

[Editor's Note: In July, we asked the question, "Explosion Ahead for Commodity Prices?" in our cover story. The story was so well received that when author John Hummel decided to add more facts and his own twist regarding the future of commodities, we gave him an unequivocal "yes!"]

While there are many ways to make money, one timeless approach is to invest in beneficiaries of a major secular trend. Secular trends develop due to a confluence of factors that may include demographic trends, government policies, technological developments and other macro economic events that have a major impact on either demand or supply or both.

A secular trend by definition is a trend that is powerful enough to continue through two or more cycles. As a result, the extent and duration of the move does not require perfect timing. Examples of recent secular moves would include the bond market from 1981-2003 and the stock market from 1982-2000. Strong evidence exists that a new secular bull market in commodities and hard assets may be in the early stages of a generational type move. There are several reasons that such a move has begun:

- History points to commodity bull markets developing approximately every third decade.
- Commodity prices are near historically low levels on a real or inflation-adjusted basis and appear to have started a new uptrend.
- Commodities are beginning to develop relative price strength versus other asset classes.
- A global economic expansion is taking place with the full concurrence and overt efforts of most major governments and central banks.
- China and India are at the forefront of this global expansion. Developing economies experience much faster relative growth in consumption of commodities than more developed economies.
- Certain key commodities such as oil may be in short supply in the years ahead regardless of how high prices may rise.
- The dollar appears to be in a secular decline, and if so, it will add to upward price pressures in commodities due to the fact that they typically are traded in dollar terms.

Historical Perspective: The 30-Year Cycle

Looking back over long periods of economic history, secular bull markets in commodities appear to develop about every 30 years and have lasted from eight to 12 years once they commence. The last bull market occurred in the 1970s and peaked in 1980. Prior to that there was one in the 1940s, and before that, one in the 1910s. Long-term time cycles would suggest this decade as the next logical time period for such an event.

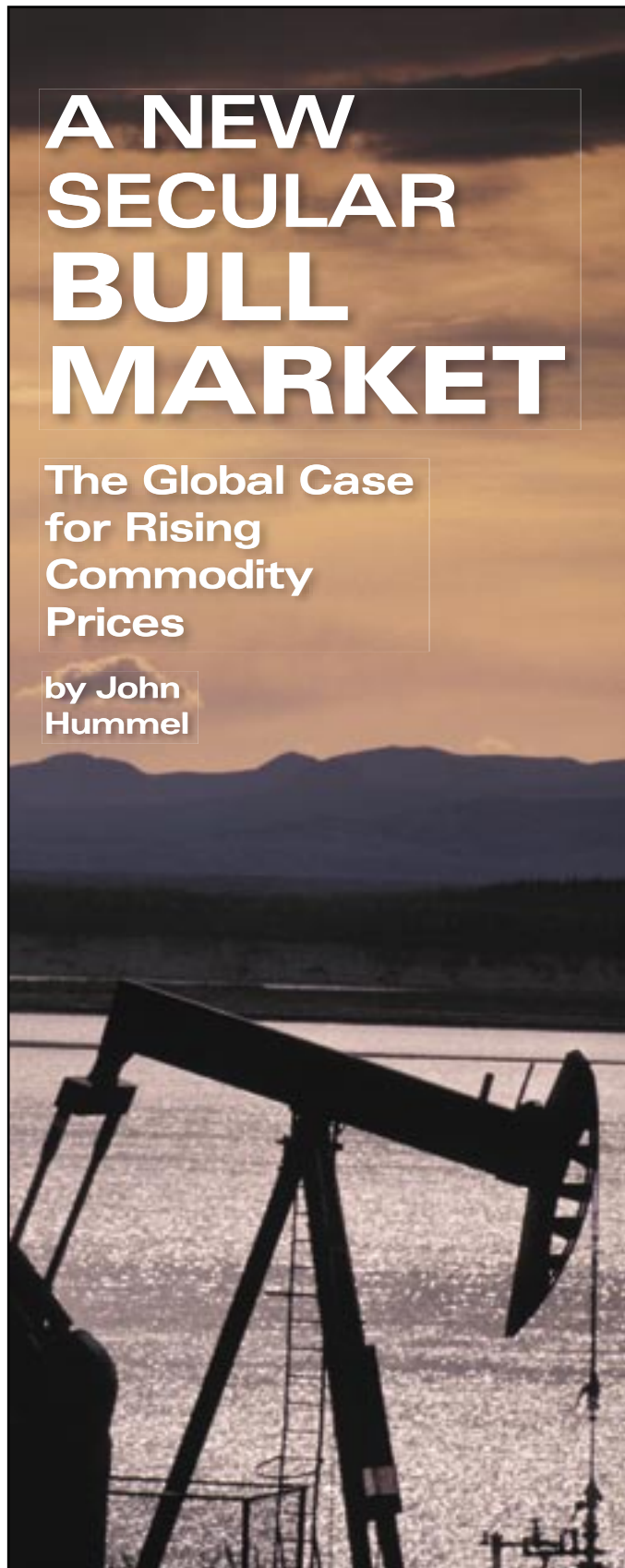
Is there logic to such long-term cycles? We believe there is, due to the differences in the time needed for buyers and sellers to respond to major price changes (what economists refer to as the differences in the elasticity of demand and supply to changes in price). Simply stated, buyers can usually respond to changing prices faster than sellers. As an example, if a shortage of copper develops, causing a major price increase, a mining company may need several years to develop new deposits. Due to the delay in any significant new production, prices often overshoot a new long-term equilibrium price level.

As many independent mining companies develop new production, a surplus often develops which drives the price down. Concurrently, as suppliers rush to bring on new production, demand may soften as users find cheaper substi-

A NEW SECULAR BULL MARKET

The Global Case
for Rising
Commodity
Prices

by John
Hummel

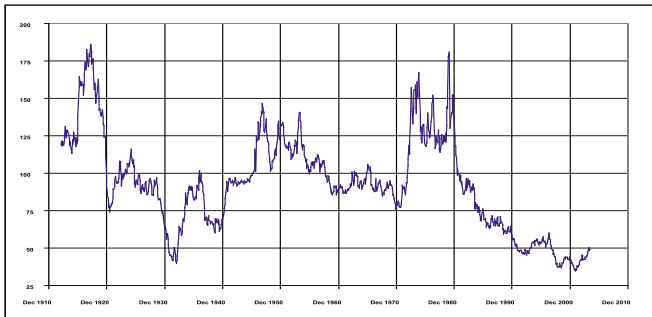


SFO Stocks Futures & Options

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CHART 1 Real (Inflation-Adjusted) Commodity Prices Through May 31, 2004



Source: Data from Past, Present, Futures and AIS Futures Management LLC

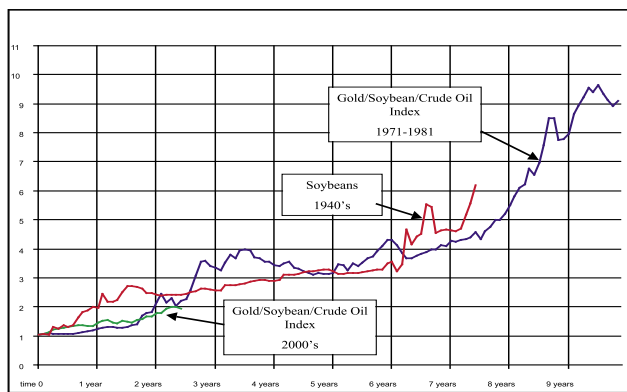
tutes. If demand is only growing slowly, it can take years or decades to work off the excess new supply. During the years of low prices, the weaker producers are financially squeezed, and this forces cutbacks of production. These periods of unprofitable operations eventually lead to shortages as slowly growing demand eventually catches up with supplies, and a new upward price spiral is set in motion.

New Uptrend from Depressed Price Levels

After two decades of excess supply in many basic commodities, shortages once again have begun to appear. This is apparent from the price rises that have occurred over the past couple of years. Because investment returns have been sub par for many years, normal rationalization has taken place to eliminate highest cost production, leaving only efficient producers. Although significant price rises have occurred, as *Chart 1* demonstrates, inflation adjusted prices still are close to extreme multi-decade lows and have a long way to go in real terms to match previous peaks. In addition, two factors, the increasing percentage of the world's population now able to afford higher living standards and the potential shortage of oil, could cause prices in real terms not only to reach old highs, but possibly to exceed them by a substantial margin. Finally, if inflation develops, the price moves in nominal terms could be substantially greater.

Chart 2 is a comparison of prices in three different time periods, all indexed to one at the commencement of each price move. The current period commenced on December 31, 2001, and is an equally weighted average of gold, soybeans and crude oil. The middle period is a similar price line of an equally

CHART 2 Prior Commodity Bull Markets



Source: AIS Futures Management LLC

weighted index of the three markets commencing in May 1971. The third line on the chart is the price of soybeans in the 1940s (the prices of gold and crude oil during that earliest period were largely fixed by government actions). As this chart demonstrates, past bull markets have made significant price advances before they ended. The soybean market in the 1940s increased six fold before peaking. The commodity advance of the three markets in the 1970s advanced more than nine times from its starting point. By comparison, the current advance has only doubled since it commenced a little more than two years ago. Because the current move started from an even more depressed price level, its potential could be far greater.

Relative Strength Versus Other Assets

Another way to confirm trends is to look at relative price performance of an asset versus other competing investment opportunities. Relative price charts are very useful in identifying longer-term changes occurring in the economic/financial environment. *Chart 3* is a ratio of the Dow Jones Industrial Average divided by the price of gold. When the line is rising, stocks are outperforming gold, and when it is falling, gold is outperforming stocks. Since 1913, there have been two complete cycles that turned out to be complete round trips in the relative price of stocks to gold. A third cycle top appears to have occurred in 1999. Since that time, gold has been outperforming stocks. It's difficult to predict the future with any certainty, but past experience suggests that once gold begins to outperform stocks, the trend remains in place for a significant period. Though there is not sufficient space to show other commodities relative to stocks, suffice to say they are following similar patterns to that of gold.

The time period of *Chart 3* coincides roughly with the time since the creation of the Federal Reserve System. One could view the chart as a financial rubber band that is stretched to its limit by government and central banks to stimulate economic activity. Eventually the system is stretched to the limits, and unintended consequences such as inflation begin to impact the economy; this then drives the prices of commodities relative to financial assets back to a point of equilibrium. The evidence strongly suggests that we are in the early stages of a period in which gold and other commodities outperform financial assets.

Growing Demand

The world is experiencing a broadly based economic recovery led by the U.S. consumer and Chinese infrastructure spending. Initially led by these two engines, growth has now spread to Chinese consumers, Japan and other parts of Asia. In addition, India is now experiencing very rapid growth and could rival

CHART 3 DJIA/Gold through May 31, 2004



Source: AIS Futures Management LLC

China as the new economic miracle. Only Europe remains sluggish, but their exports are also benefiting from the strength elsewhere in the world.

Government and central bank policy throughout the world for the past two years has been geared toward economic growth and job creation. Only lately have policy makers (such as those in China) begun to take steps to slow but not stop growth. There will be periods of overheating to which policy makers will, of course, react to a limited degree.

However, there appears to be a fundamental difference in the current period from the previous two decades when policy makers were focused on slowing inflation. As policy makers attempted to shore up economies in the last two years, so much new debt has been created that they will be reluctant to tighten too much for fear of killing the patient.

When the Federal Reserve closed its eyes to stock market speculation in the late 1990s, it allowed the first of several financial bubbles to develop. When that bubble threatened to get out of hand on the downside, it chose to shore things up sufficiently to create a new bubble in real estate. As a result, debt growth is increasing much faster than economic growth. It appears that the U.S. economy cannot now reverse these trends without major financial consequences that are politically unacceptable. Therefore, it appears that they will continue to use all their resources to feed future bubbles. The next likely place for excess liquidity to go will be the commodity markets.

Because the U.S. dollar is the world's reserve currency, our policies have consequences for other countries. As the U.S. floods the world with liquidity, it leads to financial bubbles in other countries. Most recently, China has been absorbing large dollar flows which are feeding their domestic monetary growth. Their growth in turn fuels growth in other neighboring countries. With job growth the primary goal of policy makers throughout the world, not until tight labor markets develop and the negative consequences of excessive growth impact the majority of voters will policy shift to significant tightening. Until then, central bankers will talk the talk of restraint, but their actions will not back up their talk.

The Consumer Century

The U.S., with but 4.7 percent of the world's population, historically has consumed a disproportionate percentage of the world's basic commodities. If one includes Western Europe with 3.1 percent, Japan with 2.1 percent and the four Asian Tigers (Singapore, Hong Kong, Taiwan and South Korea) with 2.7 percent, you have collectively only 12.6 percent of the world's population. This 12.6 percent consumes the majority of the world's production of most basic materials. This minority has combed the world, and with its capital and technology, developed and been the primary consumer of basic materials. As a

result of this combination of technology, capital and limited demand, prices in real terms have been kept at lower and lower levels of the average consumer's budget.

However, this historical set of circumstances appears to be changing. Never in history has the world experienced such a large portion of the world's population financially able to experience what American consumers have come to expect as their right of passage.

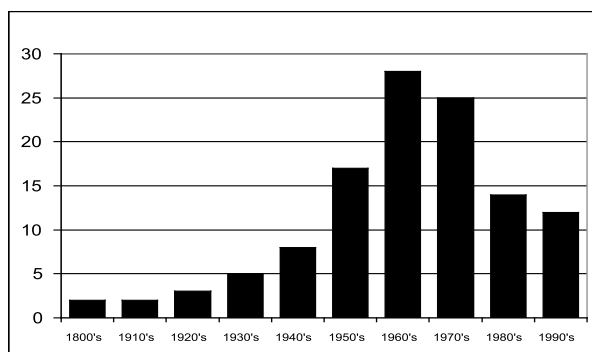
China with 1.3 billion people and India with one billion, combined, represent 37.8 percent of the world's population – roughly three times the 12.6 percent represented by the advanced consumer countries. Obviously, not all of these 2.3 billion people have benefited from the economic advances, but the benefits are trickling through their economies in a major way. Whether it is a peasant able to buy meat more often (meat requires two to four times as much grain as direct consumption), a new consumer acquiring the latest electronic gadget, or the newly rich buying gas guzzling cars, the demands on basic materials are expanding rapidly. Unlike advanced countries like the U.S., an incremental dollar of GDP growth in a developing country leads to a higher proportion of basic materials consumption. Thus, the economic expansion of these developing countries will have a greater impact on demand growth of basic commodities.

Because oil is a major commodity, a look at consumption patterns will provide an example of the impact developing-country growth will have. U.S. consumption is approximately 25 barrels per capita per year. Japan and the Asian Tigers at the start of their rapid growth phases consumed only one barrel per capita. Currently they consume approximately 17 barrels per capita. By comparison, China currently consumes approximately 1.5 barrels and India 0.8 barrels per capita per year. Even with China's current miniscule per capita consumption, it is now the world's second largest consumer of oil after the U.S. Therefore, if the world could produce enough oil and Chinese growth approaches Japanese consumption patterns, world oil production would have to increase by approximately 75 percent from current levels. If one then adds India to the equation, the impact is even more mind boggling. Given that energy is such an important component of so many other products (e.g., 40 percent of U.S. agricultural costs), the tensions that this new demand can place on world resources (and, therefore, prices) is staggering. If developing-country economic growth continues, we may be entering a different paradigm, one in which real prices of basic commodities rise much faster than living standards.

Supply Constraints for Oil

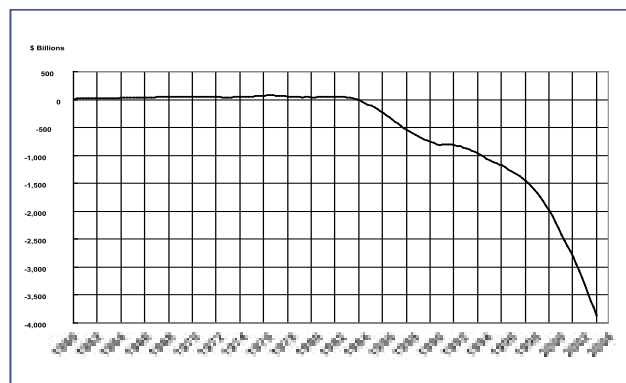
There are two views regarding the future supplies of oil. One is sanguine and assumes that, as in the past, higher prices and technology will solve

CHART 4 Giant Fields Discovered by Decade



Source: Simmons & Co.

CHART 5 Cumulative U.S. Current Account Balance (Billions of Dollars 1960Q1-2004Q1)



Source: AIS Futures Management LLC

future energy requirements. The other view holds that oil is a finite resource and that world production is reaching the limits of peak production. This approach is geologic and was originally put forth by M. King Hubbert, a noted Shell Oil geologist. In 1956, he correctly forecast that U.S. oil production in the lower 48 states would reach peak production in the early 1970s.

This school of thought argues that all oil fields follow a bell curve statistical experience for total production. Before a field has produced half of its total cumulative production, it is capable of increasing production. However, once the mid-point of total production for any field is reached, daily production begins to decline. Within the continental U.S., the peak discovery year for new oil fields was 1930. As M. King Hubbert forecast, peak production occurred 40 years later as the average field in the U.S. reached its half-way point of total production.

Leading geologists using this same approach have estimated that non-OPEC world production has reached its halfway point and that OPEC will experience its peak in the next decade. Combining the non-OPEC with OPEC estimates, this view argues that total world oil production may be in the process of peaking during the middle of this decade. The discovery rate of large fields (those producing 100,000 barrels a day or more) worldwide occurred more than 40 years ago (see *Chart 4*). In spite of higher prices since the 1970s and major advances in technology, discoveries of new reserves have not kept pace with consumption. Only smaller, more remote, finds are being made.

As the world's large fields begin to experience production declines, not only must production increase approximately two percent per year for growth in demand, but it also must add four to six percent of new production to make up for declining production from older fields. The world's oil producers could not accomplish this in the past decade and are unlikely to do so going forward. Therefore, the potential exists for considerably higher prices and disruptions to economic activity if substitutes are not developed on a timely basis.

Consequences of Dollar Weakness

From 1944 through August 1971, the world was on a dollar exchange standard. During that period, foreign central banks could exchange dollars for gold. In August 1971, of course, the U.S. suspended exchanging gold for dollars. For the last 33 years, the world has been on a dollar standard. And largely through the acquiescence of several Asian central banks, most notably Japan, China and Taiwan, the U.S. has been permitted to abuse its special status by progressively greater amounts each year.

As *Chart 5* illustrates, the U.S. has accumulated about \$4 trillion dollars of foreign obligations. This equates to 40 percent of current U.S. GDP and is rising at a rate of five percent per year. No one knows how much longer this trend can persist, but it is probably not sustainable. Asian countries have been willing to accumulate dollars and support current exchange rates as they sell us consumer goods. However, at some point as circumstances change, foreign governments will be less willing to support the dollar, and a major decline could ensue.

The catalyst for significant dollar weakness could be rising oil prices. If we enter a period of escalating oil prices, Mideast oil producers will have less reason than Asian consumer goods producers to support the dollar. Unable to spend all their new wealth on U.S. goods and uncomfortable to invest in the U.S., they are more likely to diversify into currencies such as the euro, yen and, to a lesser extent, gold. Should this happen, it will be a key test for the future role of the dollar as the world's reserve currency.

Because most traded commodities are priced in dollars, any dollar weakness immediately translates into higher dollar prices. This occurs as prices for

foreigners decline in local currency terms and stimulates demand. An example of this type of price move would be soybeans in the mid-1970s as the dollar declined against the yen, and Japanese buyers aggressively bought soybeans – driving the prices to all-time new highs.

The Bottom Line

When the stock market embarked on its two-decade advance in August 1982, it was undervalued, had experienced a decade of disappointing returns and was competing against high interest rates and other investments that had achieved superior returns in the previous decade. The public was severely underinvested in stocks and skeptical of its potential. Over the next two decades, stocks not only returned to their previous peaks in valuations, but with the help of declining interest rates and two historically long economic expansions, eventually achieved valuation levels never before experienced in U.S. financial history.

Today commodities are undervalued and under-owned and face even greater investor skepticism than stocks did in 1982. No one knows for certain if this decade will provide the backdrop for another secular bull market in commodities, but the conditions exist for at least an average rise similar to those in the past. Depending upon the course of global economic growth, the potential supply constraints for oil and the fate of the dollar, the bull market that unfolds could be one of the greatest in history.

Opportunities for the Individual

Given the potential, how does an investor participate? The natural tendency is to seek opportunities through the stock market. While this might work, there are risks. There is a general market risk that price/earnings ratios could contract due to adverse macro economic conditions. Thus, even though the investor might identify earnings beneficiaries of the commodity bull market, the compression of price/earnings ratios could overwhelm earnings gains. The other risk is that government edict could limit profits. This occurred in the 1970s when the government froze the price of oil discovered before a certain date. Thus, individuals or companies with significant oil reserves were denied the full benefit of property rights.

Recognizing that the author may have a bias due to management of funds investing in gold and diversified commodity funds, this still appears to be the most direct way to profit from a future commodity bull market. Ownership of gold bullion or futures contracts on gold and other precious metals, energy contracts on oil and natural gas, and contracts on grains and soybeans provide a natural way to participate.

Bullion and futures markets are traded internationally; therefore, they are less likely to be impacted by individual government price controls. Investors can invest in or trade these contracts directly through opening a commodity futures account or through investing in managed futures funds. It is always difficult to make investment decisions that are not considered mainstream at the time. However, that is when the investments often have the most profit potential.

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