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Wednesday, October 28th, 2009

Low commodity inventories create uncertainties - Krom River

Commodities stocks were at capacity in 2008 (i.e. everything that was produced was sold), commodities reached the top of their price range, inventories were low, people told Opalesque around the coffee table at Wednesday's Jetfin conference on commodities and energy in Geneva.

Now, lower demand in commodities, the credit crisis and low inventories may lead to higher demand next year and price hikes - as production will need time to catch up with demand. The optimistic view for 2011-2012 is that stocks will be at capacity again. Although it is difficult to predict as commodity markets are unpredictable for day to day (swayed by politics, weather, GDP, inflation... which affect prices and demand).

But not everybody is optimistic.

Krom River: expect more commodity price shocks.

Chris Brodie, founder of Zug, Switzerland-based hedge fund house Krom River (which used to be based in London), explained to his audience at the conference the way to understand commodity price behaviour:

- Commodities are mean-reverting - as they are priced off the marginal cost of production, which fluctuates due to the economic cycle, technological innovation, new discoveries and political events.
- Commodities, when supply-stressed, are priced off the marginal cost of consumption and experience price shock.
- Once consumption has been deterred by price shock, the price mean reverts to the marginal cost of production - which now is lower due to lower demand.

In short, commodities tend to spike up and then go back down to the base - time and again.

He noted that if the dollar goes down, say, by 50%, commodity prices will go up by 100% just to keep the levels.

Bloomberg reported on Monday that Krom River Trading AG, which has \$590m, had lost 8.1% in its raw materials fund in September. The Krom River fund, started by Christopher Brodie in 2006, is up 3.2% this month and returned 37% last year.

The Great Moderation has led to anemic inventory builds, Brodie said during his presentation.

Something that would have a main macro impact on demand is the dollar. Brodie believes that, whether the U.S. will succeed in selling enough debt or not, they will go bust and the dollar will go down.

U.S. interest rates' fall has forced global interest rate fall, creating emerging economy boom, and reducing commodity build. And U.S. interest rate's fall has forced the dollar lower, making dollar-traded commodities cheaper for emerging economies.

The real growth, going forward, will come from emerging economies, which consume commodities up to three times faster than OECD economies.

According to Bodie, the next upturn of the cycle will lead to renewed commodity price shocks, in particular in copper.

Copper is currently trading at around \$6,500 per tonne. Copper prices have more than doubled this year, boosted by a weak dollar, strong investment interest and record imports from China, the world's biggest metals consumer, reports Commodity Online today. Earlier this week, data showed China's refined copper imports surged by more than a quarter in September; defying calls for a drop in second half imports and sending copper to 13 month highs. Investors are now waiting to see if the Chinese will continue buying in November.

Bodie finally raised an interesting question with regards to inventories. The current ones are low (just as demand from emerging economies has increased). If we can't have full inventories during a recession, what happens when the recession stops?