



Commodity Markets Gain Popularity with the Economy Facing Stagflation

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Among the largest pension funds in the world, the \$240 billion California Public Employees Retirement System (Calpers) says it may increase its commodities-based investments some 16-fold to \$7.2 billion through 2010!

This begs the question: If Calpers is contemplating a substantial increase in its allocation of commodities-related investments, how might that speak to the choices available to many individual investors as yet unfamiliar with alternative investment opportunities? We believe this evidence suggests suitable investors ought to consider using commodities, a non-correlated asset class to stocks, to balance their portfolios.

Investors should be aware that trading futures and options involves substantial risk of loss and is not suitable for everyone.

New Investment Era

Investors are, by necessity, coming to terms with the "new investment era." Ignoring warning signs may not be the prudent thing to do. With AAA rated, insured, tax free municipal bonds down over 10% year to date, A-rated securities on sub-prime mortgages issued in 2007 down a whopping 88%, and even guaranteed government securities showing losses after inflation (interest rates on two-year U.S. Treasury Notes are under 2%; inflation is 4.28%), heightened risks abound in virtually all investments.

The 1980s

Many of us remember the year 1980, when inflation last reared its ugly head and reached a high of 14%. It was 1980 when key commodity prices surged to record highs led by gold, oil and grains. It was left to Federal Reserve Chairman Paul Volker to tame prices by sharply raising interest rates. The prime rate rose to a record 20% on April 2, causing the commodity bubble to burst and leading us into recession. After a painful "cleansing" period, the stage was set for one of the longest periods of economic expansion and the biggest increase in stock prices.

Once again, we are facing record high commodity prices led by gold, oil and grains. Prices of key commodities have even exceeded their historical highs reached in the early '80s!

However, interest rates now hover near record lows, with a weakened economy on the brink of recession. And we are presided over by a Federal Reserve that has virtually abandoned its vigil against inflation in favor of preventing a recession—with record high commodity prices adding insult to injury.

Stagflation

Instead of “biting the bullet” and raising interest rates to fight inflation as exemplified during Volker’s tenure with the central bank, current Fed Chairman, Ben Bernanke is actually lowering them, adding more fuel to the inflationary fire. **Wasn’t it record low interest rates that led to the real estate bubble which, as it deflates, is spreading its contagion throughout the economy? Rather than cleansing the economy of its speculative excesses, Mr. Bernanke has, in our view, chosen to try to evade the historical economic cycle of growth and recession with another “quick fix”. In the process, he is prolonging the agony of a deteriorating economy, potentially making things far worse!**

History has demonstrated that economic cycles of growth and recession are unavoidable. Periods of boom ending with periods of bust are integral components of any and every economic cycle. **While down cycles may be temporarily avoided by the manipulation of interest rates, in the long it tends to make matters worse.** Regardless how much intervention comes into play to prevent the consequences of rampant speculation a cleansing process, in the form of recession, will almost always result.

We strongly believe the consequences of lowering interest rates to near record levels, in the face of record breaking commodity prices and rising inflation, will be stagflation. Stagflation is not good for the economy or the stock market! The drawn out process of a collapsing real estate bubble, unwinding of mortgage-backed securities, and mounting inflation will keep stocks under pressure for some time to come!

Commodity Outlook

Twists and turns in the economy notwithstanding,

supplies of commodities are expected to remain tight with burgeoning demand from a rapidly growing (and commodity-consuming) middle class of 3.4 billion Asians, led by China and India. **To many analysts it’s not a question of if the rate of consumption of ‘energies’, metals, grains and the like will increase—it is simply by how much?**

We, like many informed investors, take our counsel from those, like Jim Rodgers, noted investor and former partner of global financier George Soros, who believes that demand will firmly underpin the commodities markets for years to come and the present bull market could continue its run all the way to 2022.

Investors should be aware that past performance is not indicative of future results. Trading commodity futures and options involves a substantial risk of loss and is not suitable for all investors. An investor could lose more than the initial investment.

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