



Commodity Futures - Increases March 2003 – March 2008

Cocoa	34%
Coffee	167%
Corn	134%
Cotton	40%
Soybean Oil	199%
Soybeans	143%
Sugar	69%
Wheat	314%
Wheat KC	275%
Feed Cattle	34%
Lean Hogs	10%
Live Cattle	23%
Brent Crude	213%
WTI Crude	191%
Gas oil	192%
Heating Oil	192%
Gasoline	145%
Natural Gas	71%
Aluminum	120%
Lead	564%
Nickel	262%
Zinc	225%
Copper	413%
Gold	183%
Silver	331%

Source: Testimony of Michael Masters (hedge fund manager) before U.S. Senate Committee on Homeland Security and Governmental Affairs.

We think that there are many attractively priced companies, so we are maintaining our **positive outlook for the stock market**, but there are still too many uncertainties to adopt an aggressive stance now. Although we recognize that the repair of the financial system is an ongoing process, one that does not preclude another corporate collapse, we think the worst of the damage is behind us. Our emphasis remains on high-quality companies. At the same time, we think the bond market is overvalued. We are maintaining a **below average duration** in our clients' portfolios and have not sought to add investment grade or lower rated corporate debt. There are occasional buys in the municipal market and there may be a developing opportunity in short-term, floating rate notes.

In our equity portfolios we have had exposure to commodity producers: coal, copper, gold, and oil. These have been our best performing stocks and, in retrospect, we wish we had over-weighted this sector more. Of course, that begs the question: Is it too late to buy?

There has been a lot of hype about commodities: metals, energy and now food. From our top-down perspective, we see various economic forces at work. First, there has been unparalleled growth in Asia that has ratcheted up demand for many commodities. Second, there has been a multi-decade confrontation between environmentalists and raw material extractors/refiners that has limited both the supply of new materials coming on the market and the capacity to process them. Third, there have been constant geopolitical problems affecting both the finding and delivery of oil. Fourth, a cycle of bad weather had devastated crops in some important food exporting areas just when a noticeable amount of corn is being diverted to ethanol production.

Some of these forces (environmental concerns and weather) have reduced supply below what it would otherwise have been, causing prices

to rise. Other forces have lifted demand also causing prices to increase.

We all know that shifting economic curves (be it rising demand curves or falling supply curves) are often self-correcting. On the demand side, higher prices depress optimism and profit potential, leading to a decline in demand. On the supply side the opposite effect generates an increase in supply. Along the way, buyers find acceptable substitutes (corn for oil being an example) and those selling find new, innovative ways to satisfy the market (cleaner burning coal, for example).

Because commodity curves take time to adjust, there have always been market speculators trying to profit by estimating how high or how low prices will go. Whether or not these short-term traders improve the liquidity of the commodity markets or dampen volatility is an academic argument and does not interest us. What does interest us are new participants in the commodity markets, *institutional investors*. Endowments, foundations, pension funds and the like are now viewing commodities as "an asset class" that deserves a long-term asset allocation in their portfolio. Buoyed by strong returns, *institutional investors* have been joined by individual investors, using "easy to buy" commodity funds. These buyers are clearly driving up commodity prices.

Will these new classes of long-term investors prevent the commodity bubble from bursting? No, but they have already exaggerated how far it will stretch before bursting. And when it does burst, there will not be enough liquidity in these securities, so commodity prices may plummet to unreasonable lows when the herd tries to exit.

While there may be enough time for speculators to capture one more, super-spike in the market during the next twelve months, **for serious investors, it's time to start selling not buying.**