



Investment Theme for 2007 – A Pause in the secular trends

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Over the last three years or so, the world has had a secular bull run in some commodities and emerging market equities. American and European bonds have held up pretty well and currencies have posted handsome gains against the USD. The broad theme underlying markets centers around three main stories. 1- China-India led economic growth 2- USD weakness and 3- the commodity bull market.

Let me begin with an asset that has gained a lot of attention lately – Gold. Gold's rally over the last few weeks has looked quite unconvincing and has lacked conviction. The recent uptrend is clearly under stress and the market could see a reasonable correction in the price of Gold. Fundamentally, Gold's recent rally came out of currency play and the strengthening of other currencies against the USD. This is hardly a good reason for a rally in Gold – at least in the short term. The recent slide in the price of Crude Oil has also taken away the wind from under its wings. The Gold-Oil ratio stands at 10.11 as per yesterday's prices. The low on this ratio was in 2005 at 6.58. The high on the Gold-oil ratio was made in 1988 when it hit 30.38. A ratio of 10.11 today certainly looks great to buy but even a correction in the ratio to 8.50 will be bad for those looking to trade on the long side of Gold. In November, the ratio broke above but failed and closed below the resistance line on monthly charts. With crude oil prices still under pressure and fears of a slowdown in global economic growth, any further fall in crude could hurt the price of Gold.

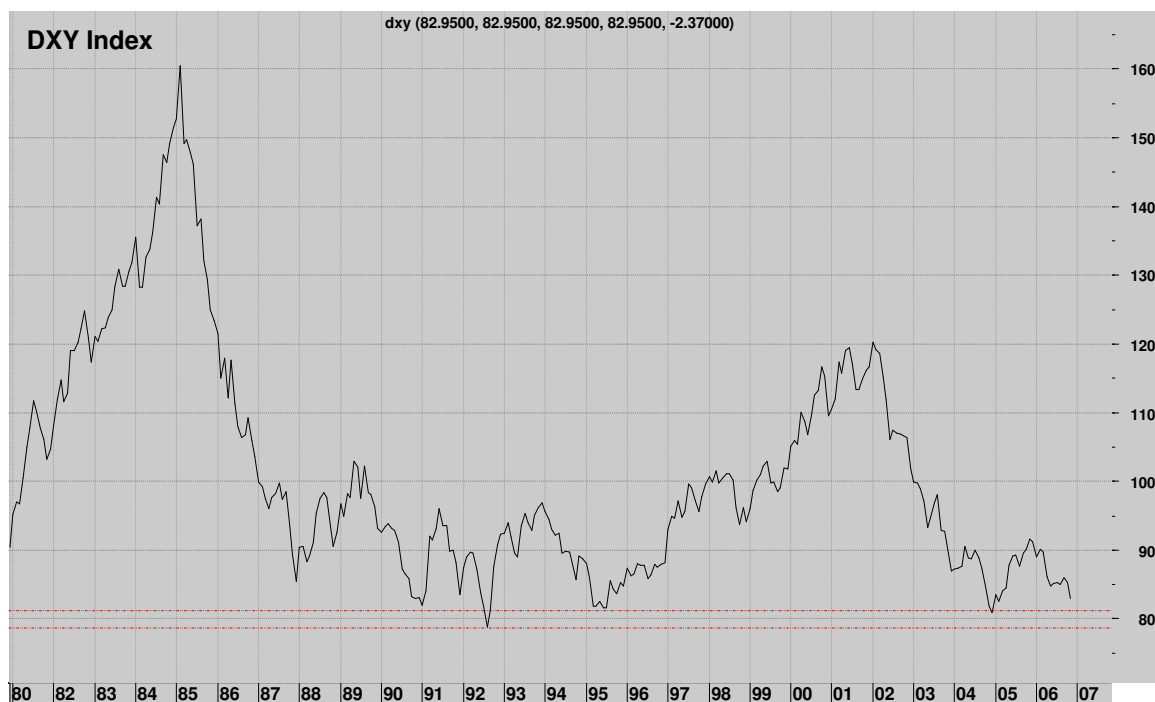




Another way to look at it is using the Dow-Gold Ratio. The Dow Jones Industrial Average (DJIA) to Gold ratio hit a high in 42.35 in 1999 and declined to a low of 17.30 this year. It currently stands at 19.50 and these levels represent a strong support for the ratio. The DJIA has spent seven long years in consolidation and has made a new high this year. This breakout could well bring out further upside in the Dow in 2007. If that does happen, it could mean markets will reverse to buying the USD and selling everything else against it (including Gold, Silver, etc). Collateral damage can be caused in emerging market equities and any other asset class where speculative money has flowed into in the last 2-3 years as the speculative money will flow out from those markets into the US stocks. Commodities like Copper, Zinc, Gold, Silver and other industrial metals have witnessed a fair share of speculative buying in their rise and these could now be casualties of the money flowing into US equities.



The DXY (Dollar) index is at 82.71 and the 80's have been a strong support for the last four decades. We have already seen a reasonable fall from 120 in 2002. Surely the Dollar can have some time to breathe and recuperate to 90 or so on the DXY index before the next slide begins.





Going ahead, Gold is surely going to be one of the best investments anyone can make in the coming decade. However, in the near term (maybe a year's time), it may have a tough task at hand and find it very difficult to escape into higher territories. For investors, the good times to buy Gold are probably going to come in the first half of 2007. Today's price on Gold is \$637 and one can anticipate a brief rally to \$640-650 in the next 2-5 days, after which we could expect to see \$615 before 2006 ends. Sometime in H1-2007, target a price in the proximity of 550. Silver may get battered a bit more than Gold if the Gold-Silver ratio is any indication. That should most likely be the best opportunity for investors to pile up on their Gold purchases. A sharp correction in crude oil to mid 40s sometime in the next 6-10 months cannot be ruled out. This will be the great buying opportunity for all of us.

Prices of agricultural commodities are still having great upside and some of them have extremely bullish fundamentals. Stocks/Usage ratio in Wheat, Corn and Coffee are at multi-year lows. The demand-supply gap is getting wider. Population growth and growing income levels are putting severe stress on demand side. Did I write Population growth? Yes, I did. Interestingly while the growth rate in population has been in decline for the past many years, the population is still growing rapidly in number to the large base. The world has nearly 6.5 billion stomachs to feed now compared to 2 billion in the 1950s. Climate conditions are getting far more extreme and unfavorable; creating supply side problems (Wheat output has been a casualty in 2006). Droughts and floods both seem to be occurring with greater frequency. Water is on its way to become the 'Blue Gold' and it's scarcity in India-China region is going to create the next bull market in grains and oilseeds.



Oil will resume its rise sometime after its consolidation / correction in H1-2007. The rise in agricultural commodities and the resumption of a rise in oil prices will once again feed inflationary expectations and bring out the real theme for buying Gold post 2007. Within the next five years, Gold is most certain to surpass its all-time highs and cross above \$850 and even exceed those expectations but after a dip in the short term.





To summarize the theme for 2007:

- Time to invest in precious metals and most industrial commodities will be well into or after mid-2007.
- Crude Oil, Copper, Zinc and other industrial metals are highly vulnerable to correction and should be expected to trend downwards in H1-2007.
- The Dow looks set to have a good year in 2007. However, it will be only the DJIA components and the large cap stocks, which will benefit.
- The rally in Dow could aggravate the sell-off in other asset markets especially the Emerging Markets Equities. Markets such as Indian equities have factored in very ambitious growth projections and have no cushion to absorb the slightest of shocks. Commodities, which have seen huge speculative flows, may also be affected, though to a lesser extent. Copper, Zinc, Silver, Gold and other industrial metals come to my mind.
- Most agricultural commodities have limited downside and infact some of them like Coffee, Wheat, Corn and Soybeans (oilseeds) still look attractive.
- The USD is likely to rebound against most currencies in H1- 2007. EUR, GBP and many other currencies should see a significant decline from here.
- The longer-term fundamentals are still intact. The Commodities Bull market is very well in place, the dollar's fundamentals haven't improved. History has taught us that even in 15 year bull cycles, we can have corrections lasting upto 2 years and we're most probably in the midst of one right now. Though long term fundamentals for the USD remain weak, it seems to have the relative price advantage over the next few months. The financial markets need to rebalance and in the process, USD stands to gain.
- Markets will re-commence the secular wave once again but only after a few months' correction. The USD will re-commence its decline, commodities will roar once again, Asian and emerging market stocks will bounce back ...only after they recoil and build up fresh energy.
- I am a great believer in the commodity bull market. I own some (mostly agricultural) myself. However, I think the bull market has gone into a pause and a period of correction. It's time for encashing the long positions in many of the assets that have risen for the last 3-4 years and keep oneself sufficiently liquid for buying the declines in the coming year.
- It's time to get contrarian and buy into assets (USD and agri commodities) least wanted and exit those that have been talked and bought all around.

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