



The Commodity Super Cycle – A Case of Fatigue

After climbing to a 25-year high on May 11th, the Reuters Commodities Index (CRB – an index of all base commodities such as oil, copper, iron ore, zinc and aluminum) began to show signs of fatigue, and then slipped into a free-fall in August and September. This index has traditionally tracked the global trend in stock markets.

At its peak frenzy, traders speculated that worldwide demand would soon outstrip the worldwide supply for key industrial commodities, namely oil, copper, steel, and zinc. The commodity demand from China and India has been remarkable with consumption rates nearing 20% on an annualized basis. There remains a range of opinions over the ability of China and India to maintain growth at these frenzied levels. Should their economies exemplify typical expansion / contraction economic characteristics, then one could expect the growth rates to moderate at times.

Despite the steady growth profile of the global economies, we witnessed a significant unwinding of certain commodities prices. The domestic investment scene in Canada reflected this commodity downdraft, with the material and energy sectors in full retreat. The benchmark S&P/TSX Materials and Energy Indices declined 6.7% and 10% respectively. The gold index lost about 11% over the quarter. Natural gas is half its trading value, and gas-associated stocks reflected this decline.

Although the nuclear game played out by North Korea has ushered in additional global uncertainty, it has had little effect on the commodities index. Iran, on the other hand, through its continued defiance, was responsible for a “war premium” of about \$10 on the price of a barrel of oil. When that situation appeared to calm, the price of crude began to unwind. Speculative investors began to sell large positions in the market.

With energy and materials making up over 40% of the broad Canadian market, many investors witnessed declines in the capital value of their portfolios. In energy intensive Calgary, it was not uncommon for energy executives to watch the value of their portfolios decline over 30%. At Brownstone we limit our exposure to commodities, yet continue to be active participants. Over the quarter declines in these cyclical holdings were offset by strength in the financial services sector, our largest portfolio weight.

We continue to rebalance portfolios as changes occur in the Canadian market. Going forward, we expect the Canadian Equity market to continue to reward investors with positive returns. However, after three years of above-normal returns for this market, expectations are for lower absolute returns. On a stock specific basis, there exists many opportunities in the market to find well managed, growing companies. We continue to review companies and take positions in investments that will deliver solid risk-adjusted returns.

The Canadian Dollar – Par Pricing with U.S. Greenback Looks Distant

Few economists in our country had any notion that the Canadian dollar would ascend over 40% in the past four years as robust energy and metal prices sky rocketed carrying the loonie on its back. Talk of our dollar reaching par with the U.S. dollar began to surface as oil prices continued their skyward climb. This speculation of a dollar at par has now faded. Statistical evidence shows a strong correlation between the price of crude and the performance of the Canadian dollar. A number of these financial models suggest an oil price north of \$90 is required to push the dollar to parity with the U.S.

The Canadian dollar has held up well against the recent declines in commodity prices, yet a revaluation of the Canadian dollar is possible. We have never been of the mindset that one can predict currency prices, however suffice it to say that the strength of our currency was not the result of prudent government management of monetary policy, a virtual dissipation of separatist talk from Quebec, or Federal government debt reduction. Clearly foreign interests have been at work participating in our resource run.

At Brownstone we have completed extensive research on a U.S. based investment fund which will provide our clients with U.S. exposure, both for growth and as a currency hedge. We expect to have this product available in January 2007. We were net sellers of U.S. securities three years ago, which proved to be timely given the surge experienced in our dollar. We are now of the view that a revisit to the U.S. market is in order for risk diversification and capital growth.

Brownstone Executive Team



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