

**Peak Oil Strategy**

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**Year End Commentary**

This time last year I wrote that markets are often said to climb a wall of worry. Sometimes, though, investors just worry. U.S. investors will probably remember 2011 as an extremely volatile year in which the S&P 500 index went nowhere. It began the year at 1257.62 and closed out on December 30th at 1257.60 while ranging roughly 25%. The U.S. markets, however, tell an increasingly small part of the overall story because it is the economies of the Far East, Middle East, and Latin America that today are driving the global economy and the increases in demand for energy, food, metals and other basic materials. The European crisis dominated the financial headlines but I believe that economic expectations for China played an equally important role in what turned out to be a disappointing year for our portfolios. China’s rate of economic growth has been slowing and investors are worried about a “hard landing” and what this would mean for everything from the need to plant more corn in Iowa to the demand for more drilling rigs. The MSCI Europe index fell 10.5% for the year (probably less than most investors imagine), Japan fell 14.19% in the wake of the tsunami and the Fukushima nuclear crisis, but Asia ex-Japan fell 17.07% and Emerging Markets overall fell 18.17%.

Index Performance	4Q	YTD
DJIA w/divs.	12.77%	8.38%
S&P 500 w/divs.	11.82	2.11
Nasdaq Comp w/divs.	7.86	-1.80

The dominant action in the markets last year was reduced to “Risk-On” and Risk-Off”. On days when there was positive news out of Europe or China, the fast-money crowd sought to put *risk on* to their portfolios- they bought economically sensitive stocks including energy, basic materials, financials and industrials, Emerging Markets and commodity futures. These were the days when the Dow soared over 200 points. At other times the crowd sought to take *risk off* their portfolios by selling these same things. On those days money flowed into U.S. Treasury bonds and, to a lesser extent, into healthcare, consumer staples, and utilities. The dollar rallied; commodities and gold fell. Leveraged ETFs (Exchange Traded

Funds) exaggerated the volatility at the end of days with big price moves. Although these trading swings may seem predictable in hindsight, they have in fact become increasingly unpredictable even for the fastest and best-paid trading talent on Wall Street. Hedge funds and traders are supposed to be able to make money off volatility but 60% of hedge funds lost money last year.

Gold stocks surprised many observers including several billionaire money managers and myself with their poor showing. Despite the reputation of gold as a hedge against economic turmoil, the XAU gold stock index fell 20% in 2011. The drop was exaggerated because gold stocks closed on an especially high note in 2010 and at a nadir two weeks ago, but we must still ask why. Gold bullion gained 10% for the year (the eleventh straight annual increase) but the closing trade of \$1,566.80 represented a drop of nearly 20% from the high of \$1,923.70 reached on September 6th. Although gold stocks never came close to being valued on the basis of \$1,900 gold, the falling price of bullion pressured the stocks lower. The risk-off trade gets part of the blame. Computerized algorithm-driven trading is not about ultimate safety- this stuff is put together by the same math geniuses who brought us the Long-Term Capital Management debacle, the collapse of AIG and who today are assembling the next derivatives bomb- no, the goal here is simply to press short-term trading correlations. Risk-off has perversely come to mean buy the dollar and sell anything inversely correlated to it. Gold, generally, has a strong inverse relationship over short and medium-term time periods and gold stocks can add leverage to that bet. These risk-off trades pushed gold down counter to the normal tendency for gold to rally during a flight from risk. When gold failed to protect investors amid the turmoil taking place in Europe some investors started to doubt its role as a safe-haven asset, further undermining the psychology. The latest trading fad will fade fast when it stops working like others before it- gold on the other hand has a six-thousand year history as a store of value.

Where to next? There is a vocal crowd claiming that the bull market is over for gold and that the dollar has bottomed with a multi-year rally to ensue. I have read many of their arguments and none make sense to me unless we can stipulate a resumption of the pre-millennium trend rate of economic growth in the West while simultaneously implementing draconian austerity budgets. The economic history of the past 100 years argues that this is a fantasy even before we start to take into account the economic reality imposed by suddenly finite resources.

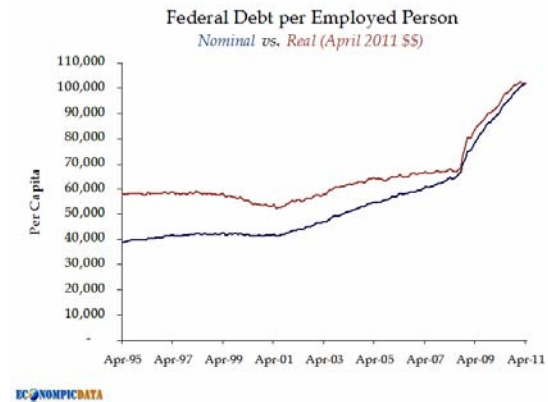
In my opinion, what we have been dealing with in the precious metals portion of the portfolio is a correction, one of six corrections of more than 10% since the start of the bull market in 2001. The chart below shows that these pullbacks in gold have happened at regular intervals and in the absence of a fundamental change in the driving factors we have no reason to think that this bull is done. The developed world's massive debt problem is proving intractable whether fiscal austerity measures are being taken (causing economies to shrink faster than their debts) or whether fiscal stimulus is in effect as in the U.S., where the national debt is growing three times faster than GDP. The U.S. Federal Reserve, The Bank of England, Bank of Japan, and the ECB are all pursuing QE policies under various guises as well maintaining short-term interest rates at or near zero. These policies have a corrosive effect on the purchasing power of their respective paper currencies; they punish savers and boost the value of hard assets but



are absolutely required to prevent collapse. Three years after the 2008 credit crisis there is no serious discussion of tightening monetary policy, only of the next official round of quantitative easing in an effort to shore up the housing market. Central banks around the world are increasing their gold purchases ostensibly to diversify their reserves, but it may also be indicative of their declining confidence in the paper currency of other nations. The Wall Street Journal reported that in the third quarter central banks bought

seven times more gold than they did a year ago. China is the world's largest gold producer but despite this its imports of gold are surging to more than double year earlier amounts. Investor demand for physical gold continues to be strong despite the price pullback that appears to be driven by trading activity in the futures markets. Gold bullion continues to represent less than 1% of financial assets. Gold is admittedly hard to value on any intrinsic basis, but when one considers that in 1968 gold made up nearly 5% of financial assets, this is a factor that allows for significant growth in the gold price from current levels. Lastly investor sentiment as a contrary indicator continues to support a secular bull market. Aside from surveys, there are two other ways to test sentiment: the first is to watch the mainstream media- each time gold drops 10%, headlines quickly proclaim the "end of gold's run"; the second is to compare gold stock valuations relative to their history. According to BMO Capital Markets, gold miners have not been this cheap in the past 20 years. Bull markets do not end amid nervousness and low valuations but with the kind of certainty that excuses stretched valuations.

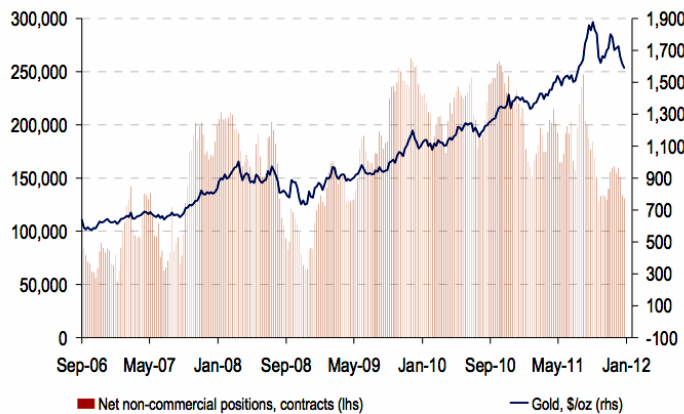
Europe will continue to be a major concern until the situation is resolved either through a fracturing of the union or increased fiscal integration. The current chaos cannot be sustained for much longer and therefore I believe we will get the answer this year. Once this happens, no matter which way forward is chosen, I believe that attention will shift back to the U.S. fiscal crisis. A shortage of safe-havens has temporarily created an unnatural demand for U.S. Treasuries perpetuating the impression that the U.S. will have no trouble funding its deficits, but how sustainable is this pattern? Factcheck.org reports that in 2011 the U.S. Federal Government borrowed 36 cents of every dollar it spent. The public debt grew by \$1.2 Trillion or roughly \$8,500 per employed worker. The total Federal Debt now stands just under \$15.2 Trillion (\$107,000 per employed worker) and exceeds 100% of GDP. Bad enough, but both the deficit and the debt numbers do not properly take into account the present value of future obligations from Medicare and Social Security let alone contingent liabilities and exposures to quasi-independent agencies including Fannie Mae, Freddie Mac, the Federal Housing Authority (FHA), the Pension Benefit Guaranty Corporation (PBGC), and the FDIC. As Niall Fergusson wrote in 2010, the day of reckoning still seems reassuringly remote but the Greek crisis is coming to America because the problems are essentially the same. Nobel prizewinner, Paul Krugman, complains that "Nobody Understands Debt", urging more deficit spending to boost growth, but what if we no longer can grow our way out as we did in the post W.W.2. oil-fueled boom? If oil flows (at economically viable prices) have become the principal limiting factor for western economies, then this would explain why we have reached the point of debt saturation where more borrowing and spending no longer yields the expected change in GDP. What our developed economies are suffering from is not a debt problem but a growth problem.



Perhaps it is because we have no direct comparable experience, but there is a curious tendency in the U.S. to underestimate China and project financial debacle on their economy. U.S. non-farm employment is back to where it was in 2001, housing prices are back to 2003 levels, and auto and light truck sales are back to where they were 20 years ago but Wall Street has been worrying that Chinese growth could drop to 6%. What would be considered a momentous level of growth in the U.S. represents a "hard landing" in China. This is a country that has been growing at better than 7% per year for the past 20 years creating roughly 10 million new jobs each year. Granted, with 8 million new job entrants each year, China's leaders have felt the pressure. According to Yiping Huang, Chief Economist for Emerging Asia at Barclays Capital, 8% growth was for many years considered the "lucky number" that would ensure social stability, however, he said recently that this represents old thinking. There are now only 5 million new entrants into the job market each year and he believes that 5 to 6% growth would create enough new jobs. He sees growth moderating (as confirmed by the most recent economic data) but no calamity. Under the worst case of a global recession he believes that China's growth could slow to 4.5% but this would unleash a major policy response. Similarly he does not believe that China is likely to have a U.S.-style housing bust. The ratio of non-performing home loans in China was 1% recently (as compared with approximately 4% in foreclosure

and another 8% delinquent mortgages in the U.S.) and Chinese homebuyers put much more money down. China's benchmark one-year interest rate stands at 6.56%, which allows their Central Bankers room to maneuver. By contrast the one-year Treasury rate has not been above 6.5% since early 1995. The general impression created by China's doomsayers is that they could blow-up, causing widespread recessions in resource-driven economies and disaster for hard-asset stocks. A Google search reveals that this has been a recurring theme, but while China's economic growth must and will slow, it is also likely to continue growing at a rate that will maintain a tight balance between supply and demand in the oil market as well as many other basic materials.

Last year in many respects was a year of waiting; waiting for the signs of resolution to the European crisis, waiting for Congress to act on routine business to prevent government shutdown, and waiting for China's policymakers to ease up on their effort to restrain the overheating economy. It was frustrating and the



Source: GFMS, BofA Merrill Lynch Global Commodity Research

extreme volatility was unnerving. As we begin this year amid what seems like great uncertainty I can make one bullish observation: expectations are very low. U.S. investors have been pulling cash from stocks and sticking it under the mattress. Futures speculators today hold the smallest net-long position in Comex gold contracts that they have had since the depths of the 2008 crash. Most other major commodities have registered similar declines in net-long positions signaling subdued sentiment. For sure there is plenty to still worry about; a Greek default could happen

by March, a shooting war could break out in the Strait of Hormuz, the 2012 elections will be upon us soon. But with large amounts of cash sitting on the sidelines, and many markets priced for bad news, small doses of good news could have a surprisingly powerful effect. In the near term, signs that China will once again avoid a "hard-landing" could be especially bullish for our positions. Goldman Sachs' Jim O'Neil (who coined the term BRIC) pointed out recently that China is adding the equivalent of the Greek economy every four months.

I believe that our portfolios continue to be positioned well to take advantage of powerful long-term trends that are far from over. "The Limits To Growth" was first published in 1972. A small team of scientists at MIT used the first ever systems-modeling software to try to quantify concepts that forward-looking scientists had been concerned about since the dawn of the Petroleum Age. It was already clear to them that human growth in population, production, consumption and waste was an exponential phenomenon existing within a finite space. They attempted to answer questions such as: "Are current policies leading to a sustainable future or to collapse? What can be done to create a human economy that provides sufficiently for all?" Today "sustainable" has become a hot marketing buzzword with little real meaning and the ideas studied by Donella Meadows, Jorgen Randers, and Dennis Meadows are as revolutionary and as far from broad acceptance as they were in 1972. There can be no doubt that the critics of LtG have managed to derail the debate for forty years but it is equally true that their World3 computer model (unlike most models created by mainstream economists) continues to be proven frighteningly valid as new data keeps rolling in.

M.S.

**The ten largest positions of the collective portfolios at year end 2011 with the S&P 500 index shown for comparison.**

Security	% of total	Average Cost	Price 12/31/11	1 Year Gain/Loss	Div Yield	P/E 2011	2011-12 EPS Growth	2011 Est EPS	2012 Est EPS
Oceaneering Intl.	9.63	\$14.66	\$46.13	25%	1.30%	23.07	27.50%	\$2.00	\$2.55
Barrick Gold	9.61	\$31.87	\$45.25	-15%	1.30%	9.25	21.68%	\$4.89	\$5.95
Newmont Mining	8.78	\$51.81	\$60.01	-2%	2.30%	13.28	32.74%	\$4.52	\$6.00
SPDR Gold Trust	7.54	\$87.48	\$151.99	10%		N/A			
Schlumberger	7.12	\$47.35	\$68.31	-18%	1.50%	18.72	33.97%	\$3.65	\$4.89
Deere & Co	5.68	\$44.42	\$77.35	-7%	2.10%	11.60	19.19%	\$6.67	\$7.95
National Oilwell Varco	5.66	\$33.04	\$67.99	1%	0.70%	14.50	25.80%	\$4.69	\$5.90
Kinross Gold	5.41	\$12.44	\$11.42	-40%	1.10%	13.60	46.43%	\$0.84	\$1.23
Weatherford Intl.	4.38	\$19.23	\$14.64	-36%		17.02	79.07%	\$0.86	\$1.54
Rowan Drilling	3.7	\$32.93	\$30.33	-13%		24.86	168.03%	\$1.22	\$3.27
S&P 500 Index			1257.60	0%	1.97%	12.90	9.95%	\$97.50	\$107.2

The earnings estimates are the most recent publicly available consensus estimates of published analysts. Price/Earnings (P/E) ratios and one-year earnings growth estimates are only a crude tool for making rough comparisons. All estimates by their nature depend on assumptions. Qualitative differences are at least as important and many other factors must be considered.

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