thebigpicture

guideposts for the private investor

Week Commencing 4 April 2005

Why Commodity Prices Are So Volatile

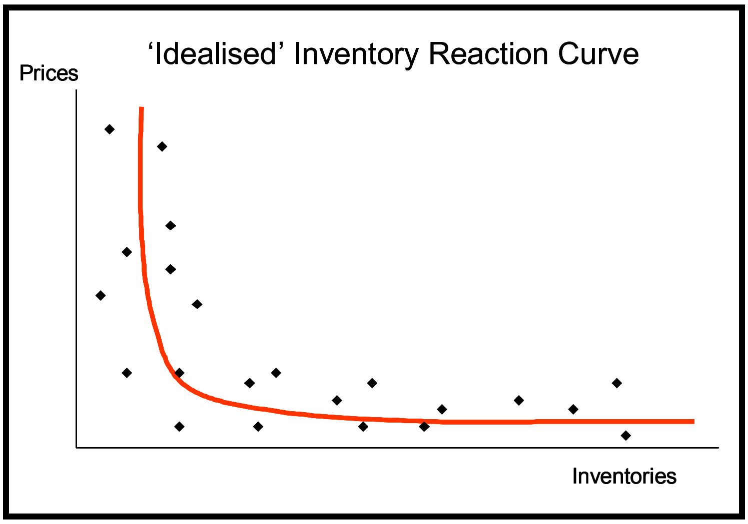
Equity investors are often surprised at the volatility in commodity prices. At times, price movements may appear bereft of any sense. But there is an underlying pattern.

Commodity price cycles follow a fairly well worn path.

- Demand rises reducing industry excess capacity but with little price impact initially.
- Further increases in demand begin to deplete accumulated inventories but as long as they remain high, the price impact is still quite muted.
- Further increases in demand begin to push inventories lower until they reach a critical point at which the perceived risk of shortages rises. At this point, the price response might be quite dramatic. This is the cyclical upturn.
- Time elapses as plans for new capacity are dusted off and companies (and banks) begin to feel comfortable about financing new projects. Exploration spending is stepped up, old operations are resurrected and secondary material is attracted from old uses by higher prices.
- With these supply side adjustments being largely uncoordinated, they exceed what would have been required to meet additional demand.
- The cycle begins to reverse as fears of shortages dissipate and a slight hint of inventory accumulation causes speculators to flee and prices to drop precipitously.
- Inventories continue to build. Most of the price fall has probably occurred but there might be a prolonged period of oversupply with prices below a substantial part of the industry's costs of production.

> *"….lower inventories imply higher prices. However, the nature of the relationship is far from being linear."*

In a general sense, lower inventories imply higher prices. However, the nature of the relationship is far from being linear. It is typically of the form illustrated in the chart which depicts an idealised inventory adjustment process based on the statistical analysis of many of the metal markets for which data on inventories and prices are released regularly.



This inventory reaction curve indicates that when invento-

(Continued on page 2)

Publishing and Subscription Information

thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

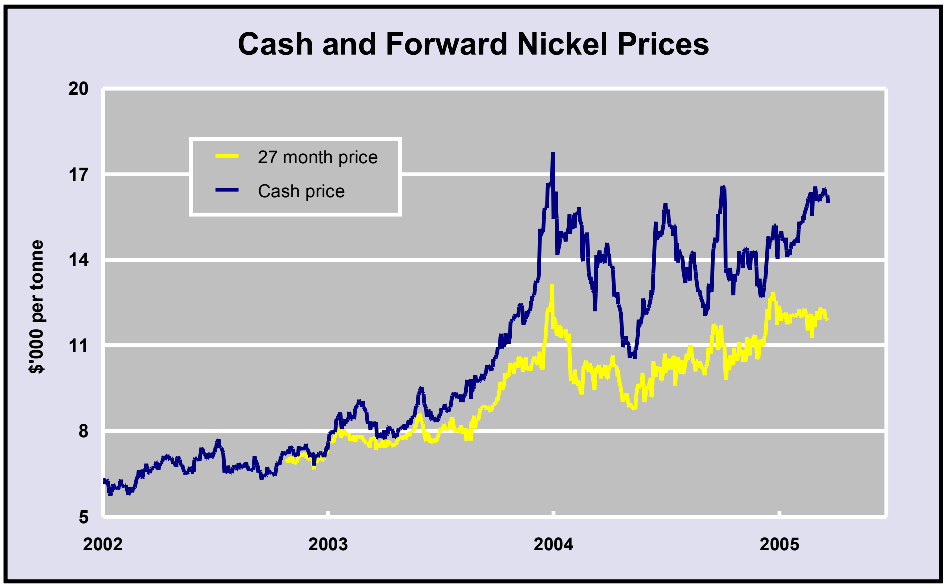
To subscribe to the newsletter, go to www.thebigpicture.com.au or send an e-mail to: admin@thebigpicture.com.au.

Newsletter subscribers may also subscribe to thebigpicture premium content which includes tailored analysis and seminars on economics, business and policy issues affecting investment decision-making. Further information can be seen at www.thebigpicture.com.au.

♦♦♦♦♦♦♦♦♦♦♦

thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

The Weekly Chart Spot



Source: London Metal Exchange

Nickel prices reflect a combination of industry supply constraints and rising demand. Depleting inventories - and associated fears of raw material shortages - have sustained cash prices well above forward prices for over two years. Under normal circumstances, forward prices should be higher than cash prices reflecting the financing costs of holding stock.

With cash prices now about 35% higher than 27 month forward prices, the market is suggesting that prospective conditions will make it easier for raw material users to source their needs. However, with forward prices also having risen by 85% since late 2002, there has been a clear change in overall conditions which goes beyond simply a short term tightening in the market balance. ■

Why Commodity Prices Are So Volatile cont'd

"…. when the balance of forces tips in favour of higher inventories... most of the price response … occurs quickly …"

(Continued from page 1)

ries are high and begin to fall, there might be little impact on prices. Because inventories are abundant, there is little perceived risk of shortages and users will be inclined to adopt a just-in-time approach to their supply management.

Continued growth in demand, if it outstrips supply growth, will reduce stock levels. Again, there might be little price impact until stock holdings move past a critical point. Beyond this point, fears of inadequate supplies are more likely. Raw material users will be more inclined to panic and more likely to push prices higher in response to any hint of supply disruption. Unanticipated jumps in demand can also have a dramatic effect.

In these conditions, speculators are more likely to enter the markets enticed by the prospect of short term price appreciation. Traders generally will provide more liquidity as they are attracted by the volatility. This is the period of genuinely buoyant prices.

How long this lasts will depend on the interaction of output growth and demand. Neither is more important than the other. As long as inventories are genuinely low and fears of shortages persist, prices can remain aloft.

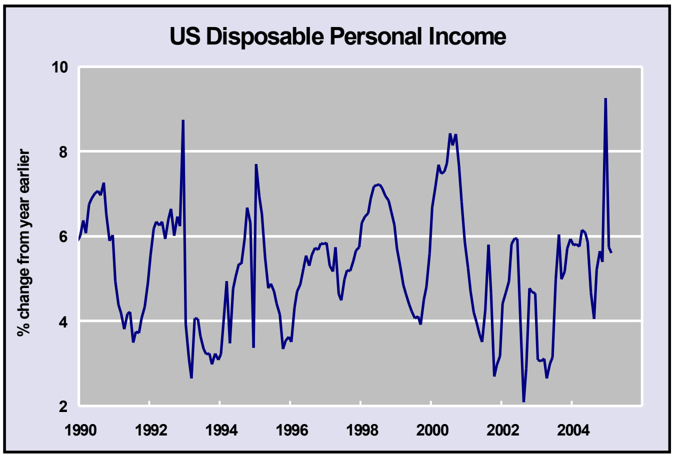
However, this position in the cycle is inherently unstable. High prices will attract new supplies. They might also curtail some uses. Also, after lengthy periods of strong economic activity, policy makers are more prone to be tightening monetary conditions helping to curtail the buoyancy in demand.

There comes a point when the balance of forces tips in favour of higher inventories. Again following the inventory reaction curve, most of the price response to these changing conditions occurs quickly with the onset of a change in market balances. Hence even small changes in underlying conditions are seen to elicit a disproportionately sharp price response. ■

US ECONOMY STRENGTHENS CONT'D

(Continued from page 4)

More recently, in December, **thebigpicture** observed that "the US economy is settling onto a sustainable growth path". Since then, the flow of data seems to have reinforced the grounds for this conclusion.



Non farm payrolls expanded by 1.6% over the year to March. The momentum of growth seems to have been easing slightly since the middle of 2004 despite the employment uptake in this cycle already being relatively slow.

Over the four recovery years from mid 1991, the average monthly employment gain was 194,000 compared with 61,000 in the current upswing. The flip side of this relatively weak employment performance has been what the Federal Reserve referred to as "robust underlying growth in productivity" in its latest monetary policy announcement.

Industrial production has decelerated from rates of growth between 4½% and 5% in the middle months of 2004 to 3.5% over the year to February. That said, current growth is more in line with the lower end of the range of outcomes during the middle 1990s.

On the household front, income growth has remained strong, an important signal of ongoing purchasing power and a sign of likely continuing confidence within the household sector. Over the year to February, disposable income expanded 5.6%. The strong income growth has managed to keep consumption spending growing at 5½-6%.

Business sales growth, despite decelerating slightly, has also remained strong. The 11.1% expansion over the year to January suggests that the forces affecting business sentiment are positive. Buoyant sales should engender more confidence and underpin growth in business profitability, employment and investment, the drivers which sustain an economic expansion once it is underway.

Overall, the activity picture is consistent with an economy on an expansion path. There are still a few signs that the current expansion has not been as robust as others but the underlying pace of growth seems to be holding.

Despite the emphasis placed on interest rates in the daily press, having a view of how the real US economy is performing is an important guidepost for an investor. Interest rates rising in a measured way while the economy is expanding remains consistent with positive profit growth rates. While signs of enhanced business pricing power might frighten central bankers, the revenue boost will be a source of additional income for those businesses that can benefit.

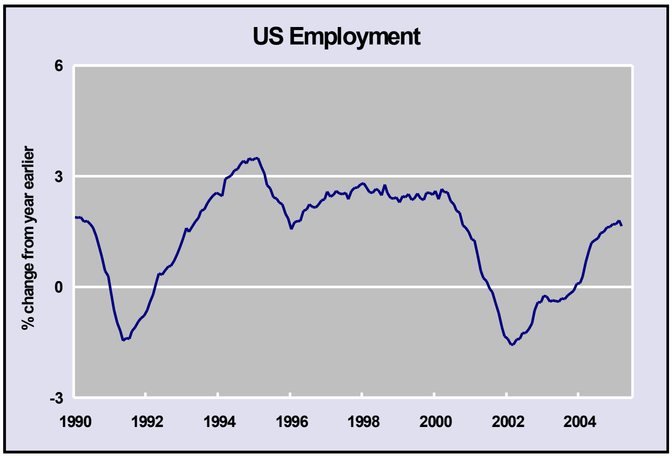
Further along the cycle, if inflation appears to be getting out of control, investors would have reason to become more wary about the outlook because that would signal more drastic action by the Fed to bring down rates of activity in the real economy as it also moves against inflation. In that case, an unacceptably high inflation and low growth condition could recur. However, current statistics suggest worries about this are premature.■

"Whatever the signs about inflation, of far greater importance for investors is the sustainability of real economic activity."

US ECONOMY STRENGTHENS

The US economy appears in robust good health according to recent economic data.

Some pessimism has crept into commentaries about the US economy because of comments by the Federal Reserve about inflation pressures becoming stronger. There has been some acceleration in the rate of price increase as the cycle has matured. One of the price measures relied on by policy makers, the personal consumption deflator, was 2.2% higher over the year to January. However, this remains within bounds generally acceptable to policymakers. In other words, there is no sign in the data that anything faster than a “measured pace” is required as interest rates move higher.



More buoyant economic conditions will normally confer more pricing power on business. This seems to be happening without any significant impact on the broadly based inflation indicators. Other than a reference that “pricing power is more evident”, the Federal Reserve seemed hard-pressed to find evidence of any dangerous inflation pressures. Importantly, it noted that “the rise in energy prices... has not notably fed through to core consumer prices” and that “longer-term inflation expectations remain well contained”.

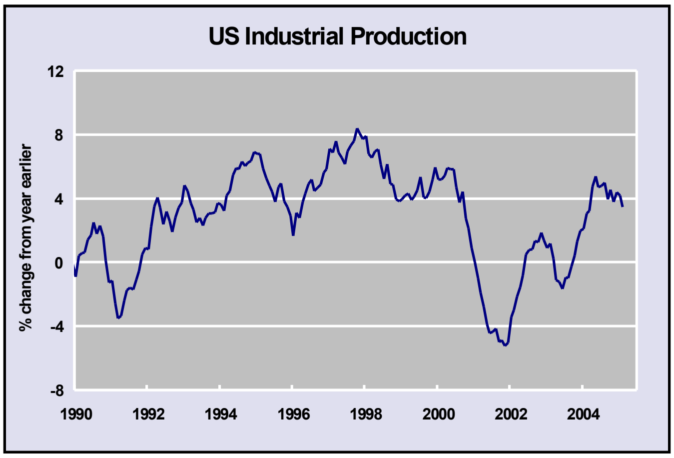
Whatever the signs about inflation, of far greater importance for investors is the sustainability of real economic activity. Investors can withstand sustained rates of real activity and higher inflation far more easily than higher inflation and lower activity rates.

thebigpicture periodically reviews the state of US economic activity against the backdrop of four key economic guideposts:

- employment,
- industrial production,
- disposable income, and
- business sales.

These four indicators are consistent with the principal activity measures used by the National Bureau of Economic Research (NBER) as guides to the position of the US economy in the economic cycle. The NBER is the organization with the job of officially defining whether the US economy has been in recession or is expanding.

Last August, the view expressed in ***thebigpicture*** was that an acceleration in activity rates from mid 2003 through the first half of 2004 had pushed growth to an unsustainably strong pace which would subsequently subside to something more in keeping with a maturing expansion phase.



(Continued on page 3)

“While signs of enhanced business pricing power might frighten central bankers, the revenue boost will be a source of additional income ….”