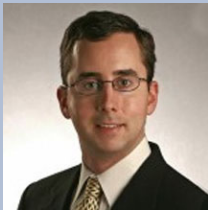
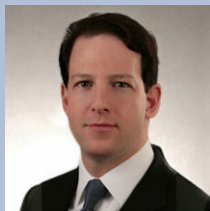


Expecting the Unexpected: Using Commodities as an Inflation Hedge

March 2009



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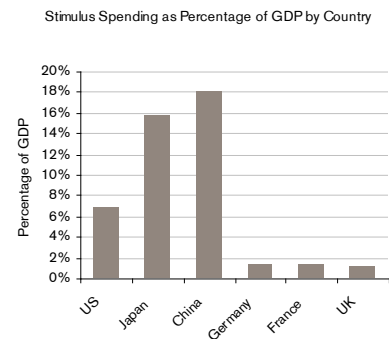
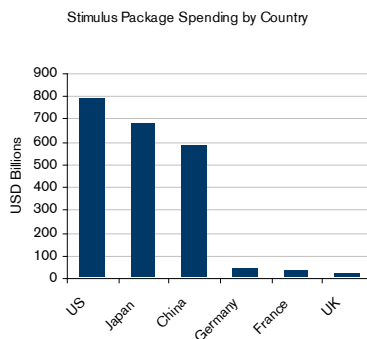
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Economic Stimulus Plans Escalate Concerns of Rising Inflation

In response to the current financial crisis, nations worldwide, including the three largest global economies—the United States, China and Japan—have implemented aggressive economic stimulus plans (Chart 1). As central banks cut interest rates to nominal levels and governments introduce massive liquidity injections into capital markets, we believe inflation rates could be poised to rise sharply in the future, posing serious concern for investors focused on real portfolio returns.

Chart 1: Key Stimulus Spending Plans



Source: US News & World Report, January 5, 2009.¹

¹ All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information.

Most inflation predictors, such as the Reuters/University of Michigan Surveys of Consumers,² do not currently forecast a significant spike in inflation rates over the near term, however if inflation does develop faster than these projections, investors may be also exposed to the risk of “unexpected” inflation. Unexpected inflation, which represents the difference between expected (or projected) inflation and realized inflation, can pose an even greater threat to investors than expected inflation as it is not accounted for in bond and equity valuations.

While the emergency fiscal and monetary policies being proposed today may be imperative to prevent a further contraction of global economies, they could have unintended inflationary consequences down the road. Going forward, investors will need solutions that seek to protect against burgeoning inflation that could impair the value of future portfolio assets.

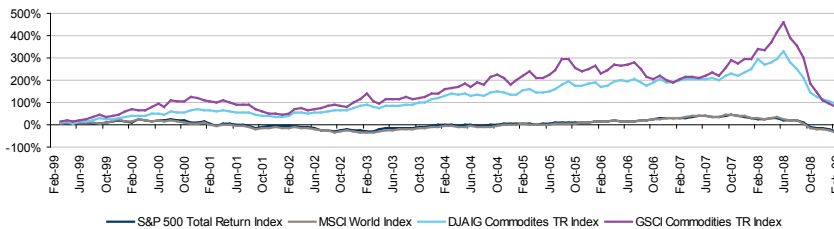
Commodities tend to be one of the few asset classes that may not only act as a hedge against, but may also benefit from rising inflation. Because commodities prices tend to rise in line with increased costs for goods and services, they may act as a natural cushion for a portfolio during inflationary periods, while also allowing investors to participate on the upside. Further, commodities are typically uncorrelated with traditional asset classes such as equity and fixed income securities and as a result, we believe that an investment in a broad basket of commodities could provide a diversified hedge against unexpected changes to inflation over the long-term while helping to improve an investor’s overall risk/return profile. However, commodity returns, like other asset classes, can be volatile as demonstrated by losses in the space last year.

The Current Commodities Landscape

Commodity prices experienced sharp declines in the 4th quarter of 2008 as global demand for raw materials fell in line with shrinking economies (Chart 2). However, there are a number of indicators, as discussed in this paper, that suggest commodity prices have oversold, and we believe the market dislocation has provided an attractive entry point into the asset class.

While commodities prices did see a substantial drop in the fourth quarter of 2008, commodities as an asset class have generated considerable returns over the long term and have significantly outperformed equity indices over the past decade (Chart 3). The DJAIG Total Return Index produced cumulative returns of 96% over the last ten years ended February 2009, while the S&P 500 Total Return Index declined 29% over the same ten year time period.

Chart 3: Cumulative Equity and Commodity Index Returns (March 1999 – February 2009)



Source: Bloomberg.³

Commodities and Inflation

The broadest measure of inflation, as measured by the US government, is the Consumer Price Index (CPI) which represents the average price of a broad basket of goods and services, including housing, transportation and food (Table 1). Other indices also exist, such as Core CPI, which excludes the impact of food and energy prices.

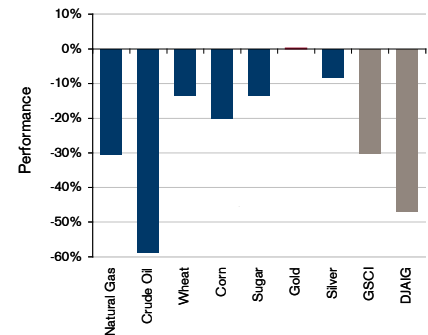
² The Reuters/University of Michigan Surveys of Consumers asks consumers to predict inflation rates over short and long term time periods.

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According to the minutes of the Federal Open Market Committee (January 27-28, 2009), members of the committee voiced concerns that there was “a risk that expected inflation might actually increase to an undesirably high level if the public does not understand that the Federal Reserve’s liquidity facilities will be wound down and its balance sheet will shrink as economic and financial conditions improve.”

Attractive Current Valuations Could Represent Opportunistic Entry Point

Chart 2: Decline in Individual Commodities Prices – Fourth Quarter 2008 (based on total returns)



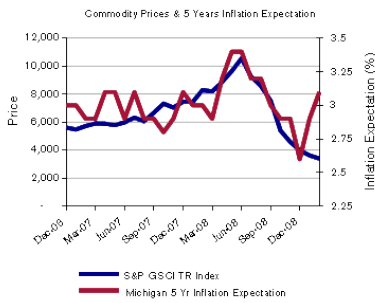
Source: Bloomberg.³

Table 1: Components of the Consumer Price Index (CPI)

Group Name	Description	Relative Importance (Dec 08)
Food and Beverages	Breakfast cereal, milk, coffee, chicken, wine, service meals and snacks	15.8
Housing	Rent of primary residence, owners' equivalent rent, fuel, oil, bedroom furniture	43.4
Apparel	men's shirts and sweaters, women's dresses, jewelry	3.7
Transportation	New vehicles, airline fares, gasoline, motor vehicle insurance	15.3
Medical Care	Prescription drugs and medical supplies, physician's services, eyeglasses and eye care, hospital services	6.4
Recreation	Televisions, pets and pet products, sports equipment	5.7
Education and Communication	College tuition, postage, television services, computer software and accessories	6.3
Other Goods and Services	Tobacco and smoking products, haircuts and other personal services, funeral expenses	3.4

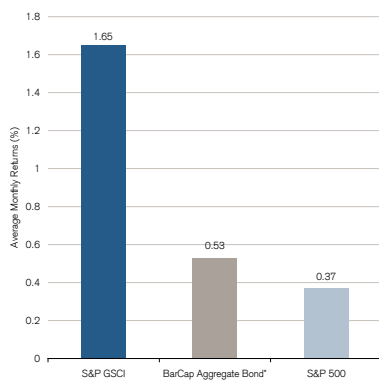
Source: Bureau of Labor Statistics.³

Chart 4: Commodities Prices & 5 Year Inflation Expectations



Source: Bloomberg.⁴

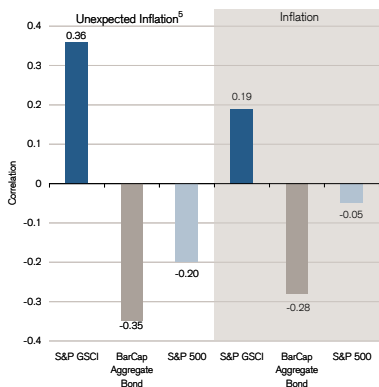
Chart 5: Average Monthly Performance in Higher than Expected Inflation Periods⁵ (1970 - 2008)



* Barclays Capital Aggregate Bond data starts in January 1976
Source: Ibbotson, Bloomberg and Credit Suisse.⁴

We believe that the primary risk to investment portfolios is one where prices change unexpectedly.

Chart 6: Asset Correlation with Inflation and Unexpected Inflation⁵ - Based on Average Annual Rolling Returns (1976 - 2008)



Source: Ibbotson, Bloomberg and Credit Suisse.⁴

As governments worldwide continue to print money to accommodate debt accrued through stimulus packages, we believe inflation is almost certain to rise.

Historically, financial assets, such as stocks and bonds, tend to go down in value when inflation rises, while real assets, like commodities, have behaved in the opposite way. This seems intuitive because commodities are essentially the raw materials which increase in price during inflationary periods. On the other hand, increasing raw material costs typically reduce corporate profit margins if companies are not able to pass price increases along to consumers, and this can lead to lower equity valuations. Further, because unexpected inflation rates are not factored into cash flow analysis used to value equity investments, upward revisions in expected inflation rates could result in higher discount rates for future cash flows, thereby lowering equity valuations.

Bonds are also susceptible to rising inflation because as inflation rises it diminishes the purchasing power of a bond's future interest payments and principal. As a result, Treasury Inflation Protected Securities (TIPS) have emerged as a popular inflation hedging tool. Similar to standard treasury bonds TIPS pay interest at regular intervals as well as the principal upon the bond's maturity. However, unlike standard treasury bonds, both the interest payments and principal amount are automatically increased during periods of rising inflation as determined by the CPI. While TIPS provide targeted insurance against inflation, they do not exhibit the same low correlations with bonds as commodities, and therefore may not provide the same level of diversification within a portfolio.

Historically, stocks and bonds tend to perform better when the rate of inflation is stable or slowing; however, assuming the market has already discounted the impact of expected inflation, even changes to CPI may not dramatically affect the performance of these traditional assets. As a result, we believe that the primary risk to investment portfolios is one where prices change unexpectedly.

In order to measure how well an asset class will respond to unexpected inflation⁵ Chart 5 compares the average monthly performance of a basket of commodities (as represented by the Goldman Sachs Commodity Index, the "S&P GSCI"), US equities (the S&P 500) and bonds (the Barclays Capital Aggregate Bond Index⁶) during periods of unexpected inflation. The chart shows that during periods of higher than expected inflation, commodities exhibit significantly higher returns than bonds or equities, on average outperforming both traditional asset classes by over 1% per month.

This makes sense as commodity prices are directly and positively correlated to inflation's key components. Because commodities can be a driver of inflation, commodity index returns tend to be even more positively correlated to unexpected changes in inflation than they are to absolute inflation. In contrast, the S&P 500 and Barclays Aggregate Bond Indices appear to be negatively correlated to both absolute inflation and unexpected inflation, as shown in Chart 6.

Incorporating Commodities into a Portfolio

When considering a commodities investment, investors should carefully evaluate their current portfolio holdings to determine their existing exposure to certain commodities sectors, such as energy, in order to avoid unintentionally over-allocating to any one area. Investors should also closely monitor the cash management portion of any commodities investment to ensure unnecessary duration or credit risk is not being taken in an attempt to outperform a collateral benchmark. This can add unnecessary risk while diminishing the diversification benefits offered by a commodities investment. For example, holding short duration bonds will likely reduce the impact of interest rate fluctuations on the overall portfolio. By contrast, long duration bonds, including TIPS, can result in increased volatility and correlations to fixed income markets.

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⁵ We have estimated unexpected inflation based on the historical relationships between 3-month Treasury Bills and CPI.

⁶ Formerly Lehman Aggregate Bond Index.

Credit Suisse's Total Commodity Return Strategy seeks to outperform the return of a commodities index, such as the Dow Jones – AIG Commodity Total Return Index or the S&P GSCI Total Return Index, using a quantitative commodity-focused research process. Commodity index total returns are achieved through:

Spot Return: Price return on specified commodity futures contracts

Roll Yield: Impact due to migration of futures positions from near to far contracts

Collateral Yield: Return earned on collateral for the futures

The success of our approach lies in our ability to identify structural inefficiencies in commodities markets that allow for added value through management of the roll cycle versus the benchmark. Additionally, our “style pure” approach to cash management seeks to reduce undue risk while investing excess collateral held in the portfolio, as taking greater duration or credit risk can increase correlations with other asset classes.

As governments continue to flood markets with capital, the risk of a sudden inflationary flare-up has become a primary concern for many investors.

Unlike other tools available to manage the impact of inflation on portfolios, commodities can provide an effective hedge against “unexpected” inflation while also serving to enhance the overall risk/return profile of a portfolio.

While we believe that commodities will continue to deliver positive returns over the long term, a commodities allocation can also provide significant diversification benefits and inflation protection when incorporated into a diversified investment portfolio.

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