Booming Commodities and an Anemic Economic Recovery
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Dear Fellow Investors:

At a recent institutional investor conference one of the speakers was the economist and chief investment officer of a major institutional investment consulting firm. He recounted that in late 2008 his firm recommended that institutions overweight commodities. This was based on all of the liquidity provided to the financial system around the world by governments seeking to combat the deflationary affects of the deep recession. He went on to say that his firm was staying with that over-weighted position as of December of 2010 despite how successful the strategy has been. From there he described how anemic this economic recovery in the US is compared to past recovery periods following deep recessions. Slow GDP growth, persistently high unemployment rates and virtually no contribution from home building led him to believe the economic recovery would remain anemic. Why would this respected firm stay with the commodity over-weight position?

This got us thinking about other times in history when there was a big disconnect between commodity prices and US economic activity. Commodity prices boomed in the late 1970's as the US wrestled with stagflation in the presidential term of Jimmy Carter. Back then an army of baby boomers were forming households and having children. The demand for real estate and most other product categories far exceeded the supply. The US economy could not provide jobs fast enough to the waves of high school and college graduates to prevent high levels of unemployment. The industrial revolution was dying (Allentown) and the information technology revolution had not yet replaced it. Inflation was the national bugaboo and investors adapted by spending the decade of the 1970's moving out of stocks into "inflation beneficiary" investments like gold, real estate and other commodities. Most historians believe it came to an end when Fed Chairman Paul Volcker tightened credit enough to produce a 21.5% prime interest rate and President Ronald Reagan stood up to the Air Traffic Controllers Union in 1981.

Why does the US have late stage economic boom commodity prices with an anemic economic recovery? At the margin, commodity prices are where they are because of the uninterrupted economic boom in China and the non-economic asset allocation decisions of institutional and individual investors. China has grown at very high rates for over a decade and they have convinced otherwise sensible investors that they are the first capitalist economy in history which can figure everything out ahead of time. Most institutions have invested in commodity indexes as a passive way to participate in commodities. In this way, they are adding capital to this asset class without regard for any differentiation among the individual commodities. It reminds me of the faith in indexing executed through the S&P 500 Index back in late 1999. It was over-weighted in Technology back then in much the same way that most of the commodity indexes are over-weighted Oil today.

Since it is China's boom driving the psychology of the investor attitudes about commodity investing, you have to look at where China is in their business cycle. They have moved from an export driven economic growth model to an infrastructure/real estate building model. They have accelerating inflation, 40% year over year housing price increases in its largest cities, unaffordable housing in relation to average annual household income and universities pumping out graduates moving to the cities to find no jobs to match their skills. They've built so much infrastructure already that they have the world's largest and emptiest mall and a number of ghost cities sprinkled across the country.

It so much reminds me of Phoenix, Arizona back in 2005. The Chinese economy is strong because residential real estate is smoking hot and the residential real estate market is doing well because the economy is doing well. Real estate market participants in Phoenix, who had the most to gain from housing prices moving up as much as 47% in 2004-2005, told us not to worry. They could see what they thought was a never ending stream of retirees moving there from cold weather states. In China, it is the peasants moving from rural farms to the major metropolitan areas. The theory is they will move there to get jobs in manufacturing and continue to provide their economy with cheap labor.

China's economy is like a game of musical chairs. First, you remove the export growth chair. Then you remove the real estate chair and finally economic growth has no place to sit down.

All of this wouldn't matter if China wasn't already tightening credit to deal with the potential social unrest from rising inflation. They have been raising reserve requirements and central bank interest rates, but trying to do it in a mild enough fashion to attempt to engineer a soft landing. The average price of residential real estate in China was 8.2 times average household income at the end of 2009 before 2010's big run up. At the peak in 1990, Japan's housing bubble burst at 8 times household income and peaked in the US at 6 times. History would argue that the bigger the bubble, the harder the landing. China's real estate bubble looks like five-year old children playing musical chairs with tall bar stools.

When it comes to over-extended markets and economies, our job as value investors is to determine whether something will happen and not be as concerned with when. Despite not knowing when, in our minds, it is only a question of how many months before the credit tightening becomes aggressive in China. This puts us closer and closer to a Paul Volcker style replay in commodity markets. Gold and Oil dropped 70% from the 1980 peak to the 1999 low. It was the definition of a bad long-duration asset allocation.

Therefore, here is our recommendation: Avoid all China-related stocks, commodities, basic materials, emerging markets and countries which have benefitted the most from China's uninterrupted growth. Prepare for the US economy to benefit from lower commodity prices over the next 3-5 years as those essential ingredient prices match up with our slow economic recovery. Lastly, always remember to flee investment momentum which divorces itself from underlying economic fundamentals.

Best Wishes,

William Smead

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