Mr. BRIC Trade is on Our Side

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Dear Fellow Investors:

A recent article in "The National" quoted Jim O'Neil as saying that current supply and demand for oil indicates that $80 to $100 per barrel for Brent Crude would be a fair price. For those of you who don't recognize the name, O'Neil is a very savvy economist for Goldman Sachs (GS), who coined the phrase BRIC trade back in 2001. Since that qualified him as an investment "Wayne Gretsky" (he skates to where the puck is going to be), we believe his thoughts are worthwhile.

O'Neil argues that there are no winners in a war over Iran's nuclear capability. Therefore, he argues that the $25-35 premium in the price per barrel, which comes from supply disruption fears, would disappear by summer. We agree wholeheartedly.

We also agree with his belief that Brazil and Russia don't benefit from lower oil and commodity prices. In our opinion, the decade long bull market for commodities is held together by oil prices stubbornly acting on a ten-year old bull case and foolish asset allocators investing in the rearview mirror. Oil is 30 percent of most commodity indexes. It hangs on while natural gas, cotton, coffee, wheat and corn are firmly in bear market territory.

When oil and gold join the bear market, we believe the race for the exits will look like the tech stock bear market of 2000-2002. Those folks who were long tech lost 80 percent from March of 2000 to October of 2002. When a non- economic market crumbles, it is like the Tower of Terror at Disney's California Adventure Park. You drop straight down without interruption!

We disagree with O'Neil in one way. He believes lower oil prices would stimulate China’s economy, helping to promote a "soft landing". We agree with Michael Pettis, Professor at Peking University, on this subject. In a recent NPR broadcast his opinion was summarized as follows:

“For Pettis, China's economic miracle is just the latest, largest version of a familiar story. A government in a developing country funnels tons of money into construction. This increases economic activity for a while, but the country ultimately overbuilds — and the loans start going bad.

‘In every single case it ended up with excessive debt,’ Pettis says. ‘In some cases a debt crisis, in other cases a lost decade of very, very slow growth and rapidly rising debt. And no one has taken it to the extremes China has.’ "

In our opinion, if China slows into a recession/depression, $30-40 per barrel oil is a possibility. Or if China doesn't grow much in the next ten years, commodity exposure will be a noose around the neck of asset allocators. Add in the likelihood that there would be poor performance among the US cyclical stocks, which have suckled on China's bounteous teat, and you have the ideal set up for an asset allocation "nightmare"!

Best Wishes,

William Smead

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