

# Long View: Classic films shed light on commodities boom

By John Authers, Investment Editor

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In *Jean de Florette*, a great French film of the 1980s, Gerard Depardieu inherits a farm in rural France but fails in his dream to grow flowers there because jealous neighbours have blocked the secret spring on which it relies for water. He dies of frustration.

In *Trading Places*, a great American comedy of the same era, Dan Aykroyd and Eddie Murphy plant false information, then hurl themselves into the trading pit. Murphy is a trading novice but makes a fortune in frozen concentrated orange juice futures and lives happily ever after.

These are allegories for two narratives now being offered to explain the boom in commodity prices. Its consequences – with riots over food prices round the world and fears of a global slump – already have the makings of a Hollywood epic. Normally, investors assume that commodity prices broadly follow economic activity. Real commodity prices and bond yields, also sensitive to the economy, rise together (when the economy is expansive) and fall together when money is tight.

But bond yields are low while the oil price is nearing a once-unimaginable \$125 per barrel. It has gained 150 per cent since January of last year. Not even the explosive growth in China can explain this.

The weak dollar is important. The US is responding to its difficulties by allowing the dollar to weaken. As commodity prices are denominated in dollars, that means they have to rise.

Hence, in the words of David Ranson of Wainwright Economics: “Cheap-dollar policies pursued in the halls of the US Treasury, promoted by congressional protectionists and supported by Ive League economists have created a mortal threat to many of the world’s poorest people.”

For months, when oil prices have risen, almost invariably, the euro has gained against the dollar. The weak dollar and strong oil price are linked. But in recent days, the euro dropped sharply against the dollar while oil set fresh highs. The weak dollar alone cannot explain the commodity price rise.

Instead, the debate is narrowing around two explanations. The *Jean de Florette* thesis is that supply is being tightly constrained. The *Trading Places* thesis is that the new speculative money moving into commodity futures has distorted the market. The former leads to tragedy – a return to the 1970s, with commodities fuelling inflation while imposing a brake on growth. But the latter does not have a happy ending. Instead, commodities’ new investors could lose their shirts as the bubble bursts. How does the evidence for the two hypotheses stack up? UBS details the constraints that are stoppering up the supply of oil. The big oil companies have made their plans on the assumption of \$60 per barrel oil, it takes time to develop new supply, and so there is little relief in sight. According to UBS, 72 per cent of new global supply in the foreseeable future will come from just eight companies.

Moreover, supply is further constricted by resource nationalism, with many countries taking steps to assert control over their resources. Protectionism pushes up food and oil prices.

What of *Trading Places*? Institutional and retail investment in commodities has shot up, lured by research that shows commodities can diversify a portfolio, and by “performance-chasing”; money pours into sectors that have made money. Fund managers cannot take physical delivery of commodities and lack the ability to do detailed research. So money pours into passive indexing strategies, using futures. According to Philip Verleger, a consultant, the amount invested that way has multiplied by five, to about \$250bn, in just three years.

But futures were meant as a vehicle for producers to hedge against changes in prices. Now that commodity-linked instruments are “considered an investment rather than risk management tools”, says Mack Frankfurter who runs Cervino Capital, a commodity hedge fund, “this has been causing a self-perpetuating loop of ever-higher prices”.

If this is *Jean de Florette*, there is no short-term solution – the world has to work on building supply. If we are in *Trading Places*, the solution is to reform regulation, making it harder to play in the commodities futures markets. Murphy might have found it harder to make his killing if there had been tighter limits on “trading on margin” (trading with borrowed money).

Neither story explains everything. Tim Bond of Barclays Capital says many commodities that cannot be traded via futures and are closely held, such as tungsten and cobalt, have risen as much as mainstream commodities. Speculators have nothing to do with this.

Mr Frankfurter points to the response in 2006 when Goldman Sachs, which oversees the most widely followed commodity index, reduced the index's weighting in gasoline futures. It led to an unprecedented sell-off as index funds cut their holdings of gasoline futures: tight supply had nothing to do with it.

The sad fact is that both allegories worked well. The commodity boom is both a farce in the US markets and a tragedy for the poor trying to work the land. [john.authers@ft.com](mailto:john.authers@ft.com)

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