

The Road Ahead: Is it Inflation or Deflation?

In November 2010 we published a piece entitled “The Road Ahead: Is it Inflation or Deflation?” and came to the conclusion that the *secular* trend for commodity prices was an upward one that had at least a decade to run. If that turned out to be the case we also opined that given the relationship between commodity prices and bond yields this would also result in a reversal of the *secular* downtrend in yields. The signal we were looking for was a break in government 30-year yields above its 8-year moving average and secular downtrendline at 4.65%. That signal never came as commodity prices experienced a *primary* trend peak in March of 2011 and bond yields sold off towards their 2009 lows.

Introduction

Throughout history U.S. industrial commodity prices and bond yields have alternated between secular bull and bear trends. History in this case goes back to the mid nineteenth century and a *secular trend* is defined as one that extends over the course of many business cycles, occasionally spanning thirty or plus years. *Primary trends* on the other hand, are those that revolve around the so called four year business cycle and mostly range in duration between 9-months-2-years. Our objective here is to examine the secular trends of commodities, bonds and their inter-market relationship to see what clues the markets themselves may be giving about the inflation/deflation outlook and where we stand today.

Why the Secular Trend is Important

Being able to identify the direction and maturity of a secular trend is critically important to investors for several reasons.

1. For any market the *secular* trend determines the characteristics of the *primary* trend, Figure 1 shows that during a secular uptrend bull markets experience greater magnitude and last longer than bear markets. In a general sense prices experience an upward sloping zig-zag pattern as successive rallies and reactions move to higher ground. The reverse is true during secular bear trends.

The Secular versus the Primary (Cyclical) Trend

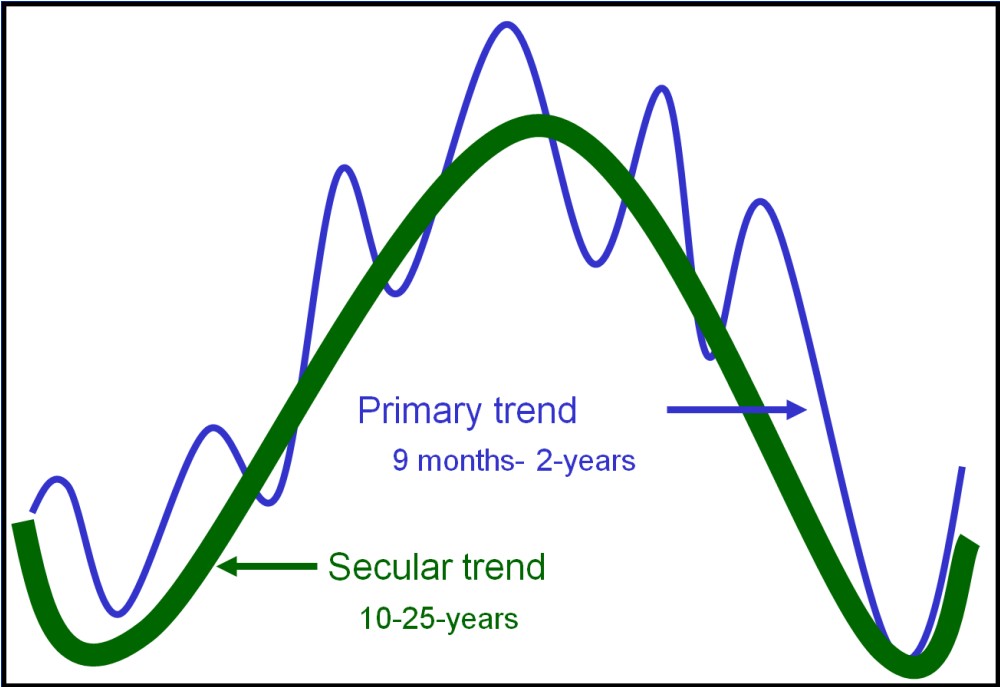


Figure 1

2. The direction of the secular trend of commodities and bond yields determines the character of the equity market sector rotation process. For example, each equity bull market can be roughly split into a deflationary and inflationary part. During the inflationary portion resource based stocks (mines and energy) out perform their deflation or defensive counterparts (utilities/financials) and so forth. When commodity prices and bond yields are in a secular uptrend the magnitude and duration of the inflationary part of the cyclical bull market is greatly enhanced and vice versa.

3. Inflation adjusted stock prices also alternate between secular bull and bear markets. With the exception of the early 1930's all the secular bears were associated with secular bull markets for commodities.

Having set out some of the basic points we can now turn to the prevailing secular trends for bond yields, commodities and the relationship between them.

Bond Yields

We start with bonds (**Chart 1**) because yields have been in a secular downtrend (bull market for bond prices) for 30-years and in terms of time served are well overdue for a turnaround. The series plotted in the chart is the US Government 30-year constant maturity (TYX) spliced to a 20-year series prior to 1994.

U.S. Government Bond Yields

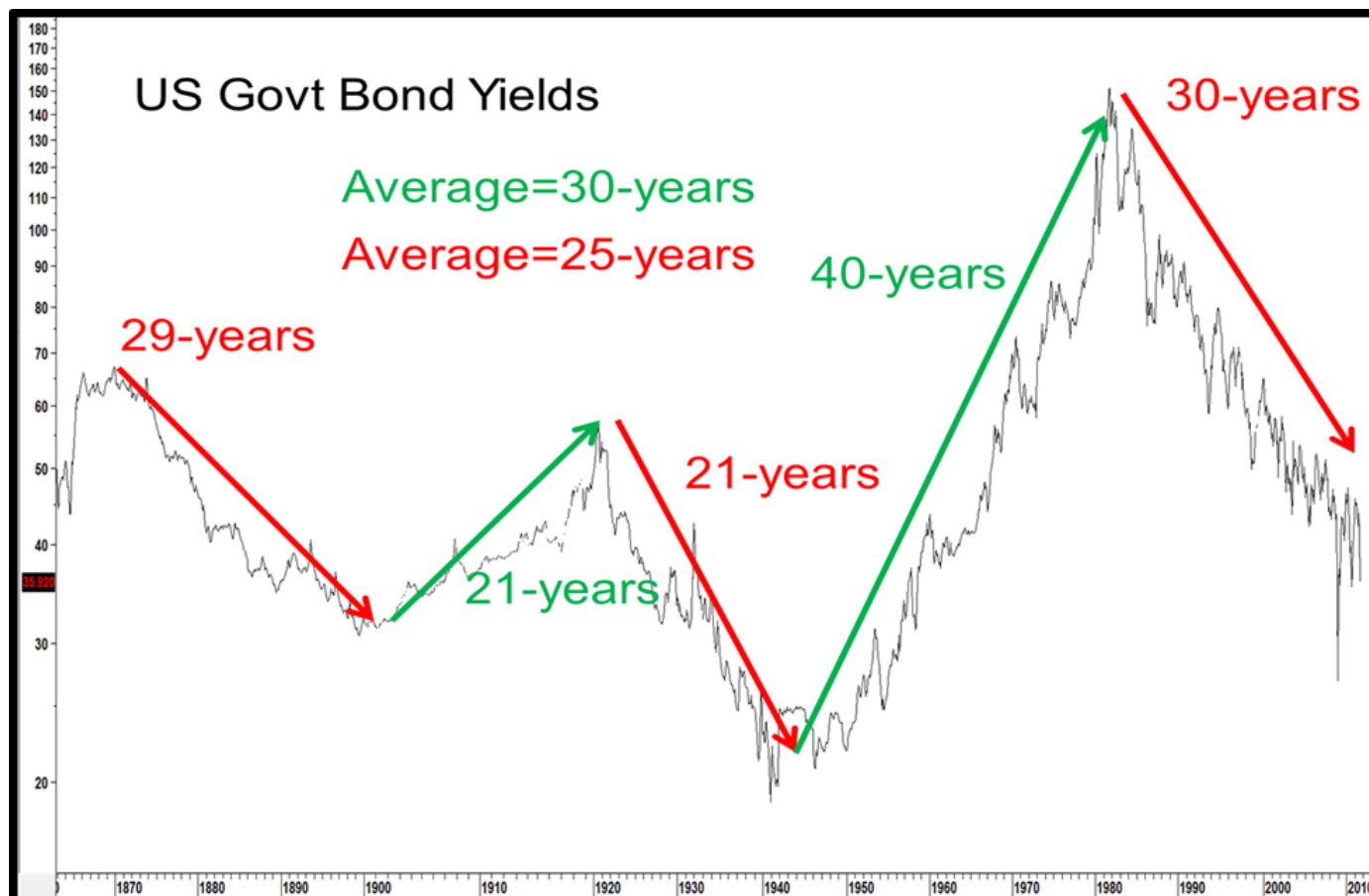


Chart 1

One technique that can help to identify secular trend reversals at a relatively early stage is to construct long-term trendlines on the 240-month Rate of Change (20-year ROC **chart 2**). When such ROC violations are confirmed by a similar trendline break in the yield a reversal signal is triggered. At the present time it is once again possible to construct a line for both series. Since they are intact so is the secular downtrend in yields.

Government Bond Yields and a 240-month ROC**Chart 2**

Another way in which secular trend reversals for bond yields can be monitored is to compare the yield to its 96-month moving average. Bullish and bearish periods identified in this way are represented on **chart 2** by the green and red highlights. It's worth noting that the yield itself has been trading below the average for several decades. It has made many attempts at an upside crossover including 2011, but each time it has been rebuffed. This repeated pattern increases its significance as a dynamic resistance area. When that (MA/trendline) zone is finally cracked we believe it will signal an end to the current secular downtrend in yields (bull market for bond prices).

At present, bond yields are falling away from their secular down trendline and 96-month MA so an imminent reversal is not at hand. It will have to await the next business cycle associated rise in rates which will probably not take place until sometime in 2012.

Industrial Commodity Prices

Commodity prices are also subject to secular price movements and these are shown in **Chart 3 (page 4)**. It features the CRB Spot Raw Industrials, which has been spliced to other series prior to its inception in 1948. During the last 170-years or so there have been nine secular bull and bear markets as flagged by the arrows. We are now in the tenth. Not all secular trends experience the same characteristics. For example, the mid to late nineteenth century bear was a slow drawn out decline.

The 1920-1933 secular trend experienced two sharp down waves compared to the trading range characteristics of the 1980-2000 period. The average secular price movement, both up and down, has lasted about 20-years, so if the current one ended in March of 2011 it would be the shortest secular trend on record. One of the problems of identifying secular trends and understanding their characteristics is that there are so few data points.

These differing patterns make consistent and timely identification of secular trend reversals a somewhat difficult task. Moving average crossovers, for example, can be untimely or subject to unnecessary whipsaws. For this reason the application of smoothed long-term momentum indicators seems to offer a more reliable signal.

Secular Commodity Price Movements

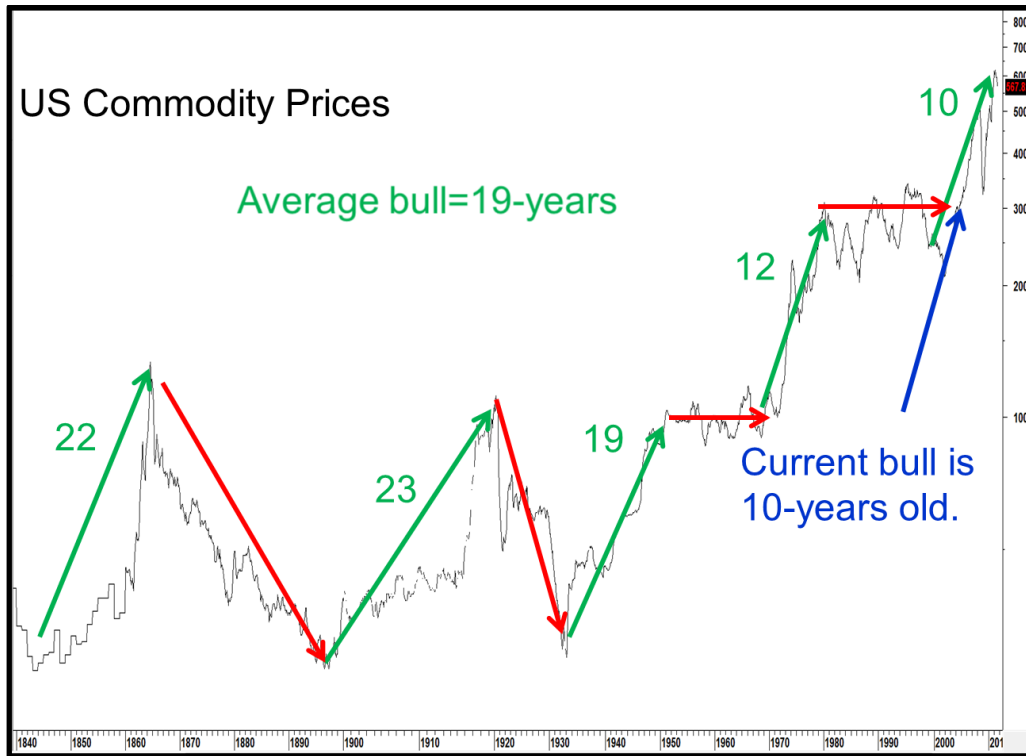


Chart 3

An example is shown in **Chart 4**, where a 360-month (30-year moving average) has been divided by a 60-month (5-year) period. Secular momentum buy and sell signals are triggered when the oscillator crosses above and below its 48-month (4-year) moving average. As long as this momentum series is rising it is assumed that the secular trend is bullish and vice versa. Bullish confirmation is given when the price is above its 96-month moving average in which case the plot is highlighted in green. Red highlights develop when both technical measures are negative and black when they are in conflict. Most of these signals have been reasonably accurate but the numerous black highlights remind us that the system is far from perfect. At present the oscillator is rising but is not particularly overextended. That suggests that the secular trend is at a relatively early phase. The signal we would look for to trigger a secular reversal would be a break below red secular up trendline at 350, which is obviously some way off.

CRB Spot Raw Industrials and a Price Oscillator

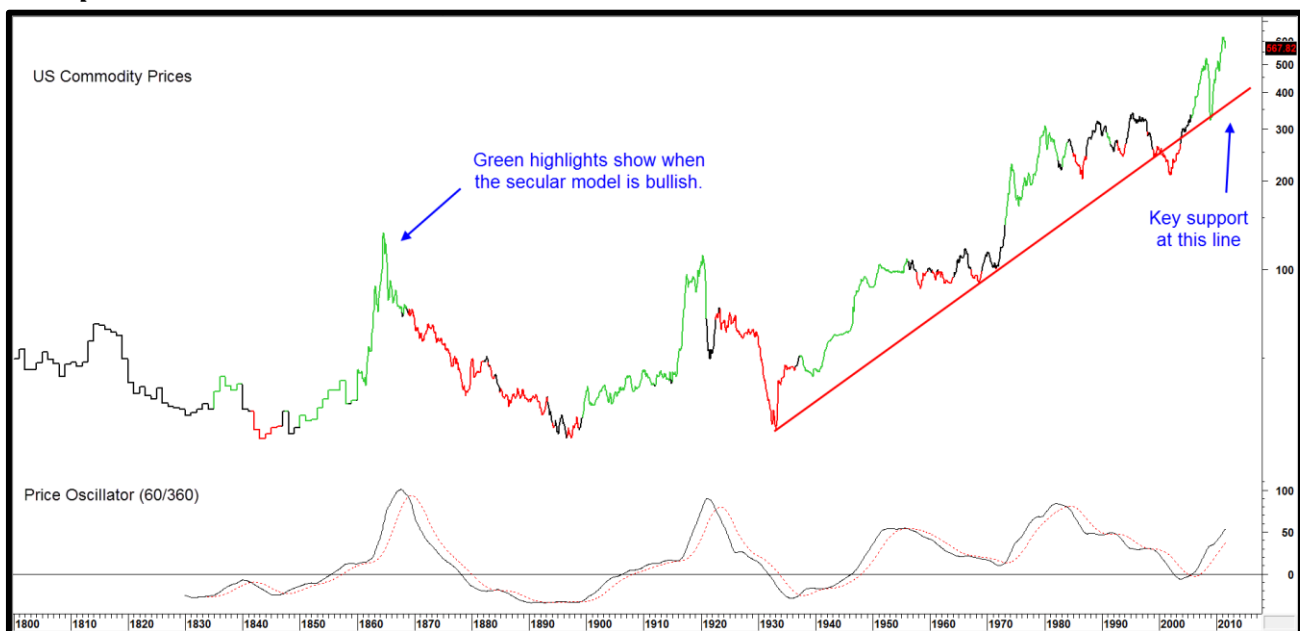


Chart 4

The secular uptrend may be positive but recent action has led us to believe that the primary trend has just turned bearish. New secular highs will therefore have to wait until the next cycle.

Charts 5 and 6 show why the primary trend is bearish. First, **Chart 5** compares our Global Industrial Commodity Index to a derivative of the Organization for Economic Co-Operation and Development (OECD) normalized leading indicators. This series has a consistent track record for calling commodity bear markets when it falls below zero. Such periods have been highlighted by the red shaded areas. The small blue arrows show when prices defied the economic environment and rose. The current reading in the indicator is again negative and so is the outlook for global commodity prices. There is no way of being able to predict the magnitude or duration of the move, but until global economic activity picks up commodity prices are likely to remain under pressure.

Global Industrial Commodity Index vs. the OECD Leading Indicators

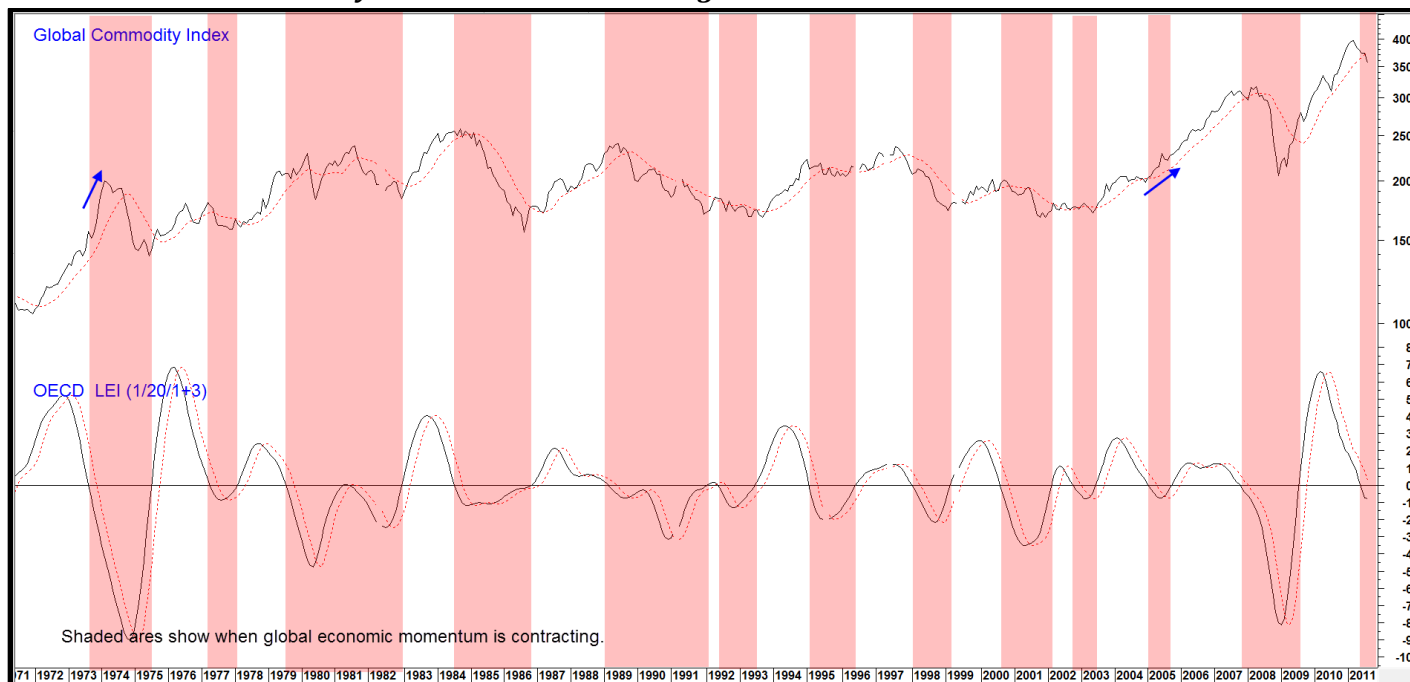


Chart 5

We have identified two levels of sentiment, a reading of 22.5 or above as a proxy for optimism and below 7.5 for extreme despondency. You can see that the P/E is continually swinging between these levels as highlighted with the arrows. While the absolute price level bottomed in 1932 the P/E for the post 1929 bear market was unable to rally move away from the 7.5 area until 1949. That's why we classify this particular bear with that turning point. Notice also that once a peak has been recorded with an extremely high P/E it has not been possible for a new secular bull to get underway until the ratio has moved back to or approached the 7.5 zone. Often it requires more than one move down to these basement levels prior to the launch of a new secular uptrend.

Chart 6 (page 6) also indicates that commodities are vulnerable. This time we are using a technical indicator, which monitors a basket of commodity prices above their 24-month moving averages. The solid arrows flag downside reversals from above zero that were followed by a bear market. The dashed arrows reflect the only two false negatives that have developed since 1965. Sometimes the sell signals have been early, which is why it's a good idea to use them in conjunction with a negative 12-month moving average crossover by the Index itself. On both counts the current trend is bearish.

Commodities Lead Bond Yields at Secular Lows

Long-term trends of commodity prices and bond yields move in the same direction the vast majority of the time, so as a general rule it is usually safe to assume that if commodity prices are in a sustainable uptrend bond yields will be in one as well. It is also evident that commodities tend to lead bonds at secular turning points.

CRB Sport Raw Industrial vs. the Commodity Diffusion Indicator

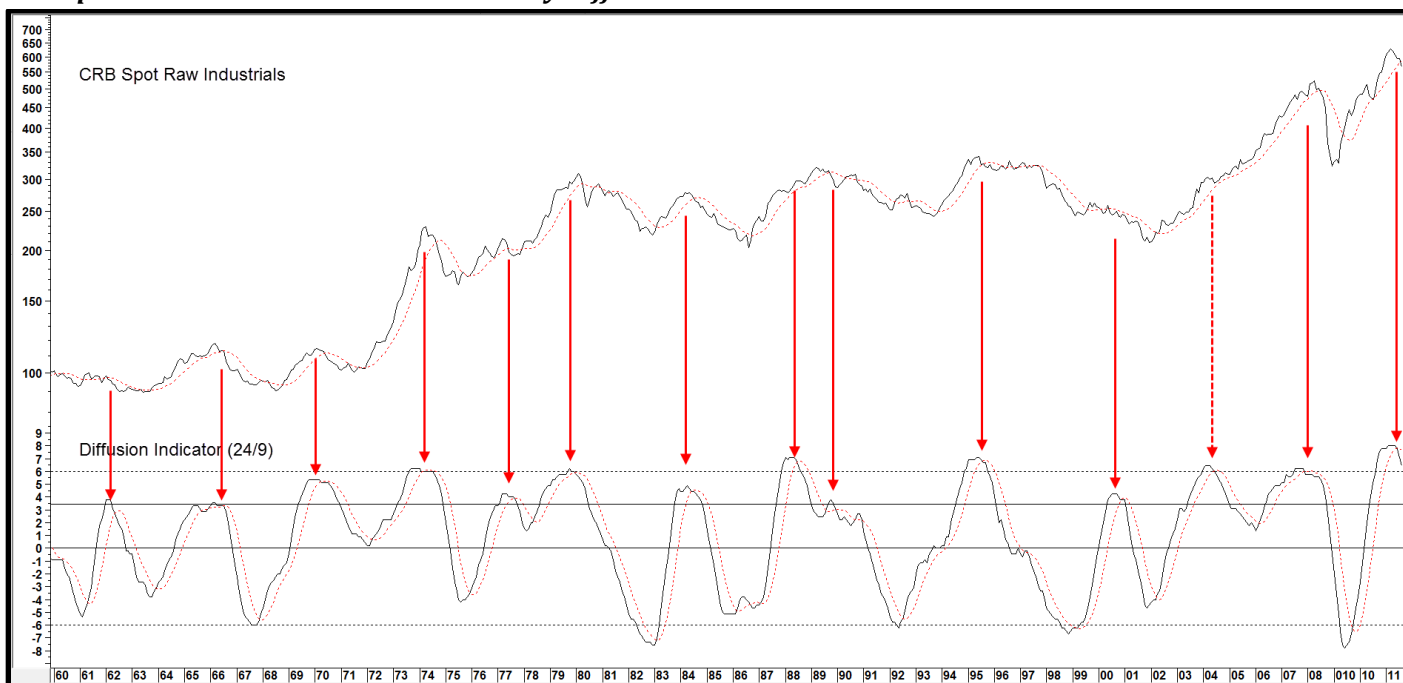


Chart 6

We illustrate this in **Chart 7**, which features government bond yields and commodity prices. The two previous secular bull markets in bond yields were both preceded by a secular low in commodity prices. Of course when limited by two data points we have to be careful about making projections. Nevertheless, the 8-year lead between the 2001 secular low in commodities and that of early 2009 for yields is certainly consistent with the two prior instances.

Government Bond Yields vs. Commodity Prices

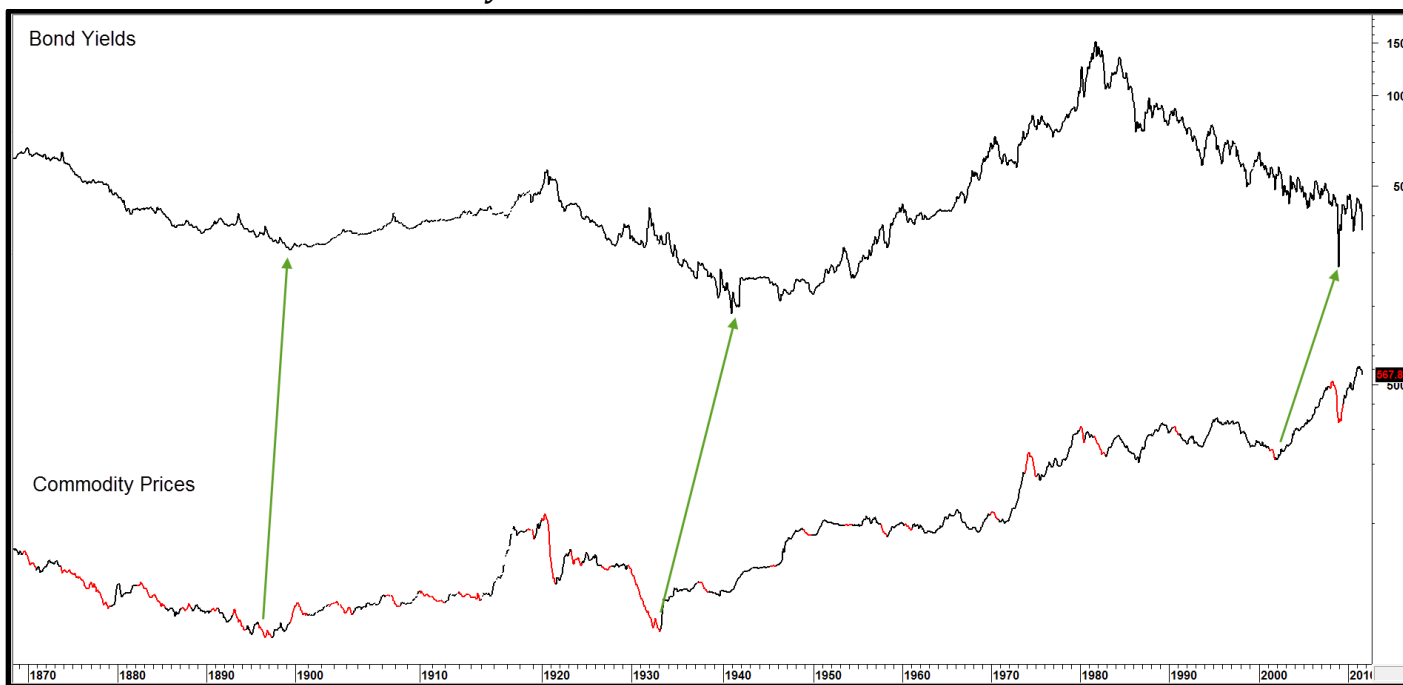


Chart 7

The Commodity/Bond Ratio--the Ultimate Inflation/Deflation Relationship

Chart 8 features the ratio between commodities and bonds, the ultimate inflation/deflation measure. As you can see trendline violations in the past have reliably signaled reversals in the secular trend of this relationship. The ratio has been in a trading range for the last 30-years and recently broke out above a key trendline. At the time we thought this

would be sufficient to signal the ratio's ability to move to new all-time-high ground. But that has not been the case, at least based on September 23 closing prices. Remember this is a monthly chart. Given the primary bear market for commodities it seems likely that this violation will be valid as further re-accumulation will be necessary. However, the low reading in the oscillator suggests that the secular bull market in this relationship has further to run once the counter-secular primary bear market has run its course.

Commodity/Bond Ratio and a Price Oscillator

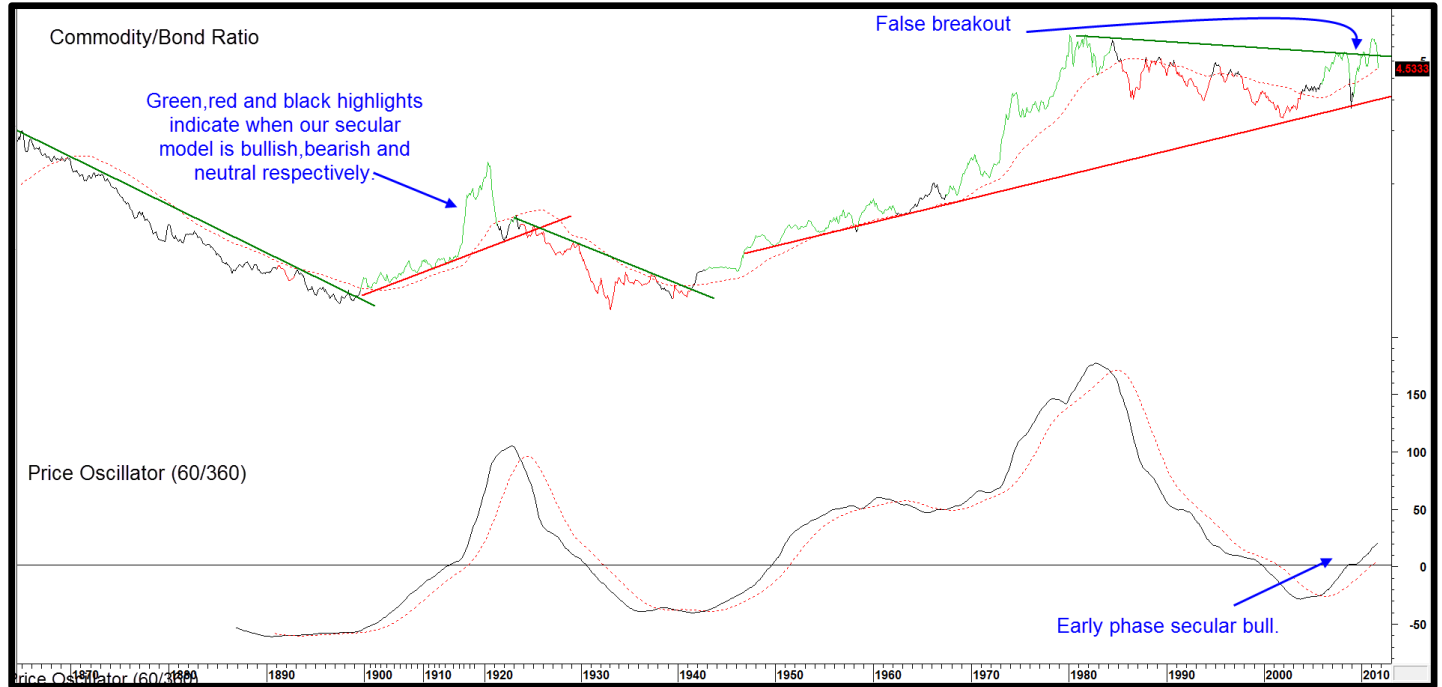


Chart 8

Commodity Prices vs. M2 Momentum

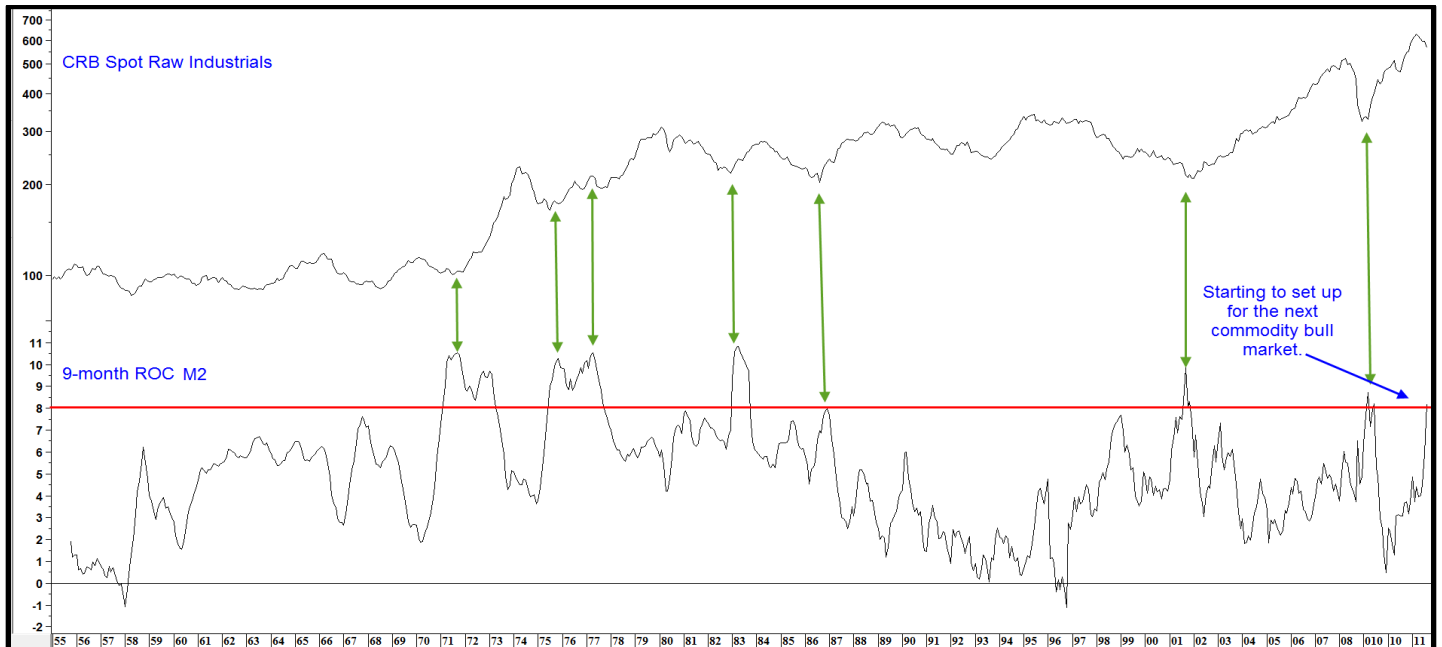


Chart 9

Summary

The secular bear market in bond yields may well be over but it has not yet been signaled by any of our long-term indicators. In the past, secular lows in interest rates have been preceded by bottoms in commodities and that occurred 10-years ago. By this yardstick it's time for yields to rally. In addition, being 30-years old this month, the secular bear market in bonds is getting long in the tooth, whereas the secular commodity advance at a relatively young 10-years is half the age of its predecessors. While the very long-term trend for commodities is up we also need to recognize that the *primary* trend of is bearish. This means that they are likely to undergo some kind of cyclical corrective action prior to any attempt at new all-time highs.

Finally, **Chart 8** suggests that the ingredients for the next primary uptrend in commodity prices are moving into place. It compares a 9-month rate of change of M2 to commodity prices. The arrows show that when M2 has expanded by a rate in excess of 8% over a 9-month period and then reversed this has resulted in a major commodity price rally. The indicator is currently at the threshold level but is still rising. Only when it reverses are we likely to get a signal and that could take several more months to achieve. A delayed signal would also allow plenty of time for prices to fall and momentum, in the form of our Diffusion Indicator (**Chart 6**) to move back to a more subdued level from which a new primary bull market could be launched.

--

Martin Pring

September 23, 2011