

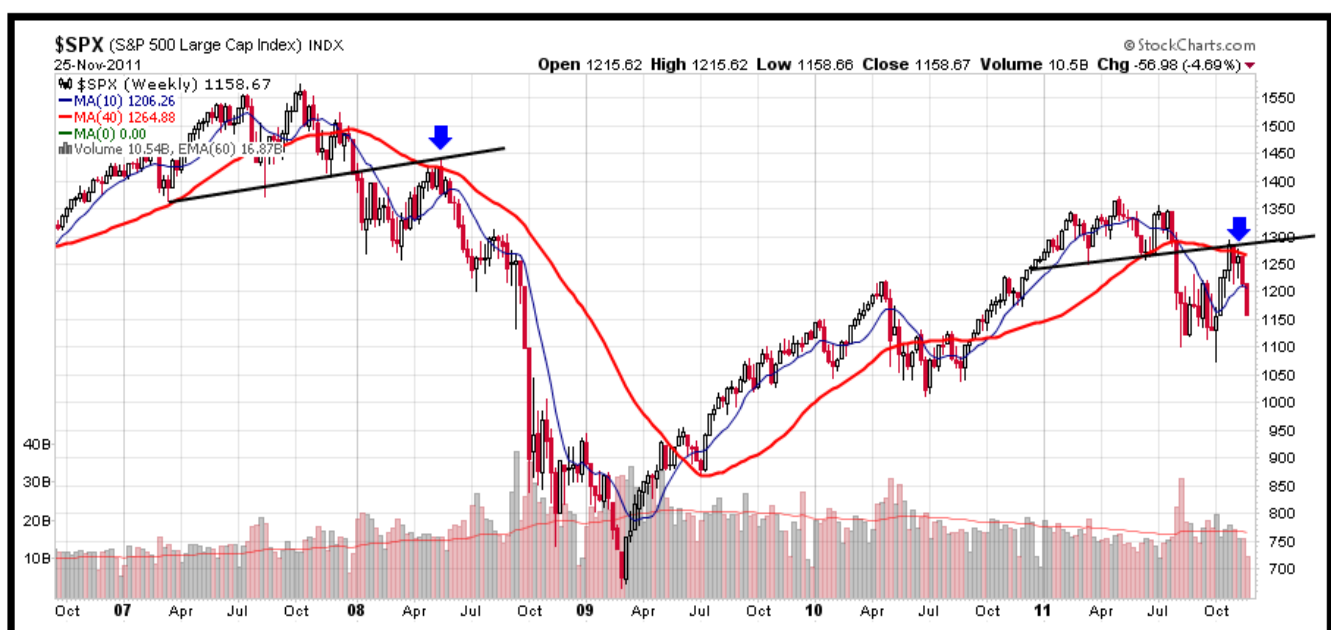
A CHILLY WINTER

BIG PICTURE – The verdict is in and investors should prepare for a chilly winter.

You will recall that in last month's Money Matters, we explained that many key markets were at 'make or break' points. Since then, the market has spoken and it appears as though the 'risk trade' is in a primary downtrend. If our assessment is correct, investors who are 'long' risky assets will feel the cold breeze over the winter months.

Figure 1 shows the weekly chart of the S&P500 Index. Instead of looking at the Dow Jones Industrial Average, we prefer to review the S&P500 Index because this represents the largest 500 corporations in the world's biggest economy. In our view, the direction of the S&P500 Index determines the fate of the vast majority of stock and commodity markets. Thus, the S&P500 Index is extremely important and for now, its weekly chart looks rather weak.

Figure 1: S&P500 Index



Source: www.stockcharts.com

As you can see from Figure 1, the S&P500 Index topped out earlier this year and the recently concluded rally failed to climb above its overhead resistance. Furthermore, this rally failed around the 40 week (200 day) moving average and this is typical bear market action. More importantly, if you look at Figure 1 closely, you will observe a similar chart pattern in spring 2008. Back then, the market also rallied to its overhead resistance, however it failed to climb above the 40 day (200 day) moving average. During that cycle, what followed was an epic crash and over the next ten months, the S&P500 Index lost over 50% of its value! Turning to the present situation, we are not forecasting a similar outcome. However, in our eyes, the path of least resistance appears to be down. Should the S&P500 Index close below its October-low, a more serious decline will probably follow and cause financial pain to those who own stocks and other risky assets.

It is interesting to observe that during this primary downtrend, major indices in the US have held up reasonably well. Whereas some of the high-flying stock markets in the developing world have already declined significantly, Wall Street is off by only 15% from its high recorded in spring 2011. Unfortunately, the stock markets of the developed nations within Europe, Australasia and Far East have not performed well either and Figure 2 reveals that the MSCI EAFE Index has already declined by approximately 26% from its spring 2011 peak. Furthermore, the MSCI EAFE Index is currently trading around a key support level and a close below 1,290 will open up the possibility of a waterfall decline. Last but not least, the MSCI EAFE is currently trading below the 50-day moving average, which in turn is below the 200-day moving average; and this set up is typically seen during a bear market. Thus, the stock markets of the developed world are in a primary downtrend and this scenario calls for additional price declines.

Figure 2: MSCI EAFE Index



Source: www.fullermoney.com

Once again, we want to reaffirm that we are *not* predicting a nasty market crash; but merely highlighting the possibility of further weakness.

After a decade's experience in the investment management business, we have come to the conclusion that the future is unknowable and the market can do absolutely anything. Thus, rather than predict, we now focus on managing risk and profiting from the ongoing trends.

At present, all the stock markets we monitor (except the Philippines Composite Index) are in a primary downtrend, and as long as this is the case, we will remain committed to our 'short' exposure and continue to hold onto a significant amount of US Dollar cash. Unfortunately, we do not know when this primary downtrend in 'risk' will end but when it does, we will cover our 'short' positions and re-position the portfolios for the next uptrend.

Given the wild swings in the financial markets and the increasing public-sector intervention, we are of the view that going forwards, a simple trend following approach will deliver much better returns than a prediction-based 'buy and hope' strategy.

Although we do not possess any fortune-telling skills, we do have the ability to dispassionately observe the present. In this regard, it is worth noting that the world's fever chart (US Dollar Index) is rising and this is bad news for the 'risk' trade. Figure 3 shows that after briefly testing its 40 week (200 day) moving average, the US Dollar Index has rallied sharply. In our view, a clean break above the 80 level will usher in the next phase of the contraction and trigger another downleg in 'risky' assets.

Figure 3: World's temperature is rising!



Source: www.stockcharts.com

Unlike us, if you are optimistic about the ‘risk’ trade and are tempted to ‘buy-the-dip’, you may want to note that various credit spreads are blowing out, 3-month LIBOR is rising, Credit Default Swaps on major US banks are rocketing higher and European bond yields are surging. Moreover, European and American bank stocks are getting decimated and the rating agencies are planning to announce further downgrades.

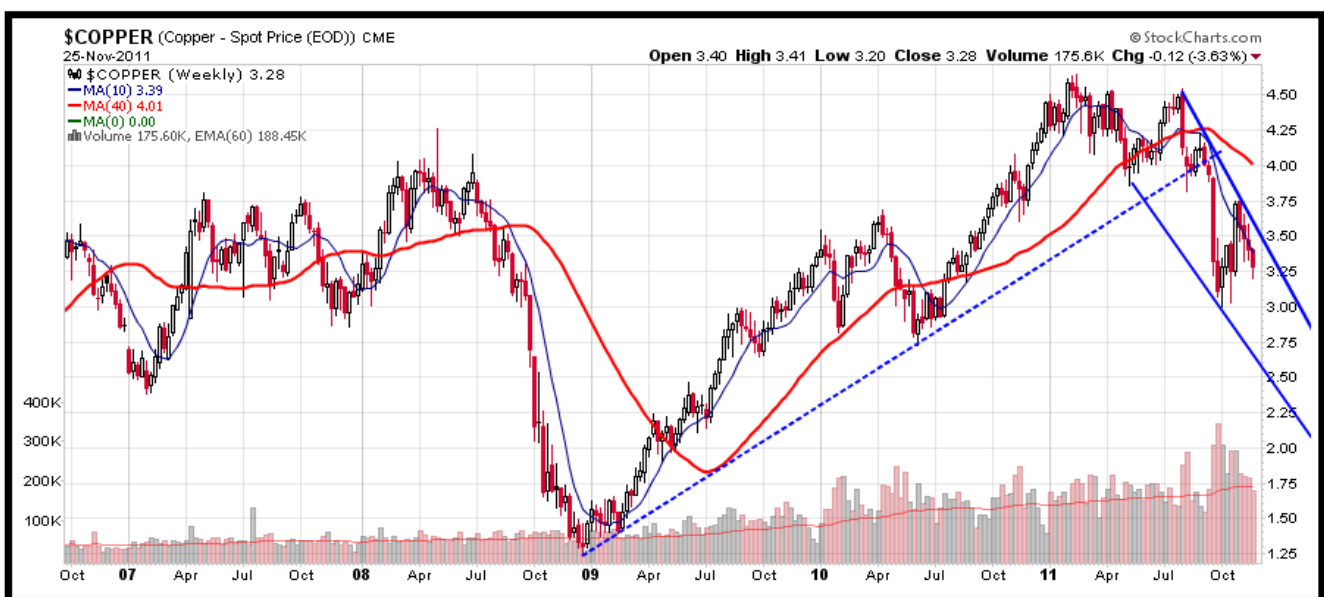
Last but not least, the European debt crisis now seems to be spreading to the ‘core’ and the disaster-show at the recent German Bund auction is yet another sign that a serious funding crisis is brewing in the Old World.

Bearing in mind all these facts, we are of the view that the ongoing primary downtrend in risky assets has further to run. Obviously, this downtrend will be punctuated by sharp, counter-trend rallies but as long as prices remain below the 200-day moving average, selling pressure should continue to dominate.

Even though the vast majority of the world’s stock markets are in a primary downtrend, it is astonishing that Wall Street has not changed its optimistic tune! For example, Goldman Sachs is still calling for a strong Q4 2011 GDP print and other houses are also urging investors to ‘buy-the-dips’. In our view, these experts and their followers are ignoring the risks at their own peril.

After all, if the global economy was strengthening and manufacturing activity was healthy, why would the price of copper be in a firmly established downtrend? Figure 4 shows that after forming a double top around the US\$4.5 per pound level, Dr. Copper started to weaken and it is currently in a downtrend. It is worth noting that the price of copper is trading below the 10 week (50 day) moving average, which in turn is below the 40 week (200 day) moving average. Once again, the most critical industrial commodity is in bear market mode and this cannot bode well for the global economy.

Figure 4: Dr. Copper – a falling knife?



Source: www.stockcharts.com

In summary, with key stock as well as commodity markets in primary downtrends, and with rising credit strains, we are *not* prepared to accept any ‘risk’ on the long side. Rather than catch falling knives, we are simply watching the show with ample ‘dry powder’, so that when the next uptrend emerges, we will be ready to seize the opportunity.

Thus, our *Discretionary Premium Portfolio* is currently ‘net short’ and we are maintaining our large US Dollar cash exposure. Finally, our *Discretionary Fund Portfolio* (where we are unable to establish ‘short’ positions) is out of every asset and we are seeking shelter in US Dollar cash.

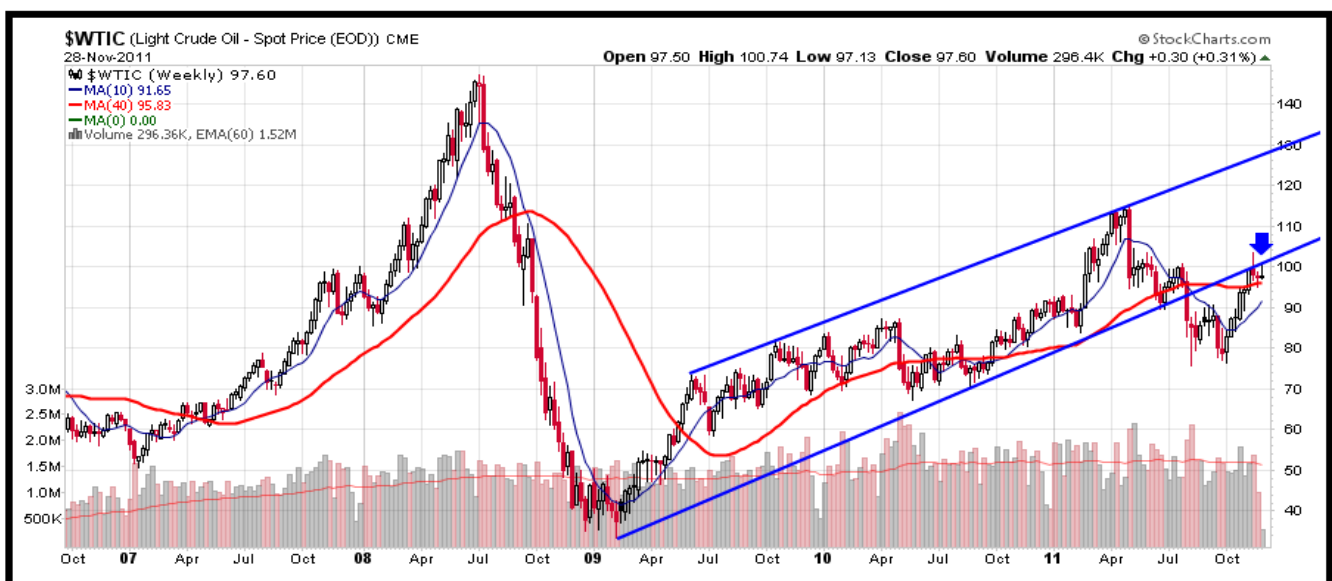
ENERGY – The majority of the developed economies are slipping into recession and this implies that the demand growth for energy is slowing down.

According to the International Energy Agency (IEA), the world will consume around 89.2 million barrels per day of liquid fuels in 2011 and usage is likely to increase by ‘only’ 1.3 million barrels to 90.5 million barrels per day in 2012. On the supply side, the IEA’s latest report confirms that the world produced 89.3 million barrels per day of liquid fuels in October.

Thus, for now, the oil supply is relatively tight and perhaps this explains why NYMEX crude is still trading around US\$100 per barrel.

Figure 5 shows that after breaking down from its uptrend channel in July, the price of oil bottomed in October and currently, it is finding resistance around its overhead trend line (blue arrow). So, it is interesting to note that despite the IEA’s optimistic demand forecast for 2012, the oil price is showing signs of weakness.

Figure 5: Crude oil – testing the channel breakdown



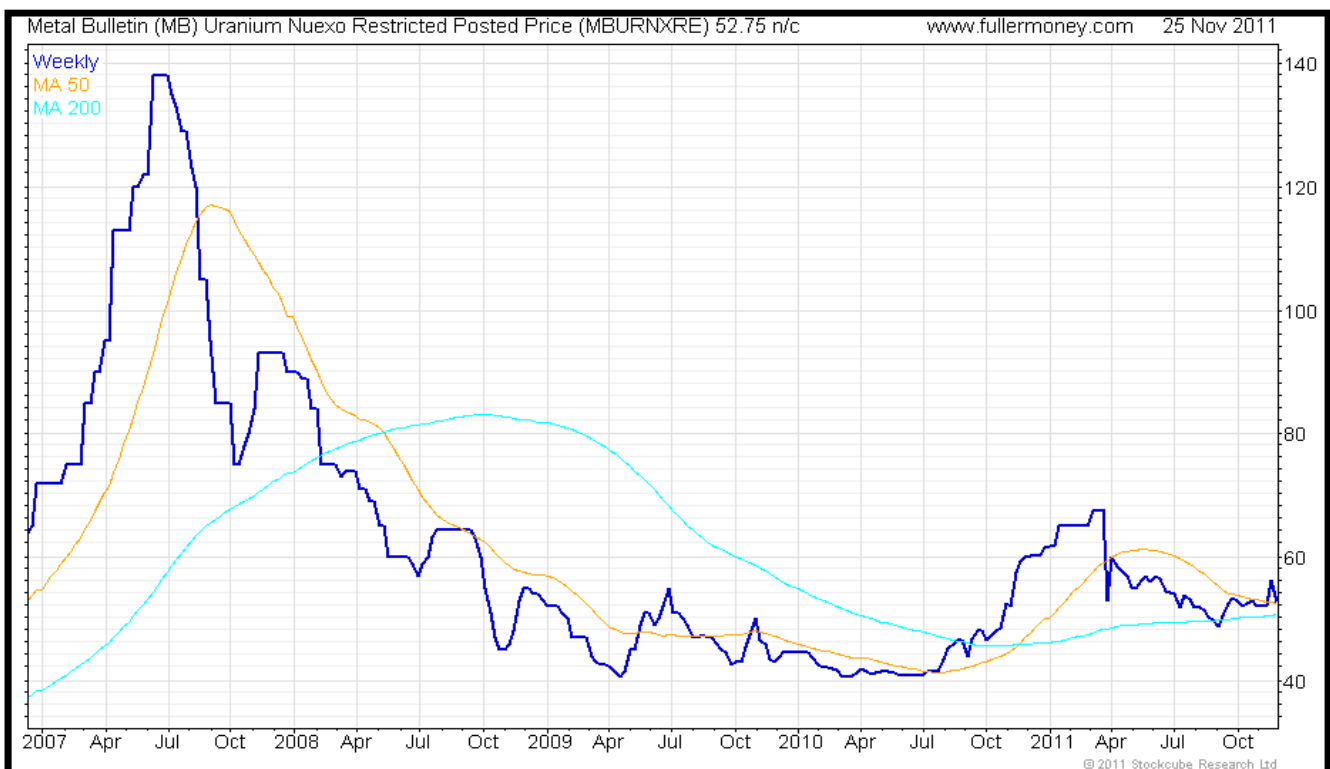
Source: www.stockcharts.com

From our perspective, should the US and other major developed economies contract, the IEA’s bullish demand forecast will prove to be too optimistic. In fact, if we get a prolonged recession, then it is conceivable that worldwide oil usage may decline, albeit temporarily. Under this scenario, the price of oil will probably decline and break below the recent low recorded in October. Should this occur, the upstream oil companies, alternative energy firms and the energy services providers will experience a slump in their business. Remember, energy is a highly cyclical industry and it is prone to severe booms and busts. Thus, during this phase of the business cycle, investors should avoid the energy patch.

Elsewhere in the energy sector, the price of uranium is building a base around its 200-day moving average (Figure 6). You may recall that in the aftermath of the Fukushima disaster, the price of uranium dropped sharply and over the past few weeks, it has stabilised around its moving averages. Around the current level, the price of uranium is well supported, but the ongoing base building period could go on for several months.

For sure, the uranium market will face a massive supply deficit in a few years’ time, but it must first deal with the looming recession and associated investor sentiment. Unquestionably, the demand for uranium will not change much in a recession (nuclear reactors will continue to generate electricity), but investor sentiment will remain weak and this may prevent a big rally.

Figure 6: Uranium – building a base?



Source: www.fullermoney.com

We want to make it clear that although we are long-term bulls on the energy sector, we have always maintained that this sector will be prone to setbacks during recessions. This is why we currently have no exposure to the energy industry, but we will re-invest towards the end of this downtrend in risky assets.

Make no mistake, unless the world finds large oilfields very quickly, during the next global expansion, the price of oil will probably surge. In terms of fundamentals, oil supply is barely keeping up with global usage and at some point, worldwide consumption will outstrip production. When that occurs, the price of oil will appreciate considerably and, as always, the price action will prompt us to buy into the rally. However, for now, we remain cautious and defensive.

PRECIOUS METALS – The bull-market in precious metals has been going on for 10 years and today, gold and silver are considered trendy assets. Undoubtedly, the gains of the past decade have converted many investors into ‘real money’ bugs and currently, many people will be quick to tell you why gold and silver can only appreciate in value.

Whilst we share the widespread enthusiasm for precious metals from a longer term perspective, we remain cautious over the near term. According to our analysis, at some point in this economic downturn, the Federal Reserve will unleash another round of quantitative easing. However, for that to happen, the US CPI will probably have to decline to below 1%.

Today, the US CPI is hovering around 4% and with ‘inflation’ running above its mandate; the Federal Reserve will struggle to unleash QE3. Thus, for now, precious metals are also susceptible to the ongoing forces of deleveraging and private-sector debt deflation.

Figure 7 confirms that after peaking earlier this year, gold found support around its 40 week (200 day) moving average; but its recent rally failed below its all-time high. It is notable that gold’s current chart pattern is very similar to 2008, when the price of the yellow metal also formed a lower high, before

Figure 7: Gold (5-year weekly chart)



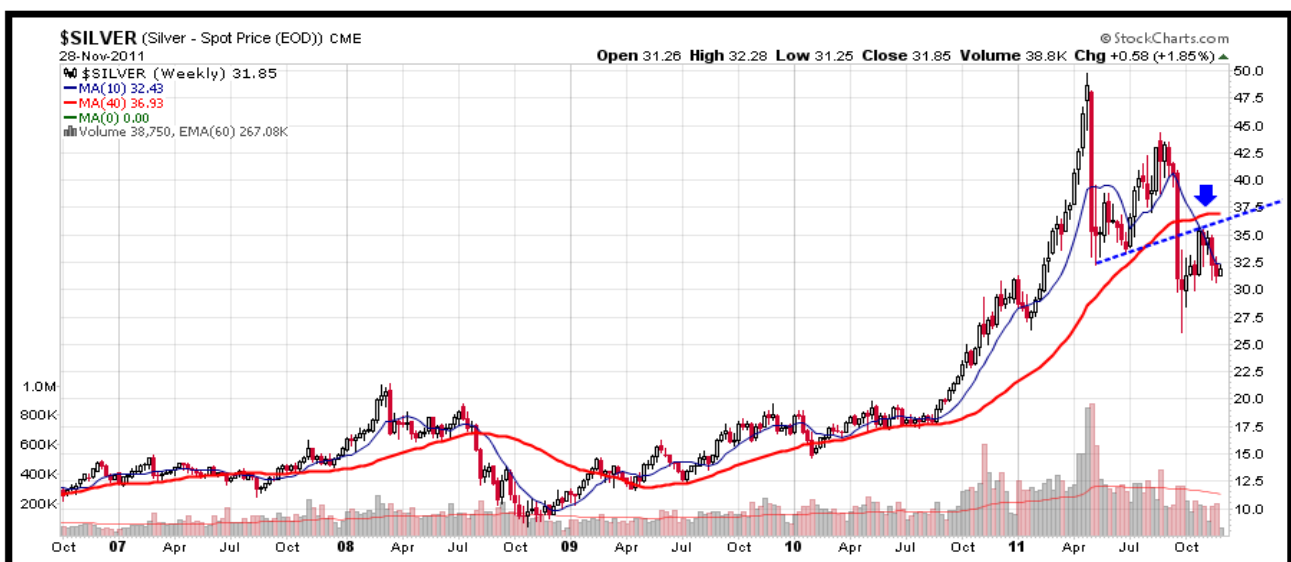
Source: www.stockcharts.com

plunging during the previous recession. Now, we are not forecasting that something similar has to play out during this business cycle. At the same time, we are not ruling out the possibility that gold may decline over the following months and test its rising trend line. Under that scenario, the price of gold could decline to around US\$1,500 per ounce and a break below that level will be *extremely* bearish for the global economy.

In our view, the price of gold is unlikely to penetrate its rising trend line. However, should we get a string of bank failures in Europe, then the price of the yellow metal will also not be immune to the deflationary bust.

In any event, we are of the belief that until the next round of ‘stimulus’ is announced, gold should hold up better than silver. Currently, silver’s weekly price chart looks very weak and as you can see from Figure 8, its recent rally failed around key overhead resistance.

Figure 8: Silver is vulnerable



Source: www.stockcharts.com

As long as the price of silver stays below US\$37 per ounce, it will remain in a downtrend and at the very least, a break above the recent high will be required to trigger a sustainable rally.

Given the bearish technicals and weak near term fundamentals, we do not have any exposure to precious metals. In our view, a better buying opportunity is likely to present itself in the future.

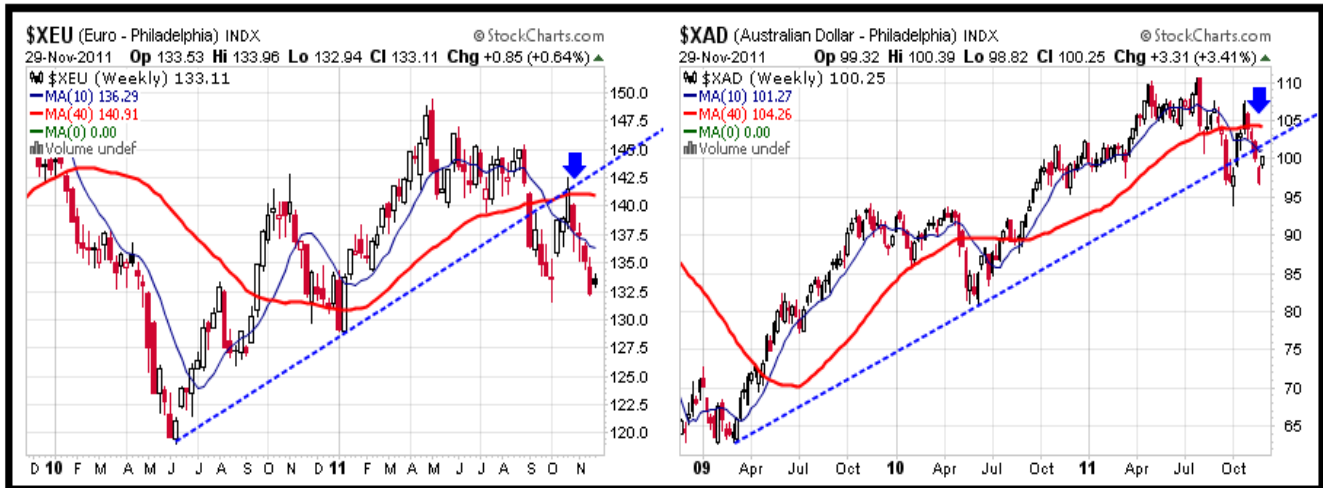
CURRENCIES – The world’s reserve currency is strengthening and for now, it is in an uptrend. The fact that the US Dollar is rallying suggests that the world’s economic troubles are growing. At the least for the time being, the Federal Reserve is not creating new currency units and this is why its currency is appreciating.

It is notable that during the previous recession, investors sought shelter in the senior currency and this triggered a big advance. You may recall that between April 2008 and March 2009, the US Dollar Index rallied by an impressive 23%!

Turning to the current economic cycle, the business expansion peaked in April 2011 and it is interesting to observe that the US Dollar Index bottomed around the same time. Since then, it has appreciated by approximately 10% and we suspect that the ongoing rally is likely to continue.

Figure 9 shows that both the Euro and the Australian Dollar are looking weak and have broken below their multi-month uptrends. Furthermore, as you can see, their recent rallies failed around the 40 week (200 day) moving average, which is consistent with a primary downtrend.

Figure 9: Euro and Australian Dollar



Source: www.stockcharts.com

At this stage, there is no way to tell how much these currencies will depreciate, but the path of least resistance is certainly down.

In our view, the single currency is sliding due to the ongoing debt problems in Europe. Whereas, the weakness in the Australian Dollar may be signaling problems in the Chinese economy. In any case, the cause of the decline is largely irrelevant, what is important is that the trend is down for now.

As long as the deflationary forces of debt deleveraging persist, the world's reserve currency will probably continue its ascent. Thus, until the Federal Reserve unleashes QE3, we will continue to hold on to a significant amount of US Dollar cash.

BONDS – The great primary uptrend in US Treasuries is still intact and despite talks of hyperinflation, US Treasury securities continue to be in vogue.

It is ironical that only a few months ago, the world's largest and most successful bond fund manager (Bill Gross of PIMCO) was 'short' US Treasuries and a host of other prominent market commentators were calling the impending bursting of the bond 'bubble'. Unfortunately, for PIMCO and the other bears, US Treasury securities did the unthinkable and rallied sharply.

Well, so far, the bond bears have been proven wrong and it is conceivable that US Treasury yields may follow Japan's footsteps and decline further. The chorus of hyperinflation aside, it may well be that the deflationary forces of private sector debt deleveraging end up defeating the Federal Reserve's efforts to inflate.

In our view, during this period of private sector deleveraging, US Treasury yields will continue to decline. However, this southbound journey will be interrupted by additional bouts of quantitative easing, whereby yields will *temporarily* head higher. At least this is what transpired during the previous two rounds of quantitative easing; rates went up while the Federal Reserve was buying bonds and fell back once fresh purchases ended.

From a technical perspective, 10-Year and 30-Year US Treasury securities are currently overextended and we would not rush out and buy them today. However, during the course of this economic slowdown, apart from periodic corrections, US Treasury securities are likely to remain strong. In our opinion, the next major decline in US Treasury securities will occur when the Federal Reserve announces QE3.

Across the pond, bond yields are surging and this is a really bad sign. At the time of writing, Italian, Portuguese, Spanish and Greek bond yields are flirting with multi-year highs and this implies that the bond market is not buying the recent European 'solution'.

Political jawboning aside, the reality is that many European nations are essentially bankrupt and they cannot repay the existing debt. To complicate matters further, their bond yields are rising and this will make debt servicing even more difficult. Now, we do not possess a crystal ball and do not know how all this will end. However, we do know that we will not be lending money to any European entity. For now, most European bonds are in a downtrend and should be avoided.

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