



The Knowledge to Decide

www.spireresearch.com

**Channel News Asia Prime Time Morning
2 June 2008**

The US dollar, Inflation and the likelihood of a Commodities bubble

Synopsis

Rising commodities prices, inflation and the downward spiral of the US dollar have weakened consumer confidence and raised questions about economic growth. Is a commodities bubble on the horizon and how will this affect the Asian region? Group Managing Director of Spire Research and Consulting, Mr Leon Perera, shares his views.

Commodities

"There are certainly some elements of a bubble in commodities. There's no doubt that much speculative money has gone into the commodities category and it's mostly driven by investors fleeing other more volatile asset classes like equities during these difficult times. And that investment has gone in through futures contracts, which are traditional mechanisms, but also through the newer, index-linked products. That speculative money has driven commodities prices to levels that are higher than they would otherwise have been.

Still, I think the market has been somewhat self-correcting. If you look at some individual commodities, prices have come down just as sharply as they rose. We saw that with oil and gold in the last week, for example. We saw that with wheat a few weeks ago. At the same time, there are classes of commodities that don't have any futures contracts and hence don't pull in the speculators' dollars where the prices have risen just as spectacularly, such as drum wheat and hay in the US.

I think there is still an upside for commodity prices because the fundamentals remain strong in the medium term, in the next one to two years. Commodities are traded and used in the real world – the demand is there from China and India because of increases in discretionary spending from the middle class, and the supply cannot keep pace with demand. That's the interesting thing about commodities as it takes time to actually bring a new mine into peak production, to create a new offshore oilfield or oil palm plantation. The key variable will be what happens to global demand, whether it softens by a great deal or a little. That will have a huge effect on commodities prices.

The US Dollar

We certainly expect the dollar will strengthen against most major currencies between now and the end of the year, even though it won't be a straight line progression and there will be reverses as well as gains. But it is overall a strengthening momentum...

I think the main drivers for the US dollar will be the Federal Reserve policy and most likely, if there's no major consumer fallout or consumer recession in the third quarter, the Fed's policy will be to stop cutting interest rates and perhaps to increase rates towards end of the year...

The other driver will be the general health of the US economy. Some of the recent data suggests that the fallout from the subprime crisis will not be as severe as we thought. If you look at the US GDP growth in Q1, the adjusted figure was 0.9%, about the same as Q4. April housing starts have actually grown by 3.3%.

And most importantly, even though consumer confidence in the US is at a low, retail spending has still held up. Retail spending is 70% of the US economy. That's still in positive territory in spite of everything that's happened in the last nine months...

Inflation in China

The economic outlook in China is positive but the inflation outlook is dire. The 8.5% inflation figure is much higher than was expected. And this was largely driven by food prices. The cold snap we saw in January has finally had results at the retail end of the food chain, driving up prices.

The tragic quake in Sichuan will certainly exacerbate inflation. Sichuan produces ten percent of China's pork and pork price rises have been a big contributor to the general inflation trend. Also, I think Sichuan's reconstruction will lead to a rise in demand for construction materials, adding to inflationary pressures. So that will continue, among other factors, to keep inflation rates very high...

Vietnam's economy

We certainly see the economic growth rate in Vietnam coming down. The main driver is the level of inflation – over 20 percent. This will reduce consumer spending... But foreign direct investment is still pouring in. There will still be considerable government spending on infrastructure this year. So we expect GDP growth to come down from the eight to ten percent range to perhaps the six to eight percent range. There won't be a collapse."

