

Stock Market Report

31 January 2010

Market at the crossroads

The market gains of December and the Christmas rally into mid January where the market traded above the October peaks were practically wiped away in the last two weeks of January. It was all looking and feeling quite nice for a further rally until the President Obama and China announcements.

President Obama announced a desire to implement restrictions to US bank trading and introduce legislation to curb the excesses of Wall Street by restricting bonuses and imposing taxes or levies to recover some of the cost of the banking bailout and also restrict public debt growth. There has been no real reform since the GFC and Wall Street are resisting any type of regulation. The old guard don't want change because they earn bonuses by lending money and self regulation does not work because Wall St cannot control itself when large bonuses are being paid.

China announced their desire to slow economic growth because excess liquidity as a result of financial stimulus is creating a bubble in their stock and real estate markets. However, China has taken a prudent course of action by restricting bank lending which reduce debt levels rather than raising interest rates which increase costs to consumers and businesses. Perhaps the RBA should consider this course of action. These announcements were on top of the sovereign debt crisis which has been brewing since the debt problems with Dubai World and Greece, acting as a reminder to all investors that global financial markets are still highly leveraged.

The euro, British pound and gold fell against a rising \$US, however we would view these unusual periods of \$US rises as short or possibly medium term rally's since \$US strength is not likely to last long. *"The US has to fund its deficit through the combination of issuing more Treasuries and printing more dollars, it is inevitable that the dollar will continue to weaken."* said Zhu Min the Deputy Governor of China's Central Bank, which owns \$798.9 billion in US Treasuries.

A genuine sustainable recovery in the US is likely to be some years away, if at all, which would imply that it is more likely that interest rates will remain very low in the US in an attempt to maintain consumer spending which their economy is so reliant, and so the US Dollar will remain weak.

Gold safe haven

The US Federal Reserve, RBA and other banks around the world are flooding the world with printed money and easy credit, so investors will seek safe assets such as gold as a potential inflationary hedge. Gold is one of those safe assets that cannot be reproduced like paper money and is a scarce resource. Gold will therefore remain a strong asset to hold as long as US interest rates are at near zero levels. A report from Societe Generale analyst Dylan Grice says that if the US dollar were fully backed by gold, as it was during the peak of the 1970's, it would trade for \$6,300 per ounce. That makes gold cheap at these prices.

Gold supply is falling and demand is rising

In addition, gold production, which has been in decline, is set to decrease further in the foreseeable future. Vincent Borg, spokesman for Barrick Gold, the world's number one gold producer: *"It's a fact that gold production from mines has been in decline since 2001 and has gone roughly from 85 million ounces to about 75 million ounces a year. It sort of goes down about one million ounces every year and our forecast is that it will continue to decline despite the higher price"*

Substantial gold finds are rarer and production levels in older mines are falling. Many gold companies are now closing their hedge books, which involves selling gold in advance for a discount, because they are so confident that the long term gold price is increasing. Hedging is a negative when prices are rising as it results in loss of profit from the price increase. Therefore, closing the hedge book is risky and can be very expensive, so companies have to be confident that the gold price is going to rise. Barrick Gold recently joined the long list of gold companies de-hedging including Newcrest, Lihir Gold, and Newmont Mining.

Demand for gold has increased and the World Gold Council's latest figures show a 21% year on year increase in demand for gold. The US Mint is suspending sales of its one ounce gold coins as it has sold its entire inventory. Falling supply and rising demand will push prices higher.

The cost of money

The general consensus was that interest rates would rise at the February RBA meeting, so individuals and businesses may have made business decisions based on what they confidently thought the market was indicating that interest rates would rise.

The decision by the RBA to leave interest rates on hold surprised the market. Although there is no certainty in the world of finance, it would appear that the decision quite possibly misled hundreds of thousands of market players who believed the RBA would increase interest rates because it was the message coming from the RBA and the mainstream press. This is another example of market manipulation that creates false signals, like the many bailouts that have occurred during the past two years.

The RBA governor, Glenn Stevens, recently stated, “...central banks had contributed to the housing bubble that plunged the world into recession and had a responsibility to help ensure the toxic cocktail of rising property prices, soaring debt and lax credit was not repeated.”

If a genuine free market was in operation without monetary manipulation from government and central banks, investors would be able to make decisions based on signals relating to interest rates and act accordingly. The free market would eventually move interest rates to a level determined by market forces. Of course, in a free market individuals and businesses can change their minds and their priorities too. However, the difference is no single entity would have the same level of control over the entire market and be able to impact the personal or business decisions of millions of people through a single decision.

Unfortunately, there is no free market economy in operation at the moment, especially in the market for money. The government has granted a monopoly on the supply of money to organisations made up mostly of the banking industry. Their main goal is to get you into debt and keep you there.

The Australian Market – Trading in a range

The Christmas rally occurred on low volume which was a concern, however the All Ordinaries (XAO) traded and closed above the October peak. The XAO rose above the October high of 4,897.5 points by early January to form a peak of 4,984 points in the week 15/1/10 indicating that the market would continue to rise, however it then fell away sharply to a low of 4,596 points by the end of the month, an almost 8% drop in two weeks. The 50% retracement level at 4,962.85 points has been respected and proved to be a resistance level.

Although the fall was significant, the index is technically still trading within a sideways pattern which is supported at around the 4,600 points level and more specifically the early November low of 4,515.30 points, formed when the market also pulled back strongly in late October and early November. Therefore a break below the 4,515 level will indicate that the market may fall further.

All Ordinaries Weekly Chart



All Ordinaries Monthly Chart



As we suggested in recent previous reports, the XAO has potentially reached either an upper target zone or a consolidation phase as it now appears to be consistently finding resistance at various significant levels that we have previously highlighted. The most obvious are the critical 50% retracement level and the 5,000 points region, both of which lie within a major resistance zone formed by the Aug 08 low of 4,829 points and the Sept 08 peak of 5,250 points (see dotted lines on weekly chart above).

In previous months we wrote: “The 50% retracement level of 4,962.85 points is now looking quite interesting as a potential target. There is also the distinct possibility of a rally to the 61.8% level at 5,400 points region based on the higher end of Elliott Wave projections, however given the undercurrent of negative fundamentals this would be a low probability scenario.”

The XAO has been rising in a channel (see dashed lines on weekly chart above) from the March low and has broken through the lower channel line with the January low. A breakout of this channel usually results in a continuation in the breakout direction; therefore a close below the lower line is a bearish signal. However, there is still no Dow Theory exit pattern (a lower low after a lower high) on the

weekly chart so a change of trend is unconfirmed, so there is still the possibility that this move may be a short term pullback or consolidation within the up-trend. The 30 moving average line (orange) is still rising on the weekly chart which is a good sign.

The market is at a critical point now and the 4,500 points level needs to provide support or the probability that the market may fall further will increase. Therefore, we will need to wait to see how the weekly bars unfold in order to get a clearer picture of where the market is heading.

Outlook

The Dubai and Greece crisis together with proposed US banking regulations and China's restriction desires have cast a shadow over the global financial recovery.

There is a global sovereign debt crisis brewing because the world's large economies have been competing in devaluing their currencies against trading partners in order to increase export earnings. "The problems currently faced by peripheral Europe could be a dress rehearsal for what the US and UK may face further down the road" said Jim Reid, a strategist at Deutsche Bank. The sovereign debt crisis could be the catalyst for a stock market reversal into another down trend or it could cause a temporary setback with another bailout that defers the inevitable.

The fact is that the global financial system is still weighed down by debt which is not supported by assets that are able to generate sufficient income to service the debt. As a result, we have concerns about the strength of the global economy and thus the sustainability of the stock market rally. We continue to be mindful that market rallies that are not driven by improving fundamentals do not last, and so we are prepared for a significant peak and reversal of the up-trend.

However this does not prevent markets from rising further, especially when bailout and stimulus packages are at hand and interest rates are being kept low. Also, China and other emerging economies are supporting commodity prices. While a sideways pattern does not provide any clear direction we get the feeling that the market does not want to break the 4,500 points level so we are leaning more towards the possibility of a further rise to or above 5,000 points before we see the major peak of this bear rally that we have been expecting.

We will need to wait and see what unfolds in the near term because the markets are not confirming any particular direction yet.

Strategy and Recommendation

Although markets have experienced a significant correction recently, it is still moving in a sideways pattern. As a result, the price action in the market over the last month has not clarified the bigger picture.

Therefore, we continue to be cautious with our investments and will take advantage of any further rise in the market until we are provided with appropriate exit signals. We have seen price falls in individual stocks recently where entry patterns and profits are suddenly reversed to trade around stop loss levels. There has been little warning before the price falls, making some investments quite difficult at the moment, as seen with some stocks currently held and recently sold. These moves have also provided re-entry points for some resources stocks that are in our open positions. We expect commodity prices via China demand to continue to support certain resources stocks.

The extreme volatility of late has also made it challenging in making decisions with regard to market and stock price direction. As a result, stop loss and support levels are constantly being monitored on our current open positions. The key as always will be exiting open positions if the markets move into a confirmed down-trend.

At this stage we need to wait for the markets to clarify clear directions before we start making decision with regard to our current holdings or any potential purchases.

Please feel free to call me to discuss further any issues relating to this report or the share portfolio management service.



Paul Tosin B.Bus
Equities Advisor - Authorised Representative

This email and the attachments are confidential. The contents can only be used by the intended recipient. It can be corrupted in transmission, and the onus is on the recipient to check for and remove viruses. This statement should not be removed, and should be filed along with any printed record of the email. If you are not the intended recipient, confidentiality is not waived, and you must immediately tell us by email or telephone +61 3 98665888 and delete it permanently from your computer. The original sender is Vantage Advisory Pty Ltd and retains copyright in the contents and attachments, and any unauthorized use may result in legal action. Vantage Advisory Pty Ltd is a Corporate Authorized Representative of WealthSure Pty Ltd, Australian Financial Services Licensee, License Number 238030, ABN 93 097 405 108. The information contained within this document is of a general nature only. Whilst every care has been taken to ensure the accuracy of the material contained herein at the time of publication neither the author nor Licensee will bear responsibility or liability for any action taken by any person, persons or organization on the purported basis of information contained herein. Without limiting the generality of the foregoing, no person, persons or organization should invest monies or take action on reliance of the material contained herein but instead should satisfy themselves independently of the appropriateness of such action.