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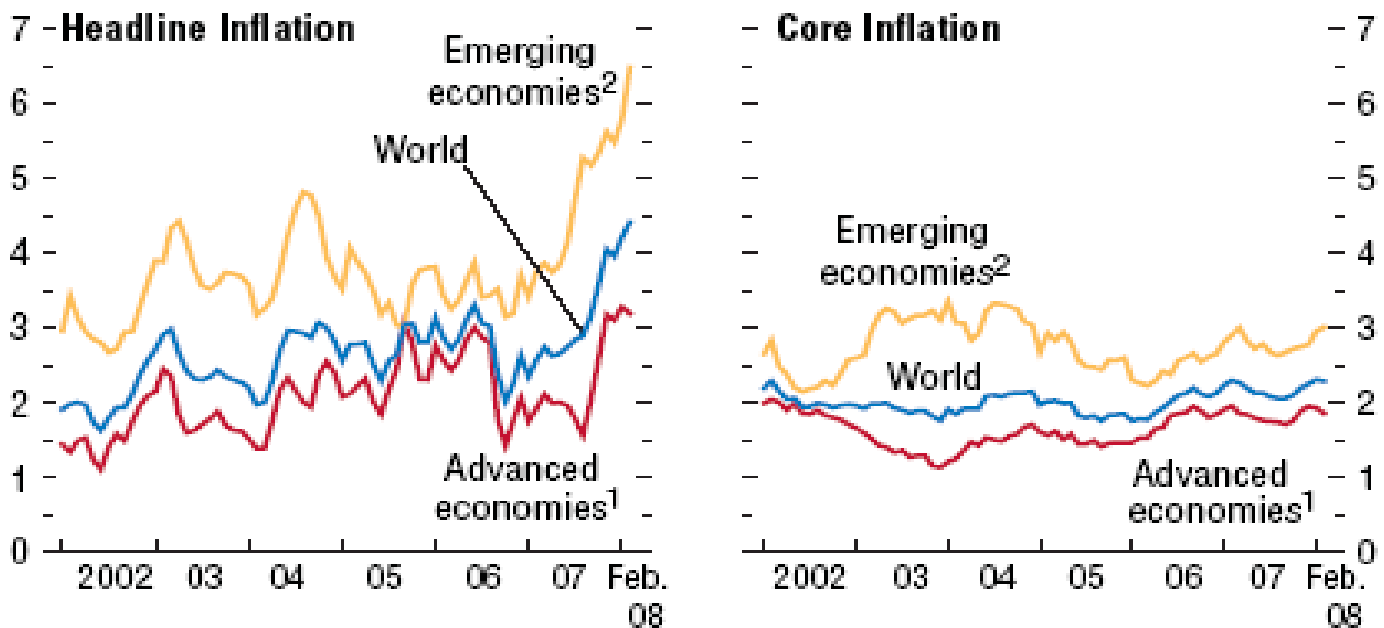
July 31, 2008

Change in Leadership

The Doha round of global trade talks, now in its seventh year, broke up without agreement on Tuesday after nine days of tense negotiations. Sharp divisions between the US, India and China about access to agricultural markets in the developing world could not be bridged and the talks came to a grinding halt, frustrating efforts by Pascal Lamy, director-general of the World Trade Organization, to broker a compromise. The failure marks the third summer in a row that ministers have left a high-profile summit empty-handed. Several ministers said the issue on which the talks had foundered – a mechanism allowing countries such as India and China to protect farmers from surges in imports – was a relatively small part of the talks, and there had been good progress in issues such as the long-running dispute over banana imports to the EU. But they admitted it was not clear whether those gains could be preserved and picked up again at a later date. Doha is dead and that is a shame.

The latest [communiqué](#) from IMF's World Economic Outlook [WEO], released Friday stressed the IMF's view of a significantly slower pace in global growth during the second half of fiscal '08, before a gradual recovery starts to take place in fiscal '09. "The global economy is in a tough spot," the fund said in its latest update, "caught between sharply slowing demand in many advanced economies and rising inflation everywhere, notably in emerging and developing economies."

Global Aggregates



As a result of soaring commodity prices, inflationary pressures are clearly increasing at a faster pace in the emerging and developing economies. As inflationary pressures gain a broader base, the impact of increased restraints for productive economic activity accelerates. This economic deterioration inevitably leads to slower demand while presenting significant downside risks to economic growth. The fund's inflation forecasts for the emerging and developing economies was raised by more than 1.5 percentage points in both 2008 and 2009, to 9.1 percent and 7.4 percent, respectively. "However, apart from the fact of inflationary pressures gaining steam from accommodative macroeconomic, loose monetary policies and other factors, one aspect worth noting is that the global fundamentals, aren't all that bad." according to the fund. You would not know it, however, judging from the stock market performance of your average emerging markets fund. The average emerging market index is down from its peak in October by 25% or more. Hedge funds are having their worst month in eight years after popular bets against banks and in favor of rising commodity prices went badly wrong. Among those hit by the

unwinding of the bank/energy trade, according to letters to investors, are two of the best-performing hedge funds of the past 18 months - Harbinger Capital and Clarium Capital. New York-based Harbinger, which manages \$26 Billion, lost 12 per cent in the first two and a half weeks of July, while San Francisco's Clarium plunged 10 per cent in a week to leave it down 4.3 per cent for the month to the 18th. Many hedge funds have been betting that bank stocks would fall further as the credit crunch continued to bite, and that oil and other commodity prices would keep rising - a trade which generated big profits this year, helping offset losses in other areas. But over the past fortnight the trade has been hit by one of the most vicious falls in commodity prices on record and a leap in financial stocks. Let's take a look.

CRB Index (weekly)



West Texas Intermediate



The first chart shows that the [Commodities Research Bureau Index](#) (commonly referred to as “the CRB”, which is a basket of 17 commodities) lost over 15% since the beginning of July. The price of crude oil (second chart) lost 20% in the same time frame. Commodity funds collected money for years based on the “theme” that the supply demand balance is permanently tilted in favor of demand (which it probably is) and the concept that “this time it’s different” (which it definitely is not) and that commodities were a new asset class, worthy of buying and holding, are turning right around and are selling into this decline. The toned down rhetoric between the US and Iran gives credence to a recent article in Barron’s, that an [amicable endgame](#) is in sight. Hoarding of crude oil is no longer a winning game and buy and hold commodity funds are quickly forgetting their long term strategies and are bailing out. Ever since the beginning of July, commodities are selling off based on the idea that the world might enter into a recession. Ever since that time too has the US market found its footing and rallied hard for a couple of days. The rally was concentrated strictly in the oversold stocks such as financials and even some retailers. Sure, the market averages rallied too (they were grossly oversold), but most stock groups that had been hiding places were not just left behind in the rally but sold down. Especially the energy sector as measured by the [XLE](#) lost 22% in just six weeks. This causes a couple of ruminations. First, we have yet to hear anyone tell us that we should be in the **early cycle stocks** like banks or homebuilders. So the good news is that folks seemingly are giving up on the theme that by the time the government tells us we’re officially in a recession the market will have moved on and begun reflecting a move out of recession. Second, although the decline of June and early July reflected concern about the horrible condition of banks, it didn’t reflect a credit crisis the way the August 2007, January and March 2008 declines and subsequent lows did. In those three previous declines credit spreads widened, pointing to some sort of financial crisis. This time that did not occur. Each of those lows ended with some sort of Fed intervention; this one did not. It ended with better-than expected earnings, or at least earnings that were not as bad as feared, announced by Wells Fargo and a couple of other banks. This is merely speculation, but I think it is possible that the six-week decline that we had in June and early July was because folks had at last given up hope and were really selling these stocks. It was not about fear. It was what we might call the “give up” phase. Keep in mind that **corrections are the market’s way of changing leadership**, and so far that is what we are seeing. People are moving out of the late cyclical like energy and into the early cyclical like banks and homebuilders.

Hermann Vohs