Tips for Traders | 12/22/2008 11:41:00 AM

The Year in Review: My Predictions for 2009-Cloudy or Crystal Clear?

We've all had quite a ride in 2008. Early in the year, oil continued its run to record highs, hitting $148 a barrel by mid-year. Gold and copper made new all-time highs, and at the Chicago Board of Trade, the cry "Beans in the Teens" was more than fulfilled, with soybeans trading well above $16 a bushel. And don't forget about the US dollar! It fell to an all-time low against the euro currency, nearly touching $1.6000 dollars per euro FX on the CME FX futures market.

And then the bottom fell out of the credit markets. The credit crisis began as Wall Street watched the failure of Bear Stearns, and Lehman Brothers and Merrill Lynch weren't far behind. The banking industry got some immediate help when Congress passed a $750 billion bailout fund-but this left many of us wondering the United States really should be nationalizing its banks. Without massive capital infusions, Citibank, Goldman Sachs, and insurance giant AIG would have failed as well.

The shock wave spread out from Wall Street quickly, as lending institutions stopped lending to just about everyone. Hedge fund managers, institutional long-only funds, and any other large speculators found their credit lines cancelled with little or no advance warning. This forced the liquidation of huge speculative and long-term investment positions. In mid-July, all the "hot" markets began a spiral lower. Oil shed $100 a barrel in five months, gold lost more than $300 an ounce, and "Beans in the Teens" seems like a distant memory. And the Dow, which saw its highest level of the year on the first trading day of 2008, accelerated its decline, shedding about 44% of its value by late November.

As 2008 draws to a close, perhaps its time to wonder what 2009 has in store for us. I have been working on a long-term study for my two largest clients for the past six months, and I thought the readers at MoneyShow.com would find the results interesting as well. This study looks at the relationship between several groups of assets. By looking at their historic relationships and following the capital flows as these relationships shift and change, we are given clues about where some key markets are likely to go in 2009.

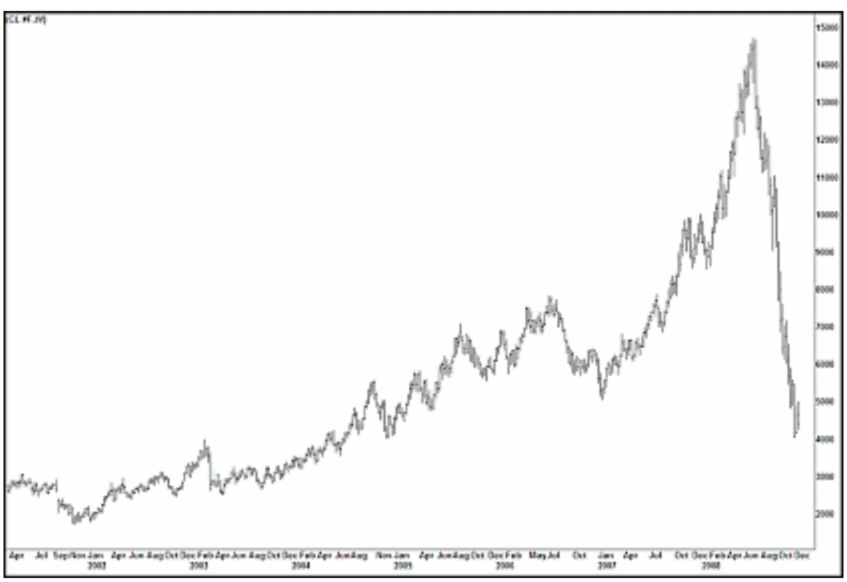
Let me start out with a preliminary look at the US dollar. As Americans, we are generally guilty of being "dollar-centric." Too often, we forget that assets are consumed by other large populations that do not pay for commodities with dollars. More and more, the world's other large economies are diversifying themselves out of their dependence on the dollar, both as a safe haven currency, and as the currency of choice when it comes to transactions. This was evident in July of this year, when the dollar reached its peak against the euro currency. Most long-only hedge funds and other investment vehicles and portfolios were holding large amounts of non-US currencies (euro currency and Canadian dollars, for example), rather than holding any significant dollar-based assets. They were either net outright long these currencies or had at least hedged their US dollar exposure completely.

When the credit crisis started to unfold in July, the hedge funds and investment portfolios that relied on lines of credit to fund their positions got calls from their lending institutions-calls that cancelled their trading lines of credit. These calls signaled the beginning of a huge liquidation of long-held positions in everything from currencies to gold and oil, and even corn, soybeans, and wheat. The mass liquidations meant two things: 1) Hard assets like oil, gold, and agricultural products plummeted in price, and 2) The US dollar came off its lows across the board, as short US dollar positions were closed, and some of the proceeds from these asset sales were turned back into US dollar assets (mainly medium- and long-term US Treasury bonds).

Let me show you a long-term chart of the US dollar against the euro currency:

This chart shows the clear uptrend of the US dollar against the euro currency. I had been watching for a sign that this strong trend might be weakening or even ending, and in late October, the daily charts started to show signs of a consolidation. Prices had been clearly making lower highs and lower lows-and then they suddenly began making higher lows and lower highs. This type of market action shows a series of narrowing pivots, and it simply means that as price narrows its trading range, it eventually works itself into a corner, and it has to break to the down side or the up side.

When I sat down with Tim Bourquin at the Las Vegas Traders Expo this past November to do our regular quarterly interviews for MoneyShow.com, I mentioned that the key to the turnaround of hard asset prices would be the US dollar, and that while it was too early to be certain, the dollar, which had been consolidating, was beginning to look like a change in behavior was at hand. The dollar had just broken above several prior swing highs, and this was the type of behavior that often characterizes a change in trend. I'll update this chart for you after I spend some time talking about the relationships between some of the hard assets and showing you some charts that highlight these relationships.

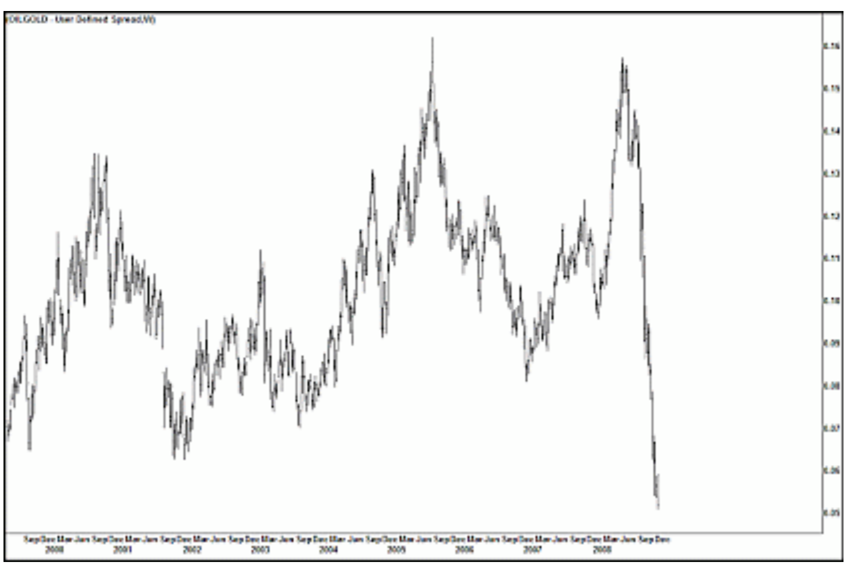


This is a weekly chart of crude oil, priced in US dollars. You can see that it took a dramatic plunge in price starting in July of this year. While there is no clear sign that oil prices have bottomed, if you look closely at the last three bars-representing prices over the past three weeks-you'll see that price is now making weekly bars with higher highs and higher lows. It's far too early to declare a bottom is in place, but this chart bears watching closely, because it may be showing the same signs we saw in the US dollar chart before it underwent a change in behavior.

Let's look at a chart of another popular hard asset, the price of gold priced in US dollars.

On this weekly chart of gold, I have added an up-sloping set of blue lines, a Median Line set, as well as a geometric expansion projection. This geometric expansion shows me that if price climbs higher from its most recent low 100% of the distance as it did from its previous major low to its previous major high, it should reach over $1100 an ounce. While being interviewed for MoneyShow.com this past November, I was asked to predict the year-end price of gold (which was trading at roughly $700 an ounce at the time), and now, looking at this current chart, my year-end prediction of $850 an ounce may have been too conservative.

Now let's dig a little deeper and look at one of the hard asset relationships I was speaking of:



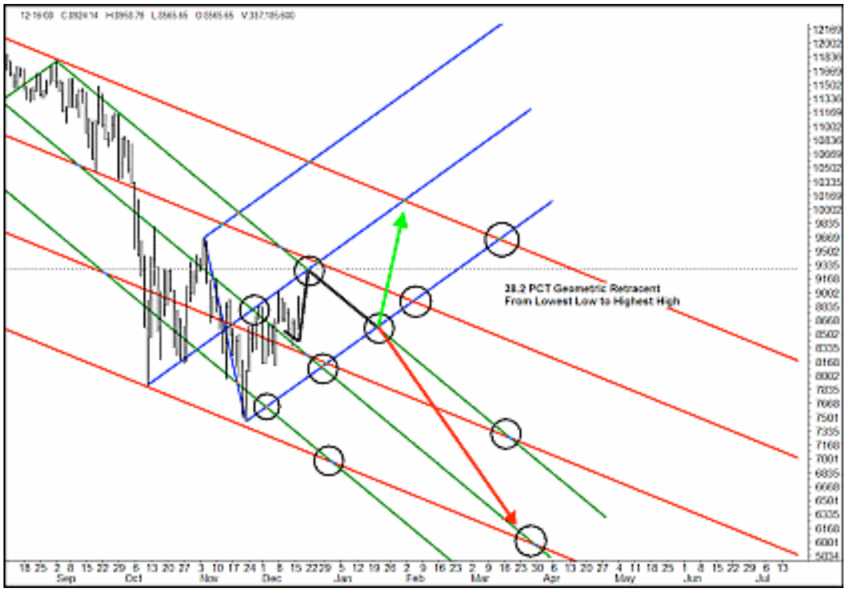
I watch the relationship between gold and oil on a regular basis. When the price of this spread gets too high, a change in behavior is likely to occur. Similarly, when the price of this spread gets too low, it's time to begin watching for a change in behavior. You can see this spread is now trading at a very low relative price-it's been this low before, but it tends to turn back higher soon after reaching these levels. For a change in behavior to occur, either the price of gold has to turn down sharply, or the price of crude has to turn and trade significantly higher. Looking at the charts of gold and oil, I think it's more likely crude will undergo a change in trend.

If gold is heading to $1100 an ounce in 2009, crude should at minimum trade back higher to test $100 a barrel. And while that's still nearly $50 from its 2008 highs, it's a doubling in the price of crude.

At this point, you might be scratching your head, wondering what would cause such a change in the price of crude, other than its long-standing relationship to the price of gold. Let me return to an updated chart of the US dollar:

If you compare this current chart with the chart of the US dollar against the euro currency at the beginning of this article, you'll see that once price showed a change in behavior, it traded significantly higher in a relatively short period of time. If you have any doubt about whether crude could change direction and double in price in 2009, note that the dollar fell faster than it had been strengthening earlier in 2008. If the price of crude does turn around, it may retrace a good deal of its fall way faster than anyone imagines.

Let's look at one last chart:



Here is an updated Dow chart, with what I consider to be the most likely path of price marked in black. I think that as commodity prices turn around, people will at first feel comfortable with some price appreciation, because I think they will attribute it to the economy stabilizing, and as a result, demand for these commodities would then be a natural thing.

But as prices for commodities continue to strengthen, and as the US dollar continues to sell off, I believe people will begin to see the resurgent strength in commodity prices as a growing threat to the economy-as they should-and a sign that inflation is beginning to spiral out of control. The US Federal Reserve has been pumping money into the US economy at an annualized 78% year-over-year rate of growth. And that will eventually translate directly into a great deal of inflation. In fact, if it doesn't translate into double-digit inflation (as measured by the US government), it's a sign that the US economy is in a deep depression, not a recession.

You can see on the chart above that there is a classic Energy Point-an area where lines of opposing force meet-coinciding with the inauguration of our next President in late January 2009. I added both a down-sloping arrow and an up-sloping arrow, allowing you to see what I consider to be the probable paths of price if the Dow breaks out of this hallway, or up-sloping trading range, to the down side or the up side. While I do think the Dow may climb some between now and early 2009, I think that any significant rally will be short lived. In my opinion, the longer it takes for the stock market to experience a cleansing, extremely deep and fast sell off, the worse this sell off will be when it eventually happens.

To summarize: I see the current sell off of the US dollar as the catalyst that will cause traders, investors, and consumers to buy commodities. I expect that most hard assets will experience "V" type bottoms and head higher as the dollar continues its fall. I believe we will see crude back at $90-$100 a barrel in 2009, and gold well over $1000 an ounce. This resurgence of commodity prices will bring double-digit inflation to the US, though it might take the US government's official numbers some time to reflect this move higher in inflation. Last, I see the US stock market making some upward progress heading into 2009, but I feel that any significant rally (a rally approaching 9600-9700) will end in an abrupt and deep sell off, most likely ending in a test of the 5700-5900 area of support.

I wish you all a wondrous and happy holiday season and a prosperous 2009!

Best,

Timothy Morge

timmorge@gmail.com
www.medianline.com
www.marketgeometry.com

Timothy Morge
President
MarketGeometrics, and Blackthorne Capital, Inc.
Web sites: www.marketgeometry.com or www.medianline.com