

MAAP May Review

June 1, 2011

The commodity and currency markets experienced a correction in May which created a negative return for MAAP for the first time in four months. The largest contributor to the decline was the long position in the energy sector, followed by the long position in metals, the short position in U.S. Treasury bonds, the long position in currencies, and a minimal loss in the long position in the grains. During the month the short position in the bonds was cut to approximately 50 percent of maximum. Wheat was sold and corn and soybeans increased.

Contributing to the correction of markets in May were concerns about the end of QE2 in the U.S., continued monetary tightening moves in China to contain inflation and increased margins designed to dampen speculation. It is important to remember that no government wants a recession. China's goal is the fastest possible economic growth rate without inflation getting out of control. At the same time the U.S. policy is aimed at stabilizing the housing market and reducing unemployment while tolerating a higher rate of inflation without admitting the latter.

The primary problem plaguing the U.S. is that the degree of monetary stimulation necessary to stabilize housing and generate faster job growth is excessive for stable commodity prices. China and other developing countries meanwhile face the dilemma that their rapid growth rates will strain available commodity supplies in the years ahead. In the previous century commodities were always in excess supply after recessions. Therefore traditional monetary stimulation from central banks could continue for several years before inflation would commence in commodity prices. With the huge new demand emanating from the developing world, unprecedented demand is now being placed on commodity supplies while labor is in excess supply in many countries. As one might expect, excess monetary stimulation will have the greatest impact on the scarcest items (e.g. commodities) and the slowest impact on those items in excess supply (e.g. housing and labor in the U.S.).

We believe there is a strong likelihood that a QE3 will be necessary in the U.S. and that China will allow a faster rate of appreciation for the Yuan. The Federal Reserve may justify a QE3 due to slow economic growth and continued high unemployment in the U.S. They are more likely to pay lip service to inflation or explain it away in order to provide more stimulus to promote job growth. China may allow faster Yuan appreciation in order to dampen inflation through more moderate import price increases if they are convinced it won't severely hurt their export industries. Governments are biased towards further economic growth and will introduce further monetary easing if there is any evidence that growth is slowing more than they desire. So investors should anticipate any errors in policy to be inclined towards inflationary outcomes. The greatest risk to global growth is likely to be limits in the supply of oil due both to slower production levels from many of the world's aging giant fields, and/or possible disruptions from political unrest in the oil producing countries. Other than those possible restraints the demand for commodities should remain very strong for the next several years. Likewise government policies should continue to stimulate demand for gold as an alternative store of value. MAAP therefore is in a strong position to benefit from several powerful trends during the next several years.