

Are We Seeing A Commodity Bubble?

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— Written by Daryl Liew

The rampant commodity-driven inflation has claimed a new “victim”, with rice joining the likes of crude oil, gold and wheat, in hitting the headlines following a sharp run-up in prices. The doubling of the price of rice over the past year on the back of fears of a global shortage, caused a rush to empty supermarket shelves of their rice supplies. Singapore government officials then had to reassure the public that there is sufficient rice in reserve to last about two to three months.

Indeed, it was interesting to learn that the Singapore government even HAS a rice reserve, through requiring all rice traders to maintain an amount equivalent to twice

their monthly imports, which is kept in three government warehouses. Hence, for every kilogramme of rice sold, you’ll be comforted to know that there is two more sitting in the national stockpile. And in the unlikely event that this reserve should ever be depleted, Singapore can tap on the ASEAN emergency rice reserve. The Philippines, the world’s largest importer of rice, has been hit hard by the rice shortage and recently had to draw 25,000 tons from both Vietnam and Thailand from this facility.

So what is the cause for the current rice shortage? Well, the International Rice Research Institute believes that the main culprit is that land use for producing rice is being lost to industrialisation and urbanisation. This problem is exacerbated by the growing appetite among Asia’s burgeoning urban middle class, especially in India & China, for meat and dairy products, leading to even less land for rice production. Temporary supply side factors such as flooding in Indonesia and Bangladesh, and recent cold weather in Vietnam and China have also hurt production. Because these rice shortages are occurring amid soaring inflation,

several major rice producing countries such as India, China, Vietnam and Egypt have imposed export restrictions to keep domestic food prices low and satisfy local demand. This “starve thy neighbour” policy has of course simply worsened the global shortage.

We have been commodity-bulls over the past few years, believing that the coupling of strong global demand with unstable supply has created a fundamental shortage in many types of commodities. As a result of this positive view, we have maintained an overweight allocation to commodities in our portfolios for the past year. While this position has benefited our portfolios, we have become increasingly concerned by the sharp and sometimes unfathomable rise in some commodity prices. With crude oil flirting with the US\$120 a barrel mark, corn reaching a record US\$6.16 a bushel, and soybean touching an all-time high of US \$15.87, the big question in our minds is, “are we seeing a commodity ‘bubble’ emerge?”

Reasons why we like commodities

To start, let us recap why we, like Jim Rogers, think that commodities as an asset

class is in a secular bull-run that will likely last several years more.

1. Infrastructure spending

Infrastructure spending is probably one of the key drivers of demand for many commodities. A number of developing countries have committed large sums of money to infrastructure projects which require the use of many different types of commodities. China for example is spending a huge amount on roads to improve the accessibility of its inland cities. India is doing the same kind of spending, as the government has realized that the country's roads, ports and airports are simply incapable of supporting future development. Latin American countries like Mexico and Brazil have also announced plans to develop domestic infrastructure. Even Singapore, though not a developing country, is joining the party with her plans to develop two integrated resorts and a new sports hub.

2. Rising middle class; rapid industrialization & urbanization

Rapid urbanization and industrialization that is happening in many developing countries is creating a huge demand for property – both residential as well as commercial. This is best typified in China, where large streams of rural folk flow into the cities every year in search of a better life. Besides boosting demand for property, rapid urbanization also causes a shift in consumption patterns. With higher incomes and rising affluence, meat starts featuring more prominently in everyday diets, thereby causing a huge increase in the demand for meat.

As a reflection of this change in consumption patterns, China and the Asia Pacific region now produce 3 times more livestock than they did 20 years ago. Middle East, North Africa and Latin America come close with 1.6 times more livestock production. Implicit in higher livestock production is an increase in grain demand (corn, wheat, soybean, rice) for feed. The world's growing livestock supply is thus turning the focus of grain planting efforts from feeding humans to feeding livestock. Indeed, the shortage and subsequent price rise of many grains today is arguably due to the world's growing taste for meat.

3. Supply-side issues

One of the key problems with commodities is the fact that most of them suffer from lumpy supply. This basically means that producers cannot instantaneously react to demand increases by increasing supply, as

supply in many commodities markets can only be increased after a time-lag. This is particularly true in agriculture and mining. For the former, crops have to go through a normal growing cycle before they can be harvested. As for the latter, exploration efforts to locate metals or minerals to be mined require much time and money. Some history: because of low metal and mineral prices in the preceding decades, there has been a drastic underinvestment in exploration and development of new mines. This lack of investment has kept supply from keeping up with the strong surge in demand, thus contributing to the current shortages. Current high prices have however sparked a large influx of money into exploration. This should result in new supply coming online in the next few years, thus helping to alleviate the global deficits.

4. Weaker US dollar / Inflation-hedge

The steadily depreciating US dollar is probably one of the main contributing reasons for the sharp appreciation of commodity prices in the past year. The greenback has been weakening against practically every other currency in the face of interest rate cuts and looser US monetary policy. Since many commodities are priced in US dollars, commodity producers have seen their revenues drop in local currency terms. As a result, producers have raised prices to compensate for the lower amount received in domestic currency terms. A case in example is that of OPEC which increased its US dollar target price for oil.

Additionally, commodity prices seem to have developed a 'hedge' function. While gold has a reputation as having a negative correlation with the US dollar, this inflation-hedging quality now appears to have spread to all commodities, with speculative money now treating commodities as a hedge against further greenback weakness. As looser US monetary policy is putting upward pressure on inflation. Commodities hence benefit from this higher inflationary environment as real assets like property and commodities are seen as traditional hedges against higher prices.

Now that we've covered all the reasons why we like commodities, it's time to discuss what has changed, such that it has sparked a rethink of our commodity positions? Well, we still believe that points 1 to 3 remain valid, which is why we are still long-term commodity bulls. Our concerns however stem from point 4.

Rise in speculative monies flowing into commodities

Since the beginning of the year, a flood of money has flowed into commodities due to a build up in speculative positions. This surge in speculative money has reportedly been to hedge against the US dollar. However, as anecdotal evidence suggests, non-commercial trades now constitute more than half of all commodities trading activity, with hedge funds being the biggest players.

Indeed, this thesis is backed by price movements in commodities over the past few weeks. Commodity price movements have depended primarily on the performance of other asset classes. For instance, when asset-backed securities spreads narrowed and equity markets rallied, commodity prices saw profit-taking; when spreads widened and equities fell, commodity prices rebounded. These price movements suggest that hot money is treating commodities as simply another investment class to reside in, another investment idea until the next best investment opportunity comes along. This treatment is definitely creating considerable risks as a rebound in equity markets may reverse the capital flows into commodities, thus leading to a further and possibly sharp correction in commodities.

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Stabilization of the US dollar

As the depreciation of the greenback has arguably been a major factor in the commodity price rally, no analysis would be complete without looking at whether this declining trend will persist. On a fundamental purchasing power parity basis, there is no doubt that the US dollar is now severely undervalued against major currencies like the Euro. If history is any guide, currencies traditionally fluctuate around their fair value, and always revert to the mean over time. Hence the big question is when and not if this trend will start reversing.

The US Fed has been the biggest culprit in the sell-off in the dollar, as it has focused all its attention on solving the credit crunch and jump-starting the US economy. With credit concerns abating and the Fed approaching the end of its series of interest

rate cuts, it does appear that there should be lesser downward pressure on the dollar. In addition, the recent G-7 meeting in Washington highlighted the fact that global leaders are increasingly aware of the risk of currency volatility. As such, we do expect to see a firmer greenback in the second half of the year.

China shutting down factories

The third reason for our concern about commodity prices in the short-term is that China has started closing factories in the areas surrounding Beijing in preparation for the Olympics. The poor air quality in Beijing is causing much consternation amongst the sporting fraternity and the Chinese authorities seem willing to take all action necessary to ensure that conditions for the games are perfect. We understand that China plans to shut even more factories in the lead up to August and these

several months of inactivity is going to affect commodity demand. China is one of the biggest players in the commodity markets, and we do think that this shutdown of many of the manufacturing facilities in the north will likely lead to a build up in inventories, and hence put downward pressure on prices.

Trimming commodity exposures for now

While we remain long-term commodity bulls, believing that the long-run cycle is intact, we do think that commodity prices are currently prone to a sharp, temporary price correction because of the above mentioned reasons. As such, we have taken the pre-emptive step of trimming our exposure to this asset class with a view to reinstating this position once prices have come back down to more realistic levels.

This is an original article written by Daryl Liew, Chief Investment Strategist of Provident, Singapore's Sole Fee-only Independent Private Wealth Management Firm. The edited copy has appeared in The Edge titled "Time to Trim Exposure to Commodities" on 5th-11th May 2008.