



Cottonfield – Market Update

September, 2005

The full damage of Hurricane Katrina cannot be fully assessed at this point. U.S. Congress has decided on an emergency package of USD10.5 bn. Oil prices and here especially gasoline prices in the U.S. have spiked as a result of actual supply shortages as well as in anticipation of ongoing or even growing shortages in oil production and refining capacity.

In the meantime, all immediate reactions of financial markets have leveled off again and normality has returned. The initial spike in U.S. 10 yr. interest rates has shrunk again and today the difference between short-term and 10 yr. interest rate is smaller than ever.

We should be interested in the medium term implications of Katrina. Again, we keep our main focus on U.S. developments since we continue to believe, that bar extraordinary events, the U.S. economy remains the main influence for the course of the global economy.

As mentioned in our last Market Update of Aug. 18, 2005, oil price increases finally have left a mark in the inflation statistics in the U.S. Katrina will exacerbate this trend. Gasoline and natural gas prices in the U.S. have climbed even higher to USD 3 / gallon and USD11 for gas, respectively. While the gasoline price can be controlled somewhat by releasing inventory of various Strategic Petroleum Reserves, natural gas prices will stay high. The percentage of incomes that is spent in the U.S. on energy by those in lower income profiles is already approaching 20%.

This increase of energy cost happens at a moment, when the U.S. personal savings rate reached a minus 0.6% in July, the lowest since 1959. Under such savings and the current debt scenarios, energy prices MUST now start to severely cut into consumer spending.

What is not visible as of today, but what **we have to expect** are the following developments:

1. **Energy prices** to stay high or climb even higher adding to inflationary pressures, to reduce spending power, and to reduce corporate earnings, with corporates not being able any longer to pass on their higher cost.
2. The U.S. Federal Government again spends money that has not been budgeted. The **budget deficit** will grow. It may also grow, because the stimulus of this USD 10.5 billion aid package together with insurance coverage paid out may not offset the loss in income and spending. This should lead to a net loss in income tax revenues for the Federal Government.
3. With releasing portions of the **Strategic Petroleum Reserves** by the U.S: and some other nations (in favor of the U.S.), oil and gasoline prices may be held at bay for some time. But reserves released today will have to be replaced tomorrow.
4. For **natural gas**, however, which has seen growing use in home heating and electricity producing utilities, there is no support available and therefore we must assume that gas prices will stay high and go higher as winter approaches.
5. The **trade deficit** of the U.S. bears the potential to continue to deteriorate significantly. Temporary higher import volumes at higher prices due the production shortfall caused by Katrina combined with lower exports as of mainly agro-products through destroyed shipping facilities in the Mississippi Delta will leave their mark.
We think that the rebuilding effort may increase import volumes for also of non-energy related goods before then finally to recede at some point in the future due to a lack of spending power of the U.S. consumer.
Net net, we expect the trade deficit to balloon in the coming months.

6. As a result of Katrina, there are voices that recommend the Fed Reserve Bank to slow the gradual increase of the **Fed Funds rate** (short-term) or to leave it even at the current 3.5% and to assess first the full impact of Katrina on the economy and consumer spending. Given that the Fed Reserve Bank continues to have very good reasons to lift the FF rate (inflationary pressures, to harness the buoyant housing market, in support of the USD), it seems unlikely to us that the Fed will change course now. As a result, increasing debt servicing burdens will have at some point a negative impact on consumer spending.
7. Having seen the **USD** weaken in the aftermath of Katrina may be viewed as indication for markets to a strong slowdown of the U.S. economy. With Katrina the dilemma for the Fed may even have increased between supporting domestic economic activity, pre-empting a burst of the housing market and supporting the USD.

Conclusions:

1. While the U.S. economy seems to have slowed down already before, **Katrina** may potentially impact the U.S. economy quite negatively on several levels. The economic stimulus is unlikely to offset the economic loss.
2. High **energy** prices are here to stay and to increase. This upward trend can be broken only by a significant slowdown or reduction in (worldwide) demand.
3. The strength of the **USD** seems to continue to depend mainly on the interest rate differential vis-à-vis other currencies.
4. As energy prices creep higher, China and other holders of large **USD reserves** may use such reserves to cover their own energy needs. The same reasons could lead to an acceleration of revaluation of the Chinese Renminbi which would further impact the USD.
5. Massively higher USD denominated profits generated in the energy sector should increase capital spending on energy resources, but at the same time excess funds may seek "safe" heavens such as in precious metals and commodities.
6. We continue to be concerned about **stagflation** in the U.S. ending in a worldwide recession.

For the time being, however, without any shock event, markets may meddle along. But as investment advisors we are prepared to **anticipate malign market developments** since the air for investors continues to get getting thinner.

Investment View:

1. **USD**: Observe developments on a short-term perspective. Any strengthening may be of temporary nature. If no hedge is in place for existing USD investments be prepared to sell and convert the proceeds back into your base currency.
2. **Stocks**: Our preference for new investments lies with energy. In case of a market slow down in economic activity, energy values will fare better than (hard) commodities. Non-energy related exposures should be reduced.
3. **Gold, Silver**: Increase the percentage of Gold and Silver as of the total portfolio.
4. **Indices**: Consider shorting stock indices by way of long-tenor puts.
5. **Agricultural products**: Increase positions. Higher demand and higher transportation prices will lead to price increases.
6. **Bonds**: Uncertainty remains. As an alternative to bonds, we continue to view as attractive.

Specific investment advise and recommendations are reserved for our clients. Cottonfield Family Office AG is a investment management company and a member of the AQUILA Investment Group. Based in Zurich, we serve domestic and international private and institutional clients.

Roy Darphin
Cottonfield Family Office AG