Economic Outlook

Economies around the world are taking a breather and it is expected that the U.S. GDP growth will at least slow and possibly contract this year. Current consensus forecasts look for a short period of recession for the U.S. with a turnaround expected in the latter part of this year. Most instrumental in these forecasts are the expectations that the monetary and fiscal stimulus provided in the first quarter of 2008, will take effect by the fall.

In our opinion the key to the turnaround is the housing market. Housing related industries account for a small portion of total economic activity (5% by some calculations), but more importantly, the housing slump was a cause of the blockage in credit markets. A stable housing market, among other factors, will be required for a normally operating credit market. A large unknown factor that will determine the timing of a housing stabilization is the possible mortgage debtor relief legislation.

Other essential factors in an economic turnaround are:

1. Stronger consumer spending driven by stronger employment numbers (unemployment may peak at 6% before turning around), and

2. Controlled inflation in an environment of bubble like commodity price rises.

The Fed is involved in a balancing act trying to stimulate the economy out of its current slump, yet not boost inflation. Consensus forecasts call for more interest rate cuts this quarter turning around to interest rate raises by next year. ■

Is This the Right Time for Commodities?

Given the dramatic run-up in commodity prices over the past year, we have received numerous calls from clients inquiring about our views on commodities. Is now the right time to buy? What do we think of commodities over the long term? To answer these questions, we began by taking a closer look at the fundamental case for owning commodities. We then examined the changing structure of commodity markets, and the significant impact that new entrants (namely speculators) are having on short term prices. We found that although global demand/supply dynamics support higher commodity prices over the longer term, speculators have bid up prices over the short term beyond levels dictated by fundamentals. Commodity prices have gotten ahead of themselves and could be in for a shorter term correction, potentially triggered by stabilization of the equity markets, weakening demand from China, or the strengthening of the dollar.

The Fundamental Case for Commodities

As emerging economies develop, the combination of industrialization and urbanization (and the infrastructure needed to support them) serves to increase demand for industrial and agricultural commodities. In the case of China and India, the two most populous countries on the planet, their simultaneous economic development has meant that demand for these basic economic building blocks has been (and will continue to be) quite staggering. These countries account for a large portion of the global population, which has increased from 2.5 billion in 1950 to 6.7 billion today, and is further projected to reach 9.2 billion within 30 years. Factor in growth in per capita incomes[1] and the resulting change in consumption patterns, and you begin to get an idea of the scope and size of demand for certain industrial commodities.

On the supply side of the equation, historically low inventory levels, coupled with capacity constraints for a host of industrial and agricultural commodities around the world, has meant that any disruptions to supply can and will continue to have a significant impact on spot prices globally. You need look no further than the effect the floods in China have had on wheat, or the effect power outages in South Africa have had on platinum prices to see how globally sensitive commodity prices have become due to decreased inventory levels (i.e., the ability to absorb supply shocks) in a rising demand environment.

Speculation Driving Short Term Commodity Price Spikes

While supply/demand fundamentals support a longer term trend of higher commodity prices, the recent spike in prices is largely attributed to increasing speculation in the commodity markets. The combination of high commodity prices and poor returns in the equity and fixed income markets has led many investors to view commodities as a good place to "park some

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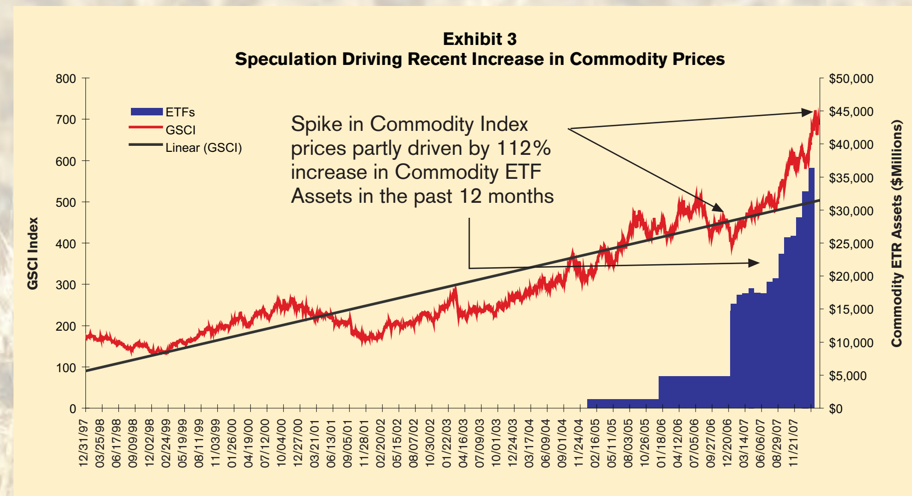
[1] *According to the World Bank, from 1960 to 2004, inflation adjusted consumption per capita for middle and upper income economies grew by more than 200%, and by 60% for lower income economies.*

Commodities (continued from 5)

short term money," at least until the equity and fixed income markets stabilize.

The primary conduits for investors looking to get into the "commodity game" have been Exchange Traded Funds (ETFs) linked to commodity indices. According to the Investment Company Institute, commodity linked ETFs now hold approximately $36 billion in assets, up 110% from a year ago (see **Exhibit 3**). Sanford Bernstein & Co. estimates that investors have poured roughly $175 billion to $200 billion into commodity linked index funds since 2001. These strong inflows have been matched by record issues of new commodity ETFs. According to Barclays Capital, roughly 140 commodities-based products were launched in February 2008, the highest ever, and roughly double the number issued monthly in 2006 and 2007 (see **Exhibit 3**).



Source: Bloomberg, Investment Company Institute. Note: Monthly ETF Data unavailable for 2004-2006.

As a result, index funds have become significant players in the commodity markets. According to figures from the Commodity Futures Trading Commission, commodity-index investors make up around a fourth of total bets outstanding in many agricultural commodity markets[2]. With record amounts of money flowing into these products, ETFs are fundamentally changing the trading dynamics of once thinly traded commodities.

Take wheat, for example. AgResource, a leading agricultural forecasting firm, estimates that commodity index funds currently hold contracts for about one billion bushels of soft red winter wheat - about twice what the US will produce this year. The obvious disconnect between the bushels scheduled for delivery (in accordance with the contracts) and the bushels likely to be harvested is indicative of speculative trading, since some investors (representing half of the contracts) will not be taking delivery of the bushels of wheat once the contract expires. To be fair, a portion of commodity contracts are usually "rolled" or swapped out prior to expiration, but the prices and quantities are usually closer to forecasted amounts. Exacerbating this imbalance is the lack of long term futures, which means that even if investors (i.e., index funds) have a bullish long term view, the only way to invest long term is to continually roll over short term contracts, which serves to increase spot prices over the short term.

Weak Dollar

Traders also point to the weak dollar as another culprit for the recent spike in commodity prices. They argue that since most commodities are quoted in dollars, producers outside the US need higher prices (in dollar terms) to maintain margins. Francisco Blanch of Merrill Lynch takes the argument one step further. He argues that a weak dollar has produced a surge in liquidity in fast-growing emerging markets like China and the Middle East, and that in an attempt to insulate consumers from rising prices, governments in those countries have instituted subsidies and price controls, keeping demand for raw materials artificially high (in spite of elevated international prices). The weak dollar argument implies that commodity prices will fall once the dollar strengthens or at least stabilizes.

Conclusion

While the combination of explosive demand from emerging economies and worldwide supply constraints are likely to drive prices higher over the long term, commodity prices have gotten ahead of themselves and are due for a correction, though the timing is uncertain. The timing and severity of that correction will depend on a host of factors, including the extent of spillovers of slowing economies in the developed world to emerging economies, the dollar, and the ultimate stabilization of equity markets. ■

[2] *Funds currently hold 31% of the open bets in wheat contracts and 23% of the soybean contracts on the Chicago Board of Trade.*