

The Commodities Conundrum

What will be the future of the commodities markets? Will commodities continue to be the place to be, with the boom in commodities continuing while stocks continue to lag over the coming years? These important questions are answered by Puru Saxena in the excerpt below from the 9/13/2005 issue of the "Daily Reckoning". Mr. Saxena is the editor and publisher of Money Matters, an economic and financial publication. He is a regular guest on CNBC, BBC, Bloomberg, NDTV Profit and writes for several newspapers and financial journals.

We believe time will prove Mr. Saxena is right on target with his analysis! See what he says below:

The Daily Reckoning PRESENTS: Stocks, bonds, property and commodities have all benefited from the abundance of cheap credit. But will this asset-boom continue forever - or will the party come to an abrupt end? Puru Saxena explores...

THE COMMODITIES CONUNDRUM
by Puru Saxena

Over the past five years, the majority of asset-classes have gone up due to record-low interest-rates. Will the boom continue in some assets, whilst the other sectors deflate and correct?

In order to answer the above questions, we first need to examine history.

The last commodities bull-market peaked in 1980 when inflation fears were widespread and interest-rates were soaring. Throughout the late 70's, the public exchanged cash for whatever tangible assets they could get their hands on. As a result, commodity prices went through the roof! Gold prices went up over 20 times, oil prices went up from \$1.5 per barrel to \$40 per barrel, and sugar prices went up 45 times! All this was happening in the 70's because people lost faith in cash and bought hard tangible assets.

During the same period, the U.S. economy was in a recession, Britain had to be bailed out by the International Monetary Fund (IMF) and financial assets were depressed.

It is interesting to note that in 1980-81, US-Treasury bonds were being termed as "Certificates of Confiscation"! At the same time, U.S. stocks were selling under 10 times earnings while yielding

over 6%! Since the entire world was convinced that cash would continue to lose its value through inflation, nobody was interested in bonds and all the money was going into commodities.

In order to contain these inflation fears and to make cash attractive, the Federal Reserve raised interest-rates very aggressively. At the peak in 1981, the Fed Funds rate was as high as 19%! Back then, bonds were extremely depressed and (in hindsight) they turned out to be a great investment. Bonds entered a bull-market in 1981 and over the next 24 years, bond investors made a fortune!

If you were to look at the Fed Funds rate since 1956, you would see that interest-rates soared up until 1981, and since then they have been falling. This trend has obviously provided a boost to financial assets such as stocks and bonds. It is worth noting that interest-rates are now close to a record-low and may be bottoming out. In fact, I am of the view that in five to ten years time, interest-rates will be significantly higher than where they are today. This will obviously put immense pressure on the bond bull-market, which is now over 20 years old!

In the near future, I expect inflationary fears to escalate, as commodities (led by oil) will continue to march forward. To put it simply, I expect tangible assets to (once again) appreciate over the coming years.

At present, the majority of analysts and experts are talking about low inflation and even lower interest-rates. The US-Treasury market certainly agrees with this consensus view as bond prices continue to rise whilst the yield is extremely depressed. But how do we know that inflation fears will not escalate again? With oil prices hitting record-highs and going much higher, how do we know that interest-rates will not go up again?

It is my belief that the bond-market has (so far) not factored in a significantly higher oil price, which will cause consumer prices to rise in the future. The establishment has done a fine job covering up inflation by manipulating the Consumer Price Index (CPI) in the United States. As far as I am concerned, the CPI figure released by America is a joke - an outright fraud. Despite the fact that every American does spend money on housing and energy, the officials who come up with this amazing concoction called the CPI, do not even include housing and energy costs in their calculations! By keeping "expensive" items out of their index, they continue to fool the world with regards to inflation. So when people hear that the CPI "only" went up by 3%, they feel confident that inflation is under control. This inflation management obviously keeps a lid on interest-rates while the bond-market continues to hold.

I don't know about you, but where I shop, prices are heading steadily higher! The price of food has also started increasing gradually. According to the establishment, inflation is around 3%, but how can that be true when prices are rising much faster than that? One day, the public will wake up and smell the rat! When that happens, interest-rates will move higher and the bond market may stage a spectacular decline. Under this scenario, stocks will also come under pressure as they usually do when interest-rates rise.

So, coming back to our original questions, I expect financial assets such as stocks and bonds to deflate over the coming years. In the short-term however, especially if the Federal Reserve starts cutting rates, stocks and bonds may continue to rise. But such a rally may end abruptly once interest-rates start rising again.

In the current economic environment, I feel much more comfortable investing in tangible assets. In the 1970's, commodity prices surged exponentially together with interest-rates. Now, commodity prices have turned up again and the universe of tangibles may inflate considerably over the coming years. So far, oil and industrial metal prices have been the biggest beneficiaries whilst precious metals and agricultural commodities have lagged.

Over the coming months, I expect gold and silver to appreciate and at the same time, energy prices may correct. Moreover, agricultural commodities are now the cheapest they have ever been; hence they may surge over the period ahead.

Regards,
Puru Saxena

Puru Saxena is the editor and publisher of Money Matters, an economic and financial publication. An investment adviser based in Hong Kong, he is a regular guest on CNBC, BBC, Bloomberg, NDTV Profit and writes for several newspapers and financial journals.

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