The Absolute Return Letter

May 2006

Summary

This month we take a closer look at commodity prices and in particular at the recent run in gold. We conclude that things do not quite add up. Usually, the price of gold is a function of investors' dollar expectations or their inflation expectations – or both. However, neither the inflation outlook nor the dollar outlook really justifies a 50% rise in the price of gold, as we have witnessed over the past 12 months, so something else must be at work.

Enjoy the read.

Something Has to Give

Global equity prices continue to do very well in the face of rising bond yields. Meanwhile, commodity prices (with the possible exception of soft commodities) are enjoying the biggest boom in living memory. As these lines are written, the oil price is hovering around $74 per barrel and the price of gold is a touch over $660 per oz. - not far from the elevated levels of 1980.

The only asset class not fully participating in the party are bonds where the yield seems to move up and down in sympathy with Fed Chairman Ben Bernanke's latest attempt to distance himself from earlier remarks.

Chart 1: Gold Price - $ per Oz.

Source: World Gold Council. London month-end prices.

Although we cannot deny that we enjoy the fun of rising asset prices as much as everyone else, we suspect that something has to give. It is inconceivable that equities and commodities and, within the context of commodities, gold and oil in particular, can enjoy a synchronised and sustained rally of this magnitude.

So, the question facing all but the most optimistic investors is which horse to bet on. Will bond yields fall out of bed now that Bernanke is on record as saying that the Fed may not, in fact, be near the end of the tightening cycle?

Will equities continue to rally on the back of a growing belief that the global economy may very well slow down later this year, but that corporate earnings may suffer only minimal damage in the process?

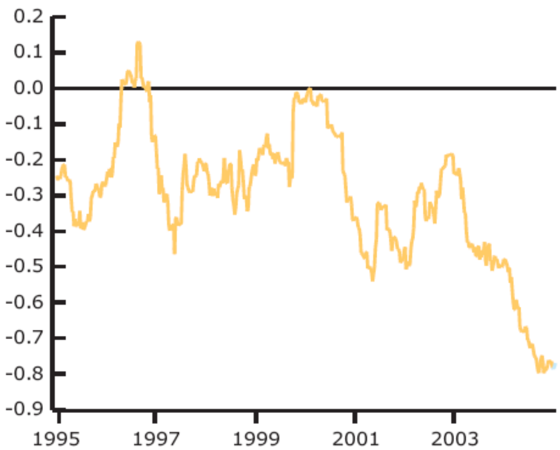
Will commodity prices continue to move higher on the belief that demand from Asia may cushion a global slowdown? Will the oil price continue its path upwards on the back of production disruptions and geopolitical risk? Will gold repeat its feat of 1979-80 and become the most sought after currency on the planet?

Or is it in fact possible that we find ourselves in the financial world's equivalent of Nirvana where inflation doesn't exist and bad news doesn't matter?

Let's begin our journey with gold. We do not consider ourselves experts on gold, so bear that in mind if you think our analysis is a little bit superficial. In fact, if you wish to read a real expert on gold, go to www.gloomboomdoom.com and click on 'Market Comments'. The author (none less than the venerable Marc Faber) has recently produced a masterly piece on gold which comes highly recommended.

The price of gold usually correlates with inflation expectations (positively) and with the value of the U.S. dollar (negatively). In fact, the gold price and the US dollar have become increasingly negatively correlated in recent years (see chart 2 on page 2). So the recent run of gold from a trading range of $420-440 during the first half of last year to $660 today should, all other things being equal, tell us something about either investors' dollar expectations or their inflation expectations - or both.

Chart 2: Correlation between USD & Gold



Source: World Gold Council, GFMS Limited. Correlations are rolling 52-week. US dollar is trade weighted.

It is not at all difficult to build a negative case for the greenback. The problem is - the arguments are no different from those used by the dollar bears twelve months ago when the price of gold was much, much lower.

Meanwhile, it is probably fair to say that the jury is still out as far as inflation expectations are concerned. Given the rapid rise in commodity prices, it is not unreasonable to expect a modest rise in inflation over the next few years - a scenario which we subscribe to. But is the inflation outlook so bearish that it commands a near 50% rise in the price of gold in less than one year? Hardly.

Supporting this view is the behaviour of so-called index-linked bonds (called TIPS in the U.S.). One of the most broadly accepted indicators of inflation expectations, TIPS are inflation-adjusted bonds where the yield moves up and down with inflation expectations.

Unlike the price of gold which is throwing out red flags as if there were no tomorrow, the yield on TIPS has been moving broadly sideways for the better part of two years now (see chart 3 below).

Could it be that TIPS (and, for that matter, index-linked bonds in other countries as well) are priced incorrectly? Well, pension funds all over the world have been busy buying index-linked bonds in recent years in an attempt to do what in the industry is known as 'liability matching'. It is certainly possible that the price of these bonds does not fully reflect fundamentals, but we doubt that the pricing is completely out of whack.

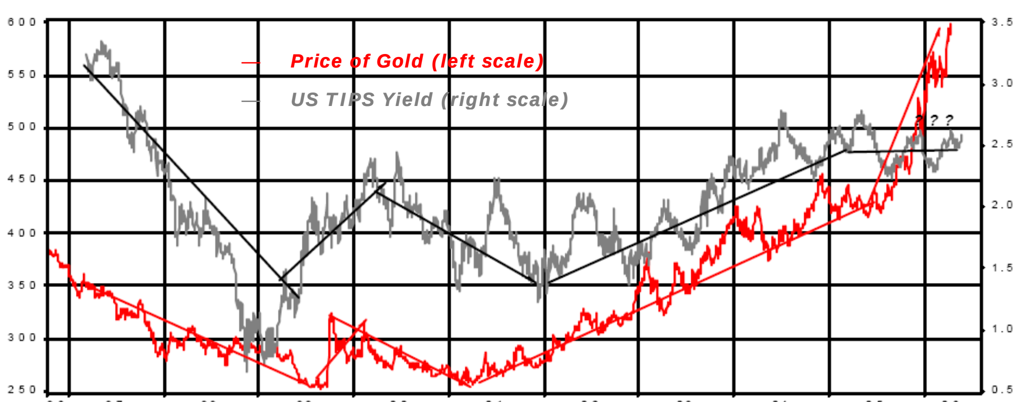
Could there possibly be other factors at work? We stumbled over this most interesting chart (see chart 4 on page 3) which depicts the growth in commodity derivatives over the past decade. Up until a few years ago, the growth in commodity derivatives outstanding was rather mundane. Then all hell broke loose with the total amount of commodity derivatives outstanding doubling from 2003 to 2004 and more than tripling from 2004 to 2005.

Realistically, such growth can only materialise if big financial players decide to join in. In other words, pension funds, hedge funds and banks have all played a role in the ignition of this latest bull market in commodities. Our conclusion is further supported by data from the World Gold Council. According to their statistics, industrial and dental demand for gold grew by only 2% last year to 419 tonnes. Jewellery demand grew by a modest 5% to 2,736 tonnes whereas investment demand grew by a whopping 26% to 600 tonnes.

The prolificacy of Exchange Traded Funds (ETFs) has also played a role in this boom. Of last year's total demand originating from the investment community, about one-third went towards ETFs and similar products, up 53% from the previous year. In this context, it is worth bearing in mind that a silver ETF will be launched shortly. One wonders what that will do to the silver price.

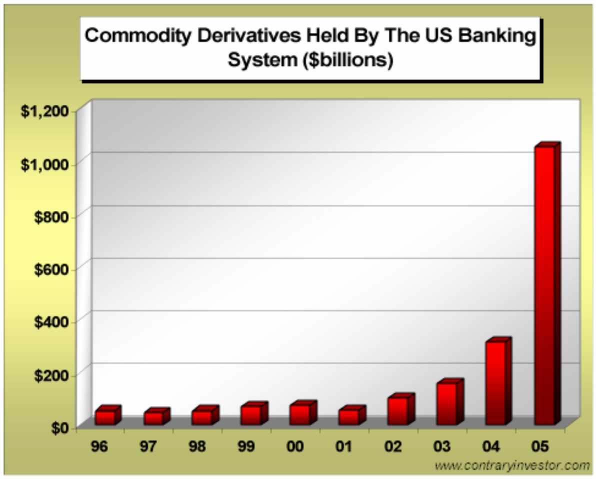
Chart 3: US Inflation Expectations

(As derived from Gold and TIPS)



Source: Gavekal Research, Ecowin

Chart 4: Commodity Derivatives Outstanding



Source: ContraryInvestor.com

It is, however, an entirely different explanation that intrigues us. Friends in the Middle East are telling us that investors in oil rich countries have been keen buyers of gold for a while now and that the recent collapse of local stock markets in the region (Saudi Arabia is down 35% from its peak, Dubai is down 55%) has only reinforced their appetite for the yellow metal.

This theory may not be as far fetched as you think. For starters, the bullion market is not as big as many people seem to believe and can certainly be manipulated with the help of a few tens of billion dollars. Secondly, dollars are not exactly in short supply in the Middle East given the strength of the oil price. Thirdly, it is remarkable how the spike in the price of gold has coincided with the collapse of Middle Eastern stock markets.

We have no way to verify this theory, but could it be that behind the extraordinary behaviour of gold in recent months is no more than a desire to diversify away from energy and stock markets by an extraordinarily cash-rich group of investors?

Is It Different this Time?

When discussing the outlook for commodity prices with our clients, we are faced with the argument again and again that this time things are *truly different*. The rapid growth of China and India as well as other large emerging economies (e.g. Brazil) will, our clients are telling us, keep commodity prices high for years to come.

Whilst we do not disagree that behind the current boom in prices is a great structural growth story which could last for a long, long time, we see signs of overheating in parts of the commodity market, and we detect very clear traces of speculative buying which could develop into a financial accident at some stage.

The problem facing us is that there is no way to tell when this might happen. There are also reasons to believe that some commodities have been subjected to speculative buying more than others. As someone pointed out to us recently: If copper prices were driven mostly by speculators, how come copper showed remarkable resilience when gold and silver both suffered from significant profit-taking a couple of weeks ago? That is indeed a very good question.

For now, and given the spike in many commodity prices recently, the only conclusion we can reach is that it seems to be the time to take a few chips off the table.

Anywhere to Hide?

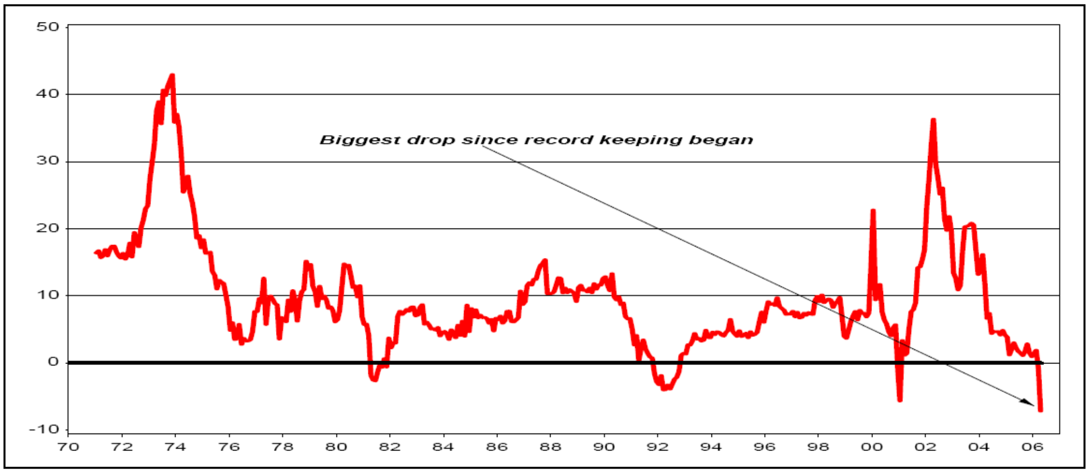
So, if it is time to lock in some profits in commodities, where do you park your money? Well, other than investing in non-directional investment strategies which we are big proponents of, but which we cannot discuss in public due to the laws of this country, we continue to believe that equities – in particular European and Japanese equities – may have a bit left in them yet. Although they have already enjoyed a good run, we believe that an environment of moderate economic growth and manageable inflation is conducive to further stock price appreciation.

In last month's letter to our clients we made the point that the Fed and the ECB may not be overly successful in draining liquidity from financial markets so long as the Bank of Japan doesn't play ball. Since that letter was written, the Bank of Japan has published new data which suggest that, although the zero interest rate policy is still in place, the monetary base in Japan is currently experiencing the biggest year-on-year drop since record keeping began (see chart 5 on page 4).

All other things being equal, this is *not good news* for global stock markets. Previous experience has taught us that when the money supply in Japan starts to shrink after a period of rapid growth, usually there is a price to pay. In the past, that price has been falling stock markets.

For now, we will not reduce our exposure to equities, but this latest development will be followed closely. As the evidence mounts that the risk of an imminent worldwide recession diminishes (contrary to what the inverted yield curve told us recently), we believe that global equities will continue to behave reasonably well. However, that view could change any time subject to the behaviour of the main central banks.

Chart 5: Japan's Monetary Base



Source: GaveKal Research, Ecowin

Is it worth taking a second look at bonds? We do not think so. We just can't reconcile Ben Bernanke's comments from last week, suggesting the two year cycle of tightening may be nearly over, with what we continue to see with our own eyes. However, over this past weekend, Bernanke ate a slice of humble pie and suggested his comments had been misinterpreted. He is now saying that the Fed will be very data driven over the next several months. In other words, all options are open to them, which is fair enough.

According to our friends at Gavekal Research (you can find out more about them on www.gavekal.com), the Fed prioritises four elements in their data studies:

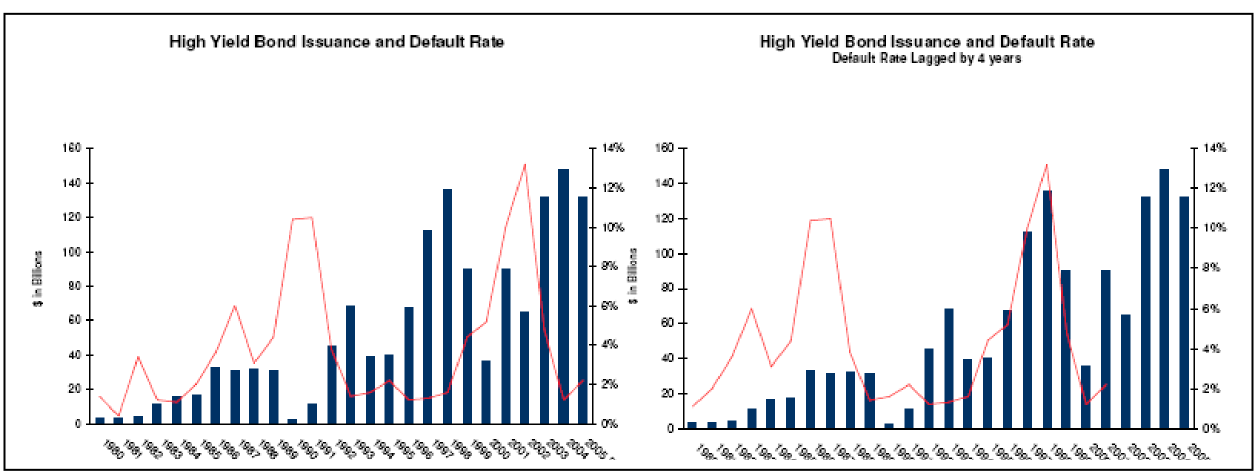
- *The long end of the bond market;*
- *ISM/NAPM surveys;*
- *Economic cycle sensitive prices;*
- *Bank lending.*

All four indicators currently point towards further rate hikes. Case closed for now.

Finally, one more note on bonds. When we look at our clients' portfolios, we often find a large element of corporate high yield bonds in there (not our recommendation!). Private investors, not unlike pension funds, have been chasing yields in recent years following the collapse of the yield curve. Long term readers of this letter will know that we turned negative on corporate high yield a while ago. However, many of our clients hold onto their bonds in a desperate attempt to generate a bit of income in a yield-starved world.

Recently, friends at Goldman Sachs kindly sent us the chart below (see chart 6). The chart illustrates the link between the amount of new high yield issuance and the default rate. It is probably fair to say that we have all been aware of some link between new issuance and default rates. What Goldman Sachs' research underlines is that the link is very well defined. There is approximately a 4 year lag between new issuance and defaults.

Chart 6: High Yield Bond Issuance v. Defaults



If history repeats itself (and, in this case, there is no reason not to believe it will), the number of defaults will rise quite rapidly in 2007 and peak in 2008 before the process reverses again. In a period of rising defaults, the risk premium will have to rise, probably significantly so. We strongly recommend you reduce (or eliminate) your exposure to corporate high yield bonds. This is not the right time to chase yields. We cannot say it more emphatically.

So, to sum it all up, we believe the case has rarely been better for non-directional investment strategies. If you are not quite sure what we mean by that, non-directional investment strategies are strategies which will suffer minimal adverse impact should financial markets go into reverse and start delivering negative returns. At Absolute Return Partners, we have developed some significant experience in this particular field of investing.

If you believe that such investment products are suitable for you, please feel free to contact us, and we can assess your personal situation in detail. In the meantime, don't forget to take some profits.

Niels C. Jensen

Absolute Return Partners

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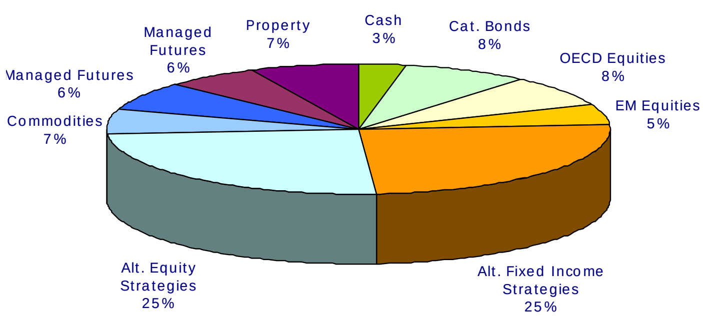
The Absolute Return
Multi-Strategy Portfolio
1st May, 2006



The Absolute Return
Alternative Portfolio
1st May, 2006