

INSIGHT INTO COMMODITIES & INFLATION

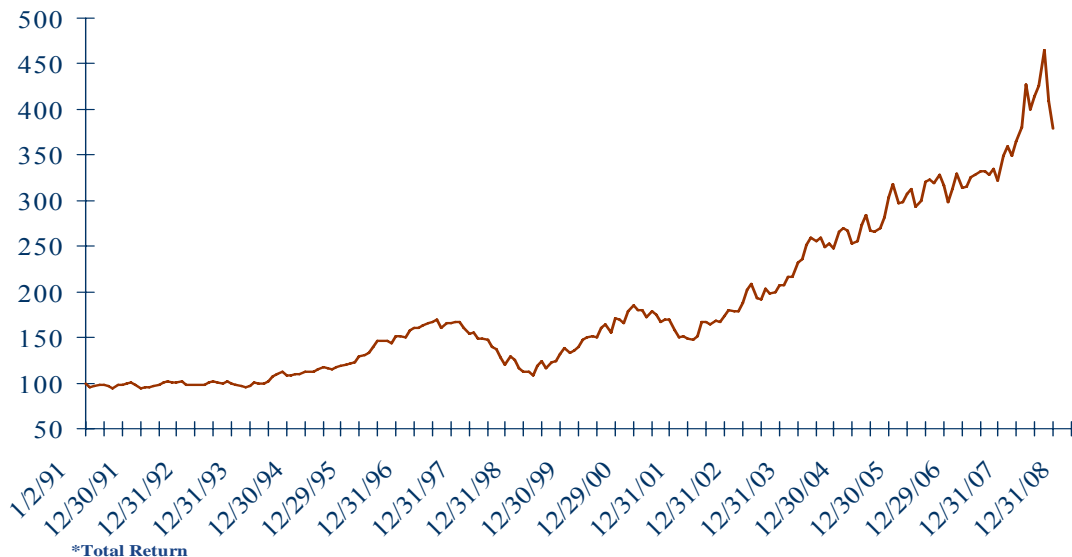
Introduction

Prices are high. We feel the effect from the grocery store to the filling station. As the global economy continues to slow and inflation fears build, investors and the general public try to make sense of it all. The following pages will discuss the general rise in commodity prices and inflation and take a close look at oil in particular. This will be followed by a discussion of how these factors are impacting our investment strategy.

Commodities and Inflation

Commodities are the building blocks of just about everything we produce and consume. Energy sources such as natural gas, crude oil, gasoline and heating oil fall under the heading of commodities, as do cattle, hogs, wheat, corn, soybeans, coffee, cotton, aluminum, copper and gold, to name a few. Following the 2002 recession, demand for commodities grew as global economies recovered. More recently, commodity speculation has become fashionable, prompting hordes of capital to be invested in the commodity markets. Additionally, an increase in demand has come from China, India and other emerging economies. All of these factors have pushed commodity prices higher as illustrated by the following chart:

DOW JONES – AIG COMMODITY INDEX*



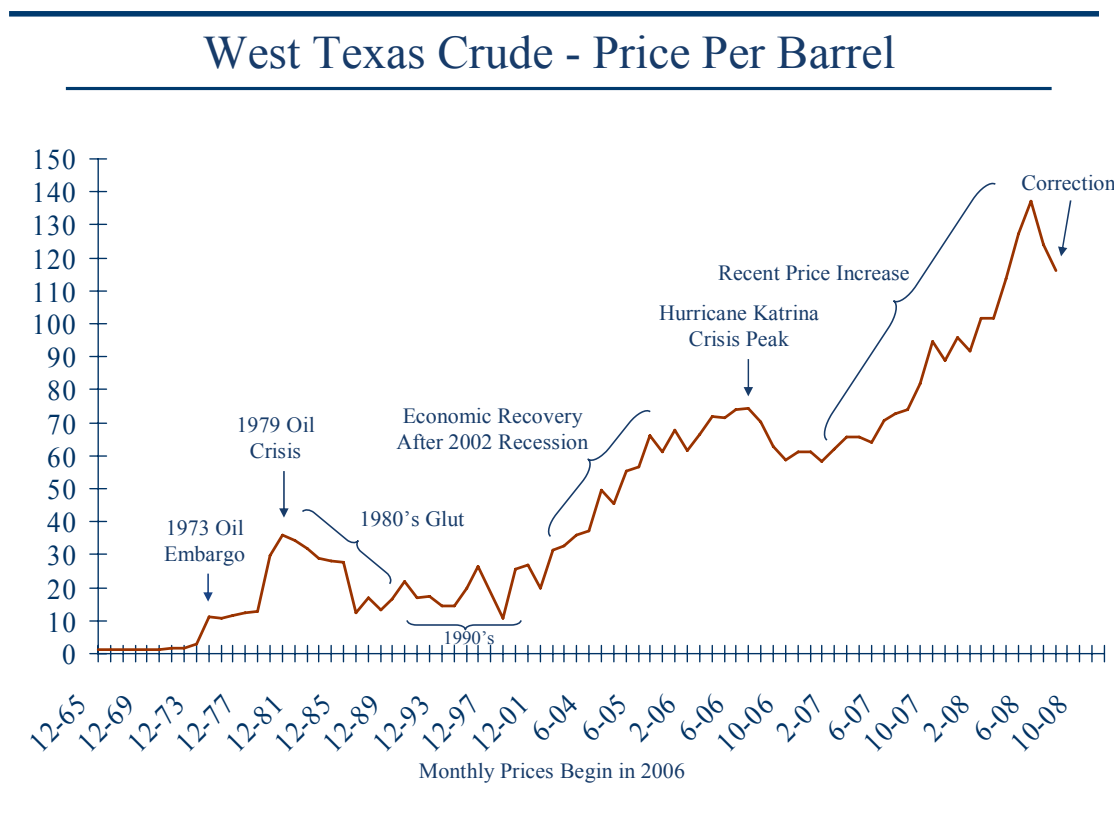
Logically, increases in commodity prices create inflationary pressure as the raw prices of commodities are reflected in products that are consumed. Measured by the Consumer Price Index (CPI), we have come through a period of relatively tame inflation.

In 1979, the annual rate of inflation registered 13.5%. Since then, the inflation rate has decreased as the Federal Reserve has made controlling inflation a priority. Since 1991, inflation rates have fluctuated between 1.6% and 4.1% per year. Early indications suggest that the rate of inflation will be higher in 2008, perhaps near or above 5%. The inflation rate tends to lag commodity increases as it takes time for the price of raw materials to be reflected in finished products.

Over 20% of the Dow Jones – AIG Commodity Index is comprised of crude oil, gasoline and heating oil, so the commodity boom illustrated above also reflects the rise in the price of oil. The general economy is affected as increased oil prices have the potential to dent consumer spending, a major economic driver. Additionally, the cost of finished products that contain oil as an ingredient increases, as does the cost of transportation.

A Closer Look at the Price of Oil

Examining the price history of West Texas Crude over the last four decades illustrates the volatility of oil prices.



With the oil embargo of 1973, oil prices jumped from \$2.81 per barrel in December of that year to \$10.98 per barrel by December of 1974. This was a 290% increase. During the 1979 oil crisis, prices skyrocketed 177% from December 1978 to December 1980. The 70's were followed by the oil glut of the 80's and the fairly innocuous 90's. By 2003 the price of oil was on the rise as global economies recovered from the 2002 recession. Oil prices soared over 116% from December 2003 to the Hurricane Katrina crisis peak of \$70.45 per barrel. After Katrina, oil prices corrected only to climb nearly 125% from the beginning of 2007 to their June 2008 peak.

Each of these high points was followed by a significant correction. Perhaps the most relevant is the current correction, prompting investors to ask: “Have we seen a peak in oil for this economic cycle?”

Basic Case for Higher Prices

Demand is greater than supply: Concern over the world’s supply of oil has been a hot topic periodically over the last fifty years. Anxiety is usually focused on oil producers and their ability or inability to increase production, and the fixed supply of this natural resource. These two characteristics are encompassed in the theory of “Peak Oil”, where worldwide oil production maxes out and supply dwindles as global demand increases. As these forces collide, the potential for an energy crisis increases.

Speculation: When prices rise, speculation in future price movements naturally increases. There have been numerous reports in the popular press examining the role of traders, hedge funds and other financial institutions in oil and commodity markets. In the recent past, market participants have driven prices beyond those supported by supply and demand. If the speculative fever of the last few years resurfaces, new highs may be reached.

Decrease in value of the dollar: As detailed in our previous commentary, *Perspectives on the Decline of the U.S. Dollar*, the U.S. dollar has lost ground to other currencies over the last several years as a result of low U.S. interest rates, an increasingly competitive global landscape and the natural cyclicity of currencies, among other factors. Oil and most other commodities are denominated in U.S. dollars, so they have had to increase in price to maintain their relative value. If the dollar continues to weaken, oil and commodity prices have the potential to continue their march upward.

General boom in commodities: Even with the current correction, commodities in general have experienced impressive growth over the last several years. Oil is one of the most basic commodities that we depend on and its price rise is arguably due to a general rise in commodity prices, among other factors. If demand from China, India and other emerging economies continues, commodities could resume their move toward higher prices.

Emotions: Our dependence on oil as a country is anchored deep in our national psyche. It may be because of our obsessive relationship with our cars, or that the price of gas is so visible, or that it is unsettling that we as a country are dependent on oil and the nations that produce it. Understandably, these factors can rattle our collective confidence and have the potential to spark a speculative frenzy.

Basic Case for Lower Prices

Global slowdown should decrease demand: After years of global economic expansion, economies worldwide are cooling down. The same slowdown the U.S. is currently experiencing is being felt or will be felt elsewhere shortly. As economies slow, demand shrinks and the upward pressure on oil prices is naturally alleviated.

Speculation: As mentioned above, market participants may have recently elevated oil and commodity values above levels dictated by fundamental supply and demand. If the current correction continues, hedge funds, investors and financial institutions will likely reduce their allocation to energy and oil which should contribute to lower prices.

Dollar could be poised for rebound: The U.S. dollar has experienced a particularly bearish period. If the dollar continues to correct to the upside, it too could play a pivotal role in stabilizing or reducing prices.

A commodity correction is likely: It is unlikely the commodity boom will continue at the same pace we have seen over recent years. Just as many thought the tech boom of the late 90's would continue indefinitely, we have seen investors pour capital into commodities and oil as if they are a sure bet.

Supply is building and alternatives are surfacing: Oil companies and governments are scrambling to tap into the undeveloped oil fields of Alaska, the Gulf of Mexico, the Middle East and elsewhere. Assuming that an increase in production is in fact likely and possible, supply should increase just as demand is weakening, leading to lower or more stable prices. In the short-term, it is difficult to adjust to high prices, but the longer prices stay elevated the more incentive industry and consumers will have to seek out alternatives.

Big oil stocks: Even though major oil companies have been under pressure from Congress and the public due to their record profits over the last few years, it is interesting to note that many of these companies' stock prices have not performed well in 2008. Year-to-date through August, Exxon Mobil's stock price is down over 14% and British Petroleum is down over 21%. Chevron has done better with a price change of -7.5%. The market appears to be voting that the price of oil has reached its peak and is headed lower.

What this means for your portfolio

We have been expecting a correction in commodity and oil prices for some time. As the correction continues and further defines itself, it should alleviate some of the negative factors that have been affecting consumer spending and earnings growth. However, growth will still remain muted for a period of time as we work through the credit crunch and real estate fall-out. The good news is that we have been anticipating this global slow-down for the last year and a half. We sold the bank stocks ahead of the sub-prime mess in the spring of '07, and purchased large, multinational holdings, as well as medical-related positions that we anticipate will produce decent earnings growth in this setting. This environment is in no way a surprise to us and our strategy to get through it was forged nearly 18 months in advance. Additionally, we will continue to take advantage of attractive buying opportunities as the markets oscillate. While our holdings have not been immune from the more emotional swings in the markets this year, we believe we have built the foundation for success as we head into the future.

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