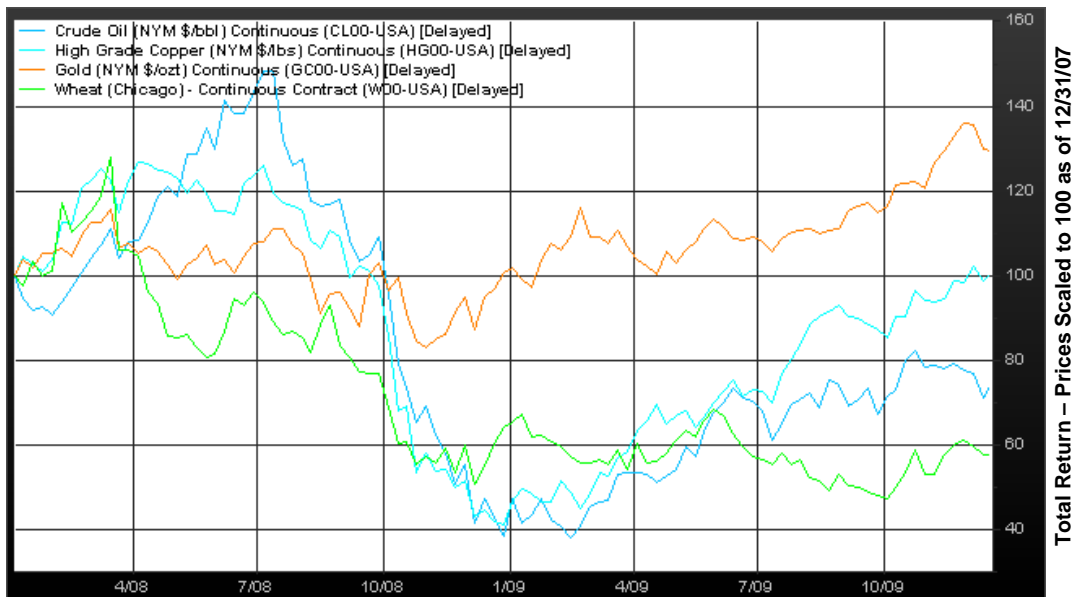




Gold and Oil – A Tale of Two Commodities

Aggressive money creation and stabilizing global economies in 2009 helped spur a powerful rally in oil and metal prices. However, declining grain and natural gas prices limited overall commodities to a gain of 15% (measured by the Dow Jones-UBS Commodity Index). **Commodities continue to offer compelling long-term potential returns based upon RiverFront's Price Matters¹ framework.** We think commodity prices will be supported by accelerating emerging market growth and accommodative Fed policy, at least through the first quarter of 2010, with the potential for further upside if the Fed extends its current quantitative easing program. However, we believe that performance across the different commodity sectors will continue to vary widely in 2010, and that successful commodity investing will require a thorough understanding of the unique supply and demand characteristics at work in each sector of the market.



Source: FactSet

While performance varies between equity sectors, the overall stock market usually pulls all sectors in the same direction. However, in commodity markets, unique supply and demand dynamics often lead to surprisingly low correlation among precious metals, agricultural products, industrial metals and energy sectors. These interplays of supply and demand are illustrated in the recent behavior of the two most prominent commodities – gold and oil.

We examined three distinct sources of demand to analyze commodity sectors: (1) real economic demand; (2) demand resulting from excessive money printing; and (3) speculative demand. Real economic demand stems from the industrial, agricultural and consumer uses of commodities and is highly correlated to global economic growth. The second demand source results from central banks' ability to print money. Commodity prices generally tend to rise when central bankers debase their currency and investors' perceive commodities as a fixed store of value. Finally, speculators become interested in commodities when they see consistently rising or falling prices and believe they can profit from these trends. The interplay of these three sources of demand varies materially among commodities. Gold has few economic uses, and

¹ RiverFront's Price MattersSM discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. For additional information see *The Strategic View -- The Heart of the RiverFront Value Discipline: Dynamic Strategic Allocation* (2/3/09), available at www.riverfrontig.com.

its demand is largely driven by the magnitude of currency creation. Thus, the increase in paper money in response to the financial crisis has had a far stronger impact on the demand for gold than the recession itself. Since the supply of gold is relatively fixed in the short run, this consistently strong demand has pushed gold prices to all-time highs. Although our Price Matters discipline suggests that gold is about 70% overvalued, previous periods of aggressive money creation have pushed gold to as much as 200% overvalued. We think that gold investors hoping for compelling long-term returns will likely be disappointed, but as long as the Fed continues to print money, gold's outlook remains positive, in our view.

In contrast to gold, oil demand is very highly dependent upon the strength of the global economy. Demand in the major emerging economies, especially China, India, and Brazil, is likely to accelerate in the coming months as these countries appear poised for sharp "V-shaped" economic recoveries. However, this rising demand may take some time to work off current excess inventories (so many oil tankers are currently being used to store excess oil that a recent *Wall Street Journal* article highlighted the potential for catastrophic oil spills). The impact of this excess supply on oil prices could outweigh the impact of increased money printing, especially if this supply is augmented by Saudi Arabia. Saudi oil ministers have indicated they are comfortable with oil between \$60 to \$80 per barrel, and that they would be willing to adjust production to keep prices within this range. This price range is high enough for Saudi Arabia to fund its social spending obligations but not so high as to spur rapid exploration for new reserves and competing energy technologies, as did \$145 per barrel oil in 2008. Coincidentally, the fair value for oil suggested by our Price Matters framework is also close to \$80 per barrel.

Saudi desire for \$60 to \$80 per barrel oil clearly did not prevent prices from rising much higher in 2008. However, we believe that changes in China's energy subsidy policies could prevent the speculative frenzy that characterized oil markets during that period. In 2007 and the first half of 2008, energy subsidies in China, India, Indonesia and other emerging markets insulated these countries' consumers from the full impact of rising oil prices. **Energy subsidies allowed traders and oil speculators to push oil prices to record highs without the collapse in demand that would normally occur**, in our view. When faced with a price-insensitive buyer, speculators will typically drive up prices until the subsidy providers either go bankrupt or get tired of funding the speculator profits.

China substantially reduced its oil subsidies in June 2008, setting the stage for deflating the commodity price bubble; the subsequent 2008 financial crisis caused the commodity bubble to collapse. China learned the lesson of the 2008 oil market bubble and altered its subsidy policies. While Chinese consumers and exporters continue to benefit from subsidized energy prices, China now fixes the subsidy rather than the price of oil. Thus, oil prices in China remain below global prices but now fluctuate up and down with them. We believe this change in policy makes it more difficult for speculators to take control of the oil market and returns a degree of control over the marginal price of oil to the Saudis. In conclusion, rising global growth and continued expansion of money reserves will support oil prices, but formidable Saudi resistance makes a return to oil's 2008 highs unlikely, in our view.

Portfolio Strategy

Commodity prices in the futures market have been consistently above prices for immediate delivery. This condition (called contango) detracts somewhat from commodities' return potential. However, our Price Matters framework and commodities' correlation benefits suggest continued allocation to this asset class.

Within commodities, we remain overweight precious metals despite their overvaluation thanks to strong upward momentum and historical precedent for even greater levels of overvaluation. Energy prices face potential headwinds due to changing supply and demand dynamics, but with oil currently in the middle of the Saudi's comfort level, we maintain a neutral weighting. We have been cautious on agriculture commodities because they are the only commodity sector in which improving technologies have consistently lowered production costs for over 60 years. Higher marginal costs of extraction and production are a tailwind for gold, oil, and most other commodities. However, agricultural commodities underperformed in 2009 and look fairly attractive on our Price Matters framework. Therefore, we remain alert for opportunities to add exposure as rising demand from emerging economies could combine with historically low inventory levels, prompting a "catch up" rally. Industrial metals represent the best combination of attractive Price Matters valuation, rising global demand, reasonable supply considerations and strong relative momentum; we remain overweight in our portfolios going into 2010. *Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.*

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