

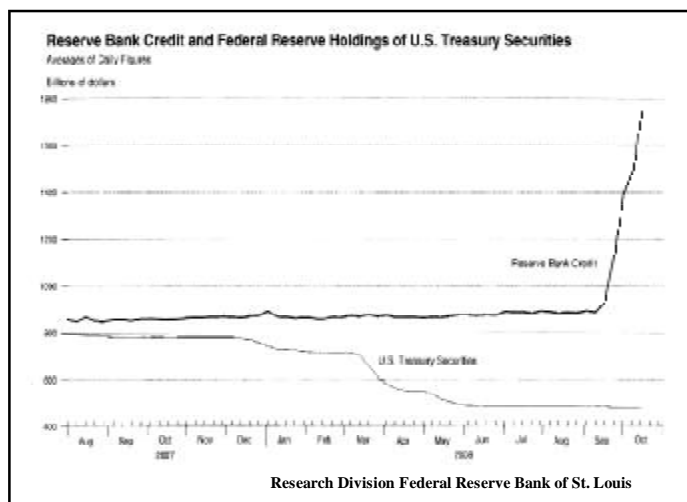
The commodity boom is down, but it's far from out.

There is a pervasive, and admittedly seductive, argument floating around that the U.S. is headed for a dire bout with deflation. These folks point to the recent decline in commodity prices as solid evidence.

I contend that the decline we have seen in commodities has been a consequence of deleveraging and the self-feeding process of liquidation brought on by highly leveraged institutions finding themselves at the door of bankruptcy, selling everything and anything to raise needed cash. Once one sells down prices, another is compelled to follow suit. This has forced margin calls on institutions and individuals who then joined the fray. The result has been to see asset prices - both paper and tangible - decline. *The real question is, what is next?*

There was certainly some froth in the commodity market as we entered the summer months, but any excesses at that time have been thoroughly washed out of the system at this point. As to the question of deflation versus inflation, the inflationary evidence is compelling. You should bookmark the site <http://research.stlouisfed.org/publications/usfd/>. This is "U.S. Financial Data" published by the Federal Reserve Bank of St. Louis. The booklet is composed mostly of charts, but there are some handy data tables there too.

All in all, the Fed has created an amazing amount of money of late. Ed Bugos, an expert follower of Federal Reserve releases, calculates that "this is about 20% of the cumulative amount of reserves the Fed has directly injected into the banking



system since its inception in 1913." It appears the Fed has approached the current crisis by first lowering interest rates - but more recently, by aggressively creating a lot of money.

Furthermore, this appears to be an important and permanent change in Fed policy. It is further significant to note that until recently, the Fed had limited tools with which to manipulate the economy. They could control reserve requirements,

The next issue will be published November 5.

- It is time to start looking through the rubble, and I am recommending Enerplus (ERF-NYSE-\$27.56) again.

Page 2



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they could conduct open market policy, and they could set the short end of the yield curve. Now they can also infuse liquidity directly into money market funds and commercial paper. Their lending avenues to primary dealers have been expanded; and with the nationalization of Freddie and Fannie, they can buy mortgages. Mr. Bugos summed this up recently, "When the Fed inflates, the banking system does soon after. The Fed has never inflated in one month as much as it did in September. The odds are against deflation."

The liquidity crisis has spurred a change in Fed policy toward a forceful inflationary stance, but there is another consequence to this summer's commodity price decline. Future production is going to suffer as E&P projects are stalled or are permanently halted. Some of this is voluntary due to pessimistic forecasts, and some is due to the difficulty in finding financing. The bottom line, however, is that the global supply of raw materials is going to decline.

The key to putting this into perspective is to realize that *global* demand is not likely to decline at all. The International Energy Agency (IEA) cut its global crude demand forecast for 2008 to 86.5 million barrels a day - down some 240,000 barrels. This reduced projection, though, is still ½% higher than oil demand was in 2007. The headlines talk about conservation in energy use and declining energy use, but demand will still be higher in 2008 than last year.

The IEA forecast for 2009 is for the world to consume 87.2 million barrels a day. Hmm...that's an increase any way you look at it. The reason is that regardless of a recession in the U.S., demand for oil will continue to climb in the economies of China, India, Brazil, Russia, the Middle East, and the rest of Asia. In fact, these non-Western economies will continue to drive demand higher globally for all raw materials for the foreseeable future. Some theorize that Chinese and Indian economies will actually benefit from a U.S. recession as domestic companies outsource to them in order to save money. Couple this with an assured decline in production from older oil fields and mines, the sudden turn away from future investment in exploration and development due to the current credit crisis as well as the current ridiculously low prices that are discounting the end of the world, and you have the stage set for the the next commodity mega-boom.

The liquidity panic may not be over as yet, but we are getting close for the time being. All that money the Fed is creating will take a brief trip through the stock market, and we will see a rebound in the popular averages. I have long preached that the averages would trade in a wide trading range for several years to come, and we are at the bottom of that projected range. I see that bottom as 7,000 in the Dow (it hit 7,882 on October 10) and 800 in the S&P 500 (it hit 839.80 on October 10). We will revisit these lows periodically over the course of the next several years, punctuated by some nice rallies in between.

There will be times that momentum will push prices below these limits. We could perhaps see that yet this month. That isn't important at this point. Regardless of the investments you hold, the odds favor higher prices by year's end. It is at that point that you will have to make some difficult decisions.

I see the Dow rising to 11,000-12,000 and the S&P 500 to 1,200-1,300 in the next rally phase. I expect the commodity issues will also rise in this rally. The commodity stocks are currently priced ridiculously low in light of the discussion above. The non-commodity related stocks are not ridiculously cheap. They are simply oversold for the time being. The next high is where the financials and tangibles will part ways. I believe the popular averages will then fall back to current levels - and they may even go lower - but commodity stocks will continue to prosper.

The biggest fear you should have at this point is not of deflation, but of a coming inflation that could well flare totally out of control. It will be the antithesis to the credit meltdown. The seeds are being sown in the political and financial arenas today for a truly nasty bout of hyperinflation. It is that prospect of hyperinflation that should be gnawing at you - not deflation.

We were stopped out of several issues this month, and I think we can reinvest those funds more advantageously. The Canadian energy trusts have been beaten back hard (I will expand on this sector in next month's letter). It is time to start looking through the rubble, and I am recommending **Enerplus** (ERF-NYSE-\$27.56) again. We originally bought this in 2001 for \$18.00 and sold it for a 136% profit in 2007. In the meantime, we enjoyed some very nice dividends. It is time to try and buy it back. Put your open orders in to buy Enerplus for \$19.00 or better.