

AGF INVESTMENT INSIGHTS

NATURAL RESOURCES: Beyond the Super Cycle

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Since 2008, financial markets have been vulnerable to fears of sovereign debt default, inflation expectations, currency debasement and slow growth in developed economies. And yet, one bright spot has remained constant through these tumultuous times – natural resources. Demand from emerging market countries has created what some are calling “a commodities super cycle,” marked by skyrocketing demand for key resources like oil, coal and copper. But the fundamentals driving growth in the natural resources sector suggest we are not just facing a normal cycle – rather, commodities are in the midst of a secular uptrend as increasing demand and depleting supplies bode well for prices in the years to come.

Much of this can be attributed to a shifting global economic landscape where unprecedented demand from emerging market economies has led to a tightening of supply, thereby disrupting the supply/demand relationship of the natural resources equation. While this creates volatility, it also presents opportunities for investors. The question is, how can investors benefit from this tightening supply-demand equation and how should they gain exposure to natural resources as a long-term source of growth for their investment portfolio?

Not just another growth cycle

One of the most significant variables driving demand for commodities is accelerating growth in emerging markets. While developed markets are struggling with massive debt loads, high unemployment and lacklustre GDP growth, emerging market countries like Brazil and China are experiencing strong increases in production, consumer spending, urbanization and infrastructure. This has led to booming demand for much-needed commodities such as oil, copper, coal and iron ore to fuel manufacturing, building and development in these countries. The International Monetary Fund (IMF) has predicted that for the next several years, annual GDP growth in emerging market countries will continue to outstrip that of developed markets (See Exhibit 1). These growth expectations continue to support rising demand for natural resources.

SPOTLIGHT:

Iron ore

Prices for iron ore and coal have skyrocketed in recent years in response to demand from emerging market countries like China, India and Brazil. These commodities are fundamental to the making of steel, which these growing nations need for residential and commercial construction and infrastructure building.

The World Steel Association has forecast that global steel demand will grow 5.3% to reach a record of 1.34 million metric tonnes in 2011 and consumption is expected to double by 2050. Therefore, prices will likely remain high for the foreseeable future.

Coal

While advances in technology have helped accelerate the green movement and other alternative sources of energy, thermal coal remains the primary source for generating electricity around the world. According to the International Energy Agency (IEA), China overtook the U.S. in 2010 to become the world's largest energy consumer. This is a result of the industrialization and urbanization in China that is expected to continue for years to come.

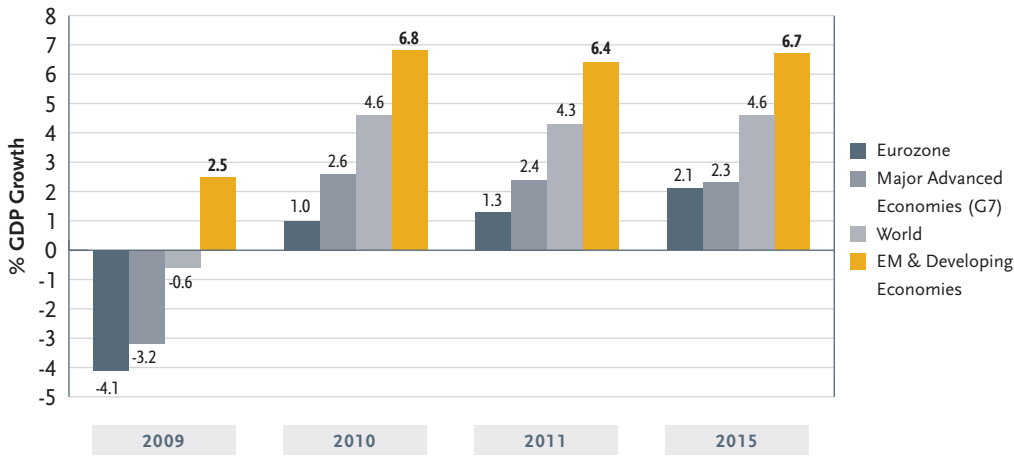
Yet, China's electricity consumption on a per-capita basis is still only around one-third of the OECD average.

TOP FIVE CONSUMERS OF COAL:

1. China
2. United States
3. India
4. Germany
5. Russia

Source: EIA (U.S. Energy Information Administration)

EXHIBIT 1: GDP Growth Rates (%)

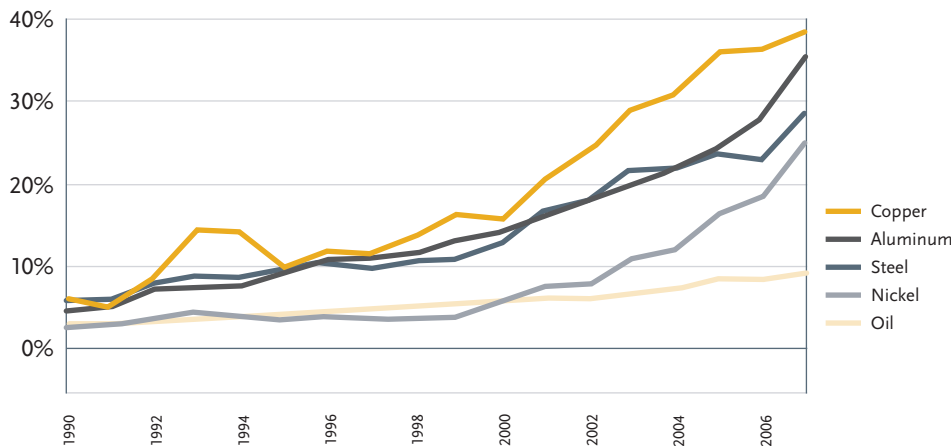


Source: International Monetary Fund, World Economic Outlook Database, October 2010

China leading the way

The biggest growth story right now is China. The nation marked the start of its 12th five-year growth plan, which will see policymakers attempt to slow down growth slightly in order to pursue key targets such as wage normalization, individual income tax cuts and more fiscal spending on social security and health care. Wealthier households in China will lead to ongoing strength in commodity consumption as the service sector grows and households become larger consumers as a result of the five-year plan. At the same time, China's continued push to bolster its infrastructure could also open up a growth opportunity for later stage commodities such as platinum and nickel.

EXHIBIT 2: China's share of global commodity consumption



Source: UBS

But it's not just China that's driving commodity demand. Purchasing power parity (PPP) is on the rise throughout the BRIC countries as household income and spending rises – that represents another huge opportunity for commodities growth. Indeed, on a PPP basis, the total size of the BRICs stood at about 31.1% of world GDP at the end of 2010, a number that is expected to rise substantially as these countries grow their economies¹.

¹Source: International Monetary Fund, 2010

SPOTLIGHT:

Copper

Over the last century, copper has been one of the most heavily used and recycled metals. Today, it is still integral to the building of core infrastructure such as electricity production and transmission, computer processors and cell phones. As emerging economies industrialize and build new infrastructure, demand for copper continues to reach new heights, with China leading the way.

TOP FIVE IMPORTERS OF COPPER ORES AND CONCENTRATES:

1. China
2. Japan
3. India
4. Korean Republic
5. Germany

Global copper mine production has grown approximately 4% a year since 1900 and has more than doubled since 1990 in an attempt to meet this demand, yet prices have continued to soar. In 2009, production stood at almost 16 million tonnes according to the International Copper Study Group. Going forward, global mining giant Rio Tinto expects demand for copper to double over the next 15 - 20 years.

Chile accounted for over one third of world copper mine supply in 2009 with production of more than five million tonnes. Peru, the United States, China and Indonesia were the next largest producers with approximately one million tonnes each.

The supply side

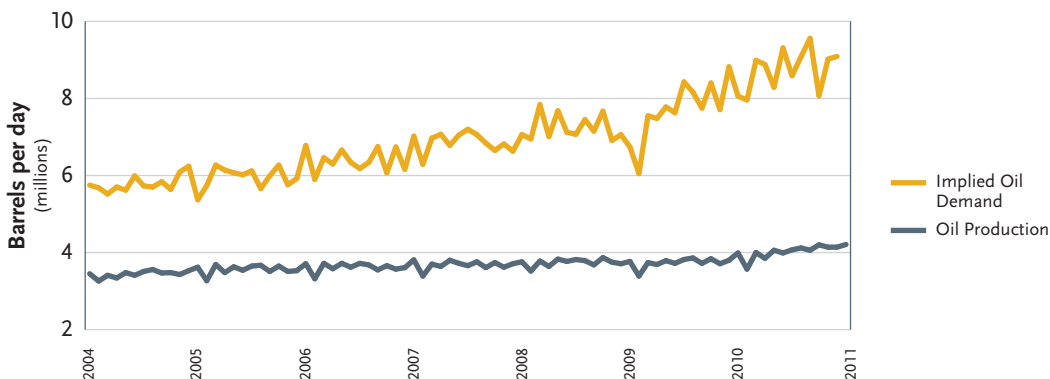
While the demand for natural resources is incredibly strong, there are clear pressures on the supply side of the equation. The big challenge is scarcity – the unavoidable fact that key resources are becoming harder to find and more difficult to get out of the ground. Commodities like oil, copper and gold are finite resources that are increasingly difficult to access and are becoming more costly to exploit.

At the same time, there are limits to how much drilling and mining can be done, especially with tighter regulatory requirements and a growing emphasis on sustainability and environmental safety. Such requirements make it much more challenging to begin new mining or drilling operations and they increase the time and cost involved, resulting in higher commodity prices.

Many commodities are experiencing considerable supply pressures. Industry analysts believe demand for copper will outstrip supply in the next 10 years, driven in large part by China’s appetite as it continues to build its infrastructure at a rapid pace. Copper is an efficient conductor and its uses are multiplying – today, it is being used for heating, air conditioning and transformers, all vast areas of demand in emerging countries seeking to build and develop infrastructure.

The world’s thirst for oil continues to grow and is not expected to subside any time soon. World oil consumption reached 85 million barrels a day in 2009, triple the 30 million barrels the world consumed in 1966². According to estimates by the Boston Consulting Group, BRIC countries will account for more than a third of automotive sales in the next four years. In 2009, China overtook the U.S. in vehicle sales and is expected to have more cars on the road than the U.S. by 2030. That will lead to a steep increase in global demand for oil to power those cars – and will cause significant stress on the supply and demand relationship. China, for example – once a net oil exporter – is now the world’s second largest importer of oil (See Exhibit 3).

EXHIBIT 3: China’s Rising Oil Thirst



Of course the benefits of high commodity prices are not universally shared by all. On one side it creates pricing power for commodity producers because resource supplies are the tightest they’ve ever been and prices will likely remain higher for much longer periods than we’ve experienced before. However, high prices can have a negative impact on global economic growth, something we saw from mid 2007 to June 2008 when the price of oil soared from US\$70 a barrel to US\$140 in the span of nine months. Such price shocks can cause global growth to pause or, even worse, decline. The IMF estimates that a 10% increase in the price of oil would reduce global GDP growth by 0.2% - 0.3%.

²Source: Bloomberg

SPOTLIGHT:

Oil

Global demand for oil has been steadily increasing for decades, with new supplies struggling to keep up. Higher prices and new alternative technologies have not quenched the global thirst for oil. As emerging economies become a key driver of global economic growth, this fragile situation is only expected to intensify. In particular, the world’s most populous countries, China and India, will soon be the primary consumers of oil as economic growth accelerates.

The price of oil is acutely sensitive to fear of potential supply disruptions. Trying to predict future price shocks is a futile exercise, yet when geopolitical tensions in oil-rich regions erupt, prices invariably rise.

OIL CONSUMPTION BY COUNTRY (AS OF 2009):

Barrels per day (in millions)

1. United States: 18.7
2. European Union: 13.6
3. China: 8.2
4. Japan: 4.4
5. India: 3.0

The asset allocation equation

It is critical for investors to navigate the line between the supply and demand sides of the commodities equation. To effectively manage the risks in the sector, we recommend an actively managed, equities-based approach over direct commodity investment for several reasons.

Active security selection provides an opportunity to balance macro factors and risks with company fundamentals, which can potentially reduce overall portfolio volatility while still capturing the strong returns being generated by the asset class. Investing in natural resource companies also offers the ability to participate in future discoveries and production growth and cash distributions in the form of dividends the company may pay out.

Introducing a basket of natural resource companies to a portfolio also offers some important diversification and risk-return benefits. As Exhibit 4 indicates, over the long term, various commodities such as oil, gold and copper have displayed a low correlation to the broader market. Introducing assets that are not well correlated to one another enhances diversification and contributes to the reduction in overall risk in a portfolio.

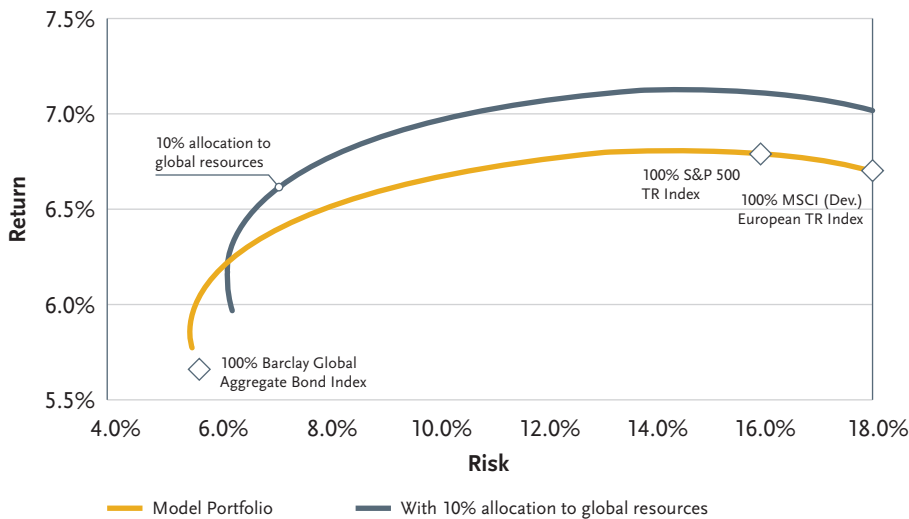
EXHIBIT 4: Commodity Correlations with S&P 500 TR Index

	Oil	Gold	Copper
10 Years	0.38	0.15	0.45
20 Years	0.30	0.08	0.39
30 Years	0.28	0.07	0.38

Source: AGF Portfolio Analytics, Bloomberg as of December 31, 2010

The efficient frontier in Exhibit 5 below shows what return an investor could expect from a portfolio of stocks and bonds for a given level of risk. The data clearly shows that adding a moderate allocation to a global natural resource equity strategy can effectively improve the risk-adjusted return profile of the portfolio.

EXHIBIT 5: Commodities can improve a portfolio’s risk-adjusted return profile



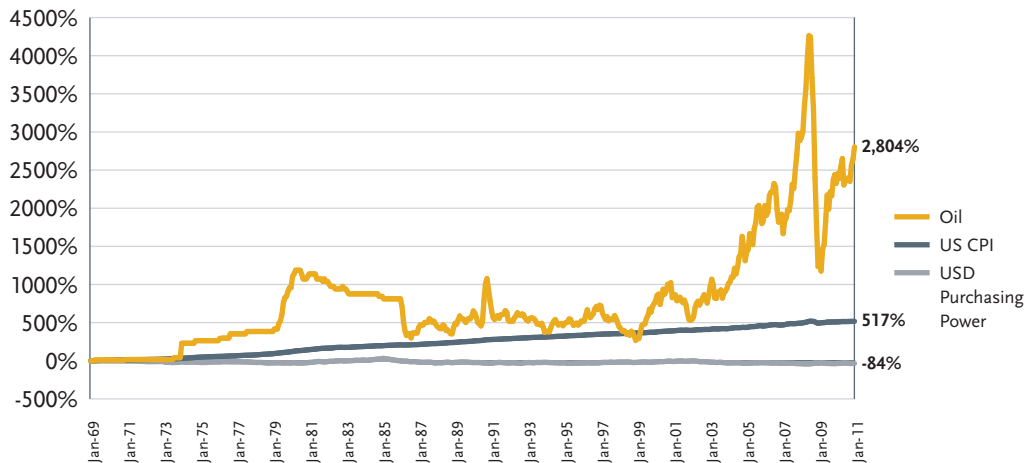
Source: AGF Portfolio Analytics and Bloomberg, 20 year data to December 31, 2010 – Model Portfolio comprised of Barclays Global Aggregate Bond Index, S&P 500 TR Index, MSCI TR European Index. Global resource allocation – 60% MSCI (Dev.) World Energy Index, 40% MSCI (Dev.) World Materials Index.

Commodities as an inflation hedge

We expect that commodities are set to experience tremendous growth in the years ahead. However, the specter of inflation is making its way through global markets and is a risk that institutional investors must be aware of. Commodities such as gold, copper and oil have traditionally been useful hedging tools for investors looking to manage inflation risk. The question is, will they still be a good hedge in the coming years?

We believe they will be, particularly as increasing demand and supply constraints continue to push prices higher. Exhibit 6 shows the price of oil (in USD) from 1969 to 2010, the CPI and USD Purchasing Power Index. Over the past forty years, while inflation has steadily increased, the price of oil has more than kept pace despite its volatility and has consistently offered an inflation hedge to investors despite market shocks. In contrast, the U.S. dollar has lost 84% of its purchasing power over this same time period. Although oil did react initially to the shock of the 2008-2009 global financial crisis, prices have since climbed significantly since then, even in the face of persistent low growth and economic troubles in developed countries.

EXHIBIT 6: Oil as an inflation hedge



Source: AGF Portfolio Analytics, Ned Davis and Bloomberg

For all the reasons we've discussed, we believe investing in natural resource companies will continue to be attractive to investors in the coming years. The challenge investors face will be determining what is the most attractive opportunity without taking on undue risk. We believe an active equity allocation to natural resources provides enhanced return potential and better diversification in order to help investors achieve optimal risk-adjusted performance for their investment portfolios.

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