RB

Brounes & Associates

4607 BRAEBURN DR. ▪ BELLAIRE, TEXAS 77401 ▪ 713.962.9986 ▪ ron@ronbrounes.com

COMMODITIES: IF IT LOOKS, FEELS, SMELLS LIKE A BUBBLE…

But is This Time Different?

By mid-summer 2008, oil had more than doubled from the prior year, while wheat had skyrocketed 90%, soybeans 80%, and even copper had risen 20% on a year-to-date basis (not bad considering that slumping homebuilders are among the primary buyers). Despite the fact that industry insiders at Royal Dutch Shell and Exxon-Mobil previously testified before Congress that $50 to $65 a barrel oil was probably more in line given current supply/demand, crude continued to surge and other commodities followed suit.

On the other hand, those "expert" pundits on the business news programs, financial blogs, and message boards proclaimed that dramatic demand growth in China, India, and other emerging markets prompted such price movements and the sky was the limit for how high they can go. (However, none could truly explain just how such increases in demand account for $5, $7, $10 price moves on some days?) Still others "speculated" that sheer "speculation" was behind much of the moves and pointed out that assets invested in commodity index funds have surged from $13 billion to $260 billion over the past five years. The substantial price increases and contagious euphoria among those investors who had been fortunate enough to participate in related investments have brought about renewed talk of one memorable word…BUBBLE.

In general, bubbles occurs when the price of an underlying asset escalates far beyond what is perceived to be fair market value and without much rhyme or reason (or real basis in economic or market realities). These price movements often take on a life of their own as more investors watch the early appreciation and jump on the bandwagon in order to participate.

Many of those key "bubble" elements seem to be in place again…

- Unprecedented investment dollars flow into these often non-traditional asset classes as new investors hear about them and determine just how to participate.
- A "greed factor" and related "herd mentality" follow as investors start taking advice from unlikely sources who claim to have reaped considerable successes, but often have little experience or even an understanding of the underlying asset: colleagues at work, distant relatives, that seemingly smart person in the adjacent seat on the airplane, etc.
- A "*this time is different*" mentality emerges as confident investors discount any views of those contrarians who try to point out prior speculative times.

It was NOT different in the late-80's and early 90's when easy credit resulted in a real estate bubble in Japan and even contributed to the Nikkei index climbing to just below 40,000. The bubble burst, the "Asian Economic Miracle" was transformed into "The Lost Decade," and the index hit a low of 7,600 in April 2003.

It was NOT different in the mid- to late-90's when the dot.coms started springing up everywhere and prompted investors to trade out of their "old economy" stocks for shares of new companies, many of which had earned no prior profits or projected any for the foreseeable future. The bubble burst after the Nasdaq peaked above 5,000 in early 2000 (it now trades about 2,400) and the country fell into recession.

It was NOT different between 1997 and 2006 when the U.S. residential real estate market reaped significant valuation increases and folks with lousy credit, no money for a down payment, and shaky employment prospects were allowed to take out mortgage loans. Home prices surged by 85% during that 10-year period and even more in the most desirable regions of the country. Valuations began to tumble by 2006, defaults and foreclosures escalated at a rapid pace, and the housing slowdown impacted other sectors of the economy.

In fact, it was NOT different in 1636 when tulip mania spread across Europe and investors even created a futures market to trade these rare flowers. By 1637, the demand for these "status symbols" dried up and the last investors standing were left holding some lovely flowers that were worth virtually nothing.

When bubbles ultimately burst, related investments often depreciate significantly, rapidly, and may lead to ramifications throughout the economy or other markets. Both the dot.com and domestic real estate bubbles slowed the economy and prompted "potentially" recessionary times; Japan's real estate bubble led to a decade of economic and financial weakness.

But This One Really May Be Different…

During prior domestic bubbles, many "bystanders" went along for the ride and reaped ancillary rewards of the positive price movements in the underlying assets. During the dot.com mania, the entire stock market rose and even those investors who shied away from Internet plays saw their portfolio values increase as well. From early 1996 until late March 2000, the tech-heavy Nasdaq was the primary beneficiary as it soared about 350 percent. However, both the Dow Jones and Russell 2000 index virtually doubled in value, while the S&P 500 index climbed by about 150% during that period. Similarly, during the real estate bubble, average homeowners saw their property values increase as they benefited from this wealth effect, even though most never attempted to "flip" a house or bought for sheer investment purposes.

During the commodities bubble, however, sophisticated (often institutional) investors primarily participated in the related investment run-up, while average folks have suffered through the rising prices and ongoing inflationary concerns. When gas prices pushed above $4/gallon, many travelers had to cancel (or revise) summer vacation plans and others cut back on discretionary spending. Similarly, soaring grain prices contributed to higher food costs and consumers once again were forced to tighten their pocketbooks (and/or change their diets).

Businesses attempted to pass along the escalating expenses to consumers and looked for other means to reduce overhead. During the summer, the unemployment rate climbed to a four-year high and GDP weakened considerably (though not to recessionary levels) during the past three quarters. The inflation gauges registered their highest readings in two-and-a-half decades. While tax rebates helped retailers a bit, most of the beneficiaries were discounters as department stores and luxury stores struggled with reduced activity. While commodity-related stocks have increased in value, the main equity indexes have suffered with double-digit losses over the past few months and many investors found declining portfolios balances with each passing statement.

A Boost From the Bust…

In reality, a bursting of the commodity bubble could have positive implications for consumers, businesses, and the markets in general.

- Lower energy and food prices make others goods and services far more affordable.

- Individuals may have additional disposable dollars just in time for the holiday shopping season.
- Other businesses should enjoy lower raw material costs which could enable them to pass along some savings to their customers and hold off on other cost-cutting measure like layoffs.
- The Fed may be less inclined to increase rates to combat inflation once the price pressures seem to be subsiding.
- Easier access to borrowing allows both businesses and consumers to contribute to the growth in the economy.
- A stronger economy with reduced inflationary pressures should prove positive for (non-commodity-driven) equities.

So, even though the increase in commodity prices looks, feels, and smells like a bubble…this time indeed may be different.