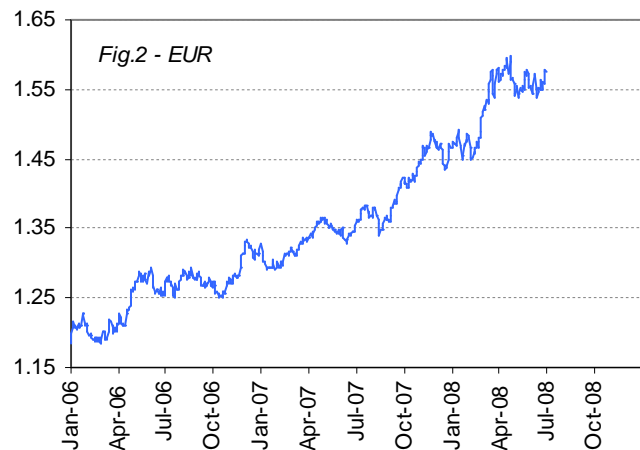
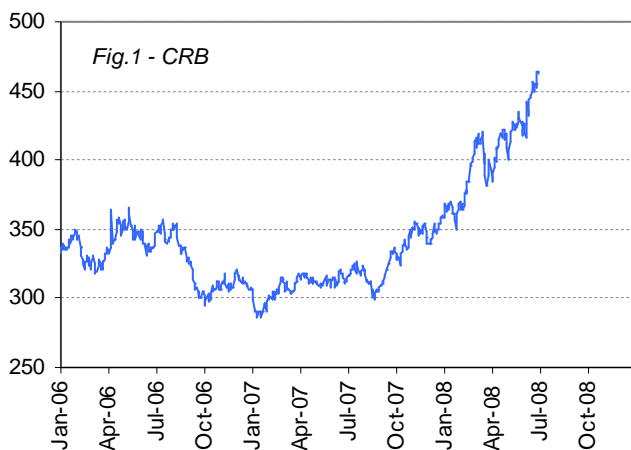




BEAR MARKET OR BULL MARKET CORRECTION? – SEPTEMBER 2008

At close of business on 30th June 2008, the CRB index closed at 462.74, just off the all time high of 464.40 which had been made the day before. The energy heavy GSCI closed at 10,560. Elsewhere, the Euro closed at 1.5745 against the dollar and sterling closed at 1.9925. The DJIA closed at 11,350. The FT Gold Mines Index closed at 3,157.



These record (or close to record) levels in commodity indices were accompanied by an ongoing bullishness by almost every market commentator. To give a flavour of the sentiment at that time, among reports we received on the 1st July were the following;

“Corn prices are on the high side...but they're not the strongest they've ever been. So, in our view, prices do not yet qualify as extreme and these "record" levels should not be treated as some kind of lid on the market. On the contrary, there is still room for surprising gains in grains and oil seeds in particular...Soybeans is another story, and may represent the best buy, still!” – UBS

“The risk case is strongly biased to the upside for gold” – UBS

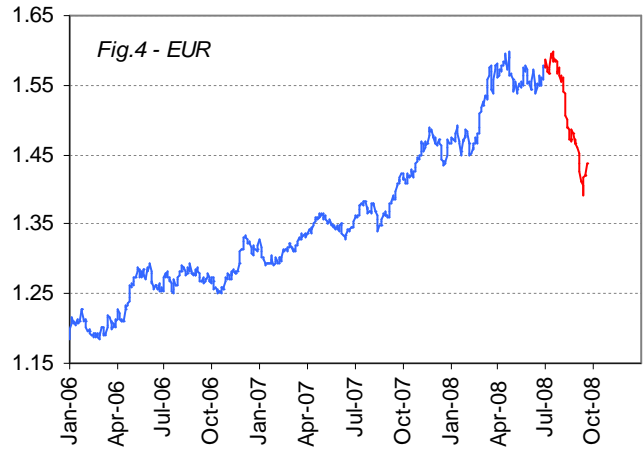
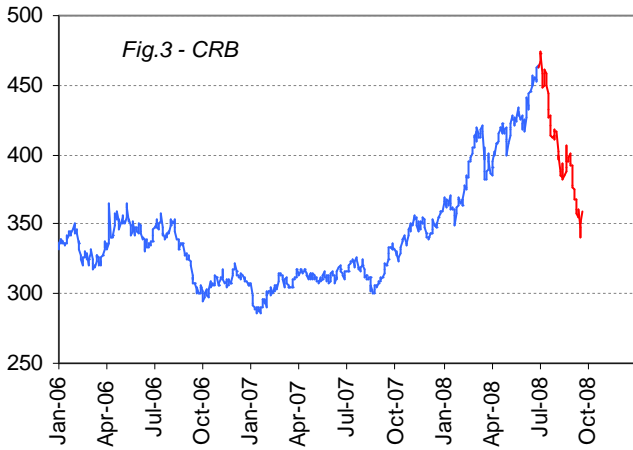
“Aluminium has climbed to a high of \$3160 this morning and we expect prices to continue to trend higher especially with the steep escalation in production costs and power constraints facing the market” – Barclays

“The combination of ...higher oil prices and rise in investor risk aversion are more than sufficient to offset any likely currency-related declines in the gold market” – HSBC

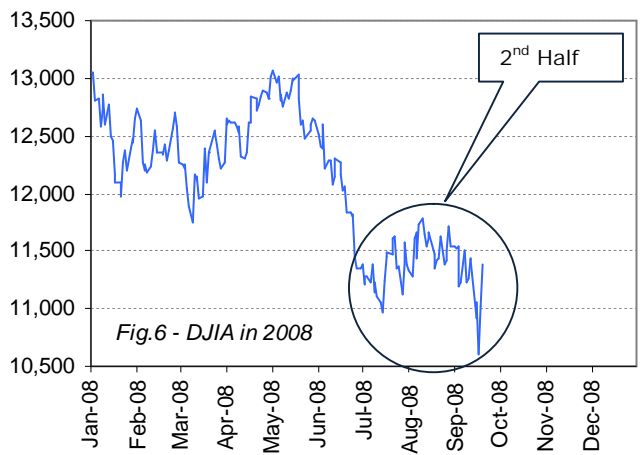
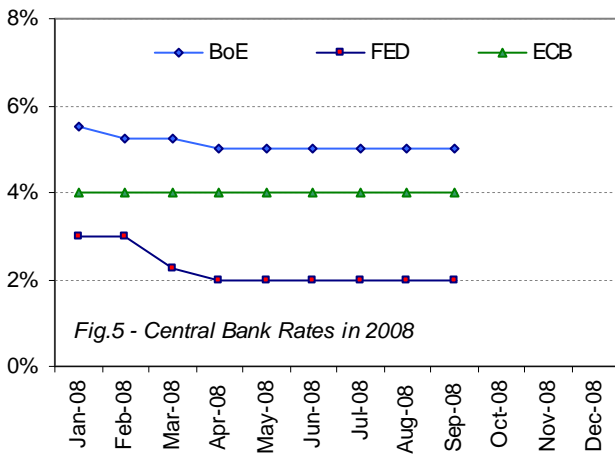
“PIRA expects {energy} prices to strengthen further in the second half of the year as near-term supply-demand fundamental tighten.” – PIRA Energy Group

Just 12 weeks later, at close of business on 19th September 2008, the CRB index closed at 359.58, a loss of some 22%, and the GSCI closed at 7,756 for a loss of some 27%. Elsewhere, the Euro closed at 1.4365 against the dollar and sterling closed at 1.8315 (loss of c9% each). The DJIA closed at 11,388 (unchanged). The FT Gold Mines Index closed at 2,286 for a loss of 28%.

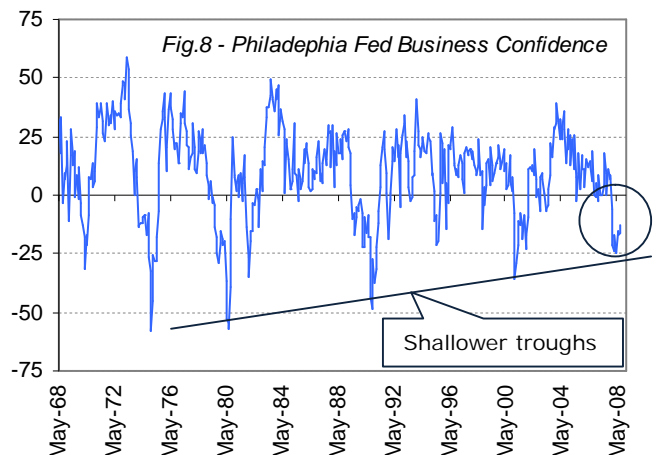
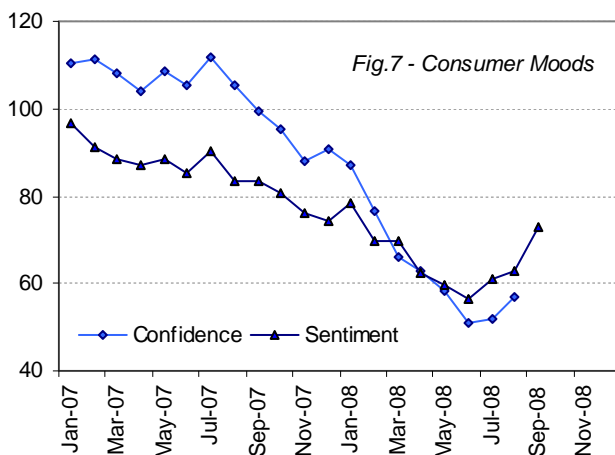
Jaguar Investments Limited



So what changed in the last 3 months to cause such a dramatic volte face in markets? Well apart from a cataclysmic financial meltdown, fundamentally speaking absolutely nothing changed. Central bank interest rates remain unchanged (see Fig.5 below). As noted above equity markets are also unchanged – the 10% loss in the DJIA (a result of the Lehman Brothers implosion and AIG nationalisation) was recouped as the US Treasury announced plans to warehouse the more toxic financial assets currently held by US banks and financial institutions (see Fig.6)

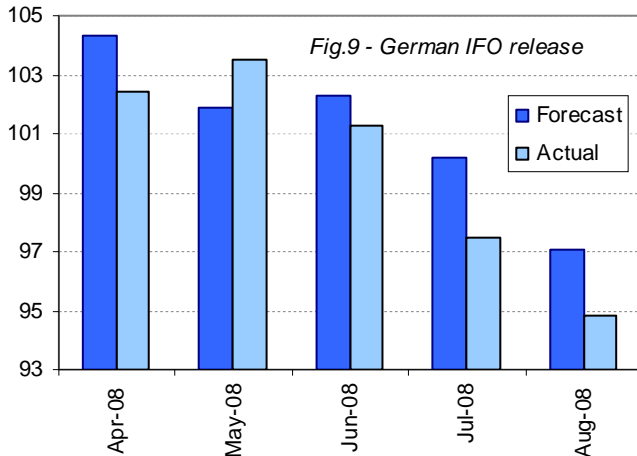


The relative stability of equity markets may have helped the recovery in the dollar, which in turn may well have been further boosted by a recovery in US consumer confidence (as measured by the US Conference Board) and US consumer sentiment (as measured by the University of Michigan) – see Fig.7 below. Business confidence as measured by the Philadelphia Fed seems as though it too may be on an uptick (see Fig.8).



Additionally there can be no doubt that economic news out of Europe has recently been poor – and perhaps sufficient to prompt an exodus from the Euro. Fig.9 below shows the most recent German IFO business sentiment releases as measured against expected numbers. Clearly the last few months have seen every release (except May) come out worse than expected, and in absolute terms it is at the lowest level (94.80) since September 2005. Sterling has also come under the hammer as the chancellor failed to grasp an opportunity to reassure the electorate – see below for some of his choice comments. Sterling did not react well!

Newspaper interview, 30th August
Alastair Darling, UK Chancellor



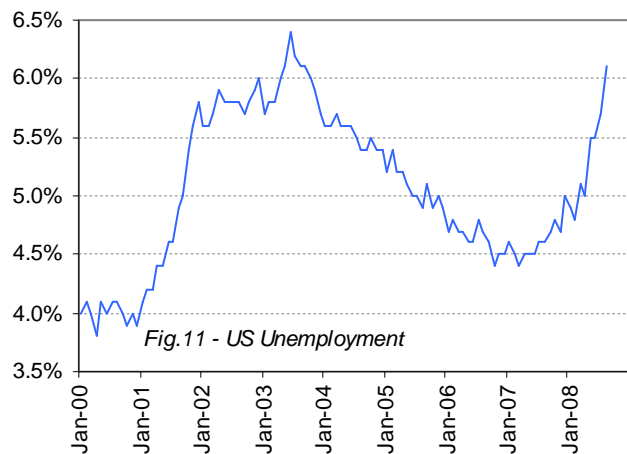
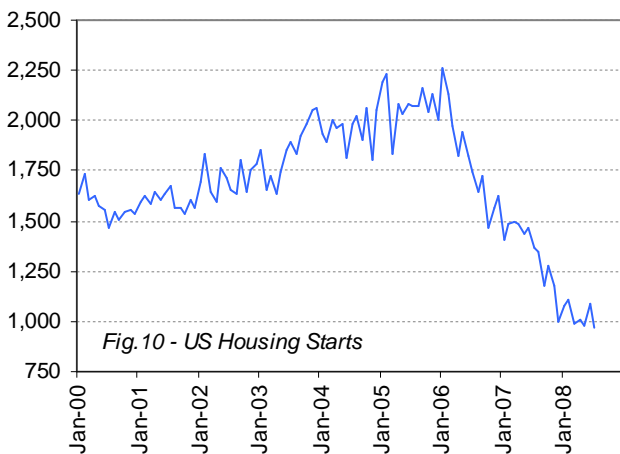
Economic times for the UK are **“arguably the worst they’ve been in 60 years...I think it’s going to be more profound and long-lasting than people thought.”**

“I think it is important I tell people in this country that we, along with every other country in the world, face a unique set of circumstances where you’ve got the credit crunch coming at the same time with high oil and food prices.”

And from 22nd June:

“Our economy along with every other economy in the world is going to be slowing this year. It will be difficult. It will be tough.”

As a UK resident I believe that UK PLC is grossly overvalued, and I can understand the dollar appreciating against Sterling. But against the Euro? Is this newfound faith in the greenback not misplaced? Of course the most recent confidence numbers above (for August and September respectively) do not reflect the most recent Lehman/Merrill/AIG debacle - but they should be reflecting almost all the other statistical data points – which remain almost universally poor!



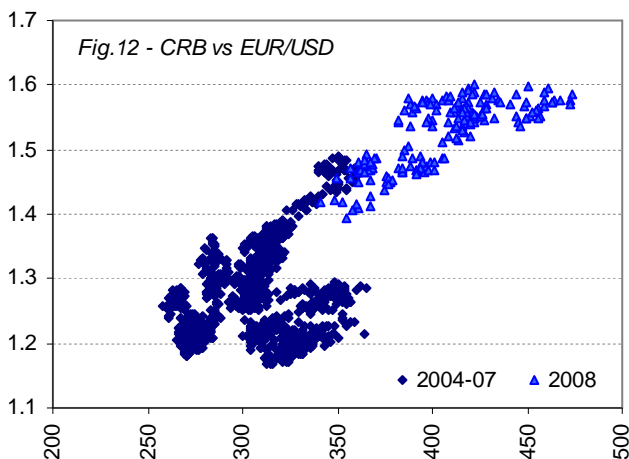
Apart from the Housing Starts and Unemployment figures seen above, Construction Spending and Capacity Utilisation are both at four year lows, and falling. Industrial Production is flat, and Business Inventories are rising. As Standard Bank noted in their currency analysis on 16th September;

“There’s been a lot of bad news for the dollar just recently. The last payroll data was very poor, Fannie Mae and Freddie Mac had to be bailed out and Lehman Brothers sought bankruptcy protection. There’s no good news in this. Some might try to manufacture a bullish argument for the dollar from amongst the rubble but it would be pretty hard to believe...market players are not interested in any fundamental story. Instead, all that’s happening is that investors seem to be exiting short dollar (and short yen) trades which have probably been built up over a considerable period of time.”

So let's agree that although some Euro weakness can be explained, much of the recent dollar strength is not the result of any dramatic shift in the fundamentals of the currency, but rather the result of the hurried (and forced?) closing out of short positions, in turn driven by a general move to delever asset exposures, reduce trading risk to a minimum and of course to repatriate dollars to shore up holed balance sheets.

But what does it mean for commodities?

Clearly the weakness of the dollar provided a huge support throughout the commodity bull run (see Fig.12 below). But the real roots of the rally lay in the improving fundamentals as outlined below. So what lies behind this recent (and extreme) weakness across commodity markets? Can it be explained by any fundamental factors or is it, too, the result of risk aversion and the neutralising of portfolios. We believe it to be the latter.



Back to basics: Part. I

Any commodity market can be simply divided into 3 sectors;

- Producers: Who produce the commodity...
- Consumers: Who buy it – either because they sell it on or else because they consume it...
- Swing factor: These guys can buy and/or sell – and contribute greatly to market volatility. They might like to consider themselves investors, or relative value players, or macro-based, or arbitrageurs. They might be short-term or medium-term or long-term players, and they may have a fundamental or technical bias, or they may be long-only. But they can all be classified as speculators, and in times of rising prices they essentially become a consumer, and in times of falling prices they become a producer.

The balance of production and consumption and swing factor equals price.

Production and Consumption

At the start of this bull market, producers were facing tremendous issues. Rising raw material costs, rising energy costs, rising freight costs and rising wage costs. On top of this, there were various climatic issues affecting food production, not least of which was a major (and growing) shortage of water. And this was set against a volatile and deteriorating geo-political situation. **None of these issues have been resolved, let alone in the last 3 months.** Yes the price of crude has fallen back by a third from the highs seen earlier in the year, but in real terms it is still extremely expensive. The climate situation has not improved and nor has the geo-political situation.

At the start of this bull market, consumers were growing in both number and appetite. The urbanisation and "Westernisation" of China, and to a degree India, led to significant increases in demand in both foodstuffs and raw materials. At the same time, oil importers, especially the US, decided that it might be a good idea to reduce their dependence on troublesome overseas producers, and instead try to develop alternatives. Bio-fuel became a buzz word – and suddenly the already growing demand for anything arable increased dramatically. **None of these issues have been resolved, let alone in the last 3 months.** Yes the consumption of luxury goods may be falling as tangible wealth falls across the Western world, and for sure the early summer spike in the price of gasoline dented demand as the US driving season got underway. But in other areas, commodities remain very much in demand. The population is still growing, and requiring ever more food. The deserts are still encroaching across Asia and China. The world has yet to develop a viable alternative to crude oil, production of which is still falling, and which in any case remains in the hands of the world's more volatile nations – witness Nigeria, Middle East, Venezuela... Chinese growth may have slowed, but it is still growing and its demand for raw materials is still large;

"While an economic slowdown in western economies might have a short-term affect on the Chinese economy, the longer-term prospects of growth in China remain strong. As a result, China is not shying away from commodity consumption any time soon. They still have roads to pave, factories to build, and cities to expand." –

Seeking Alpha – 28th July 2008

"In just the next 10 years China will consume about as much steel as the US did in the entire 20th century, when it was the world's industrial powerhouse." – *Australian Business, 23rd August 2008*

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And as I write this report, Barclays Capital release August import/export data from China. Excerpts from their excellent "Feeding the Dragon" report (22nd Sep) as follows;

- "China remained a net importer of primary aluminium in August..."
- "Early indications are that copper imports into China are rising..."
- "China was a net importer of refined lead for the 2nd consecutive month in August for the 1st time since 1997"
- "China retained its status as a net refined tin and alloys importer for the 13th successive month..."
- "The August statistics showed a sharp increase in net silver imports to China"
- "Net crude oil imports rose strongly on the month, increasing by 11% y/y"
- "China remained a net gasoline importer for the 4th consecutive month..."
- "Diesel imports continued to grow strongly..."
- "Soybean imports increased 31% y/y..."
- "Corn imports continued on their upward trajectory...imports are up 71% y/y"
- "Cocoa imports...highest since our records started in March 2004...up an impressive 453% y/y"
- "China remained a net importer of coffee for the 3rd consecutive month..."

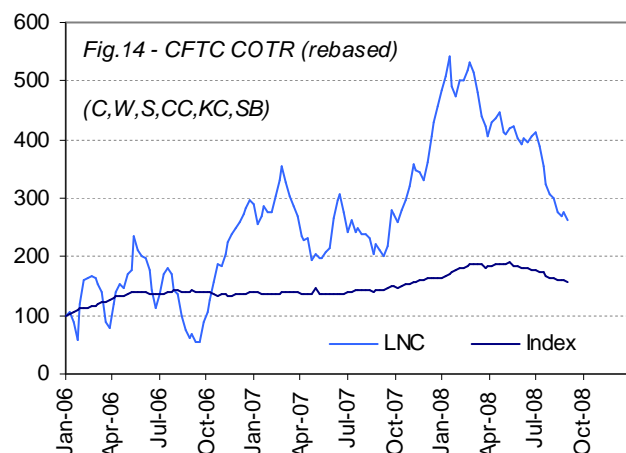
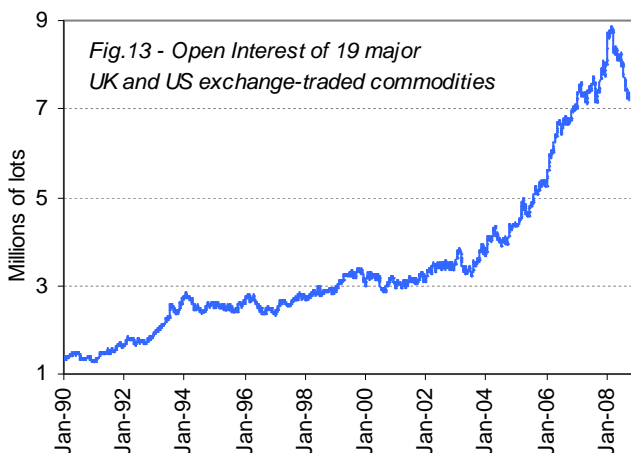
In the interests of balance, Barclays also note that imports of nickel, zinc, cotton and fuel oil fell and remain weak. Overall however they conclude that with regard to China;

"...the August data show that it is becoming a net importer of a growing number of commodities, and by a larger margin."

The Swing Factor

The swing factor is more commonly known as (depending on time horizon) speculation (short-term) or investment (long-term). In periods of rising prices the swing factor adds to demand, thereby creating a greater shortage (and hence overshoot of prices on the topside). Similarly in periods of falling prices the swing factor adds to supply, creating a greater surplus (and hence an overshoot of prices on the downside). The point at which this factor actually "swings" is signified by a period of extreme volatility and violent price action and is typically followed by a period of sideways adjustment as more "normal" fundamental influences once more begin to drive prices.

Trying to gauge the magnitude of the swing factor is notoriously tricky due to the high levels of OTC exposures and absence of any data on these products. From Fig.13 below, we can see that open interest has fallen some 20%, and from this we can try and calculate an implied dollar value – but in truth this doesn't tell us much. What we can do is try and ascertain whether this fall in open interest is down to the short-term (speculative elements) or longer-term (investment) players. To do this we can look at the supplemental reports produced by the US CFTC – although these are only currently published for the food sectors. We interpret the Large Non-Commercial (LNC) sector to be representative of the short-term speculative community, with the longer-term investor community being published separately as Index positions (see Fig.14 below);

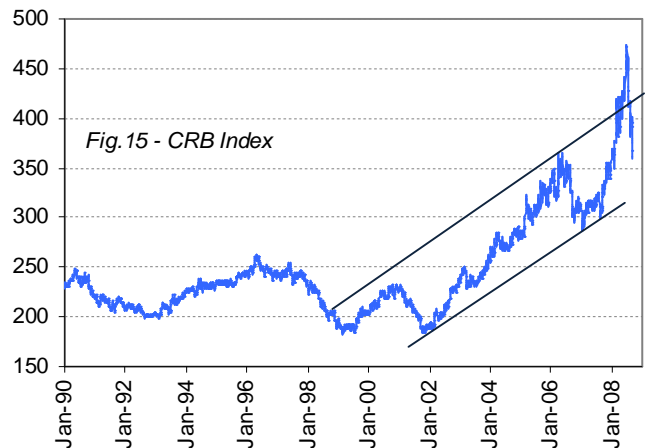


You can see clearly that the index money has been relatively stable, rising steadily over the last two years or so, with a small retracement in recent months. The speculative commitment to commodity markets however has been much more volatile. Their net interest in commodity markets rose some five-fold in approximately 18 months, and has halved so far in 2008. From these two charts therefore we can deduce that in fact the longer-term interest in commodity markets remains mostly intact, and that the recent sell-off has been driven by shorter-term players liquidating longs.

Conclusion

- Commodity prices have plummeted in recent weeks
- Production difficulties/issues remain
- Consumption may be a little softer in the West, but Chinese demand remains robust
- Longer-term Index funds/investment community remain committed to commodity markets
- Short-term players have liquidated holdings in risk aversion/dollar repatriation trades

Basis the above, we believe that the recent sell off in the commodity sector has been a short-term correction in the ongoing long-term bull market rather than the end of it. As Fig.15 shows, while the correction has been violent, prices remain within the bull channel and should continue to move higher (we believe).



So what is the best way to access these commodity markets? Sure, long-only captures the trend but is fraught with a number of dangers; contango and the cost of roll, vulnerability to down markets (e.g. the 25% drawdown seen this summer), vulnerability to credit risk of the long-only provider (invariably US banks, second largest long-only provider being AIG). CTA/managed futures risk generally gives an unquantifiable exposure to commodities – usually less than 30%, and in any case is generally centred on medium-longer term trend following strategies.

Jaguar Investments is able to provide relatively short-term long/short commodity exposure through two commodity only strategies that offer the following features;

- One strategy is fully systematic and one fully discretionary. A number of existing investors are invested in both strategies to further diversify returns
- Both strategies are available in either managed accounts or through Cayman domiciled funds that are listed on the ISE.
- The company has **no exposure to commodity equities**
- The company has **no exposure to commodity currencies**
- The company has **no exposure to commodity financing**
- The company has **no exposure to OTC instruments**
- All products are exchange-traded on regulated and recognised exchanges in the UK and the US
- Both strategies are **uncorrelated** to other asset classes and other investment strategies (see Fig.16)
- Both strategies have **annualised volatility of less than 10%**

Fig.16 - Correlation of Monthly Returns

