Why commodities cycles inflict pain (as we are now feeling)

InvestorIntel publisher Tracy Weslosky asked some pertinent questions on my posting Tuesday about low prices not, in the long term, affecting the validity of technology metals stories. In the 24 hours since I wrote that piece, we have seen the Chinese markets tumble further with 51% of A-shares in Shanghai and Shenzhen suspending themselves to avoid the carnage (boy, if only American stocks had had that option in October 1929). Then the base metals took more hits. Get this: in one session (Tuesday) on the London Metal Exchange nickel lost $1,050 a tonne. In one session!

Things don't look too good, in other words. Tracy asks when we will turn around: I don't know, and I doubt whether anyone else does either. But last year I self-published a short e-book on Amazon that attempted, not to explain what various metals do, but rather to pick some underlying, long-term factors that investors should keep in mind. Here's a short excerpt:

In 2013 David Jacks, an economics professor at Simon Fraser University in Vancouver and a research fellow at the Massachusetts-based National Bureau of Economic Research, put the metals world into some sort of perspective. As he pointed out, the global economy witnesses protracted and widespread commodity booms once in a generation.

He's right. As was shown two years earlier by McKinsey & Co in their study of commodity prices, if you look at a commodity price index graph then adjusted to *real terms* it shows that, until post-2001, the prices of commodities expressed in terms of a basket of currencies were at their highest in about 1910.

Then they declined, peaking (but to a lesser extent) again toward the end of the First World War. Then there were two deep, rapid declines: the post-war bust that began in 1920 and, of course, the Great Depression. By contrast, the Second World War (which began in 1937, 1939 or 1941 depending on whether you look at the conflict from the Chinese, British or American point of view), and then the Korean War, led to modest upward spikes, and we see that trend again with the 1970s oil price shock.

But David Jacks has looked at real commodity prices over 164 years (for thirty-two commodities ranging over animal products, energy, grain and metals – an assortment of hard and soft commodities). From this, he argues that we, too, often confuse cycles with trends. Just since 1900, and based on 2011 prices, real commodity values have risen 244.69 per cent (177.59 per cent since 1950 and 38.9 per cent since 1974).

Before you start scratching your head and saying that last figure can't be right, Jacks then shows how it is 'commodities to be grown' which have performed far worse than 'commodities in the ground'. Since 1974, grains, animal products and other soft commodities have actually seen a secular decline in real terms. Taking a base of 100 as at the year 1900, the soft commodities had three substantial peaks between 1900 and 1974 (which has given the overall index the good numbers above) and then declined from around 150 in 1974 down to that base of 100 around 2000 – neatly having them back at the same place as they were 100 years earlier.

But the metal and energy commodities show quite a different pattern. From that same 100-index starting point, the index rose to about 150 only once (during the First World War) and in 1974 was pretty well back at the 100 level. But in 1980 (no doubt spurred by the oil shock of that time) the 'in the ground' commodity index hit 350. However, it took a few blows after the 1987 crash and by 1998-99 was back close to the 100 base of 1900. We know what happened then. By 2007-08, the 'in the ground' index hit 400 as the resources boom hit.

However, Jacks does offer a word of caution. The recent boom, he believes, is largely a recovery from the prices nadir which occurred around the year 2000 – the first decade of this century being part of a cycle, and is likely near its peak (a view which seems more plausible as we headed into 2014 and prices plateaued). By contrast, there has been a long-run trend across the index of the thirty-two commodities for an uninterrupted rise since 1940. That's the trend.

Finally, back to that 2011 McKinsey report. It predicted steel demand would rise eighty per cent between 2010 and 2030 during which time three billion more middle-class consumers will be walking the planet. That's a trend, not a cycle.

The cycle part of the equation, however, is sure to inflict some pain in the shorter term.

But is the super-cycle over? Not according to JP Morgan analyst Colin P. Fenton in his 2014 commodity outlook. He writes: 'It has become popular, especially in the generalist media, to say that the recent commodity super-cycle is "over", meaning that it has "stopped". Upon reflection, it should be obvious that this claim is too glib. By definition, market cycles never stop'.

Fenton goes on to argue that the relevant question is *where* we are in the current market. And if the correct answer is that a given commodity super cycle has ended, then by definition it also means the next super-cycle has begun. He believes there has been a failure to define what a commodity super-cycle actually is: it is not 'a period when commodity prices rise every year'. The present super-cycle, in his view, began in October 1999, when spot and forward commodity prices arrived at multi-decade troughs. The super-cycle entered its steep ascent phase for spot prices in 2004. Fenton concludes: 'It is correct to say that this phase has ended. However, this does not mean the super-cycle has arrived at its “end”: we project that trough will not occur until 2028 or 2029’.

So, there you have it: another 14 years (at least) to go.

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