

WHY COMMODITY PRICES MAY GO MUCH HIGHER IN THE FUTURE: THE MONEY MARATHON

JUNE 2011

Recently a good friend of mine in the brokerage profession gave me an interesting essay written by Jeremy Grantham titled "Time to Wake Up: Days of Abundant Resources and Falling Price Are Over Forever." The essay, although lengthy and comprehensive, made some important points that are worth considering and could affect investment decisions going forward.

According to the essay, for 150,000 years our species has pushed up to the limit the available food supply many times. Every so often, poor weather and disease caused extended famine which pushed us to near extinction. The food supply limits and the periodic famines kept world population down. As farming techniques improved, over time worldwide population began to grow. As a result of this population growth, in 1798, Thomas Malthus published his "Essay on the Principle of Population" which postulated that population growth would run up against limited food supplies causing severe shortages and mass death. His recommendation was for population controls to limit the possibility of shortages somewhat like China does today. As we now know, what he predicted did not occur because about that time in history we discovered the use of hydrocarbons, which for the next 250 years accelerated growth and population and food supplies to unimaginable levels.

Population surged from 800 million in 1800 to 7 billion today, going to 8 billion very soon, a tenfold increase. By 2050, the population will have shot up more than tenfold from 1800, and wealth in developed countries as measured by average per capital income will have increased nearly 100 fold from \$400 a year to \$40,000.

According to the author, hydrocarbons are a wonder because we are fortunate to have a dense store of the sun's energy and millions of years of compressed vegetable and animal matter. In addition, we are also fortunate to have rare metals which are scarce throughout the universe, but ended up here through the death of stars.

Amazingly, even with the rapid growth in population, in the last 100 years ending in 2002, commodities as measured by a basket of 33 commodities has dropped in price by 70% or 1.2% per year adjusted for inflation. There have been periods of scarcity and higher prices like during World War I and II, followed by collapses like during the Great Depression. Basically, productivity grew faster than the marginal cost, at least until 2002. According to the author, since 2002 there has been a paradigm shift which actually started early for oil, but has carried over to most all commodities since 2002.

There are two main reasons for this paradigm shift. One reason is that commodities are becoming more expensive to find. As an example, finding cheap oil is much more difficult, and we are starting to use expensive technologies to get oil from shale. And as another example, we have to dig deeper and deeper to find lower qualities (not higher qualities) of all types of metals. Simultaneously to this, China and India, which are both growing rapidly at 8% per year, are using massive and unprecedented amounts of commodities. As an example, China is spending nearly 50% of their GDP on capital spending. Although they use only 10% of the world's oil which is about equal to their share of the world's GDP, they are using nearly 50% of the world's cement, iron, coal, pigs, steel, lead, zinc and other commodities.

The author points out that the human race is optimistic by nature; therefore, many believe that we will find technologies to expand agriculture and other energy resources. But he points out that as it relates to agriculture, good land is limited and there is an ever-declining improvement in crop yield increases as the limit to fertilizer usage diminishes.

The United States is in relatively good shape compared to the rest of the world in that we have a great deal of good farm land, plentiful water, and huge amounts of natural gas and coal. However, as commodities become scarcer, due to the twin problems of limited supply and increased demand, the result will be much higher commodity prices and shortages for the poor and undeveloped countries. This will most likely also lead to slower worldwide growth, increased worldwide starvation and instability.

What is the solution? According to the author, the best we can do is to try to manage these future shortages by trying to be more efficient with our resources by developing a long term energy plan. This, of course, is most effective if the world cooperates in this effort. An energy plan includes ways to maximize the efficiency of our resources. As an example, if cars were twice as efficient, we would only need half as much gasoline. These choices will not be easy but may prevent severe problems in the future.

As this relates to investments, it may make sense to own the stocks of companies that own or produce commodities or own a share of the commodities themselves, which includes land, water, energy, metals and other commodities. It should be noted that the author believes there actually could be a downturn in commodities as recent speculation unwinds, but the long term trend is upward and very possibly up significantly.

I don't want to scare people; and there is no way to know for sure if the author is correct, but the logic makes some sense so I think it is worth considering as you make investment decisions.

Remember, every investor's situation is unique, so it is important to review your specific situation with a financial professional.

Ed Douglas is a Certified Financial Planner/Consultant, Chairman Emeritus of Citizens Bancshares and author of three books, "Making a Million With Only \$2000-Every Young Person Can Do It", "The Money Marathon: 7 Simple Steps to Financial Freedom" and his new book " 25 Truths: Winning Wisdom for a Better Life" available at www.eddouglas.com. Ed may be contacted for financial planning services or seminars based on his books at ed@eddouglas.com or 660-646-2066 or at his office at 601 Locust.

25 TRUTHS: WINNING WISDOM FOR A BETTER LIFE - TRUTH NUMBER 5: Tell the Truth. Ed's books are available at eddouglas.com, Hy-Vee, Amazon, or BojiStone.