Limited supply, higher prices likely won't stymie global economic activity; robust demand continues in emerging markets

COMMODITY PRICES HAVE RISEN TO REASONABLY PROFITABLE LEVELS and demand remains high as 2011 gets underway. This "just not enough" environment should be ripe for companies that are efficient at finding and developing resources in a commodity sector that is sufficiently supplied or those in a resource category that has scarcity pricing power due to limited competition or supply. Here, Fred Sturm, manager of Ivy Global Natural Resources Fund, shares his observations and outlook on commodity demands resulting from rapid emerging market growth and where he feels the best resources opportunities lie.

Unrest in Egypt

In our recent presentations, we have highlighted the theme "transfer of stress to government." This is clearly what we are now seeing unfolding in Egypt. We would like to stress that Ivy Global Natural Resources Fund does not currently have investments with direct meaningful exposure to Egypt. Energy service companies have some activity there, but it does not represent a meaningful percentage of their total revenues.

We do not make long-term investments based on daily or hourly headlines. Financial markets often find an excuse to go in the direction they want or need to. Emerging markets have been consolidating since last fall, and these headlines may be the end of the consolidation and may signal anticipation of the next rally.

U.S. equities still seem well supported by recent earnings reports, but they, too, probably need some time to consolidate the six-month advance. We think a 5 to 8 percent seasonal pullback is likely, so we have raised cash and used some hedges, and the Fund is roughly 90 percent invested.

Investors may push gold as a hedge against continued political turmoil. Gold has been coming down and select gold stocks have retreated 20 percent already, so we have started to nibble again. However, we do not like it when pull-backs that have not run their course are interrupted by a geopolitical event, so we are unlikely to chase a near-term rebound. We believe gold has yet to see its highs.

The Suez Canal is the preferred passage for oil (about 1.8 million barrels per day) and liquefied natural gas ships coming from the Middle East to Europe. Interruption in canal operations would not impact production, so it would serve to raise energy prices in Europe and the redirection could lower them in Asia.

However, what the turmoil in Egypt does emphasize is that there is not much spare capacity for many resource sectors, including oil. We need open global exchange and continuous investment just to meet current demand. Disruption in the economies of more substantial Middle East and North African producers would be a major problem. We think that energy-deficit nations, including the U.S., are wise to keep focusing on renewable energy solutions.

Potential pull back may mark early 2011

Toward the end of 2010 and in early 2011, the market extended the rally that began last summer, although our models suggest that we may be due for a bit of a pause. We expect that at some point in the first quarter we will see some pull back in the broad stock markets and in certain commodity prices and producers. We have adjusted the portfolio accordingly, raising a bit of cash and creating some defensive hedges. At the same time, it is not clear to us that any pullback would necessarily be significant. We are still managing from the bull market side, while being mindful of what could happen. Instead of having a uniform correction in different sub sectors, we could have a little bit of a rolling correction. For instance, in the resources sector, we might see gold and silver come down and find their lows, and then oil may rally again.

As we have communicated on previous occasions, we have argued for this 20-year bull market in resources and have phrased it in several ways. In the 1980s and '90s the resources market was simply over supplied. There were too many competitors, some new technology that had brought on new supply sources, and the lasting overhang of too much money and capital thrown at it from the run-up in the1960s and '70s. That "just too much" early recovery phase that began in late 1998 and transitioned through the last decade into a more broad-based, "just in time" mentality that spanned many different industries. We also are arguing that in this third phase, which is now underway, we're going to run into periods of "just not enough," along with potential price spikes in order to limit a demand that will be insufficiently supplied. We think that as a result, commodity prices will maintain price levels that are mid-point to the higher end for the next couple of years, rather than mid-point to the lower end. When commodity prices are at the upper end, we'll say "too high, can't afford it." We'll do something else or we'll just not buy anymore. And at the low end, producers can't afford to produce.

Let's use oil as an example. We think that oil at $90 is level and we're currently close to that price. It's a level the world can afford to pay and it's not so dear that it's going to severely impact global economic activity. When we look at oil as a percent of total budget spent in the world, we would suggest that at $120 to $125 per barrel, oil becomes a punitive tax on economic activity. We would suggest oil in the $60 per barrel range is too low for the energy's subsector to replenish itself and meet all that is needed. Within that general range, we believe that we are now transitioning from a period of excess capacity that has existed in the oil world and still exists today.

A wall of worry

2010 was an excellent example of investment markets climbing a wall of worry. There were many significant issues to worry about and yet "risk" assets, including global stocks and commodities, posted healthy double-digit returns, meaningfully outperforming "safety" cash and government bonds. U.S. resource stocks outperformed global resources during the period, and smaller growth-oriented companies outperformed larger value-based investments. This was even more pronounced in precious metals. The Fund tends to invest in companies across the market capitalization range, as well as in growth and value stocks. The Fund was modestly behind funds that tend to focus more on North American small-cap companies. We believe a diversified approach should continue to serve investors well in the future.

Global fiscal and monetary policies were under tension in 2010 and will likely remain so for many years. Some central banks continue to push for reflation, while others, such as the central banks in India and China, are tightening policy to combat rising inflation pressures. Some governments promote fiscal support by extending tax cuts, yet others, like those in most of the euro zone, are being forced toward austerity. Central banks have the tools to crunch the system if they want to – we are just not convinced that they want to.

We continue to believe fixed-income yields have begun a path higher and that bond markets could be risky to outright dangerous relative to generic beliefs that value is always safely maintained. Market-driven rates may well lead to more central bank tightening. However, with real interest rates still quite low, rising rates are more likely to generate a couple of scares in the year ahead rather than a sustained drag on the global economy or equity markets.

Perspective on recent performance

As we have mentioned, 2010 was a decent year but not a stand-out year for the Fund. I say decent because during the last 12 years of bull market, the Fund's absolute returns have been positive in 11 of them. We have 11 out of 12 years broadly beating the global stock markets and the S&P 500 Index. And we have had 11 out of 12 years in which the Fund has been in line or near to the underlying commodity indexes using the global basic materials and energy indexes.

We are mindful of the fact that many mechanical screening systems that look at various time periods still capture the challenge that we had in 2008, when many of our models failed us and we didn't have access to the tools that we are now deploying. We understand that when you look at the performance tables, we don't screen out well. What will become visible over the course of this year is that we have had an outperformance from our Fund relative to the broad market, relative to our peers and relative to our benchmarks. That should become more evident in the months ahead as the full three-year window is captured. So there's still work for us to do, and we're hoping to fully recapture the highs. We're well underway in this recovery trend.

Moving on

The global economy is moving on and starting to consider what is ahead. Despite some concerns, we think global economic activity could reach record levels for many key industries. It may not feel like it for most developed economies, but demand in many emerging markets continues to grow (never before has car demand in China and India been greater). We expect global corporate profits to reach record highs in 2011, and that U.S. profits will recover and track to new records by year-end.

With a few exceptions, commodity prices have now bounced to what we feel are fair and reasonably profitable levels. We would characterize the adjustment of global currencies as still "happening." Last year currency markets were an important marker and were used by some market participants as a key to broader trends. Euro weakness/dollar strength in the second quarter of 2010 was a reflection of recovery concerns and a hint to sell equities and commodities but to still buy gold. A weakening dollar in the second half of 2010 was a "buy equities and commodities" signal. As 2011 begins, it looks like the dollar may be in another temporary uptrend, so equities and commodities may well pull back again. However, we caution investors that correlations like this work for a while and then stop working.

The Fund begins 2011 with a neutral to slight underweight exposure to precious metals because we find other resource sectors more compelling, but we may overweight again should shares pull back in 2011. We still expect a continuation of the steady uptrend, but it remains possible that precious metals and producers have a drop off before a multi-year trend-ending top is reached.

The threat of a double dip

There were surprises within equity markets in 2010. In the face of a consensus that emerging market prospects are brighter than developed markets, U.S. stocks outperformed the BRIC Index with Brazil flat on the year and Shanghai stocks a negative 10 percent. Given concerns of an economic "double dip," it was reasonable to position in larger and more defensive high- yielding companies. Yet the smallest U.S. stocks beat the largest by a formidable 10 percent after moving in tandem in the prior year. These two trends were of particular benefit to small-cap North American resource stocks. Within commodities, gold, silver and palladium all experienced healthy gains as speculative money flows chases these less-liquid commodities. Given the strong year-end push into silver equities, it would not be surprising to see these same commodities pull back early this year. The Fund currently does not own silver. Oil prices moved higher, but in another display of potential risks in commodity exchange-traded funds, those that track oil were down 1 percent for the year. Natural gas spot prices were down more than 20 percent, and the United States Natural Gas Fund (UNG) (0.00% of assets at 12/31/2010) was down a stunning 41 percent last year.

Not all commodities are in the same phase of scarcity pricing. Last quarter we observed looming supply shortages of copper. In November we traveled to see coal import facilities in India that could become the largest coal handling port in the world. Now we begin 2011 with epic floods in Queensland, Australia, a region critical to the supply of both seaborne coking and thermal coal. We had already expected coal markets to be tight. A retest of record highs seems possible as coal contract prices continue to rise. The Fund's Indonesian and Russian coal producers should also benefit from strong pricing.

Just not enough

The phrase "just not enough" captures an important element supporting resources investment. Applied to resources, the companies that deliver higher returns to shareholders over time are companies that are more efficient at finding and developing resources in a commodity sector that is sufficiently supplied, or those that are in a resource category that has scarcity pricing power due to limited competition and/or supply. We believe precious metals, cotton and copper have already moved into this stage. Coal, oil and corn are demonstrating some elements of this too. According to the Organization for Economic Cooperation and Development (OECD), consumption of oil is roughly 14.5 barrels per capita. China is still only approaching three and India is closer to two. Assuming the world will consume close to 88 million barrels per day, at 365 days per year, total consumption will be 32 billion barrels per year. The challenges of bringing on any meaningful new supply means that oil should remain a highly politicized commodity with upside pricing pressure. For calendar 2011, we expect improved production from Iraq will help stall oil price advances, but a triple-digit average could be in store for 2012 if the global economy continues to expand.

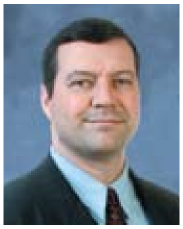
We think that pricing power for many other commodities can also be sustained for many years, but we must be mindful that a downturn in business cycles, substitution or economization by buyers, or new incremental supply can reverse prices. We believe iron ore prices will remain stronger for longer than the market expects, and cash generation will be very good in the near term, but strong supply growth over the next several years could soften prices again by the middle of the decade. Solar energy is a competitive market with excess capacity, but there is not an excess of low-cost suppliers with bankable brand recognition.

Portfolio changes

We made a number of small changes to the Portfolio in the final quarter of 2010. We significantly reduced Randgold Resources Limited (0.53% of assets at 12/31/2010) due to valuation and project implementation risk. This turned out to be fortuitous as political issues have subsequently pressured the stock further. We eliminated Vale to add to Rio Tinto (3.09% of assets at 12/31/2010), eliminated Peabody to add to Arch Coal (0.98% of assets at 12/31/2010) and Baker Hughes Corp. (0.73% of assets at 12/31/2010), primarily for valuation reasons. International Paper (0.83% of assets at 12/31/2010), the largest U.S. containerboard supplier, should benefit from an improving economy and we found the double-digit free cash generation to be attractive, so we established a reasonable position. Relative to many other funds in the category, the Fund has a value tilt.

Takeover news in fertilizers benefited the Fund as shares of Russian producer Urakali (0.59% of assets at 12/31/2010) advanced after it announced it will merge with Silvinit (not held in the portfolio). EXCO Resources (0.47% of assets at 12/31/2010), one of the Fund's targeted selections in natural gas, jumped in response to a management-led buyout. This highlights latent value in natural gas shares and the potential for appreciation as natural gas prices improve.

Improving sentiment



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Investor sentiment is recovering, but does not appear to be exuberant. In the past three years, most flows have gone into fixed-income markets rather than equity investing. This is also true of resources. The sub-sectors become increasingly risky once a steady escalation of prices gets imbedded in share valuations. Fortunately, we are not there yet. We would characterize valuations as neither cheap nor massively overpriced. We believe the business cycle is still maturing and commodity prices including coal first, then oil, and then natural gas have room to move higher. Even for the laggard natural gas, we reiterate that we believe longer-dated natural gas prices have seen their lows and are gradually recovering. Indeed, some share prices moved fast enough in the second half of 2010 to pose near-term pull-back risk. That's why we may raise a little cash, briefly layer in some defensive hedges and advocate the "buy on dips" approach for investors looking to add exposure.

We are hesitant to forecast above-average double- digit returns for global equities because three years in a row of double-digit returns are not common. Nonetheless, even from current price levels, we still expect that investing in good productive businesses broadly, and good resource companies in particular, will be a more likely path to wealth accumulation than "safety" alternatives. We will continue to manage "from the bull side" and attempt to take advantage of anticipated pull-backs.

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