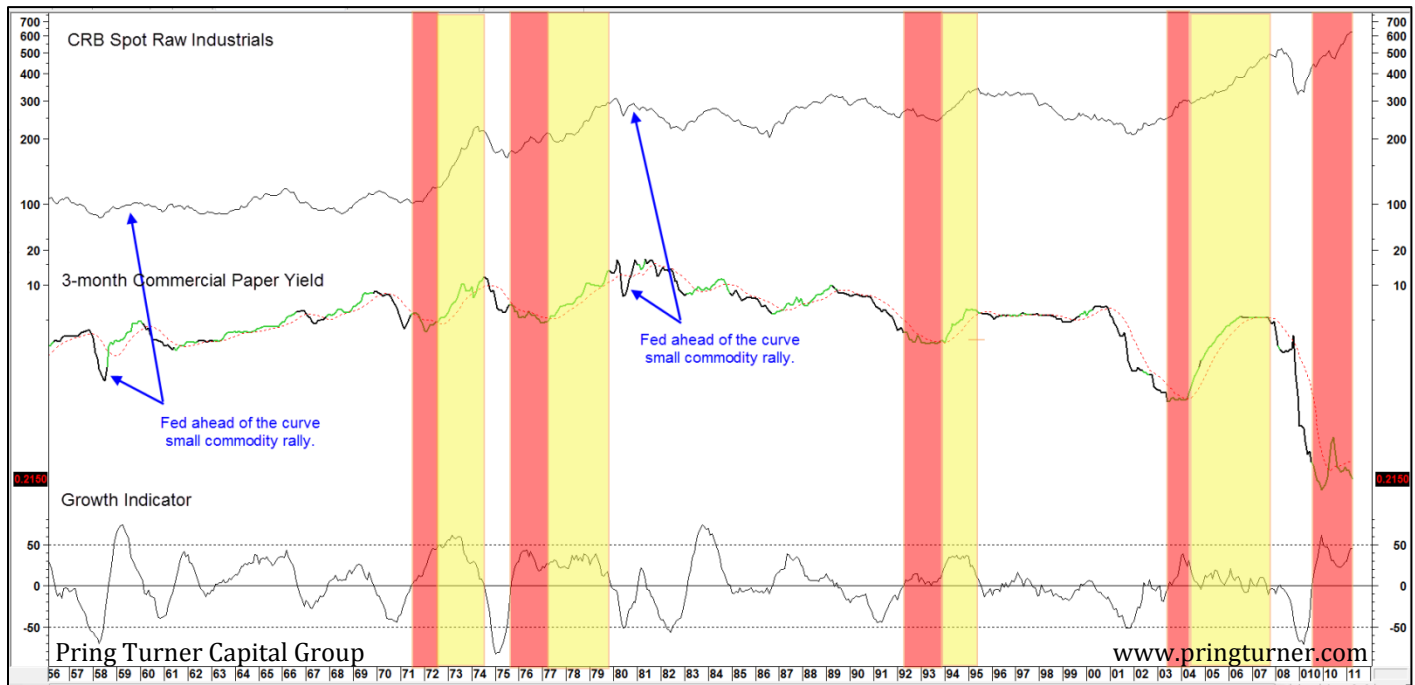


The Libyan No Fly Zone Needs to be Extended... to Ben Bernanke's Helicopter

There has been a lot of talk about the excessive loose monetary policy coming out of the Federal Reserve. However, most of the arguments concerning the implications take the form of generalizations as opposed to quantifiable market relationships. Our objective here is to show, through the historical relationship between short-term interest rates and the economy, that the Fed has been overly generous. Moreover, we will see that our evidence calls for much higher industrial commodity prices before this business cycle runs its course. In retrospect, future commodity prices will make today's elevated levels look benign by comparison.

Chart 1: Commodity Prices, Short-term Interest Rates and the Economy



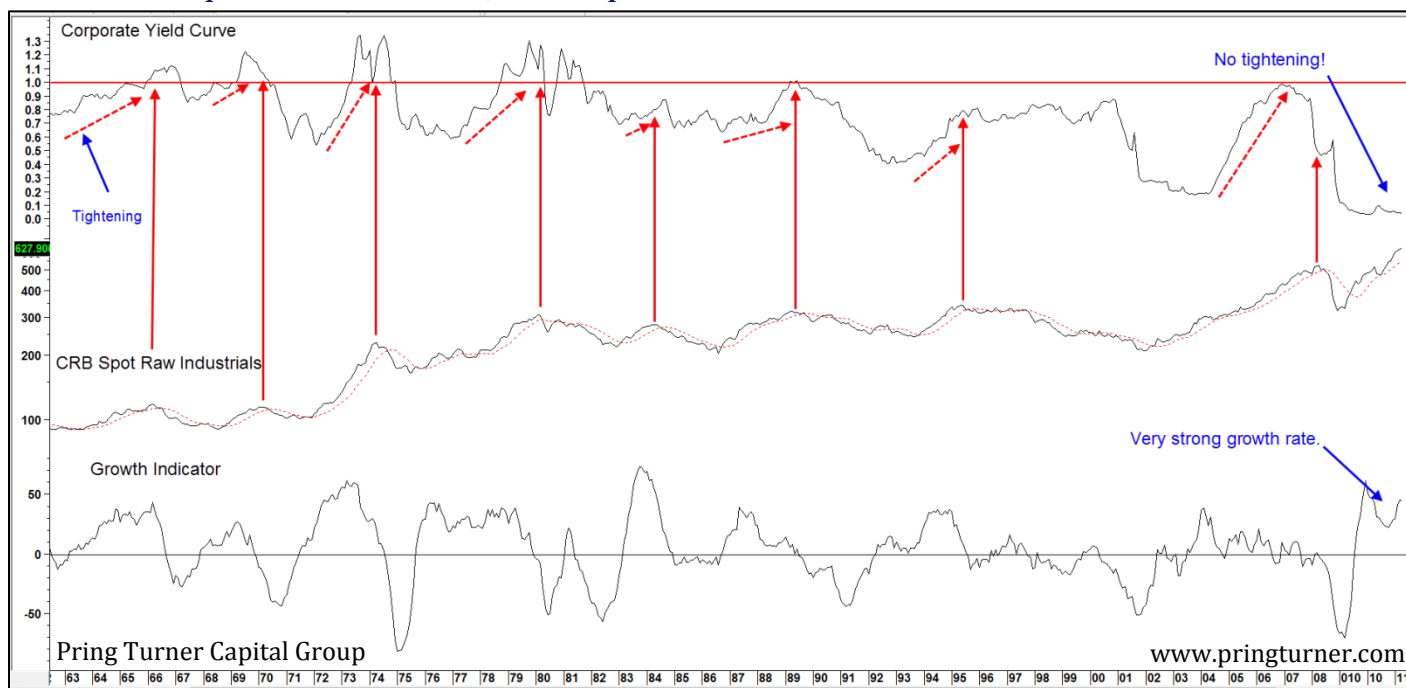
The bottom panel in the first chart shows our Growth Indicator, a composite economic measure that flags whether short-term interest rates should be rising or falling. Above zero readings tell us the Growth Indicator is signaling that strength in the economy is consistent with rising rates. These periods have been flagged with the green highlights on the actual 3-month commercial paper yield plot in the middle panel.

The pink shading indicates when the Growth Indicator, our proxy for demand, is signaling that interest rates should be going up but instead they have moved sideways or declined. The reason for that is the injection of excess liquidity on the supply side by the Fed, which has yet to conclude that inflation is the problem. In effect the central bank is keeping rates below their natural level. The result, if you look at the CRB Spot Raw Materials in the top panel, is an above average rise in

commodity prices. Compare that to the 1958 and 1981 periods when the rising black commercial paper yield indicates the Fed was ahead of the curve. At that time the result was a benign commodity rally.

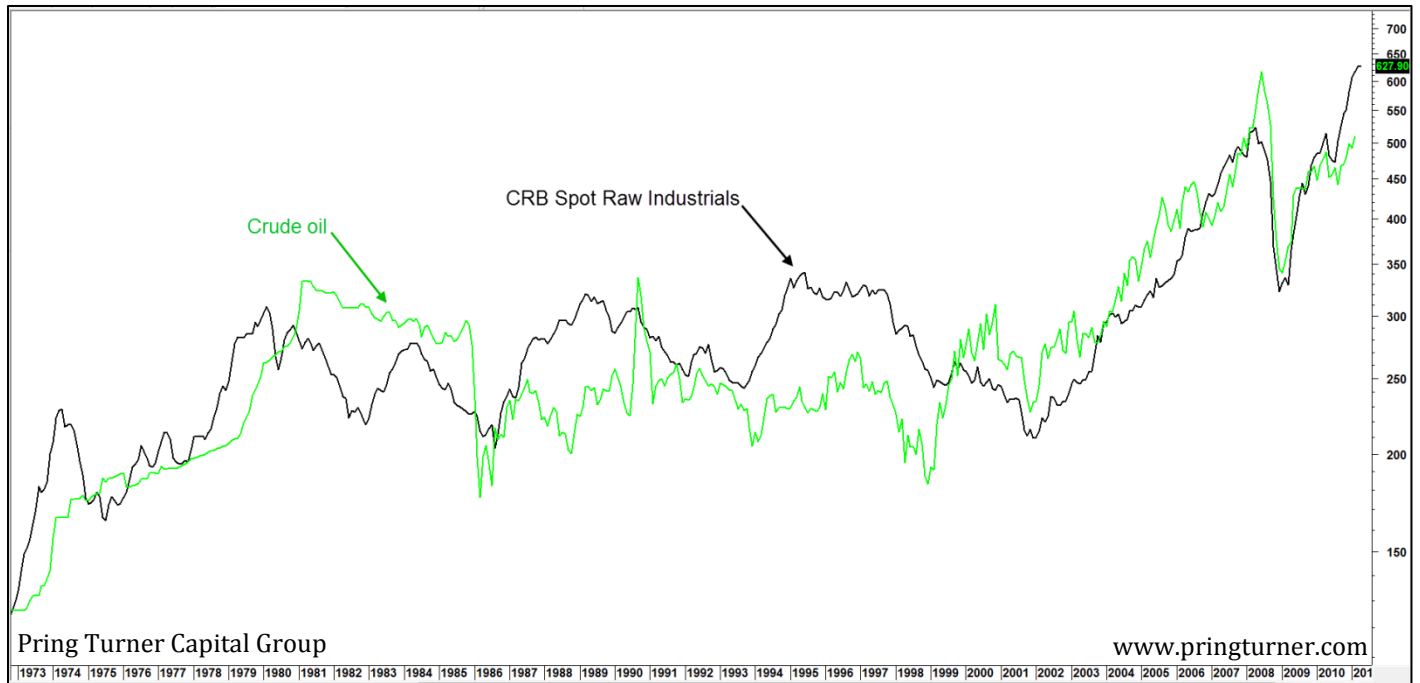
The yellow shading starts when, after one of these overly generous Fed periods or pink shaded areas, the rate starts to move above its 12-month MA, i.e. the red dashed line. Yellow shading continues until the Growth Indicator moves decisively back below zero i.e. indicating a weak economy. You can see that during these yellow periods, when the central bank is playing catch-up, commodities really start to take off on the upside. There are no exceptions. As we approach May 2011, rates are still below their MA and the Growth Indicator is not only in a rising trend, but at a pretty overheated level. Commodities are rising sharply and we have not even made it to the yellow zone yet! Notwithstanding intermediate corrections along the way, these conditions tell us that commodities are ultimately headed significantly higher.

Chart 2: Corporate Yield Curve, CRB Spot Raw Industrials and Growth Indicator



Let's take that idea a bit further by taking a closer look at the relationship between the corporate yield curve (3-month commercial paper/Moody's AAA Corporate Bond Yield), commodity prices and our Growth Indicator. The red arrows flag cyclical peaks in the CRB Spot Raw Industrials since the mid 1960's. They all have one thing in common; they were preceded by some form of tightening by the central bank as reflected by a rally in the yield curve as it moved towards a state of inversion. There are no exceptions to this rule, although some peaks (1966 and 1984) were preceded by relatively small yield curve advances. In both periods though, the cyclical low in rates coincided with a positive zero crossover by the Growth Indicator, as shown in Chart 1. This indicated that the Fed was in gear with economic conditions. The current cycle has experienced a flat yield curve for an extended period, not much different from the previous cycle. In addition the high and rising reading in the Growth Indicator is another reason for expecting higher commodity prices in the period ahead.

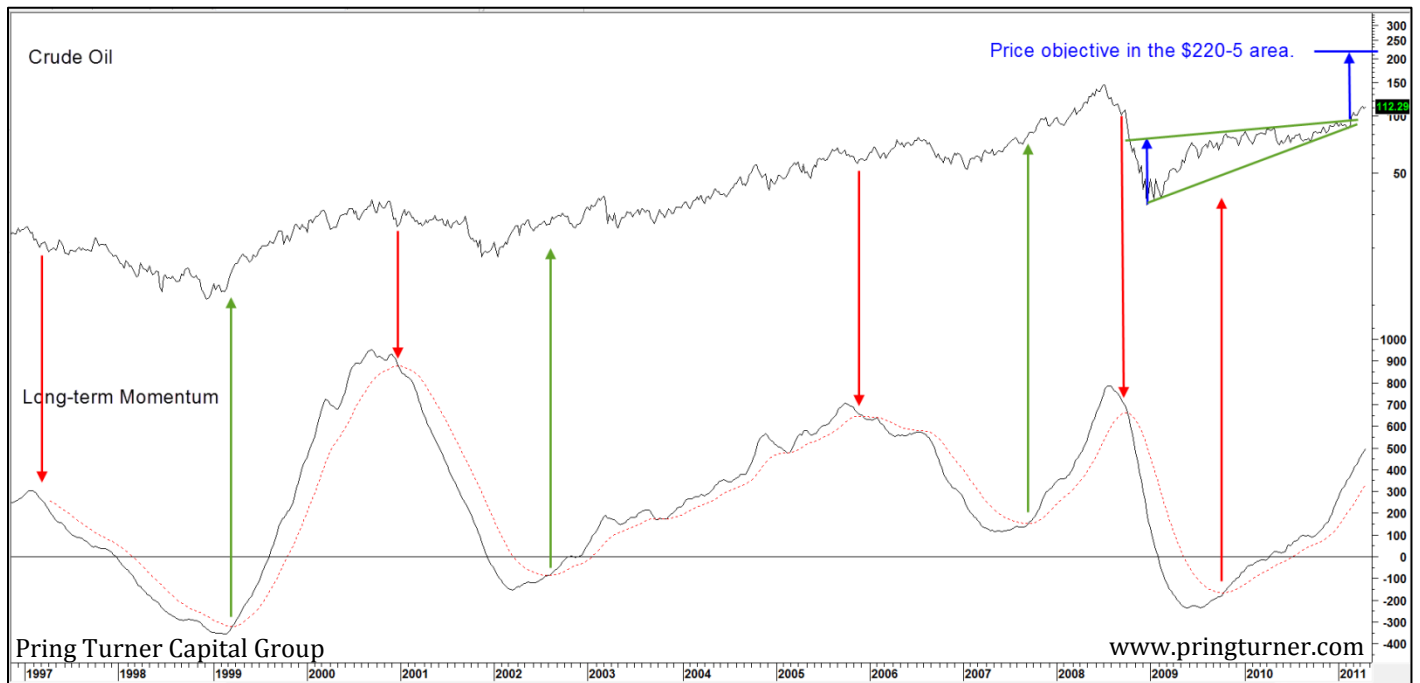
Chart 3: Oil price versus CRB Spot Raw Industrials



One of the important questions is, what does all this mean for the oil price? Chart 3 shows it overlaid with the CRB Spot Raw Industrials. There are some divergences, but in the last 10-years both series have been very closely correlated. If that relationship continues then oil too is headed substantially higher.

Unfortunately, there is no known technique for consistently forecasting the magnitude of a price move. However, market technicians use measuring objectives when a market has been in a trading range for a while.

Chart 4: Crude Oil and Long-term Momentum



In this respect Chart 4 shows the recent trading range for the oil price. The objective is measured by calculating the depth of the pattern, in this case the arrow on the left, and projecting this distance in the direction of the breakout, that's the arrow on the right. As you can see, this measuring device calls for a rally to the \$220-225 area. Since prices often move in multiples of the objective, and the global economy is consistent with significantly higher commodity prices, that estimate may turn out to be a conservative number. Consequently, \$225 is not a forecast, merely an intelligent possibility based on a combination of technical objectives and economic momentum.

Some people say that there is no need to raise interest rates because commodities will soon fall of their own volition. Chart 2 debunks that idea because there is no instance in 50-years of history when a commodity peak has not been preceded by a tightening in the yield curve. Looked at in another way short-term interest rates remain flat and no dynamic commodity rally has been halted by such a condition. It's like saying the fire will burn itself out when someone is still throwing gasoline on it.

There are two inescapable conclusions from this data. The first is that interest rates and commodities are headed much higher. The second is that the Libyan no fly zone needs to be extended to include Ben Bernanke's helicopter.

❖ Martin J. Pring -- April 26, 2011

Pring Turner (after all costs) vs. S&P 500 (Including Dividends)						
Total Return Comparison thru (3/31/2011)						
	1 Year	3 Year	5 Year	Since 2000	*Beta	*Standard Deviation
Pring Turner	14.0%	16.0%	32.8%	107.2%	0.48	9.75%
S&P 500	15.6%	7.2%	13.8%	10.8%	1.0	18.03%

Note: See Performance Disclosure *Traditional Risk Measures

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