US EIA/SAIS 2010 Energy Conference
Short-term Stressses, Long-Term Change
Short-Term Energy Prices – What Drivers Matter Most?
April 6, 2010
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What have we learned about commodities?
Structural commodity bull market looks like it is here to stay…but with a difference

- A nearly decade-long global commodity boom cycle, interrupted by 2008,
  - Was propelled initially by a rapid nearly simultaneous reduction in energy, base metals, agricultural and bulk commodity inventories and by production supply constraints
  - Coincided with the development of new financial instruments, including indices, that provided flexible instruments for investors to gain direct long exposure to commodities without incurring the costs of holding the underlying, enabling them to diversify portfolios and hedge against perceived dollar and inflation risks
  - Triggered (as a result of rising prices) capital expenditures to develop new supplies, setting the stage for significant divergences in the price paths of different commodities; commodity differentiation was already under way when prices fell precipitously in 2008

Source: Credit Suisse Estimates

Source: Credit Suisse Global Commodities Research
The rise and fall and rise of commodities

Highly correlated price increases followed by divergent price paths

S&P GSCI ER Indices:
- Gold
- Copper
- Sugar
- Crude Oil
- Wheat
- NatGas

Source: Bloomberg PROFESSIONAL Service ™, Credit Suisse Global Commodities Research
What have we learned about commodities since 2003?

Commodities constitute an asset class like equities; however, different classes and subclasses behave in very different ways. In other words, the whole may be less than the sum of its parts.

- In a bull market (2003-2008), a long-only strategy is likely to bring positive returns (i.e., in 2003-2008, of all the main commodities traded, only cotton had negative underlying returns).
- But the “super cycle” was the invention of sloppy thinking and an accident of history; profiting from commodity exposure requires more micro analysis.

Returns on Different Commodities, 2003-2008

Source: Bloomberg PROFESSIONAL Service™, Credit Suisse Global Commodities Research
As the global recovery resumes…

- Commodities are likely to become even more differentiated.
- Those whose investment cycles unfolded and saw breakthroughs in new supply through new investment alone or in combination with application of new technologies should see range-bound prices.
  - Natural gas is the most distinctive commodity in this regard.
- Those whose investment cycles started to unfold may see markets tighten again.
  - Copper and petroleum are in this category.
- A return to growth, with neither deflation nor inflation, should see precious metals lose their attraction as a presumed store of value and an inflation hedge.
Today’s markets pose enormous challenges for investors

2010 Q1

YTD

-40%
-30%
-20%
-10%
0%
10%
20%

Nickel
Live Cattle
RBOB Gas
Lean Hogs
Feeder Cattle
Cotton
Gas Oil
Crude Oil
Copper
Gold
Silver
Aluminium
Heating Oil
Coffee
Soybeans
Red Wheat
Zinc
Corn
Cocoa
Wheat
Lead
Natural Gas
Sugar

- It’s hard to predict that a particular commodity investment will yield a 15%-20% return this year.

- The “old” and “new” gold (crude oil, copper, silver) at best have preserved capital year to date.

- Bottom line: getting returns from commodities requires smart investment.
Altered investment landscape: relationship between commodities and the US$ no longer appears random…

- Here’s the typical textbook example: because silver is traded in US dollars, when the dollar depreciates, silver prices increase.
- But the historical test of this relationship has been weak…
- We have seen essentially as many periods when individual commodity prices and the US$ have had a positive as a negative correlation.
- This historical relationship has been a random walk.
But the relationship changed radically after 2007: are we now again back to a random walk?

- The summer 2007 credit crisis brought a strong negative correlation between crude oil and the US$.

- 2009 was a tale of two trends – initial recovery brought a positive correlation, but the negative correlation dominated Q2, and after Q3, a positive correlation returned.

- Unless trader sentiment shifts, we expect the relationship between the US$ and commodity prices to moderate.

Source: Bloomberg PROFESSIONAL Service™, Credit Suisse Global Commodities Research
Investment Flows into Commodity Indices and ETFs are picking up

- Forward curves moving into backwardation and commodities becoming increasingly attractive
- Inflows into commodities increasing
  - Week ending March 23rd, $2.30 billion estimated inflows ($240 million in ETFs)
  - Last week of March, $2.5 billion estimated inflows ($280 million in ETFs)

Source: Credit Suisse Global Commodities Research
COMMODITIES RESEARCH

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- **Outperform**: Indicates an above-average total return performer within its sector. Bonds in this category have stable or improving credit profiles and are undervalued, or they may be weaker credits that, we believe, are cheap relative to the sector and are expected to outperform on a total-return basis. These bonds may possess price risk in a volatile environment.
- **Market Perform**: Indicates a bond that is expected to return average performance in its sector.
- **Underperform**: Indicates a below-average total-return performer within its sector. Bonds in this category have weak or worsening credit trends, or they may be stable credits that, we believe, are overvalued or rich relative to the sector.
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<th>Percentage</th>
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<td>27% (of which 85% are banking clients)</td>
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