

Global Report – September 2013

UK

Europe

US

Japan

Emerging Markets

Bonds

Commodities

Currencies

September 2013

World Investment Strategy

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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 trends in global markets and individual stocks.

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

World Investment Strategy

This is not the moment to plant anything. This is the time to till the soil and prepare for the next harvest. Having a good cash cushion for the next three months will help to preserve capital. We will then be able to take advantage of bargain prices should they appear. Uncertainties abound and risks are high.

At the time of writing, the UK Parliament has voted against military action but the US is expected to press on with a strike against Syrian military installations. This will add to the turmoil of an already very unstable region. Stock markets hate this sort of geopolitical uncertainty – not least because it sends the oil price sharply higher. Brent crude has hit a six-month peak.

On the economic front, you have been told that the US economy is now growing at 2.5 per cent per year and the UK at 1.5 per cent and that these numbers are fantastically good. You have also been told that China is growing at 7.5 per cent and India at 5 per cent but these numbers are fantastically bad. Emerging markets are now trading on an average P/E of 10 whilst the S&P index is on 19, and the Russell 2000 is on 26. Investors are dumping their holdings in emerging market assets and buying into the western 'growth' story – particularly that of the US.

In the currency markets the most over-crowded trade was to be long the US dollar – but this has not been working. Against the euro, sterling and the yen, the dollar has been losing ground. The old market saying is that when everybody is thinking the same thing, then nobody is thinking at all. They often have a rude awakening and when this happens, cash is king.

It is an abuse of the English language to describe what has occurred in the west over the past three years as growth. It is, in fact, a partial recovery of what we had before. With the exception of the US and Germany, all western markets are lower than they were in 1999. In real inflation-adjusted terms, even the US and Germany are down about 30 per cent.

You have also been told that US unemployment is down to 7 per cent. This is the U3 measure. There are also Us 1 to 6 – all official ways of spinning the unemployment numbers. U6 is officially 14 per cent but Shadowstats.com suggests the true number is 23 per cent. The figures also show that average US incomes are well up, but this is just arithmetic. If you strip out the billionaires in the top 1 per cent, most Americans are earning less now than they did in 2000. Their pensions are also worth much less than they thought they would be. So, all in all, the consumption of 90 per cent of Americans will not be driving any growth. A demographic time-bomb is beginning to tick.

You have also been told that the emerging markets are now a busted flush. The mistake investors have made here is to assume that the path to industrialisation was a smooth, tarmac'd one. In 2006 in a book called *'Mapping the Markets'* we warned that there would be potholes along the road. We are currently encountering one of these potholes but it will not bring the process of industrialisation to a halt.

If there is going to be any real growth in the world, it is going to be in the emerging countries and their stock markets will eventually outperform. These markets have already fallen back towards levels that are beginning to represent good value. However, they could well fall further – especially in foreign currency terms as their currencies are dropping like a stone. This phase needs to be endured. Central banks in some emerging markets have been raising interest rates in an attempt to stem the selling pressure on their currencies. This will curb growth and send equity markets lower. The negative feed-back loop could well trigger the capitulation sell-off that often marks the end of a bear market. Only after this has occurred should we start going bargain hunting again. The emerging markets also show how important it is to have a currency overlay on an international portfolio. If the currency risk had been hedged, most of these markets would have been spectacular investments – and will be again.

World Investment Strategy continued

There has already been a capitulation phase in gold and silver which are now bouncing strongly.

Meanwhile in the bond markets, China and Japan are selling US Treasuries as fast as they can and the only buyer is the US Federal Reserve. Economists are now taking the view that QE has not been as effective as had been hoped but, if Fed tries to stop it, the stock markets will crash.

Our cycle work indicates that we are approaching a vulnerable period for stock markets. If correct, the low that occurs will give a good buying opportunity for a strong tradable rally in 2015 and 2016. This will probably be driven by money deserting the bond markets and moving into equities. The cycles then suggest there will be a final capitulation low in late 2017. Only after that will the world be ready to move back into a sustainable 'new normal' where we will see real growth, driven partly by Asia but also by new technologies. The latter will be dominated by the US, which will also be given a strong boost by cheap energy in the form of shale gas. We will enjoy all this if we can survive until then. To do that we need cash right now.

The World at a glance

Major markets

US relative to world: currency adjusted



- The US has been one of the best performing markets for a while but a top has formed on the relative chart which suggests a pullback is due.
- The economic news also supports a more cautious view with both the housing and durable goods figures coming in below expectations.
- The end of QE is another potentially negative factor for the stock market.

UK relative to world: currency adjusted



- After a long period of underperformance, the UK is enjoying a catch-up rally, helped by sterling's recent rally against the dollar.
- We suspect that this is not the start of a major trend of relative outperformance and so it is unlikely to break out of its sideways range. If there is a correction, the UK is likely to fall in line with other markets.

Europe relative to world: currency adjusted



- It has been widely recognised that nothing will be allowed to go wrong in the eurozone ahead of the German election later this month.
- Investors have taken advantage of this lull to go bargain hunting. This has given rise to a good rally but we retain our view that, apart from a few excellent German and Swiss companies, investors should be taking advantage of short trading opportunities such as this one rather than making lock-up-and-hold investments.

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



- The relative chart reflects the fact that the Japanese yen has been a prime beneficiary of the investment flows coming out of the emerging markets.
- The strength of the currency runs counter to Prime minister Abe's weak yen policy. The currency is a key factor in determining the performance of the large export sector.
- On the price chart, trading is volatile as the bulls battle to hold the market within its prime uptrend while short term traders take profits. Providing the Nikkei 225 stays above 12,500, the bias remains positive.

Pacific ex Japan relative to world: currency adjusted



- Weakness in the Asian markets has been aggravated by sharp falls in their currencies, giving rise to a steep decline on the relative chart but there are now signs that this is beginning to level out.
- We do, however, need to see clearer evidence of a base developing.
- Longer term, we feel this correction will set up an extremely good buying opportunity.

Latin America relative to world: currency adjusted



- The relative chart remains in freefall. Although we are in the climactic phase of the sell-off there are no signs yet of it coming to an end. We therefore have to bide our time.

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		Upward Sloping	Percentage Change (US \$)					
		25D	200D		1 MONTH		% 3 MONTH		12 MONTH	
		Moving Average		25D SMA	AVG	AVG	AVG	AVG	AVG	
Argentina	++	✓	✓	✓	9.2		1.7		27.9	
Venezuela	++	✓	✓	✓	5.9		64.3		209.4	
Denmark	++	✓	✓	✓	4.0		6.6		24.4	
Belgium	++	x	✓	✓	3.3		2.9		21.7	
Spain	++	x	✓	✓	1.7		4.6		21.8	
France	++	x	✓	✓	1.0		2.8		22.6	
Austria	++	✓	✓	✓	5.5		3.0		27.9	
Italy	++	x	✓	✓	2.0	4.1	0.0	10.7	18.2	46.7
Switzerland	+	✓	✓	✓	2.4		1.3		27.0	
Netherlands	+	x	✓	✓	0.0		3.0		17.5	
Sweden	+	✓	✓	✓	1.2		3.4		18.7	
Czech Republic	+	✓	x	✓	6.1		1.3		3.1	
Poland	+	✓	✓	✓	6.3		5.6		20.4	
Germany	+	x	✓	✓	1.0		1.8		25.2	
Hong Kong	+	x	x	✓	-0.4		-3.5		10.5	
China	+	✓	x	✓	4.7	2.7	-7.3	0.7	16.8	17.4
South Africa	0	x	x	✓	0.2		-4.0		-3.3	
Egypt	0	x	x	✓	0.0		0.4		-10.5	
United States	0	x	✓	x	-2.1		0.4		17.5	
Japan	0	x	✓	x	-2.2		2.5		17.6	
United Kingdom	0	x	✓	x	-0.7		-0.4		9.7	
Australia	0	x	x	✓	-0.8		-3.4		1.3	
Canada	0	x	x	x	-1.1		-1.3		-0.2	
Israel	0	x	x	x	-6.5	-1.6	-2.4	-1.0	17.8	6.2
Peru	-	✓	x	✓	8.9		-2.6		-22.9	
Colombia	-	x	x	x	-1.4		-1.8		-10.0	
South Korea	-	x	x	x	-1.8		-4.2		0.0	
Taiwan	-	x	x	x	-4.3		-6.0		4.7	
Mexico	-	x	x	x	-7.9		-7.6		-2.1	
Russian Federation	-	x	x	x	-3.3		-5.8		-8.9	
Philippines	-	x	x	x	-14.9		-22.0		9.1	
Singapore	-	x	x	x	-7.6	-4.0	-12.1	-7.8	-2.8	-4.1
Hungary	--	x	x	x	-3.4		-7.8		0.9	
Malaysia	--	x	x	x	-9.3		-12.5		-3.6	
Brazil	--	x	x	x	-4.9		-24.1		-27.1	
Thailand	--	x	x	x	-15.3		-24.6		1.8	
Chile	--	x	x	x	-5.9		-16.3		-16.3	
Turkey	--	x	x	x	-14.5		-34.4		-12.1	
India	--	x	x	x	-18.7		-24.5		-14.2	
Indonesia	--	x	x	x	-20.0	-11.5	-30.1	-21.8	-16.6	-10.9

Ranking and data in US Dollars

United Kingdom

■ A credibility gap

Mr Carney is finding it is a very different job being Governor of the Bank of England to being in charge of the Bank of Canada. In Canada when he provided “forward guidance” local investors took him at his word and no-one outside Canada paid much attention. In London, global investors took one look at his “knockout” clauses and decided that there was very little chance of him being able to keep interest rates low for the next three years. Quite apart from the problems associated with using unemployment as the decision-trigger to raise UK rates, in practice, it may not be his decision. If US rates start rising, it will be difficult to stop UK rates moving with them. Such a move would put the equity market into a tail spin.

It is true that there has been some rebound in the UK economy but it has been modest, extremely fragile and, at the moment, does not look capable of reaching the “escape velocity” needed to generate a self-sustaining recovery.

Political worries are also hanging over the market. The House of Commons has rejected taking military action against Syria but the situation in the Middle East is a powder keg waiting to explode.

In relative terms, the UK economy and sterling are far from being the worst place in the world in which to be invested. But being a less bad option is not the same as being a good one.

In today’s markets, asset classes that have not normally been correlated can all move together. There is no safe haven to run to when bonds, equities and gold all fall at the same time. In this respect it is useful to look at where money flows are coming from. Investors panicking out of the emerging markets have been putting their funds into Europe and the UK. But these flows are driven more by negative concerns about where they do not want to be rather than positive feelings towards the markets they are switching into. They are not, therefore, stable and can just as easily move on to other markets.

Given the normal seasonal weakness that is expected at this time of year, we prefer to maintain a high cash holding. If we are wrong we can buy back again later. This has been the right strategy since May and we suspect there will not be a significant opportunity cost in being out of the market between now and the end of October.

FTSE 100 index



FTSE 100 index relative to world



Europe ex UK

■ War and peace

The eurozone is rather like Tolstoy's epic novel *War and Peace* where a sub-plot sometimes diverts attention away from the main storyline. The impending general election in Germany is dominating events in Europe. Nothing is going to be allowed to occur that will unsettle German electors ahead of the election. It is taken as a given that Frau Merkel will remain in power. But exactly how the balance of votes will go and, therefore, the make-up of the coalition is uncertain. Even during this pre-election purdah period finance minister Wolfgang Schaeuble has admitted that Greece will need another bailout.

There is a general feeling that this bailout will not start a domino effect in the other financially-weak Mediterranean countries. But another bailout will not solve Greece's underlying problems. It has not widened its tax-collecting base sufficiently and it has also fallen behind with its programme of asset selling. So the problem of how Greece is going to stay in the eurozone remains.

The euro has been created as a non-reversible currency union. If one country were to leave, it would puncture this basic premise. Greece leaving would be

a 'black swan' event that is likely to have widespread repercussions and, as Nicholas Taleb points out, we never know how to quantify these risks. They are, by definition, unpredictable. We do know that uncertainty is always bearish for stock markets. France is supporting "its oldest ally" in taking military action in Syria, adding another layer of uncertainty. Even the mighty German stock market has fallen to its lowest level in six weeks and there is no reason why the weaker markets in the region should fare any better.

Curiously, given these background uncertainties, the euro currency has been strong. The reason for this is that it has been a major beneficiary of funds diversifying out of the emerging markets and, consequently, we are seeing a counter-intuitive rally just as election and war uncertainties are at their height. We do not regard this as a sustainable trend

After the elections, there could be some disappointment when investors realise that nothing has changed – Germany will have to continue bailing out the weaker members. We want to be liquid when this moment of realisation occurs.

European equities



European equities relative to world



Europe ex UK

France



Germany



Switzerland



Netherlands



Scandinavia



Spain



United States

■ A golden egg

Sticking with the avian metaphors; the US is rather like the farmer in Aesop's fable who suddenly finds his goose is laying golden eggs. Nature has endowed the US with a bonanza in the form of cheap oil and gas. Environmental issues do not attract such a powerful lobby in the US as they do in Europe and fracking is already producing large quantities of shale gas. By 2030, it is estimated that the US will become self-sufficient in energy. This is a major development and will have a positive influence on the longer term cycle.

It is just as well that this golden egg has arrived because demographic trends, which also have an important bearing on the long term cycle, are beginning to turn negative.

The US has always been open to immigration and this has been one of the factors that has helped to drive growth. But we are reaching a point where immigration will not offset the number of babyboomers who are retiring from the workforce.

A short term uncertainty hanging over the US market is the appointment of a successor to Mr Bernanke. Opinion seems to swing between whether Janet Yellon

will become the first female Chairman of the Federal Reserve or whether Lawrence Summers will take over. Either candidate is likely to inject some uncertainty at a time when the great 30-year bond bull market is coming to an end.

A recovery of sorts is occurring in the economy but it is still a long way off the pre-crisis trend rate. Given this relatively weak growth, it is hard to argue that the stock market represents good value. Blue chips are now on a P/E of 19 and the small stocks on 26. Bull moves do not usually start from these sorts of numbers, except during a runaway bubble which then goes on to burst.

Money flooding out of bond markets should eventually drive an upward surge in equities. But if such a surge were to start from current valuations, it can only end badly as they are already expensive on a P/E basis.

Events in Syria are contributing to short term investor uncertainty just as we are entering the seasonally weak period of the year for equity markets. Given these factors, it is advisable to take risk off the table. There is a chance that investors could well kill off the goose.

S&P 500



Dow Jones Industrial Average



Canada

■ In the middle ground

On our ranking table all the markets with large exposure to raw materials are in the middle quintile and there is no technical reason why they should move out of this neutral zone in the immediate future.

Canada has been one of the most resilient of the industrialised economies but it is feeling the effects of the slowdown in demand for commodities. GDP fell by 0.5 per cent in June and there was a \$1.1bn increase in the current account deficit in the second quarter of the year. A contributing factor was a drop in oil exports to the US – the other side of the coin to America's growing self-sufficiency in energy.

For the TSE index, a break above 13,000 would be a positive development while a move below major support at 11,800 would be a very negative step. This market might well show outperformance during a global stock market correction but it will still be going down. This does not, therefore, seem an appropriate time to be adding to what we see as a core holding in any well-balanced global portfolio.

On the currency front, the Canadian dollar has been under pressure against the US dollar. There is some

overhead resistance at Can\$1.06 but once through this level, the rate could move sharply up towards Can\$1.10. This risk also makes as want to wait before adding to positions.

Canada



Canada relative to world



South Africa

Rand on the run

Our bearish stance towards the rand in recent months has been fully justified; the currency has made new lows against the dollar.

In addition to general emerging market worries, the South African currency has come under pressure due to investor concerns about the rise in industrial action.

Gold miners have just voted to join strikers in other industries after rejecting a 6 per cent pay rise. South Africa is one of the world’s largest gold producers but many mines cannot make a profit. Obviously the fall in the price of gold over the past year has not helped these companies. But most of the South African mines are old and very deep. Having to extract the metal from so far down means they cannot compete with more shallow mines in other countries. Poor labour relations and underinvestment have also hampered output in recent years.

The stock market itself has remained inured to the industrial unrest. On the price chart the South African JSE index has been one of the top performers. It has been in a secular uptrend for several cycles. The bear part of these patterns has simply set up the next buying

opportunity. The index is still making regular new all-time highs. This trend is set to continue. But for the past two years the currency has more than undone the rise in the stock market.

As we anticipate a general shake out in world markets, now is the not the time to be buying into South Africa. But, once we are through the autumn “squalls”, the strategy will be to own the market and hedge the currency.

South Africa stock market



South Africa stock market relative to world



Japan

■ Abracadabra

It is a kind of magic. Its called Abenomics. The quickness of the hand deceives the eye. It seems to work but what really happened is out of sight.

The ruling coalition of the Liberal Democratic Party (LDP) and the New Komeito Party secured a majority in the Upper House elections in July. Control of both Houses of Parliament will enable Prime Minister Shinzo Abe to implement fully his three-part plan of monetary easing, fiscal stimulus and pro-growth reforms.

The best barometer of whether these “three arrows” are doing the trick and ending over 20 years of economic stagnation will be the stock market. On the charts it is clear a new prime uptrend started in 2003. The first surge of that move was so strong that it caused the market to become overbought. The subsequent pull back could retrace a half of the initial move. But at the moment some consolidation is underway. The trading range is 12,500 to 15,000 on the Nikkei 225 index. Support at 12,500 is reinforced by the rising 200-day moving average. Providing this key level holds, a new uptrend could begin from here, suggesting that Abenomics really is beginning to have some effect

on the economy. If, however the new policies do not work, or simply are not delivered – as happened to earlier promised reforms – the new uptrend will run out of steam and a move back to the old lows will take place. At present the chart leads us to expect the more optimistic outcome – we believe the illusion. Even so, the current consolidation phase indicates there is no hurry to add to holdings. Given the Japanese economy’s vulnerability to oil price rises, we would not be surprised to see the 12,500 level being tested in the short term. It is prudent to wait and try to catch the bottom end of the consolidation range.

Investors in the Japanese market should look to hedge the yen. A key plank of Prime Minister Abe’s strategy is to allow, indeed encourage, the yen to depreciate.

Nikkei 225



TOPIX



India

■ Keep the faith

There is no reason to lose faith in the Indian stock market. This was always going to be a long term investment. But in the short run a country that is so dependent on imported oil will see some panic selling when oil prices hit a six month high above \$117/barrel and a possible war in Syria is the headline news. Furthermore, with the tapering of QE imminent, a country with both current account and fiscal deficits plus high inflation, is bound to find its currency coming under pressure.

India is well aware that it needs to address its economic problems and the appointment of Mr Raghuram Ragan, a former IMF economist, as Governor of the Reserve Bank of India is a step in the right direction. As he noted after the announcement, he does not “have a magic wand to make problems disappear... but we will deal with them”.

It is, however, unlikely that any radical measures will be taken ahead of the general election next May. Indeed, attempts to woo the electorate, such as the recent introduction of an additional food subsidy, could mean that India’s problems get worse before they get better.

Technically, a small double top has appeared on the BSE

Sensex chart. The market is currently finding support at 18,000 but a break of this level would target 16,000. This is a massive support area and we would be surprised if the correction extended below here. According to figures published early last month, overseas investors still own about 45 per cent of freely traded Indian stocks. Not only have they not been selling but they are likely to add to their holdings at this level.

The real issue for overseas investors is the currency. The present panic in the currency will not last. Monetary policy has been tightened and measures taken to try and stem capital outflows. Unfortunately these will curb growth at a time when the economy is already losing momentum (GDP slowed to 4.4 per cent in the second quarter of the year). But between now and late October we expect lows to be made in both the rupee and the Sensex index and they will provide us with an excellent new buying window.

India



India relative to world



Pacific ex Japan

Value is appearing

Market swings normally get overdone. This then sets up the dynamic for a reversal. We believe that we are approaching this reversal point in the Pacific region markets. Some are closer to the inflexion point than others but they should all gradually move into the positive phase of the cycle within the next three months.

For international investors, the currency element of an investment must also be considered. Most of the Asian markets are in the bottom half of our ranking table, thanks in part to recent currency pressures. The two notable exceptions are China and Hong Kong. The Chinese authorities have continued their policy of a managed appreciation while the Hong Kong dollar has held up well against the dollar.

The new regime in China has a clear agenda to switch the economy towards more domestic demand. In the short term, defusing the credit bubble will keep growth relatively subdued. But infrastructure projects in many of the smaller cities should then see it averaging around 7 per cent. The urbanisation of millions of people still living in rural areas will be another driver of domestic demand.

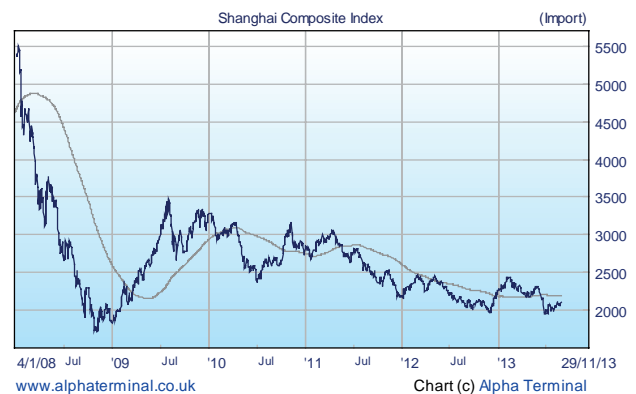
A small base pattern has developed on the Shanghai Composite chart around the 2,000 level and, with the P/E ratio down to 11, investors appear to be taking the view that the time is right to start bottom fishing. The chart suggests the market is coming to the end of a bear phase. A similar potentially bullish pattern earlier in the year was disrupted by the Fed's announcement about ending QE. The immediate target now is the May high of 2,300. A pull-back below 2,000 would negate the bullish pattern.

After rallying strongly last month, Hong Kong's Hang Seng index is consolidating. The Hong Kong dollar has been moving within a sideways trading range against the dollar, thereby bolstering the market's relative performance. Support at 21,500 is reinforced by the 50-day moving average. Other markets which are in strong secular uptrends, such as Singapore and Thailand, look as if the correction has further to go before it triggers a rebound.

Australia

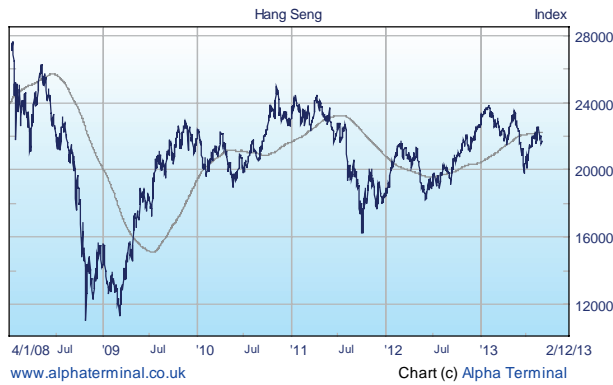


China



Pacific ex Japan

Hong Kong



India



South Korea



Indonesia



Taiwan



Singapore



Emerging markets

■ Not quite time to go back in

Last month we warned that not only were we likely to be heading into the capitulation phase of the bear cycle in these markets but the currencies also needed to be hedged. The long term arguments for investing in these markets are well known. The question is – have we reached the right entry level to go back into them?

As noted earlier, the valuation discount of emerging markets to industrialised ones has widened appreciably and it is now at levels not seen for seven years.

Technically, however, we need more evidence of a bottom pattern forming on the charts. In the case of Brazil, for example, the secular trend is strongly positive but the bearish phase of the shorter term cycle has been very severe. Recently the Bovespa index has bounced strongly off the 45,000 support level but needs to extend up through the 200-day moving average, currently at 55,000, to give a buy signal even in local currency terms.

The Brazilian real has been one of the currencies worst hit during the recent sell-off and this has undermined the stock market's relative performance, putting it in

the weakest quintile of our ranking table. The real has rallied off its lows against the dollar but there is no indication on the chart of a major change in trend. We, therefore, are holding off going back into this market.

It is the same basic story for Mexico except that its performance has been much stronger. It is as though the chart of the Mexican Bolsa index has been skewed upwards and to the right. This is our preferred market in the region but even here we would prefer to hold off buying for the moment.

After a brief pause the Turkish market has continued to drop lower. The negative crossover of the 50- and 200-day moving averages does not suggest that we are close to moving into the positive phase of the shorter term cycle just yet.

The long term case for investing in these markets has not collapsed. But, as their volatility is much higher than the developed markets, we need to err on the side of caution in deciding when to go back into them.

Brazil



Russia



Emerging markets

Emerging markets index



Mexico



Chile



Turkey



Eastern Europe index



Poland



Bonds

■ Fooling all of the people

"You can fool some of the people all of the time, and all of the people some of the time, but you cannot fool all of the people all of the time."

Abraham Lincoln

The window of time in which you can fool all of the people is relatively small. After a while the smart ones figure out what is going on. Central bankers have been fooling bond investors for some time now and we are reaching the point where Mr Market is beginning to twig what is happening.

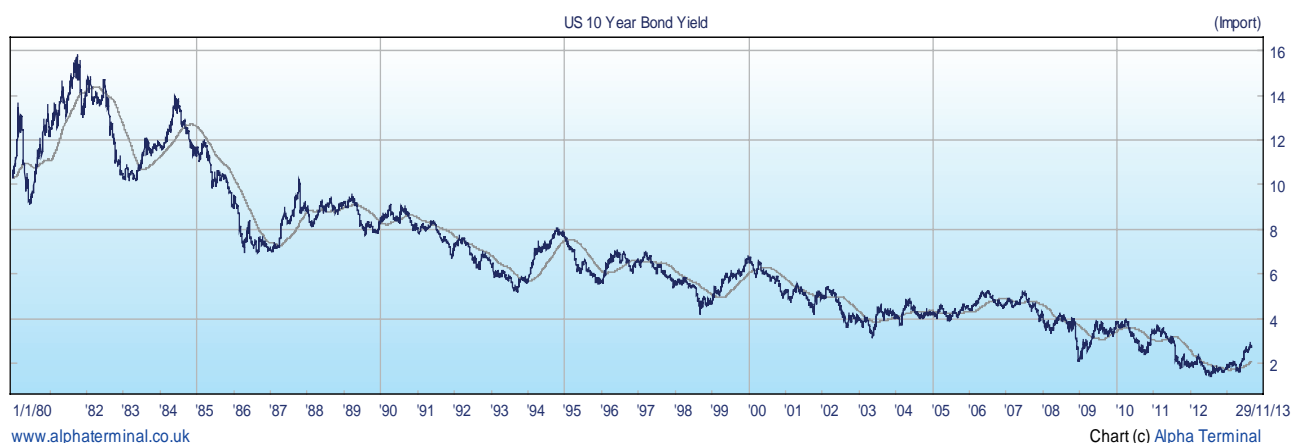
An increasing number of research papers are beginning to question whether QE has any long term beneficial effect on an economy. Even if it does have some positive impact, it cannot be continued indefinitely. If bond yields were to go to where they should be – i.e. around 5 per cent – straight away, equity markets would crash. The authorities are trying to engineer a more gradual transition. As noted in the UK section, the Governor of the Bank of England is trying to achieve this through 'forward guidance'. But the market was not fooled by this. Other tactics will no doubt be employed to try and slow down the rate of rise.

As noted last month, we believe the 30 year bull market in bonds is over. But, when there is a change in direction of such a well-established trend, there is always a lot of backing and filling as the turnaround occurs. Allowing for this short term volatility, the immediate target for the yield on the 10-year US Treasury bond is 3 per cent.

Only a short-run panic about events in Syria or renewed pressure on the euro after the German election would cause a more significant rally in bonds, taking yields back below 2.4 per cent.

A decadal turnaround in bond markets has implications for asset allocation. The normally prudent strategy of running a balanced fund needs to be reassessed. The proportion of cash in portfolios should be raised and bond holdings reduced. Remaining bonds should be switched into short-dated maturities.

US Treasury bond 10 year yield



Bonds

US benchmark bond 30 year yield



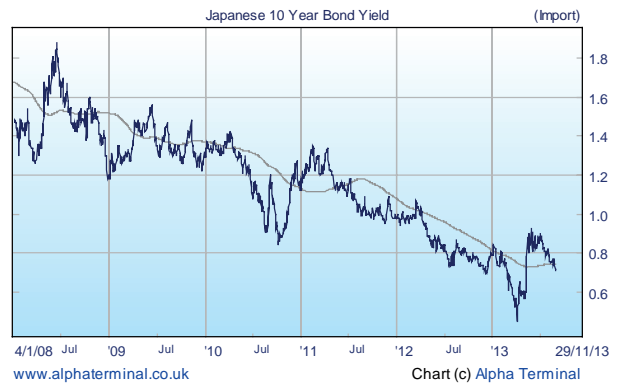
UK benchmark bond 10 year yield



German benchmark bond 10 year yield



Japan benchmark bond 10 year yield



Commodities

■ The low is in for gold

Many investors may have been shaken out of their position in gold. This is unfortunate. However, if you had sold on the break of \$1,500, then a good profit should have been made. Short positions should now be closed.

The charts indicate that a capitulation sell-off has taken place, completing the bear part of a cycle still in secular uptrend. Central banks have been trying to disrupt the bull move but they have simply ended up with nothing in their vaults. They have lent out or sold so much of the precious metal that it would take seven years of production to rebuild their reserves to the levels they were at two years ago.

In due course the next uptrend should break above the old overhead resistance levels, making new all-time highs. We are likely to experience a period when bonds, equities and many paper currencies all lose their value. Gold is one of the very few assets that will not be correlated with this move. Its hedging properties have seldom been more important. We have seen a good example of this recently in India. Indians who bought gold a couple of months ago will have completely offset the fall in the rupee against the US Dollar.

The price of oil has spiked higher on the back of rising tensions in the Middle East. But only a major escalation of the unrest would send Brent crude oil through the top end of its \$100-125 trading range. Shale gas has shifted the equilibrium of the supply-demand curve for energy downwards.

Generally, commodity markets will not move into a sustainable uptrend until growth in China starts accelerating again. This will not happen immediately as the authorities need to unwind the credit bubble that has blown up there. We take the view that they will succeed in doing this and are long term bulls of commodities. Many of the mining stocks are already looking cheap. They have rallied off their lows but we need to see a sustained break of the downtrends before buying into them.

There is one potentially rather worrying chart in the commodity complex. Copper shows what could be a massive multi-year double top. The vital support is at 300cents/lb. If that fails, it would signal the end of the recovery. Alternatively, a good rally from that base would indicate growth is resuming after a long interruption.

Commodity price index



Gold



Commodities

Platinum



Oil



Silver



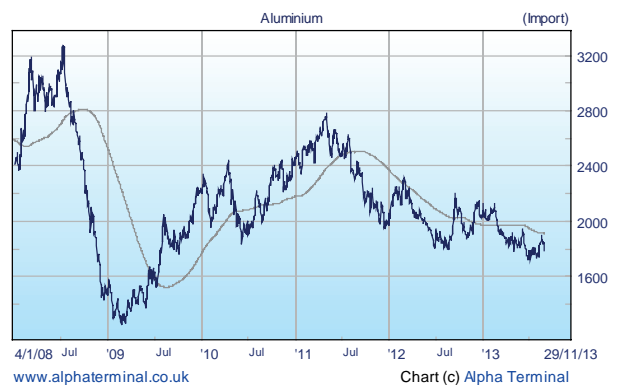
Palladium



Copper



Aluminium



Currencies

■ The crowd got it wrong

We tempted fate last month by siding with the crowd and calling the dollar higher. As we noted back then, “the one thing that is certain, when everyone thinks the same, it is invariably wrong.” And so it has proved to be for sterling, euro and yen-based investors. If you happen to be a rupee or real-based investor, the dollar has looked very strong.

The prospect of the Federal Reserve tapering off its asset purchases was the catalyst for sharp falls in the currencies of the emerging markets. Much of the liquidity that the Fed has added to the US financial system has found its way into these markets. Given the heightened geopolitical risk and rising oil prices, it is noticeable that the money coming out of these markets has not been funnelled primarily into the dollar – the usual safe haven *par excellence*. Instead it has gone into the euro and yen. Technically, the move looks rather overextended and so a technical pullback is likely.

In the very short term, the euro/dollar rate is likely to head back towards \$1.32, the top end of its trading range. There is heavy overhead resistance above this level and, failure to break above it, is likely to lead to some profit-taking, pushing the rate back towards

\$1.28. The catalyst for a weaker euro may be renewed speculation about the future of the single currency in the aftermath of the election on September 22nd. A break below \$1.28 would target major support at \$1.20.

The yen continues to see-saw between ¥105 and ¥95. The Bank of Japan will cap any appreciation beyond ¥95 and Japan’s competitors will try and prevent the rate going above ¥105.

The currencies of emerging markets with current account deficits have seen the sharpest falls as they are particularly vulnerable to capital flight. India, Brazil, South Africa and Indonesia have been some of the markets hardest hit. The scale of the sell-off has been so large – the rupee, for example, lost 8.8 per cent of its value against the dollar last month – that there is likely to be some pause in the selling pressure. But we suspect that the reversing of the QE process will see more money coming out of the emerging markets.

US dollar: trade weighted



US dollar/euro



Currencies

US dollar/Japanese yen



Euro/Japanese yen



Sterling/US dollar



Sterling/euro



US dollar/Canadian dollar

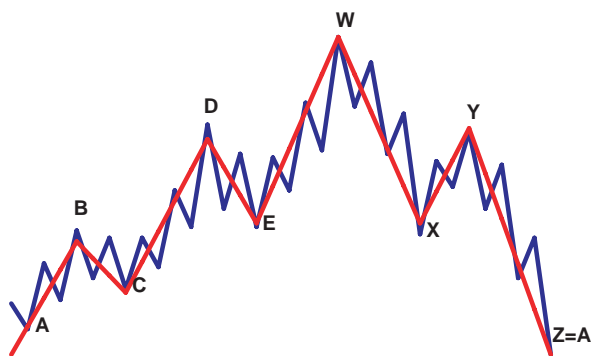


Australian dollar/US dollar



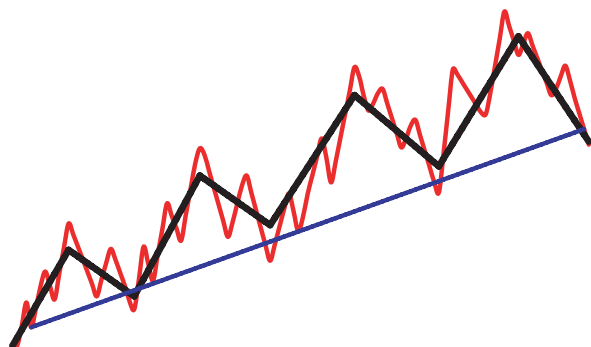
Road maps

Standard road map



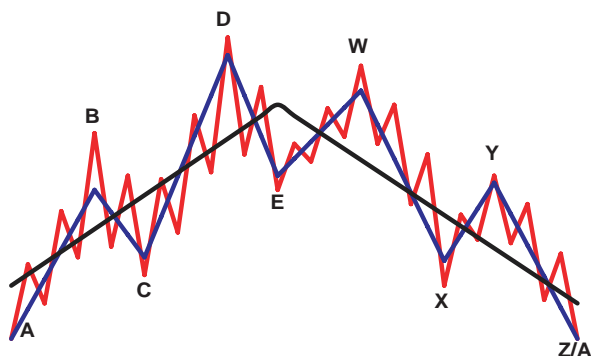
- These road maps are the basic shape of a so called Elliott Wave. We deliberately letter our maps differently from Elliott aficionados. The normal time scale for a complete cycle is four years, driven by the Kitchin wave. The bull phase has three surges getting progressively more powerful. The bear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

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