



May 12, 2008

Bill O'Grady, Chief Investment Strategist

## The Secular Bull Case For Commodities

Commodity prices have been dominating the headlines for the past year as oil prices move over \$100 per barrel, rising grain prices raise the specter of global hunger and gold penetrated \$1,000 per ounce. Anytime a market becomes this highly visible, with important commodity prices crossing major psychological points there is a legitimate concern that the gains are overdone and another "bubble" is being created. In this week's report, we will address the issue of commodity prices by taking a long-term view of this market. *Buying commodities allows for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in these markets. Any commodity purchase represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.*

- There are a number of reasons commodity prices are elevated in our view. First, the development of China and India has led to an unexpected increase in global commodity demand. Second, commodities were in a 21-year bear market from 1980 to 2001. This period was beset by persistent overcapacity across all producer groups, keeping prices depressed. As global demand rose, producers failed to respond by increasing production due to the lessons learned in the bear market. In effect, they didn't trust the price rally. Third, persistent oversupply discouraged consumers from holding inventory and investing in consumption efficiency. As prices have increased, consumers have, for the most part, complained about the increase but have not made major changes in behavior.
- The fourth reason is tied to monetary policy. When governments and central banks are engaging in disinflationary policies, there is an incentive for investors to hold financial instead of real assets. As the table below shows, periods of excessively easy policy support commodities.

| PERIOD           | AVERAGE REAL FED FUNDS | % MONTHS WITH POSITIVE REAL FED FUNDS | AVERAGE YEARLY CHG IN CRB INDEX |
|------------------|------------------------|---------------------------------------|---------------------------------|
| 7/54 – 12/70     | +1.50%                 | 88%                                   | -0.08%                          |
| 1/71 – 12/79     | -0.13%                 | 50%                                   | +12.11%                         |
| 1/80 - 12/2002   | +3.02%                 | 94%                                   | -0.29%                          |
| 1/2003 – PRESENT | +0.19%                 | 46%                                   | +10.29%                         |

*Past performance is no guarantee of future results.*

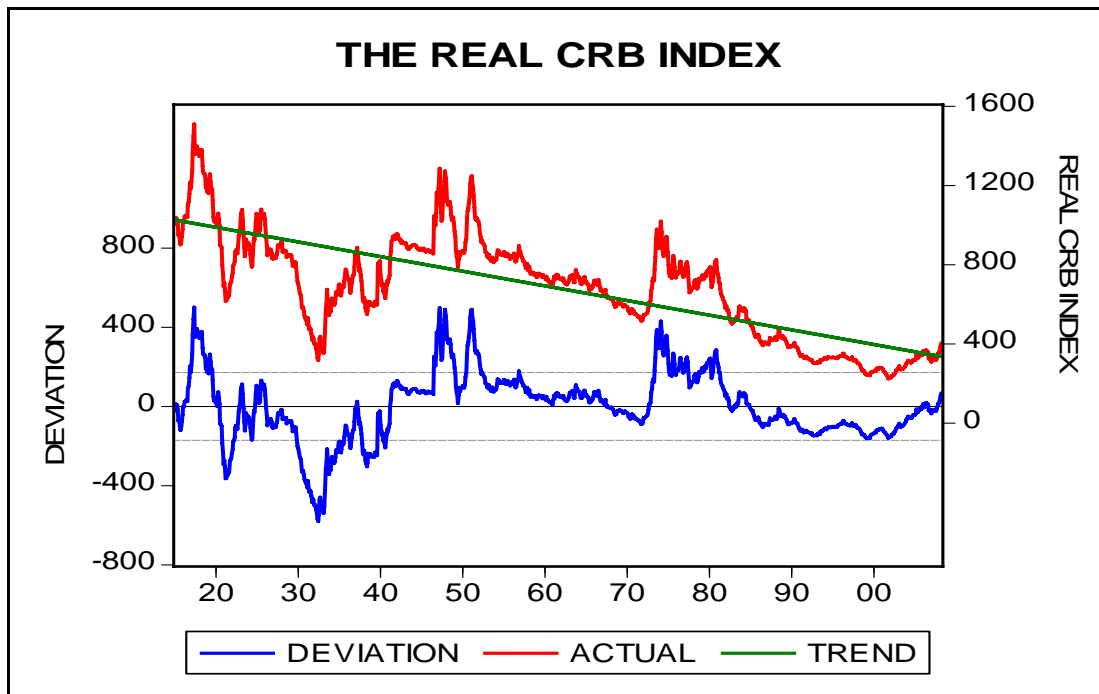
*Sources: Reuters, Federal Reserve, Bureau of Labor Statistics, Wachovia Securities.*

As the data indicate, historically when the Federal Reserve persistently keeps fed funds above the rate of inflation, commodity prices are generally flat. When the Federal Reserve keeps rates below inflation, commodity prices tend to rise. Current monetary policy appears to be encouraging investors to hold commodities as a store of value.

- Looking forward, there are two key questions surrounding the commodity markets. First, even if we are in a secular bull market, are we vulnerable to a cyclical bear market? With global growth slowing, there is a legitimate concern that weakening demand could depress prices. However, the aggressive action by the Federal Reserve to support growth should begin to have a positive impact on the economy this summer, and recent economic data suggests the current downturn will be modest. Thus, it is my belief the economic downturn won't be deep enough to seriously depress commodity prices. In addition, the Baltic Dry Freight index has moved back above 10,000 for the first time since early December. This index measures the cost of shipping non-container freight, like soybeans, cement, iron ore, etc. A rising index usually indicates increasing commodity demand.
- Second, if this is a secular bull market, what "inning" are we in? This is the topic of this week's Chart of the Week.

*Bill O'Grady has been named Chief Investment Strategist for the combined firm, responsible for providing broad-based macro analysis of domestic, foreign and commodity markets. Since joining A.G. Edwards in 1989, he has covered the debt, foreign exchange and energy futures markets as director of Futures Research, as well as performed short-term technical analysis of equities and monitored the effect of geopolitical, political, economic and social events on the equity markets as assistant director of Market Analysis. Bill was previously the Chief Global Investment Strategist at A.G. Edwards and is frequently quoted in the major media, including the Financial Times, the Wall Street Journal, CNBC and Bloomberg.*

## Chart of the Week:



*For illustrative purposes only. This does not reflect the performance of any specific investment.  
Past performance is no guarantee of future results*

Sources: Reuters, Bureau of Labor Statistics, Wachovia Securities

This chart shows the CRB commodity index from 1915, deflated by U.S. consumer prices. In the long run, one of the characteristics of commodity prices in capitalist societies is that they tend to underperform inflation. That explains the predominant downtrend. On the lower line, which shows the deviation from trend, there are four large upward spikes. All were tied, at least in part, to wars. The First and Second World Wars and the Korean Conflict are easily seen. In the 1970s, the combination of the Vietnam War and the impact of consistently easy monetary policy led to persistent above trend commodity prices.

The tight monetary policies of the Volker Federal Reserve, coupled with deregulation and globalization, led to an extended bear market where commodity prices languished below their long-term downtrend. What is interesting is that the current bull market, which likely began in 2001, has done little more than move prices slightly above trend. If commodities are in a secular bull market, one would reasonably expect that prices will continue strong for the next few years. Thus, we are probably in the “middle innings” of this secular bull market.

What ends such a bull market? We believe there are three developments to watch. First, we need to see a supply response. Commodity producers need to believe that prices will remain high and expand production. Second, consumers need to believe the same thing and reduce consumption. And, third, the central banks need to increase interest rates over the rate of inflation to a sufficient degree to encourage investors to hold assets in financial, rather than real, assets.

**Bill O’Grady (314) 955-3064**

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. The S&P 500 is an unmanaged, weighted index of 500 stocks providing a broad indicator of price movement. The Reuters-CRB Continuous Commodity Index is an unweighted geometric average of 17 individual commodity prices. Individual investors cannot directly purchase an index. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that these movements or trends can or will be duplicated in the future.

### Additional Information Available Upon Request

Wachovia Securities is the trade name used by two separate, registered broker-dealers and nonbank affiliates of Wachovia Corporation providing certain retail securities brokerage services: Wachovia Securities, LLC, Member NYSE/SIPC, and Wachovia Securities Financial Network, LLC, Member FINRA/SIPC. A.G. Edwards is a division of Wachovia Securities, LLC, Member SIPC 0508-86713

| Securities and Insurance Products                    |                |  |
|--|----------------|--|
| Not Insured by FDIC or Any Federal Government Agency | May Lose Value | Not a Deposit of or Guaranteed by a Bank or Any Bank Affiliate |