Beacon Investment Management

The Friday Brief

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Energy and Food Costs Hold the Key

Oil and food costs are the tail wagging the dog and may remain in control for some time to come. Markets respond quickly and significantly to even minor wiggles in futures representing oil, corn, wheat, sugar, and others. Prices are at records and arguably going higher, whether on speculation or on constrained supplies: Both sides can be strongly argued.

According to Bloomberg, the rally that drove oil to a record $139.12 a barrel last week surpassed the gains in Internet stocks that preceded the dot-com crash in 2000. Crude rose 697% since trading at $17.45 a barrel on the New York Mercantile Exchange in November 2001, and reached 28 record highs this year. The last time a similar pattern was seen in equities was eight years ago, when Internet-related stocks sent the Nasdaq Composite Index up 640% to its highest level ever, according to data compiled by Bloomberg and Bespoke Investment Group LLC.

We remember too well that the NASDAQ fell 78% from its March 2000 peak demolishing nearly $6 trillion in market value. Technology stocks remain tainted by their fall to this day, trading at multiples matching those of companies growing considerably slower. But can oil and food be compared to technology? Clearly, speculation plays a role in prices as investors flock to commodities chasing returns in the wake of losses from the housing and credit wrecks. But old fashioned economics still play a role.

India and China represent huge and growing demand for oil as their economies continue to grow at near double-digit rates. China's oil imports alone increased by 25% in 2007. Supply remains tight and could get tighter. The government announced Wednesday that oil inventories in the US dropped for the fourth week in a row. Refiners are waiting to buy cheaper crude. Supply disruptions are a reality in Nigeria and Iraq and are possible in Iran. Russia's oil production is declining as their government rejects western help and investment.

On the food front we are going to experience supply shortages as well. There is a rising global sentiment against free trade that could mean significantly higher prices on food commodities. Susan Schwab, US Trade Representative said at a June 12th Chamber of Commerce event that "this is a challenging time to be in the pro-trade wing of any party in virtually any country. It's hard to be for open trade, whether you are in India or the European Union or in China." Fred Bergsten, director of the Peterson Institute for International Economics in Washington said the liberalization of global trade has come "to a screeching halt. It'll take years to rebuild the foundations of free-trade policy."

Political candidates must grapple with a growing resentment in this country over the cost of free trade to manufacturing and farming jobs. South Koreans protest US beef imports, while Mexicans rail against cheap US corn, wheat, and sugar. Europe and the US argue over agricultural subsidies for farmers. And of course everybody (but the

Chinese) complains about China's artificially cheap goods prices in a currency pegged to the cheap US dollar.

The trade worry is that we not return to the pre-40's era of excessively high import duties that were in large part the cause of the Great Depression. The modern era of trade dates back to the 1940's when the US and Britain pushed the developed economies toward the establishment of a global organization to avoid harmful protectionist policies. The General Agreement on Tariffs and Trade established in 1948 was the result. According to Bloomberg, it was successful in cutting industrial duties in developed countries from an average of 40% to about 4% over the past six decades. Now known as the World Trade Organization, the body is losing to domestic politics.

Huge price increases in oil and food are causing inflation expectations to rise among investors and central bankers. The consumer price index increased 0.6%, the most since November, after a 0.2% gain the prior month, the Labor Dept. said today. Core prices, which exclude food and energy, increased 0.2%, matching the median estimate of economists surveyed by Bloomberg News.

With the threat of inflation becoming as real as was earlier perceived, the Fed has little choice now but to hold rates where they are and eventually increase them. Higher rates will bolster a very weak dollar, but they also impede an already slowing economy. Bernanke and others say that fighting inflation is now more important than supporting the economy.

We hope that central bankers will be more coordinated in their 'attack' against inflation and help for the dollar in the coming months. Michael Sesit of Bloomberg points out that no sooner than when the dollar rallies for a few days on comments from Fed Chair Ben Bernanke that rate reductions are likely over, ECB President Jean-Claude Trichet chimes in citing rising inflationary pressures and saying that an official interest-rate increase in July is a possibility. Turning on a dime, the dollar dives, giving up all its gains against the euro and then some. Get together fellows, let's not repeat 1987, or worse.

As you can tell by the tenor of this note, we are considerably less sanguine on the markets and the economy. We have taken a considerably more conservative position in our portfolios with higher cash, more dividend-paying stocks, and reduced emerging markets. The possibility of rising inflation and the reality of high food and energy prices, in our opinion, trump global economic momentum. If the commodity 'bubble' bursts or even deflates some of its speculative hot air and prices fall and remain lower, then recovery may still win out. We hope so, but we are invested with a more pessimistic outlook.