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Commodity Bubble ?

After the technology bubble in the late 1990s and the recent housing bubble many investors are wondering if commodities are the next bubble to burst. Bubble economics require two conditions: high valuations and unsustainable fundamentals. These conditions were present in the technology and housing bubbles. The case for the commodity markets is less compelling.

Looking back it is "obvious" technology stocks were in a bubble. Funny, however, how most pundits were bullish on tech stocks for most of 2000. The difficulty in recognizing the tech bubble when it was happening was that the industry fundamentals were fantastic. Venture Capital money poured into Internet-startups which used the money to buy advertising and computer equipment. Feeling a bit panicky Corporate America did the same thing. Most large-cap tech stocks had tremendous revenue and real earnings growth even in late 2000. For example, in the September 2000 quarter Sun Microsystems' revenue grew by over 60% while its earnings grew by over 80%. The reality that doesn't get a lot of attention is that tech company's *fundamentals* were in a bubble. Investors placed a high multiple on bubble fundamentals just as the fundamentals collapsed. The result was an 80% decline in the NASDAQ.

A similar situation occurred in the housing market. Rising home values and falling interest rates drew in speculators who abandoned the stock market after the nasty 2000-2002 bear market. Easy - or the more cynical might say irresponsible - financing caused housing turnover to be artificially high and prices to rise to unsustainable levels. The fallout is the same: an unprecedented drop in home prices and sales activity.

The argument that there is a fundamental bubble in the commodity space is not clear cut. There is no arguing that commodity prices have risen significantly over the past few years. However, this episode followed a multi-decade period of soft commodity pricing. Over the last 35 to 40 years, commodities have fared poorly, generally breaking even against inflation.

On the demand side, it is hard to imagine a significant retreat anytime soon given the infrastructure build-out occurring in the emerging economies. Commodities are critical building blocks in the industrialization and urbanization of emerging economies. China alone has been responsible for 50% of the increase in global primary energy demand since 2000 (the same can be said for almost any commodity or mineral). China will spend hundreds of billions of dollars building rural roads, expressways, railroads and as many as 97 airports. Russia has plans to spend about $200 billion, about a sixth of gross domestic product, for infrastructure projects over the next ten years. One company in Brazil, Petrobras, is scheduled to spend $112 billion dollars over the next five years to develop potentially huge oil fields off of their coastline. According to the International Energy Agency, the global energy sector alone needs $22 trillion over the next two decades to meet the anticipated rise in primary energy demand. After years of neglected even the developed countries like the U.S. need to crank up their infrastructure investment. The American Society of Civil Engineers forecasts a total infrastructure investment need of $1.6 trillion over the next five years. This broad based demand is unlikely to go away like the demand for technology equipment in the recession of 2001 or housing more recently. This demand is secular, not cyclical, and therefore has staying power.

Commodity prices would not be rising even with the powerful demand situation if there was an easy supply response. The surprise this time around is the extent of production disruptions and delays to new capacity as the hurdles to developing new mines increase. Bringing new supply to the market is expensive due to shortages of just about everything from tires to people. Many of the new mines are difficult to develop increasing the marginal cost of extraction which suggests that higher prices are here to stay.

Inventory levels are further evidence against a bubble scenario. At some point irrational commodity pricing would result in growing inventories but that is not the case. Physical stocks are low, with material on the London Metals Exchange at less than one week of western world demand. Most industrial metal inventories are at a 30-year trough relative to consumption. Global grain inventories are at 40-year lows, equivalent to just 15-20% of annual demand.

Even though the long-term commodity story is bullish investors should expect lots of volatility. One way to play this secular trend is through mining, energy and infrastructure companies, many of which are more tied to the significant infrastructure build-out than to commodity prices.

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