

MAAP January Review

February 2, 2009

While MAAP was down in January, on a daily basis the low point for the MAAP portfolio was December 5, 2008. Since that time the portfolio has been working gradually higher, although this is not readily apparent when viewing results from a month end to month end basis. Many commodities and currencies, like individual equities, made preliminary lows in mid-October; however, extreme lows in the various currency and commodity markets have occurred from October 27th (currencies and precious metals), December 5th (grains), and December 24th (low in most energy markets and copper). As with individual equities, there has been a great deal of backing and filling in the past three and a half months, that we believe is part of a significant bottoming process.

Many of you have raised good questions about our positions and strategy. Since many others may be asking the same questions, we will attempt to answer those most frequently asked:

If we are employing both fundamentals and trending strategies why have we stayed with the commodity positions? During the commodity bull market that commenced in 2002, each previous time that trends were clearly broken, it proved to be an important intermediate bottom. Since we did not have fundamental evidence of significant new supplies coming on to the market, and because there was not a major topping process at the summer highs, we assumed that a similar intermediate turn would occur. The Lehman bankruptcy, with its wide ranging consequences, imposed a liquidity squeeze which was not fully appreciated by either market participants or Federal Reserve and Treasury officials. While the Federal Reserve responded with the most aggressive easing in modern history, the forced deleveraging exacerbated the extent of the selloff. With hindsight it is obvious that we would have benefited from going flat.

What changes are we considering to deal with a situation like this in the future. While we will continue to emphasize long-term fundamental opportunities we are working on a process to identify higher risk environments when probabilities suggest a reduction in leverage is appropriate in the individual markets that we trade. We have always been cautious when introducing modifications to our trading approach. Since we are significant investors in this strategy, we always approach these questions from the standpoint of an investor not from a viewpoint of simply enhancing a marketing strategy. In summary, we are encouraged by the progress we are making in quantifying higher risk environments for protecting profits in the future. As we have more to report, we will do so.

How can commodity prices rise before the recession ends? Commodity prices are a function of demand, supply, credit cost and availability, and perceptions about future price levels. As a recession begins, final demand declines, credit may be scarce, and suppliers are faced with temporary excess supply. Inventories and new supplies are often cut more than final demand would justify due to cost or availability of credit and fears of ever lower prices. In addition, plans for capital expansion are abandoned. End users operate on just in time inventory levels, assuming weak pricing and confidence that supplies are easily attainable. Usually the first sign of a change in direction is central bank credit easing that lowers interest rates and increases the ease of attaining credit. At this point, any modest positive change in demand can set off a chain reaction in the opposite direction. Restocking of inventories is necessary, credit is available to finance inventories, and the cheap cost of money makes holding inventories profitable once again. Therefore just as stock markets discount the end of a recession due to credit easing, commodity markets respond for similar reasons.

What opportunities do you see for profits in 2009? Accompanying this commentary is an updated chart of inflation adjusted commodity prices for the past 100 years. When the commodity bull market began in 2002, commodity prices were at extremely low levels. At their peak in mid-2008 they were

still closer to all time lows than to the previous peaks. With the recent selloff they remain near their historical lows. It is our contention that commodities are the most undervalued asset class available to investors. Previous secular bull markets in commodities have ended when new supplies, responding to higher prices, become excessive. At the peak of prices in mid-2008 there was no evidence of excessive supplies. The excess of supplies that currently exist are a temporary result of the global recession. As the global economy comes back to life, markets are likely to be surprised by the quick shift to tightness of supplies once again.

The U.S. and global economy have been in a financial bubble environment since late 1996. Asset prices were allowed, even encouraged by central bank policy, to reach excessive valuation levels. Excessive leverage and consumption are the result of these high valuation levels. Like a drug addict, consumers and businesses have become dependent on these excessive price levels and leverage. Each successive recession is requiring a more aggressive government response to the problems. The zero interest rate, quantitative easing policy of the Federal Reserve is a new chapter in the level of response. Programs currently in place, and anticipated in the near future, will be aimed at propping up asset prices, so as to restore private sector confidence. Restoration of confidence about asset prices, real estate, bank debt, and equities, will do wonders in restoring economic growth. Debt is being transferred from the private sector to the public sector in order to enable the system to function.

We are of the belief that public policy will succeed once again in propping up the economy, overwhelming deflationary tendencies of the private sector, and ultimately creating a greater inflationary problem. The individuals directing government policy are intelligent, are fully aware of the possible future consequences, and probably believe they can respond in the future to offset an inflationary problem. However, history is replete with examples of future circumstances that make timely policy shifts difficult to enact. Central banks can create unlimited amounts of fiat (paper) money, there is an adequate global labor pool, but basic commodities will restrain future growth and prices will respond accordingly. The U.S. dollar is also vulnerable and should result in significantly higher precious metals prices.

