Newgate
Capital Management LLC

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FLASH REPORT

Speculative Bubble?

As the markets enter their fourth year of rising commodity prices, it is natural to wonder where we are in the cycle. Recently, there has been a great deal of public consideration, and even a Congressional investigation, regarding whether today's high prices are the result of excess speculation driven by commodity index investors, or a real demand-based phenomenon.

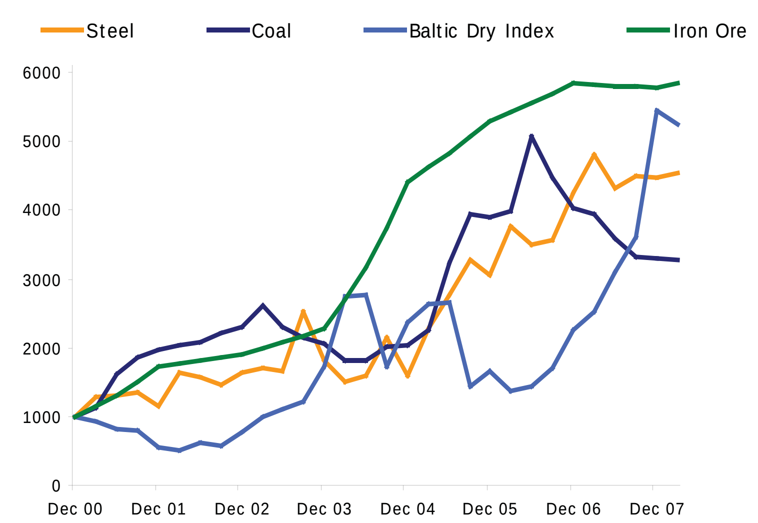
We do not believe the two are mutually exclusive. It may seem a cliché to say that we are in an unprecedented historical period. Over the past few years, approximately 2.5 billion people, roughly 45% of the world's population, have begun to come "on line" – initiating the process of integration into the global economy. Never in history have so many people joined the global community so rapidly. This economic integration is having an enormous impact on global resource markets, creating a "demand shock," sparking price increases across a wide spectrum of commodity and related assets.

Neither the increase in demand nor the initial commodity price spikes went unnoticed by investors. There has been renewed investment in commodities through a variety of vehicles. Typically, hedge funds are blamed for all things unexplained or unexplainable in the financial markets. Ironically, in the current environment, passive index funds linked to the Dow Jones-AIG or the Goldman Sachs Commodity indices are being blamed for the rise in many commodity prices. Are we in a speculative commodity bubble?

Prices for many traded commodities have shot up in the past four years, in some cases tripling or even more. This rapid rise is evidence, but not proof, of excess speculation. But there are also indicators that suggest speculation is not the primary cause for higher prices. For example, there are a variety of non-traded commodities natural resources where there are no direct or futures markets and therefore no way for speculators to "play" the price increases. Chart 1 illustrates that the prices of these commodities (iron ore, coal, uranium) show essentially the same level of increase that traded commodities have. Given that there can be no speculative bubble in these commodities, demand may be the primary (though maybe not sole) reason for price increases in other commodities. There are other indicators, such as daily rental rates for drill rigs and shipping rates for bulk commodities with similar price increases (Chart 1 also shows the Baltic Dry Bulk Index). Again, the absence of speculators suggests that rising prices are following real increases in demand.

Newgate's Global Resources Portfolio invests in the equities of commodity linked companies. While sensitive to underlying commodity prices,

CHART 1: WHERE'S THE VALUE



Based on a $1000 investment
Source: Bloomberg

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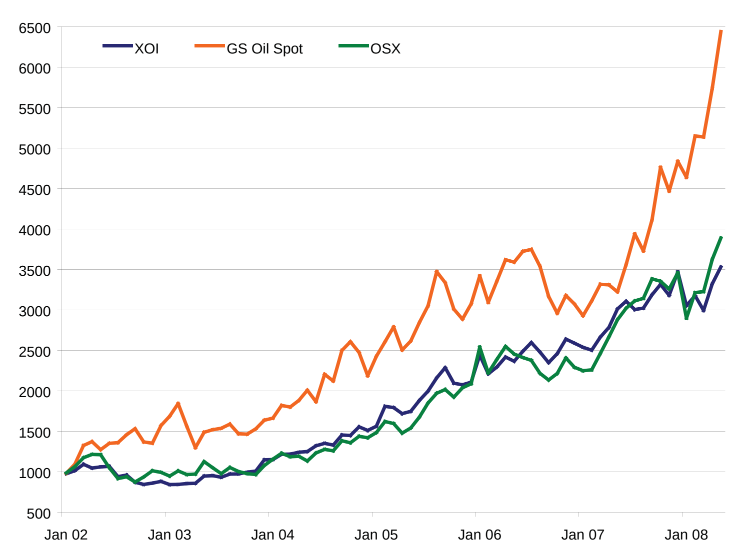
the Portfolio does not move in lock step with them. Commodity equities as a group have not kept up with underlying commodity prices. Chart 2 shows that while energy related equities have generally performed very well, they have lagged the significant price moves of crude oil itself.

Given the rapid increase in global consumption, we believe that the markets are seeking new equilibrium prices for commodities. In economic terms, we are experiencing a shift in the demand curve for all natural resources, a shift caused by the sheer number of consumers entering the market at the same time. When demand shifts outward suddenly, supply increases, but prices also rise. The issue has not been whether commodity prices will go up, but how much will they rise. This is because no one really knows what the new demand functions are. Chart 3 illustrates this shift.

This illustration does not consider the differences among commodities. Commodities with greater potential supply will see smaller price increases, more capacity-constrained markets (such as crude oil) have seen more severe, and likely more permanent, price increases.

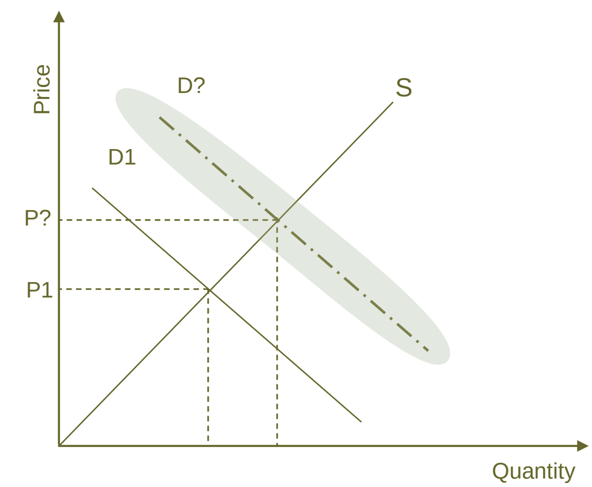
CHART 2: SPECULATION OR DEMAND?



Based on a $1000 investment

Source: Bloomberg, XOI - AMEX Oil Index, OSX - Philadelphia Stock Exchange Oil Service Sector Index

CHART 3: UNCERTAIN DEMAND



We believe that viewing the rise in commodity prices as a shift in the demand curve also properly considers the role of speculators. While speculators are no doubt influencing prices, they will be doing so as part of this process of equilibrium setting, betting on where these new equilibrium prices are. Will prices overshoot before settling down to a more sustainable range? Of course, but that is always the case in financial markets.

The Newgate Global Resources Portfolio is not predicated on indefinite commodity price increases, which is essentially the thesis of a commodity index investment. Rather, the Portfolio takes advantage of valuation discrepancies in resource companies created by rapid demand increases. No one knows where long term, sustainable prices for commodities will settle at the end of this process. However, we do not believe that, as a whole, the equities of commodity based companies fully reflect this shift in demand. Newgate's analysis suggests there is value in many of these companies despite the uncertainty in long term commodity prices.