

INVESTMENT STRATEGIES

I have had a number of people ask me about the price of oil and what is causing it to go up so precipitously. The standard answer now is to blame either the multinational oil companies or speculators for the problem, depending upon the situation at the time. The data used to prove this position is that the price of a barrel of oil has doubled in the last year, but demand has not. Therefore, either the oil companies are gouging consumers or oil investors are manipulating the markets. The solution to address both of these situations is increased government regulation in the form of excise taxes or curbs to free trade. The problem that I see with this is that it ignores a lot of facts and history while trying to impose a simple solution on an extremely complex problem.

In this newsletter, I hope to show you that there are a number of disparate happenings that impact the price of oil, that there is no easy answer to the problem, to show that the supply/demand imbalances with oil are part of a larger problem that includes food and water, and to discuss the prudent investment strategy to employ in the current environment.

I have written for the last several years about the demographic changes in the developing world. The changes show that there are more people moving into the middle class in those economies than did in Europe, the United States and Australia after World War II. As they move into the middle class, they have a desire to increase their standard of living with better homes, cars, appliances, and electronics. I have discussed the merits of investing in basic metals and energy companies over these years, and our clients have benefited from our allocation of their portfolios to those industries.

In 2006, I wrote that the next stage in this progression is an improvement in diet to include increased consumption meats and dairy, both of which require significantly more grains to produce than eating the grains in a diet focused primarily on the grains themselves. This increased demand for grain production is happening at the same time that the U. S. and European governments have legislated the use of an increasing amount of those same grains in the production of ethanol and bio-diesel fuels. I

discussed the merits of investing in agriculture companies, and our clients have benefited from our allocation of their portfolios to this industry as well.

In my opinion, we are now at an inflection point. We are seeing a change in several behaviors all at once: a change in the type of oil that is coming into production; a change in various governments' responses to high prices; a change in consumers behavior in response to high gasoline and food prices; a change in the interaction between the markets for oil, food, and water; a change in Middle East geopolitics; and a change in an astronomical event that impacts the weather – and by implication changes in crop yields and energy usage.

All of these things are happening simultaneously to create the perfect storm that is giving us \$4 gasoline and \$7 corn. Don't let anyone convince you that there are easy solutions to our food and energy inflation problems – there aren't. The first step, however, is to understand what is happening and to take control of what you can impact, and in our case we can impact our clients' investment portfolios positively by providing and implementing this analysis.

Peak Oil Theory

In 1956, M. K. Hubbard astutely put forth the theory of Peak Oil. Peak Oil is the point in time when the maximum rate of global petroleum production is reached, after which the rate of production enters terminal decline. If global consumption is not mitigated before the peak, a world energy crisis may develop because the availability of conventional oil will drop and prices will rise, perhaps dramatically. If political and economic change only occur in reaction to high prices and shortages rather than in reaction to the threat of a peak, then the degree of economic damage to importing countries will largely depend on how rapidly oil imports decline post-peak.

Sound familiar?

It is pretty amazing that this theory

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was put forth over 50 years ago, yet there are great numbers of analysts and industry experts that do not buy into it. Their contention is that as the price of oil goes up, oil reserves that were previously too expensive to explore and develop become economically feasible. The higher price justifies the additional costs of retrieving and refining the oil, it ultimately pushes down the price of oil as more oil comes to market, plus it gives incentives to develop ever more innovative methods of extracting and processing the oil. This is a very reasonable argument, and one that I believe is evidenced by the development of the oil sand deposits in Canada. When oil was \$11 per barrel, the \$35 breakeven cost to extract the oil did not make economic sense – at \$140 per barrel, there is no question that these deposits are viable.

Having difficult to extract oil reserves is not limited to Canada. Mexico, Saudi Arabia, Brazil, Russia – all huge producers – have seen their production of light sweet crude decline. They have been forced to replace it (if at all) with lower grade crude by employing advanced technology in difficult environments. This means that light sweet crude, the kind that most refineries can process, is in severe decline and its price will continue to have an upward bias:

- The new oil available from Saudi Arabia is heavy crude, which can only be refined by a select number of refineries. Additionally, they must pump significant amounts of water and natural gas into the wells to help extract it – no, its not like Jed Clampett shootin’ at some food and up from the ground comes some bubblin’ crude – the additional technology and equipment required to extract this heavy crude is incredibly expensive;
- Mexico has a significant oil field that can be put into production, but at current prices, it is too expensive to invest in the technology and equipment necessary to make it productive;
- Brazil recently announced that it had discovered a significant new oil field – four miles below the surface of the Atlantic Ocean off its coast and must lease drilling platforms at hundreds of thousands of dollars per day;
- Russian oil production is down. Their government announced that to access and develop the oil fields in Siberia, it would cost \$4 trillion and they need a partner from the West (a multinational oil company) with the technology and capital to accomplish the job. Unfortunately for them – and us – the

Russians have a history of nationalizing oil projects with the multinational oil companies subsequently losing their investments. This will likely make it difficult for Russia to find a partner to develop the Siberian oil fields.

The costs to produce an incremental barrel of oil are increasing significantly. Those arguing against Peak Oil are correct in that additional oil is available as the price per barrel goes up, but they are missing the real point: the price of a barrel of oil has a floor under it based upon the costs to produce that incremental next barrel. It may only cost \$14 to produce a barrel in an established field, or \$35 in Canadian oil sands fields, but these new fields cost significantly more and will prevent the price of oil from returning to the halcyon days of 1998 when oil was \$11 per barrel.

- ✓ *Demographic changes in the developing world cause demand to increase. The high costs of the incremental new supply that will meet that demand ensure that the price of oil stays high.*

Export-Land Model

If Peak Oil Theory is valid, then we probably want to know what happens next. Dallas geologist Jeffrey Brown, in conjunction with others, has developed the Export-Land Model (a model that attempts to predict oil usage in oil exporting countries) which basically says that as oil fields pass their peak and begin to decline in output, the exporters stop exporting in order to retain the oil to meet their own domestic demand.

The theory goes on to say that there are nine years between a country experiencing its peak production and the end of its exports. In actuality, the United Kingdom stopped exporting oil just six years after reaching its peak production and Indonesian exports stopped seven years after it reached peak production – both are now importers of oil, leading to a net swing of 2 million barrels per day off the market. Within the next five years, it’s forecast that Mexico (the second leading source for oil imported by the United States – 14% of our total daily usage), followed closely by Iran, Algeria, Malaysia and Norway will shift to net importers of oil. In fact, Mexico recently announced that it would not be able to fulfill its 2008 export contract to the United States, falling short by 11%, or 184,000 barrels per day.

According to the Export-Land Model, prices for oil will increase geometrically once they start, with the intervening periods between doublings in price growing ever shorter.

Jeffrey Brown recently wrote that: "Global production peaked in 2005, and we're now into the third year of decline. And the critical point to keep in mind is, our model and case histories show that the decline rate accelerates, year by year. Using the Lower 48 in the United States as an example, you can see the annual declines going 2%, 3%, 5%, 7%, 10%, 15%, 20%, on and on. So it's an accelerating decline rate."

Underscoring Brown's concerns, John Maudlin writes:

- "On April 15, 2008 the Russians, the world's second largest oil exporter, announced that their oil production appeared to have peaked, with production in the first quarter of this year declining for the first time in a decade. If they have indeed peaked then, based on the Export Land Model, the world could lose Russia's current 7 million barrels a day in exports within 6 to 9 years.
- "Echoing the baseline premise of the Export Land Model, Herman Franssen, president of International Energy Associates, projects that Iran, the world's fifth largest exporter, may consume an amount equal to their exports by 2015. A prominent oil analyst, the late Dr. Ali Samsam Bakhtiari, estimated that Iran is either at or near peak.
- "Most concerning, this April Saudi Arabia's King Abdullah announced they were not going to raise oil production above 9.5 million barrels a day (by July, Saudi production will be at 9.7 million barrels per day, inclusive of a 200,000 barrel increase announced this weekend). Commenting on the news, Tom Petrie, vice president of Merrill Lynch, said: "King Abdullah's quote speaks to the fast-emerging reality of what I call 'practical peak oil.' The Saudis and other exporters are placing a new emphasis on elongating the petroleum exploitation and depletion cycle. This stems from a growing awareness of the challenges of conventional resource maturity, as well as rising resource nationalism. This is likely to result in an earlier occurrence of global peak oil output than many consumers yet recognize."

Brown continued: "The reality is that this thing is coming so much faster and so much harder than even most pessimists were expecting."

- ✓ *With the price increasing, additional oil fields can come online and provide supply to replace the exports – but logically under this theory there is no chance for oil prices to return to previously low levels. The swing of a country from oil exporter to oil importer means that if they were exporting light, sweet crude they will keep that for their own use and now be importing the heavy crude that is being produced at the margin. This demand at the margin means that the expensive supply will set the price for oil in the market.*

Speculators

So far, we have discussed a lot about supply, but let's discuss an element of demand that is currently getting a lot of press. The news now is full of stories about how speculators are driving up the price of oil and food, and that they need to be regulated so prices can go back down. The demand caused by these speculators has likely contributed to price increases in all commodities.

Jordan Kahn recently wrote that: "Institutional investors, battered by the bear market from 2000 to 2002, turned to a new asset class in the form of commodities. Investment demand came from all sorts of institutions -- from hedge funds, endowments, pension funds, sovereign wealth funds and exchange-traded funds. In the first quarter of 2008 alone, global investments in commodity indices rose \$40 billion (up 28% year over year), to \$185 billion, a larger gain than *all* of 2007, according to Citigroup.

"Hedge fund manager Michael Masters testified before Congress that, while China's demand for oil has increased by 920 million barrels in the past five years, demand for petroleum index futures has increased by 848 million barrels. This means that the effect of speculators is just about as large as all the growth from China.

"So it's clear that demand is rising, but it's not just from growth in emerging market economies. That part of the equation is relatively easy to quantify. The wildcard, and the one that I believe has more to do with the recent parabolic

spike we've seen in crude prices, is from the new "index speculators," as Mr. Masters has called them, or institutional investors."

The Commodity Futures Trading Corporation will allow speculators to buy only so much of any given market. These rules were implemented in response to the Hunt Brothers' attempt to corner the Silver market in 1980. But, there was a loophole in the rules that allowed investment banks to trade without limits. The institutional investors have been able to go to the investment banks and buy a swap on the price of oil and been able to avoid the rules limiting the amount of commodity holdings by speculators because of this loophole in the rules.

This means that as more and more money flows into commodity index mutual funds – an institutional investor in this circumstance – the demand for swaps creates a huge bid in the commodity market. This huge bid deters the short sellers (i.e., speculators on the falling price of oil) from entering the market and taking positions as they see that the risk-reward ratio of a short sale is not profitable. This situation pushes up the price of oil without the normal forces on the other side of the trade (i.e., the short sellers) pushing back down.

Speculators are a normal and essential part of a functioning market. They allow family farmers to sell their corn crop forward at a higher price than might possibly be available at a specified future date. This provides the farmer with a known level of income from that sale and allows him to successfully operate his farm and make plans for the future. Without a speculator on the other side of the transaction betting that the price will actually be higher allowing them to make a profit on the spread between the two prices, the family farmer is subject to the swings in market price once the crop is harvested.

Illinois Senator Dick Durbin stated on CNBC his intention to go after speculators by creating a worldwide monitoring system that closes the "London Loophole," tracking down and identifying speculators no matter on which world exchange they may trade.

The flipside to this is that speculators and investors aren't causing oil prices to soar, the head of Chicago's futures markets told a skeptical congressional hearing.

"Blaming speculators for high prices diverts attention from the real causes of rising prices and does not contribute to a solution," said

Terrence A. Duffy, executive chairman of CME Group Inc., at a special joint hearing of the Senate Agriculture Committee and the Senate appropriations subcommittee on financial Services. He blamed high prices on "normal supply and demand factors."

- ✓ *Speculation is not bad, but rather the loophole in the rules that discourages speculators from betting on the fall in the price of oil is adding to pricing pressures.*
- ✓ *Any increase in regulation to address this should be well thought out and not over reaching in scope. There is no consensus that this aspect of oil's price increase is the root cause.*

Government Intervention

Representative Maxine Waters of California suggested that unless oil executives promised to lower gas prices she would make it her duty to ensure that the government would take over the and run the oil companies. She called it socializing the oil companies but she really meant nationalizing. You can find the video on *You Tube* if you want to watch our Congress in action – you can watch her fellow Congressmen laughing at her misstatement in the background, probably not the best example of our government at work.

Government intervention of this type frightens me. Most of the countries with the largest oil reserves have nationalized their energy industries: Venezuela, Russia, Saudi Arabia, Iran, Indonesia, et. al. This has not kept the price of oil low, and in fact, it has reduced oil output in both Russia and Venezuela.

When Vladimir Putin nationalized the big BP oil fields, he virtually guaranteed that Russia would have trouble convincing the multinational oil giants to invest billions of dollars in their energy industry in the future. Now, Russia acknowledges that they need \$4 trillion plus the technology and expertise of BP and its competitors to further their oil industry, and until they get it, their production will be in decline.

A step away from free market principals and toward government ownership has had severely negative consequences in Russia. Doing something drastic like that in the U. S., would have equally unanticipated consequences. In taking steps back toward a collectivist society in Russia, a western reporter asked former

President Putin what it was like to have so many former KGB agents working in his government. His reply: "There are no former KGB agents."

- ✓ *The unfortunate part about bad government policy is that it can have unintended consequences that can outlast even the careers of KGB agents.*
- ✓ *Nationalizing the oil industry in Russia has led directly to a reduction in potential new oil supply, which will be a contributing factor to high oil prices for a long time to come.*

Hummer? Bummer...

There were all sorts of predictions that \$3 gas would cause Americans to change their energy usage behaviors. Not until \$4 came about did we start to see some changes. General Motors announced that sales of SUV's, particularly the massive Hummer, had plummeted and that small cars and hybrids were in huge demand. Mass transit ridership is at record levels, and consumer surveys show that people are planning to stay home for vacations instead heading out in the car on the traditional long drive across the country.

Energy demand in the U. S. has fallen a bit, but so far, demand in the emerging markets has increased to cover the U. S. slowing. That will probably change – many countries in the developing world provide subsidies to their citizens that have kept gas prices low, and several have ended those subsidies.

Vince Farrell writes: "The *Financial Times* took a stab at comparing (gasoline) prices in the U.S to those of subsidized countries. In (the June 7th) edition, they said that if gas were \$1 a liter in the U.S. (there are 3.8 liters to the gallon), the subsidized prices would be 64 Cents in China, 12 Cents in Saudi Arabia, and 5 Cents in Venezuela. China has a budget surplus and the Olympics, so it will not be (ending its subsidies) anytime soon. Saudi Arabia uses as much oil per person, or a little more, than the U.S., but produces less than one-sixth the GDP from all that usage. Talk about wasteful practices! But they won't (use any less oil) either."

Some countries – like India, Indonesia, Malaysia and Taiwan - are beginning to end the subsidies in order to curb demand. This will put upward pressure on inflation in those countries, but they have little choice since their state-run oil

companies are losing significant amounts of money, and the subsidies are getting to be a noticeable share of their GDP. The other thing you can see from this list is that these are countries that have already or soon will move from oil exporting nations to oil importing nations.

- ✓ *The impact of higher prices in these developing countries will likely be similar to our own. Demand will decrease as prices rise, having an overall slowing impact on oil's price increases.*
- ✓ *Unfortunately, behavioral changes are generally temporary as people get used to the high prices. Once they have adjusted to the new price, demand will increase again.*
- ✓ *Oil prices may pull back, but they will not permanently retreat. Human nature, demographics, and the Export-Land Model all support this assertion.*

The Three Amigos: Oil, Food & Water

The U. S. had legislated that we would produce 11.5 billion gallons of ethanol by 2017. Doing the math, this equates to 50% of the U. S. corn crop each year. That is a huge amount of food removed from the system, but in reality it will amount to only a 10% reduction in U. S. oil usage.

The economics of ethanol make it difficult to justify that large of a reduction in our corn crop. Strategist Gary Halbert recently wrote that ethanol receives a government subsidy of \$1.90 per gallon. The cost of a gallon of ethanol is over \$5 when you include the subsidy, making it even more expensive than the cost of a gallon of gas. Ethanol is also 20% to 30% less efficient than gasoline, meaning that you get that many fewer miles per gallon driven. To put it in perspective, it takes 450 pounds of corn to produce the ethanol needed to fill the tank of an SUV one time. This is the equivalent of the amount of corn required to feed the average person for one year. Additionally, given the fuel expended to grow the corn (plowing, planting, fertilizing, and shipping), there is an estimated 1:1 ratio of energy production to energy usage with ethanol compared to 10:1 for gasoline.

Granted, Mr. Halbert used numbers from studies that supported his analysis, but in general I haven't read any analysis that shows

corn-based ethanol is anywhere near as efficient as sugarcane-based ethanol. Plus, at anything near a 1:1 ratio of production to usage, ethanol does not appear to be a force to lower oil prices.

One of the more disturbing aspects of ethanol production is that it takes four gallons of water to produce one gallon of ethanol. Analyst Marc Chandler recently wrote that: "The global use of water tripled in the 1950-2000 period, and the water table is falling in countries that are home to half the world's population. Almost three-quarters of the water is used for irrigation, and during the last half century, the amount of land being irrigated also tripled.

"To grow a ton of grain requires 1,000 metric tons of water (1,000 cubic meters). In comparison, it takes about 62,600 gallons of water to make a ton of steel. Already the shortage of water has begun to affect agricultural practices.

"China's shortage of water is one of the factors behind their drop in grain production from the 1998 peak of 392 million tons to 358 million tons in 2005. That decline is larger than Canada's annual wheat harvest. Corn, which requires less irrigation than wheat or rice, is the only major grain for which China's output has not declined. Through its heavy demand for water, China reportedly is creating a desert the size of the state of Rhode Island every year.

"Since grain is so water-intensive, importing grain is an efficient way to import water. Countries that have a water deficit are likely to import grains. Already, Algeria, Egypt, Iran and Mexico import more of their grain. The band of countries from Morocco in the west through Iran in the east, which have rapid population growth, rising affluence and water shortages, are among the fastest-growing grain import markets. Some countries, such as Israel, have now prohibited irrigation of wheat fields. Other countries, such as Saudi Arabia, have been forced by fiscal considerations to cut subsidies to farmers.

"Roughly speaking, 97% of the water on earth is salt water in oceans and seas. Two-thirds of the remaining water is trapped in glaciers, permafrost and the polar icecaps. That leaves 1% of the water for everything else. Through the desalination process, salt water can be made fresh, but the process is very energy intensive. One estimate suggests, for example, that if China's water shortfall would be met fully by

desalination, it would require almost a third of the world's annual oil output."

Mr. Halbert continues: "the Ogallala Aquifer below much of the Midwest is currently being depleted faster than it can be recharged, and cranking up more ethanol plants will accelerate this process." Here in Champaign County, the Mahomet Aquifer is also being impacted. A 2006 study by the Illinois State Water Survey at the University of Illinois noted that the Mahomet Aquifer is also being depleted.

Oil, food and water are closely connected and will continue to be concerns in future years. The demographics in the developing world show that there is an increasing reliance on animal protein in those societies. There is a direct connection between water, grain, meat, and oil, with 70% of water in the U. S. used for irrigation and 17% of all energy used in the production of food. With the demand for animal protein increasing, there is no reason to think that energy usage in the agriculture industry will decrease, and there is every reason to believe that this level of demand will continue despite high prices.

- ✓ *Oil and grains are legislatively connected because of ethanol and bio-diesel.*
- ✓ *Water is a necessary component for the production of grains and in the extraction of oil as evidenced by Saudi Arabia's use of water in its troubled fields to force oil to the surface.*
- ✓ *All three are experiencing increasing demand and have supply difficulties. The tight supply in each is supportive of increasing prices across the board.*

Mid-East Politics and Oil

About 10-days ago, Israeli Prime Minister Ehud Olmert warned of a preemptive strike on Iran if its nuclear programs were not curtailed. This in and of itself is probably not an earth-shattering announcement since Israel made a similar strike on Iraq during Saddam Hussein's rein. But, this seemed to be yet another in a series of odd things happening in the Middle East that may be pointing toward some sort of confrontation. Here is a list of some of the things that have been detailed by George Freidman, a geopolitical strategist that I follow:

- On September 7, 2007, Israel bombed a target inside Syria near the Turkish border.

Israel refused to identify what it was, but Mr. Freidman reports that it was likely a nuclear reactor site provided to Syria by North Korea, and that Iran was assisting with its construction;

- In February, 2008, the U. S. started to expand and fill the Strategic Petroleum Reserve (a storehouse of oil to protect the country in case of supply disruptions) in spite of record high oil prices;
- Also in February, someone assassinated Imad Mughniyah, a leader of Hezbollah in a car bomb explosion in Syria. Hezbollah has not yet retaliated for the attack, but they publicly blamed Israel;
- In March, the USS Cole was dispatched to the Lebanese coast and later was replaced with two escorts from the Nassau Expeditionary Strike Group. It is unusual for the Navy to park warships in an area where they won't be needed, particularly given our active commitments in Iraq and Afghanistan;
- In April:
 - Israel conducted the largest military and civilian defense exercise in their history. Named Turning Point 2, it was designed to test the civil defenses and the ability of the national command authority to continue to function in the event of an attack with nuclear and chemical weapons. It involved calling up reserves – a costly disruption to society - and deploying them in the North where they would anticipate an invasion to be launched by Syria and Iran;
 - Syria deployed two armored and one mechanized divisions to their border in the Bekkaa Valley;
 - The Lebanese government evacuated civilians from the southern part of Lebanon;
 - An Israeli news organization reported that the September, 2007 bombing of Syria was performed to destroy the location of the Iraqi Weapons of Mass Destruction that were transferred to Syria by Saddam Hussein prior to the onset of the war – I haven't read of any proof offered by them, but I would

sure think the U. S. would be trumpeting it if our government believed it to be true; and

- During all of this warlike activity, the U. S. government did not issue any warnings or cautions to the various parties, but instead just maintained its strike force off the Lebanese coast.

I have no idea if this is the prelude to an Israeli strike on Iran but I think you have to take it fairly seriously given: 1) the volatile state of affairs in that part of the world, 2) the stated objective of Iranian President Ahmadinejad's declarations that he is planning to use his nuclear weapons to destroy Israel, and 3) Israeli President Ohlmert's warning of a preemptive strike.

- ✓ *This sort of unknown geopolitical risk has added to the increase in the price of oil.*
- ✓ *Investors/traders/speculators do not like unknowns as there is no way to quantify pricing impacts.*
- ✓ *The threat of a supply disruption from a Middle East conflict likely permanently has added a significant risk premium that is built into the price of oil.*

The Dollar's Impact

The U. S. dollar has significant problems *vis-à-vis* other currencies. It has fallen in value against most other currencies over the last couple of years. U. S. corporations that have significant overseas sales have benefited from this as their products priced in dollars are cheaper for foreign buyers. But, much of the rest of our economy has felt the impact of higher prices due in part to a weak currency.

Simon Constable writes: "Essentially, when the dollar is weakening, it means the U.S. currency will buy fewer units of a foreign currency than it would previously. For example, five years ago, one dollar would get you 0.85 euros, whereas now it will fetch only 0.63, a 26% decline.

"Likewise, the dollar has depreciated 12% against the Japanese yen from its level of a half-decade ago. The greenback is also down 15% against the pound over the same time period. Ultimately, that means higher costs for many of the things we buy, such as gasoline, heating oil, flour, bread and baked goods.

"A weak dollar pushes up commodity prices because they are directly priced in dollars," says Josh Feinman, chief economist Deutsche Asset Management in New York.

There are a number of analysts on Wall Street that are blaming the entire increase in the price of oil on the fall in the dollar. However, Jim Cramer reports that according to the most dire study he has read, changes in the price of the dollar have no more than a 6% correlation to changes in the price of oil.

- ✓ *Yes, the falling dollar has an impact on the rise in the price of oil, but it is just one of several factors that are adding to oil's rise.*
- ✓ *Oil priced in Euros has double during the time that oil priced in Dollars has tripled. This implies to me that at most the fall in the dollar has cause 1/3 of the rise in oil.*

Sunspot Activity

Investors Business Daily ran an editorial in April discussing the surprising failure of sunspot activity to resume on schedule.

Investment Strategist Don Coxe writes that: "Since Galileo's time, astronomers have recorded the variation in sunspot activity. It is ordinarily a 10-11 year cycle. When sunspot activity shrinks to near-zero or zero levels, it has been associated with very cold weather...the previous cycle ended in 2007...according to the Goddard Institute, the global temperature last year fell 0.7 degrees Celsius, sending temperatures back to 1930-levels. Snow fell in Baghdad for the first time in centuries. Icebergs in Antarctica reached levels not seen since James Cook."

Given the rains we have had this spring in the Mid West, the impact of sunspots on our weather - although not scientifically understood - is worrisome. The rains have kept the farmers out of the fields and both corn and soybean planting is behind schedule. If the sunspots do not resume to start the next cycle soon, we could likely have an early fall and winter, further impacting crop yields in a negative manner. This would naturally impact the ethanol industry, inflation, and food supplies across the globe.

- ✓ *In terms of its impact on energy, there is a direct impact on natural gas and heating oil prices. We have seen natural gas double in price over the last year, and if*

we have an early fall and winter, it will likely continue moving up.

Also, for those of you that are wonder what is happening with the Colony Collapse Disorder discussed last year in this newsletter, the U. S. population of honeybees is down 36% this year after a 31% drop last year. California had to import one-third of the nation's bees to pollinate its almond crops last year. This spring, the almond crops were also successfully pollinated, but they had to import one-half of the nation's bees.

- ✓ *Food price inflation is clearly impacted by more than just the demographics of the developing world and ethanol.*

Oil Price Forecast

Long-term, the price of oil is headed higher. New supplies will be increasingly difficult and expensive to extract and refine. U. S. supplies in Alaska and offshore will likely not be developed due to environmental concerns. Nuclear power facilities will not likely be built due to fear of catastrophe and apprehension about nuclear waste. Demand will continue to increase with the demographic changes in the developing world. Geopolitical issues in the Middle East, Russia, Nigeria and Venezuela will continue to put upward pressure on oil prices because the threat of supply disruptions is always present.

- ✓ *In short, in a dangerous world demand will continue to outpace supply and new sources of supply will be more expensive than current sources.*
- ✓ *This is the crux of why we have high oil prices now and why they will remain high for the foreseeable future.*

Short-term, there is the possibility that oil will retreat significantly before moving to the next level - not withstanding Morgan Stanley's forecast of \$150 per barrel oil by the 4th of July. Temporary reductions in U. S. demand coupled with reductions of demand in the developing world as price subsidies are lifted will impact prices. Economies around the globe will likely slow some due to energy price increases, leading to lower demand. If oil prices retreat, my best approximation is a return to \$100 per barrel, a roughly 50% retracement of its increase over the past year.

Or, it may just bounce off \$120 and head higher like it has the last two times its pulled back.

Investment Strategy

Our client portfolios will continue to reflect:

Agriculture – there have been reports of food shortages in Asia along with food price inflation in excess of 20% in the first quarter of 2008. This month's Consumer Price Index report noted annual food price inflation in the U. S. was in excess of 6%. The combination of demand for food and ethanol will keep agriculture in a secular up-trend for several years.

Energy – demand continues to outstrip supply, and until either significant new sources of oil are discovered or the price climbs so high as to reduce demand significantly, this is a secular trend with years to go.

Base metal – miners continue to report that demand from the developing world is increasing, yet the big players in the industry have no new mines under development. This will continue to limit supply and keep upward pressure on base metals prices. On a short-term basis, if the world economy slows some due to high energy prices or inflation-induced high interest rates, base metals prices may see some downward pressure. However, the modernization of the developing world is a secular trend that will continue.

Gold – rising inflation will keep increasing gold prices as this is the traditional hedge against the devaluation of currencies caused by inflation. Gold is also the safe-haven in times of geopolitical risk. Gold is a key portfolio component in today's investment environment.

Defense – in spite of all the rhetoric of the campaign season, anyone that becomes our next President will want to protect our country from a second 9/11. It is a dangerous world and our country will continue to have a strong defense to accompany the reinstatement of diplomacy that each of the candidates advocate.

Biotech and Medical Devices – the baby boomers have begun to retire, and with that we have a wave of potential business for new innovations that will allow them to lead active and satisfying lives. Every aspect of the baby boomers existence has caused secular changes in the developed world – the desire and

need for advanced health care to maintain an active lifestyle will be no different. The downside is that the current election cycle is filled with discussions of universal healthcare, and that is generating several unknowns about the future of this industry. We are currently short-term cautious on healthcare investments until we see some concrete plans from our government.

Global infrastructure – the demographic changes in the developing world are creating a huge demand for infrastructure, not the least of which is new ports and oil refining facilities. The companies that can design, engineer and construct these multi-billion dollar projects have billions of dollars of projects in the pipeline, and they will continue to experience significant levels of earnings growth. As long as the secular demographic changes in the developing world continue, the global infrastructure boom will continue.

Multinational U. S. stocks that have significant overseas sales – the profligate spending by the U. S. government and much of the consuming public has caused us to be the world's most significant debtor nation. Our dollar is in a multi-year bear market and will likely continue to drop in value against stronger currencies. The strengthening of developing world currencies against the dollar is the next leg in the dollar's fall, and it has just started. The multinationals that have significant Asian, South American, Middle Eastern, and Eastern European sales will see their earnings growth continue to accelerate, even if the dollar rebounds against the Euro and the Yen.

Water – water is a precious commodity, it is in short supply, and it is being depleted at a rapid rate around the world. We have added water investments to our short list of favored investment themes and we will be building positions in client portfolios accordingly.

Very Short Duration Fixed Income and Cash – bonds are a dangerous place to be right now. In the last month, the yield curve has steepened significantly, with the 10-year treasury increasing 0.75% in yield. What you will likely see is a shifting of the entire yield curve upward when the Fed begins to raise interest rates. You will also likely see the yield curve continue to steepen as yields on longer-term maturities move even higher.

Mutual Fund Portfolios – in keeping with our Investment Strategy, we have positioned our mutual fund clients as follows:

- Equity Allocations – We have reduced traditional equity allocations by 15% in favor of mutual funds focused on commodity (energy/ag/metals) and gold investments. We also continue to favor the international markets in our fund selection given their higher growth rates and non-dollar-based positions.
- Fixed Income Allocations – We have reduced the risk exposure in our bond fund allocations to a mix of short-duration funds and money market funds in an effort to protect principal from the impact of inflation and rising interest rates.

In Summary

Energy investments have been an important part of our investment strategy for several years. The secular shift in demand from the developing world is a major trend that has years to continue. As the trend continues, there will be increased volatility in the price of oil and in the share prices of energy investments.

Higher oil prices may temper consumer demand, but it will not quash it. An easing of demand may cause oil prices to fall temporarily, but falling productivity in many of the world's oil fields will cause new nations to enter the club of oil importing nations.

The increasing cost of producing the incremental next barrel of oil will continue to push the price of oil upward. Geopolitical events will continue to add a risk premium to oil as the threat of supply disruptions will be an ongoing concern. Unintended consequences of government regulation can and do have a negative impact on oil prices.

- ✓ *There are several factors that have come together in a perfect storm to cause oil prices to consistently break new record highs.*
- ✓ *There are no easy answers to the difficulties caused by high oil prices.*
- ✓ *Nationalizing our oil industry, imposing excise taxes on oil companies, diverting 50% of our corn crop to ethanol to reduce gasoline usage by 10%, and developing a Homeland Security level monitoring system for speculation all seem to be knee jerk reactions.*

- ✓ *Our country needs a well thought out national energy policy that addresses all aspects of the problem. It needs to be openly debated by our elected representatives and responsibly put into action by all involved parties. Until then, expect oil prices to remain high.*
- ✓ *The prudent investment plan (which we employ) is to develop a strategy to capitalize upon the opportunities presented by these secular changes.*
- ✓ *The demographic changes in emerging markets that cause supply/demand imbalances in oil, metals, food, and water are secular changes that are not going away anytime soon.*
- ✓ *The companies that provide products and services that will facilitate these changes are those that have the best investment characteristics in the current environment.*
- ✓ *This has been and will continue to be our focus in client portfolio management until our analysis shows that new secular trends are emerging to take their place.*

As investment managers, it is our job to navigate difficult issues and provide competitive returns for our clients. As of May 31st, our year-to-date average return for balanced portfolio clients invested in individual stocks and bonds was a gain of 5.80% compared to a combined loss in the stock and bond market of -2.94%. Our trailing 5-year average return was a gain of 17.42% annually compared to 7.33% for the stock and bond markets. Our average return since the 1991 inception of our business has been 16.13%.

If you are currently our client, we want to thank you for your continued business, and we look forward to coming years of achieving well-above average returns for your investment portfolios.

If you are not yet a client and you would like to have your investments managed according to the *Investment Strategies* you have just read, please call Mark Ballard, John Clausen, or Andy Thorman at (217) 351-2870. We would be happy to discuss with you how we can put our strategies to work for you.