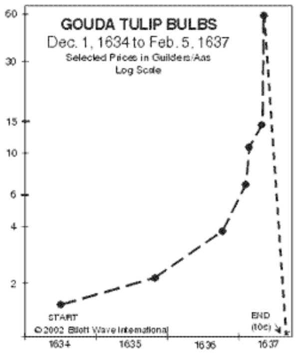
Recently Dennis Cox, the CEO of Risk Reward Limited, presented as part of a panel at the Investment Horizons event organised by the UK based Securities and Investments Institute. At that event he promised to develop some of these themes in the next Risk Reward Limited update.

In terms of our views of the current commodities markets we conclude that there are parallels from the past which do need to be considered. There have been a number of times in the past when markets have left reality with the price of assets either massively exaggerating a trend, or having the opposite effect. It is our view that such matters are entirely predictable.

Tulip Bulbs



The first event of what might be called the modern age was the Dutch bulb bubble. In this case the humble tulip bulb was the subject of major speculation resulting in a pricing spike. The reasons for this are perhaps less important than the result and were the first of a series of "bubbles" ranging from the South Seas bubble to the internet bubble.

Rice

What is most important is to notice the trend – firstly there is a demand led trend and then there is a speculative trend. The end of the speculative trend is a warning that the market is likely to collapse – the only question is how high is the peak and when will the market collapse?

Consider a staple food like rice, for example:

This is a graph downloaded from CME Groups web site. Notice once again the trend. During the period 2002-2007 there is a demand led increase in the market price of rice which lasts until the middle on 2007. At that time speculation takes over and the price exceeds 2,000 in Q1 2008 when the extrapolation of the previous trend would suggest perhaps 1,300.

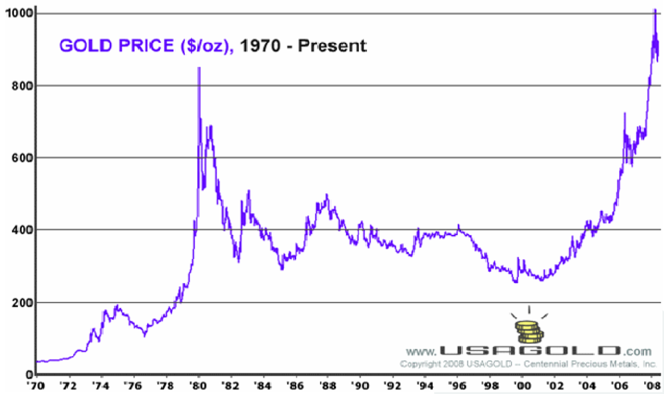
The Risk Reward view is that the long term demand trend for commodities will apply in the longer term and therefore the graph will revert to that position, suggesting a real price for rice (Rough) at nearer 1,400 than the current price.

'It is our view that the market is effectively demand led and that speculation moves the price away from this trend, but that it reverts over the longer term.'

Gold

The key issue is whether this is replicated in the case of other commodities. Let us consider how the gold price has moved:

This graph is downloaded from www.usagold.com and shows some interesting issues. There is once again a demand trend which in this case operates during the period 2001-2005. A speculative trend then takes over, and the gold price spikes. At the peak there is a high level of price volatility which we explain as being the impact of a demand led curve impacting upon a speculative curve. The demand curve would suggest a natural price for gold of perhaps 575 and our view is that the price will long term revert to this trend.



Platinum

Taking this further let us review the movements in the platinum price:

What is Happening in the Commodities Market? (Continued from page 3)

Once again there is a demand pull operating between 2001 and 2007, then the speculation takes over to hit a high point and a period of volatility. This would suggest that the natural price of platinum is in fact perhaps 1,600 and again that the long term trend will revert to such a position.

Copper

Of course not all markets actually have the same level of speculation. In terms of such markets Copper is perhaps a prime example. Because the copper price was previously exploited by unscrupulous traders, this time they do appear to have kept away. Look at the following graph downloaded from www.kitco.com:

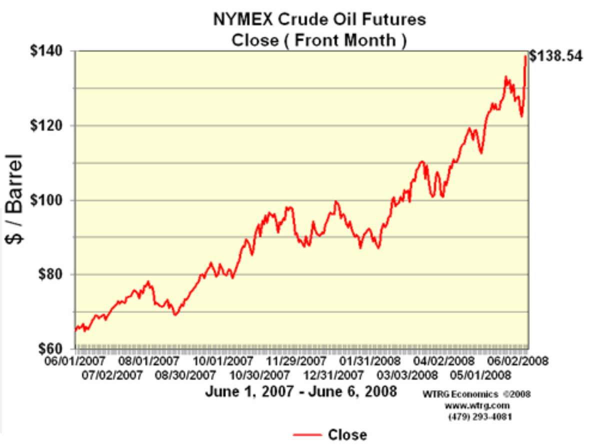
Here there is some evidence of speculation on April-June 2006, but the price has reverted to its long terms demand led trend. Indeed we would expect the copper price to remain above 4,000 for the foreseeable future.

Oil

So the judgement is clear – it is our view that the market is effectively demand led and that speculation moves the price away from this trend, but that it reverts over the longer term. Let us now apply this though process to the oil price:

The graph that you normally see produced is as follows:

This graph care of WTRG Economics shows a relatively steady growth curve, however let us look at the longer term trend:

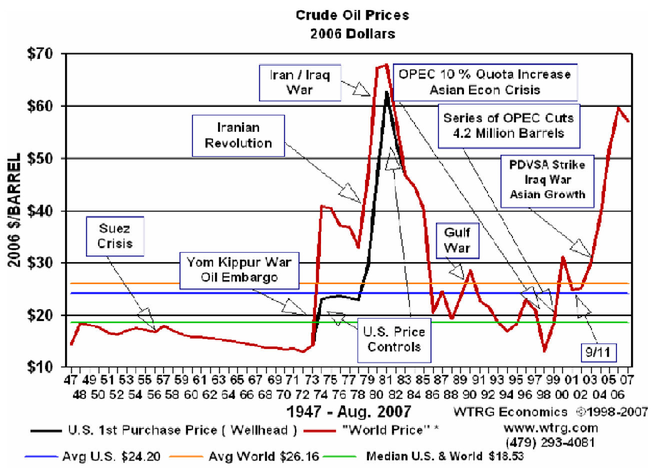


Now we see rather a different trend. Here you see a rather volatile demand curve during 1994-2004 to be followed by a speculative curve. This has continued from 2004 to the current date. What we are now seeing is the volatility that tends to be a signal for the peak of the trend.

Of course in the case of the oil price it is hard to remove the impact of speculation, but our view is that the natural price of oil is in the $50-$75 band. This is consistent with the view of Saudi Arabia which is stating that $60 is the natural price.

The question is not will the price revert to a long term trend; it is when will this happen.

One of the clear messages that come from this is to the teams that are setting interest rates in country around the world. This temporary speculation causes externally generated inflation which will revert. It is important for governments and central banks to discount such inflation in their management of their economies. The classic answer of increasing inflation to reduce demand in the economy and suppress inflation will have the opposite effect this time since the inflation pressures are externally generated, rather than internally driven. The best thing that the economists can do is nothing.



The Problems of Accounting Standards

In previous updates we have discussed IAS 39 and its problems. Of course the problem that we identified then has now occurred. To explain what is happening you do need to go back into the vagaries of IAS 39 (and its ill considered cousin SFAS 157).

IAS 39 states that assets may be held to maturity in the banking book. If there is a permanent diminution in value then the assets should be written down, the comparison being against what is referred to as fair value. If anything other than an insignificant amount of the assets are sold then all held to maturity assets must be shown as fair value and gains and losses should be taken through the profit and loss account.

Worse than that any firm that sells anything other than an insignificant amount of held to maturity assets loses the right to have held to maturity assets for a period of three years.