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Commodities – much talked about, but what are they?

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A reader has asked me to explain commodities and the commodity cycle. I'll start with the standard definition of a commodity, being 'a basic thing, a building block used in the production of goods and services'.

There are food commodities such as wheat, milk and cocoa; gold, silver and copper are a few metal commodities and oil and natural gas are energy commodities.

Commodities are interchangeable in terms of quantity and quality. A barrel of oil is a barrel of oil, irrespective of where you extract it from and how much effort and cost you put in to obtaining the oil before it goes into the barrel.

Commodity prices are determined on a world market, based on demand and supply. You cannot read a business news bulletin these days without a mention of commodities. The headline will shout that the oil price has reached a new high, or that the gold price has bounced on stronger economic growth.

There are all sorts of explanations as to what drives commodity prices. Every time there is a commodity boom, we hear arguments about how there is a finite supply of oil or gold. However, over long periods of time, commodity prices have tended to trend downwards because commodities tend to follow a common pattern.

As the demand for a commodity increases, lots of suppliers emerge, leading to an oversupply. The price falls, so production is reduced ...then we get a shortage, suppliers re-emerge, and so on. If commodity prices rise too much, substitutes emerge. For example, when wood and metal became too scarce and expensive in the 1950s and '60s, plastic became an affordable substitute. Commodities can be traded either in their physical form (where you buy a kilogram of gold) or as a futures contract (where you agree to pay a price for a kilogram of gold in the future, without ever collecting the physical gold).

Traders buy and sell commodities to reflect their view of the future. If, for example, they feel positive about world economic growth, they might buy some copper or silver (because these commodities are used to 'build things').

However, if the traders felt that inflation was looming, they might buy some gold as a hedge against inflation. Gold is often thought of as the best commodity because of its intrinsic value (the theory being that it will always be accepted as payment, even when paper currency isn't worth much).

Commodity prices have been rising for some years, before stalling last year as the world entered recession, only to resume their upward climb in recent months.

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Not all commodities are rising uniformly, and the commodity cycle is certainly not a smooth one (a lot of commodity price charts look eerily similar to share market price charts). Much of the volatility is due to currency since commodities are priced in US dollars, and the dollar has been volatile.

The other major driver has been the economic growth in China and India. The statistics about the likely growth in these economies are staggering, and as these economies develop, commodities will be required to build shopping malls, produce mobile phones and feed populations whose tastes are changing.

Commodities investing is not for the faint-hearted and is more complicated than just buying a silver ingot or some BHP shares. Commodities are an integral part of economies and markets, so we should get used to hearing about commodity prices and cycles – even though we may never truly understand what drives them!

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