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There are three classes of people: those who see...those who see when shown...and those who do not see. - Leonardo da Vinci

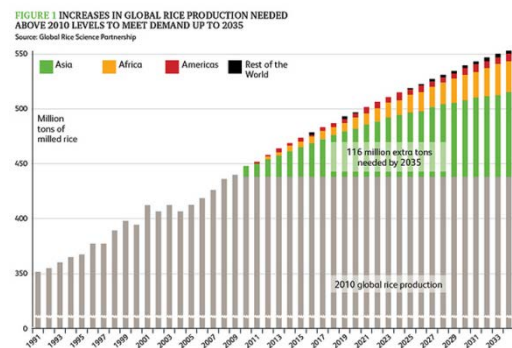
Demographics

The market is full of news but much of it falls into the category of background noise – in other words it is not relevant except in the very short term. It is vital to attempt to filter out the white noise of markets so as to stay on track with the longer trends.

Amidst the tumult of the markets there is very little mention of population growth and yet this is a key component of demand and the evolution of prices. We felt that it was time to remind ourselves of the speed and scale of population growth because it is such an important factor.

Back in October 2011 the world's population reached 7 billion, having crossed one billion in 1800 and the population continues to grow with 10,000 new births every hour. The United Nations estimates that the total number of people on the planet will rise to 9.3 billion by 2050 although, like so many predictions, it is subject to a wide margin of error both in terms of the total as well as the timing of when this growth will occur. We should bear in mind that the world's population was a mere 2.5 billion as recently as 1950.

This raises many questions about the use of the limited resources that are out our collective disposal and this is most acute in terms of food, water and energy. Some think the answer to a sustainable future will come from algae for energy production and food. There has also been significant research put into cross-breeding plants that are hardier and more productive than existing varieties. The Chinese scientist Zhikang Li has been working with the Chinese Academy of Agricultural Sciences and the International Rice Research Institute in the Philippines to develop a so-called "green super rice", which is able to produce more rice whilst being more resistant to droughts, insects and disease.



Increases in rice production needed to meet demand up to 2035.

Source: "Growing a new Green Revolution" by John Berthelsen

There is little doubt that mankind needs to seek out solutions to these very real problems if we are to live in a sustainable way – population growth places the world's resources under extreme pressure, something that was recognised by Malthus in his series of essays on population published between 1798 and 1826 (ahead of his time!). His observations led him to the following conclusion:

"The power of population is indefinitely greater than the power in the earth to produce subsistence for man"

Of course, limited resources and ongoing demand results in upward pressure on prices – the classic case of too much money chasing too few goods. Readers who have followed our reports for some time will know that we see the quantitative easing/ money creation by central banks as inflationary actions too, as newly minted money is the very definition of inflation. Eventually this money finds its way into the economy and although governments are keen to tell us all that inflation is not a problem, there are signs that money is indeed leaking into the real world. This is certainly true in the auction world where record prices are being paid for diamonds (an auction in December in New York saw prices soaring to four times estimates including a record price paid for Elizabeth Taylor's pearl and diamond necklace of just under US\$12m), art (US\$4.3m was paid for a photograph in November of the Rhein in Germany <http://z6mag.com/arts-entertainment/world-record-auction-price-of-4-3-million-for-a-photograph-162901.html>) and wine is also doing rather well with top Burgundies especially sought after. Ordinary folk tend to see inflation in their food basket and when they fill up their cars – oil is now holding at well over US\$100 per barrel.

It is well worth taking a look at *"The Great Wave"* by David Hackett Fisher, which was written back in 2000. He looks at four distinct periods in history that saw price increases that extended for decades and was not a transitory phenomenon. Inflation was caused by a rise in the level of demand which came about because of an increase in population. He describes the way that the waves repeat across each period of history that experienced this greater inflation as follows:

1. Each wave starts slowly and follows on from a period of sustained stability. Population growth begins to put pressure on aggregate supply of the essentials - food, fuel and housing. It is more expensive to bring new supply to market because the *"low hanging fruit"* has already been picked. As a result, returns on capital begin to increase. The rich benefit the most while everybody else suffers a decline in real wealth. Prices do not take-off in this period and it is not generally recognised that they will continue to go up.

2. Money supply begins to increase soon after prices start to rise. Many forces drive money supplies higher. Velocity of money increases; more money changes hands and more things, such as credit instruments, are used as money. Governments create more money to mitigate the rise in prices — people cannot buy what they need with the money they have, so the government creates more. This growth in money supply fuels inflation that is already taking hold.

3. Material decreases in the standard of living for the poor: The economic situation for the poor and middle classes gets steadily worse as they lose purchasing power. Now the penny has dropped and people have understood that prices are on the up. This is the start of social order problems starting with crime and eventually leading to wars.

4. After some years of disorder the population starts to drop once more and this in turn sees demand head lower. During this period of equilibrium, real wages for the poor and middle class increase and returns on capital fall. The gap in wealth between rich and poor shrinks.

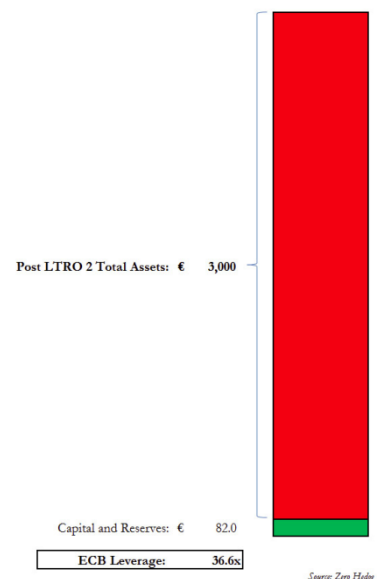
5. After a period of relative equilibrium and general stability the population starts rising once more and the cycle begins again.

Many economists will not agree with this interpretation of events and monetarists especially look only to the money supply in order to explain inflation. However, it seems obvious to most people that a rising population will put pressure on existing resources and rising prices are one means whereby the economy seeks to balance itself. Higher oil prices can partly be explained by the increase in demand from countries like China where there is increasing wealth.

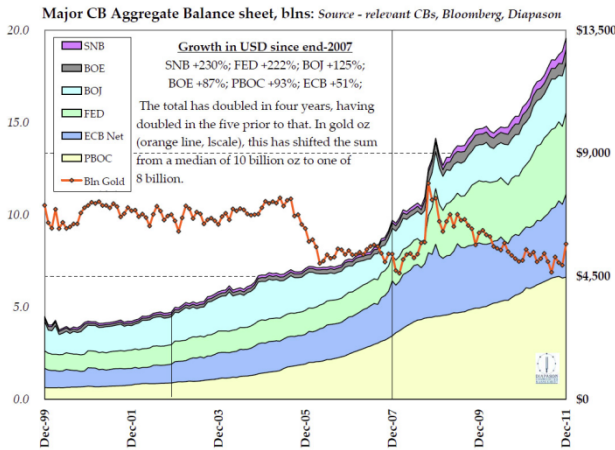
The vast creation of money by the world's central bankers has so far not led to the rise in prices that would normally be associated with this scale of printing and this has led many pundits to declare that the

link to inflation has been broken. However, consider that corporate balance sheets are flush with cash that has been built up over the last two to three years and that this money is not yet circulating in the wider economy. Banks have also been actively repairing balance sheets and sitting on cash reserves rather than lending money out to the real economy. Nevertheless, this money exists and, as with retail money sitting on the sidelines, there will come a moment when it will be used. There are already signs of merger and acquisition activity rising and in most cases, cash is being used as a key component of the offer — companies want to be rid of cash and want to preserve the existing shareholder base perhaps realising that cash is an asset class with diminishing prospects. (Glencore bidding for Xstrata, Molycorp bidding for Neo Materials in the rare earth space, Viterra the grain handler in Canada attracting interest from numerous buyers, Roche bidding for Illumina and a host of takeovers in the tech world). Is this the third wave that Hackett Fisher refers to in his book — the recognition phase where people start to convert cash to real things in anticipation of a decline in purchasing power?

We have added two charts here to show just how much money has been added to the money supply by central banks in the last few years (and in the case of the ECB, the last few months):



ECB balance sheet gearing. Source: Zerohedge



Central bank balance sheet growth since end 2007. Source: Diapason

Inflation is baked in the cake and is just a question of time as to when it manifests itself more fully with an increase in the velocity of money and therefore inflation.

Robert Fitzwilliam of the Portola Group recently spoke of the seventies experience and what it may mean for the situation today:

"Around 1975 there was this distinct realization that prices were going up. So, I switched from being a saver, which I had always been because I was building a family, but I remember, with everybody, the mindset changed completely. What made sense was not to save, but to go out and buy everything you could get your hands on.

It wasn't because of some deep analysis of what Arthur Burns was doing about monetary policy, it was really on a gut level, from the man and woman on the street, that they needed to get rid of their cash and start buying things. Those are the things that will start to happen when the velocity of money really starts to take off.

Then, when people start to get educated and understand that money is rapidly losing its value, you will get something like we saw in the 70s where people wanted out of paper money. We are still very, very early in this cycle but these are the types of things KWN readers globally should expect."

http://kingworldnews.com/kingworldnews/KWN_DailyWeb/Entries/2012/2/28_Fitzwillson_-_Bull_Market_Dynamics_Explosive_for_Gold_%26_Silver.html

Currency Wars

Brazil spoke out in 2010 about currency devaluation as a means of gaining a short-term economic gain over your trading partners and they have been critical of those who have been doing this. The topic was brought back out into the public by Brazil at the beginning of March by the country's President Dilma Rousseff. She said that countries were releasing a "tsunami of cheap money" that was cannibalising the country and emerging markets in general. Brazil has had to cope with an inflow of money from abroad, which has made the currency rise in value and made it harder for them to compete in the global market.

"We have a currency war that is based on an expansionary monetary policy that creates unequal conditions for competition. We will continue to develop (our) country by defending its industry and ensuring that the strategy used by the developed countries to exit the crisis does not cannibalize emerging markets," said Rousseff.

Brazil went on to cut interest rates on the 8th March to deter capital inflows and to generate economic growth. However, they are ignoring the level of inflation domestically and their policies may well fuel inflation in Brazil further.

Of course, Brazil is not alone in their struggle to deter currency inflows that make them uncompetitive and Norway cut interest rates unexpectedly on 14th March. It is clear that countries are prepared to set interest rates so that currencies remain competitive even if inflation at home is a concern (Norway is trying to cool its housing market down so cutting rates will not help them achieve this).

As countries engage in this unwinnable race-to-the-bottom investors will need to be conscious of exposure to currency as the macro moves have a significant impact on the value of investments.

Iceland and Canada

As fund managers we also pay close attention to currency matters and it was therefore interesting for us to see that Iceland, a country that came close to adopting the Euro, has been speaking about its desire to move closer to Canada and its currency. According to the Globe and Mail newspaper:

"Iceland is looking longingly to the loonie (Canadian dollar) as the salvation from wild economic gyrations and suffocating capital controls...And for the first time, the Canadian government says it's open to discussing idea. There's a compelling economic case why Iceland would want to adopt the Canadian dollar. It offers the tantalizing prospect of a stable, liquid currency that roughly tracks global commodity prices, nicely matching Iceland's own economy, which is dependent on fish and aluminum exports."

This discussion might seem odd given that the US dollar remains the world's reserve currency but it is perhaps a sign that the dollar has been under pressure recently, with countries reaching trade agreements that are bilateral and bypass the dollar altogether. This pressure is going to increase as countries like China reduce their exposure to the US currency in favour of other more direct arrangements.

Investors in SUNARES will know that the fund holds a significant portion of its assets in Canadian dollars. This is mainly because Canada offers so many opportunities to purchase good resource companies but it is also a considered approach to holding a currency with strong fundamentals (we also like Norwegian Krone and Australian dollars):

Canadian government finances are relatively sound and they are one of the few countries that is rated AAA by the major credit agencies and they back this up with a sound balance sheet. Growth in Canada is also strong and is outpacing the US and the employment picture is similarly rosy.

Of course, any investment that is not made in your home currency is a risk and there are times when currencies can deliver poor performance. The Canadian dollar fell more than a quarter in 2008 as investors headed to the perceived safety of the US currency. Nevertheless, the Canadian currency rebounded swiftly because of the inherent strength of the country and its economy.

Gold

We wanted to remind readers of the long-term themes that are running in the market and we leave you with a point-and-figure chart from 1975 – the third upward leg is supposed to be the longest and strongest and it has yet to occur. Given the fundamental backdrop we think that it will happen and may not be too far in the future. Mania lies ahead!



Source: Casey Research

With best regards from your SUNARES team,

Colin Moor

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