The Road Ahead: Is it Inflation or Deflation? What the charts are saying.
Pring Turner Capital Group
By Martin Pring
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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 down trendline 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.

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 well into 2012 or 2013..

Industrial Commodity Prices

Commodity prices are also subject to secular price movements and these are shown in ***Chart 3*** . 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. 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 on record. One way to identify secular reversal points is to apply a smoothed long-term momentum indicator to the data.

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. Positive 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. 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 up trendline at 405, 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 <u>the primary trend has just turned bearish.</u> The evidence for this is presented in ***Charts 5 and 6***. 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 is again negative and so is the outlook for global commodity prices.

Global Industrial Commodity Index vs. the OECD Leading Indicators

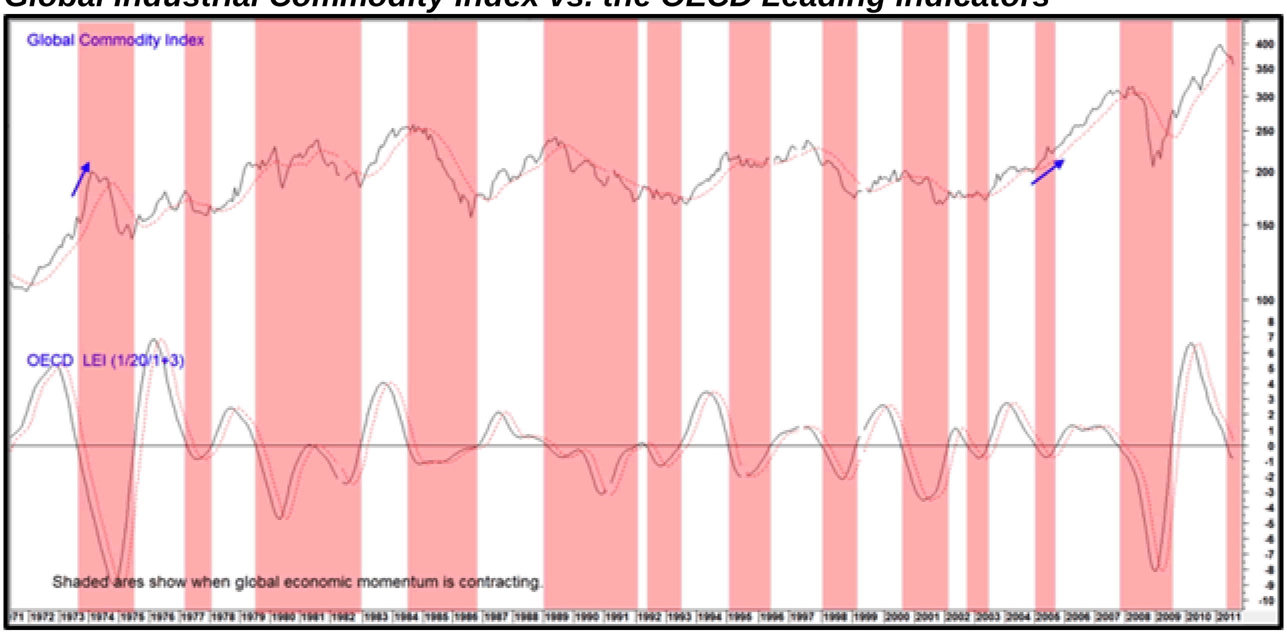

Chart 5

Chart 6 also indicates that commodities are vulnerable. This time we are using a technical indicator, that monitors a basket of commodity prices above their 24-month moving averages. The solid arrows flag downside reversals from above zero. In pretty well all instances a bear market followed. 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.

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

Chart 7 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 was recently close to the top end of the range. It now seems likely that further re-accumulation will be necessary as the primary bear market unfolds. Nevertheless, 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.

Summary

The secular bear market in bond yields may well be in its terminal phase but a reversal has not yet been signaled by any of our long-term indicators. However, being 30-years old this month, it is getting long in the tooth, whereas the secular commodity advance at a relatively young 10-years is half the age of its average predecessor. While the very long-term trend for commodities is up we also need to recognize that the *primary* trend of is bearish. They are therefore likely to experience additional corrective action prior to any attempt at new all-time highs.
Martin Pring October 1 2011

CRB Spot Raw Industrial vs. the Commodity Diffusion Indicator

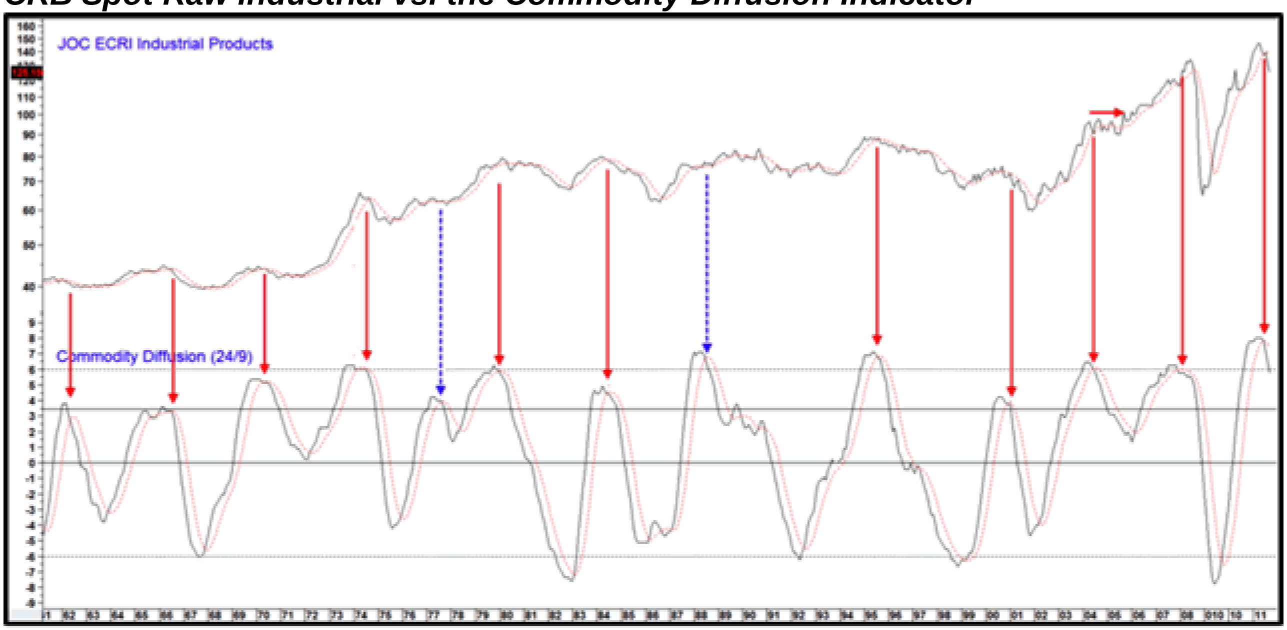

Chart 6

Commodity/Bond Ratio and a Price Oscillator

Chart 7

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