. And if we went to $375, there would be still fewer, I guess.

McHUGH: And that is when to buy. But long term, gold should do very well as fiat currencies over-inflate and over-expand, and economies get dredged as debt loads increase, and the public's perception of things gets darker. Gold will then get very popular. And that would be a wave three—in Elliott Wave analysis, wave threes are the really dramatic moves. And so what we will be doing here is enduring a correction over the next year or so that would set up a sharp wave three rally.

TAYLOR: Richard Russell talks bout parity between the Dow and Gold. Do you think there is a chance of that? Historically it has happened about three times at major bear market bottoms in the last century.

MCHUGH: I read Richard Russell, too, and I think his argument is compelling. I think it makes a lot of sense because I also agree that we can see a scenario of the equity markets falling 50 percent to 60 percent and a scenario with gold rising 8 to 10 times. That would certainly do it.

TAYLOR: You do a lot of Elliott Wave analysis. We recently interviewed Robert Prechter in our letter. He is, of course, very bullish on the dollar. He is a deflationist. However, he is very bearish on gold. He doesn't see deflation as being positive for gold, even though I believe that, historically, there are many reasons to believe gold will actually perform best during a deflation. Assuming you differ with Prechter, how do you account for those differences since both of you use Elliott Wave analysis?

McHUGH: I think the explanation is mostly based on timing. I think Bob's analysis is absolutely terrific. I sometimes see different timing than he does because of some additional tools I incorporate into my analysis. I use other technical tools to enhance my interpretation of Elliott Wave patterns, such as price patterns like the Head & Shoulders, or Symmetrical Triangles, etc., or my proprietary Stochastic and Purchasing Power buy/sell signal indicators. These are most useful in helping me interpret when Elliott Waves are beginning and ending. They supplement my Elliott Wave analysis, sometimes giving me a different take as far as whether we are yet at the top or the bottom of trends.

TAYLOR: So would you say they are simply more "pure" Elliott Wave analysts then?

McHUGH: They are a little purer with EW. They do incorporate some other things, such as sentiment readings. I think supplemental technical tools give each analyst a little different take with regard to timing, but all in all, I think more often than not, I and those who practice Elliott Wave are in general agreement.

TAYLOR: I noticed in Prechter's last book he is suggesting that people buy gold now. I'm wondering if he thinks you should own gold but not until we hit the bottom of the cycle.

McHUGH: I think so. You would have to ask him to be sure, but from what I have read of his stuff, he does think gold has a future. I think there is one more down-up move before the intermediate-term, 9 month to a year correction lower, begins.

TAYLOR: And this year-long correction should take us to where, again, for gold?

McHUGH: About $375ish.

TAYLOR: In our Model Portfolio, about 40 percent is allocated to gold shares, but we are buy and hold folks. We try to pick the primary trends and then ride those trends out for the long term. But I know our subscribers would also like to know your views for the short and intermediate term for gold shares. And perhaps you could also comment on whether you see the gold market and the gold share market closely correlated.

McHUGH: I think there are some differences. HUI, the gold bugs index, is a stock portfolio. It isn't aboveground metal. It's mostly belowground metal, with some inventories and futures positions. HUI is a hybrid, both as a stock and as a gold metal. So it behaves differently than gold. Sometimes it behaves as a metal and other times like a stock, so it is difficult to track it. As a stock, it has operational, funding, regulatory, and growth challenges that are not present in gold the metal. Therefore, sometimes gold the metal and HUI will temporarily diverge. Just looking at the pure technical analysis of it, I think the HUI needs to correct down to below 150, according to an Elliott Wave count.

I also see a Gartley pattern that is bullish long term but bearish in the short to intermediate term. It is calling for a decline into the 150 area, or slightly lower, over the next six to eight weeks.

Then there is a potential head and shoulders pattern that is nearing completion. It is a beautiful symmetrical textbook pattern. If the HUI drops below 170, it will signal that the HUI could drop to as low as 140.

TAYLOR: As a point of reference, where is the HUI now?

McHUGH: On Friday (July 1) it was at 202. This morning it was down $4.

TAYLOR: So we are looking at a pretty good whack from a percentage viewpoint.

McHUGH: Yes, it's a good whack but the good news is that if you are a long-term player—again realize this is a corrective wave or a "2" wave in Elliot Wave jargon—nonetheless it is inside a rising long-term trend. So the good news is that once this index bottoms, the HUI should really take off. But we have another six months to a year of turbulence to live through in this index. Then it is off to the races.

TAYLOR: While we are on the precious metals topic, what are your views on silver?

McHUGH: Silver is similar to gold. I see silver almost identical to gold in its pattern. Again it is in a Symmetrical Triangle that is right out of the textbook. It's a perfect formation that has taken place. Most triangles are wave fours. In Elliot Wave analysis, an impulse wave always needs a fifth wave. So whenever you see a triangle you usually are in a wave four, and that means there is another move yet to come in the same trend direction as before the triangle. The trend for silver has been up for the last two years or longer. So if you have a wave "4" triangle here, it is saying you need another step higher.

Silver took a beating on Friday (July 1) but it was doing well a few weeks ago, so it will be interesting to watch. If it falls decisively below $6.70 or so, then it will blow up that symmetrical pattern and we would get a failure here. That would be very rare for a symmetrical triangle. But if we get that failure we would have to consider the possibility that the top is in for silver and its intermediate one-year corrective move down underway. Watch the Gold:Silver Ratio. If it rises, where Gold rises and Silver falls, for example, it is a forecast of dangerous economic and perhaps political times coming.

TAYLOR: We also have allocated about 15 percent of our portfolio to some oil and gas plays. Do you have a short-term and long-term view on oil and gas?

McHUGH: I look at the WTIC index. And what I have here is that it is topping. There is a Rising Bearish Wedge pattern, which is a topping formation. This is an interesting pattern because it allows for a final spike up—a kind of a buying panic top. And then it breaks down from there. There is a lot of talk about how oil is up for good and it is going higher for a long time. But if you look at an Elliott Wave count over the last three years, it looks like it is exhausting its upward trend. On the basis of this pattern, we called for a rise above $60, which has now happened. It can go to $65 on a spike, or even $70, because the pattern allows that. Or it may be completed and the corrective move down in wave "2" could begin at any time. And then it would rise along with gold and silver as a long-term rising pattern continues again in about nine months.

TAYLOR: That is interesting, because as I hear what you see in the charts, the markets for "stuff" including gold should be rising together, and paper or financial assets would be declining. Is that the way you see it?

McHUGH: Yes; the inflation assets should rise in harmony.

TAYLOR: Among our subscribers we have a raging debate between those who think the major threat to our markets and economic stability is inflation and those who think it is deflation. By deflation we mean a declining money supply, and we define inflation as a rising money supply. As you have pointed out, the Fed has been able to increase the money supply pretty much as it desires, and it has done so under Greenspan whenever a crisis has arisen, starting with the 1987 crash. Do you have any view on which of these two unstable events poses the greatest threat?

McHUGH: I think deflation is the worst of the two evils. But hyperinflation can lead to deflation. We saw that back in the Great Depression. But once we get into deflation we are really in trouble. It's like a black hole that feeds on itself. It's a spiraling contraction of everything in the economy. Bonds, equity, real estate—everything falls.

TAYLOR: The establishment, or at least those who live by debt, are destroyed? And those who are liquid and have avoided debt are rewarded, at least if the politicians allow the markets to function even in part.

McHUGH: That could be the fallout. We could get forced central planning, and a loss of free markets.

TAYLOR: Some would argue that the very creation of the Federal Reserve was a major step toward central planning, at least with respect to the money supply. You and I have talked about that earlier in our discussion. I think you implied that the Fed is in the markets on a regular basis, intervening—or manipulating, if you will—interest rates, etc.

I noticed that you frequently publish scripture verses in your newsletter, as do I from time to time. Once in awhile, I receive criticisms from people, and, on occasion, a cancellation. The typical comment is that I should keep the ideas of faith in God and eternal salvation through the death and resurrection of Jesus to myself because these views have nothing to do with providing insights into the various financial markets, which is what they pay me for. I'm wondering if you have received similar comments, but in any event, how would you respond to that kind of criticism?

McHUGH: Jay, I think anyone who has studied markets closely and has seen the astonishing order that arrives out of chaos, can clearly see that where and when markets travel is not random. The more I get into technical analysis, the more I am humbled by the incredible order of the markets. When one considers there are thousands of investment theories and millions of investors conducting billions of transactions involving trillions of dollars, and then from those seemingly random activities you get perfect patterns in perfect ratios, both for time and price, I can only conclude that God has a sense of humor. He is saying "Hey mankind, go about your business, but ultimately I am in control."

A perfect example of this has been a Fibonacci *phi* mate date analysis we include for subscribers. Every single significant top or bottom in the Dow Jones Industrial Average since January 14, 2000, has been a Fibonacci .382 or .618 ratio of another top or bottom. Every single one! And mankind can't do that.

TAYLOR: So what you are saying is that it would be impossible for mankind or some central planning agency to achieve that with all those billions of transactions taking place randomly.

McHUGH: Only God could do that. So what I see is that God is in control—the markets are not—and that bothers people because a lot of people like to think they are in control.

So I guess I quote scripture because I want to give readers hope. No matter how bad things are going or how good things are going, I want people to be reminded steadily at the end of the day that God ultimately is involved and ultimately in control. He sent His son Jesus to die for us. He arose from the dead. Jesus has a relationship with God the Father who has control of the markets and has given all authority to Jesus. So it makes sense for us to enter a relationship with Jesus so we can have access to God who has control of the markets. It is just going to make us better investors and better, wiser businesspeople because we are acknowledging His control. Seek a relationship with Him and follow His lead. That's why I [quote scripture].

TAYLOR: That's great! I really appreciate your testimony. As you were talking about the patterns in the market, I was thinking of the perfectly formed patterns in the universe and in biological design here on our planet. Also of course as the Psalmist noted, we live to be 70 or 80 years of age and then it is all over on this earth. And so as my 58 years of life have taken their toll on my body, I find the assurances you talk about not only reassuring with respect to market manipulation and tough financial times, but also helpful in providing hope in the future, when life on this earth is over. I'm sure you share that hope as well?

McHUGH: Like you, I am looking forward to eternity with our Lord. Until then, He is my strength.

TAYLOR: I notice that you provide a free subscription to investors for one month. Can you explain how our readers can avail themselves of that terrific deal?

McHUGH: They can simply go to our Web site at www.technicalindicatorindex.com and just e-mail us with a request. There is a "contact" button at the lower left corner of the home page. Just ask for a free 30-day subscription, and we will be happy to sign you up to experience what we are all about.

TAYLOR: Robert, thank you so much for taking your valuable time to share your insights and views with our readers. I'm sure they will benefit greatly, and hopefully you will pick up at least a couple subscribers from our subscriber base.

McHUGH: Thank you, Jay. I really enjoyed chatting with you. And your insights are also of value to me

TAYLOR: Thank you, Robert. I think we have a lot in common and so I look forward to continuing our relationship into the future.