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HOT COMMODITIES

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The Next New Thing Is—Things

A new bull market is under way, and it is in commodities—the "raw materials," "natural resources," "hard assets," and "real things" that are the essentials of not just your life but the lives of everyone in the world. Every time you walk into the supermarket or the mall, you're surrounded by commodities that are traded around the world. When you get into your car or truck, you are surrounded by other widely traded commodities. Without the commodities "futures markets" to set and regulate prices, the things we all need in life would be scarce and often too expensive. These essentials include oil, natural gas, wheat, corn, cotton, soybeans, aluminum, copper, silver, gold, cattle, hogs, pork bellies, sugar, coffee, cocoa, rice, wool, rubber, lumber, and the 80 or so other things listed in the traders' bible, the Commodity Research Bureau (CRB) Yearbook.

Commodities are so pervasive that, in my view, you really cannot be a successful investor in stocks, bonds, or currencies without understanding them. You must understand commodities even if

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you only invest in stocks and bonds. Commodities belong in every truly diversified portfolio. Investing in commodities can be a hedge against a bear market in stocks, rampant inflation, even a major downturn in the economy. Commodities are not the "risky business" they have been made out to be. In fact, I believe that investing in commodities will represent an enormous opportunity for the next decade or so.

For most investors, commodities trading is a land of mystery full of legendary dragons. Intelligent, well-informed people who can recite P/E ratios of large caps and small caps, who study the balance sheets of high techs and biotechs, semiconductors, and small banks in the South, self-proclaimed "savvy investors" who follow bond prices and yields more closely than the baseball box scores and who might even have an eye on the dollar versus the euro, the yen, and the Swiss franc, know nothing about commodities. And if they do know something, it's typically second- or third-hand information, usually mistaken, and, more often than not, involves a cautionary tale about "a brother-in-law who lost his shirt in soybeans." Like Americans who never travel to foreign countries for fear of being humiliated or cheated because they don't know the local language and customs, investors who shy away from commodities are missing out on an incredible opportunity.

You cannot ignore an entire sector of the marketplace—not if you really want to be considered an "intelligent investor." If a friend of yours who was heavily invested in the stock market went through the 1990s without even considering buying a technology stock, and ignored what was happening in the world of Microsoft, Cisco, Amazon, eBay, and even IBM, surely you would find such behavior strange. Yet that is precisely what most investors have done with respect to commodities.

One reason that companies and stocks did so well in the 1980s and 1990s was that raw materials were in a bear market: Cheap commodity prices removed the cost and margin pressures from companies that depend on natural resources to do business. In-

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vestors who figured out that the commodity *bear* market was ending in the late 1990s realized that the stock bull market would be ending, too. The CNBC anchors were still giggling with glee, still advising to buy more dot-com shares, while the smart investors were exiting the market and moving to commodities. They could see that the costs of doing business would soon start eating away at profits—and that stock prices would soon follow.

It is hardly the bush leagues. In fact, natural resources are the largest nonfinancial market on the planet. The annual production of just 35 of the most active commodities traded every day in New York, Chicago, Kansas City, London, Paris, and Tokyo is worth $2.2 *trillion*. The volume of dollars traded on the commodities exchanges is several times that of the common stocks traded on all U.S. stock exchanges. (Commodities dealings for many times more than that amount take place outside the commodities exchanges.) And wherever there is a market, there are opportunities to make money. I know—the business pages of your newspaper, the financial magazines, and CNBC devote most of their time and space to stocks. According to the media and other stock-market "experts," the equities bull is forever hiding just around that next corner on Wall Street. But millions of investors who listened to the experts back in 1998–2001 about "the New Economy" got hammered in the stock market and are still trying to get back to even. The smart investor looks for opportunities to acquire value on the cheap, with one eye out for a dynamic change in the offing that might make that investment even more valuable.

Today, commodities fill both bills. The commodity bear market ended in 1998, when prices were approaching 20-year lows (equal to Depression levels, when adjusted for inflation). That year Merrill Lynch, the largest brokerage firm in the U.S., decided to leave the commodities business, and I began a commodities index fund to capitalize on the end of the bear market.

I am convinced that value and strength in the commodities markets will continue for years to come—that we are, in fact, in the

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midst of a long-term secular commodities bull market. The twentieth century saw three long commodities bulls (1906–1923, 1933–1953, 1968–1982), each lasting an average of a little more than 17 years. The new millennium has begun with another boom in real things. In my opinion it began in early 1999. The aim of this book is to explain *why,* showing, along the way, *how* to profit from it. Better still, by understanding natural resources, you will become a better investor in every other asset class.

There is no mystery to it. What could be more straightforward in this world than its very basic materials? Corn is corn, lead is lead, and even gold is just another thing whose price depends on how much of the stuff is around and how eager people are to own it. And there is certainly no magic to figuring out the direction in which prices will go in the long term. These alternating, long bear and bull markets in metals, hydrocarbons, livestock, grains, and other agricultural products do not fall from the sky. They are prime players in history, the offspring of the basic economic principles of supply and demand. When supplies and inventories are plentiful, prices will be low; but once supplies are allowed to become depleted and demand increases, prices will rise, just as inevitably. It has not taken any genius on my part to understand this dynamic; it's just the way the world works. But the investor who sees this supply-and-demand balance going out of whack and is willing to put some money on the table will be rewarded manyfold.

We are now in one of those periods when a new bull market is under way—and it is in commodities. And when that happens it's time to get a lot more money into *things*. Do you see another alternative for your money that I'm missing?

- ***Stocks.*** Most equities are overpriced on a historic basis; P/E (price-earnings) ratios for the Nasdaq are in the stratosphere. In fact, at every level of consideration—price-earnings ratios, price-to-book ratios, dividend-yield ratios—corporate equities are all

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extremely expensive compared with past markets. Do you really think stocks will be able to soar from such exalted levels?

- ***Bonds.*** With interest rates lower than they've been in decades, the bond market is not about to make you rich—especially as rates go up. The yields on long-term government bonds are pathetic, while better-paying corporate bonds are expensive. And if your financial consultant advises you to buy bonds issued by the "government-sponsored" mortgage agency Fannie Mae or Freddie Mac, hang up the phone. The White House, Congress, HUD, and federal regulators are all gunning for both agencies. Sitting on top of $7.3 trillion in home mortgages, Fannie and Freddie are scandals in the making. (N.B.: "Government-sponsored" does not mean "government-backed"; if either Freddie or Fannie goes down, Uncle Sam is not obliged to give you your money back.)

- ***Real Estate.*** Housing is already too expensive to be much of an investment, at least in those places where you'd be willing to live. (You've even missed the real-estate booms in the U.K., Spain, Australia, New Zealand, and other countries where prices have accelerated beyond their historical average rates of increase.) U.S. housing prices have been rising faster than the rate of inflation for more than eight years; home-equity values may be inflated by as much as 20 to 30 percent. In New York and Southern California, housing prices have doubled in the past five years. A massive speculative bubble in the U.S. housing market seems to be floating from coast to coast, and when it bursts (as bubbles always do) some serious pain is in store for the millions of Americans who have been borrowing against their home equity at record rates—$750 billion in 2003. The resulting loss in wealth could be between $2 trillion and $3 trillion, sparking an economic downturn reminiscent of the one that resulted when the dot-com stock bubble went kaboom. Even if the air stays in the real-estate market, prices are way too high for investors to make a lot of money.

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- ***Currencies.*** The U.S. is already the world's largest debtor nation—with more than $8 *trillion* in outstanding international IOUs, and increasing by $1 trillion every 21 months. For the past 20 years, we have been borrowing heavily in the world's financial markets to finance large trade deficits—now about $600 billion a year (or 6 percent of GDP, the highest ever). Our interest payments to service those debts in 2003 alone totaled $330 billion. That's roughly a billion dollars a day just to keep the dollar afloat. We are now living off other people's money. With the White House in a race with the Federal Reserve to spend money faster than the Fed can print it, the dollar is shakier than ever. Foreign investors eyeing our balance sheets are beginning to see a banana republic emerging on our shores, and many have already bailed. (In the 12-month period between June 2003 and June 2004, net foreign investment in the U.S. was a negative $155 billion.) During past trade deficits, it was foreign investment that financed our standard of living; now it's being paid for by foreign buyers of U.S. bonds—mainly Asian banks, including the Chinese—looking to keep their own currencies under control. Should those lenders decide that they would rather not finance our profligate ways, the dollar will decline even more, interest rates will rise, and so will inflation. Foreigners have already begun to sell U.S. dollars. But to where do you run? The Swiss franc and the Japanese yen are stronger than the dollar, but those governments are also playing monetary monopoly, fiddling with the money supply and the interest rates to make their products more competitive. If you had changed your dollars for euros at the end of 2001 when the euro was worth 89 cents, in October 2004, your euros would have gone up to $1.25, a very nice 40 percent gain. But the euro, too, is a flawed currency long-term. If anyone has a fix on a great currency, let me know.

Commodities, in fact, have been outperforming stocks, bonds, and real estate for years now. The Rogers International Commodities

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Index, which I founded, was up 190 percent six years after its start on August 1, 1998, while the Lehman Long Treasury Bond Index was up only 56 percent and the S&P 500 Index of major stocks was down 0.542 percent. After a five-year period ending in 2004, the two stock mutual funds with the most assets under management—the Vanguard 500 Index and Fidelity Magellan—were in negative numbers.

How do your stocks stack up against these gains in commodities? Of course, you might be a much more talented stock picker than most. But even if you're an absolute wizard you ought to be putting some of your winnings into commodities—or companies and countries that produce them—if only in the interest of being genuinely diversified.

I suspect that the prospect of immersing yourself in the ups and downs of soybeans, sugar, cotton, crude oil, or even gold might not strike you as "fun." Admittedly, I have often relished buying a great company cheap and holding it long-term; to be sure, finding the next GE, Microsoft, or Amgen can be an intellectual as well as a profitable adventure. But let me assure you that when the price of sugar futures went from 1.4 cents to 66 cents between 1966 and 1974, those holding cheap sugar had a whole lot of fun watching sugar rise *more than 45 times*. Back in the 1970s, when oil went from $3 a barrel to $34 in just six years, man, that was where you wanted to be! Those who invested in commodities in 1998 made nearly 190 percent six years later.

I don't know about you, but for me that's fun.

Open Your Mind—to Commodities

A friend of mine recently called his broker at a major New York investment firm to discuss moving a modest chunk of his portfolio into commodities. "You're aware of how risky commodities are, right?" she said. He said he was aware of the risks involved in in-

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vesting in anything. The broker took that as a "No," and proceeded to tell a story about her colleague who had "one of the big corner offices" on the same floor. "He was heavily into commodities," she said. Then, after a pause pregnant with the offer of some wise, free advice, she whispered, "He's no longer with the company." When my friend insisted that he still wanted to explore commodities, she confessed that she couldn't help him; she had never bothered to get her license to deal in commodities, mainly because there had never been a good reason to do so. After a bull market in stocks that has lasted longer than the careers of many of today's financial managers and consultants, not to mention the journalists who feed off them, it is understandable that most investors and their advisers have trouble wrapping their minds around the prospect of investing in commodities. The last time serious money was being made in commodities, these people were in college or maybe even junior high school. Some may even have been in diapers.

Most investors could use some mental deprogramming. At certain points in history, stocks (and bonds) are not the best investments to make. If I had advised you, for example, in 1982 to put all your money into an S&P 500 Index fund, you would have thought I was insane. Stocks had been going sideways for more than a decade. But commodities were on a roll: Sugar went up 1,290 percent between 1969 and 1974; corn went up 295 percent. Oil went up 15 times in the 1970s, to $40 a barrel; gold and silver rose more than 20 times in a decade; and the price of many other commodities spiked. By 1979, that famous *Business Week* cover had already proclaimed, "Equities Are Dead!" In 1982, the Dow Jones Industrial Average was under *800—down nearly 20 percent from its first almost 1,000 close of 995.15 in 1966.* (The Dow didn't officially hit 1,000 until November 1972.) Everyone knew that as an asset class corporate equities were *finito.* What they didn't know was that they were already in the early stages of a bull market for stocks that would last nearly 20 years.

Today the cycle has turned back to commodities. How can I be

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so certain that commodity prices will continue to rise over the next 12 to 15 years? I'm not certain about anything. "Certainty" is an incomprehensible word to any rational and responsible investor. Only political ideologues, religious fanatics, and other madmen believe they have all the answers. Happily, you need neither omniscience nor certainty to get rich. All you have to do is pay attention to where the opportunities are in the markets, keep an eye out for major changes that might affect them, and then act rationally and responsibly. That also means seriously considering markets other than real estate, stocks, and bonds, none of which are likely to appreciate significantly in the next decade. At this particular moment in history, it means taking commodities seriously.

Of course, it would be nice if I could claim that I've come to this conclusion as a result of my own uncommon genius. But the advent of every commodities bull market is due to the most basic principle of economics: supply and demand.

Why Commodities—Now?

Quite simply, the current supply-and-demand balance for commodities worldwide is way out of whack—a classic sign of a long bull market on the way.

When I was a child in the 1950s, my family would drive from Alabama, where we lived, to Oklahoma to visit my grandparents. I can still remember being amazed to see fires in the fields along the road. No one seemed to care. It was only decades later, as a young man on Wall Street looking around for some investment opportunities, that I learned the reason for those fires along the Oklahoma roads of my childhood. There were oil fields out there, and in 1956 the Supreme Court had ruled that the government had the right to regulate the price of natural gas. Washington kept natural gas so cheap that it was more economical for those Oklahoma producers to "flare" it—burn it off—than to produce it while pumping oil.

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And there was certainly no financial incentive for anyone to look for new sources of gas or oil, for that matter, which was plentiful (and thus inexpensive) in the 1950s and 1960s. Drilling companies went out of business, and exploration dropped off.

The same was true for most other commodities—lots of supply, low prices. By the early 1970s, those prices had begun to rise. Why? Time turns even excess inventories into empty warehouses. No matter how much of a given commodity there is, if supplies are not maintained on a regular basis they will become depleted, leading to price increases. More and more Americans were driving bigger cars; cold winters still required heating oil; and air-conditioning made it possible for more people to thrive in areas of the nation where the heat and the humidity had once discouraged enterprise. And then all those stockpiles of natural gas and oil began to disappear—with nothing to replace them, because no one had been able to make a buck in the hydrocarbon business for years. Soon investors were falling over one another in an effort to capitalize on escalating prices.

Between 1966 and 1982, the stock market went nowhere and with double-digit interest rates the bond market collapsed. Meanwhile, commodities boomed. But high prices soon did their normal work of encouraging new supply while cutting demand. Companies began drilling for oil, opening up new mines, and planting corn and soybeans. Gold plunged from $850 in 1980 to $300 in 1982, sugar went all the way back down to 2.5 cents in 1985 from the 66 cent price reached in 1974, while oil collapsed to less than $10 a barrel in 1986.

And then the cycle began to repeat itself. With supplies of commodities high and prices low, investors looking for value opportunities eventually returned to the stock market in the mid-1980s. That, too, was predictable: Investors never chase bears. By the 1990s, U.S. investors, mesmerized by the Internet bubble, were funneling every cent they had into company shares of "growth stocks" selling for more than 50 times earnings. In 1999 alone,

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venture capitalists invested $42 billion—more than the three previous years *combined;* IPOs raised $68 billion, *40 percent more than any year on record*. Not one IPO was for a new sugar plantation, lead mine, or offshore drilling rig, I can assure you. In the meantime, metals mines and oil and gas fields were becoming depleted.

To me, it was déjà vu. The oversupply of two decades had created low prices that eventually spawned a bull market in commodities—just what happened in the late sixties. Once again, commodities had been plentiful and cheap. The Asian and Russian crises of 1997 and 1998 led to the final liquidation of those regions' commodity inventories at fire-sale prices—and worldwide prices hit bottom. During these decades of depleting supply, demand for commodities continued to grow. Asia boomed; the economies of the West and the rest of the world also grew. And, once again, Americans began consuming commodities at an expansive and carefree rate. Years of cheap oil had given drivers a taste for gas-guzzlers again. Everyone seemed to be driving SUVs that only movie stars used to own, driving fuel-economy averages to the lowest levels in 20 years. Those new McMansions rising around the nation, thanks to record-low mortgage rates, required lots of heating and cooling. Big cars and houses also eat up huge supplies of lumber, steel, aluminum, platinum, palladium, and lead for vehicle batteries. Europeans, too, were experiencing a housing boom and driving more and bigger cars than ever, including SUVs. Natural gas, cleaner and more efficient than oil or coal, had become the fuel of choice for North American power plants. Demand in the energy and industrial metals sectors increased further with the widespread economic recovery in Asia. South Korea has become one of the world's leading importers of commodities. Short of scrap, Japan is racking up record imports of refined copper.

And then there was China, gobbling up commodities like the giant economic dragon it was destined to be. I was in China in 1999, and was astonished at the changes that had taken place

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since my previous visit at the beginning of the decade. In my last book, *Adventure Capitalist,* I included a photograph we took in Shanghai that summed up China's economic growth perfectly: A young Chinese girl, fashionably dressed, carefully made up and with color in her hair, sits on her motor scooter talking on a cell phone. I don't think that's what Mao Zedong had in mind when he launched millions of Red Guards throughout the country in the 1960s to root out "Western influences."

Communist China is now home to some of the best capitalists on the planet. Driving through the countryside, we saw men and women working from dawn until dusk, and when the sun went down we saw them improving the roads—already the best roads in the world, in my opinion—under floodlights. Shanghai is quickly emerging as one of the world's most exciting, economically robust cities. Giorgio Armani has opened up a new flagship shop in Shanghai; Prada and Louis Vuitton already have at least nine stores each in China, while Ermenegildo Zegna, one of Armani's prime competitors, has opened 29 shops since his early arrival in China in 1991.

China has had the fastest growing economy in the world for years, expanding more than 9 percent in 2003 and 2004. Chinese factories and builders are cranking out everything from television sets, computers, and cars to shopping malls and urban town houses. China is now the biggest user of cell phones on the planet, and it's quickly heading to No. 1 in Internet use. It has passed Japan to become the No. 2 consumer of oil in the world, next to the U.S.—and the No. 1 consumer of copper and steel. Based on reports from China's National Bureau of Statistics, the nation consumed one-third of the global supply of steel in 2003, more than the U.S. and Japan combined. A major *exporter* of commodities not long ago, China currently imports half of its copper, three-fifths of its iron ore, and one-third of its oil. The People's Republic is also draining European recycling plants of every bit of scrap they can produce.

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With more than 1.3 billion people to feed, China faces a mind-boggling demand for foodstuffs. The Chinese are now eating more meat than ever before, though their meat consumption is still lower than the per capita levels in other Asian countries, Europe, and the U.S. All those cattle, sheep, and chickens to feed a population more than four times the size of the U.S. will also require more *corn* feed. In addition, China is now importing soy from as far away as Brazil and Australia. A growing sweet tooth among its more affluent people—candies and other confectionaries have become a fashionable gift for hosts—has also boosted Chinese sugar imports.

All this demand has come at a time when China is short of virtually every raw material it needs. Nor are its neighbors in any position to chip in. With few homegrown commodities of their own, South Korea and Japan are now competing with China for raw materials. In fact, most of Asia has grown dramatically over the past 25 years, pushing up demand further. India's economy, too, has been growing at its most rapid rate in 15 years, supposedly expanding more than 8 percent between March 2003 and March 2004—which would make it the second-fastest-growing economy in the world after China—and thus increasing its demand for goods. And while Russia may have vast deposits of oil and minerals, the country is falling apart economically as privateers and mafia capitalists strip their nation's assets, undercutting world supply and further hiking prices.

Ironically, U.S. investors were too distracted by their own booming economy and stock market in the 1990s to invest any money in increasing productive capacity of raw materials, agricultural products, and other hard assets. And thus the seeds of the current commodities bull market were sown throughout the world: exploding demand for commodities at the very time that supplies were becoming depleted and investment in the natural resources infrastructure was virtually nonexistent. With that kind of supply-and-demand imbalance, prices can go in only one direction, and that's up.

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RUNNING ON EMPTY (AGAIN)

"We're stuck with a commodity that we have to have," said Dave Wilson, president of an Idaho construction company that builds luxury homes, lamenting the high price of lumber in April 2004. "We have to pay whatever they charge."

Welcome to the commodities bull market, Dave. Users of virtually any commodity around the world could have said the same thing. They need stuff, and they want it *yesterday at low prices,* but there's nothing in the pipeline. Let's take a quick look at current capacity in several prime areas:

Oil. No major oil field has been discovered in the world for more than 35 years. Some of the largest discoveries of oil—the multibillion-barrel reservoirs known as "giants" or "elephants"—are 50 to 70 years old. U.S. production peaked in the early 1970s and then began declining—and that also includes Alaska's giant North Slope reservoir. North Sea production peaked in 1999, and some geologists and petroleum analysts have concluded that the oil fields of the current world champion producer, Saudi Arabia, are just years away from declining or may already have reached their peak. Whatever oil is left is likely to be a lot more expensive to find and get to market. The U.S. has not built a new oil refinery since 1976—and the number of domestic refineries has actually decreased by more than half since 1982 (from 321 to 149). There were 4,530 rigs in the U.S. at the end of 1981 actively exploring for oil and natural gas. In 2004, according to industry figures, the total was 1,201.

In fact, no one seems absolutely certain how much oil most nations have, since countries never allow independent audits. The Organization of Petroleum Exporting Countries (OPEC) determines quotas based on each member nation's oil reserves, thus providing an incentive to inflate their numbers. Take a quick look at the OPEC member list—Algeria, Indonesia, Iran, Iraq, Kuwait,

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Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, Venezuela—and tell me which nation you would trust not to inflate its reserve numbers.

U.S. officials and oil-company executives have looked to oil-rich Russia for salvation. But Russian oil technology is backward. And while the Russians are pumping plenty of oil, they do not have the pipeline capacity to get more than half of it to market. In the meantime, ingenious privateers have been stripping the nation's oil assets as fast as they can send the money to Swiss bank accounts, and the Russian government has once again begun meddling in the oil business. Russian oil is not likely to push prices down. I would also be concerned about the political stability of Venezuela, the world's fifth-largest exporter of oil; and Nigeria, with large offshore oil deposits, will struggle to survive as a viable political entity. Unless someone discovers some more "giant"—and accessible—oil fields soon, the world faces declining production.

Natural Gas. Production in North America has not kept pace with demand, and the prospect of supplies catching up is remote for the next decade or so. Federal officials and industry executives have been expressing their alarm in public over the prospect of prolonged natural-gas shortages. Like oil fields around the world, the known gas deposits are getting on in years; producers have already picked off most of the low-hanging fruit. New deposits have been identified, but, like new oil, the gas is deeper and more expensive to extract; and the capital investment dollars haven't been there for years to find new supplies. Gas fields in Canada and the northern slope of Alaska are still without the pipeline infrastructure necessary to speed the gas to market. Environmental regulations also make it tougher to dig new wells, and even with permission, local restrictions sometimes limit drilling to only three and a half months of the year.

As demand and prices increased in 2003, the necessary steps for

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increased natural-gas production were under way. In 2003, drilling rigs actually increased by a third—though in 2004 those rigs had yet to increase gas production. The U.S. government has encouraged the building of new natural-gas terminals on the East and West Coasts and the Gulf of Mexico that could handle large amounts of imported natural gas in liquefied form. Energy companies moved ahead with plans for 25 or so terminals, but they ran into formidable opposition on environmental and safety grounds. (Liquefied natural gas can leak from transport tankers or storage terminals—and explode.) Seven projects have been canceled. If any of the others make it to completion, that will be years away, as natural-gas supplies continue to diminish. One sure sign of low supplies: Ted Turner, who took a major hit on his AOL stock, has allowed drilling rigs on his prize 588,000-acre ranch in New Mexico—to exploit natural-gas reserves.

Metals. Virtually no new mine shafts have been opened in 20 years worldwide. As the demand for copper, silver, iron ore, aluminum, palladium, and lead increases, where are the new mines, not to mention the new deposits? Small mining and metals exploration firms have reported that venture capitalists have ignored them for years. In 2004, I met with a group of Canadian mining CEOs who, in spite of the current boom in their own markets, conceded that they had virtually no new mines opening in the near future. In fact, they had invited me to explain why I thought a bull market was under way as part of their efforts to determine whether to increase spending. Others have begun to get the message.

But even if more metals mines were on the horizon, where are the new smelters to make them usable? In 2004, aluminum smelting capacity alone was growing at about half its annual rate since 1961. According to a report in the *Wall Street Journal* in May 2004, 8 of 10 smelters in the Pacific Northwest had been idled or closed down in the past few years as a result of high energy costs. Alcoa, the world's largest aluminum company, announced plans

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for a $1 billion smelter on the island of Trinidad and was breaking ground for another in Iceland—the first to be built in 20 years. In the meantime, however, supplies are expected to dwindle for the next few years. The last lead smelter was built in the U.S. in 1969. Of the actual mining exploration reportedly taking place in the past few years, more than half of it was for gold.

Sugar. Have you heard of anyone opening a sugar plantation lately? Supplies are diminishing, and by some accounts the world sugar market is expected to be down 3.4 million tons in 2004–2005—the first time demand will have exceeded supply in a decade. Sugar has also become an energy commodity, having been turned into ethanol, a clear alcohol that can be used in its pure form to power vehicles with special engines or blended with gasoline to produce "gasohol." More than 60 percent of the world's ethanol is produced from sugar. Brazil, the world's largest producer and exporter, has been using half its sugar crop to power the nation's cars. By 2005, 60 percent of Brazil's new cars produced by Volkswagen, General Motors, and Fiat will be "flex-fuel" and able to run on gasohol—a number that will only increase with the price of oil and gasoline. Japan is also committed to using more of the cleaner ethanol fuel, as new emissions standards are introduced to meet the Kyoto Protocol deadline of 2012. The Brazilian industry has already promoted ethanol sales in China. (Ethanol use is increasing in the U.S., though most of it is made from corn.) More sugar in the gas tank means less for export—and higher prices.

Low supplies, increasing demand, nothing in the pipeline. All the pieces are in place for happy days for commodity investors. Bottlenecks in the supply chain have goosed prices even further. There are not enough ships worldwide to ferry existing commodities to their destinations, and those in operation will be using up more, expensive fuel.

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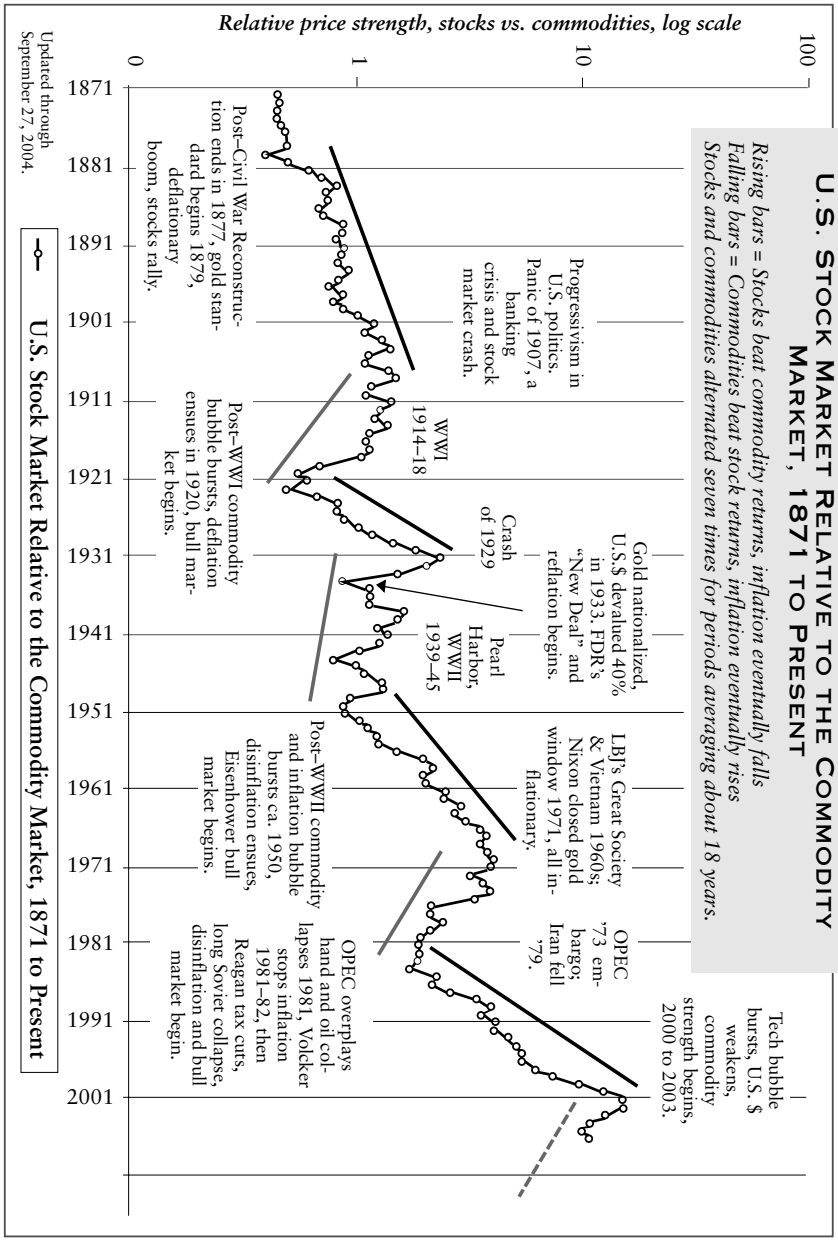
While predicting exact prices is not my expertise (or my investment strategy, for that matter), I do know that in mid-1999 commodity prices, when adjusted for inflation, were lower than at any time since the Depression. So even at today's highs, when you factor in inflation there is still plenty of room for most commodities to go even higher. (Crude oil's record high in the 1970s would be $90 a barrel in today's dollars.) History tells us that in every bull market nearly everything reaches an all-time high. I haven't even factored in war and terrorism—and that's because the commodity bull market would thrive without that terrible duo. Historically, however, war and political chaos have never been good for anything but pushing commodity prices higher, unfortunately.

That prices are likely to rise for years to come is reason enough to invest in commodities. But there is another factor that makes such a prospect even more comforting.

When Stocks Go Down—Commodities Go Up

Historically, there has been a negative correlation between the price movement of stocks and commodities. On any chart of bull markets in stocks and commodities, they are parallel lines going in separate directions. Commodities were hot in the period between 1906 and 1923, when stocks went nowhere—and the reverse was the case during the Roaring Twenties. Many of us still remember the hot commodities—and cold stocks—of the 1970s. Quite the opposite was the case during the 1980s and 1990s. Now the cycle is turning in favor of commodities. Studies have confirmed this negative correlation between stocks and stuff. Two recent studies, for example, headed by Barry Bannister, a capital-goods analyst for Legg Mason Wood Walker, Inc., the Baltimore-based financial services company, show that for the past 130 years "stocks and commodities have alternated leadership in regular cycles averaging

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Source: All formats Barry Bannister, Legg Mason Wood Walker, Inc. Used by permission of Barry Bannister. For the U.S. stock market index: For the period 1871 to present the Cowles Commission U.S. stock market composite data from Standard & Poor's Corporation are joined with S&P 500 12-month annual average prices. For the PPI for All Commodities: For data from 1793 to 1890, the Warren & Pearson study, a U.S. commodity average constructed from the following components: farm products, foods, hides and leather, textiles, fuel and lighting, metals and metal products, building materials, chemicals and drugs, household furnishing goods, spirits, and other commodities. For the periods 1891 to 1913, the source is the Wholesale Commodities Price Index from the Bureau of Labor Statistics (BLS) and other agencies. For the period 1914 to present, the source is the PPI for All Commodities modern series.

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18 years." Bannister heard me talking up commodities in the early 2000s and kindly sent me his own research on bull markets in stocks and commodities since 1880.*

When you look at these trends on a graph, it is positively eerie. It looks as if God himself were a trader who enjoyed playing the stock market for 18 years or so and then switched to futures, until he got bored again, after another 18 years or so, and went back into the stock market. Why the negative correlation? I'm not sure, but I have a theory. Consider the Kellogg Company, the world's leading cereal producer, with $8 billion in total sales. When the price of the massive supplies of wheat, corn, sugar, and paper that Kellogg needs to make and box all those different cereals is low, the company is likely to make a lot more money. At worst, the cost of doing business is under control; at best, it's declining, and Kellogg makes bigger profits at bigger margins. In the commodity bear market of the 1980s and 1990s, when commodity prices were very low, Kellogg stock did extremely well—moving from a $2 stock to more than $40 in 1999. By the end of that year—and the first year of the commodity bull market—Kellogg stock had sunk by 50 percent. The stock inched up over the next six years—Kellogg has made major acquisitions outside the cereal business—but it never got much beyond its 1999 range.

It stands to reason that when the prices of the commodities Kellogg needs are going up, the company is under more pressure to control costs and profit margins. And so a rising commodity market would hurt many companies and their margins, while decreasing prices for those same goods over long periods would help them. In theory. And that is my theory for this apparent reverse correlation between stock and commodity prices. It would also ex-

*Barry Bannister and Paul Forward, "The Inflation Cycle of 2002 to 2015," Equity Research Industrial Portfolio Strategy, Legg Mason (April 19, 2002). Bannister, "War, Legacy Debt, and Social Costs As Catalysts for a U.S. Inflation Cycle," Legg Mason (May 16, 2003). In both studies, the authors point to a new bull market in commodities that is under way. I agree.

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plain why commodity-producing companies (oil and mining companies, for example) and those that support and serve them (oil-rig manufacturers, tanker and container owners, trucking firms that haul metals and scrap, and so on) tend to do well during commodity bull markets.

I have not sat down and done a study of this phenomenon. In fact, I always used to recommend it as a dissertation topic for ambitious graduate students, but the hard data has been coming in. Bannister and an associate actually began their analysis of the commodities and equities markets by asking their clients, "Do commodity-serving companies deserve your capital?" They concluded that, while stocks for most companies went down during a commodity bull market, companies connected to the commodities business—their focus was manufacturers of heavy machinery used in agriculture, such as John Deere and Caterpillar—were likely to do quite well. That, too, would be explained by my theory. When oil prices were making record highs in 2004, the stock pickers on CNBC were shaking their heads about how awful the market was—except for oil and other energy-related companies, which, of course, was exactly what happened during the last bear market for stocks (and commodities bull) in the 1970s. While the stock market was going nowhere generally, there were some great success stories among oil and oil service companies.

This trend is no fluke, evidently—at least according to an even more recent, and extremely important, study from the Yale International Center for Finance entitled "Facts and Fantasies About Commodity Futures," which was published while I was writing this book.* To study simple properties of commodities futures as an asset class, the authors created their own commodities index of returns on future contracts between July 1959 and March 2004.

*"Facts and Fantasies About Commodity Futures," by Gary Gorton and K. Geert Rouwenhorst, Yale ICF Working Paper No. 04-20, June 14, 2004.

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They, too, found that returns from investments in commodities were "negatively correlated" with equity returns (and bonds, too). This result, they explained, was "due, in significant part, to different behavior [between stocks and commodities] over the business cycle." When the stock market is in decline or just going sideways, investors are always looking for a hedge. Ignoring commodities in a bear stock market, as so many tend to do, turns out to be quite irrational—and fiscally irresponsible.

The Nation's Economic Health Is Not a Deciding Factor

The twentieth century's longest bull market in commodities began during the Great Depression in 1933 and grew even stronger during that period, a period that serves as the very standard for "hard times" in America. Economies all around the world suffered, yet commodity prices kept rising. And thirty-odd years later, during the famous worldwide recession of the 1970s, commodity prices skyrocketed again.

In both cases, supplies had dwindled during previous years, while demand rose or at least remained flat. Supply and demand, that's what it's about. When the stock market is on fire, as it was during the twenties and the sixties, investors ignore companies that specialize in raw materials and other goods. And then, no matter how badly the economy is doing, the necessities of life (food, heat, shelter) and the basic means for jump-starting the economy (construction, mining, agriculture) sustain demand for commodities.

And even when demand dwindles, prices can still climb. How? If the supply falls faster than current demand, the supply-and-demand imbalances only increase—and so will prices. You can't just turn on the spigot at a copper mine. Ramping up production of an existing mine takes years. And once the product is depleted

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there will be a supply vacuum. Finding new mines, exploiting them, and bringing the metals to market, as I have pointed out, can take decades.

The Yale study also concludes that "commodity futures are positively correlated with inflation, unexpected inflation, and changes in expected inflation." That was pretty obvious to those of us who participated in the commodity bull market during the 1970s, when double-digit inflation was rampant. Investors worry about inflation, particularly the unexpected variety, because it cuts the purchasing power of their returns and other income. Looking for a hedge, some head for stocks, others head for short-term government bonds and treasuries. Back in the 1970s, as a young investor searching for ways to make money I actually drifted into commodities for the first time because I saw so little value anywhere else. I certainly had no idea that was the way the world worked during a long-term bull market for commodities. (At the time, I didn't even know that I was in the middle of a big commodities boom.) According to the authors of "Facts and Fantasies About Commodity Futures," commodities have been a better hedge against inflation than stocks *and* bonds for the past 45 years.

Today, as a much more experienced investor, I would have been dumbfounded if Professors Gorton and Rouwenhorst had discovered otherwise. But many people are confused about inflation. I am constantly asked about inflation (and "deflation") during speaking engagements. People refer to it as if it were some kind of magical entity that existed on its own, independently of market mechanisms. But what is inflation but higher prices? And higher prices do not happen without a reason or cause. And if I'm right that current supply-and-demand imbalances will be pushing up most commodity prices for years to come, that's the root of inflation. Most people just don't notice it until those higher commodity prices are passed along to them—when more expensive oil and metals, for example, raise the price of their cars and gasoline. If inflation were a marching band, higher com-

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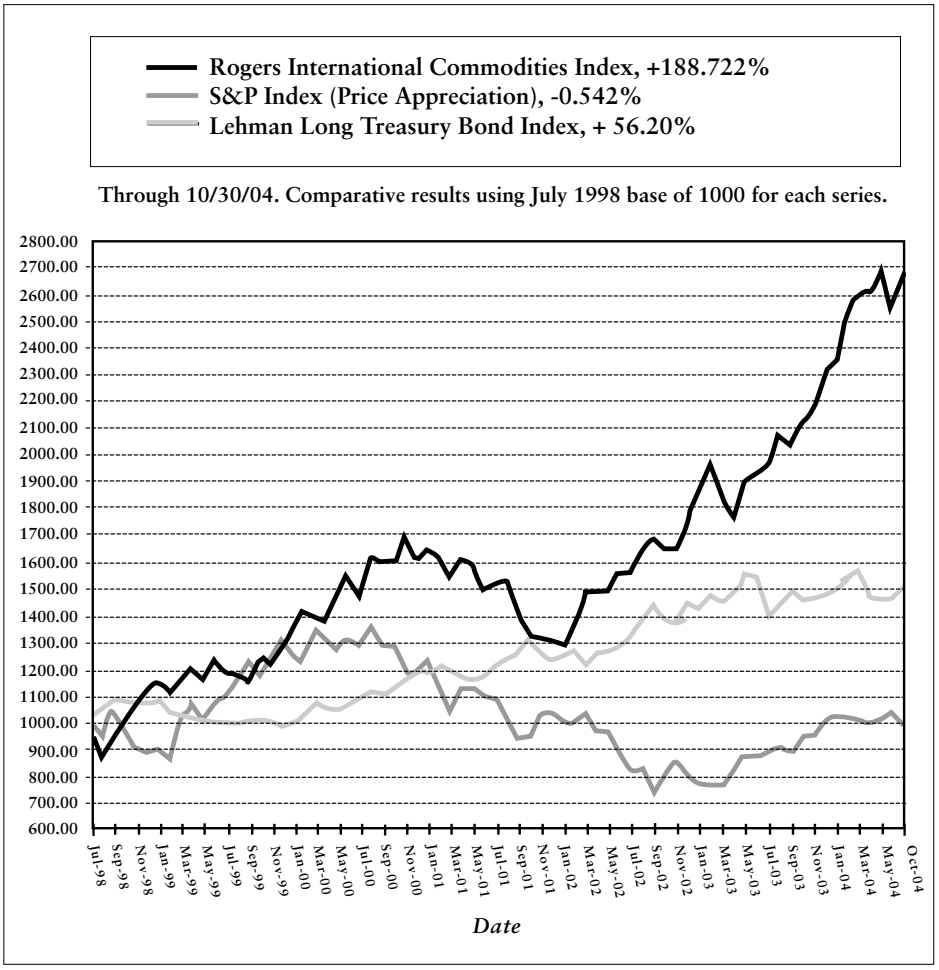
modity prices would be the majorettes leading the musicians down the street. And by investing in commodities you can beat the band.

WARNING! THERE WILL BE SETBACKS

I cannot promise a stairway to heaven. No bull market in any asset has ever gone straight up; periodic corrections will always occur. In this bull, too, there will be corrections; things will go down. And when they do the smart investor will buy more. In the last commodities bull, which ran from 1968 to 1982, commodities went up and down slightly for the first three years and then spiked more than 200 percent on the CRB Index, went down a bit, then up a bit—and then plunged 53 percent over the next year. Commodities gained 22 percent on the CRB by 1977, only to lose 15 percent of that gain the following year. After five years of ups and downs in the same range, one might have thought that commodities had stalled. But one would have been very wrong—and would have missed another 104 percent spike in prices before that bull market ended in 1982.

The stories of particular commodities were also filled with corrections. In the late 1960s, gold, for instance, was at $35 an ounce. In 1975, it skyrocketed to $200 in anticipation of the effects of the recent decision by the U.S. government to allow Americans to own gold again. Within the year, gold lost 50 percent of its value, plunging back to $100. A lot of people sold their gold. Too bad for them, because gold proceeded to go up eight and a half more times—to $870 an ounce in January 1980! When oil made its historic rise to $40 a barrel in the 1970s, there were periodic dips along the way. A look at the performance chart for the Rogers International Commodities Index launched on August 1, 1998, about four months before the bull really began, shows plenty of ups and downs, particularly in 2001, when commodity prices for the 35

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goods included in the index were down 18.51 percent for the year. Experienced traders expect setbacks, and when they see prices going down they simply buy more.

Warning No. 2! China Has Caused Some of the Gain—and Will Cause Some Pain

In the near future, you may see headlines reporting "China in Turmoil!" With an economy that's been growing at a phenome-

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nal rate for a decade (more than 9 percent in 2004, which was at least three times faster than the U.S. economy), there are bound to be some problems. Mix a massive amount of new market capitalism into a centrally controlled Communist system, and you generate enough confusion and inexperience for a hard landing or two.

When the political and economic shock comes, it will send waves throughout the world. Japan's current growth is dependent upon China, which is also importing massive amounts of commodities from the rest of the world. When the prime minister of China suggested in the spring of 2004 that the economy needed to be slowed down in order to stall inflation, the prices of copper, gold, and oil fell on the news—and so did shares on the Asian and U.S. stock exchanges.

I will take up China in more detail in Chapter Five, but up front I want to be clear that when China sneezes the rest of the world will be reaching for aspirin. In particular, commodity prices will fall, and a lot of investors will panic. You and I, however, will be buying more commodities. We know that history and simple economics are on our side: Supply and demand have conspired to create a historic bull market in commodities, and that means prices should continue to rise at least until 2015. Those 1.3 billion and still counting Chinese are not about to disappear. Buying more commodities cheap during those setbacks for the market is where you will make some real money.

What Is the Difference Between a Consolidation and the End of a Bull Market?

A consolidation is caused by a glitch in the supply-and-demand relationship. When the Chinese government actually forced large banks to tighten up loans to manufacturers in an effort to

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slow the economy, that put a further crimp in metal prices. But as long as worldwide supplies are still low, and demand is still high, once China starts importing commodities again prices are likely to rise. A consolidation is simply a *temporary* decrease in prices.

The signal that a bull market is over is a series of fundamental changes in the way we live. In 1972, for example, the Club of Rome predicted that the world would soon run out of natural resources. Oil went from $3 a barrel to $34, and the prognosticators were publishing charts with oil prices heading for $100 by the mid-80s. President Jimmy Carter soon had Americans wearing sweaters, turning down their thermostats, buying smaller cars, and cursing OPEC. European nations began using nuclear power plants instead of oil to generate electricity, further decreasing oil demand. And then oil from new deposits discovered in the North Sea and Alaska began to come on line, increasing supply. By 1978, oil production had exceeded demand for the first time in years—a major fundamental shift, which should have signaled the end of the bull market. (Prices, however, continued to rise for two more years, proving that human beings can make markets move in strange ways. The last leg of a bull market always ends in hysteria; the last leg of a bear market always end in panic.) If scientists discover that orange juice causes cancer, the news will not result in a simple correction in the orange juice market; it will be the death of it.

When you see headlines about the discovery of new oil reserves or wind farms popping up outside major cities, when you see new mines coming on line, when you discover that stockpiles of all kinds of commodities are rising, those are fundamental shifts—then it's time to get your money out of commodities. The bull market will be over.

Those days, in my opinion, are a decade away, at least.

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Review Box: The Brief for Commodities

- The 1980s and 1990s saw a bear market in commodities. Rarely have commodities been as inexpensive as they have been in recent years—when compared with the Consumer Price Index or the price of other financial assets, such as stocks and bonds.
- This long bear market in commodities has created a sharp reduction in capacity—and thus large supply-and-demand imbalances. Quite simply, demand is increasing and supply is extremely low and declining, and it will take years for this imbalance to improve.
- As economies in Asia continue to grow, there will be a strong worldwide demand for all commodities. China, in particular, has quickly moved from a major exporter to an importer of commodities, consuming iron ore, copper, oil, soybeans, and other raw materials voraciously.
- Historically, the prices of commodities show a negative correlation to the price moves of stocks, bonds, and other financial instruments. When stocks are down, commodities are up, and vice versa. That means if you are not investing in commodities, you are not genuinely diversified.
- Commodities are tangible assets that offer different characteristics—and no credit risk. They are also liquid. Commodities are traded on open markets throughout the world, and their prices are listed in the press and other media.
- Commodity prices can rise even when the economy is stuck in reverse.

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- Commodity returns outpace inflation.
- Stock prices can go to zero. Commodities cannot. Unlike shares in a company, commodities are real things that are always likely to be worth something to somebody.
- The U.S. Federal Reserve and other central banks in the world have been pursuing a policy of debasing their paper currencies. Hard, tangible assets will, once again, be the place where value and growth can be found—the real money.
- The U.S. Federal Reserve's policy of monetary stimulus and rapid credit expansion will continue to push up the prices of hard assets such as precious metals and other commodities—as more and more money chases a diminishing supply of assets. And while central banks have the power to create money as quickly as they can warm up the printing presses, they cannot create new raw materials or foodstuffs out of thin air or speed up the customary procedures for bringing what is available to market.
- History shows that war and political chaos only push commodity prices higher, unfortunately.