



Thought for the Week: Monday, May 9th, 2011

The Dollar and Commodities

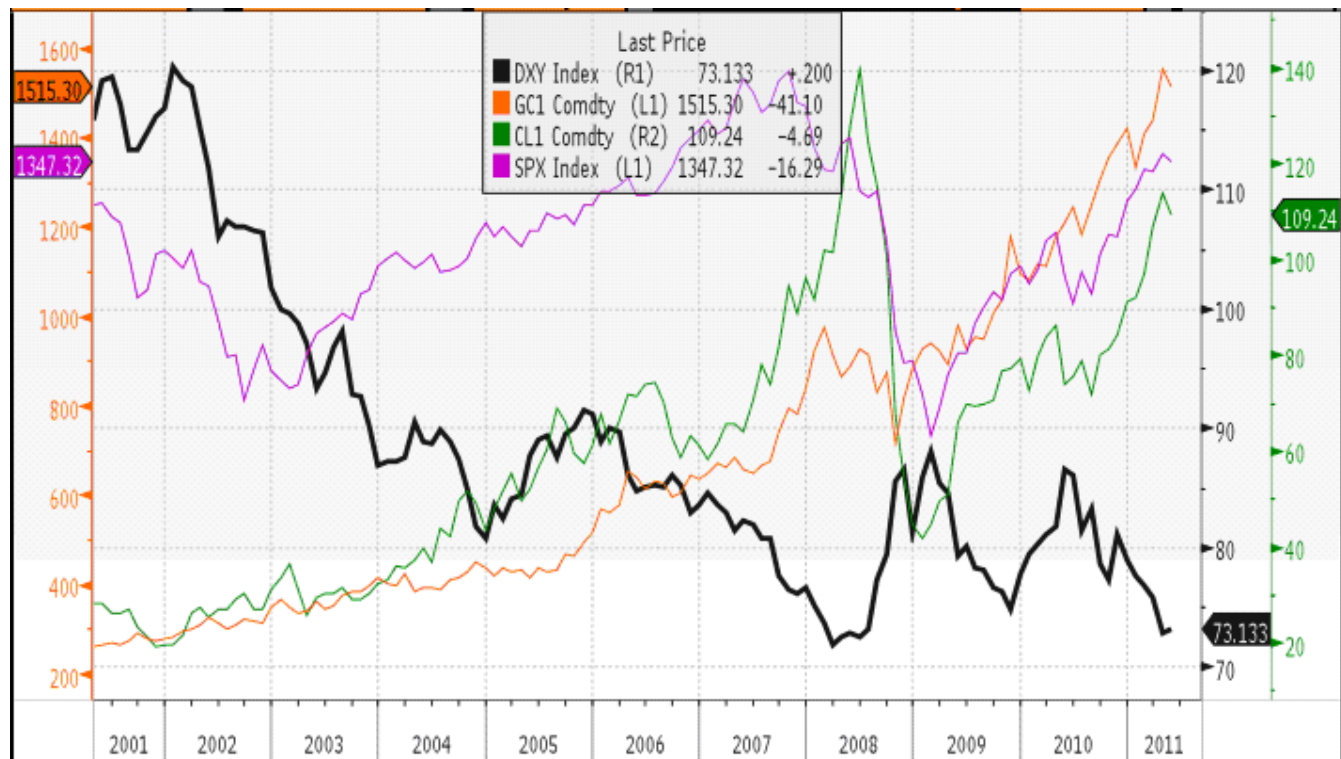
Commodity prices have been moving higher and higher for some time now. This is **fueling price inflation** across the globe. Gold has risen to such a high that even Mr. T of the 'A' Team is considering selling all his gold necklaces.

You will hear **many reasons quoted for this rise** including:

- **Supply** – as the world exits from recession, commodities will appreciate in price.
- **Demand** – if China keeps expanding they will consume the entire world's supply of commodities by a date that's not too far away.
- **Risk** – the world is in such a bad state your money is only safe in Gold at \$1,500 an ounce.
- **Speculation** – commodities can only go up.

The chart below shows one of the **biggest reasons for commodity price fluctuation: the Dollar's value**.

The black line is the value of the U.S. Dollar compared to a basket of currencies. The green line shows the value of Oil. The two move inversely; **when the dollar rises, oil drops and vice versa**.



Looking at this chart, are you still convinced commodities move according to pure supply and demand economics?



The orange line above shows the **value of Gold**, once again an element of inverse movement compared to the Dollar is obvious. **As investors lose faith in the U.S. currency, Gold starts to glitter.**

The purple line shows the S&P 500 - isn't it interesting to see how this has moved with the fortunes of our fair currency?

We believe the **U.S. Dollar is a major fundamental factor in the price of those commodities** traded in Dollars. The further the Dollar falls, the higher commodities could rise, and vice versa.

The **peaks and troughs of these movements may be intensified by Speculation** as investors follow the herd into an appreciating asset class or stampede out of the door. It's the direction of commodities that is influenced by the U.S. Dollar.

The View from Europe

Imagine living in Euro land last summer when one Euro bought you \$1.20 when oil cost \$80 a barrel. You would therefore pay 66.67 Euros (80/1.20). Fast forward to last week when oil averaged around \$110 a barrel and one Euro bought you \$1.47. That meant that oil now costs 74.83 Euros (110/1.47).

For American residents, oil has jumped 37.5% from last summer, a rise which dramatically changes many business models and figures on everyone's "Inflation radar".

For those earning and spending Euros (including many of our own multinationals), oil went from 66.67 Euros to 74.83 Euros, **a rise of 12%**. Not an insignificant jump, but approximately one-third of the increase experienced in the U.S. If you are spending Australian Dollars, you may have seen oil go down in price!

On a Euro weighted scale, Oil has risen 12%. This is certainly not a speculative bubble; it is a more **realistic reflection of the prevailing Global Demand economics** associated with the continued growth of Global GDP.

Sure, Oil is not cheap as it once was in America, but remember, **this is a "weak currency" issue** which isn't a big factor for those with a strong currency. Anyone who travels overseas will probably tell you how expensive everything is – "these days".

Our Investment View

Commodities and currencies are volatile; there's money to be made and money to be lost. However, **we generally resist direct investment** in these asset classes partly because of the volatility but mainly because it is difficult to research and analyze their true, intrinsic value. Debt and equity securities have hard financial facts which can be collected and assessed to form a valuation. Commodities tend to trade on emotion and speculation.

We invest in commodities via **stable and profitable companies who hold cash balances and, in many cases, pay dividends.**

As institutional investment professionals, we try not to get too emotional or speculative.

For a number of years, we have been asked our thoughts on investing in Gold. Although we have dabbled with the **Gold index (GLD) as a hedge to protect capital**, the trade is too speculative for us to consider for a full portfolio holding. **We did have a short Silver position** before its recent dive; the trade was too good to resist in the land of investment "singles and doubles". How could you be long Silver at nearly \$40?

Past performance is not indicative of future results. This commentary is not intended as investment advice or an investment recommendation it is solely the opinion of our investment managers at the time of writing.
Nothing in this commentary should be construed as a solicitation to buy or sell securities.