



FLASH REPORT

Global Resources - Update

Natural resource markets have gone through a difficult period since the end of the second quarter, when many commodity prices hit all time highs. Consequently, the Newgate Global Resources Portfolio has also seen a significant retreat since the end of June.

It is important to note that the Global Resources Portfolio is predicated on increasing demand for natural resources, which is not the same as increasing prices for those natural resources. Prices do not go up indefinitely. Rather, they reach periods of relative stability, followed by periods of relative instability as new factors are digested by the market. Changes in demand are an important factor in price changes, but it is not the only factor.

As we discussed in the last Flash Report (Speculative Bubble, 6/16/08), we believe that the market is trying to recalibrate equilibrium prices, given new supply and demand issues. Historically, market participants had very good models for predicting demand and could reasonably forecast prices. Supply was the unknown, due to political unrest, strikes, weather and a number of other factors. Many of these models no longer function well for a number of reasons, including:

- a. Unknown demand functions from emerging markets, most notably China and India.
- b. Uncertain “demand destruction” in the US. While there has been lower demand in the US recently, it is

unclear how much of this is permanent vs. temporary.

- c. Uncertain capital flows into and out of the commodity futures market.

Prices for many commodities, most notably oil, went up very far, very fast and have since come down. The high level of volatility in oil prices has spilled over into the other natural resource markets and now down to the prices of related equities. Over the past three months, the related-equity sectors have been highly correlated to the price of their underlying commodities, especially oil.

The Portfolio invests in companies whose earnings have varying sensitivity to their underlying commodity prices. Many stocks in the Portfolio are in the servicing, drilling, construction and other aspects of the natural resource production cycle for energy, metals and agricultural commodities. Short term, the securities of these companies can be highly sensitive to their underlying commodities. However, the revenues and earnings for these companies are not nearly as dependent on commodity prices. Valuations for these companies have been greatly reduced in the current selloff, but future earnings appear minimally impacted, leading to value creation in many of these sectors.

For production companies, where earnings are more directly tied to commodity prices, the long term commodity price assumptions used in the valuations of the companies are still well below current prices, even after the most recent decline. As a re-

sult, we believe that there are opportunities for performance, even if commodity prices do not increase from here. Price stability, not increases, is what will benefit the Portfolio in the near term. We are also seeing evidence of increased merger activity, which buoys the stocks of many of the small- to mid-sized companies across these sectors.

The Portfolio acts as a hedge, or an insurance policy against a number of negative event risks that remain very real, including hurricanes, war (especially in the Middle East) and political unrest in countries such as Nigeria, Venezuela, or Russia. We believe that it is unlikely that commodity prices will completely collapse. However, should commodity prices retreat another 25% from current levels and oil settles (not merely touches) at \$80/bbl, we would expect that emerging Asian markets, and other commodity CONSUMERS, would benefit tremendously and share prices would rally.

The current swings in both the commodities markets in general and the Newgate Global Resources Portfolio in particular do not appear to be negating the overall thesis of the Portfolio. We hold a diversified portfolio of companies that we believe are poised to benefit from what we still see as an increase in global demand for resources. The current global economic slowdown is, at this point, merely reducing the long term increase in demand, not suggesting an actual reduction in demand for most natural resources. ♦

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