



Last year we produced two reports, one in April and a follow-up in September that highlighted our thoughts on the three issues that we deemed most important to commodity prices, namely; (i) China, (ii) the vogue (passion?) for commodity indices, and (iii) market liquidity. Given the dramatic price action seen in recent months, and just after the first anniversary of our original report, we thought it might be worthwhile to revisit our earlier analysis. We have also included our thoughts on commodity equities and commodity bubbles. Hopefully you may find it interesting.

A BEAR IN A CHINA SHOP – MAY 2006

Our previous reports were “cynically bearish” on China, with views based on both anecdotal evidence and the relatively poor performance of the Shanghai stock market. Anecdotally it seems little has changed. There are of course plenty of nice new, shiny (and very tall), buildings still going up – developers pumped \$47 billion into property in the first quarter of 2006. But the amount of unsold real estate rose 24%, and bad property loans reached 12% of the total. Our people tell us it “feels” slightly healthier (than this time last year), and that the volume of empty apartments seems less. But they also caution that one reason for this may be new legislation incentivising purchasers of new property to hold onto their acquisitions for a minimum of 3 years. To us it smacks somewhat of desperation by a government that perhaps realises the dangers of “irrational exuberance” in the housing market. Those more cynical than us may think it an attempt to ensure full houses at the Olympics in 2008 when the world will be watching Beijing.



Fig.1

The performance of the stock market seems to have ignored these ongoing fears. Figures 1 and 1a left and below, illustrate the performance of the Shanghai Composite Index (SSECI) since our previous two reports.

Clearly prices have moved higher and are now some 60% off of the lows seen in the summer of 2005. Confirming this buoyant optimism, recent GDP data indicates that the Chinese economy grew 10.20% y-o-y in the 1st quarter of 2006 vs. expectations of 9.70%.

Western observers also clearly believe that China remains in good shape, and their forecasts remain, perhaps unsurprisingly, extremely optimistic.

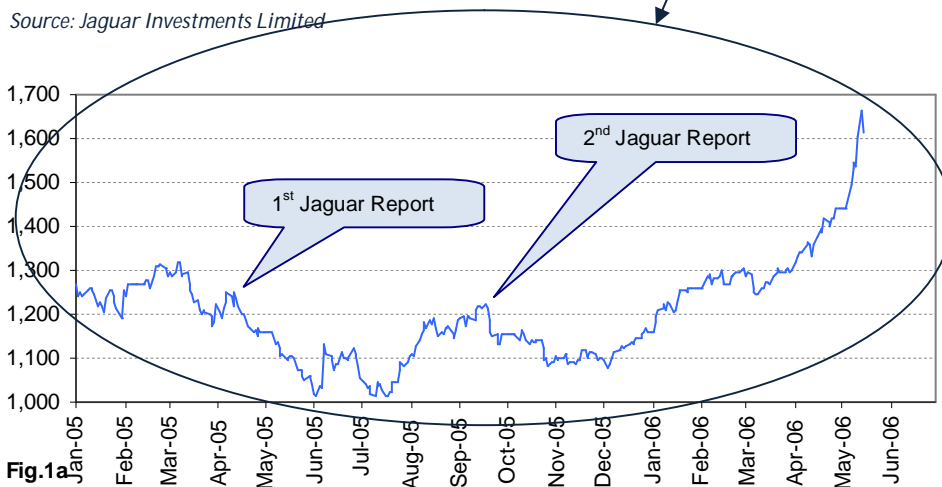


Fig.1a

Source: Jaguar Investments Limited

In recent reports, Jim O'Neill, chief global strategist at Goldman Sachs predicted that the Chinese economy will overtake that of Germany "in the next year or so" and will be challenging Japan for the number two position in the next five years. He believes that China will overtake the US by 2035.

And maybe it will. But we are not convinced, and it seems we are not alone.

In reviewing their 1st quarter performance, Noble Group (headquartered in Singapore with extensive commodity interests in Asia) referred to the current pricing of commodities as a "fairyland". And they specifically noted that;

"It is a fairyland defined by the hundreds of patently ridiculous apartment blocks, vacant shopping malls, and never to be occupied factories lining a road, with overpasses to nowhere, stretching between two cities that you have never heard of in China. If we have drunk too much coffee and are having a really bad dream, we don't drive between the two cities you have never heard of in China counting all the shrines to misallocated capital, we ride a massive, super slick, steel hungry, Maglev train that is 95 percent empty and operates only sporadically."

The Chinese government have also been talking recently. In talking about the phenomenal growth in credit availability in the 1st quarter of this year (bank lending reached \$211 billion which is more than half the target set by the government for the whole year), government spokesman Zheng Jingping noted that

"There are prominent problems that call for our attention".

The Chinese premier, Wen Jiabao said recently that China risked repeating Japans blunders of the 1980's by pouring money into "blind investments" and factories that have outrun market demand. And in a recent report, UBS noted that China faces

"a perfect storm of problematic trends".

Perhaps most damning of all is a briefing report of 12th January 2006 by The Congressional Research Service. In the report "Chinas' Economic Conditions" by Wayne Morrison (Foreign Affairs, Defence and Trade Division), Morrison notes;

Financial->

"The banking system faces several major difficulties due to its financial support of State-owned Enterprises (SOEs) and its failure to operate solely on market-based principles...Ernst and Young estimates that the level of non-performing loans by Chinese banks in 2002 was \$480 billion (equal to about 43% of Chinas' GDP). The high volume of bad loans now held by Chinese banks poses a serious threat to Chinas' banking system. Three out of the four state commercial banks are believed to be insolvent...Corruption poses another problem for Chinas' banking system because loans are often made on the basis of political connections."

Pollution->

"Public unrest over pollution, government corruption and growing income inequality poses threats to social stability...Pollution in China continues to worsen, posing serious health risks to the population. The Chinese government often disregards its own environmental laws in order to promote rapid economic growth. According to the World Bank, 16 out of 20 of the worlds most polluted cities are in China, and the direct costs to the economy (such as health problems, crop failures and water shortages) is estimated to be hundreds of billions of dollars yearly. The Chinese government estimates that there are over 300 million people (approximately 25% of the population) living in rural areas that drink unsafe water (caused by chemicals and other contaminants)."

Social->

"Rising income inequality, particularly between people living in the urban coastal and those living in the inner rural regions of China, has become another source of tension. A number of protests in China have stemmed in part from frustrations among many Chinese (especially peasants) that they are not benefiting from Chinas'

economic reforms and rapid growth, and from perceptions that those who are getting rich are doing so because they have connections with government officials...The lack of the rule of law in China has led to widespread government corruption, financial speculation, and misallocation of investment funds...Many US firms find it difficult to do business in China because rules and regulations are generally not consistent or transparent, contracts are not easily enforced, and intellectual property rights are not protected (due to the lack of an independent judicial system)."

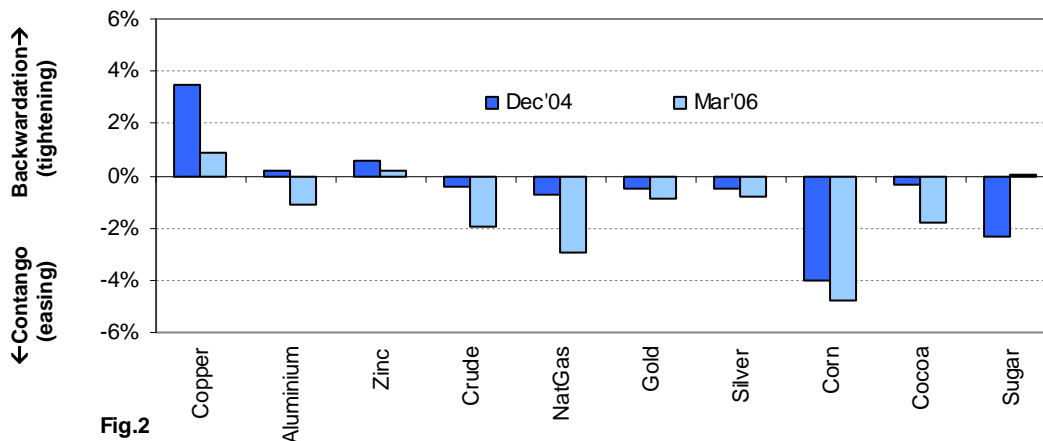
For our part, and at the risk of sounding naïve, we would lend greater credence to more neutral reports (such as those above) than some of the more bullish rhetoric emanating from investment banks with vested interests. Especially when the government itself is being so open in acknowledging the seriousness of these structural issues.

THE LONG AND THE SHORT OF IT, or "TOO MUCH, TOO LONG?"

Recent chatter among the commodity investment community has centred on the increasing lack of "Total Return" available from commodity indices. To be frank I am a little disappointed about this because we had been among the first (if not the first) to point out the probability of this happening last year and I was hoping to crow about it coming true in this report. When we last discussed Total Return in April 2005, we wrote that we expected "**diminishing backwardations**" and prophesied that

"...the vast sums of money being allocated to these strategies (*long only*) will ultimately deflate this phenomenon".

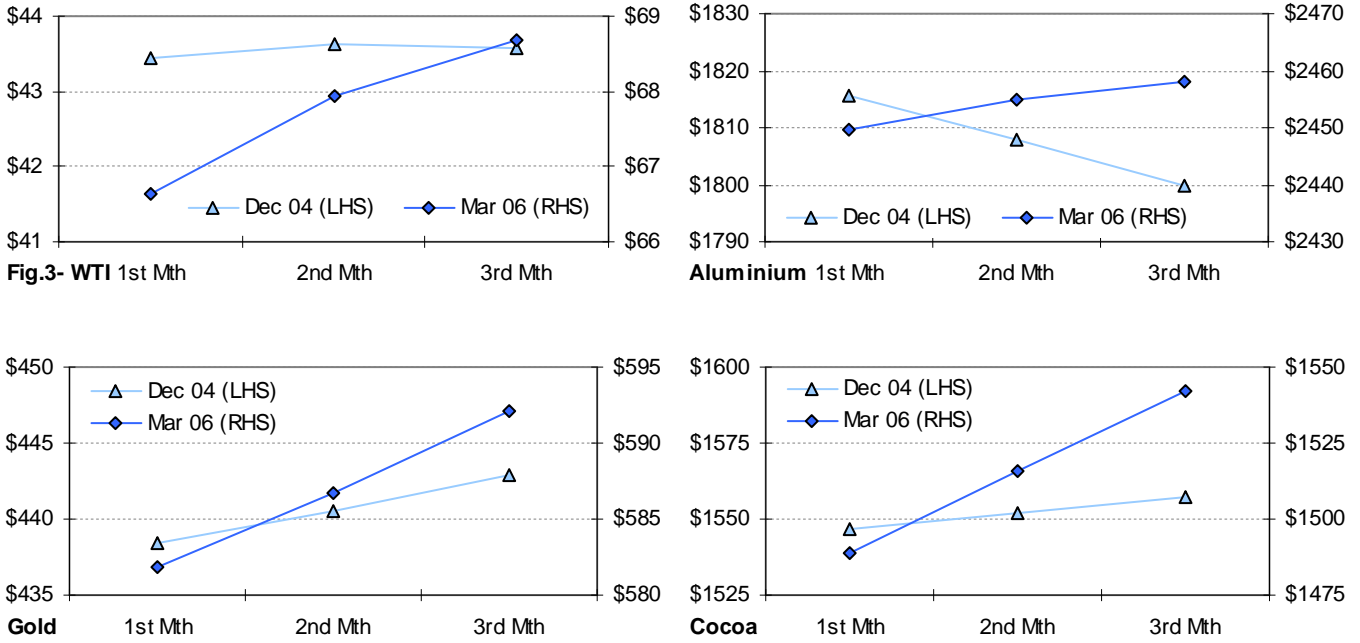
You will recall that "Total Return" is the additional return (over and above outright capital gains) generated by rolling long commodity futures positions in backwardated markets. We liken it to the return achieved by receiving (and reinvesting) dividends in the equity market. In much the same way, this return has historically been responsible for the bulk of commodity index returns (rather than outright capital gains). In their excellent paper "Facts and Fantasies about Commodity Futures", Gorton and Rouwenhorst (2004) demonstrate that an investment in a commodity futures index from 1959 to 2003 returns approximately three times that of the same "spot" index. So far so good! However the weight of money flowing into long only commodity products has increased dramatically in recent years. According to the latest quarterly commodity report by Barclays Capital, inflows into commodity indices came to some \$30b in 2005, leaving current exposure at approximately \$80b. These positions need to be rolled. Moreover the market knows they need to be rolled. Consequently, and as a direct result of this extra money, the majority of these backwardations have eased substantially as shown in Fig.2 below.



Source: Jaguar Investments Limited

The chart shows the movement in front month spreads (expressed as a percentage of underlying price) for the 10 commodities included in the Jaguar Commodity strategy. One can see that with the exception of sugar, all markets have eased and that with the exception of copper and zinc, all markets are now in contango. This represents **a structural shift which has huge implications for long-only (index) investments**. Ultimately it means that for an index to remain unchanged over a given period, the underlying prices need to rally by the same margin as the relevant contango – because lending in contango markets costs money...

For example-> Basis current markets, if you were to buy Jul06 WTI crude oil on Nymex at \$70/bbl, and roll into Aug06, you would pay/lose approximately \$1/bbl. The crude contract rolls on a monthly basis which implies an annual cost of some \$12/bbl for running a long crude oil position. Or to put it another way, the outright price would need to rise to \$82 (or 17%) for you to break even. The GSCI is almost 50% crude oil. Using the same methodology, the gold price needs to rally some \$50/oz, or 8%. Fig.3 below shows the changes in the front end of the curve of WTI crude, aluminium, gold and cocoa;



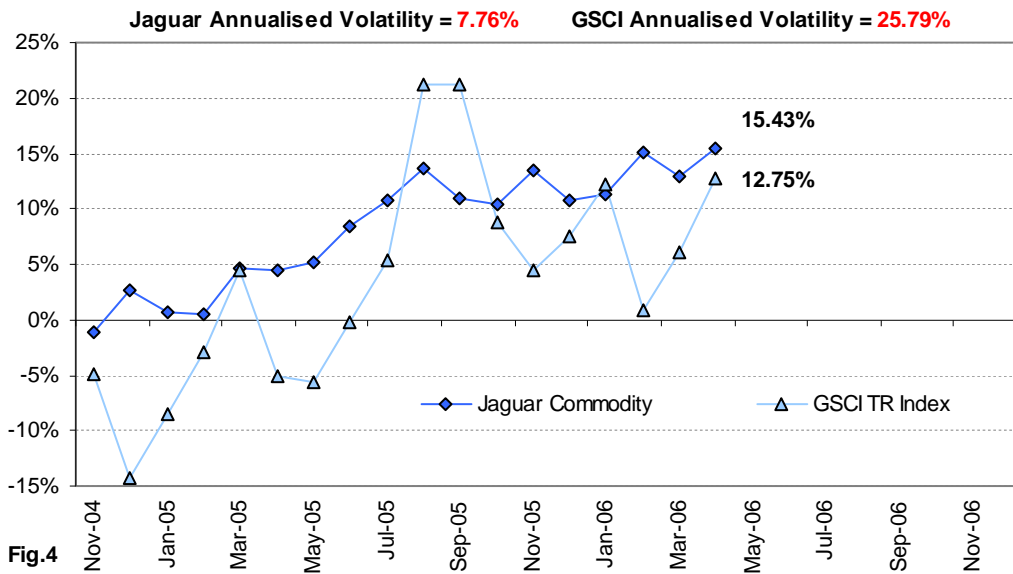
Source: Jaguar Investments Limited

Clearly the WTI, gold and cocoa markets have steepened, and the aluminium market has flipped completely from backwardation to contango. As above, this phenomenon has **significant implications for the expected return of commodity indices**. For your information, I have shown below the current weightings of the GSCI;

Crude Oil	30.58%	Aluminium	3.51%	Gold	2.11%	Wheat	2.37%	Live Cattle	2.05%
Brent Crude	14.55%	Copper	4.57%	Silver	0.28%	Red Wheat	0.98%	Feeder Cattle	0.61%
Unleaded Gas	8.16%	Lead	0.29%			Corn	2.30%	Lean Hogs	1.43%
Heating Oil	8.12%	Nickel	0.83%			Soybeans	1.38%		
Gas Oil	4.50%	Zinc	1.14%			Cotton	0.79%		
Natural Gas	6.80%					Sugar	1.89%		
						Coffee	0.59%		
						Cocoa	0.18%		
ENERGY	72.71%	BASE	10.34%	PRECIOUS	2.40%	AGRICULTURE	10.47%	LIVESTOCK	4.08%

A performance comparison of the GSCI Total Return Index, vs. the Jaguar Commodity Strategy from inception (Nov'04) to the end of Apr'06 is shown below in Fig.4 below;

Jaguar Investments Limited



Source: Jaguar Investments Limited

It should be noted that while this paper refers to the GSCI, the concept and subsequent structural shift are applicable to all the major indices, including the DJ-AIG index, the RIC1, and the Reuters/Jefferies CRB index. Weightings of course are different but the issues presented by the roll and the impact on total return is the same.

CHANGING GEAR

Aside from long-only indices, a common method of capturing upside commodity price action has been through exposure to commodity equities. There are two main reasons for this. Firstly, and simply, equity markets are possibly the most accessible, and liquid financial products on the planet, and therefore easily tradable. The second reason is the gearing they afford;

Consider a gold producer whose cost of production is \$200/oz. When gold is at \$250/oz, the producer makes \$50/oz – when gold goes to \$300, the producer makes \$100/oz. So for a 20% rise in price, the producer has doubled his profits. This leveraged return (in this instance of 5x) should of course be reflected in the producers share price – at least in theory. But this gearing only works to a degree. In the same example, if gold moves from \$650 to \$700, i.e. 8%, the producers’ profits rise from \$450 to \$500, i.e. 11% - still a better return but not substantially so. And when markets rally substantially (as they have done) there is the very real risk that wage inflation rears it ugly head – certainly base metal producers have suffered extensive production cuts in recent months as a result of strike action and increased union demands. Fig. 5 below shows the deteriorating leverage curve of gold using the example above;

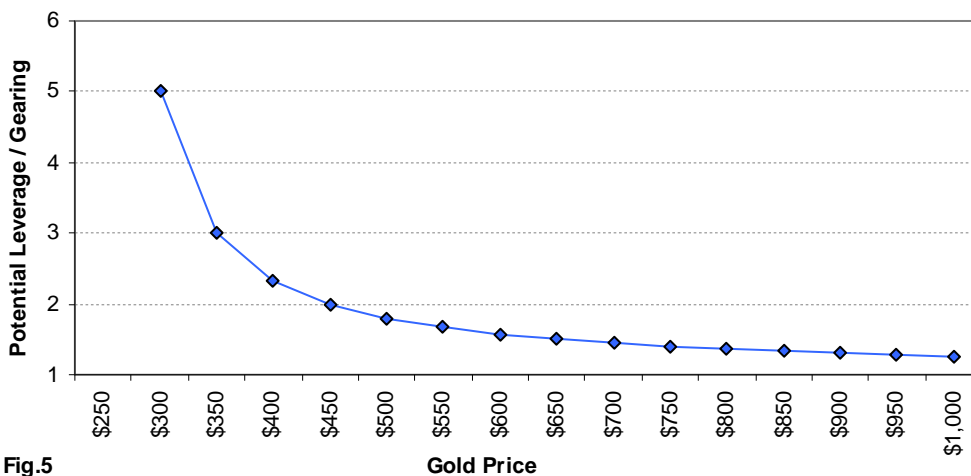


Fig.5

Source: Jaguar Investments Limited

Clearly the gearing effect of holding gold equities at \$700 is less than that at \$300.

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HOW MANY BUBBLES CREATE FROTH? or WHEN IS A BULL MARKET NOT A BULL MARKET?

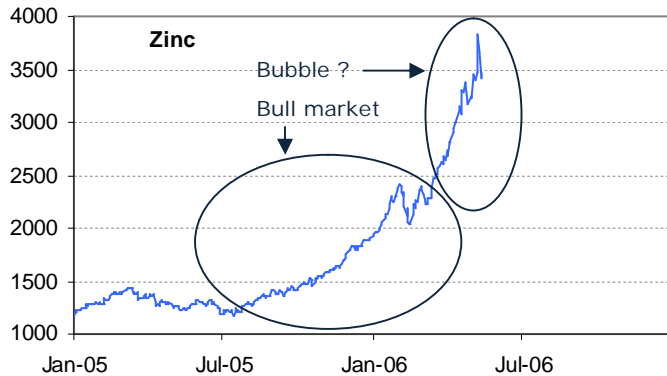
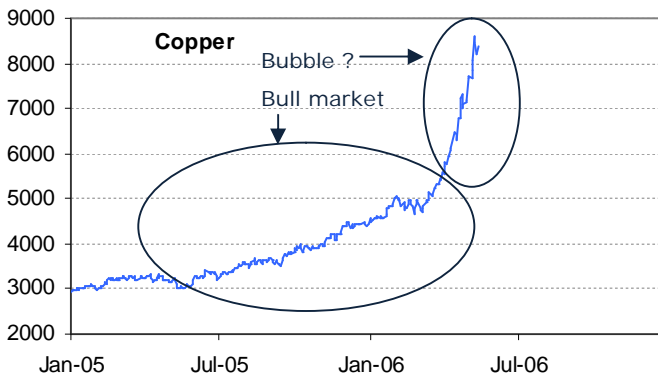
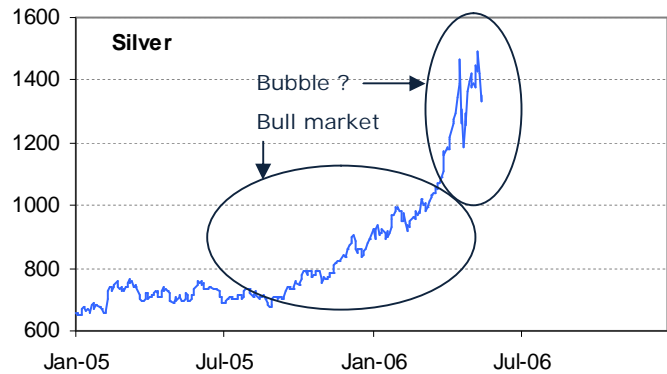
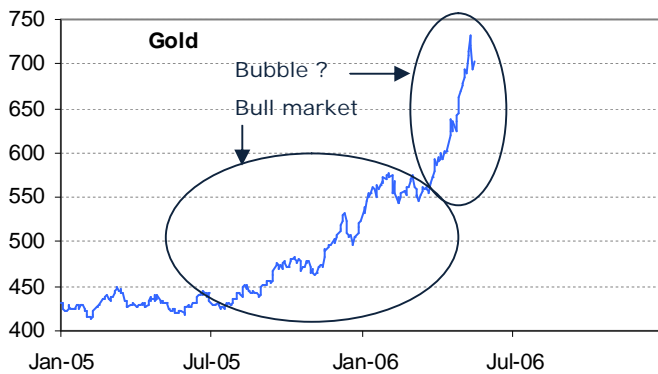
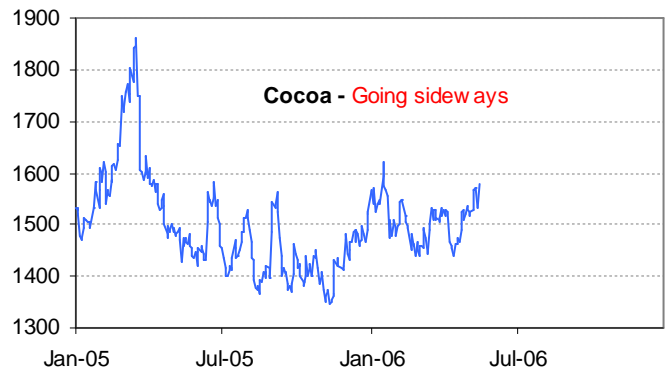
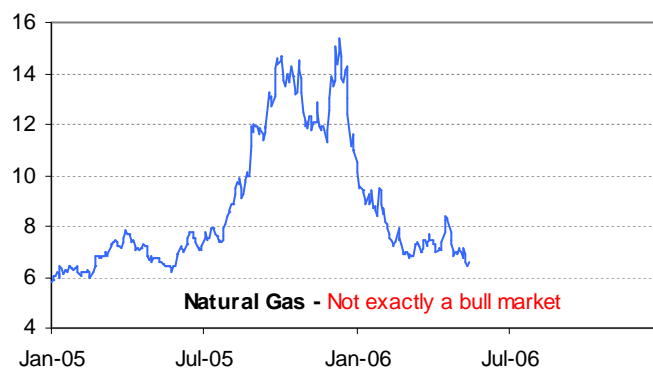
We highlighted in previous reports our concern that market participants were perhaps losing track of reality. The quote we used came from the HSBC quarterly economic report for Q105, which claimed that;

“The old ways of looking at the global economy are no longer relevant”

The phrases “this time it is different” and “a new paradigm” still loom large in commodity articles, and maybe they are right. We become more nervous every time we see these phrases however, and instead prefer to keep in mind the thoughts of the widely respected Yale economist Irving Fisher, who declared in September 1929;

“Stock prices have reached what looks like a permanently high plateau”

Far wiser men than I have tried to define bubbles, and more importantly have tried to predict their bursting points. I am not going to try to better their theories here. But I would like to show you the following charts. You may draw your own conclusions;



Source for all charts: Jaguar Investments Limited

MARKET LIQUIDITY BREAKING NEW RECORDS (ON THE DOWNSIDE?)

One conclusion invariably drawn from this weight of money being invested into commodity markets is that these markets are now so much deeper and more liquid than ever. This perception is lent more credence by the exchanges themselves - who of course are extremely keen to demonstrate their record volumes. Recent releases include;

"LME Announces Record Full Year Exchange Volumes for 2005" 12th January

"ICE Futures Surpasses 100,000 Contract Mark in ICE WTI Crude Futures; Contract Sets New Daily Volume Record" 12th April

"ICE Futures Sets Exchange-wide and ICE WTI Crude Futures Volume Records" 11th May

"CBOT corn futures contract sets volume record" 15th May

Those familiar with our approach will recognise our focus on market liquidity, and scepticism over headlines such as those above. Given that we trade these markets on a daily basis, we can confirm that if anything, the opposite is true. In our opinion, markets are substantially less liquid today. In our opinion, market liquidity cannot be measured by open interest alone. Fig.12, below left, demonstrates the rise in both volume and open interest of 19 major exchange-traded commodities that we track;

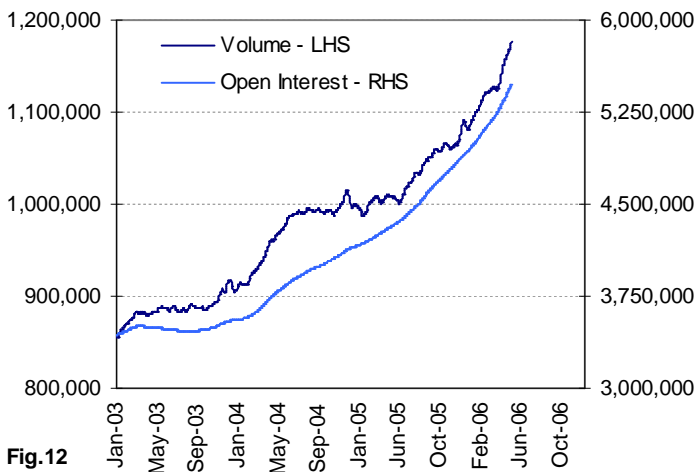


Fig.12

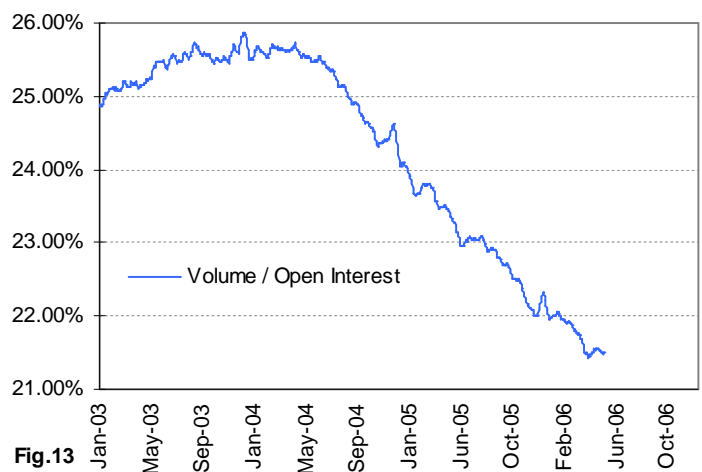


Fig.13

Source for all charts: Jaguar Investments Limited

On the face of it everything looks good. Logically, with so much money coming in to the long-only space, one would expect to see rising open interest. But Fig.13 (above, right) shows that volumes traded, relative to open interest, are in fact falling dramatically. In our view, this is a far better measure of market liquidity – if only because it fits with our intuitive feel of the markets. To give you more of a feel for it, the last 10 years have seen this measure range between 23% and 26%, and it is interesting to note that it has now been falling steadily for around 2 years - it is currently making new lows at around 21.50%. In order to better quantify this market liquidity issue, we have developed other proprietary measures that incorporate market volatilities, daily trading ranges, number of market makers etc. All point to an ongoing deterioration in market liquidity. Fig.14 below shows the change in the Jaguar proprietary measures;

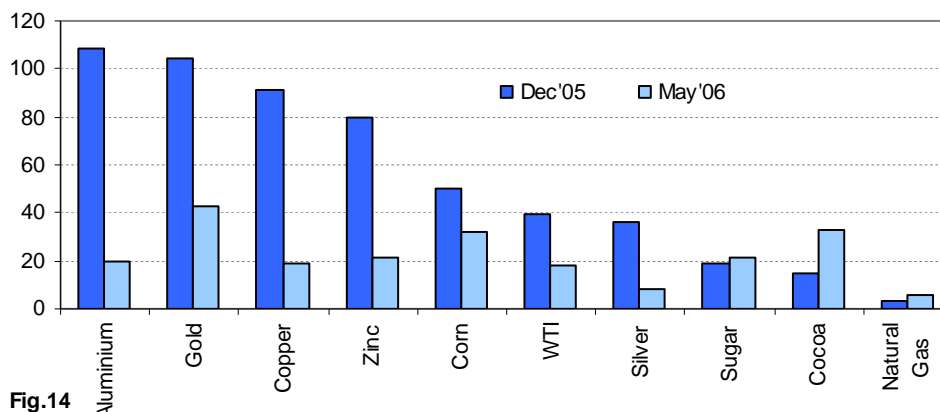


Fig.14

Source: Jaguar Investments Limited

This is not necessarily a bad thing – the bad thing, as with all risk, lies in not recognising the changing market scenarios. The smarter guys in the market are beginning to latch on to this – and their solution is quite simply to trade further down the curve. Fig.15 below shows how open interest has rolled further forward in LME copper, but similar patterns are appearing all over the commodity sector;

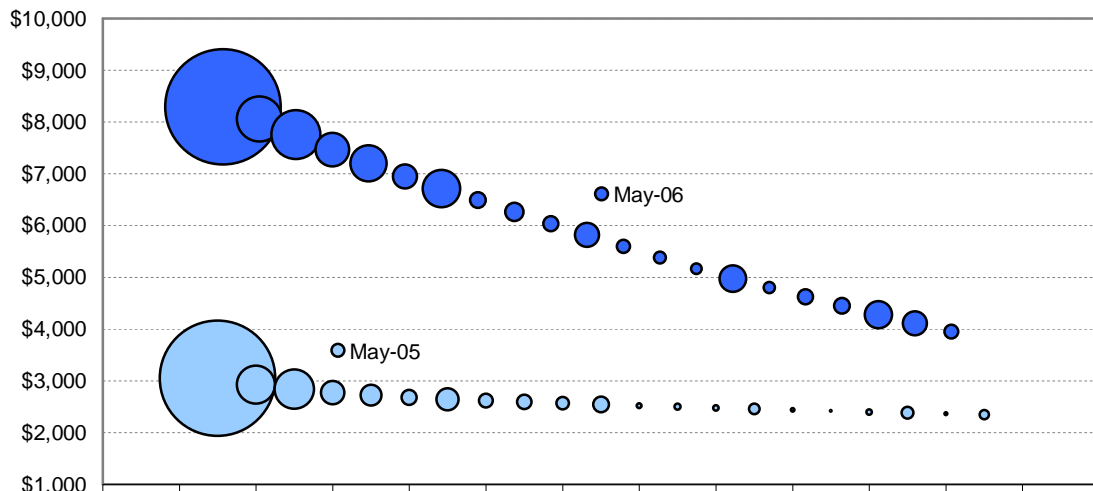


Fig.15
Source: Jaguar Investments Limited

The chart doesn't look particularly dramatic, but in fact the percentage of open interest in the first 12mths has fallen from around 87% to just under 70%. Similarly the percentage of open interest in the 3yr to 5yr period has increased from around 3% to around 13%.

SUMMARY

1. China is not necessarily going to remain the buyer of last resort...
2. Commodity indices are undergoing (already have?) a structural shift away from the source of their historical return...
3. In any case, commodity indices remain energy heavy, and volatile...
4. Leverage achieved from being long commodity equities is substantially reduced at higher price levels...
5. Certain commodity markets (esp. metals) are possibly exhibiting bubble like price action...
6. Market liquidity has fallen substantially, and is moving further down the curve...

CONCLUSION

We believe that commodity markets remain in a cyclical uptrend that will last for a few more years at least. We also believe that these markets will continue to have substantial price corrections, and accordingly we do not believe that the buy and hold strategy is valid. In this environment, we would advocate investors select active commodity managers, who are able to demonstrate the following qualities;

- Extensive trading experience of different market conditions
- Disciplined risk management focus
- Continued and ongoing research into market liquidity

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