

January 8, 2004

Seismic Rumbblings Coming Changes in the Investment Geography

This is a combined (for TAAP and MAAP clients) yearend commentary on the issues we think will affect all investors.

2003 A Watershed Year

Recognizing new trends and events that will alter current trends enables the investor to identify areas that are not properly discounted by the markets. This creates profit opportunities and allows the investor to avoid significant risks. Furthermore, concentrating investments in a newly emerging bull market will lead to far larger profits than chasing a bear market rally.

AIS believes that 2003 represented the start of a multi-year uptrend in commodities just as 1982 represented the commencement of a multi-year up move in stocks. When investors are profiting from a myriad of rising trends, as occurred last year, it is difficult to recognize significant secular change in the works. In the fall of 1982 investors could have made money in the bear market rally in inflation beneficiaries such as gold (page 7). The prior decade had been dominated by a declining dollar, rising inflation and interest rates, a bull market in gold and other commodities, and a poorly performing stock market. In the second half of 1982 many of the most profitable markets of the 1970s staged a strong bear market rally. Many investors were inclined to go back to the markets that had worked best in the previous decade.

More foresighted investors in 1982 began to invest in the newly emerging bull market in stocks. With hindsight, buying stocks in 1982 now seems like an easy decision. However in 1982 investors had been worn out by the previous decade's bear market in stocks. It was not easy making investment decisions in an area that had underperformed so badly for so long. Today we think the reverse has occurred. A bear market rally in the U.S. stock market is taking place along side of an emerging new bull market in gold and other commodities.

Financial Equivalent of Geological Fault Lines

There are four issues that may confront the investor in this decade and significantly impact portfolio returns. They are the financial equivalent of geological fault lines. A financial earthquake has not happened but the pressure is building for a potentially major tremor.

These four issues are interrelated and will feed into and back from each other:

1. The U.S. political process has been progressively promising the voting public more than a well developed economy may be capable of delivering. As the U.S. becomes increasingly dependent on foreigners' willingness to finance current policies, the limits of current policy will usher in a difficult financial environment.
2. The dollar reserve system that fuels the world economy and enables the U.S. to live beyond its means is becoming more tenuous and at risk of imploding.

3. The emergence of China and India, with 37.8 percent of the world's population, into the mainstream of the world economy will place demands on the world's resources in a way never experienced before.
4. World oil production may become supply constrained even without the increasing demand pressures from the newly industrialized nations.

Bread and Circuses

Since the advent of the Federal Reserve System approximately 90 years ago and the Roosevelt New Deal in the 1930s an evolving, and progressively more unrealistic, expectation has emerged that government can and should do something about economic problems. Prior to that time individuals did not believe that government could do anything to improve economic conditions. The Federal Reserve was originally created to stem banking panics by being a last resort provider of liquidity, not to promote economic growth. Even the New Deal architects, who at the time were viewed by many as radical, had a limited view of what they might accomplish economically. As with the original role of the Federal Reserve, the New Deal largely viewed itself in an emergency role of trying to fix a broken private sector, not as a primary agent of growth and prosperity.

With the passage of the Full Employment Act in 1946, government began to increasingly view its role as an agent of economic growth and job security. During the Kennedy administration in the early 1960s a further ratcheting up of government's role emerged. Economic planners became convinced that government could, through active economic intervention, prevent recessions. While history proved their shortcomings, economic planners, with politicians' blessings, continue to view their role as one of enhancing economic wellbeing. The latest and most aggressive chapter in the progression of government intervention arrived with Alan Greenspan at the helm of the Federal Reserve. Under Greenspan's reign, government now is not only viewed as a primary agent of economic growth and job creation but also a guarantor and promoter of wealth preservation and accumulation. An attitude has developed among the average individual that the government should and will enhance stock market and real estate gains in addition to economic and employment growth.

To carry out this policy of stimulating growth in the economy and propping up asset values has required an excessively stimulative budgetary policy and an aggressively easy Federal Reserve fostering excessive credit growth. Since domestic savings are insufficient to finance these activities, the U.S. has become very dependent on foreign financing. This has been made easier by the dollar's international status as the world's reserve currency. Currently the U.S. current account deficit is over 5 percent of GDP. This is a level that has caused other countries to experience wrenching financial disruptions. Due to the cumulative deficit of the last decade (page 7), foreigners now own U.S. debt and equity investments equal to approximately 35 percent of GDP.

Anything Unsustainable Won't Be Sustained

The growing U.S. current account deficit has reached a size that may now be subject to the Herb Stein rule of limitation—anything unsustainable won't be sustained. The current account is the broadest measure of money flows between the U.S. and all other entities abroad, both government and private. It reflects the net flow of trade, investment capital flows between countries, and all other government or

private financial transfers. If a country is in deficit then some combination of foreign individuals, corporations, and governments must become owners of debt or equity in the deficit country. When other countries have a deficit larger than foreigners are willing to finance, it usually leads to a currency crisis consisting of a large devaluation and a restriction of credit until the currency is stabilized. However since the U.S. dollar is the world's reserve currency, there is a significantly greater willingness to finance the U.S. current account deficit. At least this has been the case up to the present.

Many foreign countries (especially developing countries but also Japan) have followed mercantilist policies, seeking to sell more goods abroad than they import. To do this they will often intervene in currency markets to prevent their currency from appreciating against the dollar, thereby making their exports more competitive. As a result of very one sided trade with the U.S., many of these countries have built up huge reserves of dollars. Unless the central banks of these countries sterilize the dollar inflows, the dollars received have a very stimulative impact on the foreign economy as their money supply expands excessively. This often leads to speculative booms and overbuilding due to the excessive credit. As long as the U.S. has followed free trade policies, foreign producers of goods have found a ready market in the U.S. and U.S. consumers have been ready buyers of less expensive products. Thus there has not been any major pressure to stop the buildup of dollars.

A Legal Ponzi Scheme Or The Emperor Has No Clothes

To draw an analogy, imagine if you or I could simply keep writing checks to the local merchants in our town and the merchants never cashed our checks. Instead of cashing the checks they either held them or paid their employees or suppliers with our checks. In turn these individuals never cashed them but rather kept them in circulation. In our wildest dreams this might happen but not in reality. And yet, this is the monetary system on which the world operates today.

The dollar reserve system created at Bretton Woods at the end of World War II was based on a set of circumstances that no longer exist today. The U.S. was at that time a significantly larger economic power relative to the rest of the world and one of the few countries unscathed by the war. It was the world's largest creditor nation and held the majority of the gold held in central bank vaults. The dollar was as good as gold and became the only currency convertible into gold at official government levels. Because the dollar was scarce internationally and convertible into gold, it took on the role of primary reserve asset for government transactions.

As Europe and Japan began to recover and U.S. cold war expenditures grew, the U.S. gradually shifted into a trade deficit. This led foreign governments, and especially the French, to begin converting excess dollar holdings into gold. As a result, in August, 1971, President Nixon ordered the end to gold convertibility for the dollar. From that point to the present the world has been on a dollar standard, with the dollar lacking any official convertibility. While the world has functioned successfully on this dollar standard, it is beginning to show strains and vulnerability. If a new Bretton Woods was held today, it is unlikely that world currency system would be built on a dollar standard. All of the reasons for a dollar standard in 1944 do not exist today. The U.S. is now the world's largest debtor nation and growing larger each year. The dollar reserve standard is a vestige of the past and increasingly likely to breakdown at some point.

The dollar standard has allowed the U.S. to live by rules that are different from any other nation, a system that Charles de Gaulle once referred to as America's "exorbitant privilege". If the dollar standard ceases, the U.S. will be forced to live within its means. Living within our means will lead to a lower standard of living for most Americans as our dollar seeks a level that once again allows us to be competitive with other nations' goods and services.

The emergence of China and India, like Japan and the Asian Tigers (Korea, Taiwan, Singapore, Hong Kong, Malaysia, and Thailand) before them, into the modern world economy has been largely fueled by the dollar standard. All of these countries have followed mercantilist policies, (restricting imports while encouraging export industries) building their economic growth on exports to the U.S. The U.S. consumer has benefited from the lower prices of these cheaper foreign produced imports and the U.S. has exported dollars to pay for the merchandise. Once a developing country's exports have established a growth dynamic in their own economy, local income growth takes on a life of its own to stimulate further domestic infrastructure development. All of this has been positive for world economic growth. Two challenges are developing however. First, incremental growth in the U.S. is requiring more debt (and especially more foreign owned debt) per dollar of GDP growth and U.S. job creation is becoming more difficult with each economic cycle. Second, the huge populations of China and India will place a level of demand on basic raw materials that the world has never before experienced.

The Consumer Century

China, with 1.3 billion people, and India, with 1.0 billion people, combined represent 37.8 percent of the world's population. They are both now on a rapid economic expansion path similar to Japan between 1950 and the early 1970s and later the Asian Tigers from 1965 to 1995. For most of the past century a small minority of the world's population has consumed a disproportionate share of the world's resources. The U.S. represents approximately 4.7 percent of world population, Western Europe 3.1 percent, Japan 2.1 percent and the Asian Tigers 2.7 percent, or collectively 12.6 percent of world population.

This small portion of the world's population consumes the majority of the world's resources. A look at oil consumption patterns provides a good proxy for the demand for basic resources. The U.S. alone consumes approximately 26 percent of oil produced each year or approximately 25 barrels (bbls) per capita per year. When Japan and the Tigers entered their respective rapid economic expansion phases, per capita annual oil consumption expanded from 1 bbl to 17 bbls per person. China and India are now at the early stages of these growth curves, currently consuming approximately 1.5 bbls per capita. Given that their combined populations are 18 times that of Japan and 14 times that of the Tigers, their quest for modern consumer lifestyles has mind boggling implications for basic resource demand.

Until now industrial country consumers have grown used to declining real prices for basic resources. With the exception of periodic price spikes for these commodities, productivity enhancements combined with new exploration frontiers or new farm land expansion have led to long term declines in the real prices of these basic resources. As consumers have become wealthier and the real cost of these basic items has declined, their cost as a percentage of consumer income has become less and less significant.

At the present time commodity prices are at inflation adjusted price levels not far above levels reached at the depth of the 1930s depression (page 8). With a worldwide recovery in place one would expect at

least a cyclical up move in commodity prices. Considering that it has been over two decades since a commodity bull market has occurred, one should expect a period of strong price increases ahead. The real wild card however is the potential for something far greater this time. If the economic growth of China and India follows the growth paths of Japan and the Tigers, commodity markets may experience a price shift of truly monstrous proportions. A century of declining real prices may be replaced with a secular rise in real prices due to unprecedented demand. Only significantly higher prices will ration increasing demand.

Running on Empty

Price levels will be impacted not only by rising demand but also by the risk of limited supplies. This is particularly true of oil. Several leading experts have presented a strong case that total world oil production may peak by the middle of this decade. These experts argue that oil discovery and production have followed a bell curve distribution pattern that points to a peak in the curve in the middle of this decade. In the 1950s a well respected Shell Oil geologist, M. King Hubbert, made a highly controversial, but strikingly accurate, prediction that U.S. domestic production would peak in the early 1970s. The U.S. discovery rate followed a bell shaped distribution and peaked in 1930. Forty years later production peaked in the U.S. Respected geologists using the same quantitative techniques have now built a strong case that world production will peak within the next few years. Interestingly the discovery of large fields (defined as those producing over 100,000 bbls. a day) has followed a bell shaped distribution curve which peaked in the 1960s (page 9). As with the U.S. experience of first a discovery peak and then a production peak forty years later, world production is now facing that timetable. With more and more of the world's largest fields now quite old, new discoveries not only need to provide for growth in demand but also take the place of declining production from the world's older fields. This becomes the geological equivalent of running faster on a treadmill just to stay even. Just as the world may be entering a period of unprecedented demand growth it may also be confronted with increasingly scarce supplies. Possibly only rationing through significantly higher prices or increasing formal rationing will face consumers and investors.

Investors have grown complacent after two decades of declining interest rates and rising stock prices. What they fail to appreciate is that this financial bull market has been built on the back of highly stimulative government policies dependent on the special international status of the dollar and on cheap and plentiful basic resources. The rapidly increasing U.S. current account deficit is clearly an unsustainable trend that is likely to dethrone the reserve status of the dollar. When smaller countries reach an overextended financial state similar to the current U.S. situation, the International Monetary Fund usually prescribes a massive devaluation, and severely restrictive fiscal and monetary policies until the financial excesses are squeezed out of the system. While this is the I.M.F.'s prescribed medicine for smaller developing countries, the U.S. falls into the too big to fail category. The rest of the world is too dependent on U.S. consumption patterns to allow this solution. The global political fallout would simply be too disastrous.

About the only fallback position that is available to the U.S. is its relatively large gold reserve. If gold were revalued to approximately \$4,000 an ounce, the U.S. could then offer to exchange all of its external debt obligations for gold. If the U.S. once again offered to exchange its gold for debt obligations or foreign held dollars, at a much higher gold price, it might reestablish confidence in the dollar. This in

turn would buy both the U.S. and the rest of the world time to correct the massive imbalances that have been allowed to develop.

What's An Investor To Do

With the gold price in early 2004 just above \$420 it might be hard for the reader to imagine a gold price of \$4,000. However from 1968 gold rose from \$35 to \$850 in January of 1980 (page 9), a 24 fold increase. A 24 fold increase from the late 1999 low of \$252 would yield a price of \$6,000. We don't expect the government to arbitrarily raise the price to some huge multiple of the market price. Rather we expect the free market to respond to financial and market conditions and possibly drive the price to a substantial multiple of the present level. Governments would only reluctantly respond to the realities of the market price.

In addition to the obvious investment opportunity in gold, the other major investment opportunity is in commodities. The combination of a weakening dollar, the rapidly growing demand from China and India, and the possibility that the supply of some basic commodities such as oil are becoming more scarce, sets the stage for a secular bull market of major proportions. Investors always find it difficult doing something different from what they have historically been used to. It is especially difficult for the investor to do something that very few others around them are doing. Periodic opportunities will develop in the stock market, however the trends developing in gold and commodities may be a once in a lifetime profit opportunity.

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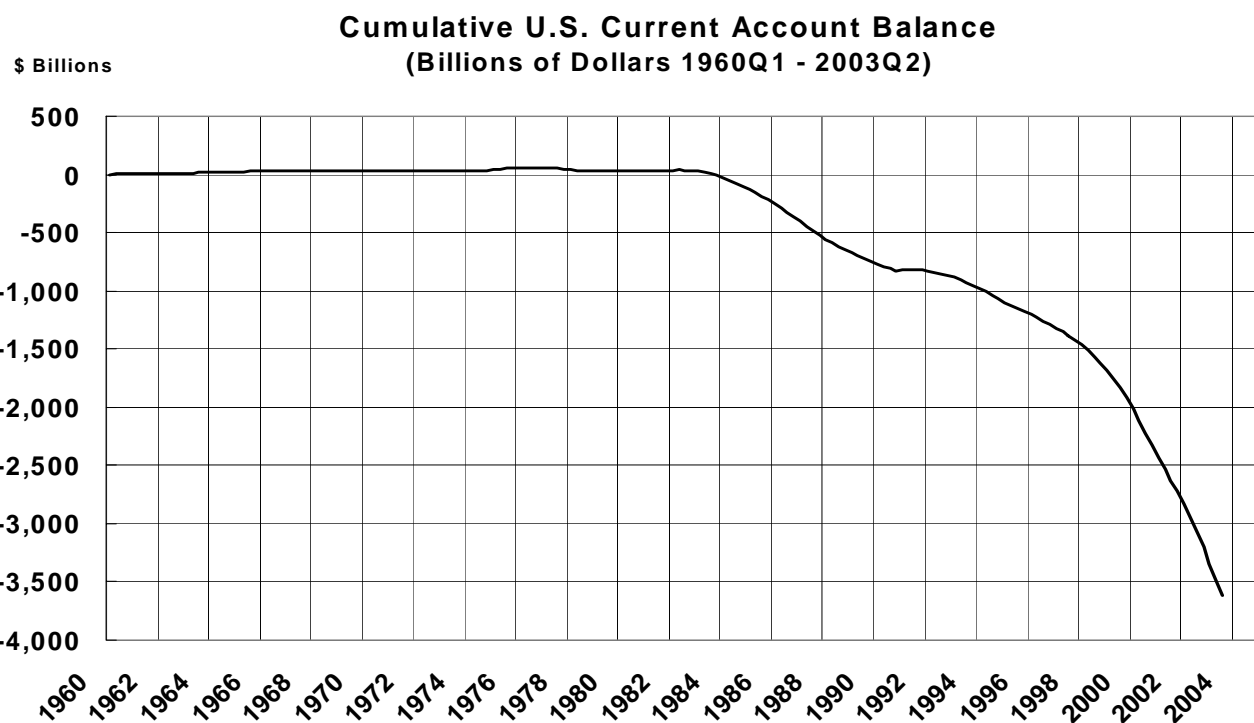
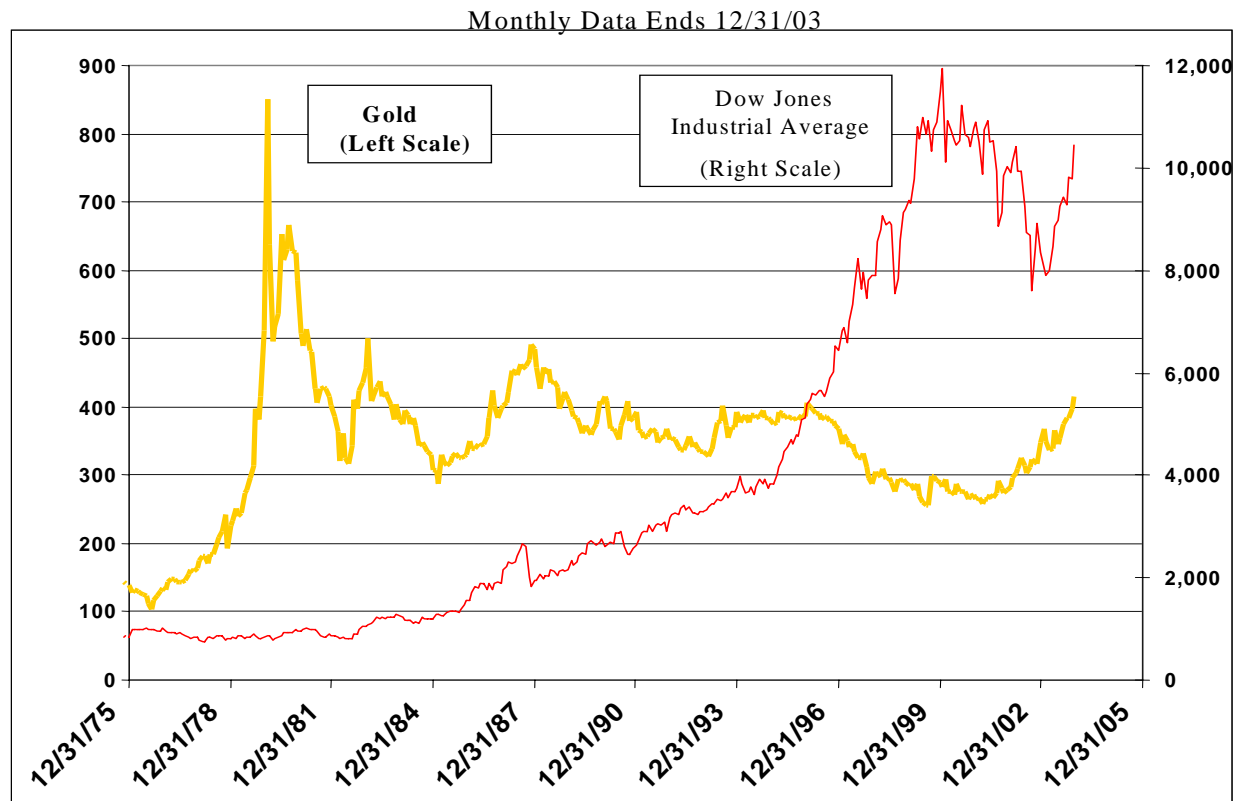
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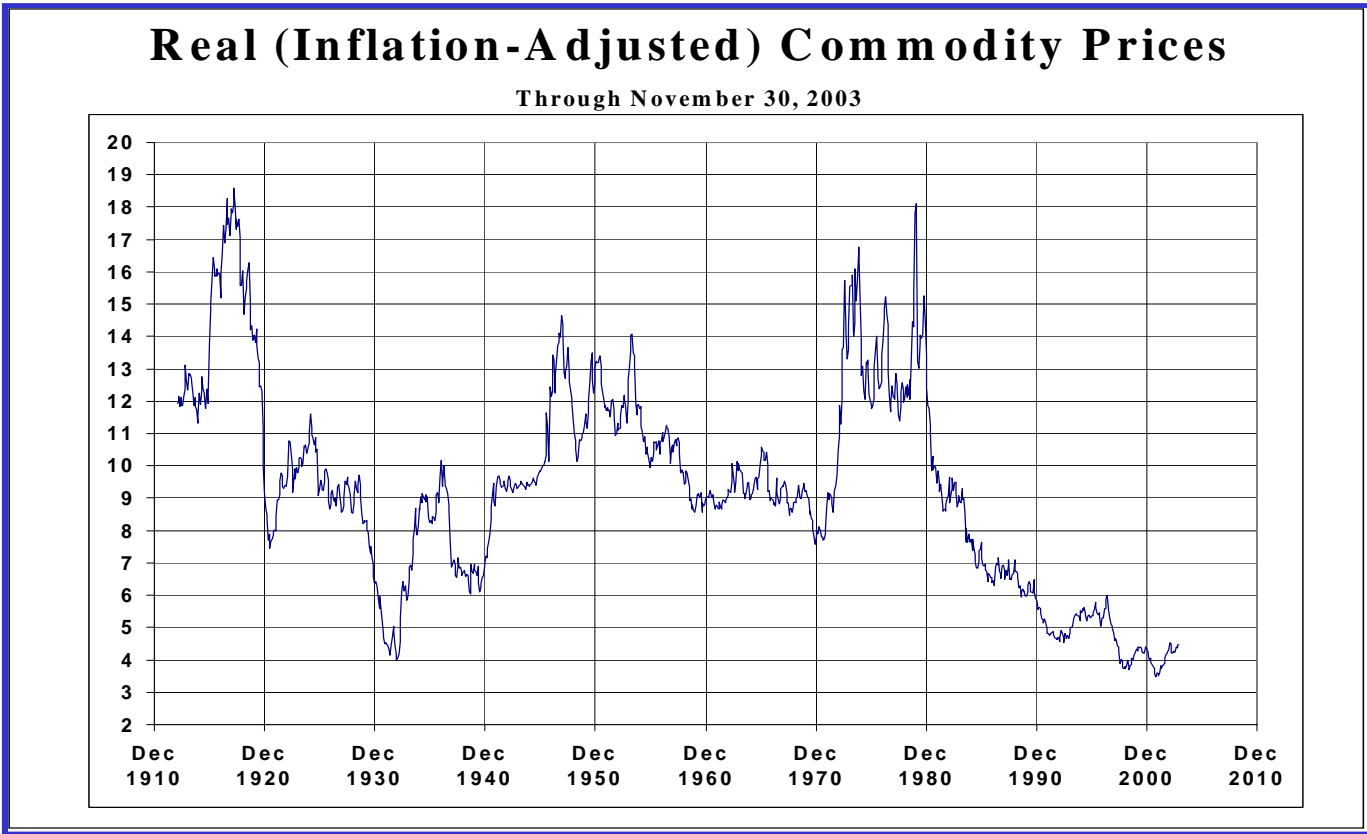
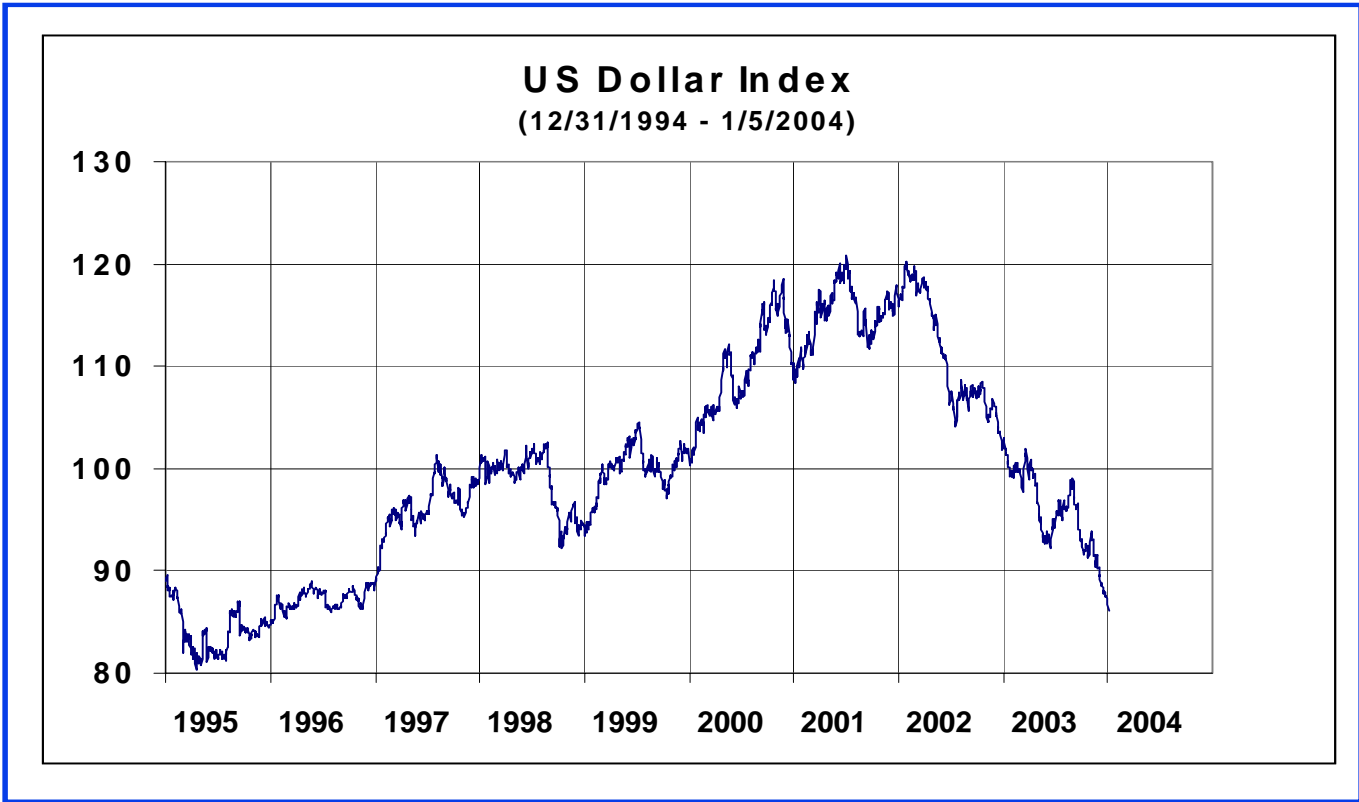
TAAP (The Asset Allocation Portfolio) provides the investor with a disciplined approach to investing in equities, bonds, gold bullion, and cash equivalents. The strategy tactically over weights those asset sectors likely to outperform and under weights those areas perceived to have above average risk.

MAAP (Multi Asset Allocation Portfolio) is a diversified managed futures program that invests in six asset sectors, equities, bonds, currency, metals, grains, and energy. The goal is to profit from major investment trends.

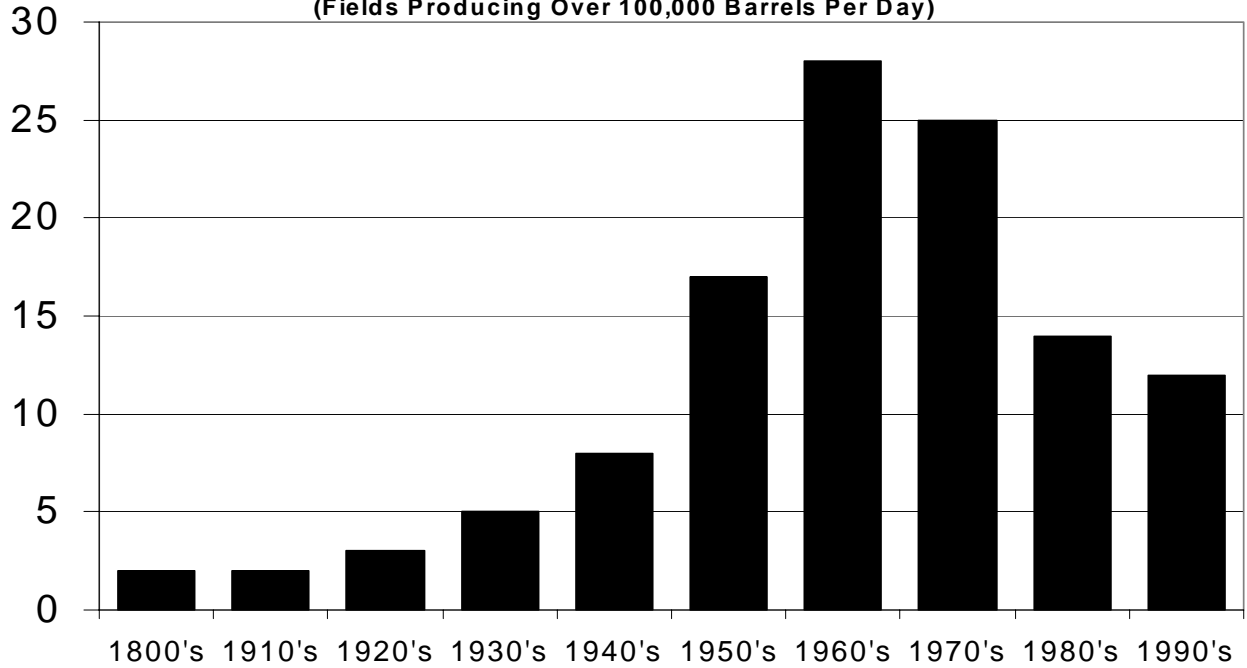
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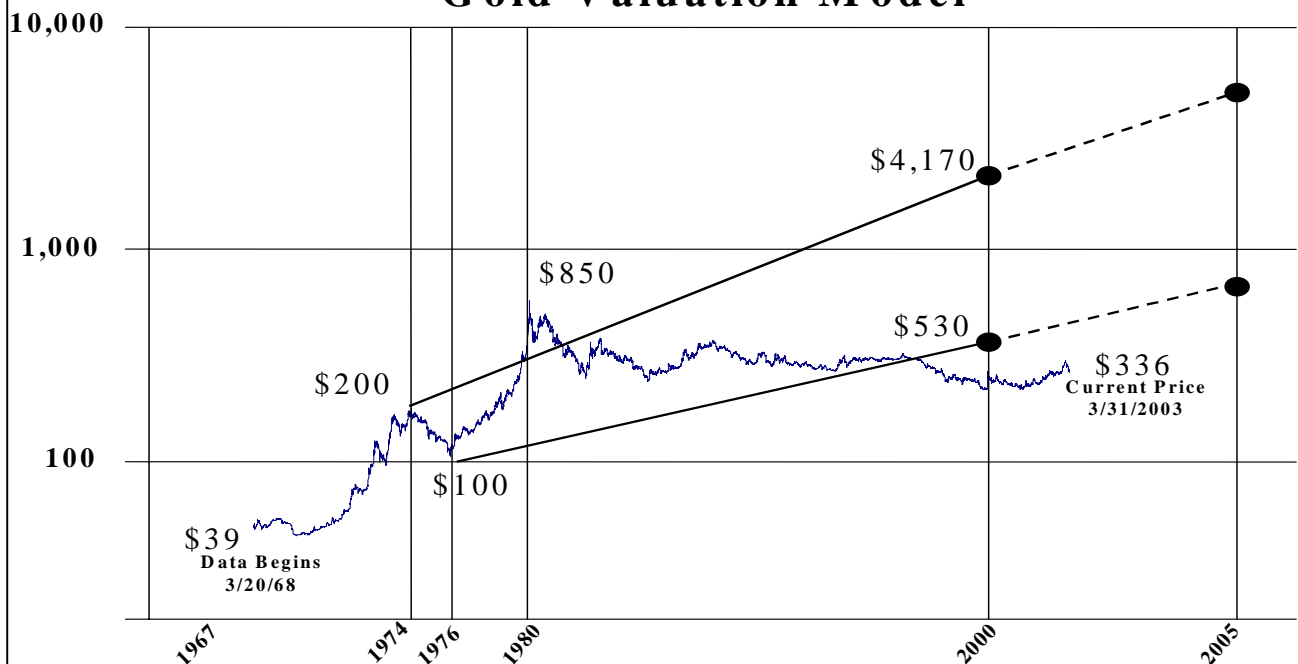




Giant Oil Fields Discovered by Decade (Fields Producing Over 100,000 Barrels Per Day)



Gold Valuation Model



This gold valuation model compares the historical relationship of the market value of gold held by the U.S. in its official monetary reserves versus 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.