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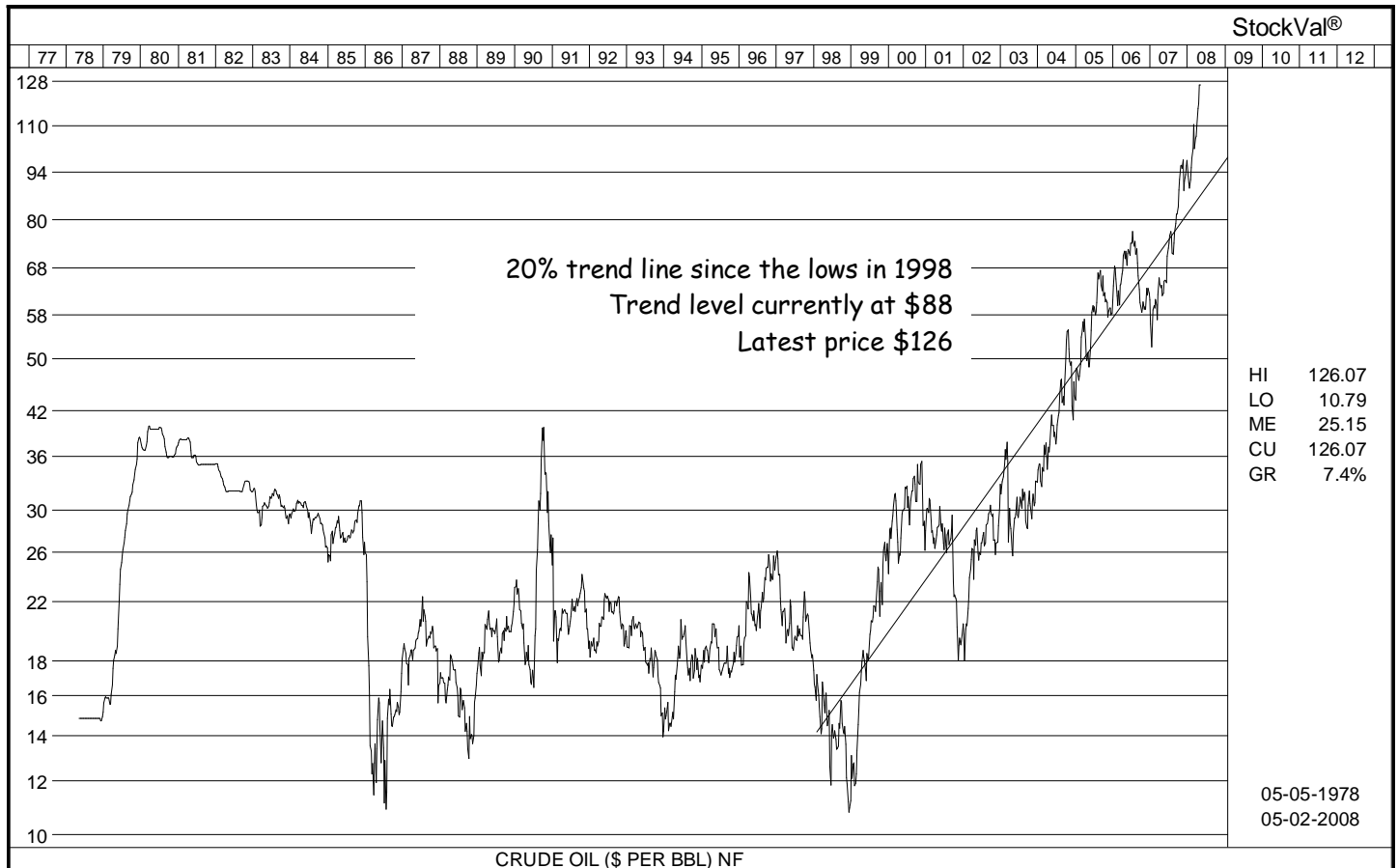
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## Not *If*, But *When*... Part two: Commodities and Oil

- **Not if, but when...** For commodities, we think the issue is *when* to reduce weightings, not *if*. This is in contrast to stocks, where we argued last week that the issue was *when* to add to weightings. Our challenge is to devise a methodology to assess the risk/reward in commodities. We do it by looking at the long term trend of total returns, net of inflation and observing current prices relative to the trend. This reveals that commodities in general are 25-30% above their 38-year inflation adjusted trend. Reflecting that, Riverfront recently lowered our long-term (five year plus) annual return estimate to just 3% over inflation from our estimate of over 6% per year, made last summer (see Michael Jones' *Commodities Are Overvalued: Is It Different This Time?* at riverfrontig.com). With commodity prices still making new highs, momentum clearly favors retaining some exposure, but we have reduced our weightings into the current strength.
- **Beware the Crowd at Extremes...** Common sense suggests that one major commodity, oil, must soon take a breather. Oil prices surpassed \$120 last week. For us, this is something of a landmark as oil prices have now risen 10 fold in ten years. The fundamental rationale for oil's strength is valid in our opinion. Indeed we have made it many times — demand is up (especially from the developing world), long-term supply is in question, geopolitical uncertainty in oil producing countries is high and the cost of extraction is rising fast. We think all of these positives help explain why the trend rate of oil's price advance in the last 10 years is some 20% per year (see chart), but the current price is almost 40% above that trend! Thus oil is even more extended than other commodities.
- Oil prices could fall below trend (currently \$88) and still be entirely consistent with the 20% up-trend as our chart shows. Equally, prices could go sideways for almost two years before the trend line catches up. Each scenario assumes that the 20% trend is sustainable. In the long run, we think a 20% trend will be hard to sustain. Consider: the trend line price of oil is currently \$88. In five years it will be \$220 and in ten years \$550. That would mean gasoline prices approaching \$20 per gallon, something that we think the world economy could only absorb if significant improvements in fuel efficiency are achieved, which in turn lessens the likelihood of such a high price. Thus, we repeat, in our view it is a question of *when*, not *if*, oil prices decline or at least go through a multi-year consolidation period.
- For timing, we turn to technical analysis. Having just made a new high, both oil prices and the broad commodity indices are showing that the bulls are still in control, but we note that the pace of advance is losing momentum. Additionally the crowd sentiment poll for energy futures, compiled by Ned Davis Research, is at the highest level since its inception in 1990. We have done some selling and will likely do more once momentum breaks to the downside.
- Fundamentally, we believe the dollar is a critical macro variable for commodities. In turn, the dollar is a direct reflection of US monetary policy relative to other countries. Since US interest rates are currently below the inflation rate, investors have little reason to own the dollar and because commodities are priced

in dollars they usually rise when the dollar falls— all other things being equal. The Fed has chosen to set its monetary policy for the weakest link in the economic chain, namely the housing industry and the financial system, and to diminish its role in preserving the value of the dollar. The result has been an 8% decline in the trade weighted dollar since the Fed started cutting rates in August. Until US monetary policy returns to less reflationary policy, the primary trend for commodities will likely to be up, though as we point out commodities, and especially oil, are now at record levels above their primary trend. We therefore judge the risk/reward unfavorable.

## The Weekly Chart: Oil prices have risen too far, too fast.



*Past performance is no guarantee of future results*

Our chart shows the 30 year history of oil prices including the oil shocks of 1979 and 1990. It highlights the significant advance over the last 10 years, relative to the previous 20. The trend line we have drawn is rising at an annual rate of 20%. Oil prices are about 40% above this trend line. We think this makes the risk/reward unattractive until prices fall or the trend catches up.

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