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Charting a Course for the Future

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Market Outlook

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The stock market rose for a second month in a row with the Nasdaq Composite (+4.6%) leading the advance, while the Standard & Poor's 500 (+1.3%) inched higher , and the Dow Jones Industrials (-1.4%) fell modestly. Technology led sector performance with a gain of 5.5%, while financials were the worst performing sector, posting a loss of 6.4%. The recent rise in stock prices would seem to contradict the consensus view that a recession is either pending or upon us, yet most investors forget that the stock market is a forward-looking economic indicator that discounts future events.

Those embracing an overly pessimistic view of the stock market and economy point to the decline in consumer spending and confidence, falling home values and mounting unemployment claims as reasons to avoid stocks and forecast recession. Many will also point to the continued fall-out from the credit crunch that crippled our financial system over the past year and led to billions in losses from sub-prime loans and credit derivatives (credit default swaps). Today, the rise in gas prices to $4/gallon, oil eclipsing $132/barrel and a global food crisis are dominating the headlines. We believe inflation continues to be the greatest concern for investors as it has stifled the potential for any sustained advance in stocks over the past 18 months. While all these factors are relevant, they are predominantly lagging indicators, telling us little about what to expect moving forward.

> We continue to believe the stock market bottomed in March and that the rally that followed will continue through the remainder of 2008, leading to new highs for the S&P 500.

The last time we saw such a resounding consensus was in 2003, but the forecast then wasn't for inflation, it was for deflation! Oil was a mere $20/barrel. Yet this marked the beginning of the greatest five-year bull run in commodities we have ever seen. Today's debate is centered on how high food and energy prices will soar, based on limited supplies and the uninterrupted growth of developing countries like China and India. As difficult as it was to buy an energy stock, a commodity fund or a barrel of oil for $20 in 2003, it feels equally as misguided to sell them today, but reducing exposure to this sector is the prudent move.

We continue to believe the rate of inflation (CPI) in the U.S. peaked at 4.4% earlier this year after doubling from just 2% in 2007. While the food and energy components of the consumer price index (inflation) have soared, wages remain stagnant and falling home prices have limited rental inflation. Wages and rents combined represent a larger percentage of the CPI than do food and energy. Rising food and energy prices can be deflationary forces in an environment when wage growth is stagnant, because these price increases act like a tax increase, reducing the demand for other goods and services. We now believe we are nearing a pause, if not a significant correction, in the broad commodity complex, as two forces supporting the recent parabolic move in commodities change direction.

It was the explosive growth in developing countries, led by China, which accounted for the incremental demand in raw materials, food and energy, and resulted in the rise in commodity prices over that past five years. Yet it is the speculative investment flow into financial instruments that track these commodities on futures exchanges, seeking to capitalize on this incremental demand for financial gain, that has led to the parabolic rise in prices over the past year. Fortunately, we see a decline in the rate of growth in developing

countries combined with increased regulation of commodity trading markets putting downward pressure on food and energy prices in the second half of this year.

China is the growth engine of the developing world, but most investors do not realize that the majority of its economic growth (60%) is derived from exports to the U.S. and Europe. Many other developing countries derive their economic growth from exports to China. With the U.S. economy at stall speed and European growth slowing rapidly, it is unlikely that China and the rest of the developing world will be able to maintain their rapid growth. Domestic consumption in the most populous countries of China and India combined is less than that of the United Kingdom and not significant enough to offset declining exports. The dramatic declines in the stock markets (leading indicator) of these developing countries over the past six months are also indicative of slower economic growth ahead.

With respect to oil, many developing countries have artificially inflated their demand for fuel by limiting price increases for consumers through subsidies to oil refiners. As a result, despite soaring oil prices, consumer demand has not declined as it has in the U.S., and the governments of these countries have absorbed the escalating costs. This tide has now turned. Indonesia recently raised fuel prices 30 percent, and Taiwan and Malaysia have announced plans to cut subsidies. We believe China will wait until after the summer Olympics to raise fuel prices. Subsidizing rising fuel costs is not likely to continue, as exports and trade surpluses decline.

We believe demand has been further artificially inflated by institutional investors whose only motivation is financial gain. While the debate about the role speculation has played in rising commodity prices continues, an independent mind need only look at the increase in dollar volume of crude oil futures contracts traded each day to find the answer. Over the past five years the dollar value has risen from under $10 billion per day to nearly $140 billion today. The dynamics of the futures markets have changed completely.

A futures contract represents the market price of a physical commodity at some point in the future. Traditionally, futures market participants were either the producers or users of the physical commodity, or speculators on futures exchanges that provided the market with liquidity by selling when prices were too high and buying when prices were too low. Traditional speculators are limited in the size of the positions they can hold to limit their influence over spot prices. Over the past five years, as stocks and real estate lost their luster, institutions have diverted billions into commodities through the futures market in an effort to capitalize on growth in the developing world. The continual and escalating flow of funds into a buy-and-hold strategy of a basket of commodities with no sensitivity to price has led to the parabolic move in prices over the past year. The regulatory body for the futures exchanges (CFTC) has compounded the problem by exempting Wall Street banks from the limits under which traditional speculators operate. As a result, anyone can use a Wall Street bank as a counter-party to speculate on commodity prices with no limitations. We believe futures contract prices are now dictating spot prices to the benefit of no one other than those seeking financial gain.

Commodity prices have clearly divorced from fundamentals in our opinion, particularly in the oil market. We believe new regulations will limit the flow of funds into commodity exchanges just as demand from developing countries deteriorates, resulting in a significant correction in commodity prices. Oil prices are likely to fall back below $100/barrel. A decline in food and energy prices would lead to a lower rate of inflation in the U.S. and eliminate what we see as the major impediment to higher stock prices. We continue to believe the stock market bottomed in March and that the rally that followed will continue through the remainder of 2008, leading to new highs for the S&P 500. ■

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