



David Donora  
Head of Commodities

## COMMODITIES – AN EFFECTIVE HEDGE AGAINST INFLATION JUNE 2011

Commodities have long been recognised as a credible hedge against inflation, especially unexpected inflation. Recent volatility and an unexpected resurgence of what appears to be cost push inflation raises the question: is this still the case? I contend that commodities continue to provide protection against inflation and its destructive effects, particularly as long as emerging markets growth remains robust and developed market governments continue to deploy unorthodox economic policies.

### **Key driver 1: emerging markets demand**

Rapid emerging markets economic growth has been a key driver of the recent rise in commodity prices. China accounts for the vast majority of commodity demand growth over the last decade, becoming the world's largest consumer of energy and industrial commodities. With urbanisation set to forge ahead there, followed by other countries such as India, demand for natural resources is set to continue to increase.

Emerging markets growth is highly commodity-intensive owing to the need to build infrastructure and improve the living standards for nearly half the world's population, so this trend appears well entrenched. Additionally, the extraction and production of hydrocarbons, particularly crude oil, is becoming increasingly difficult - current global demand for oil, at over 90m barrels per day, is approaching global production capacity. This leaves price as the only instrument to ration demand. Moreover, while energy is subsidised in many emerging market countries, and therefore not really a driver of inflation, higher world prices do not necessarily reduce demand there.

Commensurate with this growth has been relatively high inflation and, although China has been tightening monetary policy since early 2010, this is only a normalisation of policy following the tremendous fiscal stimulus of 2009, and only slightly mutes the second key driver of inflation.

### **Key driver 2: declining US dollar**

The long-term value of the US dollar and its position as the world's reserve currency is being compromised through continuous issuance of debt at the Federal, State, municipal and consumer levels. On the current path, the best case scenario is that there will be a sustained decline in the value of the dollar. With commodity prices denominated in dollars, this means that the price of commodities will continue to climb. Other scenarios include the possibility of a US debt and currency crisis, which abruptly dislodges the dollar's reserve currency status and has broader implications for the global economy.

With these two macro drivers firmly entrenched, commodities will continue to be an effective store of value. This was well demonstrated by the 30% rally in commodity prices during the second half of 2010, which drove inflation higher globally in the first half of 2011. Given that investors can easily allocate 5-10% of their diversified portfolio to commodities, one has to ask why an investor would not hold part of their portfolio in the instruments whose prices cause the inflationary impact. This is particularly relevant for investors for whom inflation is an important component of their liabilities, such as pension funds. It would be difficult to justify not holding an allocation to the asset class that is most likely to cause an unexpected inflationary impact.

### **The return of geopolitical risk**

If 2010's commodity price increases were driven by global demand and exacerbated by weather effects, 2011 has seen the resurgence of geopolitical risk as a market driver. The 24% increase in the price of crude oil in the first quarter of 2011 served as a gentle reminder of how powerful these forces can be. Late in 1973, after the US government had imposed price controls on oil in response to rapidly rising inflation, OPEC placed an embargo on selling oil to the US and increased the price of crude by 70%. Fast

forward from October 1973 to January 1974 and the price of oil had increased from \$3 to over \$11 per barrel. A similar price shock was experienced after the Iranian revolution in 1979.

The response to an inflationary shock has historically been to raise interest rates, best exemplified by Paul Volker's assault on US inflation pushing 3-month US government bond yields to over 15% in 1981. This response would then benefit investors who could increase bond holdings once their yield had risen in response. Currently, there appears to be little prospect of developed economies increasing rates, which has a degree of logic, considering that the incremental demand for resources is being driven out of emerging markets.

#### **Unsustainable debt**

Additionally, given that much of the developed world is creaking under the weight of an unsustainable debt burden, the politically (in the short-term at least) less painful path is to allow the purchasing power of the currency to decline. This means that interest rates are unlikely to increase enough to attract capital back into cash for anything other than short-term tactical positioning. This is likely to lead to higher levels of volatility in commodity prices as financial flows wash in and out of the markets. However, until there is a credible and sustained effort to strengthen the dollar through higher interest rates, increased taxes and decreased public sector spending, money will be invested in hard assets. The risk of sharp increases in commodity prices therefore remains greater than normal.

#### **Conclusion**

Looking forward, while the risk is that we have to contend with a more volatile world, commodities continue to provide an effective hedge against inflation.

**For Investment Professionals use only, not to be relied upon by private investors.** Past performance is not a guide to the future. The value of investments and any income from them can go down as well as up. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. The mention of any specific shares or bonds should not be taken as a recommendation to deal. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Investment Services Limited. Registered in England and Wales, Registered No. 3701768, St Mary Axe, London EC3A 8JQ, United Kingdom. Authorised and regulated in the UK by the Financial Services Authority. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited ("TPSHKL"). Registered Office: 21F ICBC Tower, Citibank Plaza, Central, Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Please note that TPSHKL can only deal with professional investors in Hong Kong within the meaning of the Securities and Futures Ordinance. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. Issued in Singapore by Threadneedle Investments Singapore (Pte) Limited, 07-07 Winsland House 1, 3 Killiney Road, Singapore 239519. Any Fund mentioned in this document is a restricted scheme in Singapore, and is available only to residents of Singapore who are Institutional Investors under Section 304 of the SFA, relevant persons pursuant to Section 305(1), or any person pursuant to Section 305(2) in accordance with the conditions of, any other applicable provision of the SFA. Threadneedle funds are not authorised or recognised by the Monetary Authority of Singapore (the "MAS") and Shares are not allowed to be offered to the retail public. This document is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.