



Investment Strategy

April 4, 2011

From Surplus to Scarcity—Aligning our Thinking with Reality

Sell What the Governments Can Make (i.e. Paper Currencies)

The Federal Reserve is trapped by the excess private debt and speculation they allowed to develop from the late 1990s up through the present. If they don't continue their unprecedented easing policies, the high levels of unemployment and the weak housing market could cause economic weakness to return. Therefore in spite of rising inflation pressures, they are likely to continue stimulative monetary policies. In this environment gold is becoming an important and growing alternative store of value as both central banks and private investors seek an alternative to fiat currencies being debased by governments. Journalists like to talk about bubbles in gold and commodities, but the only real bubble is government financial excess.

Own What the Developing World Wants and Needs

The world is in the midst of the greatest expansion of people entering what economists define as middle class. History shows that regardless of the culture they come from, they develop similar spending patterns. This is placing unprecedented demand pressures on all types of basic industrial and food commodities. Supplies of these items will be strained by this demand and prices will rise to substantially higher levels.

In December 1999 we wrote a paper entitled “Can a Bear Market Be Hiding Behind the Goldilocks’ Stock Market”, questioning the continuation of the prevailing bull market in stocks. Little did we know at the time how prescient that call would be as a significant bear market commenced in 2000.

In April 2001 we wrote a paper entitled “The Coming Commodity Inflation Tsunami” suggesting that commodities then at an all time inflation adjusted low offered an attractive investment opportunity. That call was a few months early as commodity prices did not bottom until October 2001.

In late 2007 and early 2008 although our investment strategies took a bearish stance on the stock market, our research work concluded that the long-term commodity bull market was far from complete and we underestimated the extent of the subsequent liquidity squeeze on all assets, including commodities. With hindsight, the 2008 decline in commodities appears to have similarities with the 1987 stock market crash. It was a severe interruption in an ongoing bull market.



We continued with our bullish view of commodities in 2009 and remain convinced that the factors driving commodity prices will remain unusually positive for the foreseeable future. The unprecedented confluence of events from excessive monetary and debt creation in the developed world, combined with the massive expansion of the middle class in the developing world, could create one of the greatest commodity and precious metals bull markets in history. In this environment investors are being forced to throw out the old investment rules as Federal Reserve policy has destroyed returns on what have historically been defined as low risk investments. To achieve acceptable returns additional risk and volatility must be accepted. Currently owning what historically have been considered high quality debt instruments (i.e. U.S. Treasuries and insured bank deposits) are providing savers with inadequate nominal returns and may in the future subject the investor to negative real returns as inflation rises.

Investors like reference points (precedents from the past) from which to make decisions. Unfortunately the U.S. financial markets are charting new territory in many respects. Most investors employ a rational analytical thought process in constructing their portfolios, but they are also conflicted by the emotions of fear and greed. They operate on a memory bank of prior experiences. If current economic or financial inputs are similar to the past, humans can be expected to make informed decisions. When conditions change, investors struggle. They try to make sense out of new data, but attempt to organize it around past expectations. Markets under these changed circumstances often take time to properly discount reward and risk. This creates both opportunity and possible losses for investors who fail to adjust to new realities.

The current period is one of those challenging times. Within the three year memory bank of investors is the powerful 2008 first half advance in commodity markets followed by the financial crisis in the second half of 2008 through early 2009. For most investors this financial crisis was the most devastating in their lifetime, both in real financial terms and emotionally. As a result fear still dominates as the overriding emotion. For many it is difficult to separate the emotion of fear from factual reality. By this we are not suggesting that the fundamentals are all rosy, simply that the emotion of fear continues to weigh heavily on the process of decision making. In fact the financial economic environment remains stressed and overleveraged creating all types of distortions that the investor must deal with. Therefore as individual commodity prices have approached or exceeded first half 2008 levels, many investors have one foot out the door, fearing a repeat of the fall of 2008. This is especially true if the investor has never owned gold or commodities, or was late investing in the prior cyclical advance, entering the market in its last couple of quarters of 2007 or early 2008. For the latter, there is a powerful desire to “get out even”, regardless of whether the fundamentals argue for much higher prices.

While in many respects the world remains in a high risk financial environment, we continue to believe that the commodity markets are in an extremely bullish long-term trend to much higher prices. The most profitable time period for being invested in commodities and precious metals may still lie ahead. Chart I illustrates the movement



of commodity prices adjusted for inflation over the last 100 years. During most of this time period the consumption of commodities was dominated by a small portion of the world's smaller total population. The U.S., Europe, and Japan represented about 15 percent of the world's much smaller population in the last century, while consuming the vast majority of these commodities. Beginning in the last decade, the economic emergence of the developing world began to dramatically change the dynamics of commodity consumption. As one can see from Chart I, the current commodity bull market commenced in 2001 from what was an all time low in inflation adjusted terms. During most of the past 100 years the world economy was awash in supplies of commodities. Unlimited supplies were taken for granted. Even at the peak of commodity prices in June 2008, commodity prices adjusted for inflation were closer to their all time lows than to prior peaks. The financial crisis of 2008 caused a sharp correction in commodity prices. A renewed uptrend has commenced but in inflation adjusted terms, prices still remain less than half of the prior peak levels. When one considers the massive increase in potential demand from the world's expanding middle class, within a much larger worldwide population, a strong case can be made for prices significantly exceeding the prior inflation adjusted historic highs.

A Quick History of Significant Monetary Changes

Before a more detailed discussion of the current environment, and the basis for expecting a major further rise in commodity and gold prices, a brief review of the last century's monetary history is in order. In the early part of the last century, the world was on a gold standard, the British pound was the key currency, and central banks were established in the developed world, primarily to provide liquidity at key times of the year (e.g. harvest time) when liquidity was scarce. This was done in order to stem bank runs and financial panics. WWI and its aftermath created financial strains in a number of ways, including the runaway inflation in the Weimar Republic in Germany, and an overvalued British pound, which led to Britain's abandonment of the gold standard. A vacuum of leadership developed as the world searched for a new monetary structure to replace the old gold standard and the British pound for international transactions.

The roaring Twenties brought stock speculation, the stock market crashed in 1929, and a global depression developed, which ushered in the more activist Roosevelt administration in early 1933. It is important to remember that at this time central bankers and governments did not believe they could influence business cycles or promote economic growth. As activist as the Roosevelt administration was, it was still operating with a very different mindset in terms of what it felt it could accomplish. The administration may have been filled with those who were convinced that capitalism was a failure; but it lacked a conviction, that exists today, that government can promote full employment, economic growth, greater wealth, and continual prosperity. Central bankers remained most concerned about defending their respective currency's integrity and value, not promoting full employment.

Significant changes occurred as the Roosevelt administration first eliminated private ownership of gold, abrogated gold payment clauses in contracts and bond covenants,



and then raised the gold conversion price from \$20.84 to \$35.00. As WWII wound down the Bretton Woods conference in 1944 established the U.S. dollar as the world's reserve currency. Foreign central banks (but not private individuals) were allowed to convert any dollar holdings into gold at \$35 to the ounce. Congress passed the Full Employment Act in 1946 encouraging government to enact policies that would promote economic growth and employment. The Kennedy administration went further, as their Harvard trained staff economists were convinced they could eliminate recessions through Keynesian deficit spending, whenever the private sector's growth would slow. The Nixon administration took a further step in August of 1971 by eliminating the ability of foreign governments to convert U.S. dollars for gold. A full fiat (un-backed) dollar now became the world's standard for transactions giving the U.S. an unrestrained ability to run deficits without worrying about financing these deficits.

The fiat nature of the dollar and its continued acceptance as the world's reserve currency enabled subsequent administrations and the creativity of Federal Reserve Chairman Alan Greenspan to first finance the speculative blow off of the equity markets in the late 1990s and then the subsequent housing bubble and debt extravaganza in the past decade. The current chapter of this evolving monetary policy is now headed by Federal Reserve Board Chairman Ben Bernanke, an academic student of the 1930s depression, who has now introduced a new phase of policy with Quantitative Easing, the Fed's buying of longer dated Treasury and mortgage securities.

The U.S. Dollar is No Longer Your Grandparents' Dollar (See Charts III & IV)

We think it was important to take a cursory review of this monetary history because living Americans, born and raised here, have never lived through invasions, government overthrow, or events that have led to replacement of their currency. On the face of it one could easily think that we have always had the same dollar. However, behind the face of that dollar has occurred significant change. One outcome of these changes is apparent in Chart II, which illustrates 200 years of inflation in the U.S. Prior to the middle of the last century the U.S. experienced price stability. The nation periodically experienced inflation, primarily during war times, after which, deflation returned the price index to its prior level. However after the depression of the 1930s and WW II something changed. Since then we have been living in an environment of continual inflation—periods of accelerating inflation followed by disinflation but not deflation. The private sector has a natural tendency to revert to deflation during periods of recession, as debt and malinvestment are wiped out by business failures and individual bankruptcies. With the advent of more extensive economic involvement of government and counter cyclical Federal Reserve policies, these private sector tendencies of deflation have been overwhelmed.

A Changing Economic Environment

Each succeeding business recession has been met by more aggressive Federal Reserve intervention and greater Federal deficits. It was possible to carry out these policies first because other countries would accept our dollars in unlimited amounts,



and, second, inflation was slow to materialize as raw materials were usually in surplus. This typically would allow easy monetary policies for several years before price increases would begin to occur.

In the last cycle circumstances appear to have shifted dramatically. While the amount of fiscal and monetary stimulus needed to stabilize the U.S. economy in the last two recessions has never been greater, the response time for higher commodity prices has been shortened dramatically and the degree of price rises has dwarfed prior cycle increases.

With rates extremely low in the U.S., a carry trade of sorts has commenced where individuals and businesses are moving funds abroad to seek higher returns. This in turn feeds the economic growth in the developing world which is strong anyway. Developing growth in turn is stimulating commodity demand, as economies in an earlier stage of economic growth are much more commodity intensive. This rising demand in turn is driving commodity prices to new levels. In the most recent monthly trade report for China, their imports were up 50 percent in monetary terms, but only 25 percent in terms of quantity of goods imported. The other 25 percent was due to price increases. Inflation is becoming a serious problem in the developing world. Overall price increases in China are just under five percent and food inflation is now approximately 10 percent. In places like India, inflation is even higher. China and other developing countries have raised interest rates and/or tightened bank reserve requirements in order to slow inflation and economic growth to more manageable levels. While these tightening moves may temporarily slow economic growth, these countries have no desire to stop growth. In addition they may also begin to allow their currencies to appreciate at a faster rate against the dollar. While this may hurt their exporting industries, it will help by lowering import costs given the strength of their internal consumer spending growth; this may be a better solution than higher interest rates in these countries. It will also further stimulate commodity demand.

In time this inflation will spread to the developed world. For items like food and energy, it is already occurring. But the Federal Reserve likes to look at "core inflation" which excludes food and energy. This provides them with the political cover needed to keep monetary policy easy in order to address the low level of capacity utilization and soft labor market in the U.S. While they are correct that substantial unused capacity and labor exist in the U.S., we are not in a closed environment. Rising prices elsewhere will infect the U.S. as world demand is creating scarce supplies.

While the past decade experienced powerful new demand trends in the consumption of commodities, the next decade will dwarf these demand levels. The big question is whether or not supplies will be adequate to meet this demand. In commodity after commodity, China, in the past decade, has gone from being either self sufficient, or a slight net exporter, to becoming either the largest, or close to the largest, net importer of these items. For instance, they are major producers of soybeans but are now importing roughly half of the world's soybean exports. They were nominal net exporters of oil until 1996 and are now the second largest importer behind the U.S., even though their per



capita consumption of oil is only slightly more than a tenth of ours. One could site similar statistics on many other basic commodities, whether industrial, food, or precious metals, where their economic growth now requires major dependence on imports to meet their needs.

A Tipping Point for the Developing World (See Charts V to X)

The developing world is reaching the tipping point where several factors are at work driving demand for basic commodities. First, developing country governments and their private citizens do not have the debt burdens that exist in the developed world. Second, large numbers of people are entering middle class status which accelerates their demands for animal proteins and all types of industrial commodities in order to experience more convenient lifestyles. Third economic growth leads to greater urbanization which also places greater demands on industrial commodities. Finally, developing economies have now reached a size where their continued growth ratchets up overall global economic growth even with a continuation of sluggish growth in the developed world.

The middle class will likely grow from 1.8 billion people in 2009 to 3.2 billion in 2020 and is forecast to grow to 4.9 billion people in 2030, with 85 percent of these people in Asia. China's middle class was estimated to make up 12 percent of its population in 2009, 43 percent in 2020, and 75 percent in 2030. While India is further behind China in this regard, their population is growing faster, and the number of Indians entering the workforce will surpass all other countries. In summary, demand growth is the bright side of the equation. Whether the world's supply of food and other commodities can meet these growth projections is the unknown question.

Limitations of Supply

Several factors, which are interrelated could create supply limitations going forward and in turn strain global growth. First with regard to extraction industries (e.g. mining and oil drilling), grades of ores and the types of petroleum being found are of lower quality and/or smaller deposits than in the past. They are also often located in less hospitable locations both geographically and politically. In addition, extraction and agricultural activities are energy intensive and have become more so over time. With regard to the tar sands in Canada, intense amounts of energy are needed to liquefy the tar so that oil can be extracted from the ground. There is often a tendency to focus on huge potential reserves in the ground, suggesting that there will be no potential shortages in the future. However, with the types of less conventional oil still available, the flow rate out of the ground is a more critical factor than the ultimate reserve size in the ground. Non-conventional oil reserves do not have anywhere near the flow rates that conventional oil wells might have.

The global discovery rate for oil peaked in the mid-1960s and for roughly the past 24 years the world has been consuming more oil than it has been finding. In the past several years discoveries have been less than half of what has been consumed. Oil



field flow rates usually peak or plateau when roughly half of the extractable oil has been taken from the field. From that point, annual production goes into gradual decline, which on average is approximately a four percent decline rate. Therefore the world must locate new oil deposits just to maintain existing production rates, let alone increase annual production. Uninformed optimists point to technology and alternative energy. Unfortunately the quantity of energy they are likely to provide is estimated to be very limited by the most respected analysts. Therefore the world may be facing restraints of supply that at a minimum will lead to much higher prices. At its worst it could create more severe economic disruptions and political turmoil.

Equally considerate of thought are the potential restraints on fresh water and food supplies. The green revolution which doubled food production in the last several decades was accomplished by tripling the use of water and energy inputs, through irrigation and fertilizer use. Water is in critically short supply in both China and India. Agriculture consumes 70 percent of fresh water supplies. Wheat for instance requires 1,000 tons of water to produce one ton of grain. As these Asian countries, as well as other water short areas such as the Middle East, industrialize and become wealthier, they will partially solve their water shortage problem by importing more of their food supplies. In addition as they move to more meat protein, the quantity of grain required will increase substantially. It takes two to seven times as much grain to produce a pound of meat than for people to gain the same level of nutrients if they consume grain directly. Therefore the growing middle class in the developing world will put major strains on those countries with sufficient water supplies, which are capable of producing grains and animal proteins.

Already many Asian and Middle Eastern countries are seeking long-term contracts with grain growing countries and with African nations that are less developed. In African nations, many cultures do not have land ownership as we do in the west. As a result in some of these countries, government officials have committed large, previously nomadic, land areas to become modern new mechanized farms. Unfortunately these new farms will prohibit nomadic groups from using the land or employing them in any significant way. As a result the poorest members of the society will be most negatively impacted by these changes. Lack of food at reasonable prices has already contributed to political unrest in the Middle East and elsewhere and may well become a bigger issue in the future.

As the world increasingly struggles with limited food supply and higher prices, the questions of converting grains and sugars to bio fuels, and the current government subsidies encouraging these processes, are likely to be reconsidered. Currently nearly 40 percent of the U.S. corn crop goes into ethanol for mixing with gasoline, and receives a federal subsidy.

The Federal Reserve's Dilemma

Since the 1930s the U.S. has gradually created a set of social welfare programs and a debt trajectory that its economy ultimately cannot support. Each administration and



political party has participated in this process to one degree or another. Because the U.S. has had such a powerful economy and military presence in the world, combined with the dollar serving as the world's reserve currency, it has been able to carry on these policies well beyond what other countries could get away with. Although this process has gone on for decades, the Greenspan Federal Reserve ratcheted policy to a new level. From late 1996 through 2007, inflated asset values of equities and then real estate, became a source of spending to stimulate economic growth beyond what incomes would have supported. Now the current Federal Reserve Chairman, Ben Bernanke, introduced Quantitative Easing (QE 1 and QE 2), whereby the Fed has begun buying longer dated U.S. Treasury and mortgage securities in a further attempt to promote job growth and spending by stimulating equity and real estate values. The side effect of this policy is to send capital to faster growing developing countries with higher rates of return. In turn this is driving up commodity prices and precious metals prices. Smart investors are seeking cover in things the government can't manufacture at will. Bernanke may talk about his ability to recognize inflation when it appears, and his ability to control it; however we question the Fed's ability to shift gears on a timely basis. We question its ability to move against inflation both because of the lead times needed in shifting policy and from a lack of political will, given the high level of unemployment. If food and energy prices are rising and squeezing consumers' budgets, he cannot sit idly by and allow a new recession to unfold. A new recession at this point would be devastating and further crush the private sector. The Federal Reserve would have no choice but to continue their easy money policies to offset any economic weakness. If they have to choose between a recession with potential deflation or accelerating inflation, they will choose the inflation route, as it will be less socially destructive, at least in its early stages. We expect inflation and a further significant rise in the price of gold from policies already in place for the last several years. Equities that are perceived to have rising underlying asset values will also benefit. The purchasing power of fixed income investments will be gradually destroyed.

Regardless of whether there is a QE 3, as QE2 ends in June, Federal Reserve policy is likely to maintain unusually low interest rates and an accommodative monetary policy for at least the remainder of the 2011. There is division on the Fed's Open Market Committee as to whether further QE is required. Those most favoring it base their argument on continued high unemployment, a sluggish housing market, and a view that current inflation is transitory. Those opposed argue that the economy has sufficient staying power without additional monetary easing and fear inflationary expectations are becoming more imbedded in the system.

The real challenge will develop if inflation continues to spread while job growth remains anemic, wages remain static, and consumer budgets are squeezed. In this scenario very slow economic growth is the result. This confluence of events would likely weaken stock and housing prices further exacerbating the situation. In our view this is the real fear of Federal Reserve Chairman Bernanke, as well as several other Federal Reserve Open Market Committee members. For this reason Bernanke will continue to talk a good game on inflation, and point to its transitory nature in impacting only items which



are “beyond their control”. This will give him cover for additional QE if he believes it is required.

Regardless of how the intermediate term plays out, unless the American public is willing to accept an extended period of economic austerity, we are probably going to remain on this path that our economy cannot ultimately maintain. Ultimately, this path will likely lead to some type of currency/debt crisis. At some point foreign holders will refuse to accept greater amounts of U.S. debt or the dollar as reserve currency. Our primary argument for the probability of significantly higher gold prices is the over four decades of excessive increases in foreign held U.S. debt and the total increase in fiat currencies held by all governments as the basis of their official reserves. Ultimately the owners of these government created instruments are holding a liability of questionable value. Foreign held U.S. debt has increased at over 16 percent a year for four decades and total world currency reserves held by all governments have increased at over 14 percent a year in the same time period. Total above ground gold supplies have increased at less than two percent per year. As the questionability of these liabilities increases, gold’s alternative as an asset, not a liability, takes on increasing importance as an alternative store of value. Given how little gold is held in either official government portfolios, or by the private sector’s portfolios, it may have considerably further to increase in value.

Summary

One of the most emotionally challenging investment paths is to take positions that are different from that of the consensus. However doing so often creates opportunity that the consensus misses out on. We believe this is one of those periods where the reality of the situation is pointing to important change. The developing world is rising in importance while the developed world is being weighted down by decades of political and economic overreach. In the process the conventional wisdom of what constitutes prudent investment policy is being turned on its head. The idea that the U.S. dollar and U.S. Treasury and Treasury guaranteed debt are not the safest investments is a hard pill to swallow. The idea that investments in debt not only fail to provide respectable nominal interest returns but also could have their value trashed by unexpectedly high inflation is a sad state of affairs.

For investors to protect the purchasing power of their assets and receive an adequate return now requires accepting more volatility of daily price movement. However, investments that are in gold, food and industrial commodities, or companies that are benefiting from developing world demand and precious metals mining should outperform future inflation and provide the investor with more than sufficient reward for the additional daily and annual volatility they may experience.

Any decision to invest in any AIS product must be made solely on the information provided in the necessary documents to effect the transaction which will be provided upon request. All of the material presented here is either historical fact believed to be reliable or AIS’s opinion of the future. As such, any characteristic of AIS products portrayed on an individual basis or in combinations with other AIS products or other more common traditional investments, including the ability of AIS products to mitigate volatility, declines in account value, or even make positive returns are historically based and may or may not continue into the future.

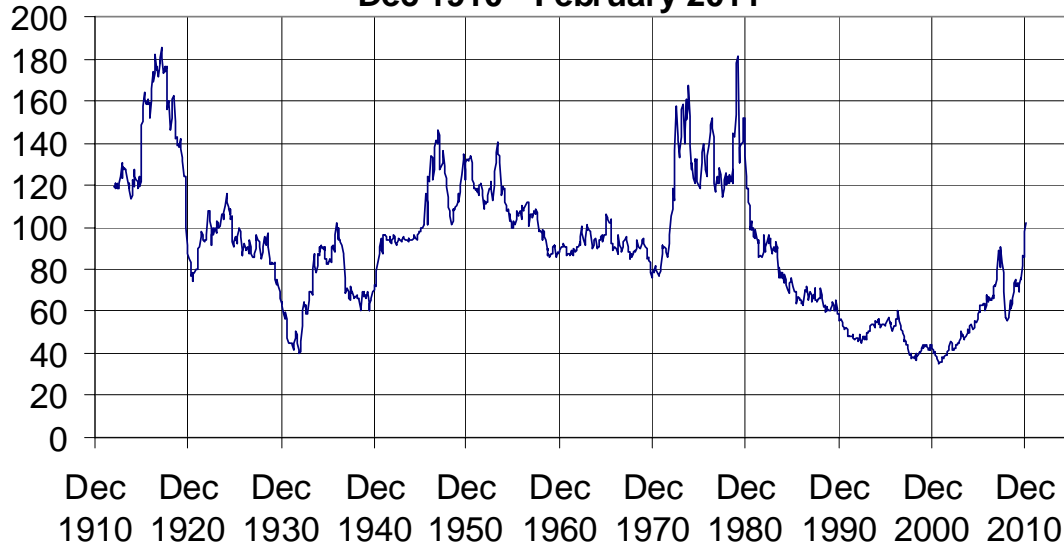


I.

Appreciation Opportunities

Real (Inflation-Adjusted) Commodity Prices: Dec. 1910 – Feb 2011

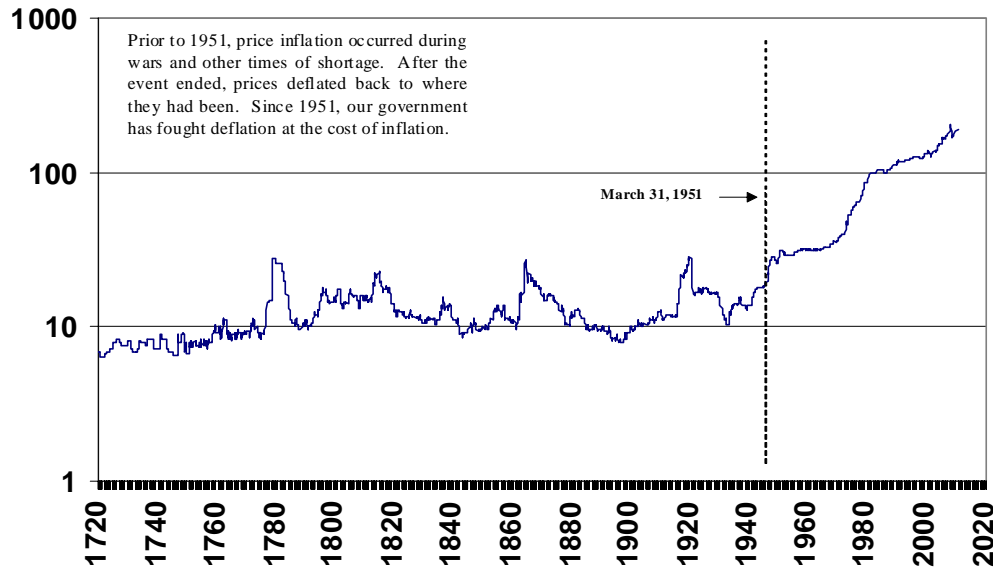
**Real (Inflation-Adjusted) Commodity Prices
Dec 1910 - February 2011**



II.

The Impact of Government on Inflation

Producer Prices (1720- November 2010)

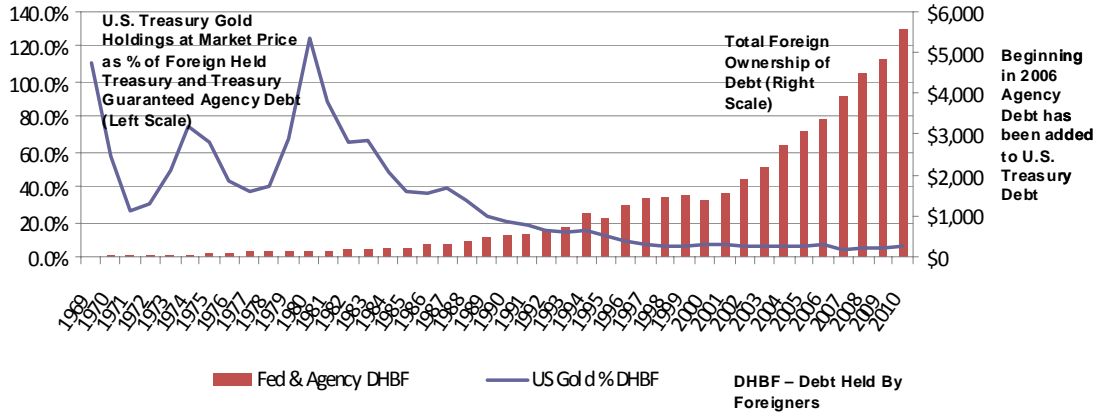




III.

**U.S. Gold Reserves Versus Federal and Agency
Debt Held by Foreigners
(1969-2010)**

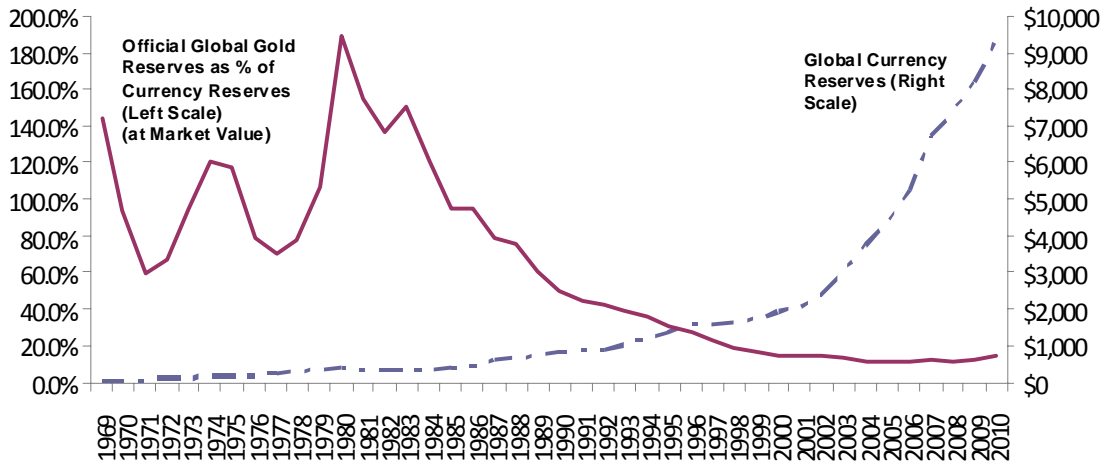
(\$ in Billions)



IV.

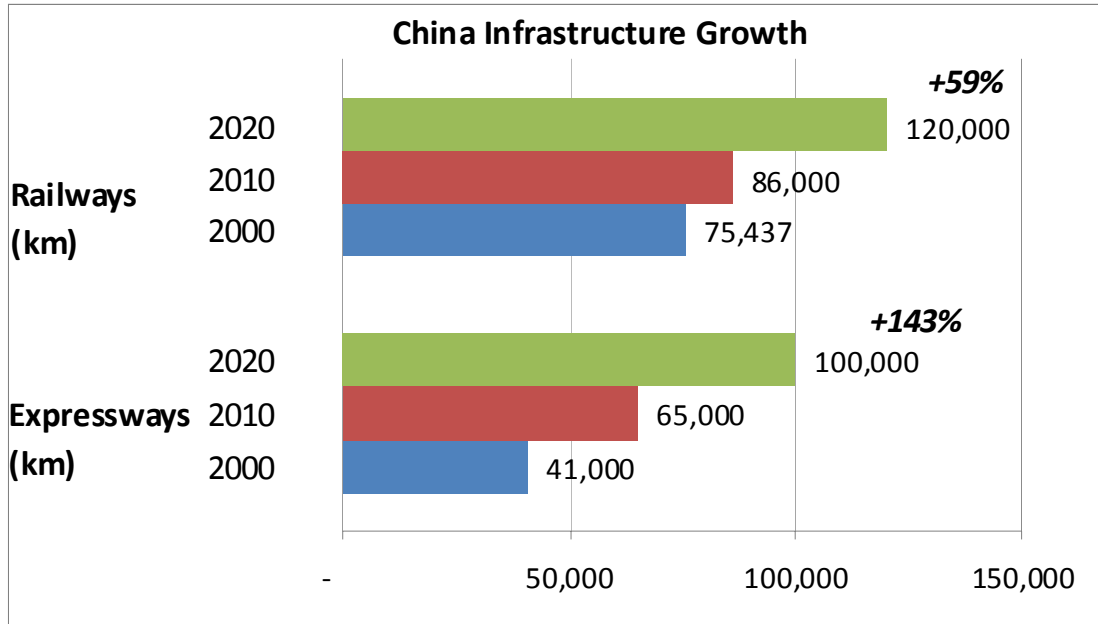
**Total Global Government Gold Reserves Versus
Total Global Government Foreign Exchange Reserves**

(\$ in Billions)





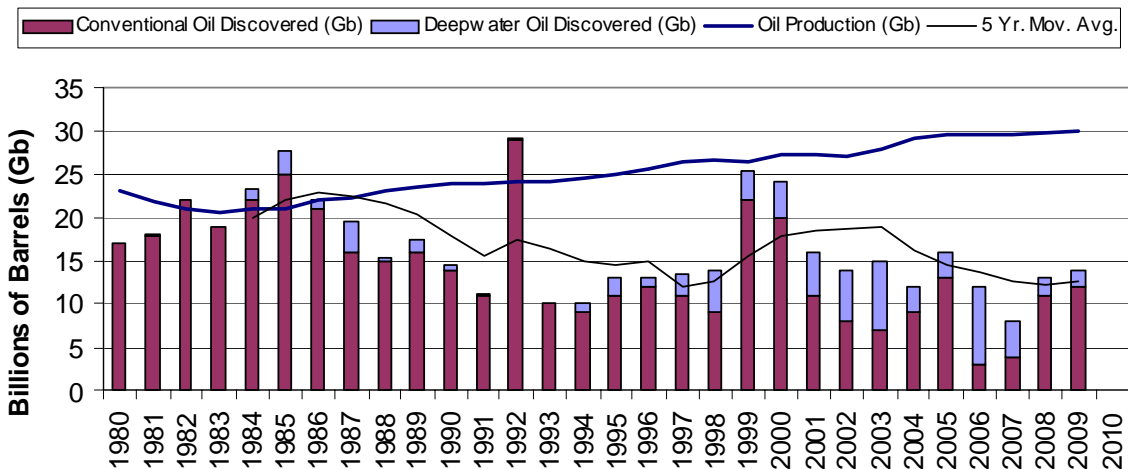
V.



VI.

Global Oil Discovery (1980 - 2009)

5-year Moving Average for Oil Discovery



Source (Oil Discovery): Dr. Colin J. Campbell, ASPO
Source (Oil Production): BP Statistical Review of World Energy 2009



VII.

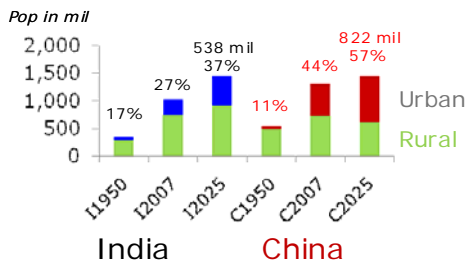
Oil Consumption



VIII.

Demand for Grain – Wealth Effect

China and India are more urban and wealthier...

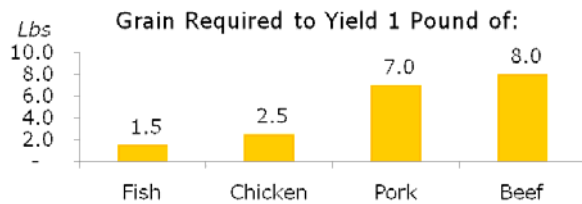


And eating more animal proteins...

Per capita meat consumption	China	India
1970	9 kg	3.6 kg
2000	50 kg	5.0 kg

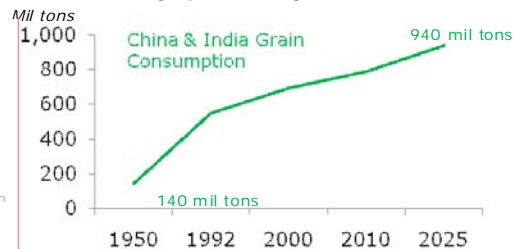
Source: Food and Agricultural Organization of the United Nations

Which require high amounts of grain to produce...



Source: USDA, Iowa State University

Driving up overall grain demand

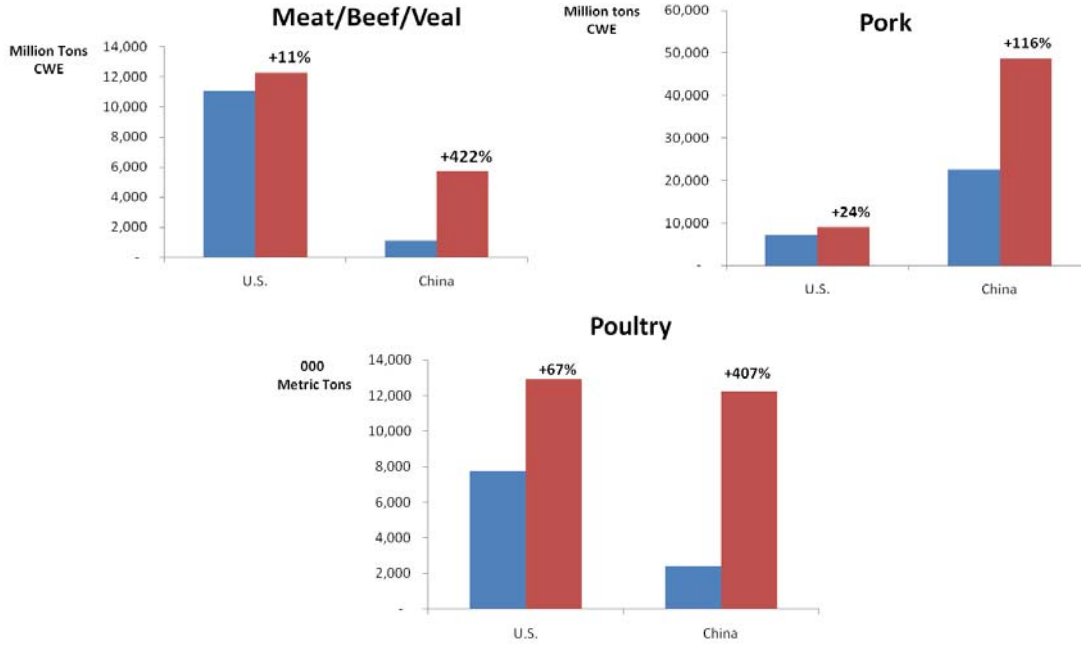


Source: Brookings Institute, USDA



IX.

Agricultural Consumption Meat, 1990-2009



Source: USDA Foreign Agricultural Service, PSD

X.

