

TUNING UP

Around 50 years ago, the jazz great Duke Ellington penned music titled “Money Jungle”. His metaphorical association between money and jungle suggests parallels between these two environments. Wild price moves, such as recent leaps and dives in oil and silver lands, certainly encourage the use and enhance the appeal of jungle language in Wall Street’s competitive stock, debt, currency, and commodity arenas.

CONCLUSION

The territories of stocks, interest rates, foreign exchange, and commodities are full of tangled and overlapping relationships and unclear paths. Given the diverse and interrelated yet often conflicting marketplace variables, and the inevitable uncertainty (and mistiness) of reasoning related to them, it’s especially premature to provide a conclusion before offering the various and extensive verses of its accompanying argument. And subsequent essays will expand upon the viewpoints expressed in this note (and those of previous essays). Yet no more hiding and delays. Audiences ravenously insist on first hearing a conclusion, preferably one without many (if any) qualifications and warnings.

The S+P 500 is at or near an important high in price and time terms. Watch the major resistance of 1440 (the May 2008 final high before the acceleration of the worldwide economic crisis), plus or minus five percent. Commodities “in general” likewise have achieved or soon will make a noteworthy top. Suppose these reversals haven’t begun yet. What is a guideline for the latest time for them? At the risk of being attacked by hunters armed with hindsight wisdom, let’s climb out on a limb and say midsummer 2011. However, the Federal Reserve and its allies will rush to the rescue and strive to prevent any sustained major fall in equities.

What about the broad real trade weighted dollar (“TWD”)? For the near term, its April 2011 level of 81.3 represents a low or is close to one, with its timing linked to that in stocks and commodities. The United States 10 year note yield will continue to meander sideways. However, yields eventually will move higher and attack the four percent barrier.

OVERTURE

“Time present and time past
Are both perhaps present in time future,
And time future contained in time past.” T.S. Eliot’s “Burnt Norton”, one of his “Four Quartets”.

Choruses of opinions differ as to how various financial marketplaces interrelate. Picture the quartet of equities, interest rates, currencies, and commodities “in general”. These four realms and instruments within them do not necessarily respond to the same beats or dance in the same fashion. Key price summits (and valleys) in each do not necessarily occur at or around the same time. Debates reasonably rage regarding which domain leads or lags another and why.

In recent years, the linkage between equities, commodities, the broad real trade weighted dollar, and interest rates has been close.

Focus first on price and time notes for these arenas in the period of the dismal depth of the worldwide financial crisis. The S+P 500's major low was 667 on 3/6/09. What about commodities? They achieved lows roughly around the time (within a few months) of that in the S+P 500 (and many other key stock battlefields). That of the broad Goldman Sachs Commodity Index was 2/19/09 around 306. The London Metal Exchange Index ("LMEX"; base metals) bottom was 12/24/08 at 1614, the low in gold 10/24/08 at 681. In petroleum, NYMEX crude oil reached ground (nearest futures continuation) on 12/19/08 at 3240, Brent/North Sea 3620 on 12/24/08. The Goldman Sachs Agriculture Index trough was 3/2/09 at 268.

What about the United States dollar during those dark and dreary days? It had rallied as stocks were mauled and commodities bloodied. The broad real trade weighted dollar ("TWD"), though in a long run bear trend dating back to February 2002's 112.7 peak (monthly average), climbed to an interim high around 96.7 by March 2009. This timing of a (relatively) strong dollar fits with the bottoms in equities and commodities.

Many pathfinders enjoy focusing on the Euro FX as the key cross rate versus the dollar, particularly in the commodity context. The Euro FX made important lows at 1.2330 on 10/28/08 and 1.2457 on 3/4/09, consistent with the TWD behavior and the equity and commodity floors. As for interest rates, the "flight to quality" yield low in the US 10 year government note occurred within this several month range, at 2.04 percent on 12/18/08.

Now venture further back in time, to the lofty heights in stocks and commodities during the sunny days of the wonderful Goldilocks economy, and before the vicious bears returned home from their forest rambles. Entertaining marketplace guides increasingly had (and have) trumpeted that commodities represent an asset class, a fine alternative investment. Though the major peak in the S+P 500 was 1576 on 10/11/07, its final high was 5/19/08 at 1440. This May stock elevation was shortly before the major high in the broad GSCI on 7/3/08 around 894. Compare the time of the final top in the GS Agriculture Index on 6/26/08 at 496 (major high 2/27/08 around 513, not long before gold's peak at 1034 on 3/17/08). Although the LMEX pinnacle occurred 5/4/07 at 4557, its final highs were reached about one year later. These LMEX plateaus of 3/5/08 (4400) and 7/2/08 (4038) were around the times of tops in the S+P 500 and other commodity pastures. In the petroleum patch, remember Brent's ultimate spike of 14750 on 7/11/08, with NYMEX crude oil's top also cresting over 14700 that day.

Recall that the TWD's descent to a crucial low at 84.0- the level of previous major bottoms (1973-present)- in April 2008 was accomplished around the time of these peaks in stocks and commodities. In this context, note the 6/13/08 interim yield high at 4.27pc in the US Treasury 10 year note. As equities and the commodity complex collapsed, so did government yields.

Before late summer 2010, many central banks around the globe, led by Chairman Ben Bernanke's benevolent Federal Reserve Board, had joyfully sung the merits of low interest rates and easy money. The money printing road had particularly appealed to the Fed and several other nations. In addition, deficit spending ("economic stimulus") measures designed to remedy the crisis also enlivened the US and international economy. **What about the marketplace bandwagons since late summer 2010?**

The additional quantitative easing conducted by the friendly Federal Reserve, announced in August and November 2010, has played a major role in ensuring time and trend harmony for stocks, commodities, and the broad real trade weighted dollar. Start with and underline the S+P 500's lows at 1040 on 8/27/10 and 1174 on 11/30/10. Compare those in the broad GSCI on 8/25/10 at 490 and 11/23/10 at 556. Though the GS Agriculture Index made a noteworthy low on 6/7/10, don't overlook those of 10/4/10 at 380 and 11/23/10 at 424. As for base metals, the LMEX flew upward from 6/7/10 at about 2790 and 11/23/10 at 3640. What about crude oil (nearest futures)? Brent soared from lows on 8/25/10 at 7175 and 11/23/10 at 8243; NYMEX dovetails with these, at 7076 on 8/25/10 and 8006 on 11/17/10. Thus there's not much dissonance between the trends of stocks and commodities. The TWD pattern is consistent with this; it eroded from a minor high in June 2010 at 89.8, cascading lower after September's 86.7 level. Note the timing of lows in the Euro FX cross rate versus the dollar: 6/7/10 (1.1877), 8/24/10 (1.2588), and 11/30/10 (1.2969).

The US 10 year Treasury note has wandered sideways since late summer 2010. However, its yield low on 10/18/10 at 2.33pc still fits within the price and time rhythm of these other financial regions and the Fed's new easing symphony.

Timing may not be everything, but it's pretty important in both music and marketplaces.

What does this forest of data for stocks, commodities in general, and the broad real trade weighted dollar portend for their current and future environment? There have been two alternating marketplace songs in recent years. Strong stocks/strong commodities/weak dollar has been one clear tune, with sagging stocks/cratering commodities/strong dollar the alternative one. It is very likely that a major or any very significant high in stocks and commodities will occur around the same time (within a couple of months). That peak probably will happen around the time of an important low for the dollar.

Over this period (and indeed any time horizon), the ties of US (and other) interest rates to stocks, commodities, and the TWD is a complicated one. In any event, take the standpoint of the US Treasury 10 year note and permit lead/lag considerations (for example, the issue whether and how bond prices lead stock ones) to lurk in the shadows. Roughly speaking, rising UST prices (2007 yield highs to the December 2008 yield valley) have been associated with falling stocks (and commodities). The perspective since end calendar 2008 is somewhat cloudy. However, the increase in 10 year note yields (though it hasn't been massive) relative to their December 2008 and October 2010 lows parallels to some extent the rally in stocks and commodities. Fears of renewed economic decline inflate 10 year United States Treasury prices ("flight to quality"), but recovery, money printing, and substantial commodity price inflation tend to boost yields. Yet the sustained low short term rate policy of the Fed, as represented by the Federal Funds level, has assisted rallies in stocks and commodities.

The future need not repeat or even echo the past. Nevertheless, the problems of the worldwide economic crisis that emerged in 2010 have not been completely repaired. The massive government deficits in the US and elsewhere, the still-damaged American consumer net worth, high unemployment, and weak real estate marketplaces evidence this. If all is fine or soon will be so, why are the Fed and many of its allies not braver about raising rates more quickly?

Price and time considerations warn of a top in stocks and commodities and at least an interim low in the TWD. History shows that spring/early summer 2008 was a key turning point for stocks, commodities, and the TWD. For the S+P 500, five percent under the May 19, 2008 peak of 1440 equals 1368. Compare the high to date in the bull move in the S+P 500- 1371 on 5/2/11. In regard to a potential equity price peak, link the current time (“around now or within a couple of months”) to the calendar month of three years ago.

And consider stocks alongside the TWD and commodities. Compare the April 2008 TWD low (and its timing) with the recent TWD low achieved at 81.3 in April 2011. Also, this April 2011 TWD level is within five percent of the April 2008 one. Did the Euro FX make a notable high versus the dollar on 5/4/11 at 1.4940? Various commodity benchmarks have been achieving highs around the times of lows in the TWD and the recent high to date in the S+P 500. The broad GSCI's recent highs are those of 4/11/11 at 762.2 and 5/2/11 at 761.7. The high so far for the bull move in the Goldman Sachs Agriculture Index was a bit earlier, at around 571 on 3/4/11 and 567 on 4/8/11. The LME X tops also were somewhat before recent highs in stocks and the broad GSCI; note the 2/14/11 top at 4478 and 4/8/11 at 4469. Gold 's recent high of 1577 (nearest futures) occurred the day of the recent S+P 500 high, and not long after silver's collapse from around fifty dollars (4/25/11 at 49.82).

What about the 10 year US government note relative to this very recent history in stocks, foreign exchange, and commodities? Recent high yields in the Treasury 10 year were on 2/9/11 at 3.77 percent and 4/8/11 at 3.61pc. Remember the 2007/08 period in this context. Though yields may well ascend at some future point beyond these levels, the yield decline since February/April 2011 is consistent with an eventual stock (and commodity) price fall. Widening credit spreads would tend to confirm weakness in equity marketplaces.

Stocks and various commodities have their own supply/demand outlooks, and so equity trends and those of one or more commodity sectors may not stay in harmony. But a noteworthy and sustained commodity fall hints that declines in equities eventually will follow. The sharp decline in petroleum and silver last week may not represent a final top for commodities, but they warn of one. And US real estate prices generally remain feeble.

Observers have pointed to the substantial net noncommercial length in commodities. That in the petroleum complex has been noteworthy. Yet leverage and “speculation” creep into landscapes other than commodities. What about equities? Take a peek at New York Stock Exchange margin debt levels. In March 2011 (the most recent month available), it was about \$316 billion. This is about 82.1 percent above the low of February 2009- around the time of the major S+P 500 low in early March 2009. The high in margin debt during the last major equity bull run was in July 2007 at about \$381bb, not long before the equity top in October 2007. The final high for this margin debt total was in June 2008 at just over \$314bb, close in time to the S+P 500's final high of May 2008. Since the March 2011 (and probably the present) NYSE margin debt level is about that of May 2008, stock watchers in the current price and time context should view that level as a warning sign that equities are vulnerable to a decline soon.

ASSORTED UPCOMING RHYTHMS

However, the Federal Reserve is determined to improve consumer balance sheets and support economic recovery no matter what, as are most other central banks and politicians. The rally in equities has been an important reason for the improvement in the US household balance sheet since early 2009. However, household net worth still has not recovered from injuries suffered

during the fierce Great Recession. The Fed probably will start printing money again or find new ways to ease policy after June 2011 if stocks decline toward the August/November 2010 S+P 500 lows (1040/1174). Keep an eye on around any 20pc drop following a new high. For example, a 20 pc fall from 1371 is about 1096 (a 10pc dip from 1371 is 1234, not far from the 4/26/10 top at 1220).

Any big equity price fall arguably will encourage more significant US political action on the federal deficit. A notable shift toward fiscal responsibility (even if not comprehensive or a substantial solution to the long range deficit problem) is bullish for equities. Will the US default on its debt? Probably not, despite current posturing in Washington. Fears remain regarding the fiscal situation of European nations such as Greece, Portugal, and Ireland.

All else equal, the longer the Fed keeps short term interest rates very low, the greater the risk of further dollar weakness. From September 2010 to February 2011 (the most recent data), foreign official holdings of US Treasury securities have been about unchanged, with overall foreign ownership up only about \$150 billion. What happens when the Fed cuts back in its Treasury buying at end June 2011?

In its battle to sustain the stock marketplace, create some inflation, reduce unemployment, and mend the consumer balance sheet (and aid nominal GDP, corporate profits, and real estate), the Fed will risk further dollar declines. New all-time lows for the TWD eventually may arrive.

If a further TWD decline carries toward ten percent under the former major support at 84.0 (1973-present; toward 75.6), the strong stocks/weak dollar link of recent history may not hold. Such substantial dollar weakness might inspire a flight from stocks (and perhaps from US debt securities as well).

Inventories are adequate in petroleum, perhaps even a bit high in some areas such as the US. However, even allowing for some demand destruction due to high prices, cuts by Saudi Arabia (not only Libya's) gradually will slash days coverage levels somewhat over calendar 2011. The Middle East political turmoil likely will continue for some time.

Though high prices encourage boosts in agricultural plantings in the US and elsewhere, the 2011 ultimate output of key US crops such as corn remains subject to weather uncertainties. And over the long run, worldwide population will keep rising. So will popular demand for higher living standards (and protein).