

Trend Watch

December 10, 2010

Inflation-Deflation Timer

Current Indication: Inflation

Our proprietary Inflation-Deflation Timer Model (the “Timer Model”) is a trend-following model and as this class of model does not call tops or bottoms the value is in its ability to spot trends!

The marco-trends our Timer Model is looking for are:

Inflation, Deflation and Neutral Signals

Buying the QE2 Risk Trade

Market technical indicators point to a continuation of the bullish momentum begun last week. We call this the QE2 risk trade and what we saw last week could be the start of a significant move higher in risky assets.

Market relative charts can be revealing. The chart below of the Morgan Stanley Cyclical Index compared to the S&P 500 shows that the cyclicals staged a relative breakout last week, indicating that investors are piling on the QE2 train.



Speculation is not excessive

The QE2 risk trade has much more upside potential. Consider the performance of the TSX Venture Index, which represent the small cap juniors, compare to the more senior TSX Composite. The chart on the next page shows that the juniors have been fair steadily outperforming the large caps since late 2008. The TSX Venture/TSX Composite ratio is nowhere near levels indicating high levels of speculative activity.



China is the wildcard

The greatest risk to the QE2 Risk Trade is a potential slowdown in Chinese growth. Indicators such as the Baltic Dry Index are suggestive of incipient weakness. The Chinese have indicated that they are worried about inflation and they may take further steps to tighten monetary policy by increasing banking reserve ratios in 2011.

Should China slow, then it would be extremely negative for the global economy and commodity prices. We therefore remain with our model discipline of letting the winners run and limiting losses.

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