

June 2011 Alvine Newsletter

## **Commodities – no super cycle**

### ***Key issues***

The increasing ‘financialisation’ of commodities leaves investors exposed to sudden moves in market sentiment. The 2008 cycle is unlikely to be superseded as higher prices have led to an inevitable increase in supply.

### ***Key recommendation***

Commodities are no inflation-busting panacea, rather another financial product subject to market volatility. Investors should only hold limited exposure as a new cycle unwinds.

‘The entry of new financial investors has paved the way for the financialisation of commodities. Consequently, global commodity markets have become more sensitive to portfolio rebalancing by financial investors, which has made commodity markets more correlated to other asset markets, including equity markets.’ The Bank of Japan (*Source: Simon Hunt Strategic Services, June 2011*)

Many market professionals and investors have been caught up in the commodity wave. Booming BRIC demand has fuelled fears of a supply squeeze as the world’s developing markets get a taste for western style consumption. While undoubtedly greater demand already exists for oil, copper, etc., financial speculation has tended to amplify this effect leading to greater volatility. Higher prices have unleashed investment in greater productive capacity, tending to undermine the overall cycle.

Long-term sustained higher prices are possible, but this will be combined with sharp swings and as many busts as booms.

**‘Wanted: the next big investor idea in commodities’** (FT, 8 June 2011). It seems so simple, with the emerging world rapidly acquiring the means and desire to emulate western consumption levels, demand for these basic building blocks is rising and prices can only go one way. We share a sense of optimism about the future. World economic activity should continue at pace whether it is China, or the N 11 emerging countries such as Turkey/Indonesia/Mexico, etc. (Goldman’s acronym for the Next 11 fast-growing EM group).

## ***Demand exists***

With gold at \$1,500 per ounce, oil over \$100 per barrel and cotton hitting multi-decade highs, it seems a bull market has arrived.



CRB chart (Source: Bloomberg)

It is clear that the bear market for commodities, which arrived with the puncturing of 1970s inflation, is now over. The growth in demand from developing countries has produced ‘a profound paradigm shift in almost all commodities. From now on, price pressure and shortages of resources will be a permanent feature of our lives’ (Jeremy Grantham, co-founder and chief strategist at GMO, *FT*, 6 June 2011).

With the world population pushing forward above 6 billion and supplies of water tightening, the era of abundance since the Second World War may be at end. Further, with the rise of China and the rest of the Ems, ‘it is expected that urbanisation and the expansion of the middle classes will keep commodity prices high’ (Source: *Reuters*).

**‘The era of cheap oil is over’** (Source: *Energy and Capital*). Isn’t it just that simple?

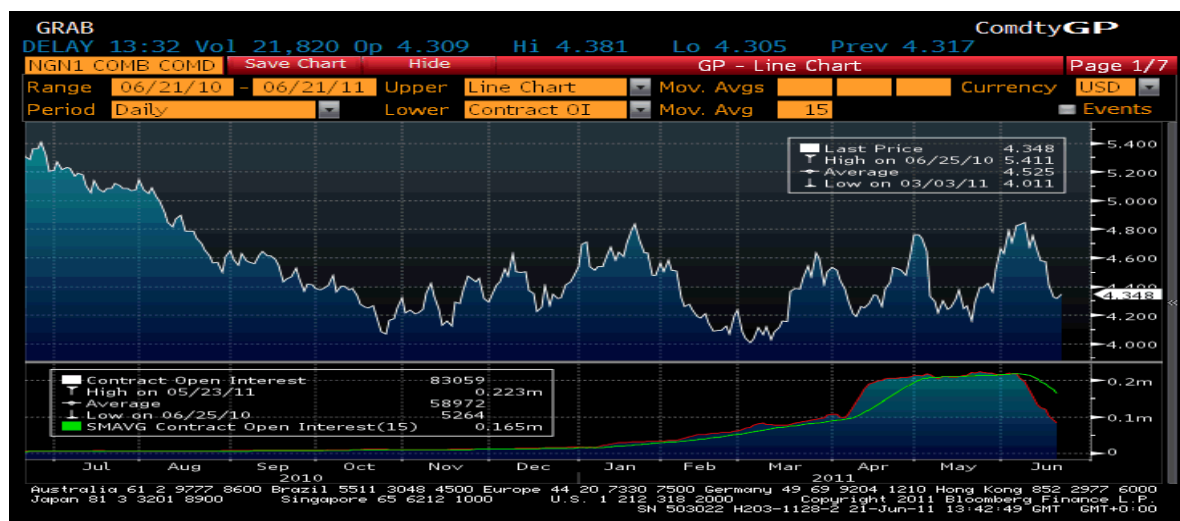
## ***What about the supply side? Investment – technology-inventory***

Let’s accept the fact that demand has, and will rise. As the world grows, while this matrix may be subject to the same uneven plane as the demand for houses or water, it will still be ongoing.

But as any economical model will tell you, prices are where supply meets demand. Now our commentator above, Energy and Capital, was quick to tell us that we have serious problems here too. For instance, the oil supply from continental US has been on a downward trend for 30 years and even the Saudis are now reaching exhaustion. So surely there is every bit a concern with the commodity supply as with the demand?

Higher prices bring investment. It should be axiomatic that the economies of production are affected by the price of the good produced, hence supply is elastic. While it may be true that Mother Nature will not produce any more oil, extraction techniques can revolutionise the productivity of even mature oil fields.

The best example of a supply-side miracle exists with the advent of shale gas. Ed Reed, from NewsBase Ltd, explains; **‘There was a prediction in the early 2000s that by about this time, the US would be a net importer of gas. The fact that the shale-gas boom has happened meant that the US is now the top producer of gas in the world’** (Source: RadioFreeEurope, 17 June 2011).



### Natural Gas Future July 2011 (Source: Bloomberg)

It had been known for some time that vast gas reserves exist in shale, but it was only when Devon Energy brought about a process called ‘horizontal drilling’ that extraction became viable.

Other sources of supply have come about due to globalisation. Regions of the world, such as Africa, have been opened up to investment in all sorts of commodities such as agriculture, copper, cotton, etc.

**Supply is not finite.**

***Cost of carry – contango***

Investors who are used to a steady income from dividends, or the coupon from bonds, need to factor into their calculations when they buy commodities that these products do not generally generate any yield. In fact, warehousing and other costs to store securely the underlining asset will eat into returns.

For financial investors who play in the futures market, the contango effect of an upward sloping curve can also be expensive. While there are no fixed relationships here, it is more than likely that longer-term returns will need to cost this actual drag to roll each position on a quarterly basis.

***Speculators emerge***

When the Board of Trade of the City of Chicago developed the first formal trading of commodity financial instruments in 1848, and the CME founded in 1919, created a boon for producers. From farmers to global resource giants, to know what the market for their products is has given a boost to all. Further, the ability to lock in prices forward, and hence hedge future revenues, must also have assisted with investment planning. The resultant extra product produced must benefit us all.

Commodity exchanges existed to allow both producers and consumers to plan forward their business to mutual benefit. However, in recent years speculation has started to overwhelm these natural flows.

**‘The real story about copper is the size of the financial sector’s involvement in buying surplus copper and warehousing it outside the reporting system both in China and elsewhere’ (Asianomics Limited, June 2011).**



Crude oil open interest (Source: Bloomberg)

Open interest at Nymex also demonstrates the rise of speculation

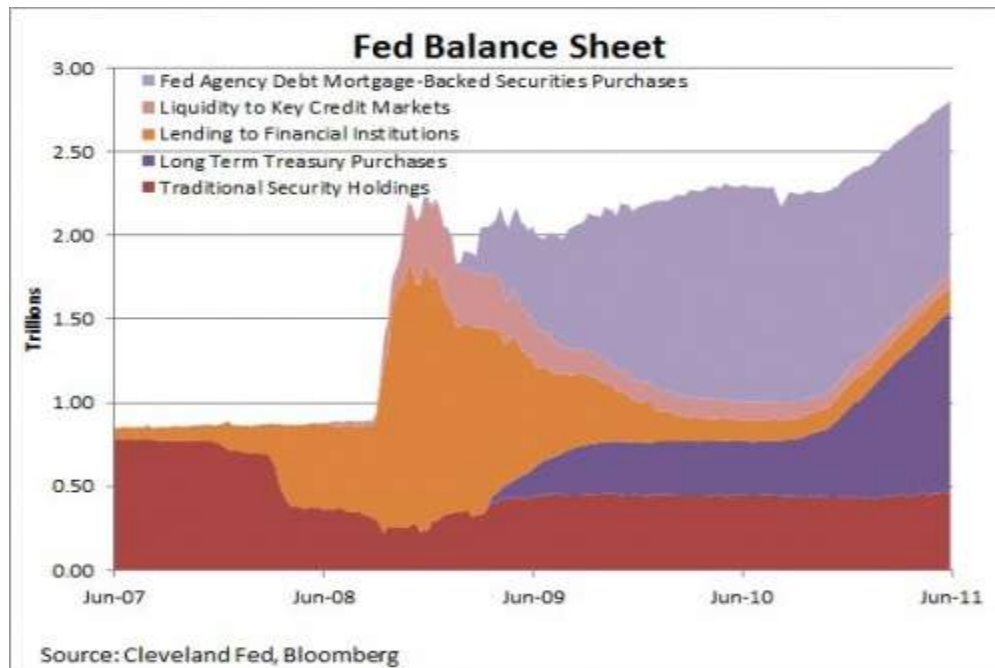
In effect, this stockpiling of the industrial metal has given a misleading impression of final demand from China and elsewhere. This process has been exacerbated further by the extraordinary growth of ETF funds covering many commodities. As speculation has grown and prices rise, the whole process feeds on itself, leading to spikes in prices.

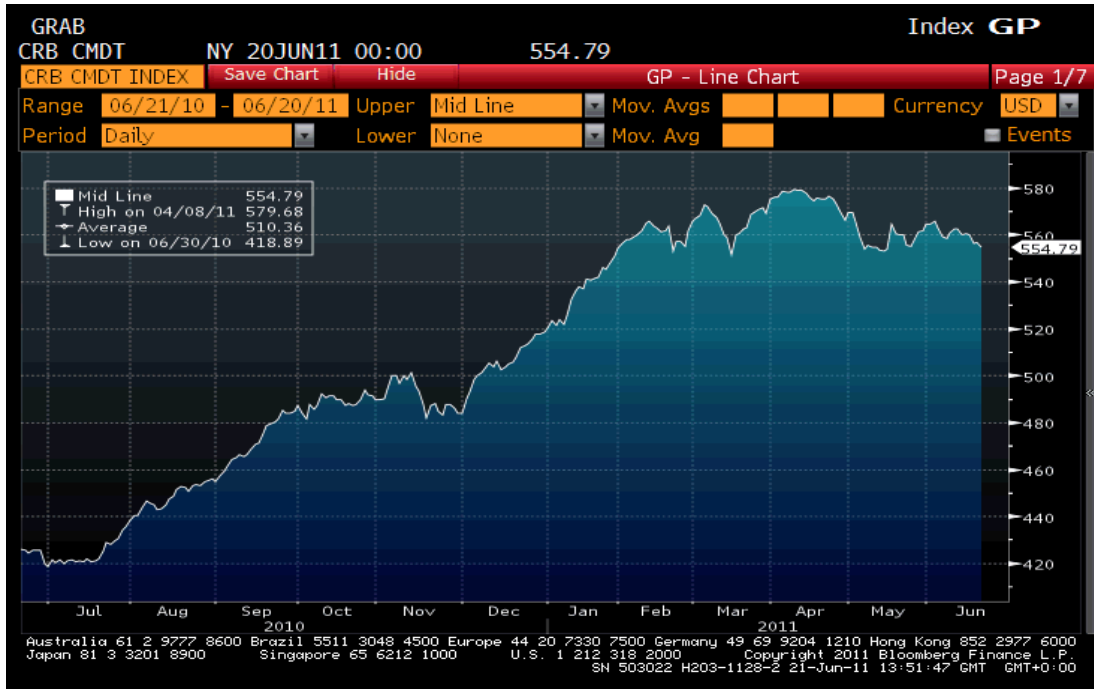
### ***Higher prices – crimp demand and cause substitution***

Just as higher prices impact the investment returns on marginal production, so do higher prices affect end users. US demand for petrol has stalled out, with \$4 per gallon an important pivotal inflection point, ‘more telecommunity, more purchase of fuel-efficient vehicles and cutting down on discretionary travel’ (*John Felmy, Chief Economist at the API, Bloomberg.com 18 June 2011*). **Stocks of gasoline hit a 30-year high in May 2011** (Source: *API*).

For industrial users, the higher prices of the past few years have caused financial strains on working capital. So it is hardly surprising that efficiencies and substitution are all the rage. In the industrial world of copper, a whole range of processes such as ‘high temperature super conductors, nanotubes and carbon fibres for low- and medium-voltage power cables and new aluminium alloys now make it possible to connect aluminium to copper’ (Source: *Asianomics, June 2011*). All these process eat into the final demand for copper.

### ***It’s the Fed that did it – the role of fiat money***





CRB Index (Source: Bloomberg)

If you print enough money, the story will be the same whether you are in Weimar Germany or 21<sup>st</sup> Century Zimbabwe. Sound monetary policy brought in by Paul Volcker as a direct result of the large major inflationary shock of the 1970s, can very well now be consigned to history.

Here lies the best argument for commodity investment as this 'currency', especially precious metals, cannot be debased in the same way as fiat money.

### ***Commodities – conclusion buyer beware***

Readers of this newsletter know that we fear inflation, believing that the long deflationary cycle that started in 1980 is now well and truly over.

With monetary policy amongst most western economies ultra-easy at best, and at worse still printing money, the turnaround in inflation is not far away. On that basis, it is tempting to join the herd and suggest an aggressive exposure to commodities.

While we are not bearish on this asset class, on a 5 to 10-year basis it is likely we will see key products like gasoline become more expensive for consumers. However, we fear the crowded nature of this trade. Further new technology can rapidly upset even expert opinion and completely change the rules of the game. Possible breakthroughs could exist in shale oil, as well as legions of new clean energy technologies.

The prevalence of speculators means that any investment will be subject to wild volatility.

For this reason, we prefer to maintain a cautious attitude to this asset class.

### ***Model portfolio – choppy setback in motion***

We can't hold out any longer without confirming that a proper correction is now underway in all equity and risk assets.

A combination of continued tightening amongst major EM economies like China and India has been coupled with a re-emergence of Europe's debt crisis and a mid-cycle slowdown in the US.

Risk off has ironically been led where the maximum speculative positions have been held, oil/silver and other commodities have fallen sharply since early May.

There are two key issues to judging whether this combination of factors may overturn our bullish stance.

Earnings – are coming through very nicely. They said it could not last, but it has. Corporate America, and elsewhere has continued to do very well out of the current economic cocktail. In fact, the recent pull-back in raw material has removed cost pressures. Low cost of capital, slack labour markets and hence little wage pressure, have combined with the benefits of 21<sup>st</sup> Century technological advances. All the while, the EM boom has made up for little top-line growth in western markets. This earnings performance has made equities as far as P/E ratios nearly as cheap as they were at the base of the bull market in 2009! With bond yields confounding the pessimists and actually falling so far this year, this makes comparison valuations even better.



S&P 500 and P/E (Source: Bloomberg)

**Monetary Policy – is our main driver.** As a student of the great depression, Ben Bernanke has always taken a monetarist view of demand. If you create enough money, then eventually at the very least nominal demand will see through.

After the last QE 2 programme was commenced in late 2010, it is fair to say that the Federal Reserve faced mounting criticism about the entire direction of US monetary policy. A barrage of abuse was led by right wing Republicans at home, and foreign Central Banks. With the US federal deficit now at a scarcely believable \$14.5 trillion, would US policymakers really have the stomach to go further?

US politics is key to answering this critical question. The special election called for New York's 26<sup>th</sup> congressional district for 24 May has marked an interesting turning point in the Republican Party's thinking with less than 18 months to go before the next Presidential election. The fact that this once-solid Republican seat was lost would be enough. However, the nature of the campaign marked a deliberate strategy on behalf of the Democrat outsider Kathy Hochul to make the contest a plebiscite on the Republicans' plans to seriously cut the Federal deficit. By demonstrating little electoral appetite for drastic spending cuts, and hence real progress on the Budget, this has caused a major reigning back in the party's thinking.

The recent Republican Presidential debate in New Hampshire showed a more balanced and less partisan ideological consensus amongst all the candidates. This leaves us feeling there will be little real domestic opposition should the Fed move to

implement QE3 before November 2012's election. We believe this presages a reversal in (the Republican) Congressional moves to reduce the deficit and reign back the Fed. This is not to forecast an immediate round of treasury buy backs, but that the Bernanke put still stands.

So with equities still cheap and with monetary conditions likely to backstop any real declines, we will maintain an overall overweight equity position, and make no changes to the model portfolio.

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