Commodities are No Country for Old Men

By Richard Thomas

"Never under-estimate the predictability of stupidity" says Bullet-Tooth Tony from Guy Ritchie's most awesome movie, Snatch. Making calls that the Commodity market is about to burst is, quite frankly, stupid. So, if the saying is true – which it is, then we can predict that prices will march on their upward spiral and label those advocating the contrary as stupid-in-real terms. The commodity market will continue on its course for the foreseeable future as misalignments in trust, confidence, and expectations continue to violently adjust.

To begin, trust in US economic activities is diminishing at an increasing rate world wide. Without trust, no (contractual, personal or private) relationship can exist. This concept is deeply rooted in our politics, economics and critical to maintaining popular belief in the system.

To date, the Federal Reserve Bank tools have not worked which has caused them to fundamentally depart from traditional practice and policy, e.g. indirect intervention into the collapse of Bear Stearns (which sum have dubbed the end of global-free market capitalism) and unprecedented capital infusions and rate cuts. [1] As central bankers prove themselves ineffective, politicians exacerbate the problem by inciting national pride policies and disguise economic discrimination in the cloak of national security, e.g. the denial China's purchase of Uncoal, UAE's purchase of our Ports and Taiwan's acquisition of 3Com. [2]

Yes, these acquisitions cause alarm and raise significant and credible concerns, however, if our system is capitalism and our mission is the free flow of capital then our intrusions help materialize fears of our friends losing trust in our system. This will only give credence to our enemies' call for everyone to reconsider their relationship with us and may cause the US toward a more complex and difficult depression.

This is gravely problematic on multiple levels, the main ones being the erosion of confidence and negative impact on forming expectations. Between the US financial institutions exporting sub-prime products and CFIUS lurking along the coast line, foreign confidence in assisting the US financially (and politically I may add) is just not there. This is codified in the rampant rise in the Euro-dollar exchange rate and record reductions in the value of the dollar. Add the fury of nationalism and developing expectations becomes more of an art than science.

No macro or Google algorithm can entirely value the risks inherent in the "unknown unknowns". They will always be missing an unquantifiable variable and the data will be skewed by periods of euphoria or fear. This is not to discredit time honored observations that diversification lowers risk and correlations can insulate investment portfolios from broad swings; this is only to point out that the models are fragile abstractions of the full breadth of the real world.

The commodity market will remain bullish as foreign friends and foes reconsider their relationships with the US. Numerous market frictions caused by lack of trust and dwindling

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[1] These actions will only prove to exacerbate the problems in the years to come because we will later find out that the Fed transferred market risks from market players to tax payers. Granted they may be issuing loans against assets, but with regulatory changes permitting reclassifications of debt instruments you can expect off-balance sheet liabilities to be dressed up to fit the bill.

[2] Perhaps a more lighthearted example will do, how about rating agencies providing analysis services in conflict? Or gross oversights in corporate governance resulting in the loss of employee pensions for private parties? No matter the substance, the form is similar and outcome the same, that is, not good.

confidence has emboldened emerging economies to take greater ownership and pride in their goods and services. Their newfound sense of confidence and productive purpose will inevitably lead to new supply-side expectations of higher price thresholds (and living standards – we are not the only people that like nice things).

Enter stupidity-in-real terms. Commodity critics are failing to factor in that the rules to the game have changed. For example, Rio Tinto, Vale and Xstrata, Brasil's and London's largest mining companies, not only ended negotiations on their buyout deal, but have strategically refused to engage in traditional long term supply contracts due to lucrative spot market opportunities. This decision was not reached because of the fast money to be made, but to sustain the current price level while meeting domestic demand. We are already tempered to paying over $3.00 per gallon of gas when less than three years ago it was below $2.00 per gallon. No matter what happens, we all have to eat, stay warm and use energy for our shelter. Why not set new price floors when consumers demonstrate inelastic demand for raw materials?

The decision for commodity suppliers to break from traditional industry practices on pricing has made valuing commodities extremely difficult for the market. It has also made static executives exclaim, "I no longer believe in the market's self healing power"– here is a good example of the pitfalls of executive compensation. The market is healing itself to the detriment of more developed countries and to the benefit of emerging economies. The real problem is that the West is use to the East being poor and unable to purchase products. As more consumers come on-line, Eastern suppliers are adopting western strategies of "waiting to see" how many more consumers are coming to market domestically. Conversations with plantation owners revealed that 75% of their production is dedicated to meeting growing domestic demand. Further, their plans to expand production are set to accommodate domestic consumption only.

Growth in the emerging economies has prompted service providers to "collaborate" on how best to provide services to Indo-China and Eastern Europe instead of the ailing US. This is confirmed by Robert Wright in his article, "Economic worries set a cautious tone". He adds that there will be more shifting than we expect due to congested ports and increased costs due to (i) labor shortages, (ii) high fuel costs, and (iii) rising steel costs. For example, shipping lines such as CMA CGM, Maersk, and MSC have entered in an unprecedented co-operation agreement to cut-back on their trans-pacific business and share resources to deliver goods to other faster growing markets without compromising service. This is an Industrial Organization phenomenon and psychological boost to "Tiger" economies.

Do not be mislead, the market is healing itself…just not to the liking of conventional thinkers. Those chiding for a collapse in commodities prices are wrong. To discredit growing demand from emerging economies based on a US recession is reckless. Blaming speculation is a ploy to buy time to retool flawed quantitative systems. Of course speculators share some blame but not all. The real issue is that the roles in determining prices have been reversed and the rules are changing with terms of trade.

Let's consider the facts. Firstly, the Fed has not been successful and seems to be OK with inflation, which is not good. Secondly, CFIUS is alienating significant flows capital and creating unnecessary financial resentment.[3] In addition, foreign companies have adopted new strategies to

[3] Only Alabama's Senator Richard Shelby gets the point that collaborating with foreign friends makes them happy and not dwell on the crap we sold them! In terms of foreign foes, we need to take aggressive actions to persuade otherwise as kindergarten quarrels over their choice of government are not worth our blood and treasurer. If they

sustain their interests, i.e. OPEC's reticence to not pump more oil. Thus, it would be folly to believe that the commodity prices will collapse because they have been low in the past. Palm Oil at $400 per metric ton or Crude Oil at $30 per barrel is a distant memory. In the absence of confidence, the lack of trust and evolving expectations, we can reasonably predict that a price collapse in the commodity market is just plain stupid. It's almost as silly as believing that the MTA is going to increase service.

How we respond to the financial crisis and rise of the "Comodo Dragon" will determine its length and spread. So far, stupidity has dominated the discourse on how to revive the economy along with chatter about the unraveling of commodity prices. Instead, our response should be aggressive investment in Private Public Partnership projects beginning with expanding ports in the US and updating our energy distribution infrastructure. We need to press our elected officials to lower tariffs on commodity products as nationalism inhibits proper market participation, e.g. Brasil cannot sell a lot of its products in the EU or US without a 20% tax – that's an inefficient allocation of resources and certain deal killer. We need to be flexible and ready to embrace changes in both our lifestyle and economic position in the world as we are not the super economic power we delude ourselves to be. We need to upgrade and go green in warp speed! However, we must be prepared to accept higher commodity prices as a result of our attempts to fuel switch.

This crisis is "No Country for Old Men" because we have everything to lose and everything to gain. Only if we let go of the past focus on maintaining the constants of trust, confidence and expectations for the future will we get out of the jungle and into the clear.

Afterword: Technically this paper should be in the theme of Snatch since every player and their "grandmum" is in the market for the "diamond"…but the situation is so bleak that I had to call it what it is, No Country for Old Men. Thank Josef Ackerman. Also, I could delve deeper into the numbers but it would make this blog painfully longer. Should you desire such a commentary I will engage your queries.

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threaten our security…then we should defend our blood and treasure. But to take an imperialist position that the world needs democracy and only democracy…I'm not sure if that is proper as Iraq is draining the US economy only to leave the oil groups to "consult" on how to best utilize and access their oil reserves. Like Cai Guo-Qiang, "I want to believe" but the wolves continue to run "Head On" into the wall.