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We are in the midst of a real commodity shock: Prof Chalmin

Professor Philippe Chalmin, an economics and commodity expert from the University of Paris Dauphine, thinks that we are in the midst of a real commodity shock. "The tension within all the commodity markets is probably at its highest since the beginning of 2008, and also since the early seventies," he told the audience at yesterday's JetFin conference in Geneva.

According to his France-based research firm CycloPe, commodity prices rose by 30% in 2010. This is an average of well-quoted commodity prices, in an index in U.S. dollars. "And the U.S. dollar itself is, by the way, a commodity," he added.

In 2010, world commodity prices were almost as high as those in 2008, and in January 2011, price levels were higher than they were in 2008. "And this is especially the case if we take out oil," Chalmin added, as the increases were mainly in food and metals. The crisis is over but we are still in a commodity shock, he stressed.

Oil prices look, in comparison to foods and metals, almost stable. Although he pointed out "today we don't know what the price of oil really is." Also, Brent (on the European markets) is in backwardation, and WTI (on the U.S. markets) in contango, "which is a bit of a problem at the moment."

Oil has been extraordinarily stable in the last 18 months, even with the ongoing geopolitical risks. This stability is all the more impressive when looking at the rest of the commodity market. This is due to a large capacity of protection to cope with new demand, especially from China. There are a lot of reserves in Saudi Arabia for example. Chalmin believes we should have a stable oil market in the near future.

There are also other sources of energy, one of which is the increasingly popular natural gas, which in the US, is currently one-third the price of oil. Because of gas reserve discoveries in the U.S. for the first time cargos of energy are exported from the U.S. to Europe and Asia. The Wall Street Journal (WSJ) said in 2009: "the U.S. is now swimming in natural gas," as new discoveries were made in Louisiana, Texas, Arkansas and Pennsylvania. More recent discoveries have been made elsewhere in the world, such as in Israel and Mozambique.

Natural gas is slowly taking over the whole energy complex, noted Chalmin, and this should be taken into consideration when looking at oil prices.

Then there is coal, and its price has been rising slowly due to high demand from China. Indeed, China's coal reserves and consumption no longer match. Its net coal imports exceeded 106 million metric tons in the first nine months of 2010 (higher than the whole of 2009) and state companies have been aggressively buying coal assets from abroad, according to the WSJ. But as most of the coal imports come from Australia, the recent floods meant that imports have decreased and coal prices have increased from \$89 per metric tonne up to \$120, said The Street last month.

Non-ferrous metals are back at their May-2008 levels, said Chalmin, in tune with world economic growth and speculation. Although, "It is not entirely caused by speculation," he added. He believes that some regulations should be introduced in the commodities market, especially in

Europe, as high volumes and large holdings can sometimes be a problem.

"The more speculation you have, the better the market behaves, and the most efficient it is," he explained. However, as well as the lack of regulatory agencies in Europe, the current development of trackers and ETFs based on physical positions can be an issue: physical stocks can be frozen and held up, just when they are needed by buyers.

The most striking case, among metals, is copper, Chalmin thinks, as its prices have fluctuated for a very long time. The cash cost of production averages \$2,000 a tonne (in any case, no more than \$5,000); it sold at \$9,000 a tonne in 2008, and at \$10,000 in January 2011. "This is extremely high," said Chalmin. From a fundamental aspect, it can be explained by a lack of supply and high demand (again, especially from China), as it is used to make electrical wires.

At what level of prices will you have start going for substitutes? And for those metals that cannot be replaced, can prices go any higher? He asked, quoting a recent Barclays forecast that sees copper go up to \$13,000 a tonne by Q4-2011 (averaging \$11,000 in the year). "This is crazy because we don't know what will happen with the elasticity of demand," he said. "We don't know how high we can go, but trees certainly never reach the sky."

He would short tin as it is now overpriced at \$30,000. "Tin is used in tin plates, but we use less tin in tin plates; it is also used in electronics, but it can be substituted? The price is completely crazy," he explained.

The price of rubber almost doubled in 2010, and this market is not very liquid. Considering that each car has five tires, and that last year 60 million cars were sold in China, the demand is really high. However, there are not enough developments in rubber production to cope with the demand, which is why prices multiplied by ten.

Cotton has never been so expensive since the end of the 20th century due to high demand. Wheat's prices, now at around \$9 a bushel, are linked to the current climatic situation. Corn is linked with energy, as a third of it is used to make ethanol. Soja's prices, at around \$14 a bushel, are linked to high Chinese demand. And sugar is also affected by climate and rising demand.

Freight is the only declining commodity; its decline at the end of 2008 was the most extreme in the whole commodity market owing to a lack of trade. However, due to the recent arrival of new ships on the markets, shipping costs are still so low that most ship owners are losing money right now.

Growth forecast

on the fundamental level, demand will be driven by the world economic growth, which is expected to be 4.8% this year. But one has to bear in mind China's "extraordinary" industrial production, which is driving demand for commodity. "I think this will continue in 2011. Although I am not sure about China [s demand] as it is an opaque country; we know there has been some de-stocking, so there will be some re-stocking. But don't imagine that the China story is rational."

Chalmin cited the 50 million tonnes of iron ore imported in China in 2009, compared to the 650 million imported in 2010 (driven by steel demand). China's iron ore imports surged 48% (68.97 million tonnes) in January 2011, compared with a year ago, as traders replenished stocks in expectation of rising ore prices, reported China Daily yesterday.

Chalmin's economic forecast is 4.4% for 2011, skewed towards emerging markets, and job recovery in the U.S.

On the supply side, climatic conditions are important, even for minerals. "As far as food is concerned, we are in a tight spot," he said. "Prices will rise this year if crops are not perfect. The food market is highly tense."

One of the issues we will face on the commodities front is that as the time frame of investments in commodities is usually long-term (it takes 15 years to get a mining project to full capacity for example), we are now paying for a lack of investments done at the end of the 20th century. And there are still not enough investments done now.

Another issue is that commodities are a curse for producing countries; indeed they are the key for understanding geopolitical tensions.

"Commodities are a new class of assets," he concluded.