

INVESTMENT STRATEGIES

This issue of Investment Strategies has been a long time coming. Since I last wrote, an entirely new investment theme has emerged, upon which we have been acting and which I wanted to share with you. This theme has far reaching impacts for the stock and bond markets that I believe are being ignored by most of the investment community. This is good news for our clients and the money that they have entrusted to us.

In past issues of this writing, those of you who follow it have read about our faith in the energy and metals stocks to be the big winners in this first decade – and maybe the second and third decades – of the new century. You know that our thesis has been based upon demographic factors in Asia that have nearly one billion people moving from subsistence living into the middle class. This demographic change is happening to the largest extent in China and India, but Vietnam, the Philippines, and Malaysia – as well as other non-Asian economies, like Brazil, Russia, and Eastern Europe - are adding to the trend.

The initial impact of this trend, which we spotted a few years ago and which caused us to shift our investment emphasis to energy and metals, has provided our clients with huge investment returns compared to our competitors, 2006 notwithstanding (all themes take a break once in awhile, and after the huge stock price increases over the preceding four years, it was time). This year, we've seen a return to the earnings-based investment fundamentals that have driven up the stock prices of energy and metals companies.

As the middle class grows in these third world countries, their demand for housing, consumer durables, and autos increases. These demands have caused China to be the world's biggest importer of petroleum and metals, and the biggest consumer of them after the United States. This demand, in spite of the Chinese

government's desire to reduce their economic growth rate to the 8% level from the near 11% level, shows no sign of slowing – particularly given all of the infrastructure building that is happening in anticipation of the Beijing Olympics.

The next phase of the Asian demographic move to the middle class is a change in diet. A primarily rice-based diet is steadily being supplanted by a desire for meat and processed food. This shift is the basis for the newest investment theme we have been acting upon in recent months: *Food Price Inflation*.

Food Price Inflation

As the demand increases for meat and processed food in the third world, the prices for food world-wide will increase. As it currently stands in the U. S., consumers have just started to see the beginning of price increases at the grocery store. For the first four months of 2007, U. S. food and fuel prices within the Consumer Price Index have increased 25% (led primarily by increased fuel prices, but food prices have begun to increase as well).

Most of the food price inflation has thus far been absorbed by the producers and not passed along to the consumers. This is evidenced by the Producer Price Index for unprocessed foods increasing 25% over the last 12-months while prices for processed foods have only increased in the mid-single digits. Soaring feed grain prices have just begun to force producers of meat, eggs, dairy products and processed foods to raise their prices. The CEO of Smithfield Foods recently was quoted as saying that the leap in corn prices will no longer be absorbed by his company, stating that “the meat industry hasn't got a price increase in 30 years.” Expect to pay higher prices for food in coming months – and years.

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We have been in a sustained period of disinflation since 1982. This has been a very profitable time to own long-dated treasury bonds and common stocks, subject to some typical (albeit violent at times) market corrections. Prior to August 12, 1982 (the date of the end of the equity bear market that started a decade earlier), inflation was rampant and it was devaluing both stock and bond markets. There were a number of factors that contributed to the inflationary cycle – the 1973 Arab Oil Embargo; the baby-boomers' demand for housing, consumer durables, and autos (hmmm...that sounds vaguely familiar); and the failure of the 1973 Peru Anchovy harvest. Along with Russian grain purchases (that increased demand for grain), the lack of anchovies triggered runaway grain prices and food price inflation for grain products, meat, eggs, dairy products, and processed foods. Anchovies were used two-fold in 1973: as additional protein enhancers in feed grains for cattle and in fertilizer (the lack of anchovies caused a reduction in grain supply at a time of increased demand, pushing up prices).

There is a saying that history never repeats itself. But from an investment standpoint, the rising energy and food prices in the 70's seem eerily familiar today. The demographic demand-based influences of the 70's are being repeated today, with the Third World's development of a strong middle class replacing the baby boomers own development of a middle class in the U. S. and Western Europe, and a reduction in the number of honey bees replacing the lack of anchovies in potentially limiting supply of some agricultural products.

Colony Collapse Disorder, as further described in U. S. House of Representative Bill HR 1709 (you can read about it at <http://www.govtrack.us/congress/bill.xpd?bill=h110-1709>), is the current name for the fall in the number of honey bees available to pollinate crops. In today's Chicago Tribune, they note that nationwide, the bee population has dropped by a third. World-wide, the bee population is collapsing and no known cause exists. Nine countries in Europe as well as Brazil are impacted, all – along with the United States – provide much of the agricultural products that feed the world.

Bees are a critical component to the production of 1/3 of the American diet, equating to \$15 billion of the U. S. economy; nationwide, 35% of the bees have disappeared, and in some critical agricultural areas its up to 90%. All of the world's food baskets are being hit at the same time. "If the bee disappears off the surface of the globe, then man would have four years left to live," said Albert Einstein. "No more bees, no more pollination, no more plants, no more animals, no more man."

I'm not saying that we are going to lose all the bees. Rather, I think we just need to extrapolate what happened with the 1973 anchovy harvest to today: we can expect some supply shortages in the agricultural products that rely heavily on bees to pollinate crops. Of particular concern will be the fruit crops and alfalfa, which is 100% bee pollinated. If the alfalfa harvest is less than normal and alfalfa prices go up, watch for increased dairy prices at the store.

Economic Considerations

If our thesis is correct, this has far-ranging impacts on the economy. No longer will the Fed have the ability to stimulate the US economy by lowering interest rates – an Alan Greenspan staple – while knowing that inflation is in a secular disinflationary cycle. The Fed under Greenspan could juice the economy with low interest rates without fear that inflation would increase in any significant manner.

Alan Greenspan is now retired, and his timing could not have been more perfect for his legacy. Ben Bernanke, upon assuming the role of Fed Chair concurrently with the start of this new secular inflationary cycle, has been spelling out his job description for us in his speeches and writings: he sees his job as primarily inflation fighting, not stimulating the economy. The analysts on CNBC that continue to call for a Fed rate cut based upon a slowing of the economy will surely be disappointed by this new Fed perspective.

With a US Current Account deficit of 7% of GDP, and the dollar in a sustained bear market, Mr. Bernanke has to assure the foreign holders of our Treasury Bonds that he is not

planning to significantly nor quickly devalue our currency. His job is being made more difficult by others in our government who have a different agenda – getting re-elected.

It is popular in Congress to deride China and call for their currency to move significantly higher against the dollar – both political parties do it. There is logic to this in that a lower dollar makes U. S. exports to China cheaper for Chinese consumers, a fast-growing market. This logic says that more exports to China means more jobs in the U. S. China, though, happens to be the largest foreign holder of our Treasury Bonds. To accomplish the significantly higher move in their currency called for by Congress, China would need to dump their holdings of Treasury Bonds on the world markets, which would drive bond interest rates significantly higher. This would be disastrous for Treasury Bond investors world-wide, and for the U. S. economy since we rely so heavily on foreign buyers of Treasury Bonds to fund our current account deficit.

Our Treasury Department appears to understand this and is working to cause a gradual devaluation of the Dollar against the Yuan, which has fallen from 8.3 to 7.6 Yuan to the Dollar over the last two years. As long as this policy of gradual devaluation continues, there should be no run on the Dollar and Mr. Bernanke can fight inflation by maintaining current interest rate levels. Unfortunately, as food price inflation begins to become more noticeable to consumers, he will likely have to raise rates. If Congress is successful in causing China to significantly increase the value of the Yuan in short order and investors sell Treasury Bonds, he will likely have to raise rates faster and higher than he might otherwise need to in order to defend the dollar.

In short, the secular bias for interest rates has shifted to higher rates, not lower rates. Any recession that might be on the horizon may temporarily reduce short-term rates on a cyclical basis, but the general direction of rates through the end of the decade will be up.

Investment Considerations

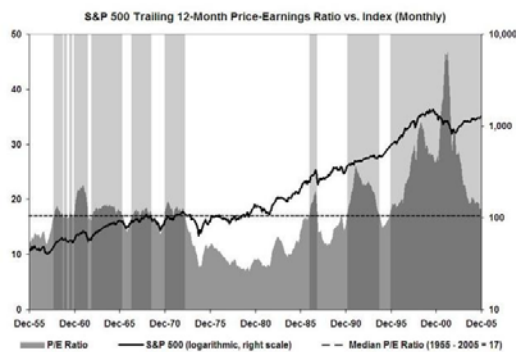
An investment environment of rising interest rates is not a friendly place to be. If you

look back at the decade of the 1970's to 1982, you will see that the Dow Jones Industrial Average returned a net 0% in all that time. That is not to say that people didn't make (and lose) money, but you had to be a very active trader, successful market timer or short-side investor to make money – things most people and most institutions are not – as the market fell to multi-year lows, ran up to the old high, and then fell back again.

During this time, the commodity stocks – energy, metals, ag, and gold – were in a major bull market phase. The stocks in industry groups that are inversely correlated with the commodity stocks – technology, financials, consumer stocks – were in a sustained bear market. The P/E ratio on the S&P 500 dropped to mid-single digits during this period as investors continued to devalue the non-commodity stocks. The energy stocks, as a percentage of the S&P 500, increased from low single digits to 25% of the entire capitalization of the S&P 500 as they were valued upward.

I started my career in this business in the early/mid-1980's. I didn't experience the pain of my mentors who lived through this, but I did learn from their retelling of their experiences. The Dow finally broke out of its bear market bottom on August 12, 1982. The U. S. and Great Britain had made an assault on inflation when the Reagan/Thatcher/Volker plan to crush it from the supply side began to make impacts. The high interest rates that dried up the supply available of credit and sent economies into deep recessions, actually was good for the stock market.

Stock markets, being leading forecasters of economic activity, projected that the Draconian measures enacted by the trio above would be successful and that corporate earnings would again begin to rise. This was the beginning of the end for the commodity stocks that soon went into a 20-year bear market just as the P/E on the S&P 500 began its move from 6 to 46 in 2000 (and coincidentally now back to 16 concurrent with the energy price inflation that began shortly after 2000). The chart below shows you the relationship of P/E's to the S&P 500.



courtesy of *Mike Panzner*, Rabo Securities

I believe it is unlikely that we will see the severe inflation that we had in the 70's, the double-digit interest rates required to combat it, nor the extreme devaluation of the U. S. stock market to single digit P/E multiples. I do believe it is instructive, though, to learn some of the lessons that worked and employ them in our portfolio management strategies today.

Investment Strategies

Since we have been properly positioned in energy and metals companies for the past few years and have benefited from the demographic changes described earlier, it is now time to examine how we are going to profit from the food price inflation theme while balancing the impacts of our other themes.

1. **Remain overweight the base metals stocks:** core investments that will continue to benefit from the world's demographic changes.
2. **Remain overweight the energy stocks, with an emphasis on the Canadian Oil Sands stocks:** oil in safe areas of the world will become even more valuable as oil in geopolitically troubled areas depletes or becomes too dangerous to extract.
3. **Maintain positions in gold and gold stocks:** when the concept of food price inflation becomes more widely accepted, gold will be viewed quite favorably as an asset and should make an assault on its historic highs.
4. **Reduce exposure to consumer and financial stocks:** history shows that they

will lose value as their P/E's are reduced in favor of commodity stocks.

5. **Increase exposure to agribusiness companies:** earnings will be strong through the end of the decade, if not longer – watch for P/E's to increase along with earnings.
6. **Reduce fixed income duration:** rising inflation is bad for bonds, no way around it.
7. **Maintain exposure to emerging markets:** growing financial influence, increased economic growth, and positive demographics make them less risky than previously thought, from a portfolio management perspective.

Summary

Since the last publication of this newsletter, BankChampaign, N. A., has reorganized itself. We have added a new Vice President of Wealth Management, John Clausen, to our staff. He has taken over much of the administrative work performed by Mark Ballard, allowing Mark to concentrate on the strategic issues of the bank and its investment management business. This newsletter, as well as our blog – which you can access from a link at www.bankchampaign.com – should be regular sources of information on our investment strategy for clients and friends from this point forward.

Our investment returns continue to be superior. Our since inception (May, 1991), the average annual return for blended portfolios of stocks and bonds has been 15.27%. If you have a need for our Investment Management Services, please contact Mark Ballard or Andy Thorman. If you have a need for our Trust and Fiduciary Services which incorporate the investment strategies discussed herein, please contact John Clausen. Our number is (217)351-2870.

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Thanks and sources for the research contained herein include: Don Cox of BMO Financial Group; Ken Duft, College of Agriculture, Washington State University; Barry Ritholtz, Ritholtz Research and Analytics; the Chicago Tribune; and Shannara Johnson at Investor Insight.

Please contact Mark Ballard or Troy Schaudt in the BankChampaign, NA Trust Department at 217-351-2870 to have your trust or investment portfolio professionally managed according to the strategy described in this article.