

NEW MINERVA REPORT

Commodities

Only a couple of months ago, economic pundits were slating Ben Bernanke and the US Fed for not having cut interest rates far enough. Now those same pundits are saying that the Fed should be raising interest rates because of the heightened risks of inflation. The biggest contributor to the risk of rising inflation is the increase in commodity prices. In fact, the US Senate has been investigating the causes of rising commodity prices. The problem is that there are conflicting views on why commodities, and in particular the price of oil, have risen so sharply over the past year or so. It was not that long ago that there was speculation that the price of oil could get to \$100 a barrel. Since then we have seen the price well over \$130 a barrel. There are two opposing views on why the price of oil has risen so much. On the one hand there are those that say it is simply a matter of supply and demand. We have the emerging markets, like China and India, that are boosting demand, and then we have supply being restricted, in particular by OPEC. The other view is the one that OPEC members espouse to as the cause of the price rise, this is that speculators are pushing up prices.

One of the testimonies to the US Senate was given by Michael Masters. Mr Masters is a partner at Masters Capital Management which is a long-short equity hedge fund manager. His view was that institutional investors were contributing to food and energy price inflation. He believes that the supply of oil is ample and that we are experiencing a demand shock coming from the commodities of futures markets. Institutional investors like corporate and government pension funds, sovereign wealth funds, and university endowments now account for a larger share of outstanding commodities futures contracts than any other market participants. Mr Masters termed these investors as index speculators, who allocate a portion of their portfolio to popular commodity indices. In his testimony was a chart showing that the amount of money allocated to commodity index trading strategies had risen from \$13 billion at the end of 2003 to \$260 billion, as of March 2008. At the same time the prices of the 25 commodities that made up the indices in which this money had been invested had risen on average by 183% in the same five years. By Masters' calculations the demand by index speculators for oil over the last five years is almost equal to the increase in demand from China. The problem, as Mr Masters sees it, is that these index speculators, because of their portfolio weighting, will never sell. Thus maintaining upward pressure on commodity prices. Additionally, as more investors copy the weighting in commodities, the upward pressure will only increase.

Our view is that both parties to the argument are partly right. There is no doubt that investors have been diversifying into commodity indices because of the belief that they are not correlated with shares and bonds. On the other hand, there is no doubt that supply is not coming on stream as quickly as many

expected. In particular Russia, which had been seen as a swing supplier, has seen new supply dwindling. One of the reasons for this is the tax regime that was developed many years ago when the price of oil was closer to \$30 a barrel. The Russian government takes almost all profits from oil prices over \$30 a barrel into its Stabilisation Fund. This has meant that Russian oil companies have no incentive to develop new supply. As existing fields become older, they become less efficient, and extraction deteriorates. Mr Putin, now the Prime Minister, is aware of the taxation problem, and is attempting to change the tax regime. However, it is likely that increased supply following taxation changes will take time.

We have a situation where long term secular trends are combining with short-term cyclical trends. Increased demand from emerging markets is secular. Investor demand is cyclical. Most of the commodity indices in which investment is made, have at least 30% in oil related products, but they also have percentages in agricultural commodities. This effectively creates a new correlation between commodities as a whole. It is easy to envisage how a fall in the oil price could cause all other commodity prices to fall. An interesting fact is that there has been an increased demand for tankers. These tankers are being leased and filled up with oil by people that believe that the price of oil will continue to rise. If the price of oil does not continue to rise, the oil being stored in these tankers will come to the market as fast as the people leasing the tankers can get it there. There is therefore a potential for a pickup in supply that is currently not being acknowledged by the market. Our view is that after the current correction, there is the potential for one last upward move in the oil price later this year. However after that, the price could fall back below \$100 a barrel. It is interesting that the share price of oil companies reflects oil prices nearer \$70 a barrel. In the long term we need oil prices to stay relatively high in order to curtail demand, and hopefully introduce some new form of energy which will lessen the emission of greenhouse gases.

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