

## Buttonwood | Material concerns

### Commodity prices are surging at a very early stage of the cycle

**S**UBPRIME mortgages may have dominated the headlines in 2008 but high commodity prices played a significant part in the economic turmoil of that year. So it is striking to note that *The Economist's* all-items commodity index is now even higher than it was back then.

Admittedly, our index excludes oil, which is more than \$50 below its 2008 peak. Nevertheless, at around \$90 a barrel, oil is high enough to prompt petrol prices of more than \$3 a gallon in America and record pump prices in Britain, where tax plays a much larger role.

The strength of raw-materials prices raises three vital questions. Given that the global recovery is at a very early stage, do high prices indicate that the world faces significant supply constraints, which will be a problem for years to come? Will such constraints lead to prolonged inflationary pressures and cause central banks to tighten monetary policy? Or are high prices simply a bubble, the result of speculative activity in the futures markets?

On the speculative front, 2011 began with record numbers of long futures positions for commodities on American exchanges: some 1.85m contracts, according to Ole Hansen of Saxo Bank. (That seems to have caused a bit of profit-taking in the first few days of the new year.) But it is still hard to pin all the blame for high prices on investors. Studies have shown that commodities that are not traded on exchanges have tended to rise as fast, and be as volatile, as those that are.

In any case, it seems likely that investors and commodity consumers are motivated by the same factors. Prices rebounded in the second half of 2010 after clear hints from the Federal Reserve that it would pursue a second round of quantitative easing. That might have caused speculators to pile into the market; it

might equally have prompted companies in America and elsewhere to stop worrying about an economic double dip and to start rebuilding their inventories.

Over the long run, investing in commodities has not been a great bet. Companies use the term "commodity business" to describe humdrum, low-margin activities. In real terms *The Economist's* commodity-price index has gone backwards since 1862, falling by around half since then. People have become more efficient at growing, finding or refining raw materials. As Dylan Grice, a strategist at Société Générale, remarks: "When you buy commodities, you're selling human ingenuity."

One would expect commodities to be anchored by the cost of production. A market price well above that level will cause new supply to be brought on stream; too low a price will cause mines to be mothballed or arable land to be switched to other crops. In turn, the cost of production is cyclical since it requires a good deal of other commodities (such as oil) in the process. Higher grain costs, for example, feed through into cattle prices.

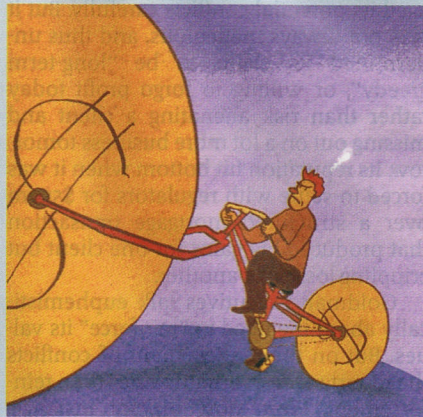
Clearly, at the top of the economic cy-

cle, consumers will be so desperate to get their hands on raw materials that they will pay well over the cost of production. So the current surge in commodity prices, at a time of spare economic capacity in the rich world, suggests one of two things is going on. Either the needs of the developing world are causing demand growth to outstrip supply for an extended period, or new sources of supply can be found only at higher cost. Both explanations add weight to the idea of a "commodity supercycle", a long-term surge in prices that might last for 15-20 years.

In the short term this is bad news for the developed world which, in aggregate, is a commodity consumer, not producer. Higher prices may cause a surge in headline inflation but their main effect will be to act as a tax on consumers. For many parts of Europe, this tax is being levied at a time when the spending power of consumers is already being squeezed by the efforts to eliminate the fiscal deficit. Unfortunately for the Europeans, their own demand may be inconsequential in setting the global price, which is more dependent on America and China.

The inflationary impact is clearer in the developing world, where raw materials are a bigger proportion of the shopping basket: Indian food prices, for example, have risen by 18% over the past 12 months. The only cause for comfort so far is that rice, the most important foodstuff for Asian consumers, has not shown the same strength as other food prices. Nevertheless, Asia is starting to tighten policy; China pushed up rates last month.

If the Chinese economy slowed sharply, then commodity prices would slump. But that is not an outcome that the developed world should hope for.



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► regulators trying to implement the Volcker rule, which curtails the latter, are finding.

There is plenty more in the 63-page report for cynics to scoff at: a "matrix" of client responsibilities; flabby talk of "encourag[ing] ownership and accountability for client service"; and the creation of several committees that threaten to bog the firm down in bureaucracy and foster the dangerous impression that groups, not individuals, bear responsibility for its conduct.

One thing that will not change, for now, is the top brass. Gary Cohn, the firm's president, will take on an extra role as head of the business-standards committee. Mr

Blankfein will remain chief executive and chairman, jobs he has held since 2006. Though a target of public ire, he continues to enjoy strong support from clients, investors and the board. The level of backing among the 470 partners is harder to gauge. A few are said to see benefits in changing the leader. But there is no reason to doubt that the sharp, good-humoured Mr Blankfein remains popular with colleagues. In any case, "he wouldn't want to go at a time when it might be construed as being down to external pressure," says a person who knows him. One possible successor is Michael Evans, co-leader of the group that

wrote the report.

Goldman says the recommendations will take up to 18 months to implement. Its ways may not be much different at the end of that period. Clients will get less double-dealing, investors a bit more information. The mighty firm need not care much about what the wider public thinks: after all, it does not serve moms and pops. The former partner thinks that Goldman will be able to do "80-90% of what it did before", and that its smart young things will make up much of the difference by sniffing out new opportunities. Call it self-improvement, Goldman style. ■