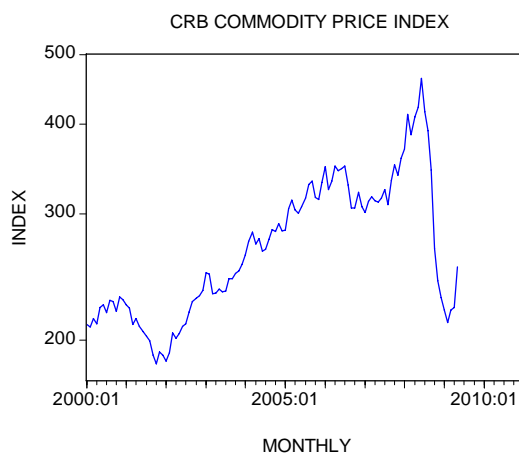


Where are commodity prices heading?

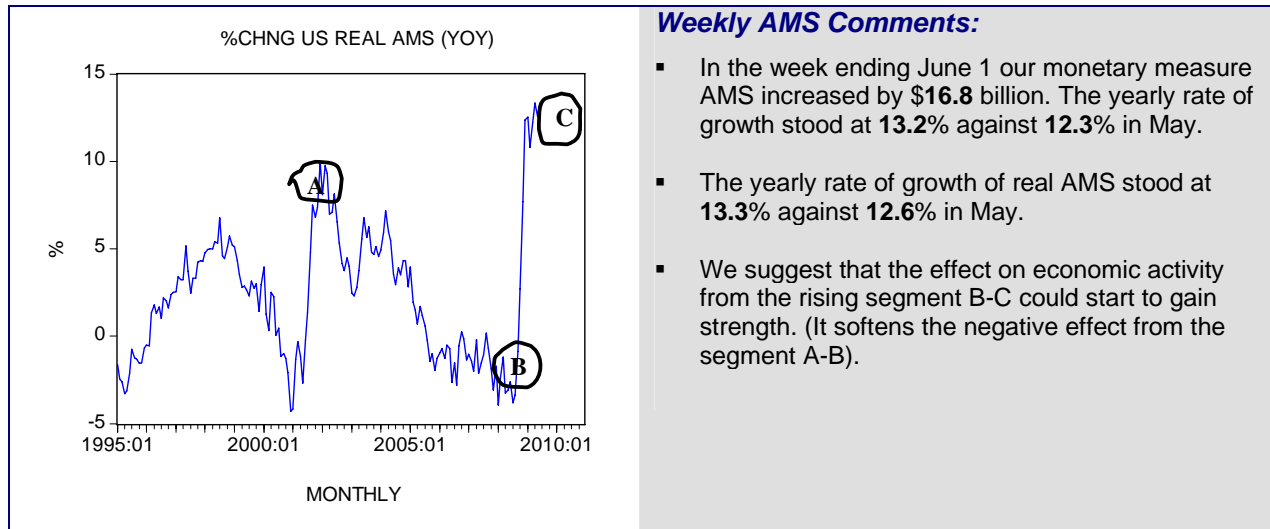
KEY GRAPH:



Eco-flash

- Our model indicates that as long as US and Chinese economic activity holds up well commodity prices are likely to push ahead (p 3-4).

- Prospects for commodity prices. The Fed is pumping at a slower pace. US household net worth fell further in Q1. Focus on last week's US economic data (p 3-8).
- Focus on last week's non-US economic data. US stocks have continued to push ahead. US Treasuries gained on Friday (pn9-11).
- The meaning of liquidity. Glossary (p 12-14).

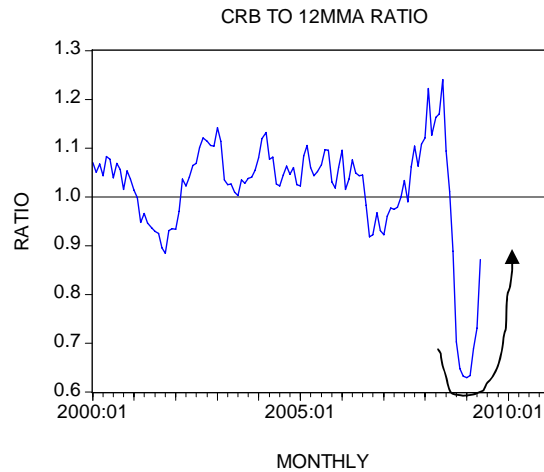
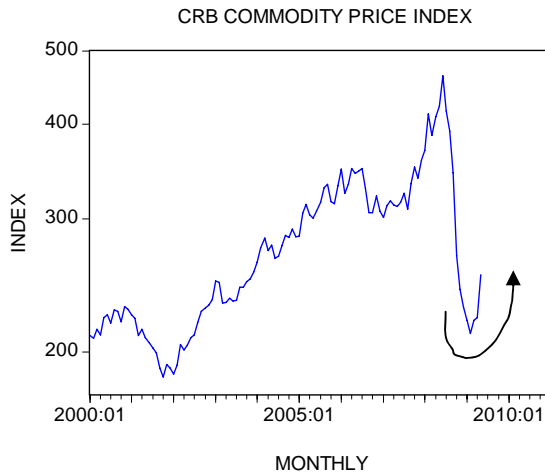


Executive summary

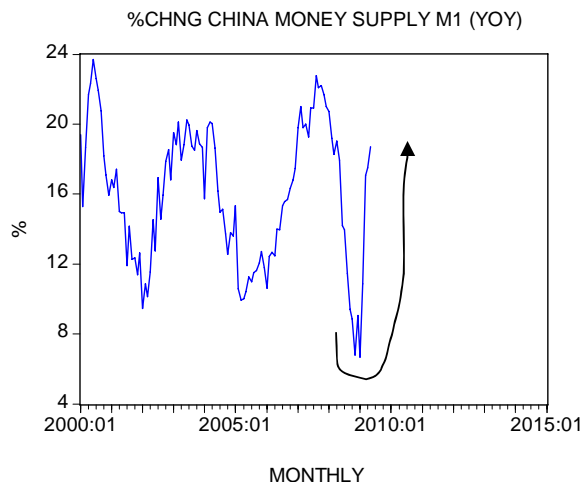
A key factor behind the visible rebound in commodity prices is the strong increase in US money supply and the strengthening in China's economic activity. We expect the up-trend in commodity prices to stay in force for the time being. In the meantime, the US central bank's monetary pumping is starting to ease. A fall in the Fed's balance sheet raises the likelihood that the US central bank may have started the process of removing the pumped money since Q3 last year. The net worth of US households fell **2.6%** in Q1 after declining by **8.6%** in the previous quarter. Net worth fell by **\$1.3 trillion**. Last week's economic data continues to indicate that US economic activity remains depressed. Also, economic data for Japan the Euro-zone and the UK portray still depressed economic activity (p 9). The US stock market is still marching ahead. We expect that the S&P500 will surpass the **1,000** mark by October this year.

Prospects for commodity prices

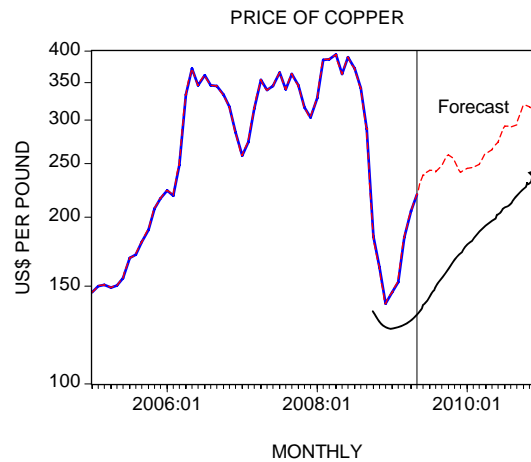
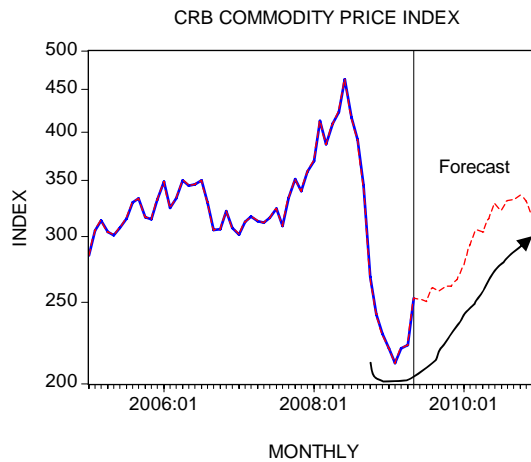
At the end of May the CRB commodity price index closed at **253.05** – an increase of **13.8%** from the previous month. Also the growth momentum of the CRB has strengthened last month. The yearly rate of growth rose to minus **40.1%** from minus **45.7%** in April. The CRB to its 12-month moving average ratio jumped to **0.872** in May from **0.730** in April.



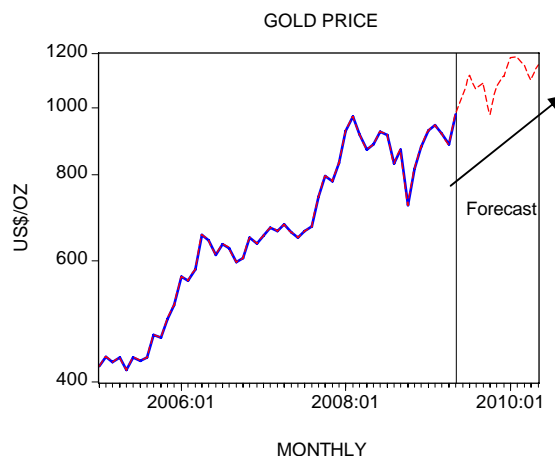
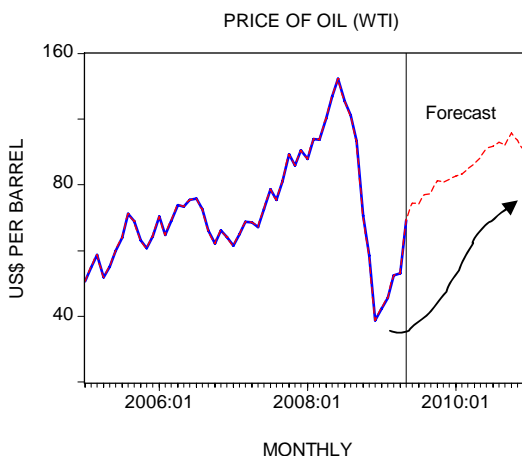
We suggest that a key factor behind a visible rebound in the CRB index is the strong increase in the growth momentum of US money supply and the strengthening in Chinese economic activity. An increase in monetary liquidity is an important factor in pushing prices up in general. Ultimately it is an allocation of money to a particular market that will set the price in that particular market. Remember that a price is the amount of money paid for a good. A strengthening in China's economic activity means that a large slice of dollars that comes from exports is allocated by China towards commodities. The rebound in the growth momentum of China's money supply M1 has continued in May. The yearly rate of growth jumped to **18.7%** from **17.5%** in April. Year-on-year the yearly rate of growth of retail sales climbed to **15.2%** in May from **14.8%** in April while the rate of growth of industrial production rose to **8.9%** last month from **7.3%** in April.



To assess the direction of the CRB index, the price gold, the price of copper and the price of oil we have employed our models that are driven by the state of economic activity and liquidity in the US and the state of China's economic activity. (Please note we assess commodity prices within the framework of a mild US economic recovery). We expect commodity prices to proceed along a gentle up-trend. By December this year the CRB index is forecast to settle at **270**. By October next year the model expects the CRB to close at **340** before settling at **320** by December. The price of copper, which closed in May at **219.75 US cents per pound**, is forecast to rise to **260 cents** by October before falling to **240 cents** in December. By December next year the model expects the price of copper to settle at **310 cents per pound**.



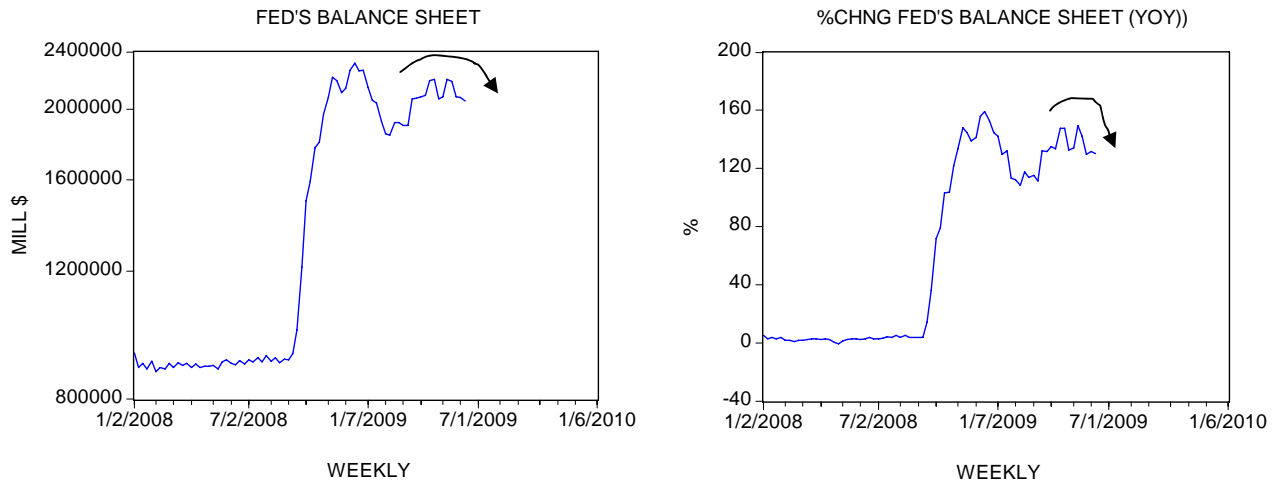
The price of oil (WTI), which closed at **\$66.28** per barrel in May, is forecast to climb to **\$82** per barrel by December this year. By October next year the model expects the price to close at **\$105** per barrel before settling at **\$95** per barrel in December 2010. Our gold model remains very bullish on the price of the yellow metal. According to the model the price of gold could close at **\$1,100** per ounce by August. The price of gold is forecast to stay at above **\$1,000** until May next year. (The model's forecast is from June 2009 to May 2010). The message from the models is that as long as Chinese and US economic activities are holding up commodity prices are likely to trend up.



Fed is pumping at a slower pace

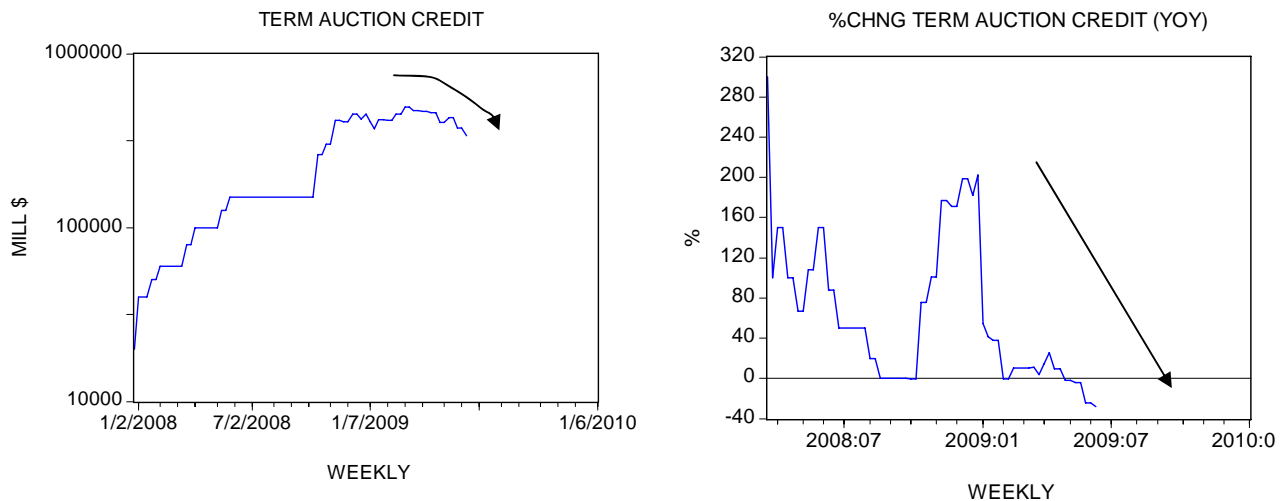
After settling at **\$2,198.269** billion in the week ending April 22 2009 the Federal Reserve balance sheet has been in a visible decline. In the week ending June 10 the balance sheet stood at **\$2,053.821** billion – a fall of **6.6%** from April 22, a fall of **\$144.448** billion.

The yearly rate of growth of the US central bank balance sheet fell to **130.3%** in the week ending June 10 from **131.8%** in the week before and **149.5%** in the week ending May 13.

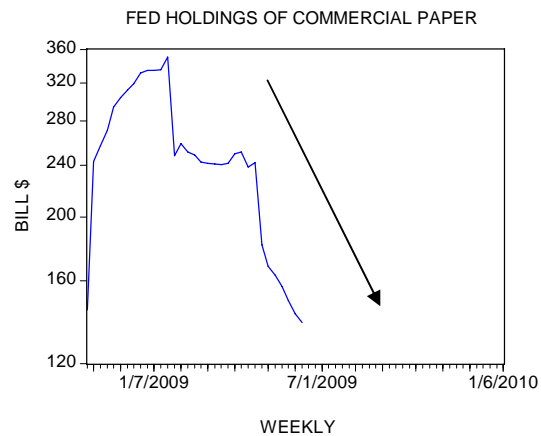
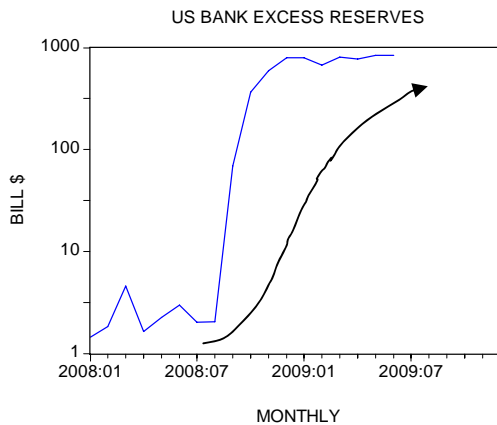


It seems that the Fed is starting to cut on its credit facilities to depository institutions. In the week ending June 10 the term auction credit stood at **\$336.566** billion – a fall of **\$119.233** billion from the week ending April 22.

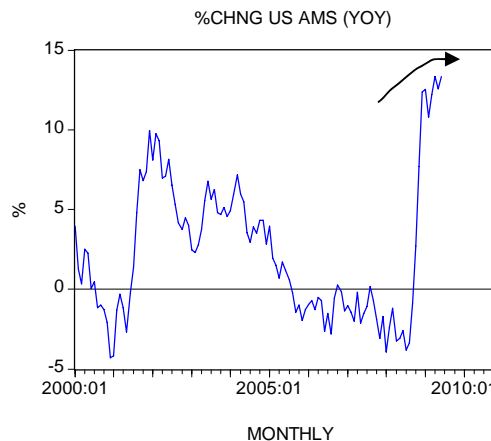
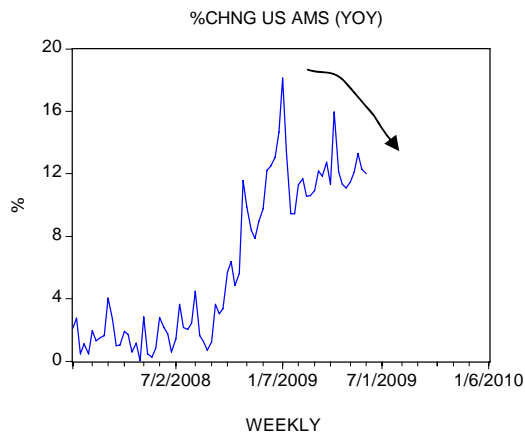
The growth momentum of credit displays a visible fall. Year-on-year the term auction credit fell to minus **28.2%** from minus **24.5%** in the previous week. (Please note that in the week ending April 8 the yearly rate of growth stood at plus **25.8%**).



We suggest that a fall in the Fed's balance sheet raises the likelihood that the US central bank may have started the process of removing the money it has pumped since Q3 last year. The main objective of this is to prevent a possible monetary explosion if the banks were to decide to lend out all the surplus reserves that they are holding. (Note that by means of fractional reserve lending potentially banks can amplify the given level of reserves many times over). In early June banks excess reserves stood at **\$838.5** billion against **\$2** billion held in August last year. In the meantime, the Fed has also slowed down its direct contribution to the money supply through direct lending to the private sector. In the week ending June 10 Fed's holdings of commercial paper fell to **\$138.44** billion from **\$142.6350** billion in the previous week and **\$350.52** billion in the week ending January 21.

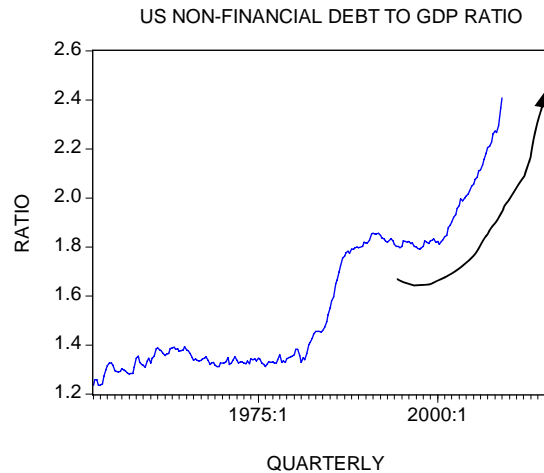
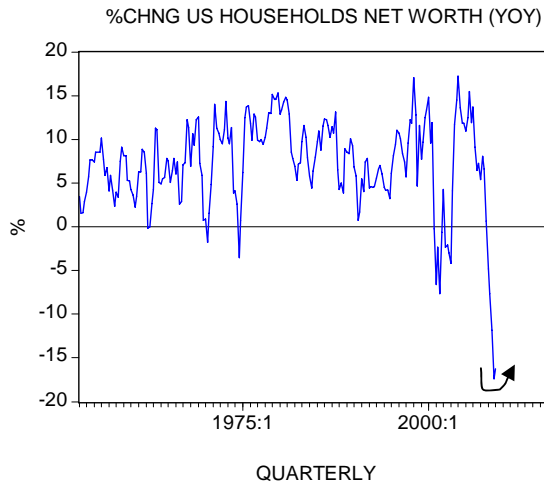


A softening in the pace of pumping by the Fed is likely to slow the growth momentum of our monetary measure AMS. In the week ending June 1 the yearly rate of growth fell to **12%** from **12.3%** in the week before. Observe that in the week ending April 1 the yearly rate of growth stood at **16%**. Also the growth momentum of real AMS shows softening. In the week ending June 1 the yearly rate of growth of this monetary measure stood at **12.3%** against **12.6%** in the prior week and **16.4%** in the week ending April 1. We suggest that the weakening in the growth momentum of weekly AMS points to a weakening in the yearly rate of growth of monthly AMS (see chart).

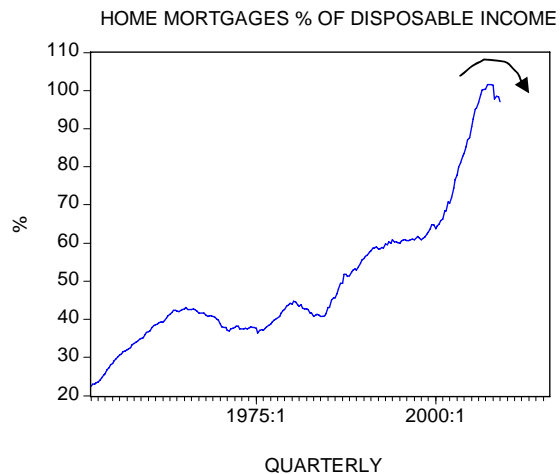
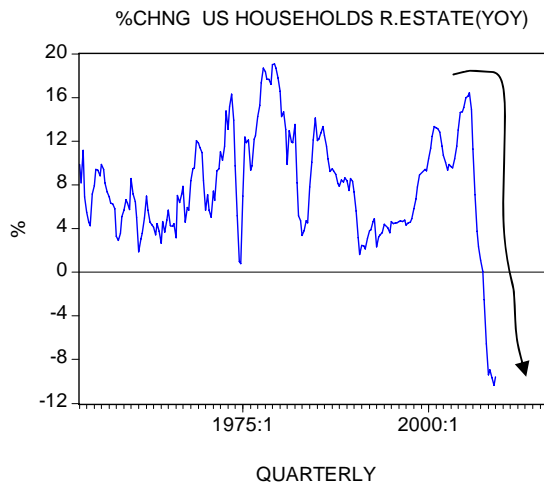


US household net worth fell further in Q1

The net worth of US households fell **2.6%** in Q1 after declining by **8.6%** in the previous quarter. The net worth fell by **\$1.3** trillion from the prior quarter to **\$50.4** trillion. In relation to the previous year Q1 net worth fell by **\$ 9.8** trillion. The growth momentum of net worth had a slight increase in Q1. Year-on-year net worth rose to minus **16.2%** from minus **17.4%** in Q4. The non-financial sector debt increased by **1%** in Q1 to **\$33.9** trillion. The yearly rate of growth stood at **5.6%** against **5.9%** in Q4. The ratio of non-financial debt to GDP rose to **2.41** in Q1 from **2.36** in Q4 2008.

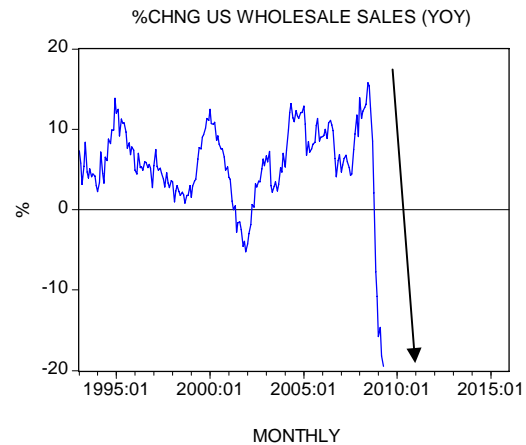
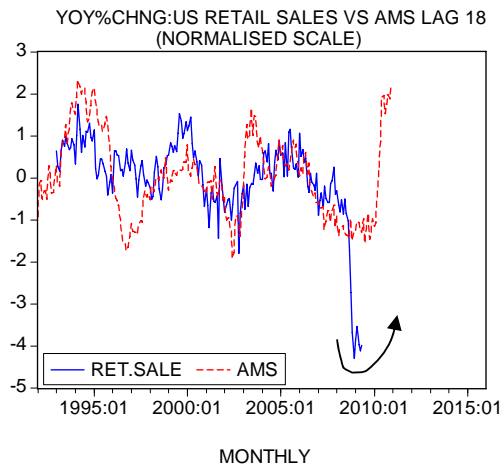


In the meantime, the value of household's real estate fell to **\$17.87** trillion in Q1 from **\$18.318** trillion in the previous quarter – a fall of **2.4%**. The growth momentum of the value of real estate rose slightly in Q1. Year-on-year the value of real estate rose to minus **9.6%** from minus **10.4%** in Q4. After climbing to **101.5%** in Q2 2007, home mortgages as a percentage of disposable income fell to **97%** in Q1. In Q4 2008 the percentage stood at **98.3%**. Observe that in Q1 2000 the figure was **63.7%**.

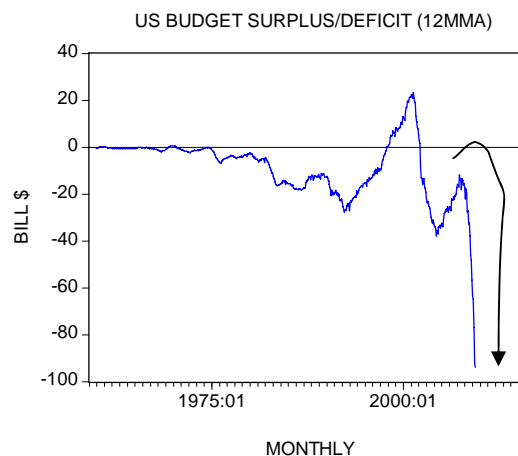
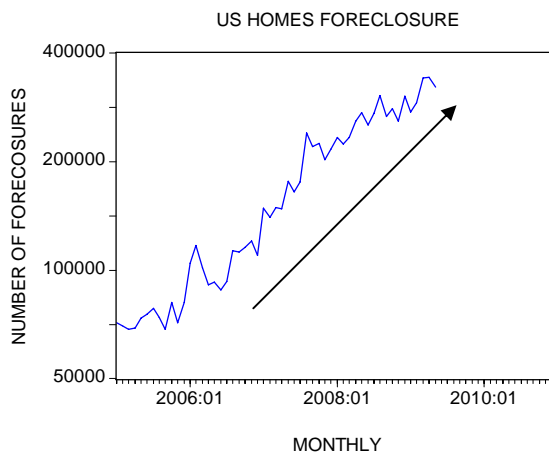


Focus on last week's US economic indicators

Seasonally adjusted retail sales increased by **0.5%** in May after falling by **0.2%** in April. The growth momentum rose slightly last month. The yearly rate of growth rose to minus **9.6%** from minus **10%** in April. Using the lagged growth momentum of AMS we can suggest that there is a high likelihood of a visible bounce in the growth momentum of retail sales in the months ahead. The growth momentum of wholesale sales remains in free fall. Year-on-year wholesale sales fell by **19.5%** in April after declining by **18.2%** in the month before.



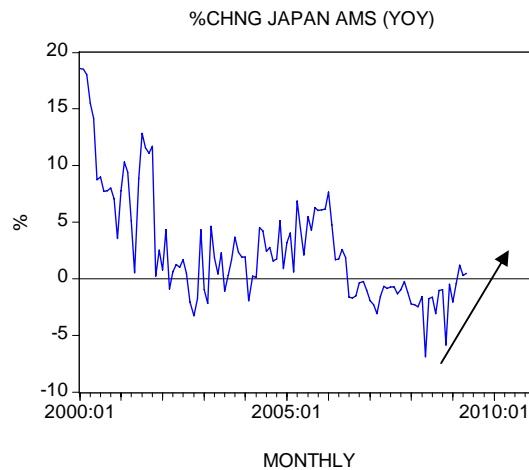
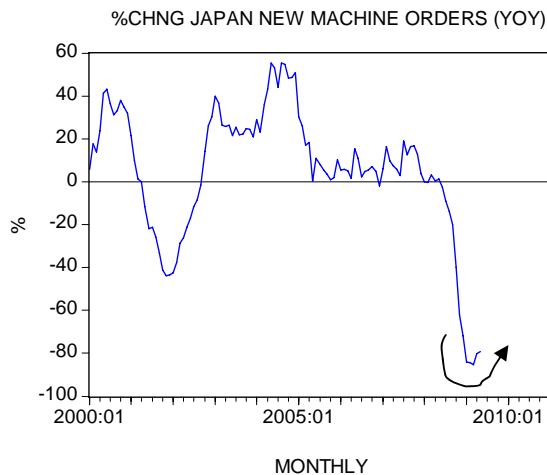
Meanwhile home foreclosure fell **6%** in May from April. The growth momentum of home foreclosures has eased further last month. The yearly rate of growth fell to **17.8%** from **32.3%** in April. The number of foreclosures in May stood at **321,480** against **342,038** in April. The May figure was the third highest month on record. The US government posted a **\$189.65** billion budget deficit in May. The 12-mma of the budget stood at a deficit of **\$93.9** billion against a deficit of **\$92** billion in April. In May last year the 12-mma of deficit stood at **\$27.7** billion. For the first eight months of fiscal 2009 the budget deficit totaled **\$991.95** billion compared with **\$319.4** billion in the same period of fiscal 2008.



Focus on last week's non-US economic indicators

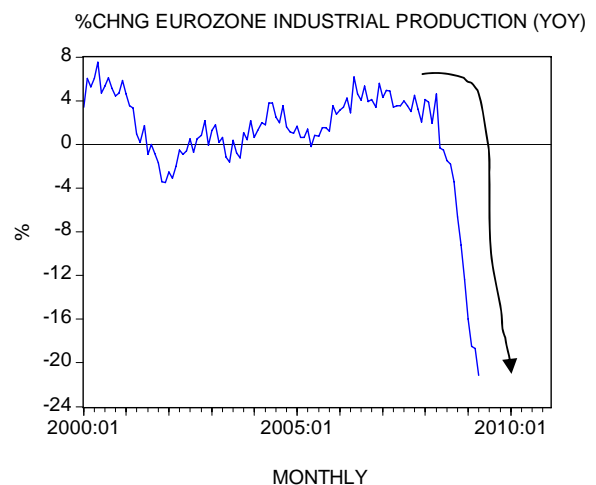
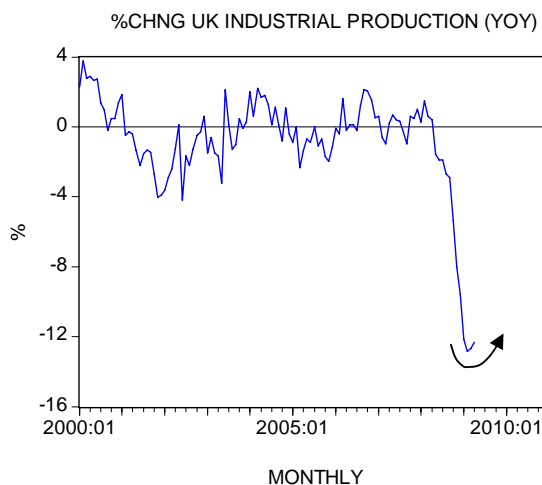
The growth momentum of Japan's machine orders appears to have bottomed. Year-on-year orders rose to minus **79.3%** in May from minus **80.3%** in April.

Japanese money supply had a positive rate of growth in May. The yearly rate of growth stood at **0.5%** against **0.3%** in April and **1.2%** in March. Note that this was the 3rd consecutive month of a positive rate of growth.



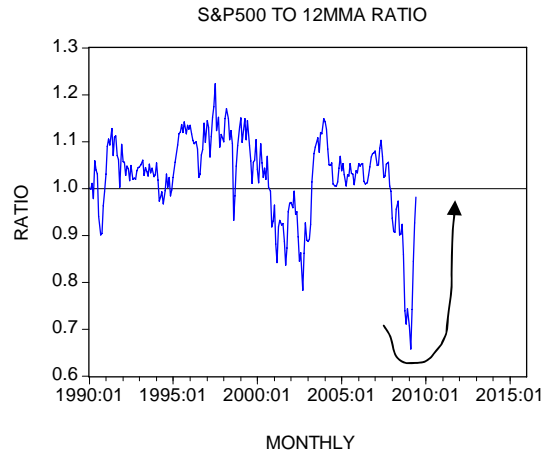
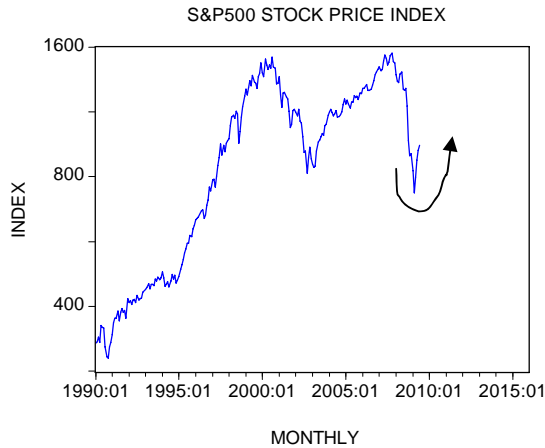
In the UK industrial production rose for the first time in over a year in April. Production increased by **0.3%** on the month – the first increase since February 2008. The yearly rate of growth stood at minus **12.3%** in April against minus **12.7%** in March.

Meanwhile the Euro-zone industrial output has continued to fall. Seasonally adjusted the output fell by **1.9%** in April after declining by **1.4%** in the month before. Year-on-year output fell by **21.1%** in April after declining by **18.7%** in March.

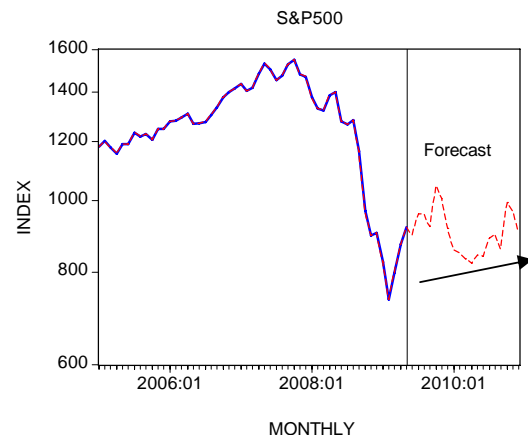
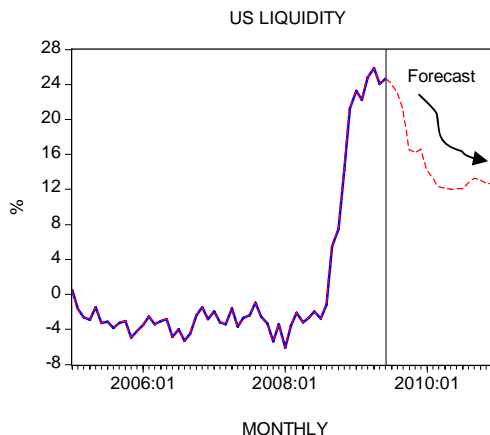


US stocks continue to push ahead

On Friday the Dow Jones industrial average rose **0.3%** to close at **8,799.26**. The S&P500 gained **0.1%** to close at **946.21**. The S&P500 is up **4.8%** for the year to date. Against the end of May the index was up **2.9%**. The growth momentum of the index shows a visible strengthening. Year-on-year the S&P500 rose to minus **26.1%** from minus **34.4%** in May. For the week the S&P500 gained **0.7%**. The S&P500 to its 12-month moving average ratio rose to **0.98** from **0.926** in May. In short, the S&P500 is not far from moving into an overvalued territory relative to its 12-month moving average.

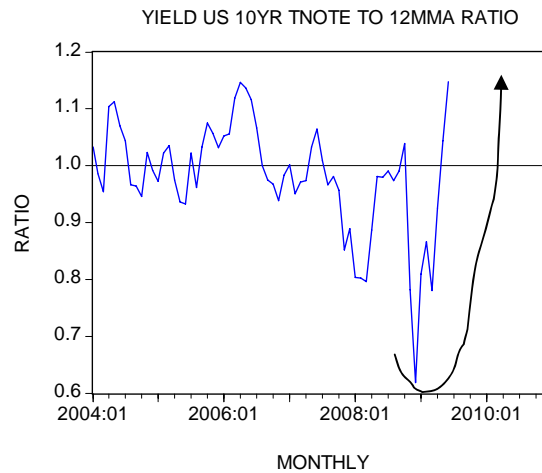
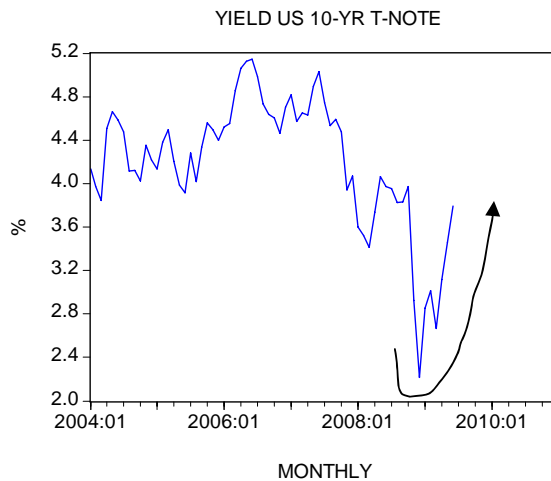


It is quite possible that the growth momentum of our measure of liquidity has already peaked at **26%** in April. By December this year we expect the yearly rate of growth of liquidity to close at **16.6%** before falling to **12%** by June next year. By December 2010 the yearly rate of growth is forecast to settle at **12.7%**. What weakens the growth momentum of liquidity in our forecast is a weakening in the yearly rate of growth of money supply and a strengthening in the pace of nominal economic activity. To establish the possible direction of the S&P500 we have employed our stock market model, which is driven by lagged monetary liquidity. According to the model the stock price index could reach **1,050** by October this year. Thereafter the index is forecast to come under pressure falling to **820** by April next year before closing at **900** by December 2009.

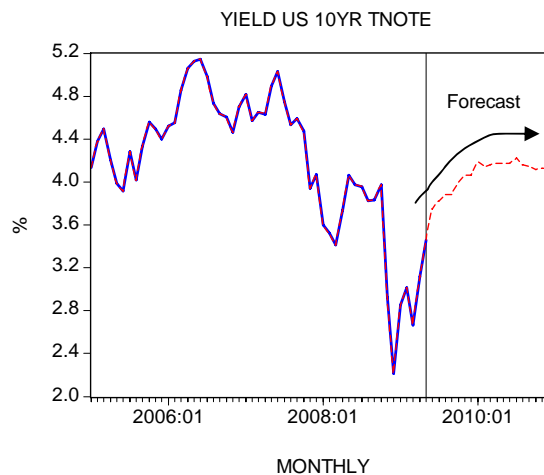
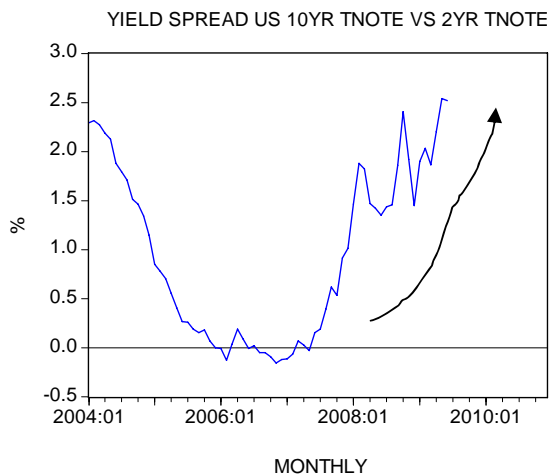


US Treasuries gain as Japan expressed confidence in US debt

Treasury notes prices rose after Japanese finance minister said his nation's confidence in US securities is unshakable, easing concern a record supply of Treasuries will damp foreign purchases. Japan holds **\$686.7** billion of US Treasury debt the second largest holder after China, which holds **\$767.9** billion in US government debt. President Obama's administration is likely to borrow a record **\$3.25** trillion this year against **\$892** billion last year. The yield on the 10-year T-note fell to **3.79%** on Friday from **3.86%** in the previous day. The ratio of the yield on the 10-year T-note to its 12-month moving average stood at **1.148** against **1.04** in May. From this perspective the 10-year T-note is in under-valued territory.



The yield spread between the 10 year and the 2 year Treasuries eased to **2.52%** from **2.54%** in May. In January the spread stood at **1.9%** and in June last year it was **1.35%**. The spread between the 3-month Libor rate and the 3-month US Treasury bill fell to **0.45%** from **0.519%** in May and **1.07%** in June last year. According to our model the yield on the 10-year T-note is forecast to increase to **4.2%** by January next year. After a possible increase to **4.3%** by July next year the yield is forecast to settle at **4.1%** by December.



The meaning of liquidity

In a market economy a major service that money provides is that of the medium of exchange. Producers exchange their goods for money and then exchange money for other goods.

As production of goods and services increases this results in a greater demand for the services of the medium of exchange (the service that money provides). Conversely, as economic activity slows down the demand for the services of money follows suit.

The demand for the services of the medium of exchange is also affected by changes in prices. An increase in the prices of goods and services leads to an increase in the demand for the medium of exchange.

People demand now more money to facilitate more expensive goods and services. A fall in the prices of goods and services results in a decline in the demand for the medium of exchange.

Now, take the example where an increase in the supply of money for a given state of economic activity has taken place. Since there wasn't any change in the demand for the services of the medium of exchange this means that people now have a surplus of money or an increase in monetary liquidity.

Obviously no individual wants to hold more money than is required. An individual can get rid of surplus cash by exchanging the money for goods.

All the individuals as a group however cannot get rid of the surplus of money just like that. They can only shift money from one individual to another individual.

The mechanism that generates the elimination of the surplus of cash is the increase in the prices of goods. Once individuals start to employ the surplus cash in acquiring goods this pushes prices higher.

As a result the demand for the services of money increases. All this in turn works towards the elimination of the monetary surplus.

Once money enters a particular market this means that more money is now paid for a product in that market. Or we can say that the price of a good in this market has now gone up. (Remember a price is the number of dollars per unit of something).

Note that what has triggered increases in the prices of goods in various markets is the increase in the monetary surplus or monetary liquidity in response to the increase in the money supply.

Whilst increases in the money supply result in a monetary surplus, a fall in the money supply for a given level of economic activity leads to a monetary deficit. Individuals still demand the same amount of the services of the medium of exchange. To accommodate this they will start selling goods thus pushing their prices down.

At the lower prices the demand for the services of the medium of exchange declines and this in turn works towards the elimination of the monetary deficit.

A change in liquidity or the monetary surplus can also take place in response to changes in economic activity and changes in prices. For instance, an increase in liquidity can emerge for a given stock of money and a decline in economic activity.

A fall in economic activity means that fewer goods are now produced. This means that less goods are going to be exchanged – implying a decline in the demand for the services of money – the services of the medium of exchange.

Once however, a surplus of money emerges it produces exactly the same outcome with respect to the prices of goods and services as the increase in money supply does i.e. pushes prices higher. An increase in prices in turn works towards the elimination of the surplus of money – the elimination of monetary liquidity.

Conversely an increase in economic activity whilst the stock of money stays unchanged produces a monetary deficit. This in turn sets in motion the selling of goods thereby depressing their prices. The fall in prices in turn works towards the elimination of the monetary deficit.

There is a time lag between changes in liquidity i.e. a monetary surplus and changes in asset prices such as the prices of stocks.

For instance, there could be a long time lag between the peak in liquidity and the peak in the stock market. The effect of previously rising liquidity could continue to dominate the effect of currently falling liquidity for some period of time. Hence the peak in the stock market emerges once the declining liquidity is starting to dominate the scene.

(The reason for the lag is because when money is injected it doesn't affect all the individuals and hence all the markets instantly. There are earlier and later recipients of money).

GLOSSARY

Money AMS - stands for the Austrian School of Economics money supply definition. The aim of this definition is to ascertain as accurately as possible the amount of money in an economy.

Monetary liquidity - stands for the yearly rate of growth of money AMS adjusted for the rate of growth of nominal economic activity.

The pool of funding - stands for the stock of final goods ready for human consumption. The state of the pool sets the limit for economic growth.

Real savings – the amount of consumer goods produced locally less the amount taken by the producers of these goods.

The reshuffling process - the diversion of real savings from wealth generating activities towards activities that sprang up on the back of loose monetary policy.

Productive consumption - consumption that is preceded by production of wealth i.e. consumption that is backed up by the production of wealth.

Non-productive consumption - consumption that arises as a result of monetary pumping and is not supported by wealth production. This type of consumption weakens the flow of real savings.

Unbacked loans - lending that is not backed up by real savings. This type of lending is created through fractional reserve banking i.e. lending out of "thin air".