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Why commodity inflation may continue further

Market watchers are perplexed by the asset price inflation in commodities and are at a loss for explaining why industrial commodities, energy and agricultural commodities are going through the roof, especially at a time when the world is going through a depression. The primary reason for this confusion is the mindset that many analysts suffer from – commodities and equities are different animals and cannot be painted with the same brush. Let's take a look at various asset classes within the commodity space –

Industrials – base metal prices are normally the barometer of industrial health of the economy. Rising prices usually mean higher demand offtake and therefore higher industrial production. Copper is usually the bell weather among the industrial assets and is followed by Aluminium and Zinc. But it gets a lot more complex from here onwards. Consuming industries book their raw material requirements many quarters in advance and therefore mining companies know how much to produce. In the recent decline in industrial activity, supply exceeded demand and therefore mining companies laid off workers, engineers, did not renew contracts to hire excavation equipment and even closed down mines. Now that demand is expected to pick up, getting skilled and unskilled manpower, mining equipment, finance and even restarting mines will not be possible with the flick of a switch. Therefore, the supply side constraints are driving up prices. Stockpiling by consumers, the falling USD vis-à-vis the Euro are other factors that will keep industrial commodities prices firm.

Bullion – many analysts assume that a decline in the real economy results in a rally in bullion and vice versa. I would beg to differ. Take the example of Gold and Silver from 2002 – 2008, equities rallied and economies expanded. Yet Gold was a four bagger and then some ! The fact is that many analysts have omitted the influence of the "parallel" economy. After 9/11, free flow of money at the press of a computer button virtually stopped. Gold has become the official currency of the unofficial economy. You and me as tax payers in the official economy are poorer, not so the players in the parallel economy. Their currency (Gold) is stronger, has attracted more profits (more Gold) and is therefore better poised to support it's currency. Also note the USD weakening vis-à-vis the basket of currencies. That is likely to result in safe haven buying. Even if the real economy improves, bullion will still rally. The forward sales by Gold mining companies to raise cash for working capital requirements indicates that much short covering will be seen at higher levels. Watch the London "Gold fix" effect on the metal in the coming weeks.

Energy – we are staring at Hubberts Peak (declining oil prices here onwards) in the face. The Society of Petroleum Engineers (www.spe.org) endorses that view. So does the Association for study of peak oil (www.peakoil.net) and these are men and women who brave the elements to hunt for oil. Many myths have been floated by investment analysts – primary one being technology making it cheaper to drill for black gold. Schlumberger (global leader in drilling equipment manufacturer) doesn't seem to endorse that view. Drilling equipment and other costs continue to zoom. New discoveries are elusive and well pressures are falling. Lukoil former soviet union's heavyweight producer (Russia has one of the highest proven reserves in the

world) has officially confirmed a 15 % decline in oil well pressure. Mexican wells have reported even steeper fall in pressure – upto 40 %. Alternate sources of oil like oil sands of Alberta and sasol have been touted as alternatives. But they are sadly economically unviable. Emerging economies are ill equipped to shift to alternate fuels without sinking in international debt to finance the capex needs. Expect natural gas and crude to appreciate further. Throw in the falling USD effect and you know what to expect here too.

Agricultural assets – with a 8 % decline in arable land this decade, rising population and the Earth's closest proximity to the Moon in 300 years causing irregular rainfall, floods and droughts, you know that supply is likely to be tight. Take the case of sugar – we are now in the second year of the "down" cycle (consisting of 7 – 8 years typically, 4-5 up years and 2 – 3 down years) when production is lower and the soil "recuperates". You may try to arm twist everyone in the supply chain – from the farmer to sugar mill barons, but the prices will rise. You can take it or leave it, things wont change. I suggest buying agri commodity far month futures instead of cursing the situation. That view holds for maize, wheat, rice, dals, spices and edible oils. Sure there will be bouts of sporadic price declines but the larger trend is up. Also remember that energy and bullion are unique animals and must be viewed in the long term perspective. What's long term for equities is the blink of an eye for energy.

Well informed is fore armed. Prepare for higher inflation as it is a given. Instead of subscribing to the conspiracy theory, understand it as an event of nature. Let your smart thinking pay for the higher living expenses.

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The analyst is the author of the book – "A Traders Guide to Indian Commodity Markets" **–** the first technical trading guide for commodity markets in the country

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