



June 2, 2009

An Investment Blueprint For 2009 And Beyond

Approximately eight years ago, in April 2001, we wrote **The Coming Commodity Inflation Tsunami**, outlining our view that the world was entering a future of greater scarcity of raw materials, a weakening U.S. dollar, rising general price inflation, and a significant investment opportunity in commodity futures and precious metals. Several months later, in late 2001, the dollar reached an important price peak, and a six and a half year bull market in commodities and precious metals commenced. Equities exhibited less relative strength, and did not turn up until March 2003.

As all investors are well aware, the bull market in stocks ended in the fall of 2007. Then the bull market in commodities was abruptly interrupted in the second half of 2008. What followed was one of the most violent bear markets in U.S. history. Virtually all asset classes, with the exception of government bonds, experienced collapsing prices. A relentless deleveraging liquidation took place in response to the housing finance bubble crisis, the Lehman Bros. bankruptcy, and fears of a total market meltdown. In many respects it was similar to financial panics that developed in the 1800s or 1907, prior to the formation of the Federal Reserve. The only comparable market decline in modern times, that had somewhat similar characteristics, was the August-October 1987 stock market crash.

While we recognized the developing housing finance bubble early on, we believed it was a sectoral problem that would not infect every aspect of the global financial markets and economies. In the aftermath of the 17 month bear market in stocks and eight month bear market in commodities, investors feel poorer, and investment managers are chastened. Although some “green shoots” have appeared in the economy and markets, investors are debating whether strength in markets since early March is part of a bear market rally, or the resumption of bull markets in commodities and equities. After experiencing investment losses there is an increase in preferences for higher cash balances, and less volatile fixed income investments. **However the dilemma facing investors in the years ahead is the potential for a significant loss of purchasing power as a result of government policies initiated since last fall. It is quite possible that the massive liquidity already injected into our economy could unleash a doubling of the price level within the next decade. If that occurs, investors will need to accept a higher level of volatility in the short-term to avoid a critical loss of purchasing power of their capital in the long-term.**

It is our conclusion that both the commodity and equity markets have bottomed and that a cyclical global economic expansion will commence in the second half of 2009 in response to the massive liquidity and fiscal spending initiatives. Furthermore, we believe this expansion will experience accelerating inflation, along with shortages in key commodities, and will occur much more quickly than current consensus estimates.

New Opportunities Emerging

The aftermath of this recent liquidity squeeze induced bear market has created significant investment opportunities in certain areas. At the same time, the massive government and central bank response to the crisis has created significant risks in other asset classes. The challenge is recognizing both the beneficiaries and the losers in this new environment. The bear market of 2000-2002 left certain groups, such as the dotcoms, languishing in the investment graveyard for the next six years, while at the same time it created bargain hunting opportunities in sectors that had just begun to emerge in the mid-1990s and in new areas of leadership that just emerged out of the 2000-2002 bear market. Currently the same culling process is at



work. Banks and financial sector stocks will most likely languish in the next cycle, as the dotcoms did in the last. Long-term bonds could become known as “certificates of purchasing power confiscation”, as inflation destroys their underlying value. On the other hand, commodities, precious metals, and currencies of commodity rich countries will be the relative leaders. Equities will be viewed more for their underlying asset values than for their earnings and dividends as the fear of inflation builds.

It is our conclusion that the 2008 through early 2009 correction in commodities, precious metals, and equities related to these areas, was a temporary interruption in a secular bull market for these assets. Furthermore we believe that they are in the process of resuming their bull markets. The violent correction in these groups was similar to the U.S. stock market crash in 1987 (**Chart VIII**). The 1987 decline was a violent but short-lived correction in a secular market advance. Following the 1987 stock market crash, stocks advanced for another 12 years and the final peak in the S&P 500 was approximately 460 percent higher than the 1987 peak. **It may be hard to imagine commodity prices advancing another 460 percent above their mid-2008 price peaks, but the fundamentals argue strongly that commodities, precious metals and equities operating in these sectors have significant upside potential. In addition, developing economies and their respective stock markets (e.g. Brazil and Chile among others) should provide strong relative performance versus the U.S.**

Economic Stimulus

Many question whether the massive stimulus by the U.S. and other countries will succeed in generating economic growth or simply lead to stagflation. We are less sanguine about the U.S. and the rest of the developed world than we are about the developing economies. **If the world economy was totally dependent upon the U.S., as the engine of global growth, we would have grave concerns. However, the entrepreneurial forces unleashed in the developing world in the last 20 years are extremely powerful, and have reached a stage of development that is not totally dependent on the developed world.** Led by China, these countries have a growing middle class with a high savings rate, many have a positive balance of trade, and rapidly growing infrastructure expenditures.

The U.S. is using its financial power, enabled by a reputation built on historical conditions that no longer exist, to facilitate a massive transfer of private sector debt to public sector debt. The U.S. is, in effect, transferring the deflated financial sector bubble, which occurred in the last cycle, and reinflating it on the backs of taxpayers in the form of public debt. Rather than allowing for creative destruction of prior malinvestment, one of the historic strengths of capitalism, policy makers are intent on reflating the value of real estate, equities, and fixed income instruments, even though many of these assets may have been significantly overvalued in the last cycle. By reflating their values, policy makers’ hope is that they can reestablish the consumption patterns of the past decade. At the same time the stimulus package is also business as usual, allowing Congress to fund their favorite earmarks. In the short run this stimulus spending will positively impact the economy. If instead, it had been geared towards fixed investment with productivity enhancements, the long run impact of the spending would have been much more beneficial.

In addition to massive financial guarantees and fiscal spending stimulus, the Federal Reserve embarked on quantitative easing, after short-term interest rates were lowered to zero (Chart I). Quantitative easing involves the acquisition of all maturities of U.S. Treasury debt, and long-term government agency debt and mortgages. Federal Reserve Chairman Bernanke, an expert on the 1930’s depression is convinced that the Federal Reserve was too timid in its reflation efforts in that earlier period. His strongly held belief is that the Federal Reserve needs to be aggressive and creative in its reflation efforts at a time like this. **We are convinced that the Federal Reserve has the power to overwhelm the deflationary tendencies that have developed in the private sector.** However, the U.S. economy has much



more debt leverage than in the 1930s, has been running a massive current account deficit for the past two decades, and the dollar is the world's reserve currency, which requires an image of fiscal integrity. **Therefore the potential for unintended consequences (e.g. dethroning of the dollar's reserve status and accelerating inflation) is much greater than it might have been in the 1930s.**

The Chinese stimulus program, which is a bigger program relative to their GDP than is the U.S. stimulus, is almost exclusively aimed at building out infrastructure. This will enhance their productivity, thus reinforcing their economic growth. Furthermore unlike the U.S., China has both a positive balance of payments and their consumer sector has an extremely high savings rate. **Because of their large currency reserves and relatively unleveraged financial position, China is taking advantage of depressed resource prices to create long-term supply arrangements for key raw materials in return for upfront financing.** In energy they have made loans to Russia, Kazakhstan, Venezuela, and now Brazil in return for long-term guaranteed supplies. As a result of their economic growth, they have replaced the U.S. as Brazil's largest trading partner. The Chinese are also attempting to make minority investments in companies such as Rio Tinto, one of the world's largest mining companies. In addition, they also appear to be stockpiling metals and grains in order to diversify their currency reserves, and to take advantage of currently depressed prices. Finally, they are arranging bilateral trade deals using the Chinese yuan rather than the U.S. dollar, further undermining the dollar's reserve status.

The difference between the U.S. and China is similar to the difference between a socially prominent family living beyond its means, on inherited wealth and borrowings, in order to maintain its social standing, and an immigrant family, unconcerned about appearances, and willing to take any employment available in order to save and get ahead. The U.S. has been able to continue these policies because of its military strength, relative economic importance in the world economy, and dollar's reserve currency status. However, our position in the world order is gradually being challenged, and it will be increasingly more difficult to maintain the status quo on a long-term basis.

Government's Heavy Hand

A parallel concern is the current attack on capital formation, savings and investment. For example, the current administration states its desire to wean the country off of its dependence on foreign energy sources. At the same time it is proposing tax increases on domestic exploration companies and limiting offshore exploration. Tax increases cut cash flow and in turn cut capital expenditures. Thus their proposals will accomplish the exact opposite of their goals. This is only one of many examples of proposals that will reduce future investment.

Lest readers feel we are singling out the Obama administration, the problems the U.S. is facing have been building for decades. Much has been made of the Madoff Ponzi scheme. **However the U.S. government has been running a far bigger (if legalized) Ponzi scheme with Social Security and Medicare entitlement programs.** Within the next several years the taxes collected for these programs will not equal their estimated payout commitments. This will then swell the Federal deficit or force serious payout cuts. Just because they are legalized Ponzi schemes does not mean they will not end badly.

The financial bubble issues that the U.S. has been dealing with date back to late 1996 when then Chairman Greenspan recognized the developing bubble. However, he lost his courage to rein it in, when Wall Street screamed not to end the hugely profitable party. In essence we are dealing with a well entrenched elite banker class, multinational corporations, and unions whose influence crosses party lines. In the fall of 2008, under the Bush administration, we witnessed a transfer of government power from a rule of law to a rule of men, as Fed Chairman Ben Bernanke and Treasury Secretary Hank Paulson arbitrarily ran the financial



system by dictate. This rule of men rather than rule of law has continued under the current administration, most recently with the Chrysler bankruptcy. Bondholders who fought for their rightful position were threatened with destruction of their reputations if they didn't accede to the dictated terms.

Political power plays, changing rules of operation, government bailouts with strings attached, and a severe bear market within the last year do not leave investors highly confident. Nonetheless investors do need to survey the landscape and make intelligent decisions for investing their money. While uncertainty reigns, the political process that dominates our culture has an inflationary bias. In fact some main stream economists are now promoting the benefits of a 6 percent inflation rate for several years to stimulate demand. Such talk would have been heresy in the past, but it demonstrates how far policy makers have strayed from orthodox economics in order to prop up the U.S. economy. **Given that there is little, or no, political power in the hands of creditors, the voting power rests with the debtor class in the U.S. (Chart II). Deflation makes debt more onerous for the debtor, while inflation makes debt less onerous. Therefore if politicians and central bankers must make a choice between the two, one has to assume an inflationary bias to the decision process. Holding cash or fixed income instruments, without inflation protection features, is a prescription for purchasing power confiscation. The investor may feel comfortable in a nominal sense but the real value of his money will be in steady decline. Instead, the investor must hold investments that have the ability of rising in value as fast as or faster than the rate of inflation. This may increase the discomfort of short-term volatility in the nominal value of one's investments, but it is a far sounder long-term strategy for preserving one's capital.**

Inflation and Supply Restraints

Those who are sanguine about an inflation problem in the next few years point to the output gap in the world economy. They argue that it will take several years of strong economic growth to close that gap between demand and capacity, before inflation could be an issue. In an average sense they are correct, but averages consist of variations around the mean. There may well be excess auto assembly plants, for example, but other key areas such as energy, water, grains, and certain metals may quickly reach capacity limits. Those areas will experience sharp price increases well before broad gauges of inflation pick up the trends. Entities producing these items will benefit as money flows to these areas at the expense of end users of these items.

The credit crunch in 2008 and the economic fallout impacted both demand and supply. The effect on demand was more cyclical and typical of a recession than a permanent demand shift. Prior recessions have also experienced temporary demand destruction. However demand has quickly returned to trend growth in the past, once economic growth returned. Furthermore, because the primary driver of demand growth for basic raw materials is the developing world, evidence suggests that demand is already picking up, before the developed world turns the corner.

With regard to supply, the credit crunch occurred too soon to allow planned capacity expansion in mining to develop. The result is a severe setback in capacity additions for many years. Industrial metal prices, such as copper, are beginning to anticipate a renewed recovery. Once demand picks up, supplies will again become tight. Therefore both metals futures as well as mining companies should offer significant returns.

Turning to energy, there are serious questions as to whether sufficient new supplies can be developed regardless of time and price factors. In spite of extremely high prices for oil, the world has failed to replace more than a third of its annual consumption for the past several years (**Chart IV**). Non-OPEC production has probably now peaked. Most of non-OPEC production increases in the past decade were the result of increasing Russian production, which peaked in 2007. Only a handful of OPEC countries, primarily Saudi Arabia, have the ability to increase production. Because the annual attrition rate of existing world oil fields



is approximately 5 million bbls. a day, **the world needs to find the equivalent of one Saudi Arabia every two years just to maintain existing production levels.** This is probably an impossible task and is likely to lead to a new oil crisis within the next few years. The efforts in developing alternative energy are not sufficient, nor will they occur quickly enough to forestall this crisis waiting to happen. As an energy crisis takes hold we anticipate that the U.S. government is likely to fund an alternative energy program comparable to the Manhattan Atomic Bomb Project or the Space Program. Within the energy sector both direct investment in energy futures, as well as energy, energy service, and alternative energy companies should provide significant absolute as well as relative returns for the investor.

The second potential area of major crisis is fresh water and food supplies. Water shortages are an increasing problem for both China and India. Since agriculture consumes 70 percent of fresh water supplies, countries that are moving up the economic ladder, especially if they are water short, tend to give up agriculture for industrial activities. This has the effect of placing greater demands on those areas with sufficient water. Affluence also increases demand for more per capita meat consumption. Meat in turn requires from two to seven times as much grain to produce a pound of meat versus direct consumption of grain. While there is additional land that can be brought into production, there are ecological issues, such as the rain forest in Brazil. In addition, scarce water supplies will limit expansion. Thus the global supply/demand balance in agriculture will remain tenuous in the years ahead (**Chart V**). Direct investment into grain commodities should offer significant returns, as should companies which are developing better strains of seeds or that produce fertilizer.

Tied closely to the story for metals, energy, and water/agriculture is the need for massive infrastructure investment globally. Developing countries are building out infrastructure for the first time while developed countries, such as the U.S. desperately need to replace aging infrastructure. In addition, new alternative energy technologies will require build outs and mass transport will be required to help solve the expected energy crisis.

The Dollar

Our final investment theme revolves around an expected continuation in the dollar's gradual dethroning as a reserve currency (**Chart III**). We do not expect this to happen quickly but believe that it is inevitable. What will replace it is another unknown. The dollar was made the world's reserve currency in 1944 at a point when the U.S. dominated world GDP, ran a positive balance of payments, and had a positive net investment position in the world. Today these conditions do not exist, but the world has a major investment in the status quo. Countries such as China have huge holdings of U.S. Treasury debt and are between a rock and a hard place as far as extricating themselves from their position. How do they keep from accumulating more dollars without losing value on their current holdings.

Tensions surrounding the dollar's role and its value will continue to build. The dollar needs to decline in order for the U.S. to become more competitive in world markets and correct its huge balance of trade deficit. However, a decline of sufficient magnitude would put many other countries' industries in a non-competitive position. **Therefore dollar weakness will likely lead to foreign country intervention in currency markets to protect their relative position. To do this will require faster money supply growth in countries that intervene. The net effect will be accusations of the U.S. exporting inflation as happened in the 1970s. Thus while we see moderate dollar weakness we do not anticipate a collapse as might happen to a smaller country whose currency is overvalued. Thus there will be increasing currency instability, higher inflation globally, and significantly higher precious metals prices as investors seek an alternative store of value.**



Summary

As a result of cumulative Federal Reserve stimulus and government spending policies, the greatest threat to investors in the future is likely to be significant loss of purchasing power through accelerating inflation. A secondary threat will result from investor uncertainty due to increasing regulation, anti-capital taxation policies, and the increasing tendency of rule by men rather than rule by law. Efforts to preserve capital through high cash balances or heavy reliance on fixed income investments will suffer severe loss of purchasing power.

Successful investing in this environment will require a heavy emphasis on strategic commodities, precious metals and equities benefiting from the production, and development in these sectors or from infrastructure development. Equities are likely to be increasingly viewed from the standpoint of their underlying asset values as an inflationary psychology takes hold. So long as the Federal Reserve and other central banks maintain expansionary credit conditions and artificially low interest rates, leverage is likely to benefit investors. This investment strategy will be subject to short-term volatility but should succeed in preserving purchasing power of one's capital, the most serious threat facing an investor today.

AIS Investment Strategies (www.aisgroup.com/products.html)

At AIS we manage portfolios by employing a combination of four investment strategies that have the potential to invest across a wide range of asset classes, from traditional equities and fixed income, to gold bullion, and futures on both commodities and financial assets. The strategies vary in terms of investment instruments employed, whether short-selling is employed, and whether and to what degree leverage is employed. In each strategy we begin with our global macro view outlined in this paper. Some investors have hired us to allocate to these multiple strategies, while others have hired us for only one strategy. We believe strongly that it is to the investor's benefit to include a wider array of asset classes. Below is a brief description of our four strategies. We would welcome the opportunity to discuss them in more detail.

TAAP is a tactical asset allocation program that invests in four asset categories, equities, bonds, gold bullion, and cash equivalents. This portfolio uses no leverage and does not sell short. The ability to invest in gold as well as traditional financial assets has served investors extremely well in this past decade.

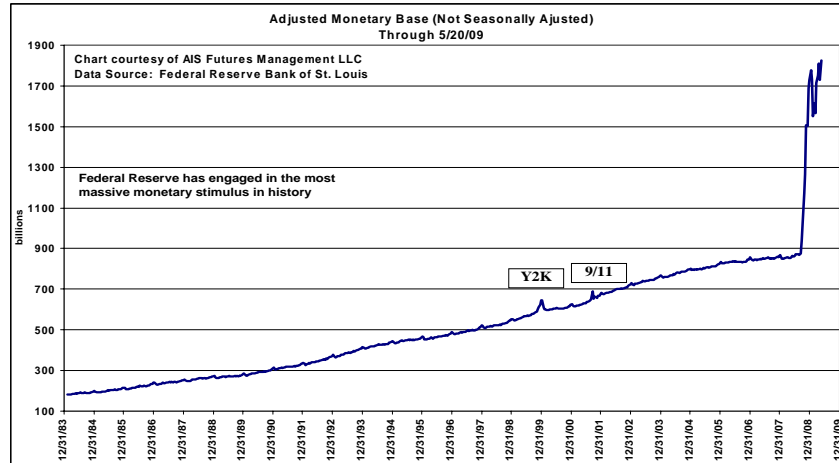
Capital Growth is an equity strategy that uses macro investment themes to identify attractive and unattractive sectors to position both long and short. Individual (long) equities are selected on the expectation of their ability to outperform the general market on a 12 to 18 month time horizon due to their industry or sector position as well as to individual company characteristics that give them superior investment potential. Short positions are taken in either individual companies or in index futures as a way of hedging market risk.

Gold Strategy invests in both precious metals futures contracts and individual mining companies. Global macro and technical investment techniques similar to those employed in our other strategies are employed in this investment program. The portfolio of individual companies emphasizes geopolitical safety and a range of both major companies and select junior development companies.

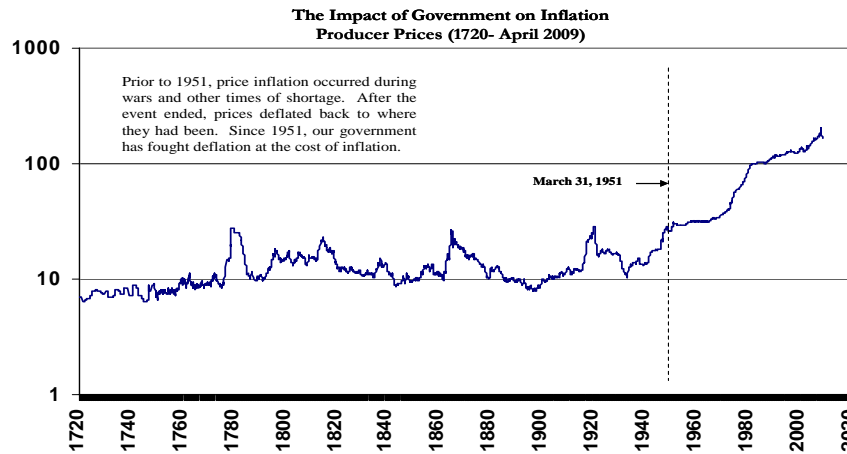
MAAP is a discretionary, diversified, long term futures portfolio that maintains either long or short positions in six different asset groups, equities, fixed income, currency, energy, grains, and metals. MAAP is unique among diversified futures programs in that its allocation to physical commodities is two to four times that of most other futures programs. The 2X-4X program has aggregate contract positions, whether long or short, that range between 2 and 4 times the equity in an account. The 3X-6X program has aggregate contract positions of 3 to 6 times the equity in an account.



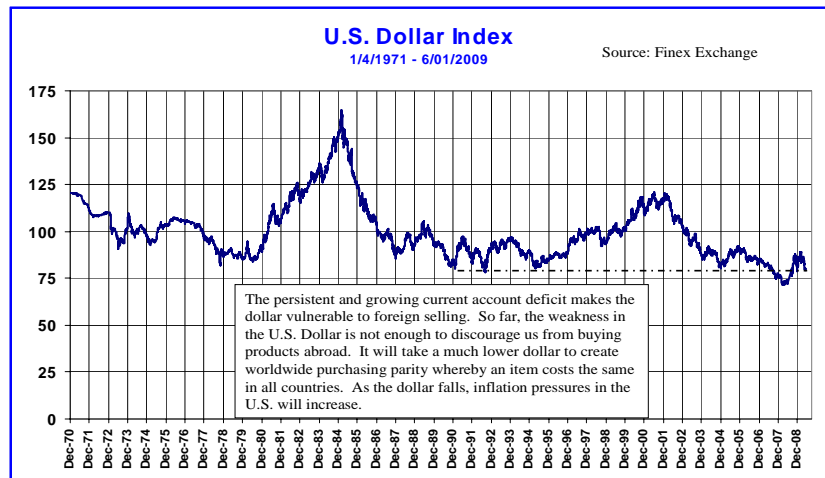
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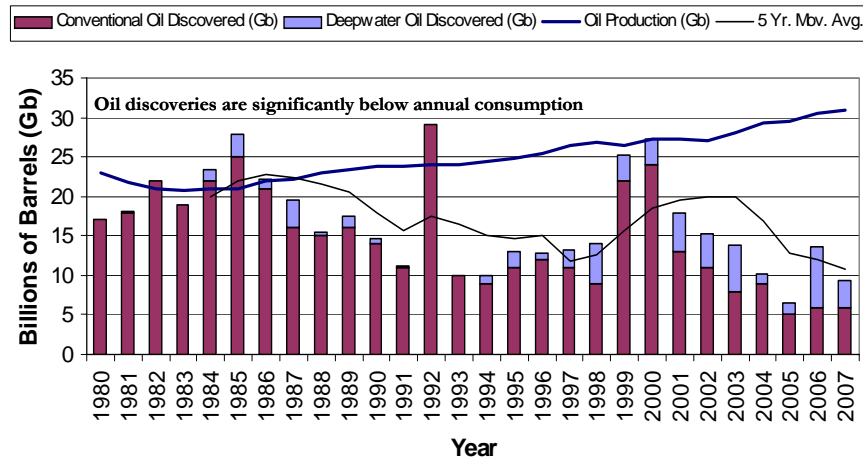
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IV.

Global Oil Discovery (1980 – 2007)

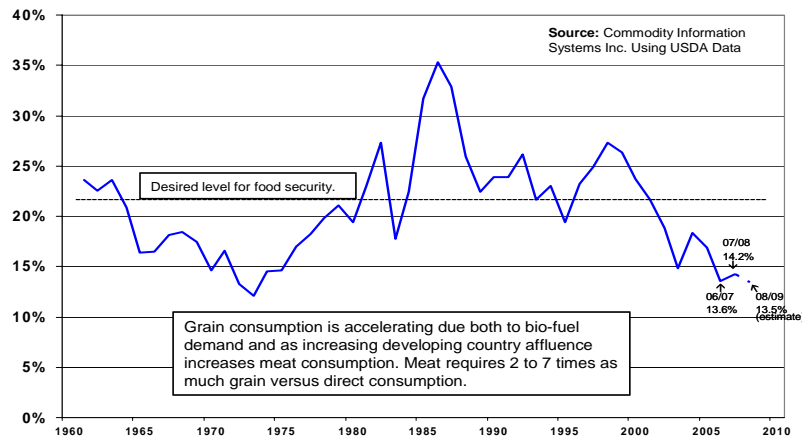


Source (Oil Production): BP Statistical Review of World Energy June 2006

Source: 2007 Est. AIS Futures Management LLC

V.

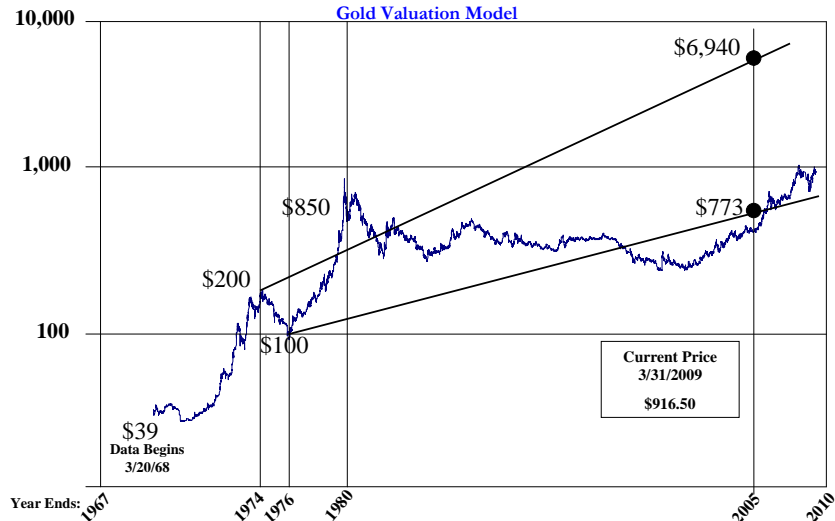
Total World Grain (1961/62) – (2007/08) Crop Years. Ending Stocks as % of Annual Usage (2008/09 Estimate)



Source: Commodity Information Systems Inc. Statistics Yearbook

VI.

Gold Valuation Model

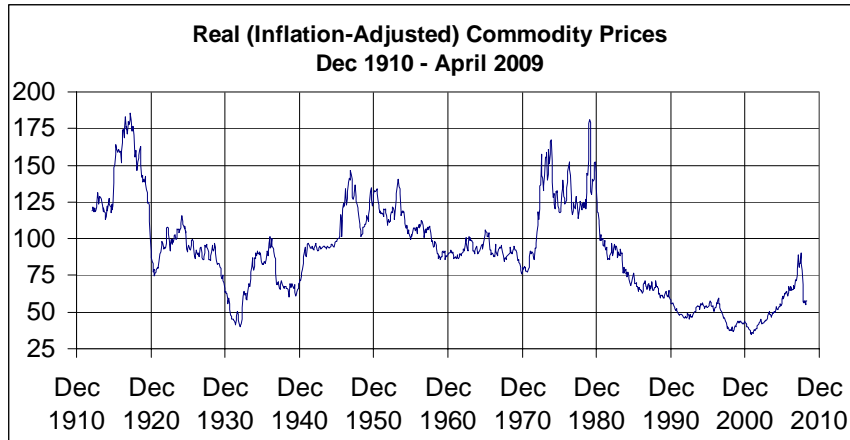


This gold valuation model compares the historical relationship of the market price of gold versus the growth in various monetary aggregates and debt statistics. In constructing the band December 1974 and December 1976 were selected since they represented key high and low points after U.S. citizens were once again permitted to own gold. The monetary/debt valuation model is not used in the TAAP investment decision process which relies on absolute and relative price movements for key buy and sell decisions.



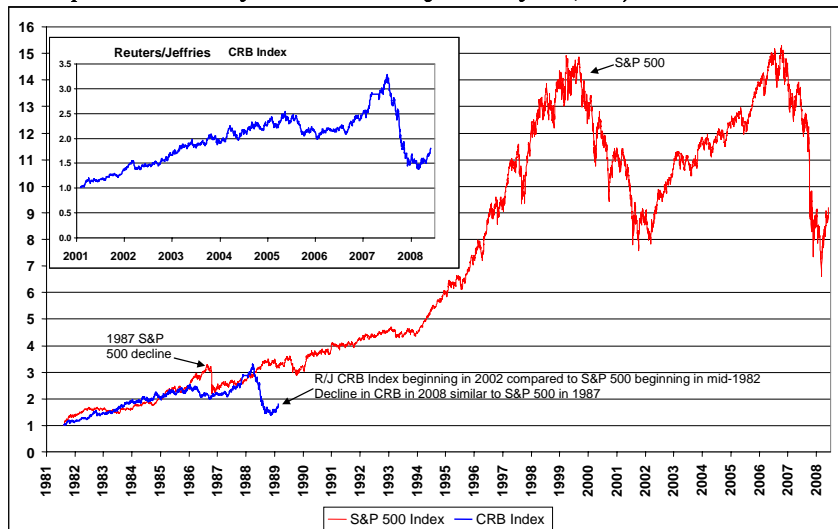
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Approximately every 30 years, demand growth has exceeded supplies which has led to significant price advances. Historically, these price advances have lasted approximately 10 to 15 years as new supplies often take time to be developed. Current low real prices suggest that we are in the early stages of this commodity bull market.



VIII.

Comparison of Reuters/Jefferies CRB Index (Jan 2002 – June 1, 2009) with S&P 500



IX.

