Forbes.com

Preparing For The Bull Market

Hungry For Raw Materials

Melinda Peer, 05.19.09, 6:00 PM ET

The credit and liquidity droughts of 2008 and early 2009 merely interrupted the grander narrative of the global economy--the building of infrastructures throughout the world and the demand for commodities that goes along with that.

Raw materials prices are on the rise. The Rogers International Commodity Index, which represents the value of a basket of commodities consumed globally, has gained nearly 10% since the beginning of the year, compared with the S&P 500, which has only added 2.8% in the same period--prompting some analysts to call a bottom on commodities prices and leading others to proclaim that an economic rebound is imminent. Copper, a trustworthy barometer of industrial needs, has been one of the year's biggest gainers. The handy metal is used in everything from electricity and infrastructure to computers and water pipes; its steady rise typically heralds an economic turnaround.

But for every futures foreseer willing to suggest that the worst is over, there seem to be just as many opposing voices warning of false starts. Copper and soybean rallies have faced particular scrutiny, since they've been largely supported by Chinese interest and investors suspect the country is merely stocking up on supplies--not responding to a real demand revival.

"That's what they always say in the beginning of the bull market," said Shawn Hackett, president of Hackett Financial Advisors, who believes the commodity bull market officially began a few months ago based on his analysis of money flows showing that commodity buyers are buying more aggressively than sellers are selling. "No one ever believes a bull market until it's well underway. The more people claiming it's not, the more optimistic I become."

Jim Rogers, hard assets authority and author of *Hot Commodities*, never lost his optimism. He contends that the previous bull market never ended and likens current doubt surrounding commodities' prospects to those who sold off stocks in 1987 only to miss out on 1000% growth.

"The strong fundamentals behind commodities haven't changed. All the things that have been going on the past 30 years are still in place," Rogers noted. "Agricultural supplies are at their lowest in decades. The fundamentals didn't collapse during this last crisis, there were just huge liquidations everywhere causing price declines."

"If anything," Rogers continued, "the fundamentals have actually improved because global supplies are still at record lows but because of credit conditions, farmers can't get loans for fertilizer now and no one can get a loan to open a mine. Since it takes anywhere from 10 to 20 years to open a new mine, all the current mines are getting depleted." Under such conditions, basic supply and demand fundamentals dictate that commodity prices are set to soar--high enough to challenge records set in the summer of 2008 before soured credit conditions roiled global financial markets, according to Rogers.

Furthermore, stronger commodity prices are expected to occur regardless of economic turnaround since policies that debase currencies inevitably lead to higher prices on hard assets.

"Throughout history, whenever governments have printed money, it has led to higher prices on real things, and currently you have governments all over the world printing money," Rogers said. "If you're going to sell something, sell your stocks, because if economies are going to get better, then commodities will lead. And even if economies don't improve, commodities are still the place to be because of the printing money situation and because of the supply situation."

After a period of curtailed production and delayed capital spending, markets could be jarred by supply scarcities at a faster-than-expected rate, depending on how quickly demand recovers.

"It's not a demand story at this point; it's a supply story," said Theresa Gusman, head of global commodities at DB Advisors, who notes that global depletion rates have been accelerating. According to Gusman, commodities with higher inventories and excess production capacity--like aluminum--will maintain lower prices for longer.

Even if energy and industrial metals are among the first commodities to regain pricing strength, as is typically the case, analysts predict that soft commodities such as coffee, cocoa, cotton, orange juice and sugar will produce the most impressive returns this time around.

"These markets were underscored during the last rally, but I think they'll be some of the biggest gainers in the next rally," said Sterling Smith, vice president of FuturesOne. "These markets have fundamentals that would lead them to surge regardless."

Smith is particularly bullish on coffee, since bean production is down roughly 20% this year. Coffee trees are in the final year of a four-year cycle, making it a lower production year anyway. Further depressing yields are weather problems in Vietnam and Central America. Columbian output is weaker since farmers there couldn't afford to apply as much fertilizer. And since most coffee drinkers consider their daily caffeine jolt nearly as essential to global productivity as crude oil, they won't be easily deterred by higher prices. That should make for an interesting market, according to Smith.

With China developing a taste for chocolate and India importing more sugar to satisfy the subcontinent's sweet tooth, scarce soft agricultural supplies are expected be in strong demand in the coming years.

"We never built up inventories on a lot of the soft commodities, which means that we're going to encounter some scarcity issues pretty quickly," Hackett said.

Unfortunately, since softs haven't yet had their time in the spotlight, there's a lack of smart investment vehicles to gain direct exposure to these commodities.

"The problem with 'soft ags' is that it's harder to get in on them," Hackett said. "The exchange-traded notes for softs are a terrible deal since you don't own the futures contract; you own the bond that's supposed to track the commodity's performance, but your investment is only as good as the bank that issued it. With these products, you're essentially a bondholder of the bank that issues the note."

Unlike the popular gold exchange-traded trust, the SPDR Gold Trust, which holds gold and directly tracks the precious metal's price movements, there isn't an equivalent investment vehicle for softs. Additionally, commodity indexes are more heavily weighted toward energy than soft commodities.

Hackett, however, recommends a commodity index over soft agriculture ETNs since he's wary of the banking sector. Unlike mining companies, which respond to the performance of metal prices, there aren't many stocks offering the same exposure to soft commodities' price movements. Of course, investors can always gain direct exposure to softs through futures contracts, but these investments require a lot of research and aren't recommended for casual investors.

"There isn't a lot of interest in softs. My contention is that this next rally will change that and better investment vehicles will likely come out of that," Hackett says. "But by then it will be too late."

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