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Update November 2012

"In capital markets, price is set by the most panicked seller at the end of a trading day. Value, which is determined by cash flows and assets, is not. In this environment, the chaos is so extreme, the panic selling so urgent, that there is almost no possibility that sellers are acting on superior information. Indeed, in situation after situation, it seems clear that fundamentals do not factor into their decision making at all."
Seth Klarman founder of Baupost Group one of the world's largest hedge funds

China and the Commodity Outlook

Emerging markets and China in particular have been a source of genuine concern to the commodity markets for some time. Opinion is divided between those who think that China has had its run and is now due a pullback in terms of the pace of economic growth – fears of a hard landing stem from the deflating real estate bubble and the decline in export growth and these have been the key concerns. On the other hand there are those who now see green shoots of recovery and also how much still needs to be done in China in terms of its industrialisation. To back this up there are indeed tentative signs that China may be picking up with growth expected to come in at 9% for this year (the global economy is predicted to see growth of 3.6% according to the IMF) and the last release of the manufacturing PMI (purchasing managers index) improved for the second month in a row to 49.1 in October from 47.9 in September. This is still below the key level of 50 which signals expansion but the data has at least stabilised at this level.

Other positive indicators can be seen for example in the 64% jump in the Baltic Dry Index from September to today (663 to 1090), a measure of the strength of Chinese demand (admittedly improving from a very low base). The Danish container shipping company AP Moeller - Maersk recently increased its prices as did its Chinese counterpart COSCO. Importantly it is Chinese domestic demand that is leading the way and this could signal that China is becoming less dependent on its export markets (early days to say this definitively but still a key development to keep an eye on).
Critics of the growth miracle in China say that it has been fuelled by debt and that money has piled into sectors where demand was never going to meet the huge increase in productive supply. Examples of this over-capacity are ship-building and solar companies, many of which now lie idle.

For a more informed outlook on China we turn to the most accurate forecaster of metal prices in the form of Justin Smirk of Westpac Banking Corporation in Sydney who has consistently beaten his peer group over the last two years. He uses economic cycles, the actions of central banks and financial markets themselves to draw his conclusions about prices and his current thinking is that copper, nickel and zinc will increase through June and forecasts a 21% rise in aluminium.

"We do see this point in time as perhaps the worst for the growth cycle. Commodity prices should be moving stronger through this year and into next."
His target for aluminium is an advance to US$2,380 a metric ton by June and that in turn will help boost energy prices given that energy makes up some 40% of smelting costs. Nickel, used in stainless steel, will climb 15% to US$18,500 a ton, copper will rally by 11% to US$8,500 a ton, iron ore could see US$170 per ton and zinc is anticipated to rise by 7.9% to US$2,100 a ton. A significant source of demand in China will be the rebuilding of inventory levels and with the general relaxation of monetary policy, as central banks continue to attempt to stimulate the economy into action, there is every reason to think that we are at an important turning point. Smirk's positive outlook is not shared by the investment community as a whole but his track record should certainly be taken into account.

What of Monetary Policy?

It is becomingly increasingly apparent to those who follow the markets and central bank policies in particular that monetary easing is still very much on the agenda. The scale of debt that has been built up across the world in the pursuit of growth and the payment of entitlements (previously known as welfare) is at a point where debts are unlikely to ever be paid back. Greece is the working example of this, being run as an experiment it seems, and the country is suffering under the yoke of austerity that has now been imposed but which is strangling the life out of the people and the economy. If we take a look at the following chart of youth unemployment in Europe then it should be clear that this is unsustainable given the current overall level of 23.3%. In Greece youth unemployment is at the tragic level of 58.8%.

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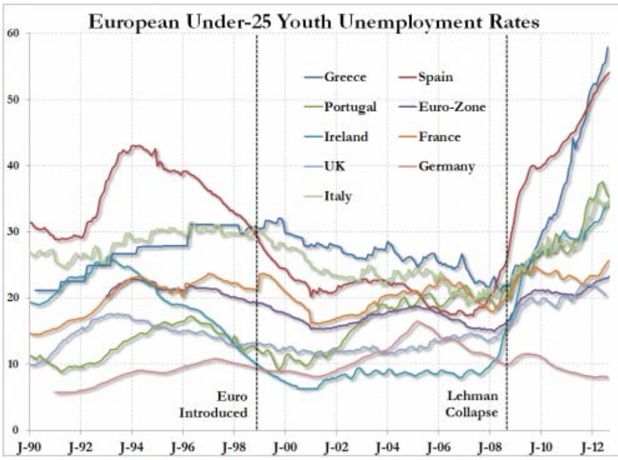
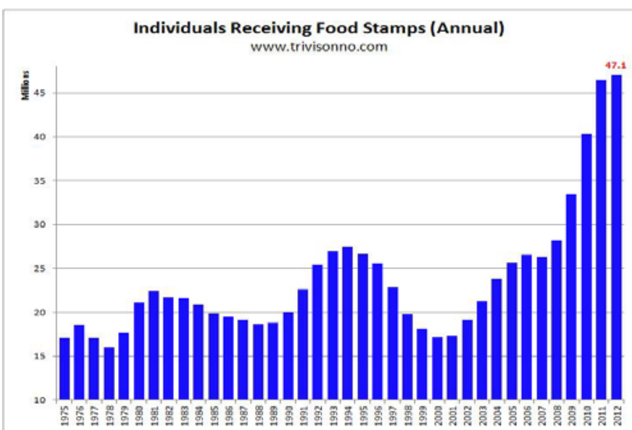


Source: Zerohedge. *Data: Bloomberg and [Greek Statistics Office]*

In the United States this picture is mirrored by the record levels of citizens receiving food stamp assistance. The latest data series was delayed by nine days and actually released after the Presidential election and perhaps with good reason, as it too makes very uncomfortable reading. Food stamp usage surged the most in one year in October, to hit a new high of 47.1 million people, an increase in the month of a shocking 420,947.



Source: Matt Trevissono: http://www.trivisonno.com/food-stamps-charts

Japan is also gearing up for further massive money printing when the opposition leader Shinzo Abe called for the Bank of Japan to print *"unlimited yen"* with the explicit goal of stoking up inflation. Although he did not mention a specific target he has spoken recently of achieving 3% after years of printing has thus far failed to get inflation going as is obvious from the following long-run picture of the consumer price index in Japan:

Source: Bloomberg: Japan CPI Nationwide year-on-year (1993-2012)

It is clear that 3% has not been seen in this whole period so the money needed to get to this level would be unimaginable! Mr Abe's statement was met with a wave of gold selling that pushed the price down and provided another neat buying opportunity for those who are starting to understand the end game that is being played out. It is interesting for us to see how investors are still able to be spooked out of their positions and have no real sense of what is happening nor who seem to have an investment horizon longer than the end of their own nose. Why on earth would anyone want to be selling gold after seeing the charts and policies outlined above?

Riding the Bull Market – Only For the Few

Perhaps this is what a bull market is meant to do, in other words cast investors off the back of the bull so that few ride all the way to the end. It made us think of the barbarism of the bull run in Pamplona, Spain where hundreds of people (mainly testosterone-fuelled males eager to prove their virility or stupidity!) attempt to outrun a herd of bulls who are released onto the closed-off streets. Only a handful of runners get to the stadium before the bulls, with the majority have been over-taken, injured or otherwise cast aside by the rampaging bulls. The Pamplona bull run is a brutal and primitive event where there no mercy is shown to the runners (nor the poor bulls) and it seems to us that markets are the same brutal, primitive and unforgiving arena and are ridden successfully only by the few. It is important to keep your head as an investor and keep focussed on the news that matters rather than being distracted by the short term noise that calls out like the Sirens of Greek mythology in an attempt to lure you onto the rocks to be ship-wrecked and destroyed.

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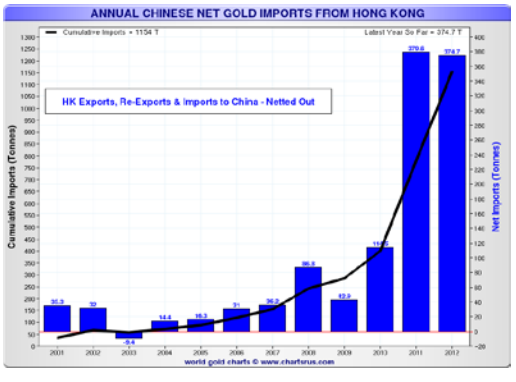
US Election

With the US Presidential election out of the way the course will now be set for the coming four years. In this context it is well worth looking at the performance of gold in the aftermath of recent US elections as it bodes well for those who hold firm with gold (and silver):

Source: Casey Research:
http://www.caseyresearch.com/sites/default/files/Gold%2065-WMA.jpg

Jim Rogers the well-known investor said this prior to the election result:
"If Obama wins, it's going to be more inflation, more money printing, more debt, more spending." Rogers expected to sell U.S. government debt and buy precious metals, such as gold.
"It's not going to be good for you me or anybody else. It looks to me like the money printing is going to run amok now, and spending is going to run amok now."

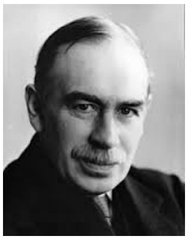
As ever we need to watch out for what the big players (so-called smart money) is doing and we can report that the Chinese are continuing to buy gold at a rapid rate and they have now bought more gold in 2012 than the Indians own (582 tons imported by China this year so far and 558 tons owned by India)! The following chart illustrates this perfectly:



Source: Casey Research:
http://www.caseyresearch.com/gsd/sites/default/files/Annual%20Chinese%20Net%20Gold%20Imports.png

According to the World Gold Council, China's gold demand has risen by 27% a year since 2007. Its share of world demand has doubled from 10% to 21%. No doubt the Chinese and other smart investors will have in mind the words of the economist John Maynard Keynes and his summary of what government policy intends to do achieve with money printing and therefore inflation:

"By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some.



The sight of this arbitrary rearrangement of riches strikes not only at security but [also] at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become 'profiteers', who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat.
As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.
Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."
Wise words indeed…

Silver

No comment on gold can be considered complete without also mentioning silver. Silver is an important part of the SUNARES fund's holdings as we see that the ratio of gold to silver is improving in silver's favour. For those investors who think that gold is going to increase in value it is logical to buy silver given that silver tends to outperform gold when the metals enjoy a bull run. During the latest sell-off of precious metals the gold/ silver ratio was able to remain relatively stable and the measure is now falling once more (meaning that silver is outperforming gold). An expert analyst on the silver situation is Ted Butler who has worked tirelessly to explain the reasons why silver will do so well and he said the following recently:

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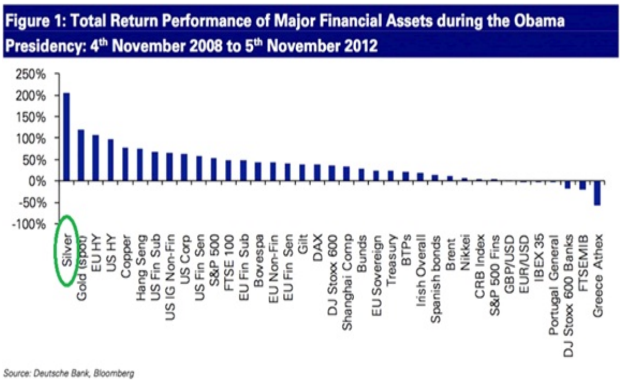
Conditions in the wholesale physical silver market may be intensifying. There seems to have been a particularly high turnover in COMEX over the past couple of weeks and this points to tightness in the market with so much visible and recorded silver inventory seemingly in constant motion. Butler feels that deposits into the big silver ETF, SLV, are also suggestive of recent high investor demand. In little more than a week, he notes, close to 4 million ounces have come into the Trust, the world's largest stockpile of silver. Metal holdings in the Trust have been in a fairly tight range for the past 18 months, after hitting an all time high of near 370 million ounces in April 2011 and he feels that the standout feature in SLV silver holdings is how stable they have been during some pretty big silver price moves up and down over that time and that silver fundamentals are looking particularly strong amid these signs that silver investment demand may have resumed.

What Butler sees as the really big physical silver story this past week came from Canada, in the form of the Royal Canadian Mint launching its own ETF-type silver product, along with the announcement that Sprott was adding to its silver ETF, PSLV. The Royal Canadian Mint thus bought 3 million ounces, while it looks as though Sprott may have bought around 7.5 million ounces. When only two entities purchase what is normally the total monthly available supply of 1000 ounce bars this should cause prices to rise. Silver prices did rise, but would have risen much further if prices had not met with a wave of selling on the futures market i.e. via the paper metal trading system.

Butler believes that the market is close to a tipping point between surplus and shortage and that the big short position holders could ultimately be overwhelmed should the market perceive that a shortage might be imminent. If this is the case then it is likely that we will have silver industrial users rushing to build inventories in order to maintain production.

It should be noted that silver is ahead of the pack this calendar year (up nearly 22% as at 26th November) and that it was the leading performer during President Obama's first term of office:



Source: Casey Research: http://www.caseyresearch.com/gsd/sites/default/files/Total%20Returns.jpg

Billing Systems Geared up for Inflation

For those who doubt that companies and markets are bracing themselves for inflation then look no further than the phone bill received by a French woman in the south-west of the country. The phone company demanded payment of Euro12 quadrillion! Most readers are only just making the adjustment to trillions so it is comforting to realise that billing systems in Europe are already geared up for the next stage in monetary inflation. The actual number reads as follows: Euro11,721,000,000,000,000 (approximately £9.4qn). Comically the company Bouygues Telecom initially demanded payment but presumably realised that the total is roughly 6,000 times France's annual GDP and agreed that the sum should in fact have been for Euro117.21. It is perhaps one small glimpse of how the future may turn out…

Food and why prices will be squeezed higher for years to come

Consider that the population grows by an additional 200,000 people (that is a net figure). Simon Black of Sovereign Man takes this number and calculates the additional calories that each person will need as an adult every day at a figure of 1,250 calories per day. Collectively, that's 91.25 billion calories per year for the entire 200,000 people that were born today. Where will the calories come from?

Consider that a cup of rice contains about 300 calories. An average annual rice harvest yields about 150 bushels per acre, or about 6.7 million calories per acre of rice grown each year.

In very simple terms, it will take 13,600 acres of cultivated, producing rice land to generate the necessary calories to feed the 200,000 people that were born today. That's roughly the size of Manhattan.

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Tomorrow, another 13,600 acres will be required to feed the people born tomorrow and so on….
This is a conservative estimate. Obviously people eat other things besides rice. Corn has an even lower caloric yield per acre. And as people move up the food chain into dairies and meats, the amount of calories per acre takes a huge nosedive.

Simultaneous to the rapid increase in demand for food, the world is also experiencing a declining trend in supply. Water shortages, loss of topsoil, weather disasters, land development are all contributing to tightening food supplies.

Monetary policy also wreaks havoc on food prices. All of the additional money ends up somewhere and monetary inflation has been a huge force in driving up food prices.
Increasing demand and tightening supply indicate that there is a long-term upward trend in food. Higher prices are most likely but we could also see food shortages developing too.

Shale Gas

OPEC have acknowledged in their World Oil Report linked below that shale oil and gas could change the future energy mix for the world. Production of shale natural gas in the US grew 60% between 2010 and today. Despite this OPEC point out that the industry is still in its infancy so the longer term outcome is yet to become clear.

www.opec.org/opec_web/static_files_project/media/downloads/publications/WOO2012.pdf

The report also recognises the clear potential for shale natural gas as clean natural gas starts to replace coal as a source of electricity and becomes a major feedstock in the petrochemicals industry. President Obama announced last year that there potentially is *"perhaps a century's worth*" of shale gas in the US. Shale oil is also coming on stream strongly with production per day of about 1 million barrels (bpd) and with estimated production to rise to 3 million bpd by 2035.

On a global scale, the report finds that shale natural gas production is coming mainly from the United States. Reserves exist elsewhere, like China and Eastern Europe, though the cartel cautioned there are *"considerable"* uncertainties when it comes to assessing the size of those resources. For shale oil, it said, there's been *"no serious attempt"* at estimating reserve potential, where recovery factors are *"very low."*
"Globally, shale oil and gas development is in its infancy, and there are thus considerable uncertainties about the size of the resources, the economics of development and the potential contribution to future supply."

Whilst there is little debate about the size of the shale gas deposits, the details about the cost of extraction and the production peaks are being discussed more openly now. An indication that all is not as rosy as first thought came in the shape of the near bankruptcy of Chesapeake Energy, with the company being forced into selling billions of dollars in assets to keep running as a viable company. Some analysts are even talking of shale gas as a commercial failure given that the fresh money that has been pumped into the sector has failed to generate returns (BHP Billiton has had to write-dwon the value of their expensive purchase of Petrohawk Energy by US$2.84bn and similar write-downs have been made by other companies like BG and Encana. BHP remains convinced of its purchase for the long-term http://www.telegraph.co.uk/finance/newsbysector/energy/oilandgas/9673380/BHP-Billiton-on-push-to-harness-shale-energy-boom.html).
The lack of profit is inextricably linked to the decline rate of the reservoirs and it is our understanding that the decline rates are very high as wells experience a steep drop in production. This is not the same production profile that we have seen for major oil fields that have peaked and then declined more steadily. If we take the giant Eagleford shale region, the decline rate is estimated to be some 42% which means that the amount of drilling required to locate new deposits is massive and drilling naturally forms a major part of the cost of production. Some analysts estimate that the cost of drilling in this region alone will come to US$10 billion simply to maintain current production rates. This is most certainly not a rosy scenario from a profit perspective!

One critical analyst is Bill Powers and he has written a book called: *"Cold, Hungry and in the Dark: Exploding the Natural Gas Supply Myth"* and he concludes that the US has little more than 5 to 7 years of production.

"Put simply: There is production decline in the Haynesville and Barnett shales. Output is declining in the Woodford Shale in Oklahoma. Some of the older shale plays, such as the Fayetteville Shale, are starting to roll over. As these shale plays reverse direction and the Marcellus Shale slows down its production growth, overall U.S. production will fall. At the same time, Canadian production is falling. And Canada has historically been the main natural gas import source for the U.S. In fact, Canada has already experienced a significant decline in gas production—about 25%, since a peak in 2002—and has dramatically slowed its exports to the United States.

The decline is a set-up for a gas crisis, a supply crunch that will lead to much higher prices similar to what we saw in the 1970s."

Ultimately the outcome will be decided by the market and the price of gas and the following charts who the substantial decline in the last 5 years of the gas price in the United States as reflected in the benchmark Henry Hub price. However, you will also note that the gas price has been steadily rising over the course of the last year. Rising gas prices will not be something new to consumers in the UK especially as there is now an investigation into the possibility that gas prices have been manipulated for years: http://www.bbc.co.uk/news/business-20305667.

Source: Bloomberg: 5 year Henry Hub gas price

Source: Bloomberg: 1 year Henry Hub gas price

In spite of the volatility in short-term pricing there is much to be positive about and we look forward with optimism as we navigate the markets and chart the course to a better future.

We look forward to receiving your feedback and to being in touch again soon.

With kind regards from the SUNARES team,

Colin Moor

"I have just three things to teach: simplicity, patience, compassion. These three are your greatest treasures."

Lao Tzu

"He that can have patience can have what he will"

Benjamin Franklin