Global Report – October 2011

UK

Europe

US

Japan

Emerging Markets

Bonds

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Currencies

October 2011

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

Everybody knows to sell in May. Then expect a mid-summer rally followed by a sudden drop down to a low in late October. This year the seasonal deviation is working rather well.

The expected pattern outlined above is a probability. There is no such thing as a racing certainty.

Last year the pattern was working well until the US Fed came up with QE2 and the final drop never occurred. That particular event should not happen this time, but there could be others.

In some years the sell-off continues well into November. We do not know if that will happen this time but trying to hit the absolute low is a mug's game (usually played by liars).

Historically, it is very unlikely that the markets will fall for six consecutive months. It has not happened at all since 1975 and only six times since 1928. On this basis, the market should make a low in October and be rallying again by the end of the month.

We know from experience that nobody is going to ring a bell when the low is formed. By definition lows only form when the news and the presumed outlook is really bad.

There are now an increasingly large number of good companies whose stock prices are selling on P/E ratios of very low single figures. We have always used 7 as threshold number. Blue chips on this multiple are moving into bargain territory.

This time around, there are plenty of multiples of 5 and even 3 on offer in stocks that are constituents of the major indices. This does not stop their prices falling several percent in a single day when nobody wants to know.

Looking back, it will have seemed easy and daylight robbery to have picked them up so cheaply. Right now it is hard to do. The fact is you have to be brave to take sweet money from little children.

Our road maps are in good shape and they are predicting a sudden swoop down in stock markets, which will be roughly the mirror image of the fall that occurred in August. It is significant that it only took six to eight days to complete that drop.

Levels for the S&P500 could be just under 1,000, and for FTSE-100 4,500, at which point the seasonal deviation starts to become positive. We then expect a rally into the New Year that could last until March.

This should be a sustainable and tradable rally. However a final drop back in 2012 is still our most likely outcome. The important low on the 10 year cycle is in 2012 and this could take indices below their lows this year.

We regard China and India as the engine of the global economic train, and they are likely to make important lows this year. They are running about a year ahead of the western markets.

It is important to separate the emerged markets from those that are still emerging. The volatility in the latter is too great for us to start embarking on a progressive buying programme.

The key assumption behind our strategy is that China and India will achieve a soft landing as they suppress inflationary pressures. They have no agenda to save the world, but do have a strong desire to keep their long term growth firmly on track.

While markets are falling, the US dollar should hold firm. But once equities steady the dollar will once again be vulnerable to selling pressures.

At that time gold will start performing again. Nothing has gone wrong with the gold story. It has fallen back from an overbought position to the underlying uptrend.

The plunge in prices we are seeing generally is setting up a buying chance. The strategy is to be ready, willing, and able to take advantage of it.

Summary: world market overview

It is the time of the year that matters. Panics and major lows almost always occur in the September to October period. Very occasionally the low is a bit early in late September and, equally often, it might be as late as November.

Do not get confused by trying to finesse the timing. If we were prepared to do some buying in late October, starting a bit earlier in the month is a question of tactics rather than strategy.

The hopeless state of Greece and other Mediterranean states is forcing the northern Europe eurozone members to take the sort of action that they would have preferred to avoid. Unwilling to abandon the entire euro project, Germany is trying to come up with what Blackadder would call a "cunning and devious" plan.

The view is gradually gaining acceptance that, if you have lent money to Greece, you are going to have to take what is euphemistically called a "haircut". Let's get on with it and then ring fence the banking system. That should stop the panic.

What this does not do is solve the real long term problem, which is that the entire western world has over a long period of years built up such a huge amount of debt that the biblical equivalent of a 'Jubilee year' may be needed.

History is full of examples of previous credit bubbles. They always take years to develop and then always require a long period of deleveraging afterwards to unwind. This is inevitable and inescapable.

The western indebted nations are all, without one single exception, in secular downtrend on their charts. All are lower now than they were 10 years ago. All will continue to have cyclical bull and bear phases around a falling trend from the highs of 2000.

The next cyclical bull phase should start in 2012 with 2013, 2014, and the beginning of 2015 all being relatively positive years. The next savage bear year will be in 2016. All this will take place at lower levels than the highs of the year 2000.

However in Asia – and especially in the emerged, markets of China and India – growth will average 7%. In a bad quarter or two it might drop down to 5%, but in a good one it will reach 10%. In saving themselves these nations will help the rest of the world from having a depression. But they, too, will also experience a deleveraging.

During this period the yield on Treasuries will remain negative in real terms. They are bad value and are likely to stay so for some time. The great boxer Rocky Marciano used to say, "When I hit a guy, he stays hit".

This is all part of the "new normal". Asia is where the growth is. Rates stay low. Consumption is weak because households are trying to get out of debt. Anybody who thinks he can regularly make 30% a year out of equities is living in a fool's paradise. Low single figure returns of around 5% will be the target.

But amidst all this gloom let us not write off the US. It is still the largest single economy and, for a while longer, the dollar will enjoy safe haven status.

There is a Presidential election next year. If Mr Market scents that the new incumbent is likely to be someone who stands for small government, minimum regulation, low taxes and who knows that it is businesses not governments that create jobs, the market could take off like a rocket.

That will not happen just yet though, as the present incumbent has a very different agenda. Things can change however. Never forget that change is constant.

The World at a glance

Major markets

US relative to world: currency adjusted

- The US has shot up the ranking table during the recent panic phase for world markets. As the saying goes, "this is the best looking horse in the glue factory."
- The S&P index is in the top category of the ranking table and will probably stay there until a sense of calm returns. On the road map this relative strength does not alter the fact that a secular downtrend is still operating.

UK relative to world: currency adjusted

- The UK comes just below the US in the ranking table. Part of the reason for the strong performance on a currency adjusted basis is that sterling has held up reasonably well.
- We can find 20 out of the 100 stocks in the FTSE-100 index that are on P/E multiples below 7. This discounts quite a lot of bad news. Overall, the index is not so cheap, but some individual companies are moving towards bargain-hunting territory.

Europe relative to world: currency adjusted

- Perversely, the best market in the eurozone, Germany, was hit the hardest in the fall to the August lows.
- The poor performance of the smaller peripheral markets also dragged the region down with the result that it put in the weakest performance relative to any other region in the world. If there is a mean-reverting rally after the autumn squalls, expect the best bounce to be here. Some of the strongest businesses have been selling on P/E ratios of under 5. The fact that no one wants to buy these companies is quite normal in a bear phase.

All these charts are in US dollars and are relative to the World index.

The world at a glance

Japan relative to world: currency adjusted

- Largely due to the strong rise in the value of the yen, the Japanese market has done very well on a relative basis. It is right in the top category on our ranking table.
- We still believe that what Japan has been through in the past 20 years is, to some extent, a role model for the west now. Some of the western banks are in the same "zombie" state as the Japanese ones were then. We are looking to buy into this market as long as the next low for the indices is above the low made in 2009.

Pacific ex Japan relative to world: currency adjusted

- The weakness of the Chinese and Indian markets is harming the relative chart for this region.
- We think this plunge may well be the final capitulation move that will set up the best long term entry point in years. We will find out soon enough if we are right on this. If we are correct, the relative performance chart will pick up again.

Latin America relative to world: currency adjusted

- Latin American markets are in secular uptrend but they are not the pace setters. They take their lead from China as to a greater or lesser extent their growth depends on the dragon economy. For this reason we do not think that they will bottom first. We need to see a soft landing for China before we buy back into Brazil and other markets in this region.
- The performance of some of the smaller markets here is often linked to a single metal, such as copper, so the same story applies – but is even more pronounced.

All these charts are in US dollars and are relative to the World index.

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
Venezuela	++	×	✓	×	-0.1		23.8		49.6	
Japan	++	×	×	×	-2.1		-8.3		0.8	
United States	++	×	×	×	-4.3		-16.0		-3.2	
United Kingdom	++	×	×	×	-7.2		-21.4		-15.0	
Switzerland	++	×	×	×	-9.7		-20.1		-9.8	
Malaysia	++	×	×	×	-12.2		-18.0		-9.2	
Spain	++	×	×	×	-4.0		-27.1		-27.3	
China	++	×	×	×	-4.9	-5.6	-14.9	-12.7	-8.9	-2.9
Philippines	+	×	×	×	-16.1		-15.5		-8.5	
Turkey	+	×	×	✓	0.1		-22.2		-33.9	
Colombia	+	×	×	×	-13.4		-20.4		-22.7	
Indonesia	+	×	×	×	-18.4		-19.6		-8.1	
Belgium	+	×	×	×	-9.2		-27.1		-24.5	
Netherlands	+	×	×	×	-7.2		-27.6		-22.5	
Peru	+	×	×	×	-14.9		-11.1		-7.2	
India	+	×	×	×	-11.9	-11.4	-24.2	-20.9	-30.0	-19.7
Singapore	o	×	×	×	-15.6		-24.0		-19.6	
Denmark	o	×	×	×	-6.1		-27.9		-21.3	
Taiwan	o	×	×	×	-12.3		-25.2		-13.5	
Mexico	o	×	×	×	-10.9		-23.6		-12.0	
Canada	o	×	×	×	-16.2		-23.6		-13.3	
Sweden	o	×	×	×	-8.6		-30.0		-22.7	
South Korea	o	×	×	×	-16.2		-30.9		-15.7	
Israel	o	×	×	×	-4.4	-11.3	-24.7	-26.2	-20.5	-17.3
Egypt	-	×	×	×	-14.9		-25.0		-38.8	
Thailand	-	×	×	×	-21.2		-22.3		-14.0	
South Africa	-	×	×	×	-12.5		-23.4		-14.3	
Germany	-	×	×	×	-6.2		-35.5		-19.3	
Australia	-	×	×	×	-14.1		-23.0		-15.0	
Italy	-	×	×	×	-6.3		-35.4		-33.2	
France	-	×	×	×	-10.4		-34.1		-26.5	
Hong Kong	-	×	×	×	-17.1	-12.8	-28.6	-28.4	-28.5	-23.7
Czech Republic	--	×	×	×	-13.5		-34.1		-24.1	
Chile	--	×	×	×	-22.1		-31.8		-27.6	
Brazil	--	×	×	×	-17.2		-31.6		-35.0	
Poland	--	×	×	×	-14.5		-37.3		-30.5	
Russian Federation	--	×	×	×	-24.7		-37.7		-22.4	
Argentina	--	×	×	×	-17.7		-34.9		-19.2	
Hungary	--	×	×	×	-22.4		-43.0		-41.2	
Austria	--	×	×	×	-18.4	-18.8	-39.5	-36.2	-31.9	-29.0

Ranking and data in US Dollars

United Kingdom

Down but not out

Tough boxing matches often end with a sudden knock out blow. The right hook to the jaw and the legs crumble, there is no support left and the once aggressive fighter crashes to the ground.

Even the greatest champions get knocked down sometimes. The only good thing (which they cannot appreciate at the time) is that, from that prone position, if they can move at all, the only way is back up again. What separates the champions from retired losers is that the champions do get back up again.

The UK market has just been dealt a heavy blow and major support has broken. This was expected on our road map.

The likelihood is of a mirror image of the drop that occurred to the low in August. The total fall from the high in July of 6,087 was 21%. Most of the drop occurred over eight days.

The low was at 4,800 from which point a line of rising highs was established. It was the breaking of that line that was the killer punch. The highest high during the rally was in early September when the FTSE-100 reached 5,400. A drop equal to the first fall from this point would target 4,500. This could be achieved in eight to 10 days. A base should then form.

There are plenty of stocks in the index which are world champions in their field. Many are not only good value, they are astonishingly cheap.

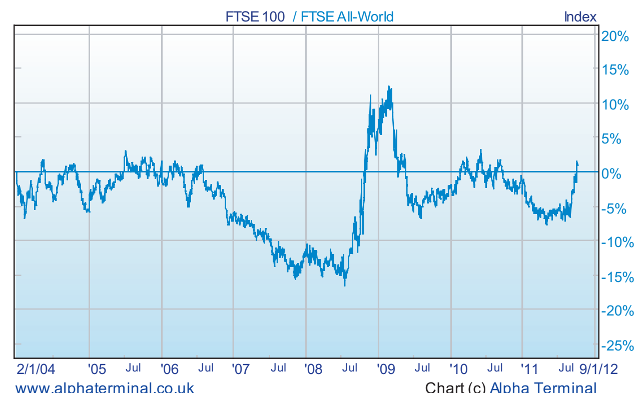
We work on the basis that a P/E below 7 usually represents a bargain for a blue chip over the long term. We can now find dozens on less than this. They are boxers that are down but not out. But there is nothing on the charts that suggests we have reached the final lows yet. We are, however, moving into the buying zone for anything longer than a short term trade.

The road map indicates there should be a good rally that will retrace at least half way back up to the July high between late October and March next year. The FTSE index will then probably drop back again to make lower lows in mid to late 2012, but many individual stocks may not go lower than they are this October.

In this shake-out we will be looking to buy stocks on very low single figure multiples that are bigger than some countries. These opportunities do not occur often, and they only happen when the background news is dire.

FTSE 100 index

FTSE 100 index relative to world



Europe ex UK

The most depressed

Even in the world of absolute returns the concept of relative strength is still valid. It is one of the central tenets of technical analysis and withstands all back testing.

The major markets that have fallen the most in relative terms against all benchmarks are the pan-European stocks. But when the rally phase begins the stronger markets should have a good bounce.

The very public strains within the eurozone are giving rise to some exceptional values.

We are already seeing some stocks on multiples of 4 or 5. This is below our threshold level of 7 but this does not stop their share prices falling further. Cheap stocks can become even cheaper. Trying to buy during the fall will feel wrong and look wrong in the short term.

However history tells us that, if we can buy really good quality stocks at around these valuations, then on a one, three or five year basis we are going to do well. Buying at an extreme low tips the odds massively in our favour but we do not need to hit the exact bottom. The tools of technical analysis should help us identify when a base is developing.

Our road map expects the current plunge to fall by about the same amount as the earlier drop in August. This could take place over a relatively short period. At that point a base should form.

This would be point E on the road map in secular downtrend. A tradable and strong rally should follow into the New Year with a top in March.

Funds will buy into the value on offer and the authorities will do some heroic stuff to ring fence the banking sector and probably allow Greece to default. That will drive the rally.

Later next year the realisation will dawn that the problems will take years to be resolved and the rest of the bear phase will follow.

In that last leg the indices will probably make new lows, but plenty of individual stocks will not. We do not want to miss them on this current fall.

European equities

European equities relative to world

Europe ex UK

France

Germany

Switzerland

Netherlands

Scandinavia

Spain

United States

The centre cannot hold

The US is still the largest single economy in the world and to many it still feels like the centre of the universe. But it is badly damaged; partly by the policies of its President, and partly by the aftermath of the huge credit bubble, which he inherited.

On the chart of the S&P index, the major support line has just failed. This is as expected on our road map.

From the high in July of 1,350 the index plunged 19% to 1,100 in August.

After the plunge there was a line of rising highs and lows on the chart, but that support has now failed.

An equal-sized fall would take the index down to 1,000. This stage of the bear phase should be completed in the first part of October. Towards the end of the month a rally should begin to gather momentum.

For as long as the markets are in risk-off mode, the US dollar should remain strong.

The US market is relatively well placed to withstand the next climatic phase of selling pressure and should hold up tolerably well. That is not the same as making money.

At present, the problems in euroland seem worse than those of the US. So America will be viewed as a haven of value. The dollar, stock market and Treasuries will all to some extent be accorded safe haven status. Consequently, you will lose money more slowly here.

But, until there is a President who ushers in a new era of wealth creation, you will still lose money.

On an individual stock basis, the US has some great world class companies. They are cheap and cash rich. They will survive and continue to pay good dividends. We are not writing off these companies. Be ready to buy top stocks on P/E ratios of under 7.

S&P 500

Dow Jones Industrial Average

Canada

Failing to discriminate

The recent performance of the Canadian stock market just goes to show that when people need to sell stocks to raise cash they will sell whatever they can. The good not only go down together with the bad, they often get hit the hardest.

It is always easier to make the decision to take a profit on a holding that has performed well, rather than cut a loss-making one. In the first case you feel rather clever and in the second you have to admit that you had made a mistake. Sellers therefore fail to discriminate and do what comes easiest.

Canada is in a secular uptrend. It is backed by metals and resources and is one of our favourite markets – but that does not stop it being in a cyclical bear phase now.

The road map is working well and, as we indicated last month, the support at 11,722 for the TSE index has broken.

A swoop down to about 10,000 seems probable.

The same has happened to the currency. It is in a powerful long term uptrend but had run too far, too fast. With the US dollar being viewed as a haven, a large pull back is under way – last week the Canadian dollar reached its lowest level against the US dollar in more than a year. The Loonie was not as pumped up as the Aussie dollar and it should, therefore, have less downside risk. Eventually, both these currencies should resume their long term uptrends.

As in other markets, value appears to be creeping back in. Those investors needing to invest in Canada in the short term should be able to pick up good companies in late October.

Others might want to wait until 2012 when we think the final low of the bear will be in place. The low this year will present a trading not a lock-up-and-hold opportunity.

Canada

Canada relative to world

South Africa

In the right place

Many economies on the continent of Africa have some of the fastest growth rates available anywhere.

South Africa is the blue chip and does well but it cannot keep up with some of the others – although these are widely thought of as being a higher political risk.

If in 20 years' time we look back at some of the investments now available, we will hardly be able to believe that we failed to buy them. With hindsight, the risks will seem to have been small. However, at present in real time they seem to be large.

In the short term, the high volatility and lack of liquidity can quickly turn an investment into an unsaleable lemon. For this reason we would rather miss the low and wait until new uptrends are clearly in place before buying.

On our road map, South Africa has been in a secular uptrend for many years. It is on the strong road map.

But it is currently in a cyclical bear phase and it is too soon to expect the final low.

Stand back and wait patiently is our best advice.

We are long term bulls of commodities and precious metals in particular. The South African market is closely linked to these markets.

We have argued before that it is a bit too soon to switch from bullion into mining shares, and, so far, that has been correct. However, it is inevitable that the miners will eventually become so cheap that they will take off.

Qatar has recently announced a $10bn fund to invest in gold mining companies and the metal itself.

We are sure that gold will become a bubble, but it does not look one yet. Our only caveat is that history shows that even in these huge uptrends we can get regular very large sell-offs. One has just occurred and may not be quite over yet. It is important not to be wobbled out of good long term positions by these moves.

JSE All-Share

JSE All-Share relative to world

Japan

Stick with the cash option

Even though world markets are now in risk-off mode, and therefore the US dollar is rallying, the yen remains an extremely strong currency.

This is remarkable. The legendary saver, Mrs Watanabe, has looked at overseas currencies and does not like what she sees. She has brought her money home again.

The strong yen does not help the economy as it slows exports at a time when the global economy is slowing down.

The chart pattern for the Nikkei-225 and Topix, indices has not changed. They have been in secular downtrend since 1989.

The secular downtrend probably ended in 2009 and, as long as the next major low is above 7,000 on the Nikkei index, a new upward cycle can begin.

But at present the indices are drifting down to the level where that important low could be made.

That low is not yet in place and it is unlikely to be Japan that takes the lead in terms of timing. More likely, once China and India are seen to have bottomed, Japan will then follow suit.

It is possible that the Japanese could, like the Swiss, intervene to curb the yen's appreciation. If Mr Sakakibara was still in his old job it is quite possible that this would have happened – he was expert in the art of intervention.

However that was then, and this is now. With the current regime it is unlikely that we will see determined currency intervention. Therefore, the present strength will probably continue.

We wait patiently. But see no need to act at present. Stocks are not yet the place to be in this market. Stick with the cash option.

Nikkei 225

TOPIX

India

Heavenly opportunities?

The Asian giants, China and India, are the potential world leaders. First China and then India will in time become the largest economies and so eventually will have the biggest stock markets in the world. We want to own them before they get there and participate in that rise to power. Heaven would be the chance to buy into them at a really attractive price. We think we are almost there now.

When the Sensex index hit 21,000, we predicted that it would fall back to about 16,000. It has done this and seems to be going slightly lower again. But it has entered the buying zone and from now on we are trying to bottom fish.

On the road map the Indian market is in secular uptrend. Unlike any western market, it is several fold higher than it was in the year 2000. It has, however, been in a cyclical bear phase for a while and seems to be leading western markets by about a year.

On this basis, the current capitulation or climactic selling pressure should be the end of the entire bear period and should set up a great long term buying opportunity not just a tradable rally into the new year.

The cooling of the world economy will bring down the cost of oil, which is good for India as this is its major import. Apart from energy, the economy is almost self-sufficient.

The next support on the chart is between 14,500 and 16,000. This range is the buying zone.

With 12 interest rate hikes the government has slowed the economy but has not quite tamed inflation. It will continue to try and do so.

We expect that the 79-year old Mr Manmohan Singh may well stand down as prime minister next year and Rahul Gandhi, who is in his early 40s and the son of the President of the Indian National Congress Party, will become more prominent. The main elections are not until 2014. The market would like this.

Overseas investors do not over-own this market, but there is a lot of potential interest. An inflow of overseas funds may prevent the index from dropping much lower.

Tactically, we cannot hope to hit the exact bottom. We could start a gradual buying programme later this month with a view to building up a heavily overweight holding in our portfolios.

India

India relative to world

Pacific ex Japan

For whom the bell tolls

We know that at the bottom of a bear market, nobody is going to ring a bell. Most only recognise that a low was in place well after they have missed it.

Our road maps have been working quite well and lead us to expect the final low of a long cyclical bear phase will be in place soon for some of markets in this region. China and India are likely to the Pied Pipers.

The risk is that China has a hard landing which will put back the low both in respect to the timing and the level. At this stage it is impossible to predict whether this will occur or not.

We are, therefore, looking to start buying but, if China's growth slows by more than we are expecting, we will have to be prepared to reverse our strategy.

According to their respective road maps, China and India are leading western markets by about a year. Their low this year should be the final low and then not only will a new cyclical bull phase start, but it will be in the presence of a secular bull trend.

Times are turbulent and hitting the exact low is probably impossible – but it is also unnecessary. We favour a tactic of buying progressively in small amounts on falling prices. In this way our average purchase level should be not too far off the bottom.

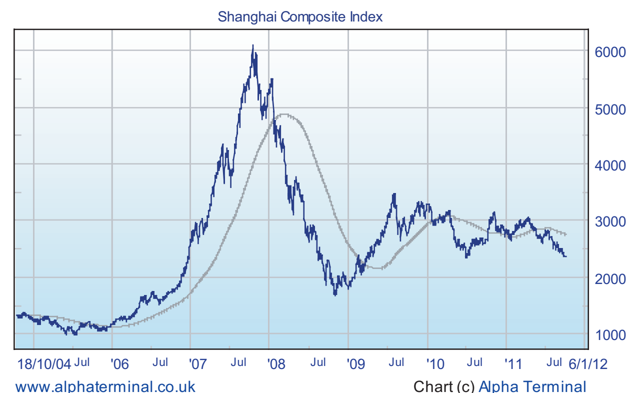
It is important to separate emerged markets from emerging ones. We are currently only willing to start a small-steps buying programme in China and India.

The volatility and lack of liquidity in some of the smaller markets makes it wise to adopt a cautious stance, even though many of them do have good long term prospects.

There will be a later starting gun for these runners.

Australia

China



Pacific ex Japan

Hong Kong

India

South Korea

Malaysia

Taiwan

Thailand

Emerging markets

Excessive volatility

Volatility in all world markets is picking up dramatically. This is usually measured by the VIX index.

The VIX index spent much of the first half of the year bumping along in the range of 15 to 20. Such a number implies not only low volatility, but complacency that the trends in place will remain in place.

In August the index suddenly jumped to 45 and seems to be rising towards 80. Such a target is possible.

What this means for emerging markets is that, whatever we do, we could be wrong by a factor of 10 per cent in a single day. With this magnitude of volatility it is not possible to define the difference between a trend move and mere market noise with any confidence.

The point is that there is a difference between being brave and being foolhardy. Catching a falling knife is not a fun game. We prefer to wait for the major engine markets to have established a low before trying to identify the bottom in smaller less liquid markets.

We suspect that Brazil and Mexico will not be far behind China and India in terms of making a buyable low as they are on a broadly similar road map. Brazil always has the problem that inflation surfaces relatively quickly. The government is well aware of this risk and is getting better at controlling it, but September's rise of 7.31 per cent shows it still has some way to go.

We are long term bulls of these markets. We expect them to resume their uptrends once it is clear that China and the other majors have made a low.

But we are prepared to miss the absolute low in order to be certain that the markets have found a floor and it is not just a volatile rally.

Brazil

Russia

Emerging markets

Emerging markets index

Mexico

Chile

Turkey

Eastern Europe index

Poland

Bonds

The new normal

The yield on the 10 year US Treasury is the same as it was a month ago, but that on the 30 year has dropped lower.

It is tempting to think that this is a short term blip that cannot possibly last, but this is not necessarily so.

Why would anybody want to buy a bond that locks in a small loss in real terms? The answer is that everything else they might do runs the risk of giving rise to much larger losses.

By panicking into bonds investors are seeking a haven where the emphasis is on the return *of* their money, rather than the return *on* their money.

A look back through history shows that markets have been here before. The lesson is that, if we are not in a normal recession but a major deleveraging process, we can expect this situation to persist for a long time. Think in terms of a decade, or more.

The heuristic rule of thumb is that a stock market bubble results in a recession, which is short lived (a few months to a year) and tends to result in inflation. A credit bubble ends in depression and tends to be more protracted.

We have lived through plenty of recessions – roughly one every four years. We get used to them and are not unduly worried by them. We only live through one, or possibly two, depressions. They are scary.

The credit bubble that took many decades to build up has now burst. It will take a long time to unwind fully.

Having already got interest rates down to almost zero the central banks have run out of bullets. They are doomed to keep rates very low for a lot longer.

The public are now deleveraging. They will not easily be encouraged to borrow and spend more. Live now and pay later is what Bill Gross has described as the "old normal". The "new normal" is to be prudent, frugal, thrifty and shrewd, and above all else get out of debt.

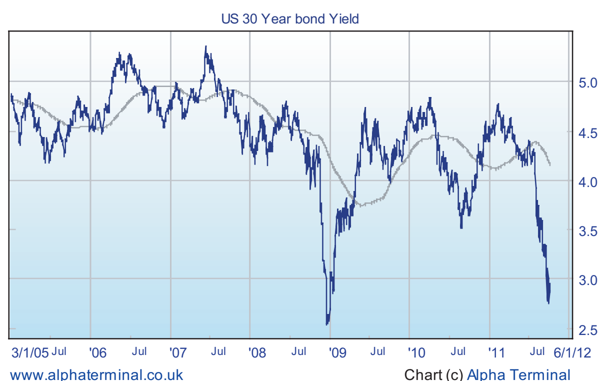
What this means is that we do not short bonds just because they seem to be bad value. They are going to stay like that long enough for us all to become accustomed to very low interest rates as the "new normal".

The bottom line is that assured, risk free, high returns are simply not available. If you can get 4% to 5% you are doing extremely well. Set against this background, some investors are prepared to accept 2% for 10 year government bonds. .

US Treasury bond 10 year yield

Bonds

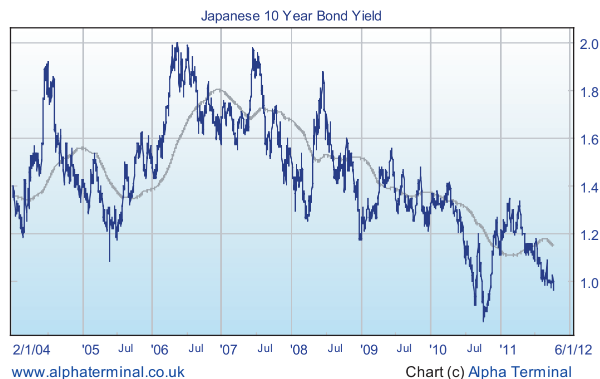
US benchmark bond 30 year yield



UK benchmark bond 10 year yield

German benchmark bond 10 year yield

Japan benchmark bond 10 year yield



Commodities

Shaken but not stirred

The recent sell-off in commodities is another example of sellers not discriminating between different asset classes when they need cash. They sell anything and everything.

The CRY commodity index is off 20% since May. It fell 14% in September. As the global economy cools down and is feared to be about to go into a recession, the demand for many commodities evaporates quickly.

When we compile lists of giant companies that are well managed and on incredibly cheap ratings, we find that many of them are in the mining industry.

RTZ, for example is on a P/E of under 5. There are many others. Even if analysts now downgrade their forecast for earnings they are still going to be well below our yardstick of 7.

Once the China economy starts growing strongly, the demand for resources will pick up and the companies that mine them will be in demand again.

Gold is a commodity, but it is also money. Nothing has gone wrong with the story about owning gold. The market has been shaken by the recent sharp falls but we have stirred from our view that commodities are in a long term upward supercyle within which there will be some very severe rollercoaster moves.

The price has fallen 15% in September but, after having done that, it is still up 24% on its level of 12 months ago. Name any other investment that has done half as well.

We think the correction to the wide deviation between the price and the 200-day moving average will have run its course by late October. The buying zone is probably between $1,550 and $1,600.

It is possible that prices will go lower than this, given the current volatile state of the markets. But a much bigger fall would be needed to alter the long term story.

While equity markets are crashing, the US dollar will rise. At this time gold is bound to consolidate. Once markets steady and go into risk-on mode again, the dollar will drop back and gold should resume its long term uptrend.

Demand from both China and India is likely to be strong. The Diwali festival, which is often the seasonal low for the metal, is on 26th October.

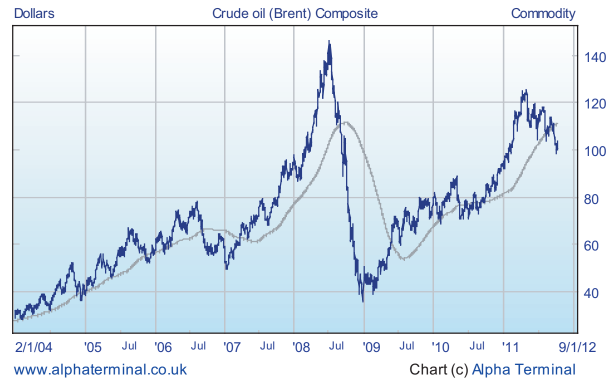
Commodity price index

Gold

Commodities

Platinum

Oil



Silver

Palladium

Copper

Aluminium

Currencies

The turning of the tide

Time and tide wait for no man. Their coming in and going out continue as they have eternally. They cannot be held back.

For as long as global stock markets were in risk-on mode – as they were from March 2009 until May this year – the US dollar was in steep downtrend.

As soon as markets went into risk-off mode and started to plunge, the dollar rallied.

We are now coming up to a time when we again expect stock markets to have a good rally. In this period we should expect some retracement for the US dollar.

By the end of October, the tide should clearly have turned, and in practice its progress up the beach has already reached nearly as far as it is going to go. A half to two thirds retracement of the rally is expected.

For the DXY, or dollar trade-weighted index, that means the current rally might extend up towards 81, but it is unlikely to break this level. A fall back to 76 is then likely.

The present fall is unlikely to take the euro below $1.30. There is then the potential for it rally back up to just below $1.40.

For sterling, there is strong support at $1.50 and a rally back towards $1.60 is likely.

As ever, the one exception is the yen. It alone remains in an unbroken uptrend against all currencies including the US dollar.

There are all sorts of reasons why fundamentally this should change but, until the trend is broken, we must stay with it. The charts indicate staying long the yen.

We expect the Chinese and Indian currencies to be strong on a long term basis. In the short term it is the Chinese renminbi that is likely to move first.

If our road maps continue to work, these rallies can last until next March after which time the tide will turn again and we would expect a period of renewed dollar strength (weakness for currencies at the end side of the cross rates except the yen).

US dollar: trade weighted

US dollar/euro

Currencies

US dollar/Japanese yen

Euro/Japanese yen

Sterling/US dollar

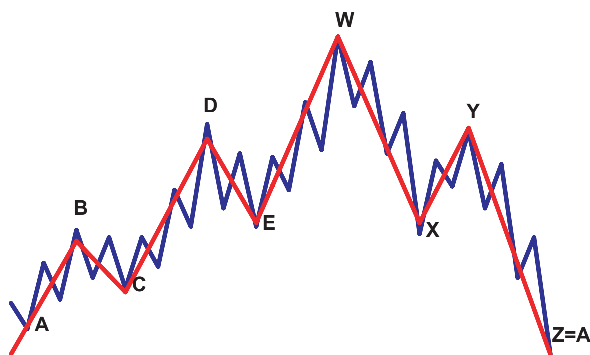
Sterling/euro

US dollar/Canadian dollar

Australian dollar/US dollar

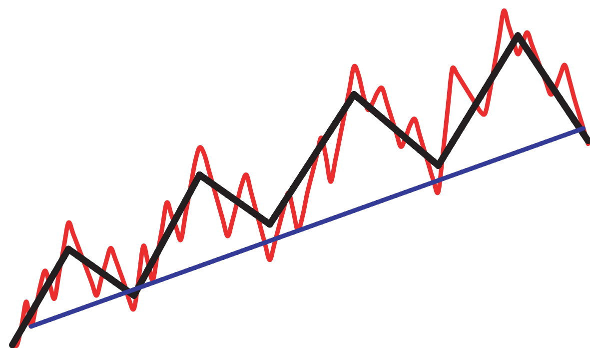
Road maps

Standard road map



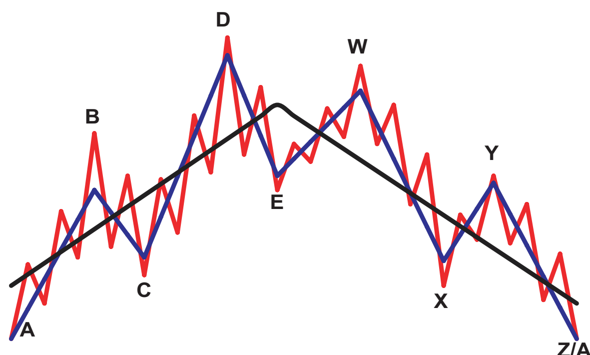
- These road maps are the basic shape of a so called Elliott Wave. We deliberately letter our maps differently from Elliott aficionados. The normal time scale for a complete cycle is four years driven by the Kitchin wave. The bull phase has three surges getting progressively more powerful. The bear phase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