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:

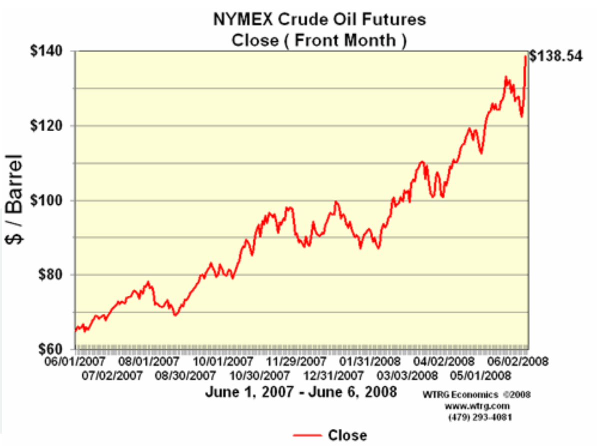
Here there is some evidence of speculation on April-June 2006, but the price has reverted to its long terms demand led trend. Indeed we would expect the copper price to remain above 4,000 for the foreseeable future.

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:

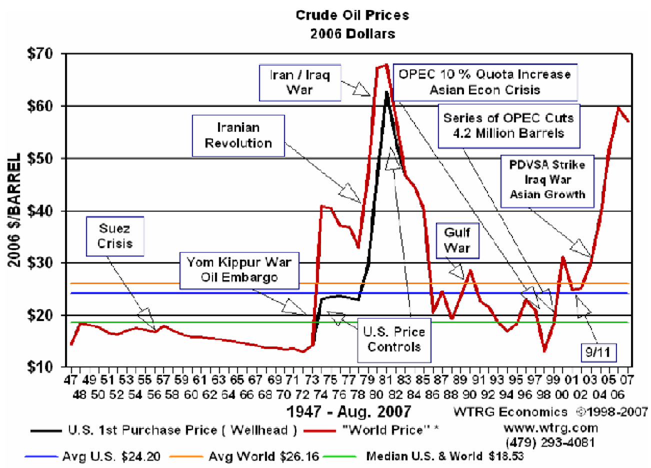


Now we see rather a different trend. Here you see a rather volatile demand curve during 1994-2004 to be followed by a speculative curve. This has continued from 2004 to the current date. What we are now seeing is the volatility that tends to be a signal for the peak of the trend.

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).

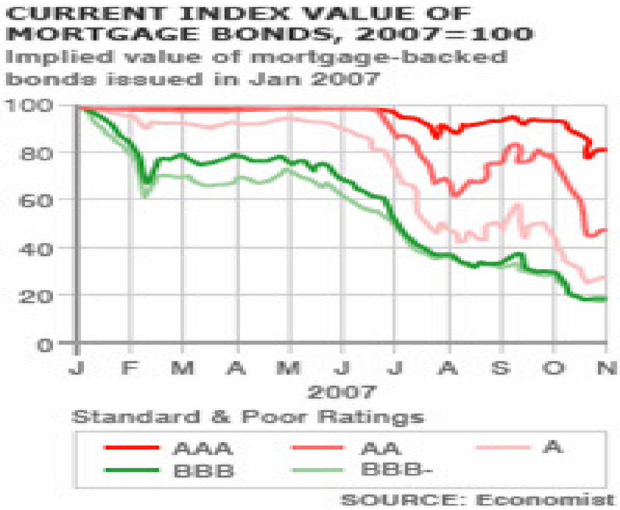
IAS 39 states that assets may be held to maturity in the banking book. If there is a permanent diminution in value then the assets should be written down, the comparison being against what is referred to as fair value. If anything other than an insignificant amount of the assets are sold then all held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

The Problems of Accounting Standards *(Continued from page 4)*

Let us look at the current crisis and what is actually happening.

Look at the following graph:



This is from the economist. What you can see is that AAA rated bonds have been written down by 20% under these current rules and the misinterpretation of fair value that is currently occurring. The statistics show that for a AAA rated tranche of a mortgage book to be impacted by a downturn in the market, 29% of the portfolio needs to go into arrears. The figures for Northern Rock were published today – arrears are 0.75%. Not 1%, not 5%, not 25%... but Northern Rock bonds will have been written down by 20% without any prospect that there will be a default.

What this actually means is that anyone that has sold such bonds in the current climate has managed to crystallise a loss that does not exist. The provisions that have been made by many of the financial institutions also do not really exist. If they were to hold the assets to maturity then they would receive full value for such assets. Of course if they have sold such assets, probably under pressure from the media and people that should know better, then they have managed to incur an unnecessary loss.

What should be done? In our view if an asset does not have any long term impairment and is to be held to maturity then it should not be written down – the current speculative market price is irrelevant. In this case we have negative speculation caused by the asset no longer being suitable for the market for which is was designed.

All that this requires is a formal definition of fair value and a change to the terms of Held to Maturity Assets. What is clear is that accounting standards that are developed without considering their implications to business will likely be fatally flawed. ***Come on IASB wake up and smell the roses***.

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The Need for Accounting Training

What this shows is that the accounting rules are becoming increasingly complex and that many financial institutions in particular have a challenge in ensuring that their accounting and finance functions are both up to an adequate standard and up to date.

The Institute of Chartered Accountants in England and Wales (ICAEW) have recognised this problem and developed a new series of products to meet the demands of this market. Created using existing materials developed to ensure that all chartered accountants meet required technical standards, for the first time non-chartered accountants can study ICAEW materials (either examinable or non-examinable).

The objectives of this new programme are clear. It enables the Finance Director and CEO to know that they finance functions are at least able to meet the benchmark standard that the ICAEW sets for technical competence in the following areas:

- Financial accounting
- Management information
- Business and Finance

'The Institute of Chartered Accountants in England and Wales (ICAEW) have recognised this problem and developed a new series of products to meet the demands of this market..'

Three other modules are also available addressing Audit and Assurance, Taxation and Law and non-examinable advanced courses are also available again using ICAEW produced materials.

These courses are available through the ICAEW training partners and we are pleased to announce that Risk Reward is the leading global training partner for this extended programme.

If you require any further information to see how this could benefit your firm please call Lisette Mermod on 00 44 20 7638 5559 or email her at **LM@riskrewardlimited.com**