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## THE CHAPMAN REPORT

Charts and commentary by David Chapman

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Between the Toronto Resource Investment Conference and a family matter to deal with our time was tight this weekend. An email version of our technical commentary follows.

### **Stocks – Intermediate Trend – Up, Short Term Trend – Up**

New highs, a lower close. A classic reversal pattern. The S&P 500 and the stock market put in its worst week in three months. The correction in June was short and ultimately shallow. The market dropped and tested its 40 week MA then in mid July the market turned up sharply and we have been on an upward trajectory since then. At its high last week the S&P 500 was roughly 20% above both its 200 day and 40 week MA. Not even during the long upward march to the highs in October 2007 did we get that high above those key MA's.

So signs were already there that we were due for a pullback and the reversal seen this week confirms those thoughts. But one week does not make a full reversal. We now need follow through to confirm the reversal. Of course this could, like the June/July drop be short lived lasting around three weeks. It would be perfect falling into the typical fall period of a drop.

Naturally this is a bullish case for the markets. AS some point there is/was a potential head and shoulders pattern seen on the charts. It is not a strong H&S but nonetheless it has the appearance of one. Potential targets are up to 1250-1300. This area represents the zone of the 4 year MA and the breakdown zone from February 2008. It is not unusual for markets to test these breakdown zones before fully resuming the bear market . Key to this scenario is that we hold preferably above 950 but absolutely above 900. This would test

the 13 week MA in the first case and the 40 week MA in the latter case.

Right now we are in the camp for this bullish case and would expect that any pullback now underway will hold the levels noted above. The bottom should be seen sometime in October but possibly out into November. A swift drop now would ensure an October low. Initial sell signals would be seen under 1030. Only regaining above 1070 would tell us that we will make a possible run to 1100 first before our correction kicks in. But right now odds favour a correction of some substance but that it should hold key levels noted above.

The wildcard in this scenario is the current situation regarding Iran. A military hit on Iran at any point in time would change the scenario to one considerably more bearish because of the impact on oil prices.

### **Bonds – Intermediate Trend – Down, Short Term Trend – Neutral**

US Treasury Bonds fell again this week although we managed to close above the gap down opening level. The trigger for the end of the week rebound was the weak US housing data as existing home sales fell 2.7% in August and new home sales were below expectations but still managed a .7% gain. US durable goods also fell 2.4%. The weak numbers were a quick demonstration that while there have been somewhat upbeat numbers of late this recession is far from over. Even the numbers that showed some growth were coming from a depressed level. US leading indicators gained .6% in August and there is some expectation that the quarterly GDP numbers to be released in October will show economic growth of 4%. But remember there has been huge fiscal stimulus thrown at the market and some of it is bound to stick if only temporarily.

Canadian bonds gained on the week but it was meagre. Canadian retail sales fell .6% in July following a 1% jump in June. Canadian retail sales have generally been positive so it is a reminder that weak job growth will and can have a negative impact. Canada is, however, so upbeat over its overall better than expected numbers that BofC governor Mark Carney announced that the temporary lending facilities put in place at the height of the crisis last year will expire in October. Still don't expect interest rates in Canada to be hiked any time soon. Like the US we will undoubtedly see very low rates for some time to come.

The Fed left interest rates unchanged last week as fully expected (0-0.25%). The Fed also pretty well confirmed what everyone already knew that they will be keeping interest rates exceptionally low for some time to come. They are doing everything they can to stimulate economic growth it seems no matter what the cost. Recall it was a long period of low interest rates coupled with unprecedented liquidity that fuelled the housing boom, the leveraged buyout (LBO) mania and also fuelled the massive growth of the collateralized debt market (CDO's). When you can borrow almost at will at low rates and put it in higher yielding securities or into the liquidity fuelled stock market you will do it. Of course with banks not lending cutting off the housing market and consumers unable to use their house as an ATM machine any more, the CDO market in tatters, LBO's almost a thing of the past the low interest rates and oodles of liquidity will have to go somewhere else.

Remember the Yen carry trade? Will how about a new US\$ carry trade. The carry trade was simple in its execution as you borrow short term in the cheap currency (Yen and now US\$) and lend anywhere you can earn a higher yield. First you know that interest rates are not about to rise anytime soon and second you know that the low interest rates will not be attracting much foreign capital and therefore any rise in the currency will be moot. Worked brilliantly for years for the Yen carry trade and it only began to become unravelled when the Japanese began to hike interest rates. So the Fed won't be raising interest rates and the US\$ will continued to be depressed no matter what they do. You convert to any stronger currency unhedged of course you continue

to borrow the US\$ on rollovers in the short term market. Goldman Sachs knows this and you can bet that patriotism will have no part in preventing their ability to maintain their billion dollar bonuses.

The longer end of the bond market is irrelevant for the carry trade. But with a weakening US\$, the growing US\$ debt because of the massive stimulus packages and huge deficits along with any modicum of economic growth anaemic as it might be will ensure that pressure is maintained on the longer end of the market. The Fed doesn't control the long end of the interest rate curve as they do the short end of the curve.

US bonds failed at resistance while Canadian bonds also failed at resistance and have broken support. We continue to look for lower bond prices going forward but it will not be straight down and the coming decline may be more gentle than the previous part of the decline but rates will rise.

This week the big numbers to watch are the non-farm payrolls due out on Friday. In August the US economy lost 216 thousand jobs and an unemployment rate of 9.7%. Generally the expectations are for a loss of at least 185 thousand jobs and the unemployment rate to rise to 9.8%. Other releases are the personal income and spending and the ISM numbers. In Canada we will see the July GDP numbers expecting a .3% gain. Canada's employment numbers will not be out until the following week.

The pressure remains to the downside for bond prices but it should be an uneven decline with short term pops. In Canada only above 122 on the 10 year bond future will turn the market up. Another break below 120 will target 119 then 118 and down to 116-117.

**Gold and Gold Stocks – Gold Intermediate Trend – Up, Short Term Trend – Up: Silver Intermediate Trend – Up, Short Term Trend – Up: HUI Intermediate Trend – Up, Short Term Trend – Up: TSX Gold Index Intermediate Trend – Up, Short Term Trend – Up: US Dollar Index Intermediate Trend – Down, Short Term Trend – Down: Cdn Dollar Intermediate Trend – Up, Short Term Trend – Neutral**

It seems that gold cannot stand lousy economic numbers. The weak housing numbers seen in the latter part of the week not only triggered the stock market to decline gold (and gold stocks) fell in sympathy. Of course the US\$ popped upwards as it seems to do when we get weak economic numbers. For whatever reason the perception is that weak economic numbers brings lower inflation (deflation?) triggering a stock market drop, a selloff in the commodities, buying of bonds and the jump in the US\$ as the US still has some safe haven status even if interest rates are numbingly low.

We also note that there has been ongoing weak commercial commitment of trader reports (COT). The most recent commercial COT was 18% but there was no change in the makeup this past week with no addition to the short position (or longs for that matter). The big jump in the short position was seen almost 4 weeks ago and it has been during this period that gold has consistently fought at the \$1000 level. We finally closed under that level for the first time in 3 weeks. We knew there was going to be a battle here at the \$1000 level due to its physiological importance. The monetary authorities quite simply do not want to see it bust through the level. But the consistent fight for \$1000 ensures that the level will eventually give away.

Much has been made of the strong seasonals for gold where the last three months of the year traditionally are the strongest of the year. The rebound often goes right into the next year for tops as early as February to even May. Note last year we rose 37% from late October to mid February. 2007 saw a rise from mid August to mid

March of 52%. 2006 rose 19% from early October to mid March. The lows are usually seen anywhere from August to October.

So a pullback would not phase us. This could set up an October low. Thus far lows this year were seen in April and in July. July seems a little early for our low but October would almost be perfect. The key of course is that any pullback holds key levels that we have noted in previous write ups. For Gold we note support down to \$960 and we could fall to that level and it would not phase us. But below \$960 then first \$930 then \$910 come into play. We don't believe we will get down that low but of course cannot rule it out. While below \$910 is of some concern we still have major support down to \$865/\$875. Again we doubt we will even remotely approach those levels but we have to cite them in the event that we do. Clearly we would not want to see Gold below that level as that would absolutely suggest a more serious correction along the lines of the 2008 collapse. To the upside a firm breakout above \$1030/\$1035 and holding above that level should ensure we are on our way to \$1100 and potential targets up to \$1200.

Silver has support down to \$14.80 but below there our support is at \$12.50 and finally at \$11.80. A breakout over \$18 would tell us we should be on our way to \$20-\$21 and potential targets up to \$27. The HUI has support at 375, and down to 300. Below 300 the correction will be steeper. The TSX Gold Index has pulled back sharply over the past few days but has looming support at 310-320. Below 300 the TSX Gold Index could be vulnerable to further losses as we could then fall to 250-275.

Key of course is the US\$ which did rebound this past week. Resistance is clearly seen at 78 but above 78 we could make a run for 80 and ultimate resistance at 82. Again we doubt it but we need to note it. A breakdown under 76 will ensure that the downtrend is once again underway and further targets of 72-74.

We noted the potential for a US\$ carry trade in bonds above. One obvious recipient of a US\$ carry trade is the gold market. Remember globally the gold market is pretty small in the overall scheme of things. Large inflows would have a profound impact on the market and could set in place a sharp run that would fulfill the potential targets noted above.

A correction here is not the end of the world. 30 years ago gold made a high in early October following a good run the upside. Many thought it was the end of the good run and the commercial COT was bearish then as well. A shallow 17% took place that bottomed in early November. What followed was the spectacular run up to \$850 Gold and a doubling. A 17% pullback now would take us down to \$845 far deeper it would seem than even our expectations noted above. But a run to \$1600 or higher afterwards would be spectacular of course. We are not saying that is going to happen but the strong seasonals, the bearishness of the commercial COT and a general moodiness in the gold market is telling us that we could be poised for an upside surprise especially once we burst through \$1030/\$1035. It should happen. The question is when. The next month will tell.

**Oil & Gas – Oil Intermediate Trend – Up, Short Term Trend – Down: Natural Gas Intermediate Trend – Neutral, Short Term Trend – Up  
XOI Intermediate Trend – Up, Short Term Trend – Up: TSX Energy Index – Up, Short Term Trend – Up**

After struggling for several weeks trying to break through the \$72 to \$75 zone (and coincidentally the 4 year MA) oil prices succumbed to the inevitable and fell a sharp \$6.15 this past week back down to the \$66 level support. A number of sell signals were seen. Natural Gas on the other hand followed through on the previous week's

jump (and a buy signal) and ran to \$4 resistance (actual high \$3.96 and we closed very near that point).

Of course the EIA reported a stronger than expected jump in the weekly stocks numbers with oil supplies up 2.8 million barrels (and up 45.4 million barrels on the year), gasoline stocks also jumped 5.4 million barrels (and up 34.4 million barrels on the year) and distillates were up 3 million barrels (and up 45.4 million barrels on the year). The NG jump in prices was surprising considering supply remains high at 3,525 Bcf and 16% above the 4 year average.

With oil prices breaking to the downside we also broke an uptrend line. With a confirmed lower high in place we now have to look at the potential for lower prices. We broke below the key 100 day MA and the 200 day MA is well below near \$56. With a strengthening US\$ we will have to think that \$56 has some potential. Only regaining \$70 can change this potential scenario.

NG on the other hand is breaking above resistance but another failure here (we are at the 200 day MA once again) will ensure we will once again test lower for a potential higher low. Key is \$3.50 and below that level we could once again test down to \$3. But a firm break above \$4 will confirm our upward move and a multi month major breakout. NG seasonals suggest we could see the latter.

With NG in ascendancy and the potential for a decline in oil prices it will have mixed impact on the stocks. Own gassy stocks but be cautious on oil stocks. Lower oil prices will continue to have very negative impact on the Canadian oil sands and stocks in that sector. Both the AMEX Oil Index (XOI) and the TSX Energy Index turned down this past week once again failing to gain any traction on what appeared as a breakout. The TSX Energy Index has support down to 270 but below that level a fall to 24 is probable. Only above 290 do we have a chance of moving higher.

The breakdown in oil prices driven by good supplies and some strengthening in the US\$ means that a test to the downside seems to be ensured. While the wildcard is of course Iran and the potential for a military hit on the regime we doubt that would occur until at least 2010 (insane as it might be to do such a foolhardy thing). Naturally lower oil prices would be positive for the economy and ensure inflation stays low.

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