



FLASH REPORT: GLOBAL RESOURCES

Portfolio Update

Commodity based investments declined in May. Of the major commodities, only gold and natural gas had positive returns. Commodity based equities declined as well, generally in line with underlying commodity prices. The notable exceptions have been in energy servicing, contract drilling and engineering firms. Earnings visibility for these companies has been greatly impacted by the oil spill in the Gulf of Mexico, and shares have fallen more sharply. The Dow Jones-UBS Commodity Index lost 6.9% for the month.

Commodity investments were buffeted by two storms. First is the continuing debt crisis in Europe. Governments are reacting to the issue by cutting spending and possibly by raising taxes. While deficit reduction is necessary and a positive long run outcome, these measures curtail growth short term, which is negative for commodity prices. Taken collectively, Europe still represents a major source of demand, although not one with high growth forecasts.

In contrast, the second concern is China's importance to commodity markets. Chinese demand, and its economy in general, are growing at a rapid pace. When demand from China appears to be above consensus, commodity related investments soar, and when the Chinese economy appears to be slowing, they decline. China has made a number of fairly modest changes to its monetary policy to slow down growth, especially in the property market.

Independently, these two issues would impede commodity price increases, but would not be likely to cause sharply lower prices. The European debt issue has been at the forefront for several months now with relatively little impact on commodities. The Chinese slowdown led to copper and other base metals declines in April. Together, these two factors have resulted in broad based declines not

only in commodities but in all asset classes tied to global growth.

Base metals continued their decline in May, with copper down 7%, zinc down 15.8% and nickel down 18.9%. The HSBC Global Mining Index fell 12.2%.

The third factor impacting the energy industry is the Gulf of Mexico oil spill. As a result of the spill, the Obama administration has announced a six month moratorium on new deepwater drilling. New regulations will be forthcoming, covering not only those wells farther offshore, but also shallow water wells. This uncertainty caused the OSX (the index of oil servicing companies) to fall 18.9% during the month.

If everything else were equal, the oil spill would result in higher oil prices. New supply coming from America is likely to be smaller as drilling is reduced, and almost certain to be more expensive. This should be boosting oil prices. However, fears of a significant economic slowdown caused oil prices to decline over 14% in May. Natural gas was up 10.7%, rebounding after months of lower prices. While Newgate continues to like the long term future for natural gas, there is a great deal of oversupply in the market.

Gold rose 2.7%, while the XAU index of gold companies declined 2.8%. The investment community typically associates gold with rising inflation and a falling US dollar. We have a more deflationary environment now, with a relatively strong dollar, especially against the Euro. So why has the dollar appreciated? What drives the financial markets toward gold is uncertainty and instability. Given that inflationary periods are more common than deflationary periods, especially on a global scale, investors associate rising gold prices with higher inflation. We added slightly to gold during the month. However, we have not made a full allocation. Our view is that

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currency instability is not only temporary, but by definition nearly impossible to predict.

The recent volatility of the Portfolio can be unsettling. It is one thing to look at the returns commodity related strategies have had since November 2008 and admit that there will be a market correction at some point. But when that correction occurs, especially given the negative news flows, concern can become fear. We never try to time the markets

short term, especially in periods of high volatility. Rather we rely on the fundamentals of companies that provide basic necessities of energy, metals and agricultural products in order to make investment decisions. These fundamentals remain sound. The global economy is growing, even if at a modest pace. Our Portfolio is tied to the underlying economic recovery and the consumption of predominantly non-renewable resources. ♦

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