2007 – A cyclical low within a major secular uptrend

The analysis of the charts display divergent messages, pointing toward an increased monitoring of the risks and opportunities involved in commodities products. Looking at the multi year charts allow to put a perspective on the short term expectations of market participants, observers and commentators: a chart is worth thousand words!

In June 2005, our previous technical analysis of commodities in the SDR focused on the secular bottom of commodities in general around the year 2000 and on the expectation of a secular uptrend for at least 10 years thereafter. Here we will follow up on this market analysis and argue that commodities are currently undergoing a cyclical correction within a secular uptrend. However, the analysis should differentiate between crude oil and many metals on one hand and food commodities and other specific metals on the other hand.

To draw our conclusions, we borrowed from two main chart sources. First, the interesting momentum work from The Notley Information Service, Ridgefield CT, USA (Charts 2, 3, 4, 6), allowing to display yearly charts since 1868 for oil and shorter term monthly momentum for Brent and coffee. Second, the excellent concept of comparing on a multi-scale logarithmic chart diverse commodities to reflect either commonality or divergences between them stems from the veteran “Gold Bug” and commodities market analyst Ian McAvity, who shared his “Deliberations” on the year 2007 with members of the Swiss Association of Market Technicians (SAMT) and of the SFOA on February 5 in Zurich (www.chartguy.com/Deliberations.htm). Charts 1 and 5 are based on the great programming skills and database of Topline Investment Graphics (www.topline-charts.com), which Ian is using as well for many years.

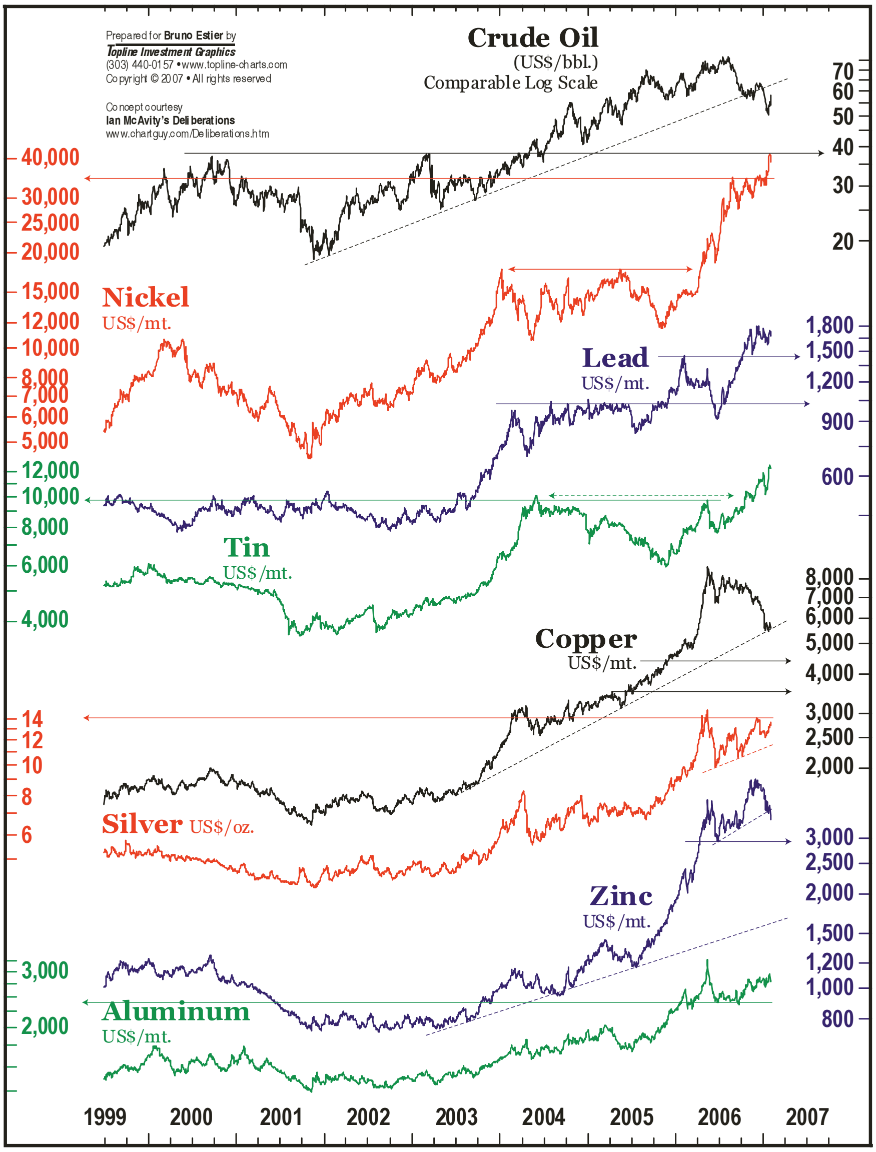

Chart 1: Major commodities, metals & oil
(Courtesy of Topline Investment Graphics, www.topline-charts.com. Concept courtesy Ian McAvity’s Deliberations, www.chartguy.com/Deliberations.htm)

The case for oil

Chart 1 displays trend lines, supports, resistances or patterns that are my sole responsibility. Namely, the clearest break of a 5-year rising uptrend is seen on oil. A possible pullback to the now resistance trend line near 64 is likely. But a cyclical top is at hand, within the context of a secular uptrend as confirmed by chart 2, which displays in red a rising smoothed annual rate of change of crude oil since the second quarter of 1999. The yearly High-Low-Close bars are shown for the last 13 years. Before that, and back until 1868, only the closing price on December of each year is recorded. In addition, on the lower part of chart 2, the relative strength of crude oil versus the S&P500 and its annual rate of change signalled also a relative strength outperformance since the second quarter 1999, after 18 years of relative strength underperformance to US equities. The yearly annual rate of change of crude oil would turn down only with a yearly

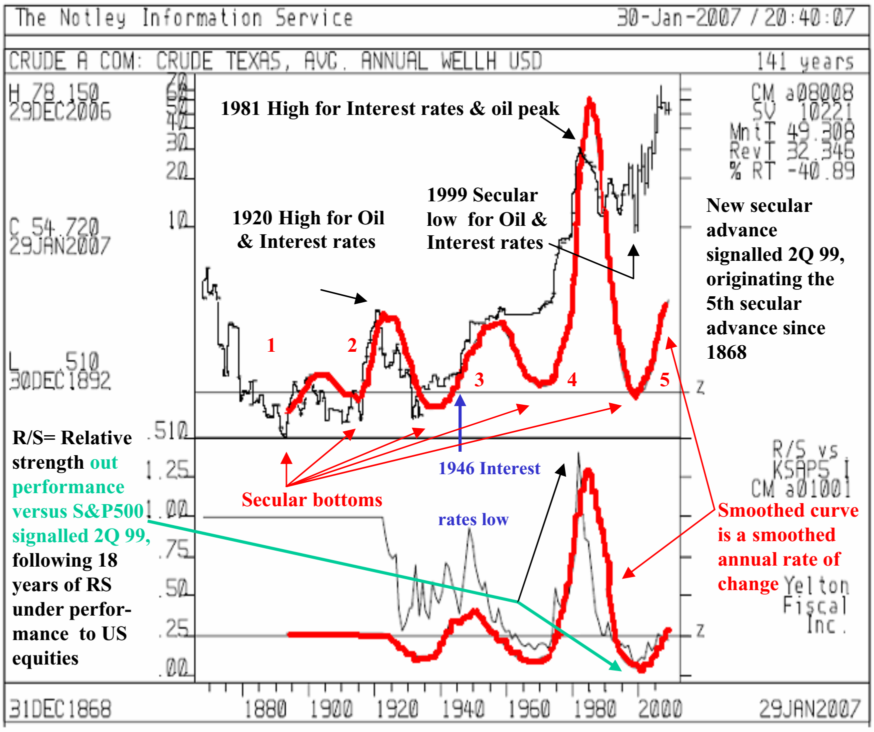

Chart 2: Secular uptrend intact above $33

(Courtesy of the Notley Information Service, Ridgefield CT, USA)

constant dollar (i.e. adjusted by the yearly GDP deflator since 1915), gives a clear sense of perspective to the 2006 high versus the 1981 peak. Further it appears evident that the area $36–42 is going to be pivotal. Below that area, we had in the mid eighties until 2002 a period characterised by disinflation and scare of deflation. Above that pivotal area, we have the current period of rising commodities and in the seventies the period of the oil shocks with the inflation of the early eighties. In other words, above constant $43, the secular uptrend of oil would remain intact.

The financial expert may have recognised on chart 1, the arrow pointing toward $40 in nominal term, which is a key support area. On chart 5, the zoom on just four charts allows to point to $45 as a 38% Fibonacci retracement between the low of 2001 and the 2006 high (on log scale). The 50% retracement would be near $37, but would overlap the 2000 and 2003 highs, endangering the bullish dynamics. We conclude that oil may break the recent low near $50 on close in 2007 below $33 per barrel, signalling then a turn down of the secular uptrend. At $57, we seem currently to be far from it.

Let's turn to the monthly 13-years graph on chart 3 to get a feeling of the current downtrend since the high at $78.15 during August 2006. The smoothed monthly rate of change suggests that the current sliding momentum will be lasting longer than during the short correction of 2003–2004 and may well – as it did in 2001–2002 – cross below the "z line" (the zero line) for a few more months into the second quarter 2007. This scenario would remain valid as long as crude oil remains on a monthly close basis below $71 per bbl.

Now that we have an idea of timing, let's focus on the price action. A glance at chart 4, with the crude oil price in

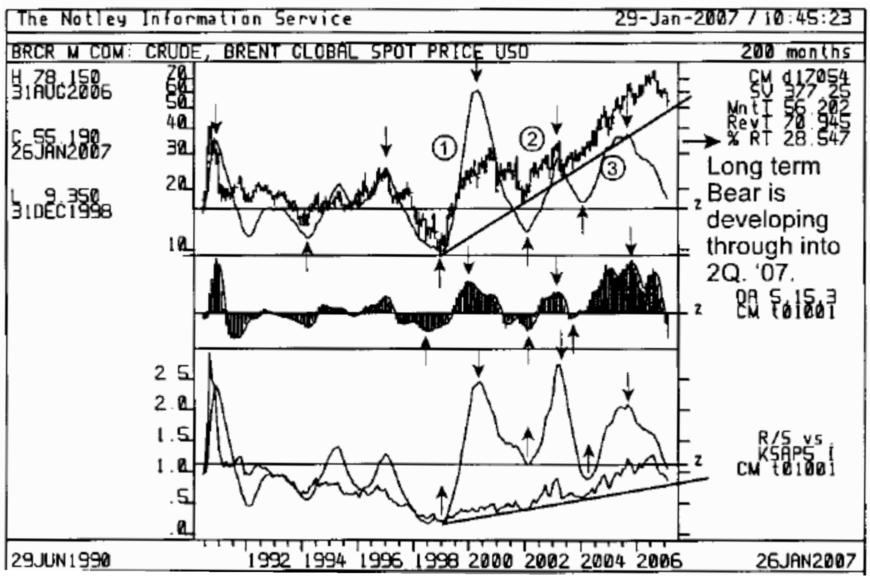

Chart 3: Cyclical correction within secular advance

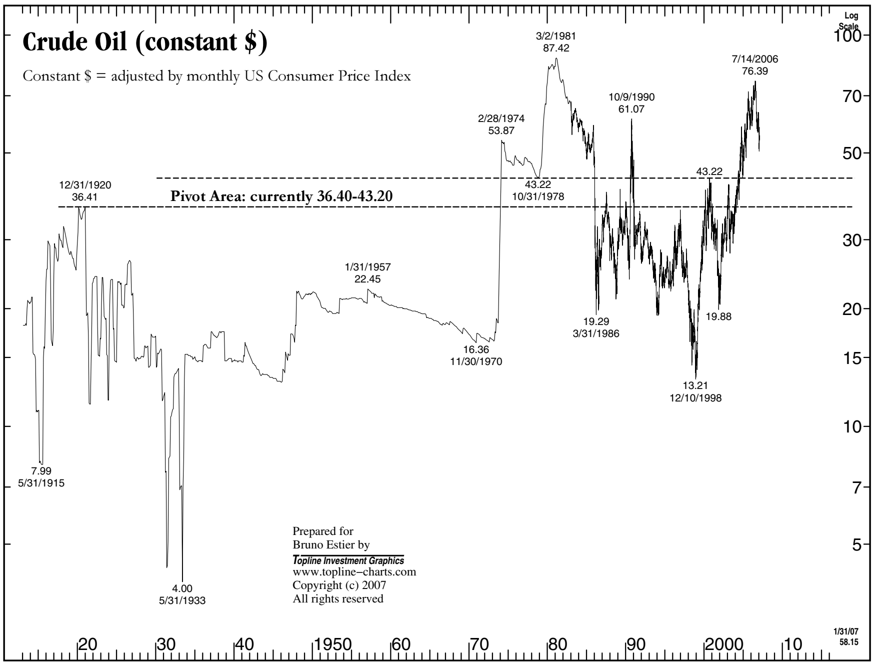

Chart 4: Oil – Key support area $36-42 adjusted for Inflation
(Courtesy of Topline Investment Graphics, www.topline-charts.com)

January 18 during the current correction phase, as long as it remains below $71. But the maximum downside in this case should be limited by $43–45 during the current secular uptrend that we are in. We believe in a tough-to-decipher $70–45 range.

The case for metals

The recent breakdown and test of the rising trend by Copper after a parabolic rise in 2006 is a testimony that the risk of breaking the trend would open a further slide toward next support at $5000/mt, a 50% retracement of the rise from 2004 to 2006. The maximum risk allowing to maintain a secular uptrend would be seen at $4200-4000/mt, which is jointly close to a 38% retracement from 2001 to 2006 and a 62% retracement from 2004 to 2006. The aficionados of the Fibonacci compass may double check these levels on chart 5, the proof is in the pudding.

"Nickel continues to march on its own drummer in making another high, while tin has been a laggard," said Ian McAvity in his Deliberations from January 24, 2007. Both metals showed a two year pause in 2002 and 2003, see the double arrows on chart 1, whose pattern could become the fate of copper, zinc and lead at least during part of the year 2007. Our arrows on chart 1 and 5 show key support areas near $33,000/mt and $25,000/mt for nickel, while the tin uptrend is still intact above $9000/mt. Curiously, aluminium and silver are staging higher lows after a parabolic spike top in the first half of 2006. Are they just the mirror of bullish hopes? We need to wait for more evidence of trend confirmation.

The case for food

While the volatility and rotation in the metals suggest some sense of speculation, the evolution of The Economist's food index at the bottom of chart 5 points to a very recent break above a lengthy 3-year consolidation, whose minimum upside target is 20% higher.

Coffee on chart 6 is a good example of the pause, which lasted for the last

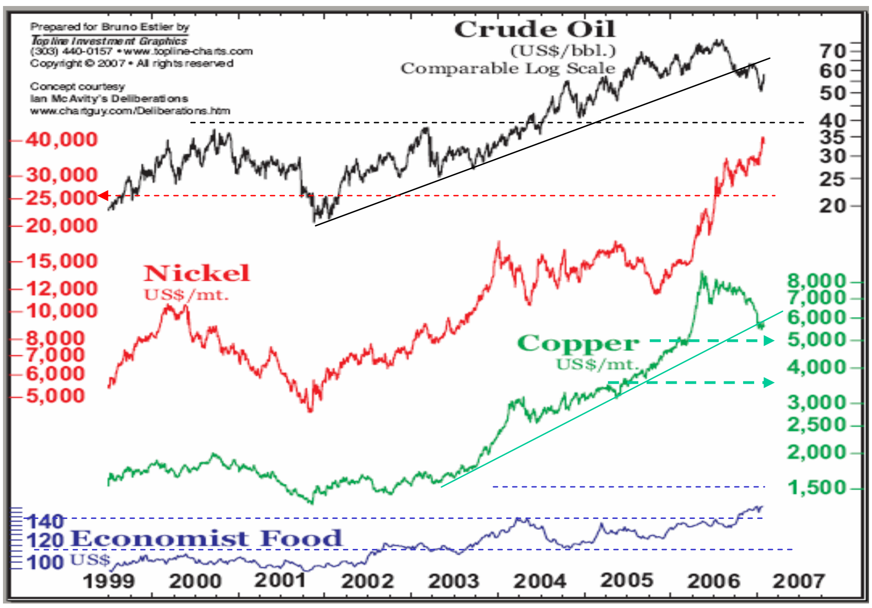

Chart 5: Divergences in some metals and oil, while food wakes up

18 months, but whose monthly momentum is up now for 6 months. It calls for a new bullish cycle, with a triangle target in the $200 area, or a whoopee 75% price increase! The rounding base of the relative strength performance versus US equity for the last 6 years, which followed 6 years of volatile underperformance, is a classic technical pattern calling for some relative strength overperformance in the coming years.

Conclusion

Ranging oil is good news for inflation and should help boost consumer sentiment: a likely positive argument for equity markets worldwide. But food commodities may play catch up, rising the spectrum of food inflation, while copper breaking down would suggest some coming economic slowdown. Such divergences in messages suggest that – for a few months at least – the easy trip on the back of commodities is over. Our friend Ian McAvity recalled that "Wall Street history suggests new products (allowing retail investors to play in exotic markets) hit the markets after most of the potential they have been designed for had already occurred. Unfortunately, most retail investors tend to buy yesterdays winning trends".

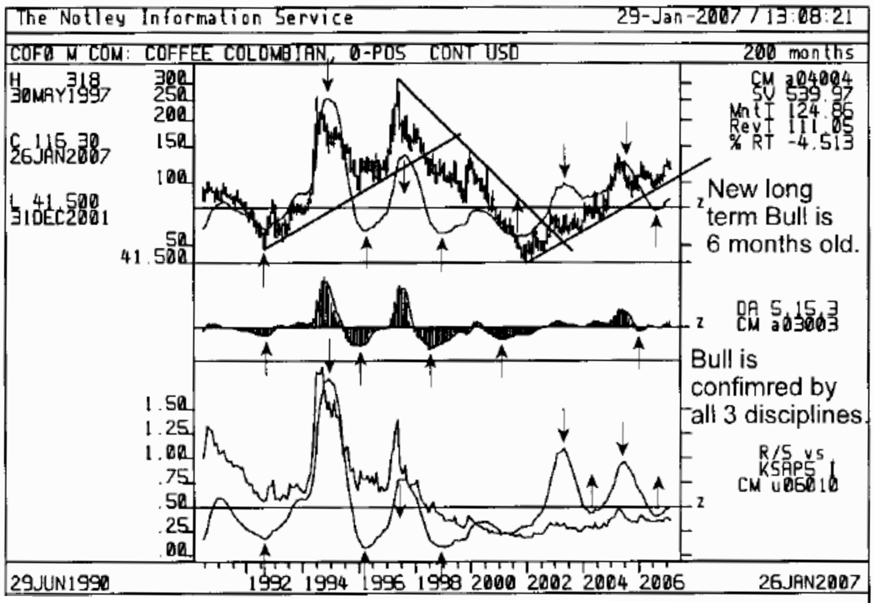

Chart 6: Coffee resuming uptrend within secular advance started in 2002–2003

Well, is Ian's wisdom overly conservative? What indeed, if the structural acceleration of the financial globalisation on world street (or may I call it World Electronic Street for Trading, WEST) was allowing hedge funds, pension funds and also retail investors to buy new products while the secular trend is already at mid course, embarking on some rising trends of tomorrow!

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