

## ***THE ROAD AHEAD: IS IT INFLATION OR DEFLATION?***

Throughout history US 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 to 2-years. Since the financial crash of 2008 there has been an intensive discussion amongst economists as to whether the fiscal stimulus and extraordinary monetary policy (Quantitative Easing, QE I and II) will lead to a significant inflationary wave or whether the system falls into a liquidity trap. A liquidity trap in Keynesian economics develops when easy monetary policies are unable to stimulate an economy, either through lowering interest rates or increasing the money supply, thereby resulting in a deflationary outcome.

Our objective here is not to dwell on the economic arguments, rather 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.

### **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 zigzag pattern as successive rallies and reactions move to higher ground. The reverse is true during secular bear trends.

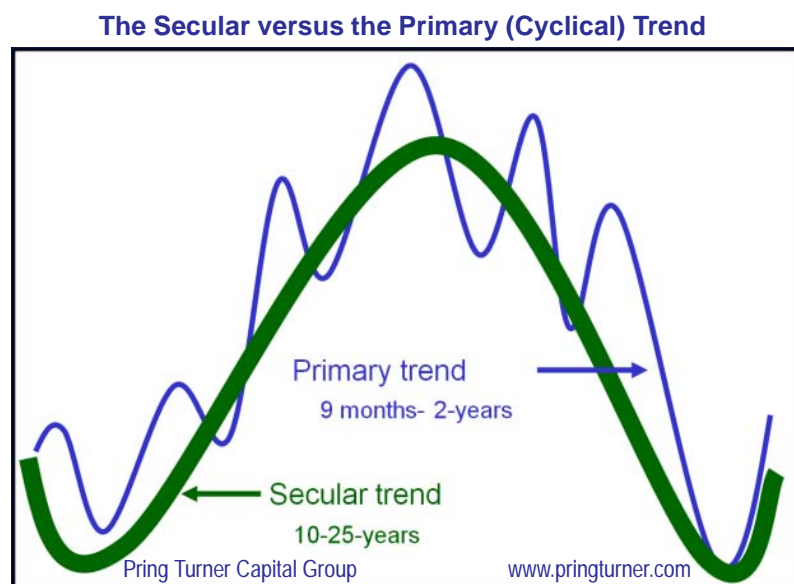


Figure 1

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) outperform 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 and 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 close to 30-years and in terms of time served are therefore well overdue for a turnaround. The series plotted in the chart is the US Government 30-year constant maturity spliced to a 20-year series prior to 1994. Its ticker symbol is TYX or carrot sign TYX on Yahoo.com.

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). 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.

Another way in which secular trend reversals for bond yields can be monitored is to compare the nine month Exponential Moving Average (EMA) of the yield to its 96-month EMA. Bullish and bearish periods identified in this way are represented on the chart 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 but each time it has been rebuffed. This reversal ability by the average increases its significance as a dynamic resistance area. When that (EMA/trendline) zone is finally cracked we believe it will signal an end to the current secular downtrend in yields (bull market for bond prices). Right now, the trendline and moving average are resting in the 4.65% area, and the October 2010 close was 4%.

### Twenty/Thirty Year Government Bond Yields and a 240-month ROC



Chart 1

A secular reversal signal may be at hand but what of the cyclical trend? In this respect Chart 2 features our Master Yield series, which is constructed from a simple average of government AAA, BAA and commercial paper yields. The KST or smoothed momentum generally reflects the cyclical trend in the Master Yield series quite well. In this respect the arrows show that reversals from an overextended level have, over the

last 50-years, offered reliable indications of primary bull markets in yields. Currently the indicator is over-extended and therefore perfectly positioned to trigger a primary bull market signal for yields. Given the proximity of recent levels to a secular buy signal we believe such a turn in the tide will be signaled during the course of the current cycle. Bond owners beware, a new secular bear market for bond prices may be close at hand.

### The Master Yield and a Long-term KST

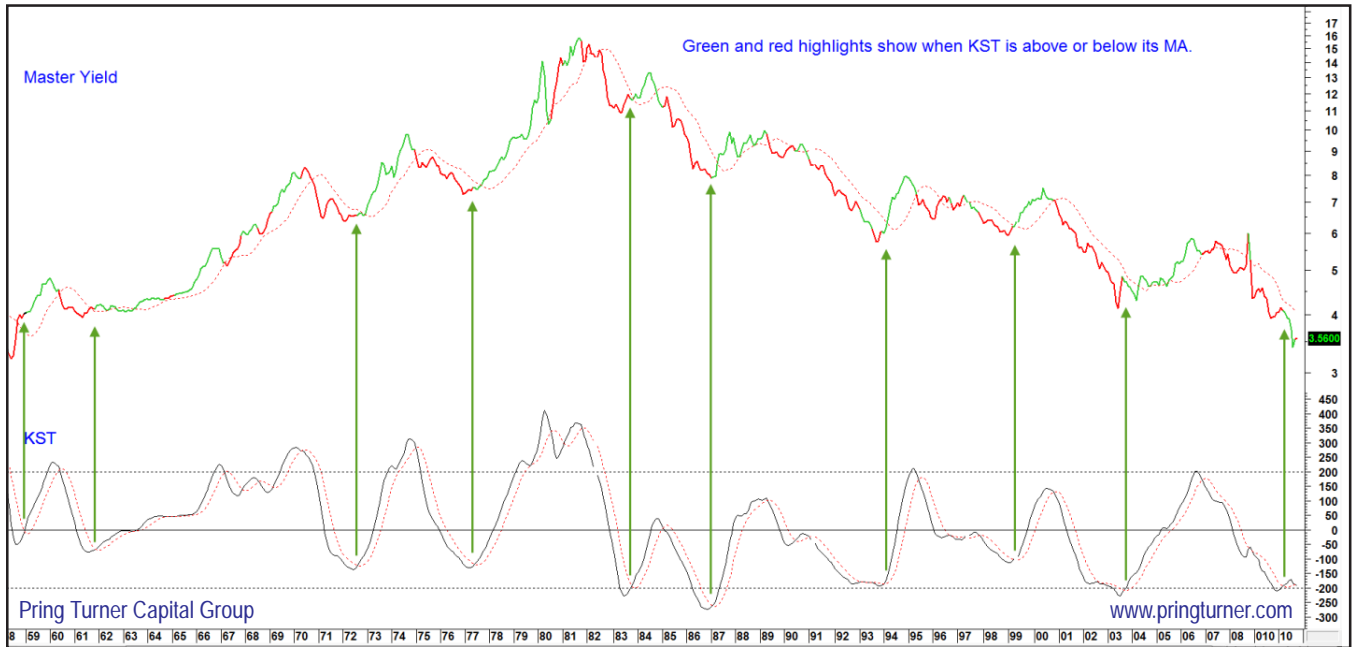


Chart 2

### Industrial Commodity Prices

One of the problems of identifying secular trends and understanding their characteristics is that there are so few data points. Chart 3 for example, features the CRB Spot Raw Industrials. Since the history of this Index only goes back to 1948 it has been spliced to other data series prior to that date.

During the last 200-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 1920-33 trend experienced two sharp down waves compared to the trading range characteristics of the 1980-2000 period. 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. An example is shown in Chart 3 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 reversal would be a break below the two converging

## CRB Spot Raw Industrials and a Price Oscillator

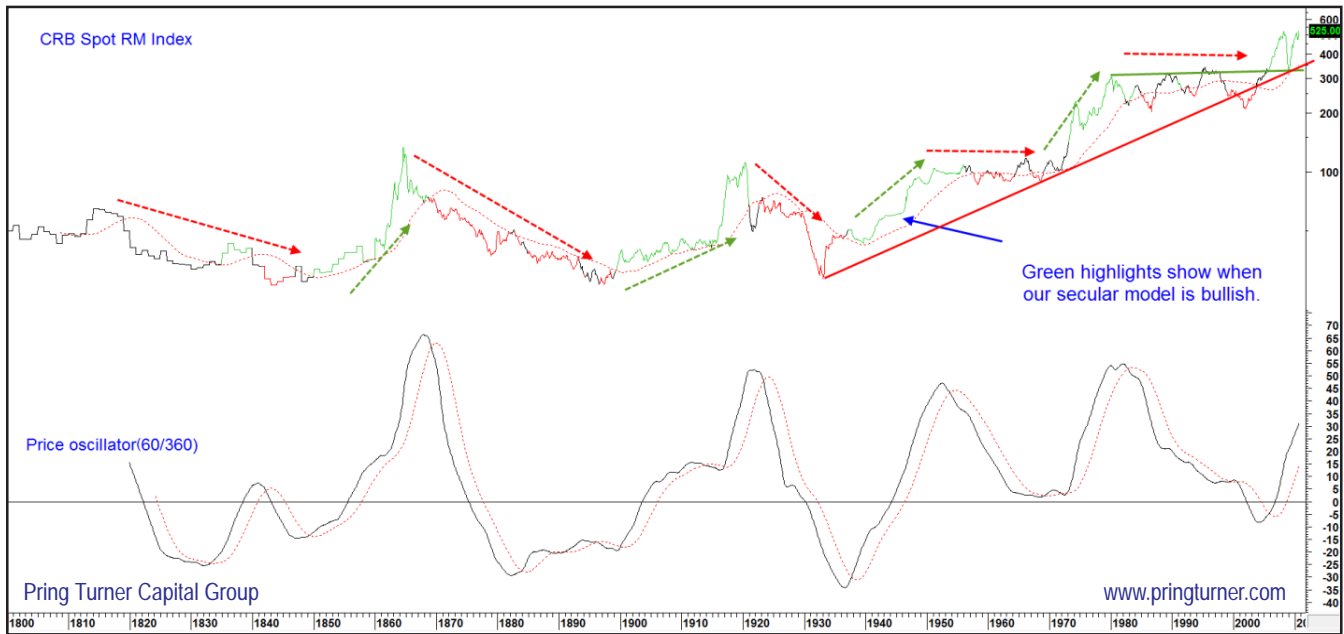


Chart 3

trendlines and the 96-month moving average, which is obviously some way off. The secular uptrend may be intact but how long is the *cyclical* part of this trend likely to extend?

For that we turn to Chart 4, which compares the CRB Spot Raw Industrials to the Organization for Economic Co-Operation and Development (OECD) normalized leading indicators. The OECD composite leading indicator provides early signals of global economic turning points. The green and red highlights indicate when this global economic measure is rising or falling and shows there is an excellent correlation between global economic activity and dollar based industrial commodity prices. Currently the OECD series is moving higher but is moderately

## CRB Spot Raw Industrials versus the OECD Leading Indicators

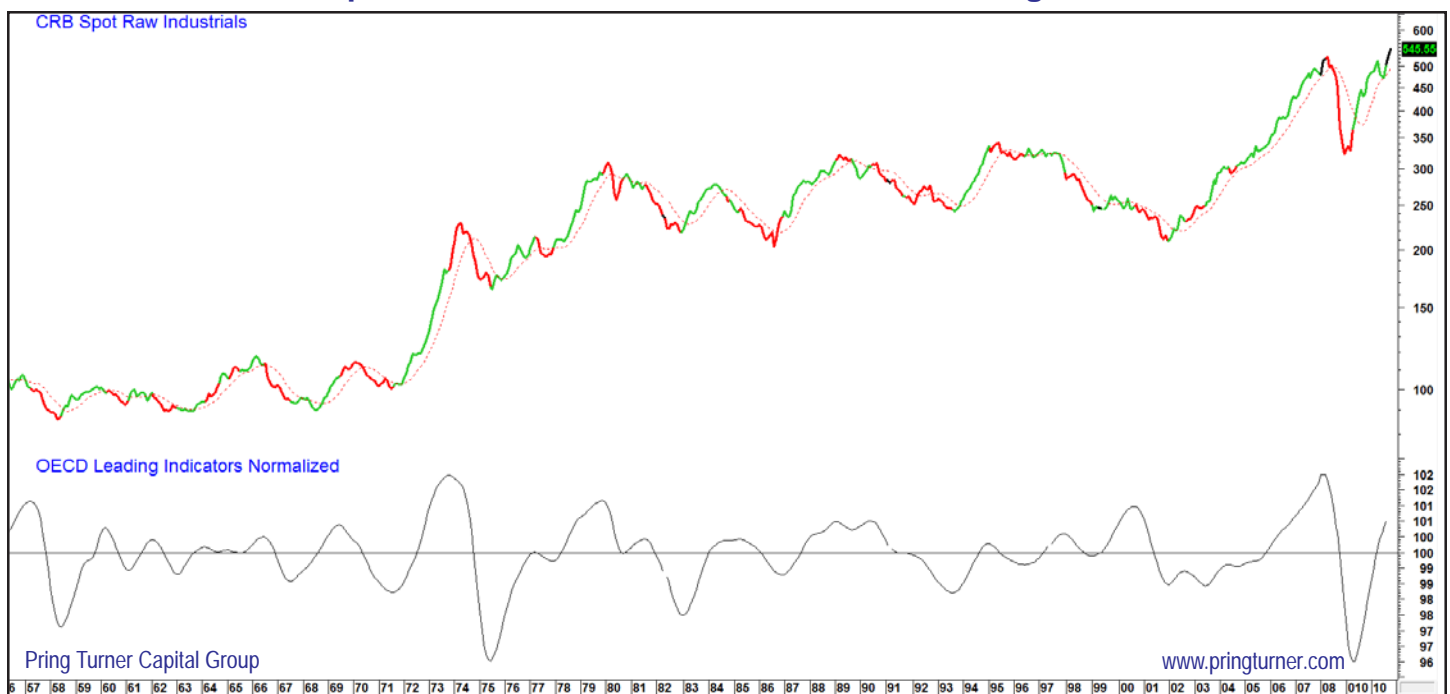


Chart 4

overstretched. That suggests that the *cyclical* bull market has further upside potential. However, the chart shows that the three previous secular up-legs in 1973-4, 1979-80, and 2000-2008 indicate that some of the best gains were reserved for the terminal months of those primary bull markets. In those two instances the red highlights show that prices peaked after the OECD series, so the rally may last well into 2011.

### 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. Having said that it is also evident that commodities tend to lead bonds at secular turning points.

### Government Bond Yields versus Commodity Prices

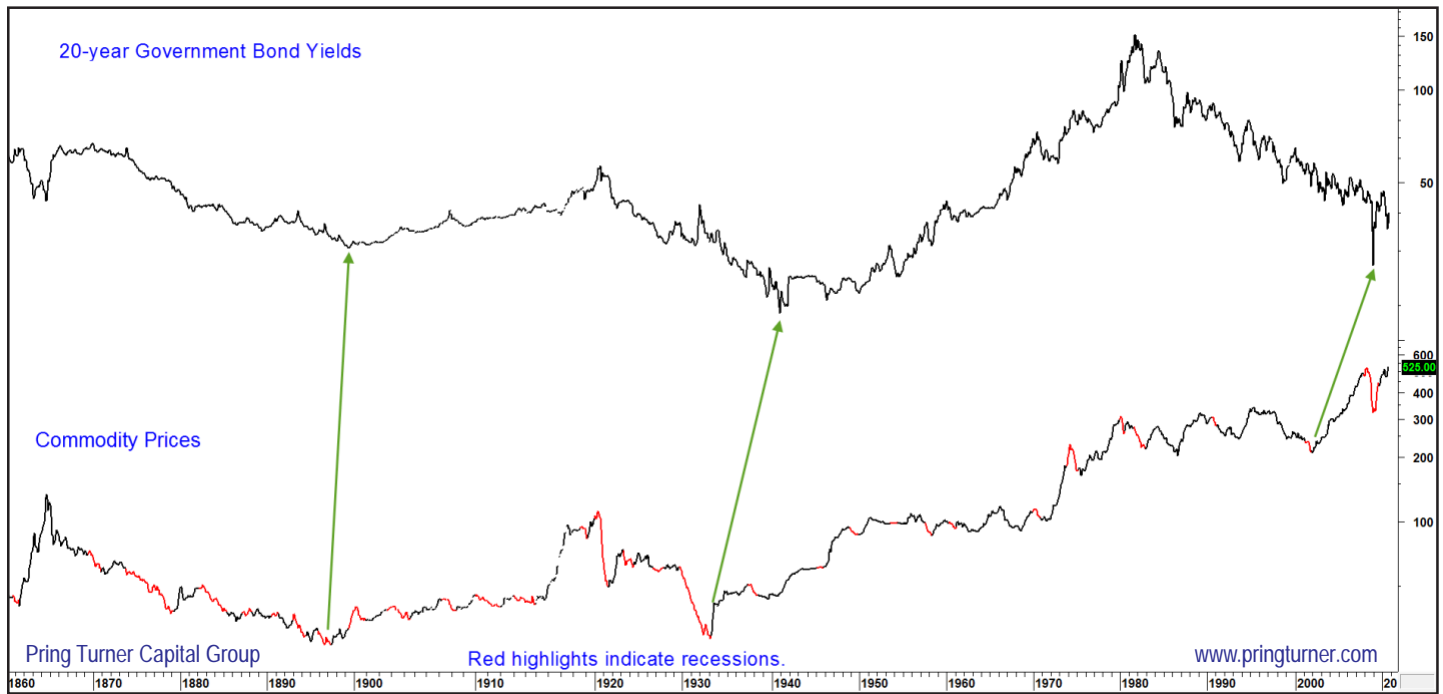


Chart 5

We illustrate this in Chart 5, 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 we are limited to just two data points we have to be careful about making projections. But the 7-year lead between the 2001 secular low in commodities and that of late 2008 for yields is certainly consistent with the two prior instances.

### The Commodity/Bond Ratio — the Ultimate Inflation/Deflation Relationship

Chart 6 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 is now approaching the upper end for the fifth time. If it punches through such action will represent a major long-term inflationary signal. That's because it will denote the out-performance of commodities over bonds for years to come. Such an outcome appears likely because the long-term momentum oscillator in the lower panel, which is constructed by dividing a 60-month by a 360-month moving average, is in the early phase of a secular advance. Note the green and red highlights are an objective attempt to identify the direction of the secular trend.

## The Commodity/Bond Ratio and a Price Oscillator

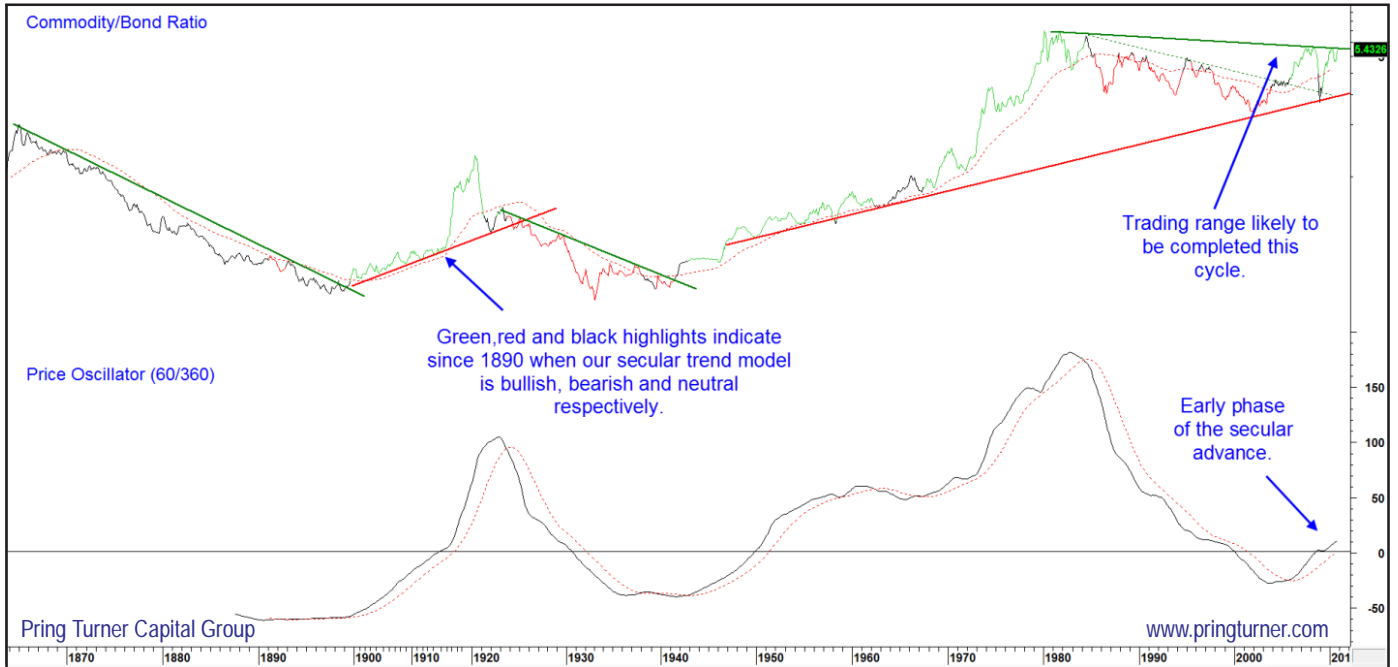


Chart 6

A green highlight is posted when the oscillator is above its 48-month moving average and when the ratio itself is above its 96-month moving average. Red highlights appear when both conditions are reversed and black signifies a neutral period, when the two indicators are contradicting each other. The model is currently signaling a bullish inflationary secular trend and likely commodity out-performance over bonds is just beginning.

## The Commodity/Bond Ratio and a 240-month ROC



Chart 7

Chart 7 shows the same ratio but this time compared to a 240-month ROC. First you can see that its recent 30-year trading range is probably going to turn out to be a reverse head and shoulders pattern, but we obviously need to see

the breakout develop before being sure. Second, the two previous secular lows in this relationship have been associated with a breakout from a saucer like bottom in the ROC. The one that developed around 1900 was only obvious after the event as it was not possible to construct a convenient trendline. However, this was possible for the mid twentieth century signal and this will be possible for the current situation. When the turn does come we will therefore be provided with a timely secular signal for commodities to break out against bonds.

### The Commodity/Bond Ratio versus Government 20-Year Bond Yields

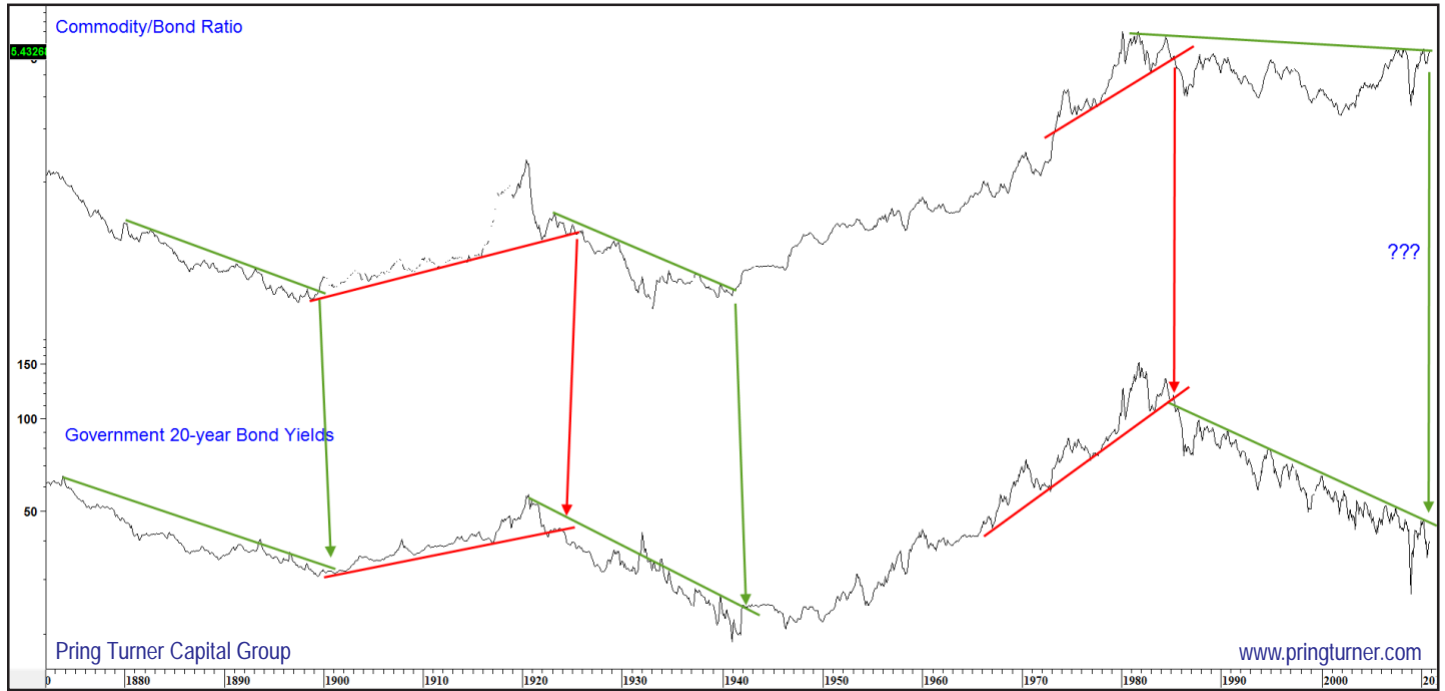


Chart 8

Finally, Chart 8 shows that secular trendline violations in the commodity/bond ratio have usually coincided with those in the 20-year government bond yield series. Currently the secular trend for yields is still down, but if the ratio does break above the upper area of its 30-year trading range the odds of a reversal in yields would be overwhelming.

### 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 bottoms in interest rates have been preceded by ones in commodities. That type of set up is certainly consistent with the current situation since commodities bottomed ten years ago. Finally, the ultimate inflation/deflation relationship, that between commodities and bonds is very close to an upside resolution of a 30-year trading range. In the past when major trend breaks of ratio have developed it has represented a timely signal that a secular reversal in one of its components, namely bond yields, has either taken place or is close at hand.

If the breakout does take place we would not only expect to see substantially higher interest rates and commodities but a strong inflation biased finish to this and forthcoming business cycles.

## **Investment Tactics if the Commodity/Bond Ratio Breaks to the Upside**

In the event that the commodity/bond ratio breaks to the upside, the odds of a reversal in the secular trend of bond yields and a significant extension to the secular bull market in commodities will increase substantially.

### Tactics for Bond Portfolios

A trend change away from the favorable environment for bond prices that has existed from a business cycle time frame (past 3 years), and secular time frame (past 29 years) will require investors to carefully re-evaluate their bond strategy since they will be faced with potentially devastating capital losses from bond investments. This will involve both tactical and strategic portfolio adjustments. Basic changes for a hostile bond environment include:

- 1) Reducing the bond allocation percentage.
- 2) Decreasing the average maturity of the bond portfolio.
- 3) Raising the overall quality of bond holdings.
- 4) Increasing exposure to inflation sensitive investments.

One method for reducing the average maturity is to execute a short-term bond ladder that ensures full return of capital within a shortened time frame. This laddering strategy enables the investor to continuously roll over maturing bonds at higher and higher rates and protect principal values. Raising the quality of the bond portfolio makes certain your principal will be returned in full upon maturity.

### Inflation Hedge Tactics

A tactic that increases exposure to inflation sensitive investments could include short-term international bonds emphasizing currencies denominated in strong natural resource based countries, such as Canada or Australia. Greater exposure to inflation beneficiaries such as natural resource sectors like energy, metals, mining, agricultural and forest products is a more obvious step. Many equity investments within these groups also offer attractive and rising dividend streams. Another possibility is the purchase of natural resource ETN's specializing in specific commodities, sectors, or broadly based commodity indexes. Since many of these vehicles are based on futures contracts it is important to check out their tax implications for your portfolio before buying. Finally, investors hungry for yields should consider resource based investment trusts both in the US and Canada, where very generous income returns are typically offered. Combining these tactics will help insulate portfolios from higher inflation, rising interest rates and lower bond prices.

Even within a difficult secular bear market environment for bonds, there will be rewarding tactical opportunities. The key to their successful exploitation is the application of business cycle analysis. Bond investor success will depend upon these tactics and taking advantage of shorter-term opportunities that occur during the course of every business cycle. The good news is the very fact that knowing cyclic and secular interest rate increases are coming will help you change portfolio tactics to protect and even grow your capital in the coming hostile environment for bonds.

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### About Pring Turner Capital Group

Pring Turner Capital Group is a registered investment advisor, providing highly personalized investment management services on a fee-only basis since 1977. The three managing partners, Martin Pring, Joe Turner, and Tom Kopas combine for over 100 years of professional investment experience. Martin Pring is the author of numerous highly acclaimed books regarding market analysis and business cycles, including *Technical Analysis Explained*, *The All-Season Investor*, and his most recent *The Investor's Guide to Active Asset Allocation*. Please visit our website at [www.pringturner.com](http://www.pringturner.com) for more information.

### PERFORMANCE SUMMARY THROUGH "LOST DECADE"

1/01/00 — 9/30/10

	Return	Risk Measures*	
		Beta	Standard Deviation
Pring Turner Performance (Net of Fees)	+94.8%	.49	9.95%
S&P 500 (Including Dividends)	-5.6%	1.0	17.96%

\* As measured over entire period by two traditional risk benchmarks

See Performance Disclosure Below

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