



FLASH REPORT: GLOBAL RESOURCES

*Portfolio Update*

Commodity investments were generally positive in February. Macroeconomic issues such as the Greek debt crisis and the sustainability of Chinese economic growth continue to influence global markets. The US economy and stock market have shown signs of recovery recently. The US dollar rose against most currencies, reflecting the relative strength of the US economy. While China has had rapid expansion, the US remains the predominant source of demand for many commodities, especially those related to energy. Most natural resource related companies are listed in the US, even as their sources of supply and demand are sited elsewhere. Merger and acquisition activity has increased, a trend we believe is likely to continue as the economy recovers and credit markets loosen. The Dow Jones-UBS Commodity Index gained 3.7% during the month.

Despite the higher dollar, oil boomed in February, up 9.3%. The US consumes roughly 25% of the world's oil, most used as a transportation fuel. So an increase in US economic activity tends to translate into higher oil demand quickly, as finished and intermediate goods get trucked. Much of the Eastern US experienced severe cold, which often has traders buy oil even though the impact on demand is not as great as widely believed. Natural gas, which had rallied sharply at the end of 2009, fell more than 10% in February. Industrial demand for gas has not increased meaningfully, and the market remains vastly oversupplied. Historically, traders looked at the relationship between oil and gas prices to allocate between those markets. However, the differences between the sources of supply and the end uses of these two commodities suggest that the relationship may not be as stable as once believed. Refiners and integrated oil companies with refineries have been unable to pass along the full increase of crude oil. Already small margins are being compressed further. Some refiners have shut down capacity at less efficient plants.

Energy equities were up during the month. Many of the companies in the sector reported earnings in February. Most companies met or exceeded expectations, though those that did not (including some major servicing and drilling companies) were down sharply. Oil focused exploration companies typically outperformed gas companies. We used recent weakness in some of the energy service companies to add to those with strong business backlogs and technological advantages. We still have avoided direct exposure to the refining sector.

Industrial metals and steel prices rose during the month. Copper gained 6.6%, one of the better performing metals. Copper was no doubt impacted by the earthquake in Chile. Though Chile is a major copper supplier, the earthquake was not in the mining region and appears to have had little if any impact on production. Zinc, aluminum and tin rose between 2.5% and 5%. Mining companies were up much more. The HSBC Global Mining Index gained 12.1% and the S&P 500 Steel Index rose 13%, though both are still slightly negative for the year.

As we look to a global economic recovery and infrastructure spending in the US to accelerate, steel and its inputs, including iron ore, metallurgical coal and zinc (used for rust proofing) appear highly attractive. In particular, we favor steel companies that are vertically integrated, those with their own raw materials. Some of these companies are located in emerging markets and are trading at discounts to their developed market competitors. We increased allocations to shipping companies, as steel related materials are a major source of their business.

Agriculture has increased to 20% of the Portfolio. The consolidation in the fertilizer group continues, with Yara International making an offer for Terra Industries and CF Industries making a competing hostile offer. There have been numerous bids, offers, rejections and other entreaties better suited to a novel rather than the financial news.

There have also been reports that some of the diversified mining companies might bid for specialty fertilizer companies. The big picture is much simpler. Increased agriculture yield is the only way to meet growing demand, and a relatively small number of

companies in the fertilizer and agriculture technology industries will be able to meet this demand. We believe that the agriculture sector has secular growth potential, far beyond the current business cycle. ♦

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