Global Report –Nov/Dec 2010

UK

Europe

US

Japan

Emerging Markets

Bonds

Commodities

Currencies

Nov/Dec 2010

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.

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

World Investment Strategy

Where are we now? That is the question. We do know that we are not in circumstances that could be regarded as the "old normal". Unfortunately the exact terms of the "new normal" have not been spelled out.

It is very unusual to find bonds, equities and gold all going up at the same time but recently almost all asset classes have done this. It seems that excess liquidity is going equally into the different asset classes, so that in effect there is only one market and only one trade – risk on or risk off.

The reason for this is that politics have intruded into economics to a far greater extent than we have been used to. The US Fed is not the only central bank to be printing money. They have printing presses and helicopters in China as well. The fact is that even in countries considered to be bastions of capitalism around 50% of people are dependent on the state for income.

Under the old normal, the month of September was traditionally the weakest month of the year. It was not so this time because the Fed poured billions of dollars into the market by using Permanent Open Market Operations (POMO).

After late October in a normal year the market picks up again into the strongest six months. However, as the usual seasonality is out of kilter, we may not get our year end rally.

On the four year cycle, which is driven by the Presidential elections, we are now in a very favourable period. It is after the mid-term election that the cycle turns up.

Our own road map (see page 25), which shows the shape of a bull and bear cycle round the four year pattern, also indicates this is a positive period – at least until March 2011.

If we were on what we describe as the standard road map, the four year low should have been in March 2009. We have just passed point E. We should then have a run up through next year, topping out in early 2012. The next bear phase would begin in 2013.

However, we have always argued that western markets are in a secular downtrend. In which case, the rise only lasts into next year and the fall takes place earlier. On this road map there is a high probability of going back down to the lows of 2009. In a worst case scenario it may even go lower.

The major question is, "has QE2 been able to drive markets back to the standard pattern or not?" We do not yet know the answer but it may not matter. Much of the money produced by the Fed's printing press goes overseas, driving up our preferred markets to even higher levels than we thought they would go.

We still come down long of gold and silver and positive about the markets of India, China-related and Brazil.

If we plot the rise in the US stock market in euros, or more importantly Swiss Francs, it has been falling. Overseas investors cannot make money buying US dollar denominated stocks as the currency is being "trashed" quicker than the market can rise.

If we read the history of the decline of great powers, their demise is normally the result of an attack by an invading barbarian, such as Attila the Hun. In the case of the US, power is slowly ebbing away due to a realignment of the geopolitical plates. But the US authorities are accelerating this process by deliberately driving the dollar lower.

The bottom line is this. We are in times when politics are overriding economics and the "normal" market cycles. The North Koreans' sabre rattling has unsettled investors while in Europe political expediency has prevented a collapse of the Greek and Irish financial sectors.

Major trends are being driven by political considerations and so many of the normal rules of technical analysis may be temporarily suspended.

Summary: world market overview

"When all around have lost their heads, 'tis folly to be wise."

Markets are rising, but they are being driven by injections of truly huge sums of printed money coming from central banks, especially the US Fed.

We know that it is unwise to fight the Fed. But the Fed itself is now under pressure. The Democrat losses in the mid-term elections mean that the Fed will not have its QE2 confiscated, but any idea of QE 3, 4, or 5 may be cancelled.

Currency wars are upon us. It is a brave man that thinks he knows where this war will end. Restrictive barriers are already coming into place. If history is any guide, this negative development will end very badly indeed if it is allowed to continue.

The really big debate is about inflation or deflation.

In the west – and especially the US – we are likely to see unemployment at a structurally high level for many years to come, and house prices have not bottomed. They probably have another 20% to fall.

The only way out of the defaulting problem, which is complicated by having to unscramble complex debt instruments rather than straight forward title to deeds, is to change some laws. This may happen, but it takes time. Without this fix, the problems are huge and the banks are not yet out of the mess. The second shoe in the banking crisis is still to drop. The share price of Bank of America has fallen 40% since June.

Meanwhile much of the money that the Fed prints goes overseas and blows inflation bubbles there. On the 18th November the Fed carried out its biggest POMO yet – $8.5bn. This is in addition to QE2.

The problem is that in the west the Fed is worried about the prospect of deflation whereas in Asia they have inflation right now. There are good economists arguing the deflation case. Gary Shilling and David Rosenberg come to mind. However in Asia, the Chinese, and Indians are acting to cool the inflation that they are already experiencing.

Can we really have the east inflating and the west deflating? Is the world not too joined up for such divergence?

The best outcome that can be achieved is that the west in general – and the US in particular – will bump along for many years at sub-par growth. GNP will be positive, in the range 1.5% to 2%, but there will be regular recurring crises. Some will stem from high unemployment issues, others will come from bank or even sovereign debt crises, but, on balance, we will muddle through.

There will be cyclical bull and bear phases but within a secular trend that is mildly negative and going nowhere. The alternative to this is a break down and a depression. All of the Fed's actions are justified if they succeed in avoiding a depression. Unfortunately the price of this success is the depreciation of the dollar.

The Asian economies, especially China, must – and will – move away from just making cheap goods to sell in America. They will need to allow wages and their currencies to rise. The latter will probably edge up at a modest rate of 5% a year. In this way we can just about muddle through.

A new currency matrix not dominated by the dollar will also have to form.

The World at a glance

Major markets

US relative to world: currency adjusted

The US has pulled up the ranking table and is now in the neutral category. However, only the very top category has actually made money in the last month. The relative trend for the US is not especially weak and it is, of course, boosted by the recent strength of the dollar. As it is still the major global currency, it benefits at moments of panic, such as the problems in North Korea, from its safe haven status. If we enter a period in which investors decide to be risk adverse, the dollar would continue to rally but the underlying market would itself be vulnerable to selling pressure.

UK relative to world: currency adjusted

The UK is just below the US on the ranking table and is in modestly negative territory although the trend of relative strength to the world index has risen above its long term moving average. What this indicates is that the UK has actually been consistently a little stronger than the US up until the Korean panic. Then sterling dropped and UK saw profit taking, while the dollar rallied. We do not know if this change is the start of a new trend for sterling or just a one- off fluctuation. Previous sabre rattling by North Korea has not lasted very long, and the earlier trends have then resumed.

Europe relative to world: currency adjusted

Germany has powered up to the top category of our ranking table, reflecting the fact that the economy does well when the euro is weak. This is just as well as it is by far the biggest economy in Europe. The burden of saving its weak euro brethren falls squarely on Germany but the economy is up to the task. There is no immediate risk of the euro breaking down against other currencies. The Korean situation has produced more of a knee jerk reaction than either Ireland or Portugal, where there is now a general strike. In this region we prefer to hold German and French stocks rather than others.

The world at a glance

Japan relative to world: currency adjusted

- The relative for this market is still negative but it has limped up the rankings to just below the UK. But, if the Korean situation is not solved rapidly, Japanese equities are likely to come under selling pressure, pushing the market back down the table. The yen has been strong to date but again that could change quickly. The risks are very high and we prefer not to play this game if we do not have to.

Pacific ex Japan relative to world: currency adjusted

- The region as a whole still looks good and it must be hoped that the North Koreans are not allowed to cause enough trouble to undermine the long term uptrends. China is in a position to provide a calming influence behind the scenes. If it fails to do so, then risks could suddenly seem much higher prompting a collapse in confidence. There is no way of predicting the outcome of this situation and so we would not advocate taking aggressive positions in the short term. But the longer term economic theme remains intact.

Latin America relative to world: currency adjusted

- Several of the smaller Latin markets are at the top of the ranking order. Mexico is the largest now in this group. Brazil, our long term favourite in this region is currently having a consolidation phase and has slipped down the table. It has just dropped 7% in the last week. This is normal volatility for these markets, and has not stopped the long term trends remaining very positive.

Global stock markets ranked by quintiles in dollars

Country	Quintile	Above 25D Moving Average	Above 200D Moving Average	Upward Sloping 25D SMA?	1 MONTH	AVG	3 MONTH	AVG	12 MONTH	AVG
Argentina	++	✓	✓	✓	13.9		32.6		39.8	
Peru	++	✓	✓	✓	8.0		36.5		43.6	
Indonesia	++	✓	✓	✓	4.1		20.6		59.8	
Mexico	++	✓	✓	✓	4.8		17.5		27.0	
Thailand	++	✓	✓	✓	2.8		20.1		62.9	
South Africa	++	✓	✓	✓	3.4		21.7		26.4	
China	++	✓	✓	✓	4.8		21.5		13.3	
Germany	++	✓	✓	✓	0.9	5.3	21.9	24.0	10.4	35.4
Taiwan	+	✓	✓	✓	4.4		11.4		16.5	
Chile	+	✓	✓	✓	4.9		16.1		56.0	
South Korea	+	✓	✓	✓	2.3		15.1		23.5	
Turkey	+	×	✓	×	-6.1		20.8		54.8	
Denmark	+	×	✓	✓	0.4		17.1		16.9	
Singapore	+	×	✓	✓	0.6		13.7		23.6	
Poland	+	×	✓	×	-1.4		17.6		11.9	
Hong Kong	+	×	✓	✓	0.2	0.7	12.4	15.5	4.7	26.0
Philippines	o	×	✓	×	-3.8		19.3		46.1	
Austria	o	×	✓	×	-1.4		19.7		-3.2	
Canada	o	✓	✓	✓	3.5		13.9		17.6	
Malaysia	o	✓	✓	×	1.2		9.2		28.7	
Australia	o	×	✓	×	0.9		17.8		8.6	
United States	o	✓	✓	✓	1.4		12.0		9.9	
Israel	o	✓	✓	×	-0.4		14.5		22.9	
India	o	×	✓	×	-2.8	-0.2	11.5	14.7	20.3	18.9
Russian Federation	-	×	✓	✓	-0.5		12.3		11.4	
United Kingdom	-	×	✓	✓	0.7		12.4		4.4	
Sweden	-	×	✓	×	-4.0		17.0		17.6	
Japan	-	✓	✓	✓	3.6		9.9		13.1	
Netherlands	-	×	✓	×	-1.9		15.5		1.2	
France	-	×	✓	×	-3.5		16.2		-6.1	
Belgium	-	×	✓	×	-4.0		15.6		-2.4	
Venezuela	-	×	✓	×	-1.2	-1.4	2.1	12.6	-37.9	0.2
Colombia	--	×	✓	×	-9.3		7.4		40.1	
Switzerland	--	×	✓	×	-0.8		10.4		7.0	
Czech Republic	--	×	✓	×	-2.7		4.7		-4.6	
Egypt	--	✓	✓	×	2.1		8.5		7.4	
Brazil	--	×	✓	×	0.4		9.0		7.5	
Italy	--	×	✓	×	-7.6		10.0		-17.1	
Hungary	--	×	✓	×	-6.1		10.8		-3.2	
Spain	--	×	×	×	-11.1	-4.4	5.1	8.2	-23.4	1.7

Percentage Change (US $) %

Ranking and data in US Dollars

United Kingdom

None but the few

The UK stock market is fortunate in that it is dominated by 16 huge companies, which only get 20% of their earnings from this country. The outlook for these stocks is better than that for the broad economy – which is likely to experience tough times.

On the charts the road map for a market in secular downtrend but enjoying a cyclical uptrend was working perfectly until September – normally the worst month of the year. But this year the index was driven up by the excess of liquidity.

We are now entering the time frame when our road map turns positive again. The six months from late October to late May are normally the best of times. It is normal to start that rise from a low point, and very unusual to start from a high, but then again, we are living in abnormal times.

If politics do not completely override the road map again, the markets should stay on a positive footing. The type of political event that could rock the boat would be a default in Greece or Ireland. The point is that politics can and will from time to time distort the normal market cycles. We think a 'muddle-through' outcome will be achieved. But this is an act of faith not a chart reading.

The FTSE-100 index did briefly go through the April high but, so far, it has not been able to secure a firm foothold above this level. The key breakout level is now 5902.

On the downside, support from the 200-day line is at 5432, with major round-number support at 5000. This is now 14% below current levels and is where we may have gone in September without central bank intervention.

The market is currently range bound between these various support and resistance levels. But, if a confirmed new high breakout is achieved, it will indicate that we are back on our road map and a rise through to at least March next year should be anticipated. This scenario would involve a new low being established above the old high, confirming that the high really had been broken.

The type of stocks we prefer are the giants with strong franchises that pay higher dividends than the coupons available on Gilt-edged securities. Investors who cherry pick good smaller stocks will make bigger percentage gains, but we think the risks will be disproportionally high. We try to be brave but not foolhardy.

FTSE 100 index

FTSE 100 index relative to world

Europe ex UK

Once more unto the breach dear friends

The entire European project is in jeopardy but can be saved by an act of political will. Loss of face may be an Asian concept but it has resonance in Europe too.

It could take a generation for a Federal United States of Europe to become a reality. It has been the goal of politicians, if not the public, and it remains to be seen whether the markets and electorate will allow politicians the time to bring it to fruition.

It took the US about 60 years to forge a single dollar, why would it not take the Europeans at least as long? This will be a journey with many bumps in the road and it may even not reach its final destination.

It follows that the "little local difficulties" have to be sorted out as and when they crop up. We will then muddle along until another crisis blows up but for the time being the show goes on.

The Irish know that their "Tiger" period was driven by very low taxes. They also know that their future will require this to continue. Therefore the problem is being presented as a banking crisis and not a sovereign crisis.

In Greece it is the other way round. It is entirely possible that Greece goes back to the drachma for a period of years, on the understanding that they can come back again at a later date. This would not break up the entire euro project, but would be seen as a regrettable but necessary interlude.

All these problems do sometimes weaken the euro on the international currency markets. This plays to the advantage of German exporters. Their biggest risk is a sharp cooling down in China but, even if this occurs, it is only likely to be temporary.

Some fundamental economists have argued that Germany is entering a powerful virtuous circle. Its economic strength is the backbone of the euro project. If they have the will to carry the show, then they can afford to do it. The political aspect is more dominant than the economic one. But what would scupper the project is if Germany finally lost its patience at the fiscal indiscipline of some of the peripheral members.

There are plenty of stocks like Deutsch Telecom that are safe franchises and the dividend yield is over 7%. That level of return – and you get your money back – is part of the "new normal".

European equities

European equities relative to world

Europe ex UK

France

Germany

Switzerland

Netherlands

Scandinavia

Spain

United States

The name of the game

Mr Bernanke has said that he thinks QE is an inappropriate description for what he has been trying to achieve. He does not prefer "Multiplication", but rather "Asset Purchases".

The plan is not to deliberately destroy the dollar but rather by buying certain assets improve their price. In this way he will activate a wealth effect and so encourage more economic activity.

It is acknowledged that the level of unemployment (and underemployment) is way too high, and risks becoming structural. This is unacceptable.

The Fed also admits that there are limits to what it can achieve alone and encourages support measures. The inference being that the Bush tax cuts may well be extended, rather than being allowed to expire at the end of the year.

It is also clear that QE is causing ripples on the currency market. Some of the liquidity is seeping overseas, causing inflation in Asia. This could partly be solved by movements in the currencies i.e. the dollar goes down while the renminbi and rupee go up, at least on a relative basis. It is also possible that a globally co-ordinated currency special drawing rights could be set up.

US equities were conforming to the road map for a market in secular downtrend very neatly until September. At this point the market zigged rather than zagged due to the Fed's POMO operations.

The S&P did briefly rally through its April high but could not sustain the break. There is now resistance at 1227 and support at 1129, the 200-day line, and below that at the August lows of 1050. The index is currently range bound between these levels.

If the Fed has been able to get the index back onto a standard road map, then the four year low was in March 2009 and we have just passed point E. The index would then rise through next year, topping out in early 2012 and 2013 would be the next bear phase.

Even on our road map for a market in secular downtrend, there should be a rise until at least March 2011, and just possibly May. However the fall then sets in earlier and lasts for longer than normal.

The problems in the housing market and the fact that the average consumer is still increasing their savings may be the factors that decide this. Our negative spin comes from the belief that more cockroaches are likely to emerge from the housing sector.

S&P 500

Dow Jones Industrial Average

Canada

Glowing in the dark

The merits of some things cannot be hidden. The truth will out.

The Canadian stock market is in a secular uptrend on our road map. It is lagging slightly, but not by much, behind South Africa and India.

The high in 2008 was W and the low in 2009 was X (see page 25). The map predicts that the rise to Y should have a special shape to it. This involves a rise, then a long consolidation phase or pull back, followed by the rest of the rise.

On this count we have just entered the last part of that pattern. In many markets, like Mexico, this leg will make a new all-time high. That would be the “norm” for a secular uptrend. But, in the case of the Canadian market, the rate of rise is not so steep and the resistance overhead at the old highs looks quite formidable.

The old high on the TSX index is 15,154, but there is a lot of resistance below that around the 14,000 level.

We are positive about the outlook for gold and silver shares and Canada has plenty of these. They should come into play now.

Gas is one of the cheapest sources of hydrocarbon energy and it will therefore be increasingly used by consumers and companies looking to reduce their costs. But no buying signal has, as yet, been given. Gas itself and Encana, the major stock in this sector, are bumping along. If they break up, we would buy, but for now we must be patient.

We are very keen on uranium. It has completed a three year bear phase and is now breaking out. The urgent need for clean power means that Asia will build many more nuclear plants and they will need to be provided with fuel on long term contracts. We have mentioned this before but now the story is really on the boil. We have long used Cameco as a core holding and bell wether for exposure to this market. It is doing all the correct things now. There are other good ways to play this. One way or another we need a position in Uranium resources.

Canada

Canada relative to world

South Africa

Africa is on the map

The entire African continent is now on the map for investors. Some of the fastest growing economies are here. South Africa is not the fastest growing of these markets but it is the blue chip.

The JSE Index is on our secular uptrend road map. It has been on it for years and is 300% higher than it was in 2000 – when western markets entered secular downtrends.

In line with India and Brazil, it is currently in leg X to Y (see page 25). We expect a new high breakout soon and this should run up to point Y. The old high was 33,309 so Y should be above that.

The map then expects a fall back again. It would be normal to make a new low above the old high to confirm the breakout. This would then establish point Z which is a new A for the start of the next cyclical uptrend, still in the presence of a secular uptrend.

In practice, the map allows for the fall back to come below the old high, back to around the 28,000 level, which was the level of the last major consolidation phase.

As to timing, the present rise should go on until about March next year and then we would anticipate the fall back. So this should be a propitious time to start buying.

We remain bullish on gold and just now are seeing new high breakouts in the mining stocks as opposed to the bullion price. This should underpin the South African market.

JSE All-Share

JSE All-Share relative to world

Japan

Is this a dagger I see before me?

The number of times people have tried to hit the bottom in the Japanese market, only to get cut by the falling dagger, is legion. Do we have another such situation now?

The Nikkei index has rallied strongly and is just cutting up through the 200-day moving average.

It has hit and just passed the resistance at 10,000. This is not yet a confirmed breakout, but it does suggest upside potential.

At the same time, the yen has weakened against the dollar, which is now above the rising 20- and 50-day moving averages

Finally, the best and biggest stocks in the market are very cheap by any standards, not just Japanese ones.

It is very tempting to get excited and do some buying in anticipation of the end of the 20-plus year secular downtrend. There is, however, still a risk that you will cut your wrist and sustain a nasty injury.

The negatives are that the legendary Mrs Watanabe is now old. She needs her money at home where she is facing hefty health bills.

The overall demographic position is massively negative. The population is both ageing and shrinking. The whole economy is going to get smaller.

There may be no alternative but to print yen as fast as dollars are being rolled out. Overseas investors are faced with an almost certain currency loss upfront before they even get the chance to try and make some money in the market.

Daggers are dangerous. We would like this one to be stuck firmly in the floor before we try to pick it up. We might miss out on something, but it is not as though there are no opportunities elsewhere.

Nikkei 225

TOPIX

India

Inflation is a problem

Inflation in India is at present mainly affecting food prices. This is significant because 65% of all Indians still live in relative poverty in rural villages. Food can represent a very large proportion of their total family budget. These people are not in that part of the economy that foreign investors are putting their money in. But they are in India and they do vote, and this really is a democracy.

Interest rates are going up, and they were high to start with. There is real pain and this is an issue that is not easy to deal with. If it is perceived that this problem is partly caused by foreign money flooding in, action will be taken to reduce the inflow.

The above factors are of short term concern and we do not believe that it will derail the long term story of India becoming a superpower. In this situation, making a linear projection is dangerous, but the consensus view is that China's economy will overtake the US in 2017. India will be growing faster than China by that time, but will not overtake it for another ten years. Demographics are the main driver of this development.

India already has 8000 quoted stocks and new IPOs are coming to the market every day. The stock market may well become number one well before the economy does.

Things can go wrong, however, and it is vital that the government enables more people to leave the villages and join in with the more modern life available in the cities. Education and infrastructure are all part of this process but people also need to eat. That is why the present cooling down period is so important.

Our road map expects the rise in the Sensex index to exceed 21,000 on the next run. This will then be point Y on our road map in secular uptrend. There should then be a correction back to lower levels at Z – probably in the range of 16,000 to 18,000.

The point is that there probably will be another chance to buy this market on a drop back. We do not want to miss this opportunity. But, as we are never one hundred percent certain of anything, there is no harm in having some exposure now. If we get the drop right we can then add to the holding.

India

India relative to world

Pacific ex Japan

Totally efficient government

George Soros has said that he thinks China currently has a more efficient system of government than the US. Command control can certainly act faster than a democracy. We saw that at the height of the credit crunch and they are acting again – this time to cool the economy down.

The liquidity in world markets is blowing bubbles in Asia. China has real inflationary pressure and it is acting to stop it.

China will almost certainly stimulate its own domestic economy, and move away from the model that relies on exporting to the US.

A new five year plan should be announced in March. The Chinese New Year is in February. After this, the renminbi will probably be allowed to appreciate by about 4% to 5% a year. The authorities are unlikely to allow anything more rapid than this. Trade and currency wars can be avoided, but a lot of negotiating will need to take place. This will drag out over time.

Our road map indicates that the Shanghai Composite index should fall back to around 2,000, at which point it will have got back in step with economic developments. It has been way out of line ever since the Olympic Games and is still in corrective mode.

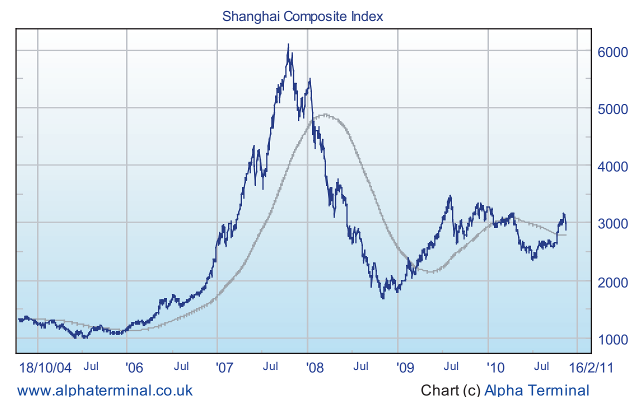
The chart pattern of a fall, followed by a rally, then the rest of the fall can be clearly seen on the chart. If the index gets down to 2,000 at the same time as the Indian and Brazilian markets hit their point Zs on the road maps, all the BRIC markets will be back in step in again.

Korea, Singapore, Malaysia and Thailand all look good for a positive run up.

Do remember that the all-time high in Taiwan was in 1989 at 12,000. For all its growth and positive outlook this is still a secular downtrend. However we think it will run up to test the resistance at the old all time high.

Australia

China



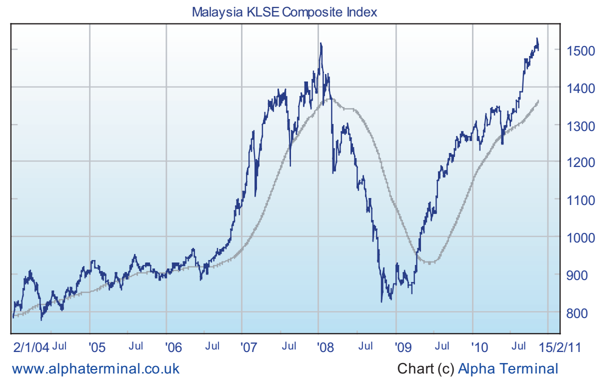
Pacific ex Japan

Hong Kong

India

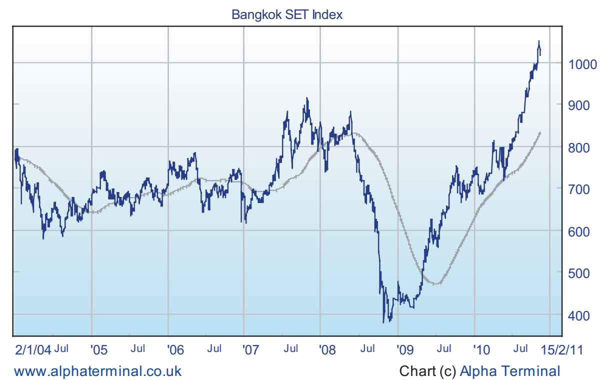
South Korea

Malaysia



Taiwan

Thailand



Emerging markets

Speedy Gonzales

Some markets just move quicker than others. Like time and tide they wait for no one.

Always and everywhere a new all-time high breakout is a buying signal.

There might be a small pull back to make a new low above the level of the breakout but this would be considered a confirming signal. Such a setback would be the last chance to get in at a good price. It is never too late to buy a good market, if it is going to go up.

South of the US border, in Mexico, all the right signals are being given. Speedy Gonzales is on his way. You might want to own a piece of him.

In Brazil, the Bovespa index is right on the cusp of making the same pattern. It has recently had a pull back but this has long been a favourite of ours and we are anticipating a new high breakout.

All these markets are on our road map in secular uptrend. They are in the leg from X to Y.

Point Y is meant to be a new all-time high, after which they fall back again one more time to confirm the breakout. This gives point Z which is a new A in the next cycle.

For the time being, Turkey is included in the emerging market section rather than Europe. But this may change over time. This market is in a secular uptrend and doing all the right things. We mentioned it last month and still think it is worth investing in. An ETF would be a low cost way to effect this trade.

The benchmark indices that many asset allocators use only give a small weighting to emerging markets. A few years from now we believe they will realise that a much larger weighting is appropriate. We think it is important to front run this development instead of waiting and then catching up after the best growth is over.

Brazil

Russia

Emerging markets

Emerging markets index

Mexico

Chile

Turkey

Eastern Europe index

Poland

Bonds

You can have mine

When the Fed effectively announced it would buy up bonds until the yield went down to really low levels, the average investor seemed to say, “well in that case you can have mine.” The price of the 30 year Treasury Bond fell rapidly, pushing the yield sharply higher to around 4% again.

The very long term chart shows a bond bull market since 1980. The vast majority of traders in this market have only ever experienced a trend of falling yields. If it reverses now, they will be in a whole new ball game.

We can forget trying to talk meaningfully about bonds of a shorter duration than the very long end of the curve because the Fed is manipulating this part of the market. The price and yield will be whatever the Fed wants it to be. At the long end there is still some input from market forces, and it is here that we see expectations of inflation or deflation being played out.

The Fed has made it clear that it sees unemployment persisting at unacceptable levels. It is trying to take action that will have a positive impact on this situation. Triggering a positive wealth effect by asset purchases is the main plank of its strategy. We do not know if this will work. Even Mr Bernanke says it will need help from other policies, such as lower taxes.

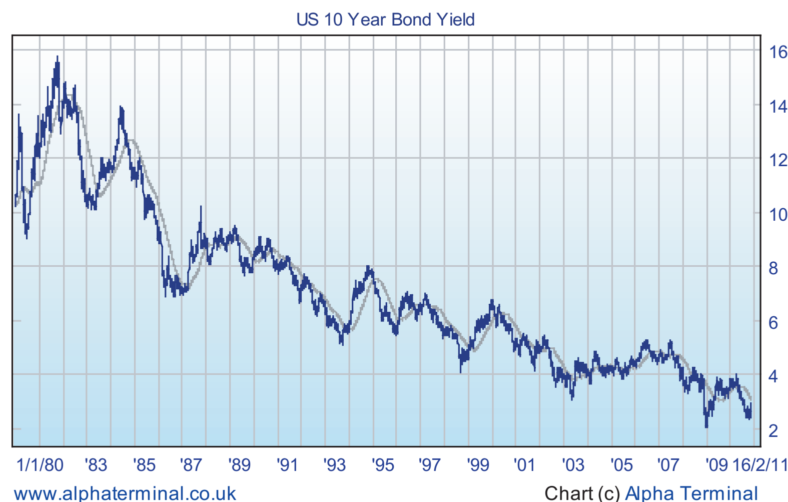
As a result of unemployment and the ongoing housing crisis, Mr Bernanke remains concerned about the risk of deflation. Robert Shiller and others would agree. Our own thoughts are along these lines as well, but further ahead there is a risk of inflation.

Asia is already experiencing rapid inflation. If this becomes a global trend and the dollar remains under pressure, the correct strategy will be to short bonds.

The chart is clear that, if the yield on the 30 year goes above 4.8%, an era of inflation is signalled. If, on the other hand, the Fed is correct, we are coming up to a good bond-buying window. We will buy on a yield of 4.8% and look for it retreat back down to 2.4%, thereby doubling our money. The stop on this trade is at 4.85%.

As a result of the mid-term elections, it is possible that the Fed will have to change tack. The Republicans will be reluctant to allow more money to be printed. In this event, bond prices would fall sharply but the dollar would rally. For the time being we are backing the Fed but are monitoring the situation carefully.

US Treasury bond 10 year yield



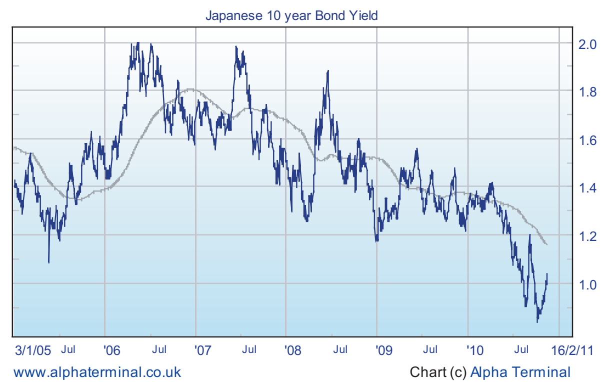
Bonds

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

Silver threads among the gold

Global investors are worried by the quantitative easing policy as it puts downward pressure on all fiat money. To hedge this risk they are buying real assets.

All commodities are "real" money in the long run, but none is better than gold, which has been in a 10 year bull trend. The rise has not even gone exponential yet and long uptrends tend to end in this way.

In that final phase, profits will be made much faster than the entire previous part of the move. So, if a rise from $250 to $1,400 is just the launch pad, the final peak should be way higher. We believe the price will move to levels in excess of $2,500 and even predictions of $5,000 are not absurd although we are not making that call at the moment.

Normally, the price of bullion moves so far that it changes the economics of mining. At this point, the mining stocks start to outperform. Up until now, they have been sluggish. But we are just getting new high breakouts by Gold Corp, Barrick Gold Corporation and some other stocks.

We think that investors should now be adding some gold stocks to their portfolio instead of just owning the ETF on bullion.

The other thing that happens in the later phase of a gold rally is that silver joins in.

The gold:silver ratio can go to extremes but it does eventually mean revert. It seems to have started doing this now. So whatever gold does, silver should do far more.

There are several ways to play this move. An ETF on silver works well. There are also silver mining stocks, such as Silver Wheaton, a US equity, which is likely to outperform. It has already had a strong run and will be volatile. If markets go risk-off, then it will drop back sharply. This will present a buying chance. After that, use a trailing stop loss order, but keep it loose. You do not want to be shaken out by small fluctuations.

Other commodities will also rise if the dollar falls further. Food prices are on a strong uptrend and some exposure to this sector could boost portfolio performance but, as the recent moves in sugar demonstrate, there are likely to be some volatile moves.

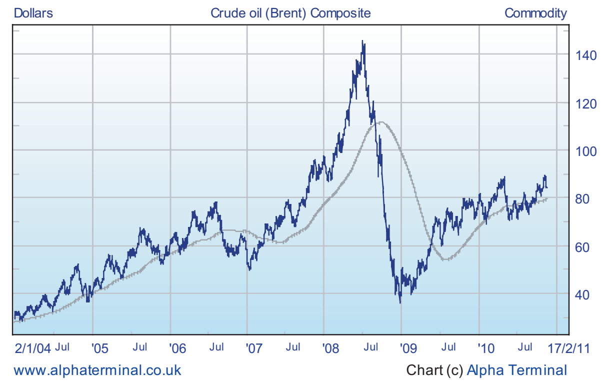
Commodity price index

Gold

Commodities

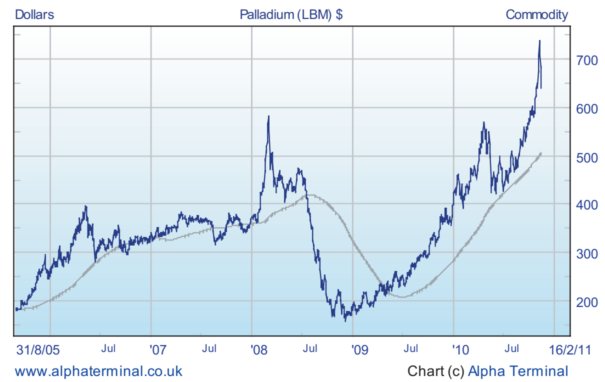
Platinum

Oil



Silver

Palladium



Copper

Aluminium

Currencies

The war of the worlds

We have seen the first skirmishes in what could prove to be a very damaging currency war. The US, with its structurally high unemployment, needs to create liquidity, which risks devaluing the dollar.

Much of the liquidity has already gone overseas and is pumping up inflationary pressure in China and India. They are dealing with this problem aggressively, but are typically not allowing their currencies to appreciate.

Other countries, such as Brazil, have already introduced taxes on inflows of foreign money. If these are just one-off measures, there is no problem but, if this is the start of a more general trend, then it risks triggering a spate of damaging beggar-my-neighbour policies.

It is probably not possible to revalue the Chinese renminbi sufficiently to restore the global trade imbalances. A move of about 40% would be needed to achieve this. Realistically, an appreciation of 5% per annum is the most we are likely to see.

But Mr Bernanke has a point that huge trade surpluses and deficits cannot be sustained for ever. Something has got to give.

In practice, the Chinese know this too and will soon – probably in March – announce a new five year plan to stimulate their domestic economy at the expense of the export sector. Once this happens, it will be in their interests to have a slightly stronger currency.

The US has borrowed so much money that it has a structural reason to want the dollar lower. It has been doing this for years, but at a controlled rate.

The dollar is, however, still the world's primary currency so, if the markets panic and take risk off, it will rally. But, if stock markets keep on rising, the dollar is likely to continue falling.

A few years from now, the Chinese renminbi will be higher and the dollar lower and equilibrium will be restored. China will have followed the Japanese example and become a major industrialised economy. In the meantime, we have to muddle along and hope that skilful negotiations will avoid old style currency wars. Watch this space.

US dollar: trade weighted

US dollar/euro

Currencies

US dollar/Japanese yen

Euro/Japanese yen

Sterling/US dollar

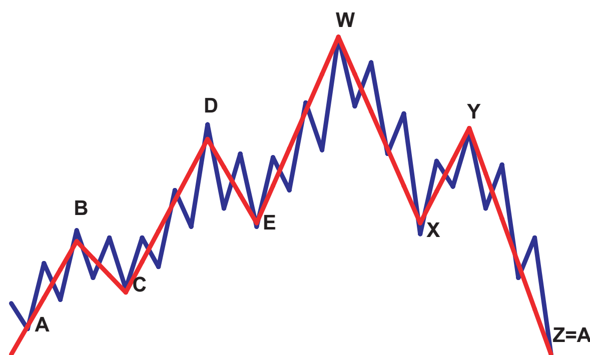
Sterling/euro

US dollar/Canadian dollar

Australian dollar/US dollar

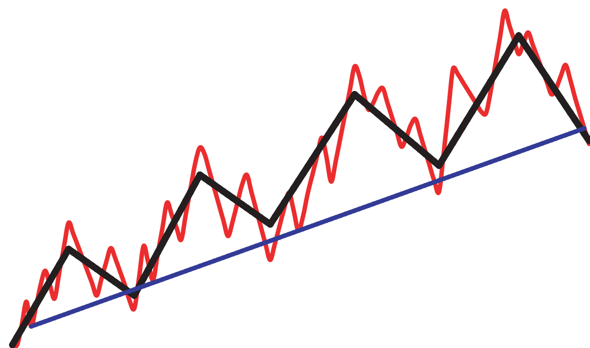
Road maps

Standard road map



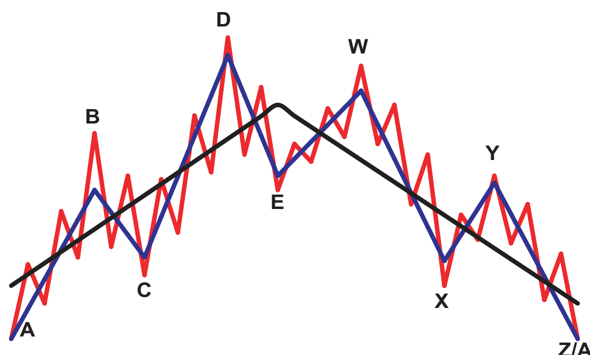
These road maps are the basic shape of a so called Elliott Wave. We deliberately letter our maps differently from Elliott aficionados. The normal time scale for a complete cycle is four years driven by the Kitchin wave. The bull phase has three surges getting progressively more powerful. The bear phase 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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