

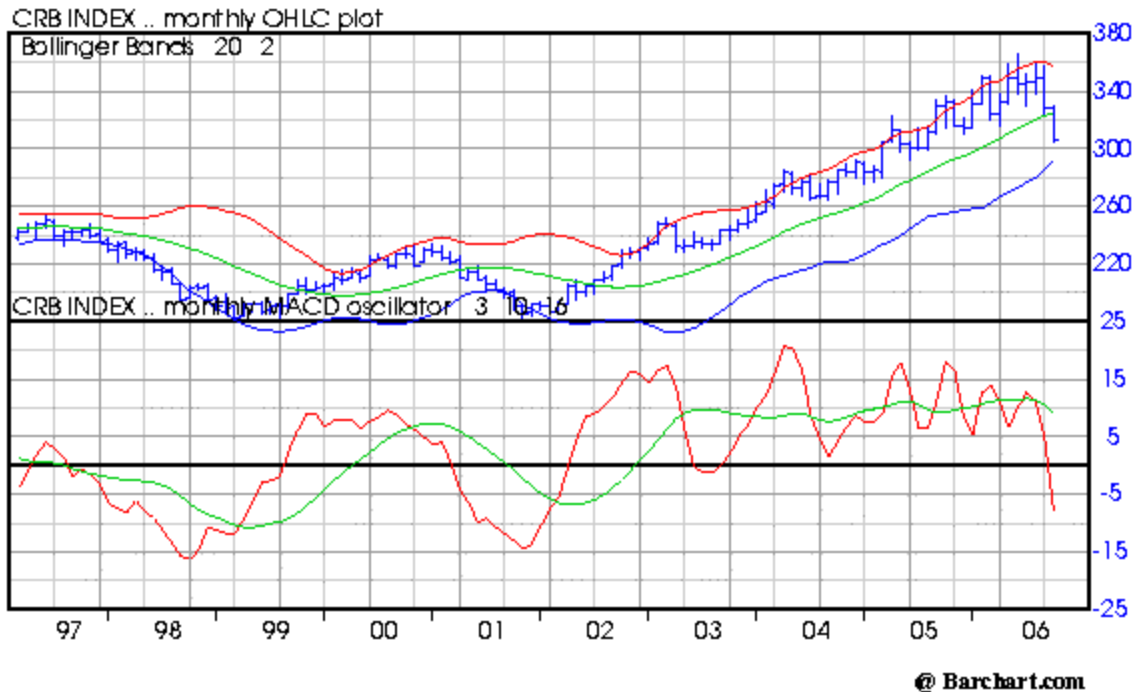
Cales Investments, Inc.

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Recession Watch

Commodity prices slid across a broad front, led lower by crude oil and natural gas. Crude fell an additional 4.4% on the week, with the nearby futures settling at \$63.33 a barrel. This is down nearly 20% from its peak at close to \$80 in mid-July, a drop that is just short of the common definition of a bear market. Gold, meanwhile, is already down the requisite 20% from its peak last May to qualify as a bear, shedding another 5.6% in the week, with the December Comex contract settling at \$583 an ounce. Meanwhile, yields on the 10-year Treasury note stayed close to unchanged all week at 4.79%. But are commodities truly in a bear market now?



The chart above captures better than any dramatic description what is going on in the commodity markets these days. The Commodities Research Bureau, which is a basket of 17 commodities, corrected by almost 20% and is also close to entering bear market territory. The index is more heavily skewed towards softs like corn and soybeans rather than metals (like the CRB/Reuters Spot Raw Industrial Index) or energy like the (Goldman Sachs Commodities Index). You can take my word for it, however, that their declines are all similar to the one you see above. So what are these crash like declines telling us? We know from technical analysis that bull markets are interrupted by short and sharp corrections which by their sheer viciousness scare many investors away and therefore create the prerequisite conditions of any bull market, which is to continue their march upward with as few people on board as possible. This might be the case at present but how can we be sure? Examination of the current fundamental backdrop gives us additional information.

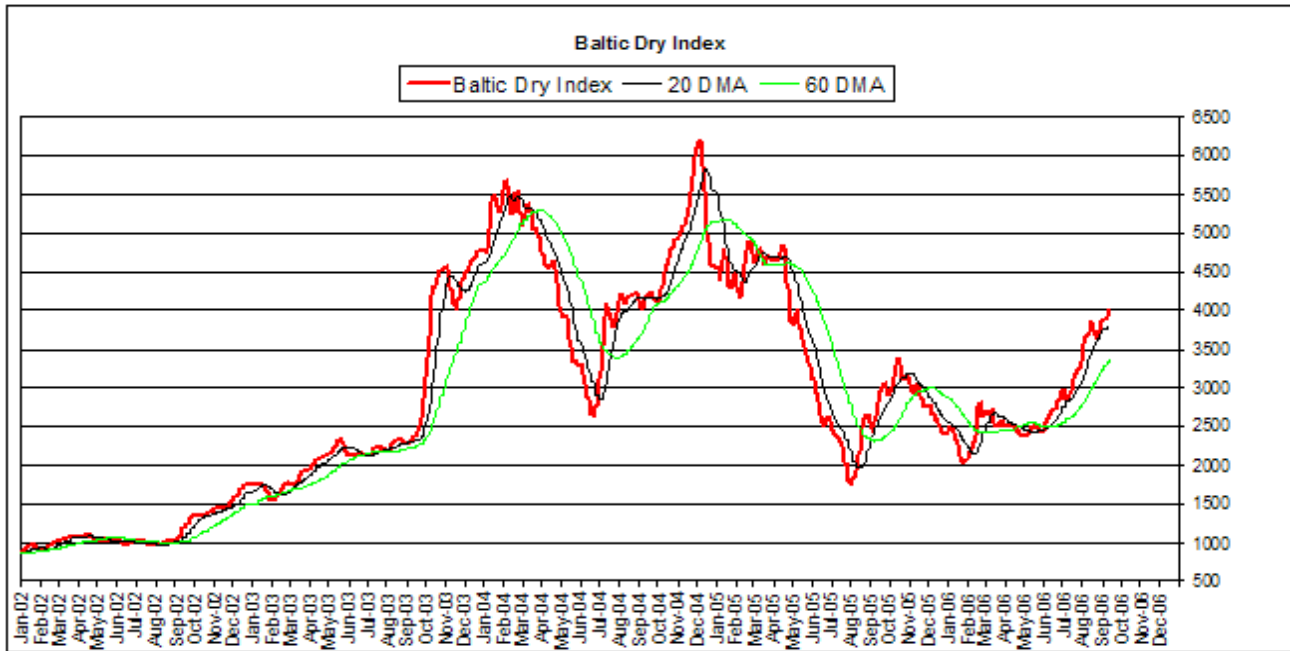
The worldwide economic expansion and the concomitant increase in demand for raw materials seems to continue unabated. This fact is reflected in the Baltic Dry Index, which just this week reached 4,200 and thus another 18 months high. The index is managed by the Baltic Exchange in London and provides an assessment of the price of moving the major raw materials by sea. Taking in 24 key shipping routes measured on a timecharter and voyage basis, the index covers supramax, panamax and capesize dry bulk carriers carrying a range of commodities including coal, iron ore and grain. The index is made up of an average of the Baltic Supramax, Panamax and Capesize indices. These indices are based on professional assessments made by a panel of international shipbroking companies. Since the cost of shipping varies with the amount of cargo that is being shipped (supply and demand), and since dry bulk is usually goods that are precursors to production (like

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cement, coal, and iron ore), **the index is also seen as a good economic indicator of future economic growth** and production. Marc Chandler, chief foreign exchange strategist at Brown Brothers Harriman and wrote in an article on Thursday: “Many observers feared that the global economy was headed for a hard landing, spurred by higher interest rates, higher energy prices and the demise of the U.S. consumer under the weight of a collapsing housing-market bubble. Those fears now seem exaggerated. As recently as Sept. 14, the International Monetary Fund was warning that the **strongest global economic expansion in 30 years** may be at risk because of high energy costs and a drop in U.S. prices. These views seem dated, and rather than a hard landing, the risk would seem to lie in the other direction: that the decline in interest rates and commodity prices prevents the kind of economic slowdown the Fed anticipates would relieve pressures on capacity constraints and prices.”



Let us also consider that **China's** economy grew at an 11.3 percent annual rate in the second quarter, the swiftest pace in a dozen years. The rate exceeded by a full point the annual rate in the first three months of the year and overshot most expectations. The official target for the year is 8 percent. The rapid growth heightened fears that the government may not be able to slow the enormous economy. China needs raw materials of all kind and is willing to pay for them. That means that goods are moving through the worlds shipping lanes towards this gigantic economy, leaving everybody else to compete for dry bulk space. The result are rising shipping costs. Surely this is not a sign of an impending economic slowdown. And here comes the best part: Along with commodity prices, **U.S. bond yields** have fallen nearly 50 basis points since peaking in midsummer. Some very preliminary indications suggest that the lower rates are beginning to help support the housing market. U.S. housing stocks were one of the best performing sectors last week. The lower term structure also means that fears that a multitude of U.S. homeowners would be significantly pinched as adjustable-rate mortgages adjusted upwards may be exaggerated. There is some anecdotal evidence that suggests many homeowners might be rolling into new ARMs, which also helps minimize or postpone the interest rate adjustment. This is also a bullish development for the U.S. economy. The decline in interest rates is not limited to the U.S. And the decline in **global interest rates** may help bolster the world economy. European 10-year bond yields have fallen 20 bp over the past three months, and 10-year Japanese government bonds yields have fallen 13 bp. It is true that these are not large moves, but the direction is important. On the margins, the headwinds of higher long-term interest rates have subsided. Regarding the recent meltdown in the commodities markets: It seems that that a bunch of traders/hedge funds who had no clue what they were doing on the way up have gotten burned by exogenous events and were forced to liquidate all the way down. The swiftness of this decline has already planted the seed for a continuation of this commodity bull market by keeping everybody scared and away from commodities.

Hermann Vohs