Global Report – June 2011

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World Investment Strategy

IRC INVESTMENT RESEARCH OF CAMBRIDGE

Introduction

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

Contents

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

World Investment Strategy

It is that time of year. Everybody knows to sell in May. There is some statistical evidence for doing this.

In an average year, the high made in May can be the high for the year. If it is in the context of a bear market, then it almost certainly will be.

However, if it is in the context of a strong bull market then it will only be a temporary top, nothing more than a trading opportunity.

At present, most markets have shown some seasonal weakness, but critical support levels have not been broken.

It is true that the volume of trade is larger on the down days and more modest on the up days but, again, the major supports for most of the industrialised countries are intact. All that has really occurred is that the previous overbought position has been reduced.

An analogy with a bed spring might be helpful. You have to push it down to make it bounce back up again. Until you do this the spring has no power.

It must be noticed that the momentum to the upside ran out in January. The big setback that followed in March tested support levels but in most cases they held up.

Trapped between good support and heavy overhead resistance, indices are range bound. The US and UK indices both fell around 4% and then rallied half way back up before coming under selling pressure again.

Forecasters seem to fall into two extreme categories. They either expect a burst of runaway inflation caused by the Fed's QE policy or, alternatively, a bout of depression. In the real world what we normally get is something less exciting and clear cut – an inconclusive muddle through.

Faced with these conflicting opinions, it seems risky to stick one's neck too far out in any direction. Well diversified risks are needed. We can come up with levels in both directions which, if broken, would give rise to aggressive action.

Our long term, or secular view, has not changed.

We see the world moving into a new era in which the emerged markets have a much larger role to play. First China and later India are likely to become the largest economies and stock markets. Brazil and other countries, underwritten by natural resourses, are also going to do very well. We want to own these, but only if we can buy them at a good price.

The mature markets of the western world are all in secular downtrend, but they do have some good companies operating in the right parts of the world.

It is clear that governments over-promise and under-deliver. They also borrow and spend too much money. They then get out of debt by debasing the currency. It is essential to hedge this risk in the time honoured manner by owning gold.

It is also clear that in the bond markets it is better to hold bonds of great companies than bad governments.

In the short term, however, the US is still by far the biggest economy and the dollar the world's major currency. If equity markets go into risk-off mode then the dollar will rally strongly.

There is a risk of this in the second half of the year, but the situation is dynamic. If markets look like going into freefall, the Fed can change its mind and offer a QE 3, 4 or even 5. Then the dollar would fall further.

On balance, it seems that early May was a selling chance, but not a time to go away. There is still likely to be a mid-summer rally and we will be looking to sell after that. Even then, there could be a change in strategy if the Fed adds more liquidity, or if China allows more growth and prevents any cooling off of the inflationary pressures.

We must be ready to react, but meanwhile be patient. We should not be accused of doing nothing, we are in a state of masterful inactivity.

Summary: world market overview

It is hot, very dry and many crops are being ruined. The Chelsea flower show is over. There is a cloud of volcanic dust over Europe, tornados occurring outside the usual ‘hurricane alley’ in the US and record floods in Mississippi. Gaia is still angry. Mankind is becoming aware that he may not be as powerful as he had thought as he is swept along by these titanic forces. Compared to the forces of nature we are small players – the equivalent of bit parts in War and Peace.

In the stock markets, the giant trends are the secular trends on our road maps. Anything lower than it was 10 years ago is in a secular downtrend. This highlights the swing in the world order from west to east.

In a well-diversified portfolio we should have a greater weight than the more conventional benchmark market indices hold in the newly-emerged markets of China, India and Brazil – as well as those markets backed by real resources like Canada, Australia and South Africa. We need to front-run the inevitable changes those indices will go through in time.

There are cyclical bull and bear trends around these secular trends and, at present, the western markets are in a bull phase that started in March 2009. Asian markets are in a downward phase that started over a year ago. They are now in the last leg down of the bear period.

Approximately two and a half thousand years ago Aristotle warned of the dangers of using analogies, as they can be misapplied. But we still find them helpful. In particular, comparing the different global economies to a train with the engine at the front and the carriages strung out behind still has resonance. The length of the train is about a year long.

On this basis, the engine markets are China, India, Brazil and also Australia, Canada, South Africa. They are all on a downward gradient now but are likely to reach an important buying level some time in the second half of this year. If the cycles work perfectly, it will be around October time.

The western markets will peak out soon, probably in late July and then fall until their next buying zone in late 2012 or even early 2013.

Several things may bend our road map out of shape.

If the Fed provides a QE3 stimulus, the dollar will fall further and the market will rise longer than we are currently anticipating.

Secondly, if China decides to stop cooling down its economy in order to prevent an economic hard landing and ratchets up growth again, the low will come before we expect it.

In any event, when fully invested we wish to overweight the growth markets. We also want to hold gold and silver as they are “real” money. All we are trying to do now is finesse the timing of these purchases.

There will be a dollar rally only if markets top out and start falling. It could be a tradable 12% move on average. The gold position is for a much longer time horizon.

There is a big debate over whether we get inflation or deflation. There are good analysts supporting both sides of this debate. It is impossible at this stage to know who is correct but we suspect that the inflation fears are more justifiable than the others. We will respond as and when signals are given on the charts.

We like real assets. We see the best growth in markets that used to be thought of as rather risky. We find that the mature markets are too far in debt to be interesting in the long term.

The World at a glance

Major markets

US relative to world: currency adjusted

Although the US market has posted five consecutive weeks of losses and May saw its worst month since last August, it was until last week holding up better than many other global markets – helped in part by a brief rebound in the dollar. However, the weak economic numbers last week culminating in extremely poor payroll figures on Friday (which massively understate the true figure according to Shadowstats.com) sent investors scurrying out of dollar assets. We continue to view the US as a trading market rather than a long term investment.

UK relative to world: currency adjusted

The UK market remains in a neutral position on the ranking table reflecting the broadly sideways relative performance since the start of the year. Held back by the banking and resource stocks, the large-cap index has been underperforming the UK market as a whole. The London market is strongly correlated to the US and will react in line with it to any steps that the Fed does (or does not) take once QE2 ends later this month.

Europe relative to world: currency adjusted

Since the start of the year, the strength of the German market has been the driving force behind the relative uptrend. More recently, worries about the exposure of the banking sector (which has a large weighting in the pan-European index) to the sovereign debt of the peripheral markets has seen this region lose ground against the global index. Much of our work focuses on macro investment themes but in Europe there is a strong case for cherry-picking stocks (and they are mainly German) with good brands that have a strong presence in the fast-growing parts of the world.

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

- Japan is still in recovery mode following the disasters of March. Although there has been a strong rebound on the relative chart, we have still not seen a strong buy signal on the price chart. The market will not like the political uncertainty following Prime minister Naoto Kan's announcement last week that he will resign when the aftermath of the tsunami and nuclear crisis has been successfully dealt with. We continue to wait for a stronger signal to overweight this market.

Pacific ex Japan relative to world: currency adjusted

- Again it is the smaller countries in this region, such as Indonesia, Taiwan and Malaysia, which are making the running. Although the region as a whole is showing strong outperformance, what we consider to be the core holdings – China and India – have not yet made convincing enough basing patterns to suggest that the lows are in place. Our timing analysis suggests that this is unlikely to occur until later in the year.

Latin America relative to world: currency adjusted

- A strong bounce has taken the relative chart for the Latin American region back up to its 200-day moving average but there has been a disparate performance amongst the individual markets. The two largest ones – Brazil and Mexico - are still languishing at the lower end of the ranking table while Chile, Peru and Venezuela have been showing outperformance. These smaller markets tend to have a strong correlation with the resource that forms the backbone of their economy.

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

United Kingdom

Anyone for tennis?

The selling pressure we anticipated in May came through. The FTSE-100 index fell back just over 4%, from 6104 to 5810. The 200-day moving average is at 5797 so the major support level has not yet been broken.

The market is in secular downtrend from the highs of 2008 and 2000. The all-time high was 6950 on 31st December 1999. For as long as it is below this level, it is in secular downtrend.

Within this long term cycle, we have seen a cyclical bear move to a low in March 2003 of 3,293. A cyclical bull phase to the 2007 high followed. The next bear sell-off was to the lows seen in March 2009 at 3,830. Ever since, we have been in a cyclical bull and this positive pattern has not broken.

In terms of timing a top, our road maps can help. In a normal cycle, we get three good years up and one bad one down again. However, in a secular downtrend the skew tends to go the other way. It is closer to two up years and two down ones. The last bull cycle was almost exactly two years long.

From the low in March 2009, we are now in the 27th month of rally. We are on borrowed time.

If the May high is not the final high, then there is a good chance that the mid-summer rally high will be, all other things being equal. The index could then be between 6000 and 6350.

On normal form, we should see a bear phase lasting until late 2012 or possibly March 2013 during which the index is likely to retrace between a quarter and a half of the rise from the 2009 low. On a bad case scenario, it would retest that low again.

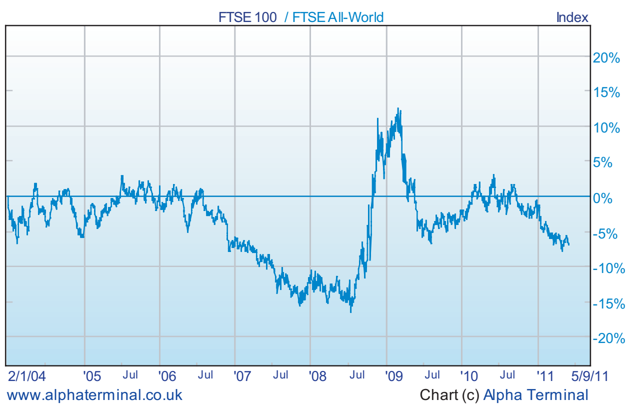
Only on a worst case scenario would it go below that level. This is possible but not probable. It would involve a new recession bordering on depression.

In the upwards direction, the market might runaway if a burst of inflation takes place. Equities would then be a better bet than bonds.

In practice, in the real world, the market could just drift along as the weather hots up. The next potential crisis will hopefully be delayed and we will be able to watch Wimbledon.

FTSE 100 index

FTSE 100 index relative to world



Europe ex UK

The beautiful game

Crisis? What crisis? In the totally corrupt world of football there is no crisis, just a little difficulty within the family. So we are told.

In Europe the politicians are taking the same line. But there is a problem – with even more money involved. The decimal point has been moved to the right by quite a few places.

The Euro is a problem that will be solved one way or the other. Mrs Lagarde is a highly competent person who understands the issues well. Rules that do not work will be changed.

The political will to produce a solution does exist and the vested interests are huge. It could be more expensive to go back than it would be to go forwards.

If we just look at the charts, it is clear that Mr Market is betting the way we have explained. The weakest major currency is not the euro but the dollar.

All western markets are highly correlated and in secular downtrend together. However if we were to pick one that might break out of this mould it would be Germany.

The DAX index is much closer to its all-time high than any others. Many of the constituents, such as BMW, have already broken to new highs and are not in secular downtrend.

At the other extreme, the weakest markets within the euro region, like Greece, are already lower now than they were in March 2009 and are clearly still going down.

Most other markets come in between these two extremes. The relatively weak performance of the French market may come as a surprise to many. The CAC index is 41% below the 2000 high and 34% below the 2007 high.

By contrast, the Spanish market is holding up much better than most expected and is only 17% below the 2000 high. The reason for this is that the Ibex index is dominated by four companies, (they account for almost 60% of the index) which are in good shape and have good exposure to Latin America.

We still expect the euro region to remain broadly correlated to the US, although resolving the problem of the peripheral countries may cause some short term fluctuations. It will respond if the Fed does more QE or not.

European equities

European equities relative to world

Europe ex UK

France

Germany

Switzerland

Netherlands

Scandinavia

Spain

United States

Suffering nature's wrath

Global warming is making all weather patterns more aggressive than we are used to. The fading *La Niña* is causing additional climatic disruptions and the US is having a particularly bad time of it. Deadly tornadoes like the one that struck Massachusetts are very unusual in the north-eastern United States. The devastation is terrible. The flooding of the Mississippi is also on a mega scale.

The President has made it clear that these are national disasters. The local regions will be given assistance to rebuild. The administration, although hugely in debt, keeps having to borrow even more.

House prices are still going down and seem to have another 25% or so to decline to get to a clearing price. Even then it will take years to move the oversupply. There are millions of mortgages that are delinquent, or due to become so soon. The banking system is still in deep trouble.

The Fed is saying that it does not need to do any more quantitative easing, but canny Mr Market suspects that the Fed will change its mind.

If all we have to fear is a slower rate of growth for a while, then most investors would think positively, however, if there is a risk of more deflation then a panic can easily take place.

Several world-renown investors like Mark Mobius, Carl Icahn, and Bill Gross fear another crisis is unavoidable as the causes of the last one have not been addressed. The problems have just been kicked down the road.

The two fears are that the slowdown will turn into a depression-like period with a financial crisis mark two that makes 2008 look like a tea party. The alternative is the Fed embarks on QE 3 and the dollar turns to dust. In practice, a muddle through the middle is likely but we must not be blind to the risks of disaster on both sides of the spectrum.

Nothing about the rally from March 2009 has been normal in any way. Many countries are deep in debt and history tells that these problems never end well and without considerable pain.

Where the biggest market leads the rest are bound to follow. We are all in this together.

S&P 500

Dow Jones Industrial Average

Canada

Learning to be patient

The long term story for investing in Canada is a good one, but there is a right and a wrong time to back it. At present we are waiting to be buyers.

Of all the markets with a huge endowment of natural resources Canada must be the most geopolitically stable.

Canada is a huge country with not many people living in it and natural wealth beyond imagining. Its largest customer is just to the south and naturally defends the longest border.

It has almost all the metals and oil and gas as well. Water will be in short supply in many countries – Canada may even export this. At the moment the world is turning its back on nuclear power but opinion will, eventually, swing back due, ironically, to its green credentials. And, again, Canada can supply uranium.

In the stock market, the TSE index is higher than it was in 2000 and so it is in a secular uptrend. However, within this context, it is in a cyclical bear phase at the moment and seems to be in step with China.

We expect it to retreat during the rest of this year to complete leg Y to Z on our road map (see page 24). The TSE index is at the time of writing at 13,806 and the fall back may reach the major support at 12,000. This would present an attractive buying opportunity.

The Canadian dollar has been extremely strong but in the past month it gave up almost 3% of its rise against the US dollar, before a modest bounce back.

This supports the view that when markets are in risk-on mode Canada will benefit but when caution is in vogue the US dollar will spring back.

We are expecting a muddle through period that will lead to a buying chance. We are well aware that the risks in markets may be a lot larger than the prevailing mood might indicate. The odds on a new crisis are high, but then not all feared outcomes actually occur.

Until the outlook is clearer we prefer to keep our powder dry.

Canada

Canada relative to world

South Africa

There is a lot to like

The entire African continent is now growing its way out of poverty into a new era of wealth and prosperity. A vital tipping point has now past and going back to the old way is not possible. These are now some of the fastest growing countries in the world. The blue chip of the area is South Africa.

The dynamic growth of both China and India is linked to that in Africa in general. The symbiotic relationship is at an early stage but should have a long life ahead of it.

This is the stuff that secular uptrends are made of and is confirmed by our road map for the JSE index. It is, however, in the cyclical bear phase and in step with Canada and Australia.

In theory, at least, there should be a better level at which to buy later on.

The risk to our view is that China does not cool down any more than it already has and they start ordering more minerals and tolerate some more inflation. However, for now, we are inclined to wait.

On the charts, the JSE topped out in February at 33,334. It then fell back over 10% to test the rising 200-day line at 30,000 in March. This vital support held firm.

The index then rebounded strongly but got stuck again at the same level as the February resistance. It has since fallen back on three occasions, but only by 5%.

It is now range bound and has lost momentum, but is still within the longer term uptrend.

Our road map expects a move down later in the year. At the moment we would regard 26,000 as a long term buying level although this is a dynamic situation.

If a low was put in at this level, it would mark the start of a new cyclical bull still in the presence of a secular bull. This is immensely powerful.

If in fact the world has a burst of inflation then the fall back will probably not occur and we will just have to pay up. In the current environment we take the view that it is better to miss an opportunity than risk losing money. Other opportunities will come around, but losses are gone for good.

JSE All-Share

JSE All-Share relative to world

Japan

To buy, or not to buy

"To buy, or not to buy, that is the question:" has the secular downtrend in Japan ended yet, or not?

Looking at the chart we can read off levels which, if broken, will give a signal one way or the other.

The first level is the 200-day moving average, which is at 9,826 for the Nikkei-225 Index. Apart from one blip in early May the index has not been above this level.

As a minimum, we need the index to break above the 200-day line to signal a prime uptrend.

Below this, support has recently been very strong at 9,400 so, if this is broken, a further downtrend is likely.

The really major support is at 9,000. This was tested twice last August when a double bottom was formed but basically held until there was a brief blip below it in March in reaction to the tsunami.

On the upside, there is resistance at just below 11,000. The actual high in March was 10891.

Putting this all together we have a narrow range between 9,400 and 10,000. A break out of this should be followed for at least a trade.

To be more certain and make a serious long term investment, we should use a wider range of 9,000 and 11,000. This would give a strategic signal to buy or sell.

In practice, we tend to favour the positive outcome as any new low above 7,000 will indicate that the secular downtrend has ended. So breaking below 9,000 would only be bad, but not terminal.

If a buy signal is given, there could be a rapid rally as most global investors are out of the market, or at least chronically underweight. This has been the position for years and so, if they tried to restore an appropriate in-line weighting again, the index would have a very powerful move

It is not necessary to predict or expect a boom to occur. We just need to accept that the stock market is good value, and that the rebuilding programme will get the economy going again, back on a normal upward cycle.

Nikkei 225

TOPIX

India

Tough love

For the long term, the Indian market is our favourite amongst the BRICs. The Indian economy has the potential to grow at a consistent, above-average rate and will probably in due course overtake China to become the biggest in the world.

In the process of doing this, the BSE Sensex index is likely to go up several fold.

Having said that, there are reasons why in the short term the Sensex index will fall to give a better buying window.

In the last quarter, the economy grew at 7.8%, as against 8.3% in the previous three months. This is the slowest rate in five quarters. Interest rates have been hiked nine times to try to cool inflation. It is working only slowly.

We are not so confident of the index falling that we would recommend selling existing holdings, but a further fall would provide an opportunity to increase exposure to this market.

The Sensex is on our strong road map and is up 600% from the lows of 2001.

The cyclical bear phase started in 2008 and the index is down 17% from the high point of 21,206.

The road map expects a fall-rally-rest of fall pattern to work out, with the entire shape twisted up to the right because of the power of the secular trend.

On this basis, the last leg down is currently underway but not yet over. A setback later this year could take the index back to about 16,000, which on the present view would present a good buying chance.

The index topped out last November and fell back to 17,303. It then rebounded to 19,803 and is now trending down again. There is good support at 18,000 which has held on a number of previous occasions. At this level the P/E ratio is 16.7. This is a little high but not an extreme premium rating.

The political scandal over the G2 telephone licence is affecting the Prime Minister's room for manoeuvre. He may well have to resign. Markets do not like uncertainty.

Interest rates have been rising to crush inflation, especially in food prices. This process has further to go.

If we get a fall back to about 14 times earnings, we would buy and become overweight in this market. For now we hold what we have, and wait.

India

India relative to world

Pacific ex Japan

Be prepared

When a market falls, most people do not want to buy it until after it has started to rally again. However, if you were expecting it to fall and were waiting for it to do so, it is easier to step in as events seem to be unfolding as you expected.

The Chinese economy has undoubtedly been in secular uptrend for many years. Even when it slows down, as now, it is still growing at three times the speed of the US. It seems inevitable that by the end of the current decade it will overtake America to become the largest economy on the planet.

The problem was that at the time of the Olympic games in Beijing investors got carried away and pushed the market onto such a forward looking valuation that the index had to fall back. The rating was roughly double that achieved by Japan at its peak.

Our road map predicted a lengthy bear period with the shape of a major fall, followed by a rally then the rest of the fall.

The Shanghai Composite Index is doing just that and is down 55% from the all-time high. The expected pattern is now in the final leg and even that is quite mature.

The last leg down started in 2009 but only in May has the index broken below the 200-day average again. This plunge should be the beginning of the end.

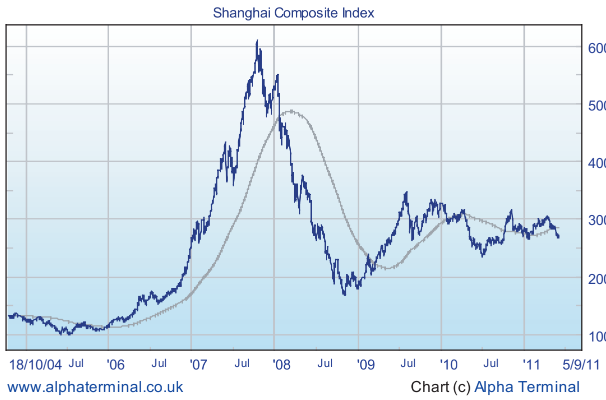
We are expecting those markets that are the engine of the world economy to get to a major buyable low later this year. They will then be at the start of a new cyclical bull in the presence of a secular bull. It will be important to buy them. They will then pull the rest of the world up behind them.

It is not yet clear if the final drop down will make a hard or soft landing.

Perhaps the greatest risk to our scenario is that there is no landing at all. Inflation is not quelled and equities just take off like a rocket. To suggest that we are on this trajectory, the Shanghai index needs at a minimum to push above its 200-day line. This is currently at 2,842. Once the low is in place for China, the other markets in this region will all fall in like carriages behind the engine. Be prepared.

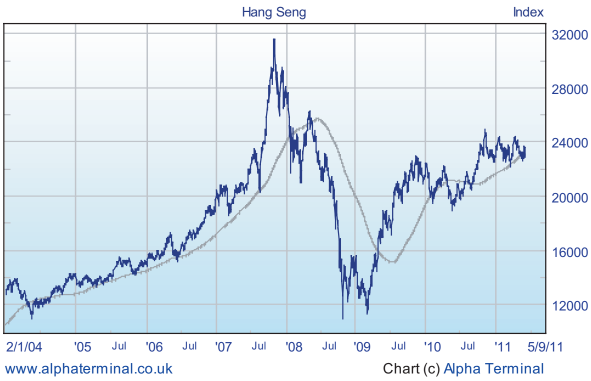
Australia

China



Pacific ex Japan

Hong Kong



India

South Korea

Malaysia

Taiwan

Thailand

Emerging markets

Winding the spring

The chart for Brazil looks very similar to that for China and India. All these markets are on the same road map.

The Latin American region is in a secular uptrend. Led by Brazil, it has positive demographics and is well underwritten by resources

We want to own these markets for the long term and expect them to be a very rewarding investment in time. It is, however, important not to overpay and to be prepared to live with above average volatility

Since 2008 the Bovespa IBOV index has been in a cyclical bear phase, tracing out the expected shape of a major fall, followed by a rally, then the rest of the fall. The final leg of this pattern is now well underway. The last move down will set up a great buying opportunity.

The first decline in the above pattern saw a 60% drop in the index, the rally then went back up to the old high. Since then the index has declined by only 15%. Given the volatility that characterises this market, there is the potential for a further decline.

The index is currently at 64260 and the 200-day moving average is 67,796. A move above this line would suggest that we are not going to get the buying opportunity that we are currently looking for and would have to just pay up and buy anyway.

The other markets in this group will all follow a similar script, to a greater or lesser extent. We expect the buyable low to be put in this year, probably near the end of the year.

The Russian market is obviously linked to oil and gas. The decision by Germany to stop using nuclear power will play well to Russia's advantage over time. Its price-to-earnings ratio is one of the lowest of the emerging markets but it does not score well on corporate governance.

In the Latin American region, the smaller markets tend to be linked to a single metal, such as copper and performance is therefore correlated to some extent to the gyrations of that particular market.

Once the low is in place, we will be looking to increase out weighting in Brazil, using an ETF. This is probably the simplest and lowest cost way of getting the desired exposure.

Brazil

Russia

Emerging markets

Emerging markets index

Mexico

Chile

Turkey

Eastern Europe index

Poland

Bonds

It ain't necessarily so

We have been very clear in the past that the great bond bull market is over, and that any rally in it is nothing more than a dead cat bounce. This remains our basic belief, but we are very conscious that we can be wrong and so need a stop loss level.

The chart of the 10 year Treasury bond yield is still within the old downtrend. The break out that we had picked up on was in the 30 year bond.

We think the 10 year price is possibly being manipulated in order to assist the mortgage market in the US. Holding this rate down is the government's way of helping to ease the pain for borrowers' loans that are close to being delinquent.

The long end of the curve gives the real picture. When the yield on the 30 year bond went above 4.8%, it broke the old trend line. It was at this time that Bill Gross of PIMCO, the world largest bond fund, made his views clear, and went short.

In the short term, prices have fallen back into a range and yields are now trading between 3.5% and 4.8%. A break out from this range will signal the new major trend.

There are two views of what will happen next. We side with the camp that says China, India and some of the other emerging economies already have an inflation problem. The QE process means that more inflation is coming – Turkey's inflation rate, for example, surged to 7.2% in May from 4.3% the previous month. It is just a question of when it comes through. When it does, bonds become toxic and equities and commodities are the way to go.

There is, however, an alternative view which might prove to be correct. This says that the role model is Japan. You can get very low interest rates and falling equities at the same time. The major pressures are deflationary. Mr Bernanke has recently highlighted high unemployment and falling house prices. In this case, bonds are a good haven. They do not make you rich, but they do preserve your capital.

The jury is out on this, but we have placed our bets. We will cut them if the 30 year yield goes below 3.5%.

We would rather lend money in bonds to good companies than bad governments. We know we are biased, and might be wrong, but that is how we are reading the situation.

US Treasury bond 10 year yield

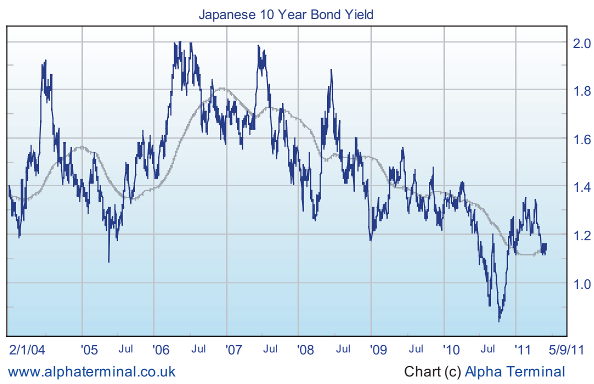
Bonds

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

Do not be fooled

It is very easy to have one's opinion altered by what we read in the press. Human beings are herd animals after all. We should resist this influence at all costs.

Only a few weeks ago some parts of the media were referring to the crash in the metal markets – especially gold. Well gold is at a new all-time high today in most currencies. In a year's time it will probably be very hard to even find this so-called 'crash' on the charts.

All governments over-promise, under-deliver and borrow too much of other people's money. They then get out of debt by debasing the currency. The public have now sussed them out and are hedging this risk by buying real assets.

The world order is changing and we are moving from a western hegemony to an oriental one. In the culture of the soon-to-be-dominant Chinese and Indian investors, gold and silver are perceived as 'real' money. They are and will continue to be the largest miners and hoarders of these metals. We should follow suit.

It is not possible to grow the global economy, even slowly – and certainly not at the pace being achieved in Asia – without using a lot of raw materials. The result is all commodities are in secular uptrend.

Oil shows no signs of going back into the trading range of last year.

We find the story about rare earths very compelling. Several small holdings in this exciting area could pay off extremely well over the next three years and we will be covering these metals and the companies that mine them in more detail in a future issue.

There will be cyclical bear phases for the commodity complex and these will be quite volatile – especially in markets like silver as we have seen recently. But the underlying long term trend will be upwards.

We must try and avoid being shaken out of good long term positions because of short term setbacks. If we do try to trade these fluctuations, then we must use tight stop loss levels. But we should not be fooled into changing our long term outlook.

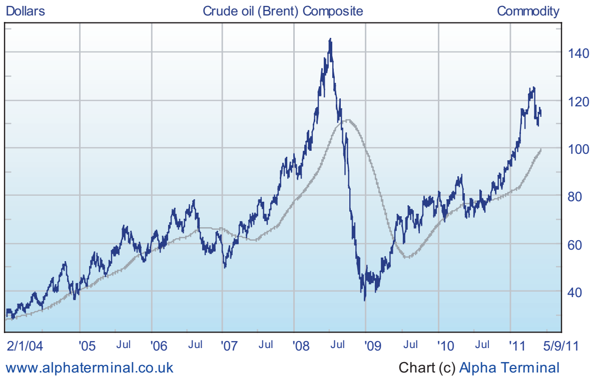
Commodity price index

Gold

Commodities

Platinum

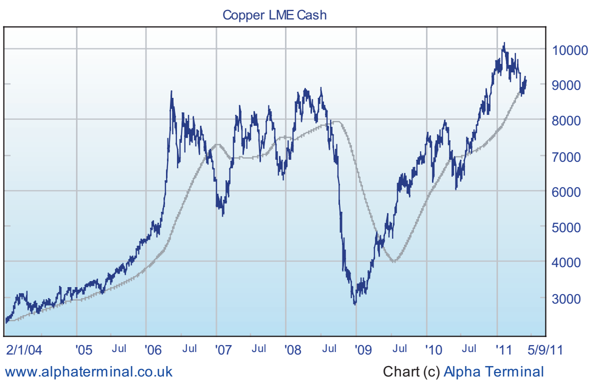
Oil



Silver

Palladium

Copper



Aluminium

Currencies

A change of mind

The US Federal Reserve has indicated that it thinks it has done enough quantitative easing and that no more need be done. However, if the stock market looks like swooning, the Fed can always change its mind and come up with as many QEs as are needed.

The charts are very clear that there is an inverse correlation between the dollar and stock markets. The idea that it is the printing of the dollar that drives the market up is reasonable. But it is, of course, only a short hand explanation.

The Fed does not print dollars, it only creates reserves. Those get turned into money by other banks when they make new loans.

Stock markets might stop rising and start a cyclical bear phase at the end of July. If this were to happen, the US dollar would have a long overdue rally. It might retrace a half of what it has lost in the past 12 months (around 25% against the Australian dollar and Swiss franc). This would open up the potential for a 12% dollar rally – a large move in the forex markets.

If we now examine the alternative scenario mentioned elsewhere from a foreign exchange perspective. If the Fed changes its mind and embarks on QE3, the stock markets are likely to push higher again. In this instance, the dollar would continue to depreciate.

At present the trends suggest the market is betting on the second view. The dollar trade-weighted index is heading towards 72 – and possibly much lower. The euro is rallying towards $1.49 and may well go to $1.60. Sterling has good support at $1.60 and could make an assault on the big $1.70 level while the next target for the yen is Y76.

If our preferred scenario is to play out, we need to see the yen break above Y82 to signal a reversal. The pound needs to break down below $1.59. The first support level for the euro is $1.40 but a move below $1.37 is needed to give a strong reversal signal. If these levels were triggered, we could expect a substantial dollar rally that could last for months. This would imply a general stock market decline with a marked slowing of the global economy. This would probably produce another financial crisis and we would then find out how big things need to be before they are really "too big to fail".

US dollar: trade weighted

US dollar/euro

Currencies

US dollar/Japanese yen

Euro/Japanese yen

Sterling/US dollar

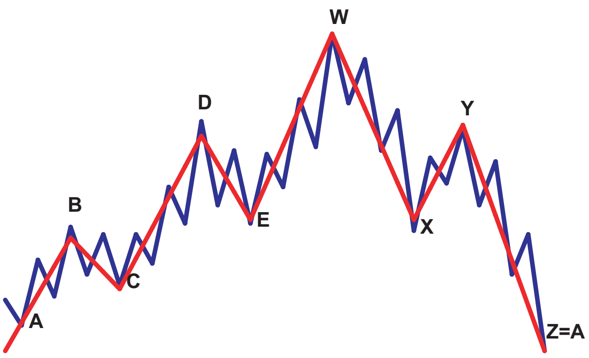
Sterling/euro

US dollar/Canadian dollar

Australian dollar/US dollar

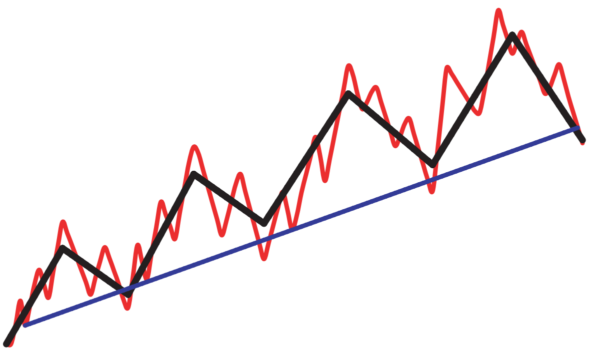
Road maps

Standard road map



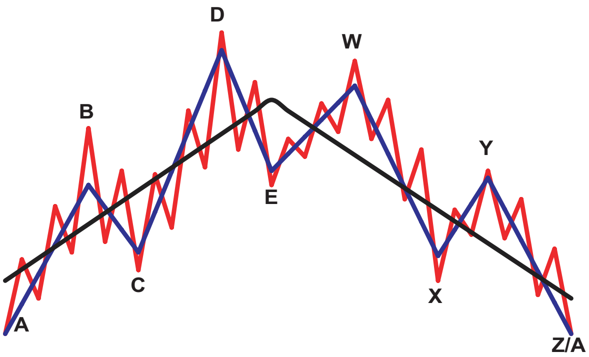
These road maps are the basic shape of a so called Elliott Wave. We deliberately letter our maps differently from Elliott aficionados. The normal time scale for a complete cycle is four years driven by the Kitchin wave. The bull phase has three surges getting progressively more powerful. The bear phase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