

The Case for Hard Assets: An Update

Background and Summary

While secular bull trends characterized equity and debt markets in the 1980s and '90s, most commodity prices were in secular bear markets, following the infamous 1980 high-price spikes in gold and silver. After 20 years of declining prices, around the turn of the millennium most commodities began to see price lows that have held. Indeed, since the stock market's high-price spike in March of 2000 and during its ensuing secular bear market, commodity prices have been rising. We regard this upward trend as a secular bull market in commodities, one that we expect to continue for many years. Our interest is particularly focused on "hard asset" commodities, that is, those tangible commodities that are both durable and storable over many years (as opposed to agricultural commodities, whose supply-demand structure is primarily seasonal).

Given that the last secular bull market in commodities (roughly 1968 to 1980) occurred during a period of steadily rising inflation, many have been puzzled that this current bull market has occurred during a period of declining rates of inflation. Many also assume that this rise in commodity prices portends an inevitable mammoth rise in inflation. We disagree. We believe the commodity bull market is due to factors that have little to do with inflation and more to do with long-term international economic and geopolitical trends that are likely to continue in place for many years. These trends are likely to sustain upward travel in commodity prices through the next several economic cycles, even if inflation fails to rise.

There are three key reasons why we believe hard assets, both the actual commodities and related equities, should perform well in the long term.

- The lack of confidence in fiat currencies will undermine their store of value function, which will encourage global savers to use hard assets as an alternative.
- The growth of large emerging economies, which tend to be more resource intensive, will boost demand.
- The decline of U.S. economic and military dominance will lead to a more unstable multi-polar world and encourage inventory accumulation

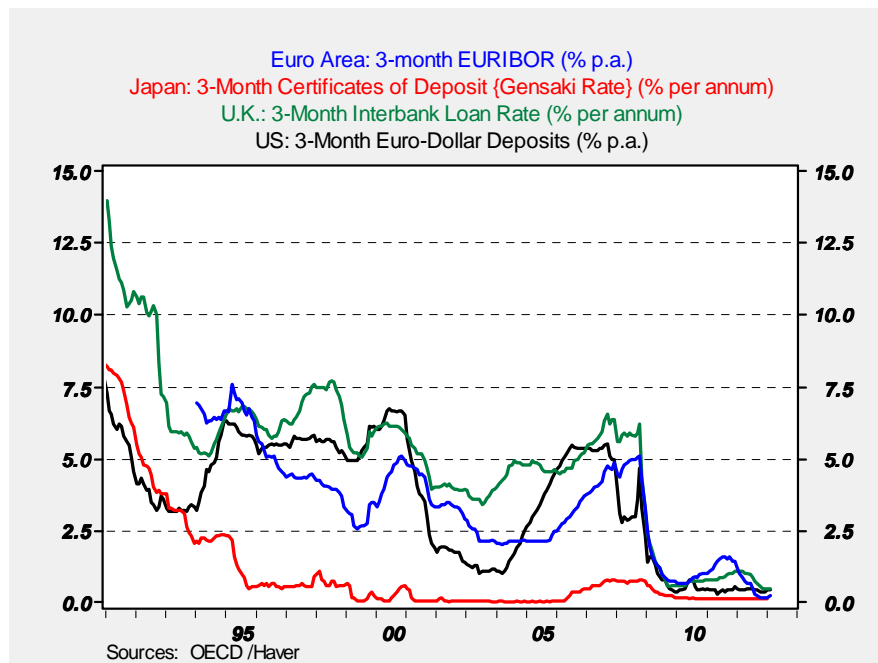
The Problem of Fiat Currencies

Until 1971, most of the developed world's currencies were at least remotely backed by precious metals, primarily gold. The link to metals, whose supply was not controlled by any

government authority, acted as a limit on a central bank's ability to expand its nation's money supply. In 1971, due to trade and currency imbalances with Europe which caused a drain on U.S. gold reserves, President Nixon suspended the dollar's link to gold. Since the rest of the world's currencies were tied to gold via the dollar, Nixon's actions effectively ended the gold standard. Since then, the world has been functioning with (mostly) floating fiat currencies (fiat being defined as its value being determined by the issuing central bank).

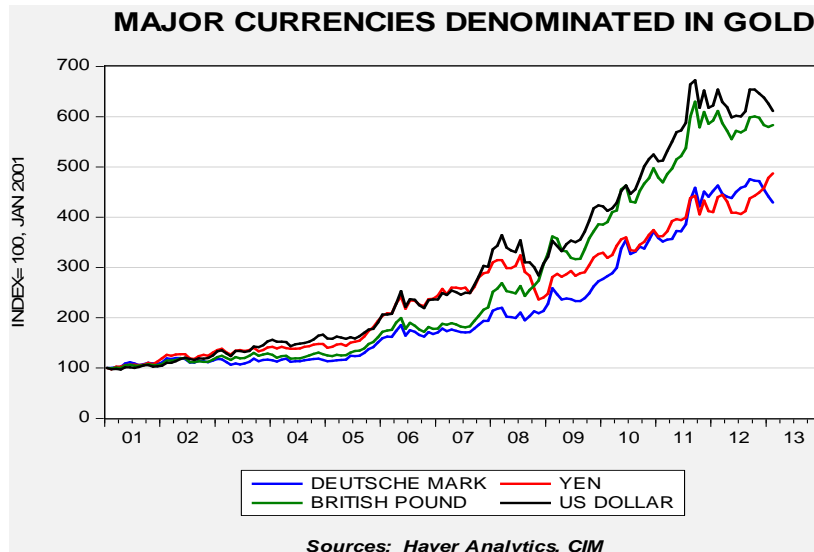
Money provides three functions to an economy. First, it acts as a medium of exchange. In theory, we could see markets work without money. Economic actors could simply barter to make exchanges. The problem, of course, is that the costs of searching for someone to trade with can be high. For example, if I want to trade my accounting services for bread, I have to search for a baker who needs accounting help. Instead, I charge money for my services and can use that cash as a universal means of exchange. Second, money acts as a unit of account; it's how we count the relative value of things. Third, it acts as a store of value. If my current consumption doesn't exceed my income, I have savings that can be used for future purchases. Holding my savings as money or near-money financial assets encourages saving and investment.

The financial crisis of 2008 appears to be undermining the third function of money. The massive expansion of central bank balance sheets, low short-term interest rates and rapidly rising government debt means that there has been a significant injection of liquidity into the developed world economies.



The above chart shows selected short-term interest rates in the world's four major currencies' countries. These nations comprise 94.1% of all global currency reserves. Note that since 2008, when the global financial crisis developed, interest rates have declined significantly.

All these rates are market rates; policy rates, set by central banks, are even lower. In the case of the U.S., Japan and the U.K., the rates are virtually at zero.



This chart shows the four major reserve currencies denominated in gold, which acts as a universal currency. Since the turn of the century into 2011, gold steadily rose against all the major reserve currencies. Over the past two years, gold prices in various currencies have been mostly range-bound, although gold priced in yen has been rising steadily since mid-2012. It appears that gold prices have established equilibrium after rising 400% to 600% (depending on the currency) from 2001 to 2011. We believe this recent range-bound market is mostly a function of crisis fatigue. A whole series of developed world crises, ranging from the debt ceiling issue and downgrade in the U.S. to chronic threats about the Eurozone breakup, have not ended in catastrophe. The longer the world skirts a major breakdown, the more emboldened investors become, which encourages them to move away from gold and bonds and into equities. However, this shift to risk assets does assume that future crises will also be avoided.

Recently, the U.S. dollar has become more attractive, sort of the “prettiest dog in an ugly dog contest.” The Eurozone economy is in recession, and it appears that the U.K. is sliding into a “triple-dip” downturn. Japan, under Shinzo Abe, is taking aggressive steps to end its two-decade deflation. Meanwhile, the U.S. economy appears to be gathering momentum which should be dollar bullish. A stronger dollar will be a short-term negative factor for hard assets; however, if the Federal Reserve continues its accommodative policy after economic growth accelerates, hard assets should benefit.

It is important to remember that the world’s four leading currencies are all engaging in policies that in isolation would be considered weak currency policies. The major central banks are showing little concern about protecting the purchasing power of their currencies. Although we still expect these major currencies to function as a medium of exchange and a unit of account, we do expect global savers will be less willing to hold them for savings

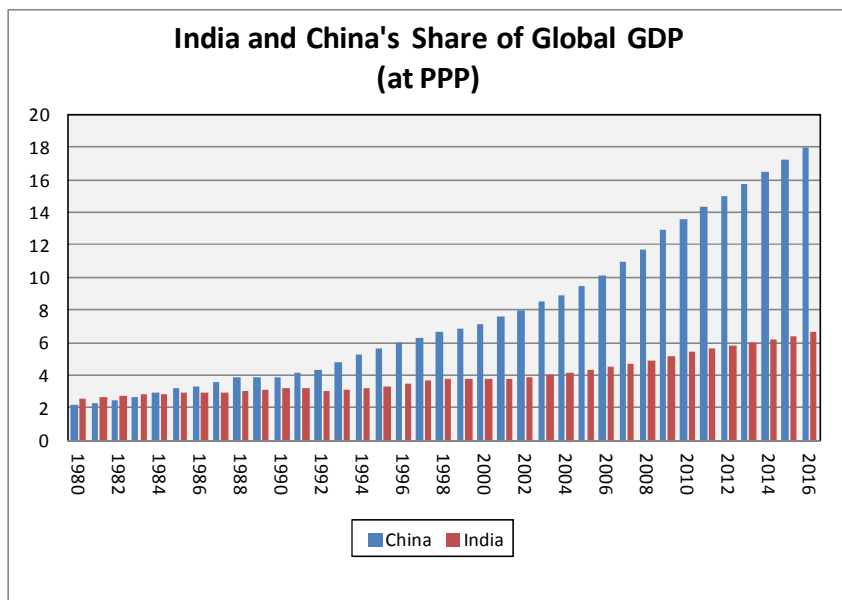
purposes. Unfortunately, there are few other currencies that can fill the reserve role for global savers. Other Western nations, such as Australia or Switzerland, have solid currencies and sound monetary policies. Unfortunately, their economies are too small to allow global savers to use their currencies as reserves in significant size. Most emerging market countries employ capital controls to prevent rapid flows of money from entering or leaving their banking system. This factor tends to undermine their use by foreign savers. And, due to their desires to control exchange rates, we doubt these capital controls will be lifted in the foreseeable future.

Thus, we expect that foreign savers will turn to hard assets as a store of value. Hard assets are usually less efficient as saving vehicles—they need to be stored, they are difficult to transfer and they pay no interest. However, given the fact that the central banks of the major nations are engaging in low interest rate policies, the opportunity cost of holding real assets has declined. In addition, due to the “magic” of modern financial products, hard assets can be packaged into instruments that reduce the costs of storage and increase their transferability.

Global savers will be searching for alternatives to holding the debt of the major developed nations, which may be vulnerable to inflation or default. Hard assets are a partial solution to this problem.

Emerging Economy Growth

One of the most remarkable developments of the past 30 years has been the emergence of China and India to the global economy.

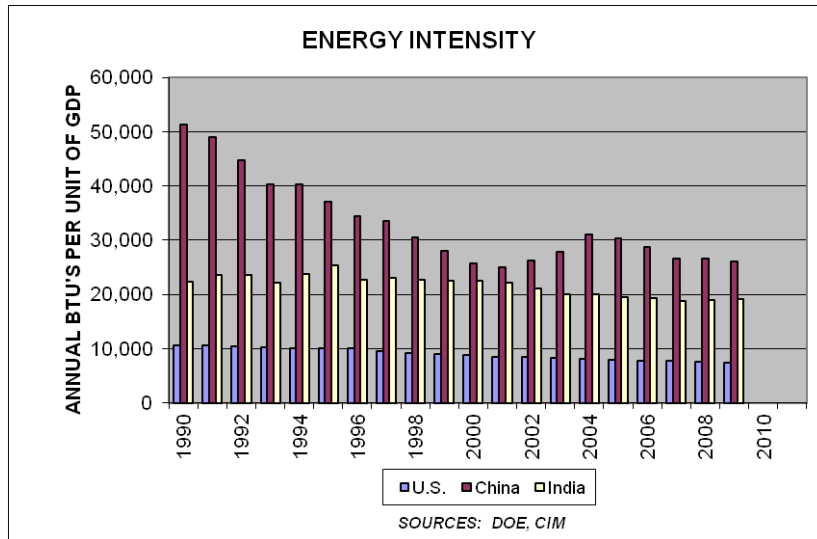


(Sources: IMF, CIM)

The above chart shows China and India’s relative share of global GDP. Since China began to adopt market reforms in 1979, its share of global production has increased. India’s share

has been steadily increasing as well. The forecast, from the IMF, suggests that by 2016, these two nations will account for nearly 25% of global GDP.

As a general rule, emerging economies tend to be more intensive in their use of hard assets in development. This is because these nations are usually building their industrial and transportation infrastructure, which requires large amounts of energy and raw materials. In addition, the lack of infrastructure tends to force these economies to consume more raw materials to generate growth—more resources are needed due to the overall inefficiency that comes from the lack of fully amortized investment that a developed country enjoys.



As an example, this chart shows the annual expenditure of British Thermal Units, a measure of energy use, for each national unit of GDP and market exchange rates. India’s energy requirement for each unit of GDP is usually at least double that of the U.S. China’s is three to five times more. Over the long run, we would expect India and China’s energy intensity to fall toward U.S. levels. However, given that both nations are seeing strong GDP growth, even declining intensity probably won’t offset growth levels to lead to declining energy consumption. **We would expect emerging economy growth to bring higher consumption of hard assets.**

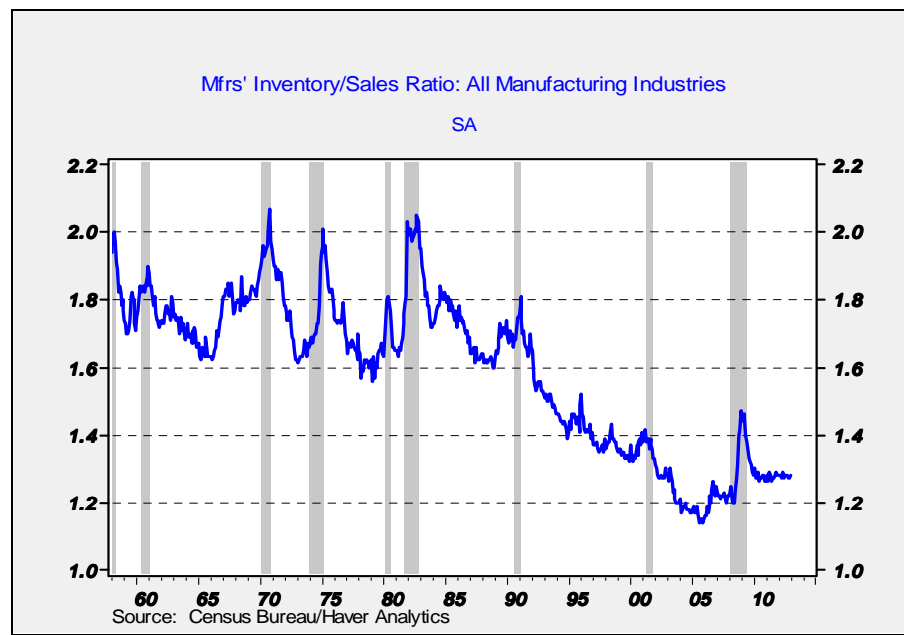
We have noticed over the past two years that China has become increasingly important to the value of hard assets. This focus makes sense, given that China is a major consumer of industrial metals and energy. China is nearing the point in its development where it will need to liberalize its financial markets and shift its economy from investment to consumption. Once this process begins, the pace of commodity demand will likely slow. And so, any news suggesting economic weakness in China adversely affects commodity prices. However, we note that other emerging markets, including India and Indonesia, will be moving into the industrializing phase of their growth and will pick up some of the slack caused by China’s restructuring. **Over the long run, emerging market demand is more than just China.**

Moving From a Uni-polar to a Multi-polar World

From the end of the Second World War to 1990, the world was dominated by two powers. After the fall of the Berlin Wall, the U.S. stood as the globe's only superpower. For most of the 1990s, U.S. pre-eminence was mostly unchallenged. However, the last decade has brought a combination of terrorist attacks, two wars, and a massive financial crisis that has called into question continued American hegemony.

From a global economic perspective, the U.S. has facilitated the development of the free world. The U.S. dollar is the reserve currency and, in that role, the American consumer acted as the purchaser of last resort. This meant the economies could safely develop by promoting exports, using the stable U.S. market to sell their goods and services. The U.S. was willing to see industry after industry decimated in the face of import pressure in order to ensure world peace. At the same time, the U.S. military ensured that global sea lanes remained safe and that "hot spots" would be contained by American military might. The U.S. has fought a number of limited wars since World War II in an effort to prevent a World War III. To America's credit, these efforts have been successful.

However, after 65 years of playing this role on the global stage, there are increasing signs that the U.S. won't be able to do so much longer. Massive fiscal deficits call into question the expenditures required to maintain a global military. High unemployment undermines the support for free trade. The temptation to reduce America's military commitments and its openness to trade is rising. If the U.S. does forgo this role, there is no other power on the horizon that appears willing to act as a replacement. This means that the sea lanes become less safe and open. It means that small wars in more places become increasingly frequent. And it means that the inventory methods that have become generally accepted will be called into question. With widespread globalization, fostered by the U.S., there has been less incentive to hold inventories.



The chart on the prior page shows U.S. manufacturers' inventory to sales ratio. From 1959 to 1990, this ratio tended to range from 1.6 times to 2.0 times. From 1990 forward, there has been a steady decline in inventories. Firms discovered "just in time" inventory methods that allowed them to avoid stockpiling raw materials. **Anyone using "just in time" inventory policies has little fear of supply disruptions.**

We believe the world is moving into a multi-polar period in which there will be multiple centers of power. These regional centers will be less stable and goods will flow much less freely than they did during the *Pax Americana*. Thus, instead of using "just in time" inventory management, we expect a move to "just in case" systems, which will mean firms and countries will stockpile raw materials, including hard assets. This additional demand will act to boost the prices of hard assets.

What about inflation?

So far, we haven't said much about inflation; there is a reason for the lack of comment. We don't believe that inflation is necessary for this portfolio to be successful. Inflation may occur at some point but, so far, the massive fiscal and monetary stimulus hasn't caused an inflation problem because of global excess capacity in both capital and labor. If we do see the development of a multi-polar political environment, inflation will most likely follow. However, continued growth in emerging markets and the undermining of fiat currencies, along with growing global instability, should boost hard asset prices even in the absence of inflation. **Thus, the Global Hard Assets Portfolio will act as an inflation hedge but is not solely an inflation hedge. It is designed to participate in what we view as historical shifts in power and behavior that will change the face of the world.**

Bill O'Grady and Mark Keller
March 2013