Global Report –October 2010

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World Investment Strategy

IRC INVESTMENT RESEARCH OF CAMBRIDGE

Introduction

Investment Research of Cambridge was established in 1945 to specialise in technically-based research of the financial and commodity markets. The company has built up an international reputation for its expertise in predicting the trend in global markets and individual stocks.

Contents

- Source of data for charts: Investment Research of Cambridge, Q-Data, Alpha Terminal, Thomson Reuters

World Investment Strategy

September is normally the worst month of the year, but this time it has been a strong month for equity markets.

This has happened before – the last time it occurred was 2007. Then the equity market rose 15% in the month of September and carried on rising until 16th October. It then crashed by 50% and bankrupted some of the world's largest financial institutions.

As precedents go, this is not a good one. We draw no comfort from the fact that markets were strong in September. They can, and are still likely to, drop back again.

In a normal, or average, year we sell in May. This time the market was exhausted by April so the downturn started a bit early. The mid-summer rally, however, began right on cue on the first of July. In most markets it then ran out of steam in mid-August but it carried on in some markets.

We need to know what caused this rise. The flow of funds analysis shows that the US public are abandoning equities. Mutual funds are haemorrhaging money. It is going into bonds. Most long-only managers are not dealing and many hedge funds have given up. Eighty per cent of turnover these days is computer algorithmic trading.

We now know that the US Fed have been doing Permanent Open Market Operations or POMOs. They started in March 2009 and have done 42 so far. Typically, they inject between $1.7-7billion in a single day into the market. This turns the algorithms positive and the computer trading does the rest. In short, the Fed has been goosing the market higher as a form of quantitative easing.

We do not wish to chase after that type of buying power. To put it into perspective, after the rise to date the US market, or S&P index, is now back to levels it first hit in 1998. Using the words growth or bull market in this context is an abuse of the English language. Not only has the market made no progress but it is priced in dollars, the value of which has fallen by 30% on a trade-weighted basis. Over this same time period, the Indian market is up 650% while Brazil is up 1400%. These are proper bull markets and that is where we wish to be invested.

Incidentally, the more the US and other western governments pump liquidity into the system, the more it just floods out again into the emerging markets. Quantitative Easing (QE) simply undermines western currencies and drives those of the growth markets up much faster than they would have done under their own steam.

To borrow Pimco's phrase, the world is moving to a 'new normal'. The old normal involved a passive holding in an index-tracking equity fund and financing expenditure by topping up the mortgage on the house which, of course, was only ever going to go up in value. You could confidently expect compound returns of 12% to 20% per annum.

Under the 'new normal', the top priority is to not lose any money. You will spend a lot of time clipping coupons on Treasury bills yielding about 2.5% and you will collect dividends on equities as long as their franchise is better than many countries. If you want growth, you will go to India, Brazil and China-related markets. The total return you can expect over the next few years will be a lot less than investors were used to and 7% is likely to be regarded as a good result.

There have been credit bubbles before and they all end the same way. The bad debts have to be written off or paid back. Governments can only delay the return to health. If they were not involved, the market would reach a 'clearing level' much quicker. It would be painful, but it would be over much sooner. As things are going, the agony will drag on for years. The best investments are in those parts of the world that are not in debt and where real growth is taking place. Go East young man.

Summary: world market overview

September has been a strong month for most markets. In a normal year it is easily the worst month for equities and leads up to a buyable low in October.

We are still worried that a drop will take place, and have not changed our minds just because markets have been goosed up by Fed Open Market Operations.

Even after this artificial assistance, the US market is now back to where it was in 1998. We simply cannot call that a bull market.

The Fed's operations have also had the effect of undermining the US dollar. It is well on the way to no longer being the world's major currency.

For many years now, the markets we have liked are India, Brazil and other so-called emerging markets. We also like commodity-related ones as they are underwritten by real value.

We are so concerned at the erosion of value of fiat currencies that we have regarded it as essential to hold some gold and silver. They are not yet in a bubble - although one could develop in due course. When that happens, they will put in a performance that will make the rise to date look tiny.

Although the QE, or POMO, process is designed to put liquidity into the US and other western markets, in practice it is finding its way into the emerging regions. As the US is so large in proportion to these markets, an injection of capital of this magnitude has caused these smaller markets to fly through the roof. My earlier bullish forecasts for these markets may well prove to be too conservative.

The bottom line is that the broad strategy of where to invest has not changed. Everything that has been done to bail out the west has simply made the eastern markets look more attractive.

It has done this on both a relative and an absolute measure. When everything is rising, the eastern markets do so faster. When currencies are taken into account, their performance looks even more impressive.

The commodity story runs on in line with Asian growth. They are a hedge against the weakening dollar.

The mid-term Presidential elections will take place on November 2nd. The likelihood is that President Obama will become a lame duck. We will also know then who will replace the retiring Keynesian economics team. These could be game-changing events.

It is, however, very hard to foresee any outcome in the US that will make its market more attractive than those of the fast-growing Asian economies The Dow Jones may be able to rally back to where it was in 2000 instead of only 1998. But in our book this does not pass the 'so what' test.

The World at a glance

Major markets

US relative to world: currency adjusted

- The US stock market is in the weakest category of our ranking table, notwithstanding its rise in September. On the relative performance chart, it is below its 200- day moving average. No amount of massaging by the Fed has been able to alter the fact that this is not a good market, they have only managed to get it back up to its 1998 level. Without this artificial aid, it would be even more of a laggard. Even the Fed now admit that there is a very real risk of a double dip and the only help that can be given is to print the dollar into oblivion. Avoid.

UK relative to world: currency adjusted

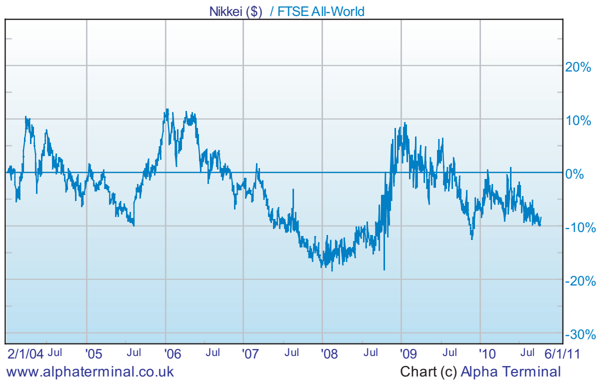
- The UK market is in the middle of our ranking table. On the relative chart, the index is above a rising 200-day moving average, which is good. The reason for this ranking is that the stocks in the index are so international that they are already heavily invested in Asia and only 20% of their earnings come from the UK. This is a fortunate accident of history. But the short term fluctuations will still be highly correlated to those of the US market. The UK economy is also deep in debt, but at least the government is trying to reduce it.

Europe relative to world: currency adjusted

- Most of Continental Europe is currently ranked between the UK and the US, in the neutral to weak section of the table – although Italy is a notably weak performer. The relative performance of the broad European index is exactly on its 200 day-average but this is itself sloping downwards. Germany has slipped in the table in spite of its export blue chips doing very well but they face stronger headwinds if the euro strengthens against the dollar. The Scandinavian markets are in the strong half of the table.

The world at a glance

Japan relative to world: currency adjusted



- The Japanese market gives the impression of being doomed. It is second from bottom of the entire ranking table. The relative performance chart shows a downtrend below a falling a 200-day average. It may well be that this market is making a final move to an ultimate low from which a positive reversal can take place. But it is always a mistake to try and anticipate the chart. Even if a low is developing, there is unlikely to be a buy signal until next year. Until then we must wait and be patient.

Pacific ex Japan relative to world: currency adjusted

- The Pacific region ex-Japan is as usual the best performing region of the world. This is a continuing story and will remain so for many years to come as a result of its much stronger growth. The people are workers and savers, not spenders. They will in time also have strong currencies to back them so investors will get a double benefit. We are bulls here and wish to use setbacks as buying chances. China has temporarily slipped to below the UK and this will set up a buying chance in due course – but not quite yet.

Latin America relative to world: currency adjusted

- This is still the second strongest region. Currently Peru and Chile are in the very strongest category. Brazil slipped to neutral during the run up to the Presidential election. Unexpectedly it has gone to a second round and there could be further wobbles until we get a clear result (although Ms Rousseff is still expected to win). We expect Brazil to rise up the rankings again and, along with India, remains our favourite market for long term investment. At the other end of the spectrum, Venezuela remains the weakest market in the entire table.

Global stock markets ranked by quintiles in dollars

Country	Quintile	Above 25D Moving Average	Above 200D Moving Average	Upward Sloping 25D SMA?	Percentage Change (US $) % 1 MONTH	AVG	3 MONTH	AVG	12 MONTH	AVG
Philippines	++	✓	✓	✓	18.8		29.0		60.0	
Peru	++	✓	✓	✓	15.8		24.8		19.8	
Turkey	++	✓	✓	✓	14.6		24.5		39.3	
Thailand	++	✓	✓	✓	9.3		26.4		48.8	
India	++	✓	✓	✓	16.1		15.7		28.0	
Chile	++	✓	✓	✓	9.6		29.7		59.2	
Poland	++	✓	✓	✓	13.0		26.5		13.8	
Indonesia	++	✓	✓	✓	12.6	13.7	18.4	24.4	57.0	40.7
Sweden	+	✓	✓	✓	15.8		20.4		22.1	
Australia	+	✓	✓	✓	15.5		18.2		12.1	
South Africa	+	✓	✓	✓	13.6		14.7		22.7	
Israel	+	✓	✓	✓	11.5		16.8		24.3	
Colombia	+	✓	✓	✓	3.3		19.9		35.0	
Malaysia	+	✓	✓	✓	5.2		14.7		36.2	
South Korea	+	✓	✓	✓	12.0		12.4		15.6	
Singapore	+	✓	✓	✓	8.2	10.6	13.5	16.3	26.6	24.3
Denmark	o	✓	✓	✓	12.7		12.4		12.5	
France	o	✓	✓	✓	14.4		15.7		-8.8	
Argentina	o	✓	✓	✓	9.9		12.3		21.4	
Hungary	o	✓	✓	✓	13.4		24.4		0.3	
United Kingdom	o	✓	✓	✓	9.4		15.0		7.4	
Brazil	o	✓	✓	✓	7.6		11.6		17.6	
Belgium	o	✓	✓	✓	12.1		15.9		-3.4	
Austria	o	✓	✓	✓	11.5	11.4	16.2	15.4	-9.5	4.7
China	-	✓	✓	✓	1.8		17.4		32.7	
Netherlands	-	✓	✓	✓	13.6		12.4		0.4	
Switzerland	-	✓	✓	✓	7.9		11.3		6.4	
Hong Kong	-	✓	✓	✓	7.6		7.0		7.3	
Spain	-	✓	✓	✓	10.9		19.6		-18.6	
Germany	-	✓	✓	✓	12.4		12.0		1.4	
Taiwan	-	✓	✓	✓	8.0		11.5		16.2	
Canada	-	✓	✓	✓	5.5	8.5	5.2	12.1	13.6	7.4
Egypt	--	✓	✓	✓	4.3		7.2		-5.3	
Mexico	--	✓	✓	✓	8.9		3.0		21.9	
United States	--	✓	✓	✓	7.3		6.3		7.5	
Russian Federation	--	✓	✓	✓	4.4		5.7		18.8	
Italy	--	✓	×	✓	10.7		12.4		-18.8	
Czech Republic	--	✓	✓	✓	5.3		14.6		-5.9	
Japan	--	✓	✓	✓	4.3		2.2		0.6	
Venezuela	--	✓	✓	✓	2.0	5.9	1.5	6.6	-36.1	-2.2

Ranking and data in US Dollars

United Kingdom

Déjà vu all over again

The last time the market bucked the seasonal trend in September was in 2007, just before the crash.

The seasonal deviations are built into our road map forecasts. They are, of course, based on average numbers, which are generally a good guide but, as any jockey with a form book knows, there is no such thing as a racing certainty.

The seasonal patterns still point to a fall back, followed by a good year end rally. This will probably follow the US market, which normally does have a good rally from the mid-term elections (which are on 2nd November). But, as the markets will be anticipating a bad result for the Democrats ahead of the election, a low very late in October still seems to be a reasonable expectation. However, we cannot rule out the low not occurring until late in November. Again, this has happened before even though it is not the usual seasonal pattern.

Markets were oversold in July but then flipped the other way to become overbought in September. Like the US, the UK market was encouraged by comments from the Bank of England that they were concerned at the pace of the economy and could not rule out further quantitative easing.

A big positive for the UK market is that most of the larger FTSE-100 companies are well placed to profit from the faster-growing regions of the world.

On a valuation basis, the UK is reasonable without being bargain basement, but the dividend pay out looks attractive compared with many other markets.

Our view will be radically altered if the FTSE-100 breaks above the April high of 5833. If this does not occur, the probability is that it will drop back to test the support levels quite a bit below the current level.

There is major round-number support at 5000. Below this, the July low of 4800 is a significant level and a sell-off could even extend as far as 4500 but it is unlikely to go below this level.

FTSE 100 index

FTSE 100 index relative to world

Europe ex UK

Not as expected

In spite of the fact that most Americans think the entire euro region will break up, it is in fact the dollar that is the weaker currency.

The only European market weaker than the US in our ranking table is Italy. On average, the euro currency and the stock markets in this region are showing relative strength to the US.

There is a huge difference between expectations and reality. Under the 'old normal', of course, the US was the superpower and had the strongest economy. In the 'new normal', however, the US is ex- growth and so deep in debt that inflating the currency is the only way out. Overseas investors do not now want to own assets priced in dollars.

In Europe, the problems in Greece and Ireland are real and ongoing, but Europe collectively is a larger superpower than the US.

Any weakness in the euro helps the powerful German export machine, even though no such assistance is needed.

On the charts, the euro region shows marked relative strength within the western world and in doing so emphasises that the real relative strength is in Asia.

There are many options for solving the Greek, Italian and Irish problems. These do not mean that the entire project will fail. On present trends it is far more likely that the dollar will be printed into Zimbabwean oblivion than the euro. Note gold is at a new all time high in dollars but not in sterling or euro terms.

In the 'new normal' we hold western equities to collect dividends which have a higher yield than government bonds, as long as they are top quality stocks. Europe has just as many of these stocks as the US. It also has the advantage that its Central Bank is not inclined to destroy the currency by rolling the printing presses.

We should not forget that the broad definition of Europe includes Turkey, which is a strong growth market in a secular uptrend. It is up 700% from the 2000 level, whereas the larger more mature markets are well down.

European equities

European equities relative to world

Europe ex UK

France

Germany

Switzerland

Netherlands

Scandinavia

Spain

United States

Goodbye to all that

All those experts who had favoured Keynesian stimuli are going back to academia. The President has realised that, if he does not change the team, he is destined to be a quacking lame duck. He may have left it too late, but the jury is out on that.

The September jobs figures underline the economy's weakness and make another round of quantitative easing almost inevitable.

The coming mid-term elections do normally provide a turning point in the market. It is often a low but, as the Irishman said, "you can't get there from here." A low cannot form at a peak.

The very fact that the POMO has pushed the market up during September makes it unlikely that there will be a runaway rally before a setback.

The election seems certain to be bad news for the Democrats, but equally it may not be good news for the Republicans. The angry Tea party could spoil the chances of a clear win. Even though the Democrats will lose control of the House, they may retain control of the Senate. The Tea party may get just enough votes to ensure that nobody has a clear mandate.

The market might actually like this. Small ineffective government is a lot better than big government doing the wrong thing.

The one certainty seems to be that the Fed are going to keep on printing money. Interest rates will go lower and stay low for a long time. The dollar will be devalued in the process. Why would overseas investors want to own it?

Despite this bearish view, if the S&P500 index or the Dow Jones Industrial average breaks out convincingly above their April highs, we will have to accept that the road map projections are wrong and we will have to change tack. But any high at a lower level than the April peak reinforces the original predictions.

The bottom line is this. After the rally to date, the S&P index is back to levels first seen in 1998. It is down 25% from the highs in 2000 and is priced in a currency that on a trade-weighted basis is down by 30%. With the best will in the world, whatever happens this is not the market to buy.

S&P 500

Dow Jones Industrial Average

Canada

To the next level

The Canadian TSE index has broken out to a new high of the year and can run on upwards to the next overhead resistance level.

The long term chart has always been clear that Canada is in a secular uptrend. It still has the short term fluctuations which are in step with the US, but Canada is oscillating around a rising trend and the US around a falling one.

We have pointed out that the US market has rallied back to where it was in 1998 - by contrast Canada is up 76% over the same time period.

The Canadian dollar has also moved favourably by 30%. From levels of $1.50 to $1.60 that applied in the late 1990s, it has achieved parity with the US dollar.

The growth in Asia means that commodities will be underpinned (although there will continue to be sharp gyrations). Canada is resource-rich and this sector represents a significant part of the economy.

The entire world has a need to generate electricity without at the same time polluting the atmosphere. Upgrading energy efficiency essentially means switching away from coal and oil into gas and nuclear power. Canada is well endowed in both of these.

The uranium market has had a three year bear phase and this seems to be coming to end. Not only is a cyclical upturn due but the long term trend should be of a secular nature as well.

Gas is so cheap and abundant at the moment that it would be stupid not to use it. It might take some time to construct the necessary infrastructure but mains power generation will gradually switch over to gas.

The TSE index has rallied up towards the overhead resistance between 13,000 and 15,000. The present surge seems likely to extend into this area, but probably will not break out of it on the current run

If fund managers are forced to hold a certain percentage of funds in equities, Canada would feature in our list of preferred markets.

Canada

Canada relative to world

South Africa

Growing up

More people are dragging themselves out of poverty on the African continent than almost anywhere else. It does not seem to be country-specific either. Some countries are mineral rich, others not, some are thought to be corrupt and others not. Across the board they are getting richer on at least a relative basis. That cannot be bad.

South Africa is the blue chip of the continent and has been on a secular uptrend for many years. The market is up 294% since the highs of 1998. The rand did not begin strengthening until 2008 but has since appreciated 17% against the dollar.

The Johannesburg All share index is now breaking out above its recent high and is only 11% below the all time high made in 2008. Even though during the bear phase it experienced a drop of 50%, that did not invalidate the secular uptrend. New all time highs are much easier to achieve in secular uptrends.

The old high was 33,309. The index has major support below it between 26,000 and 28,000.

The main reason for buying now would be to diversify out of US dollars. The massive injection of liquidity into the market will seep outside the US and inflating fiat money will prompt a demand for real assets as a safe haven. Those equity markets that are backed by commodities should do well.

In addition to being a producer of real assets, South Africa is likely to generate considerable domestic growth.

JSE All-Share

JSE All-Share relative to world

Japan

Close to zero

Interest rates cannot go any lower in Japan. They have run out of road. We must turn in a new direction. Japan will find that it is no longer possible to issue more debt.

The legendary savings rate in Japan has declined. Mrs Watanabe is now old and retiring and needs her savings to stay alive. The demographic outlook for the nation is dire.

There seems to be no alternative than to create inflation. Japan will print yen and continue to intervene in the currency markets.

Many other countries want to try to do the same thing, but they cannot all get away with it. Japan has managed to do this by dint of the fact that most of its government debt is owned by domestic investors so it is not in hock to the international markets in the same way that a country like Greece is.

If the yen depreciates, equities are likely to rise. Priced against gold, they may not go up but they will help survive the drop in the yen.

The Japanese stock market has been in secular downtrend since 1989. Although the west thought they would never go down this track, in fact they seem to be doing so which means they could have another ten years to go. As Japan is way ahead on this track, it may well end its secular trend soon.

In practice, the Nikkei index will hit resistance at 10,000 and will probably fall back again. However, in the New Year, from a level of between 8,000 and 9,000, it could emerge from the old secular downtrend and start a new cyclical uptrend.

If this happens, the yen will be extremely weak, but stocks will be strong.

It is important to remember the yen will not be weak against all currencies. There may be no need to hedge the currency from a US dollar base – Mr Bernanke's printing press will be working just as hard as that of Mr Shirakawa's at the Bank of Japan.

If paper money is worth close to zero then equities have a value by comparison.

Nikkei 225

TOPIX

India

Doing what it should

We may have been wrong about western equities falling in September, but we are correct about India. This market continues to do what it should. The road map projections are working well.

This has long been our favourite stock market. If we are in, or soon enter, a period when equity markets surge ahead, then it will still not be mature western markets that we should buy. It is the best markets of Asia where all the growth is going to take place.

In the 'new normal' we clip dividends in good western companies, but we get growth from Asian ones. The trick is not to pay too much for that growth, but rather to use setbacks to increase holdings.

India is on the road map in secular uptrend. It is moving in the leg X to Y (see page 25). Notice that this leg is made up of a rally, followed by a setback, then the rest of the rise.

We are in the last part of that now and the prediction has always been that the index will go above W. That is the present rise should make a new all time high. The all time high for the Sensex index was 21206. The present surge should exceed this level.

The road map then expects a fall back to around the rising four year moving average. This might be met between 16000 and 18000. This will be the new A and the start of the next up cycle.

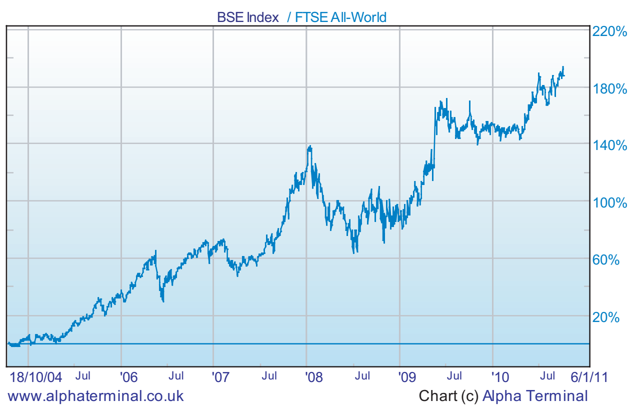
This new A will be the last chance to buy into this market at a reasonable level. It is vital to then be in with a good sized position. Do not be distracted by wasting your time with western markets.

As time goes on, this market should make much higher levels and be supported by a strong currency. It is quite normal in this type of trend to make the double whammy of both market and currency gains.

Twenty years from now the benchmark indices will be putting 30% of global money into this market, even though they only have a tiny amount invested now. We wish to be invested ahead of this development. There is no point being in behind the curve.

India

India relative to world



Pacific ex Japan

The real deal

These markets are simply the best. For ten years these are the places you should have been invested in and they will continue to be the best place for the next ten years as well, and probably even longer than that.

We wish to own markets where people work, make things, and save and prosper. We do not wish to own markets that destroy wealth for ten years and are only able to rise when goosed up by open market operations. On top of which they are priced in a currency that is being printed into a valueless condition.

There are no mature western world markets in the top two categories of our ranking table, which compares the performance of 40 world markets technically. All of the top performers are either in Asia or Latin America.

In almost all cases the story about the underlying economy and that of the stock market are in synch. This is not so for China.

The Chinese market is in corrective mode from the incredibly high level achieved at the time of the Olympic games. It still needs to fall some more, even though it is already 70% off its high. If the Shanghai Composite gets back to under 2,000 then it will have reached a level where we can buy it again.

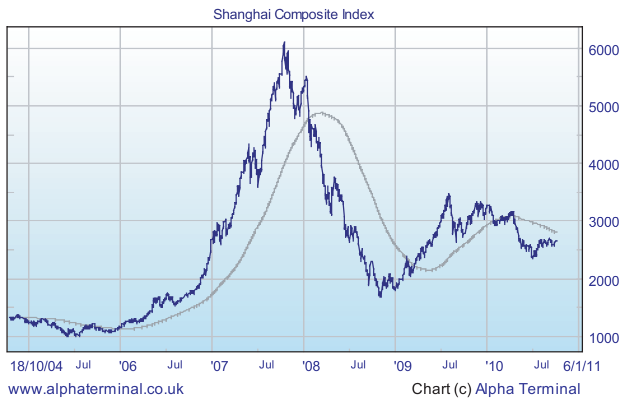
Meanwhile the top performer for the moment is the Philippines with Thailand, Malaysia, and Indonesia close behind. Owning a fund for the region would be a good way to play this region.

Technically, India comes into this group, but we would prefer to own India separately in a dedicated fund.

We need to stop regarding these markets as foreign and dodgy. They are, in fact, the real deal, where billions of people are working hard to drag themselves out of poverty. It is much better to invest here than in the mature, ex-growth and deeply indebted west.

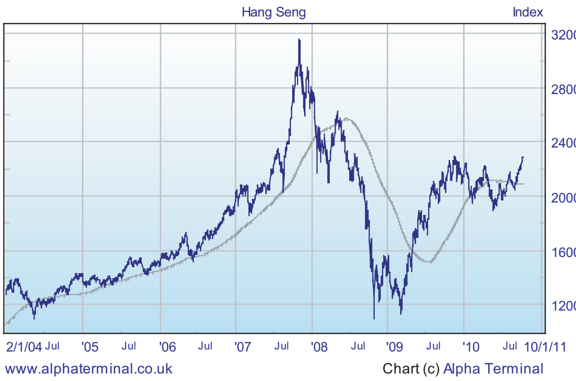
Australia

China



Pacific ex Japan

Hong Kong



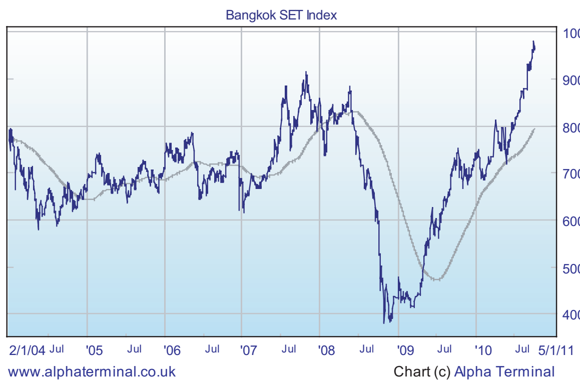
India

South Korea

Malaysia

Taiwan

Thailand



Emerging markets

New high break out

A break out to a new all time high is always and everywhere a buying signal.

We are getting this in Turkey now. We should go with the flow.

We are close to a similar signal in Israel.

Otherwise it is the smaller markets of Latin America that are trending up, having made new highs earlier.

The major markets like Brazil, which is a long term favourite, are currently in consolidation mode. This does not make them a sell, but they have not yet given the next urgent buy signal.

The road map to use for these markets is one in secular uptrend. Brazil is just about at the same place on the map as India, but lagging a little behind.

The forecast is therefore that it will break out and run on to a new high. This will be point Y on the map. It should then fall back one more time to point Z. This will be the last time to get in at a sensible price.

The old world has turned on its head in that the markets that used to feel safe and solid, are now in debt and backed by flaky currencies.

All those markets that used to be thought of in that way now have all the growth and, furthermore, they are not in debt and have strong currencies.

If the world is about to endure a burst of inflationary pressure as the big governments print their fiat moneys, much, or most, of that money will end up in the emerging world.

This just reinforces a theme that was already underway. Buy the new high break outs.

Brazil

Russia

Emerging markets

Emerging markets index

Mexico

Chile

Turkey

Eastern Europe index

Poland

Bonds

Does this make sense?

It only makes sense for bond yields to be this low if the western world is in a depression. Well guess what? That is a good description of life in Motown.

If you think that 2.4% is too low a yield for a ten year note and 3.6% too low for a 30 year one, take a look at Japan. It is possible for yields to go to zero.

The message on the charts is clear. We should not get excited about western equity markets rising in September. As mentioned earlier, they are only back to where they were in 1998. Furthermore, they are priced in dollars, the value of which has declined by 30% on a trade weighted basis over this period. You should not have been overweight in equities then, and you should not be overweight them now.

If, instead, you had been in bonds, you would have a proper pension plan. Even if you had only bought them as recently as last April you would have made a gain of 40%. The real bull market has been in bonds – not western equity markets.

The chart has not yet signalled an end to the bull move in bonds. If, however, yields do not make new lows below the 2008 lows (2% for the ten year, and 2.5% for the 30 year) and begin to turn up this will be the first signal of a reversal. But we would not get a clear signal of the end of the bond bull run until there is a break above 4% on the 10 year yield and 4.8% on the 30 year. This would flag an upsurge of inflation.

It is possible that we are going to get a burst of inflation as many central banks compete to print paper money.

If this happens, it is one of the few reasons I can think of that would justify a continued rise in the western stock markets. They would be rising to hedge the inflationary risk. They will still lose out in real terms but they would cushion the wipe out. This even happened to a limited extent in Zimbabwe.

In practice, in the new norm we should still hold some bonds for income. We will also hold some superior franchise equities in the west, just to collect the dividends. Growth will come from Asia while gold and silver are the inflation hedges

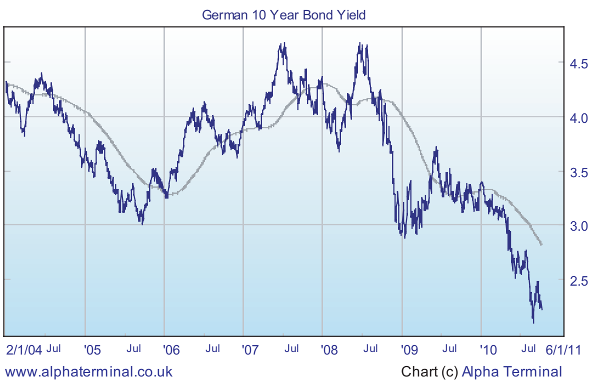
US Treasury bond 10 year yield

Bonds

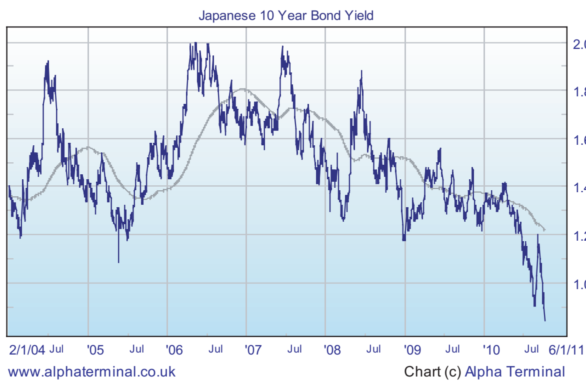
US benchmark bond 30 year yield

UK benchmark bond 10 year yield

German benchmark bond 10 year yield



Japan benchmark bond 10 year yield



Commodities

Real money

When they print too much paper money, it is real assets that go up in value. All commodities benefit to some extent.

Gold and silver are real money, and have been so for thousands of years.

Some people regard them as barbarous relics and do not see the merit of owning them. Since 1980, the price of gold in dollars is only up 128%, which is not that good, and the price was falling until the year 2000, so they do have a point.

However, since then the price is up 414% over the past ten years, 188% in the last five and 33% in the past one year. Just in the last two months gold has risen 17%. If your portfolio is doing better than that, then you do not need gold. If you have not done that well then maybe you should think again.

Silver tends to rise at a greater rate than gold once it gets going. Over long periods of time the ratio of the price of the two metals tends to mean revert. It has just started to move in favour of silver, which had been lagging. On normal form we should see both metals rise but with a chance that silver will have four times as much upside.

If we really are going to get a burst of inflation, all commodities will rise. The CRB index had been in a consolidation phase, but has broken upwards. If inflationary pressures do not start to gain traction, this index will fall back again into its recent trading range.

The confusing thing is that the bond market sees depression, but the equity markets think they see inflation. They cannot both be right at the same time. It is possible that we will live with disinflation for a while longer but then snap suddenly to inflation as a result of printing too many dollars. And it is not only the dollar that is being printed. The real message is that there is an increasing distrust of paper money. What people want is the real thing.

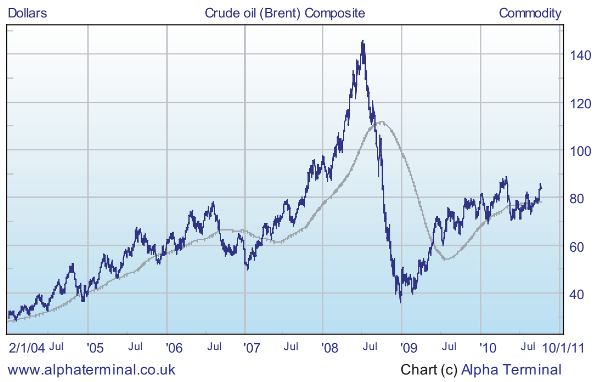
Commodity price index

Gold

Commodities

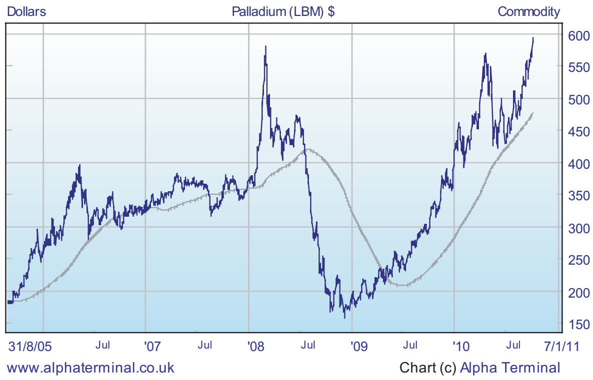
Platinum

Oil

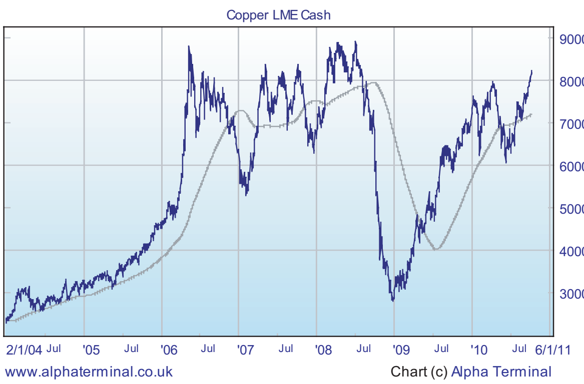


Silver

Palladium



Copper



Aluminium

Currencies

The dash to trash

There appears to be a competition to have the weakest currency. Several central banks are trying to conduct quantitative easing at the same time in order to make their countries' exports more competitive. They cannot all win at this game however.

One message that the markets have taken to heart is that the US dollar is on its way to trash status. This is why gold and silver and many other real asset classes are rising so strongly.

If, however, the markets get the idea that QE2 has already been done by using POMOs (as described earlier), they may start to panic and suddenly the dollar would rally again.

On the trade weighted dollar index, 77 is a critical point. It has retraced the maximum Fibonacci ratio of the move from the lows last December at 74 to the highs at 88.7 in June. If it drops any more it will go the whole way back to 74 again. If it is to have a rally then this should start fairly soon.

If equity markets stop rising and drop back, the dollar would rally. Gold and silver would also pull back from their new all time highs. Although we have been expecting this, it has clearly not happened yet. It is important to realise that the rise in US stock markets is more than offset by the fall in the dollar, making then uninteresting to overseas investors.

The Japanese have every reason to weaken the yen. They probably have no choice, so they will pursue this course of action with greater determination than many others.

In the end China and some of the other emerging countries will probably allow their currencies to gently appreciate, but at a controlled rate.

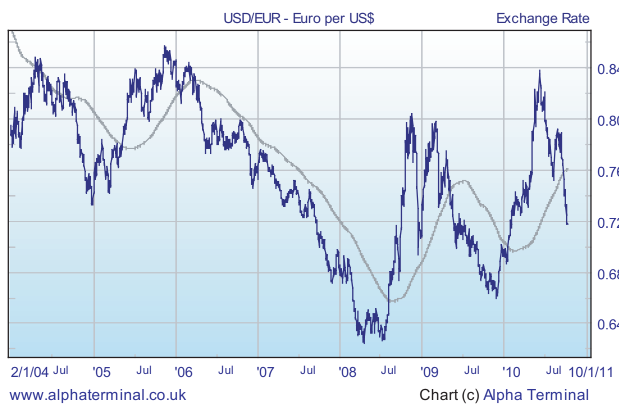
Those currencies backed by metals and resources all look certain to rise, as long as the local politicians do not make a complete mess of it. The Australians have tried hard to do this, but so far have failed.

Sterling is creeping up against the dollar but we do not see a big move developing. The UK and US are to some extent in the same boat.

The biggest bubble being blown at present is that in paper fiat money. We have had enough of it and we do not want any more. Anything priced in dollars is toxic waste. Apart from a possible short term rally, we are sellers. The currencies we like are in Asia and emerging markets. They are the future and not history.

US dollar: trade weighted

US dollar/euro



Currencies

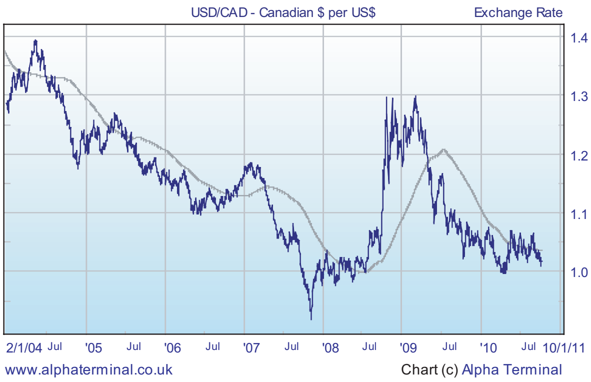
US dollar/Japanese yen

Euro/Japanese yen

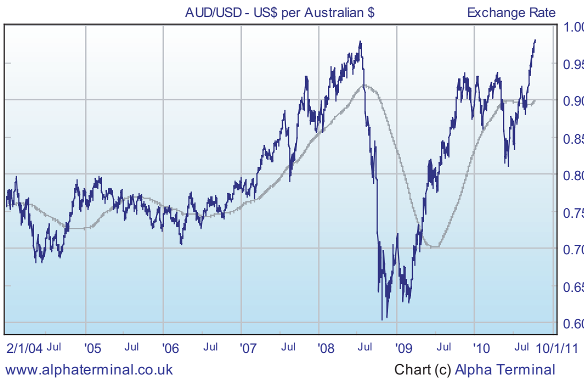
Sterling/US dollar

Sterling/euro

US dollar/Canadian dollar

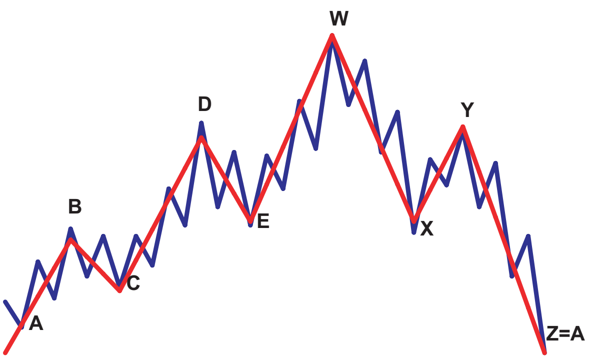


Australian dollar/US dollar



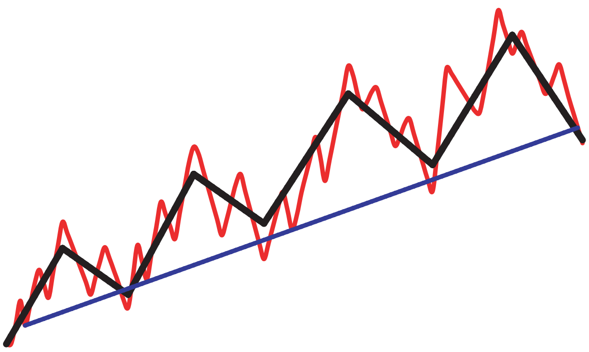
Road maps

Standard road map



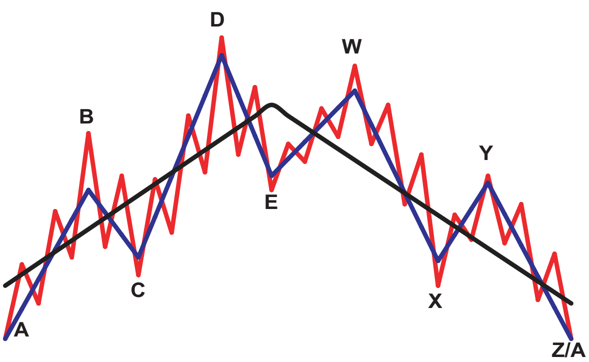
These road maps are the basic shape of a so called Elliott Wave. We deliberately letter our maps differently from Elliott aficionados. The normal time scale for a complete cycle is four years driven by the Kitchin wave. The bull phase has three surges getting progressively more powerful. The bear phase is a fall, followed by a rally, followed by the rest of the fall. Big waves are composed of smaller waves of exactly the same basic shape. In practice, the waves we wish to trade can be traced out as the Index moves away from and back towards the 200-day moving average. If it is below that average, then it is a bear market.

Standard road map skewed by secular uptrend



The standard model can be distorted positively by a strong secular uptrend. The small waves tend to take the same amount of time, but there is always an upwards bias. Even in the bear part of the cycle, a new high might be made and the next drop back is the end of the correction. The rule on this road map is always buy the dips as long as it is clear that the underlying secular trend is still valid.

Standard road map skewed by secular downtrend



The basic map can also be distorted negatively. This, in practice, makes the bull part of the cycle very short and stunted. It also has the effect of lengthening the down part of the cycle. The rule here is always to sell the rallies. The secular trends that perform these distortions last for multiples of the four year cycle. Trends of 16 to 20 years are quite normal. On rare occasions they can be longer.

Source: Robin Griffiths based on Schumpeter

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