

On The Cover/Top Stories

Can You Spell Commodity?

Bernard Condon 10.30.06

While the Dow Jones booms, commodities like oil and gas swoon. Jim Rogers, the man who called the raw materials rise years ago, is upping his bets. Economist Stephen Roach thinks that's nuts.

In three months crude oil has fallen 20% to \$60 a barrel. A price drop in natural gas severely wounded hedge fund Amaranth Advisors. Gold and sugar are in bear markets. In August the Goldman Sachs Commodities Index fell, breaking four years of month-on-month increases.

To Jim Rogers, the man who called the commodity boom seven years ago, those are mere blips. This is a great time to invest in commodities, and he's backed this up by investing more of his own money. Supply of things like base metals, oil and rubber is crimped after years of underinvestment in mines and oilfields and farms, he says, so prices are heading up. And they will go up, with some transitory hiccups, well into the next decade and perhaps even the one following. Copper, zinc and oil have all at least doubled in the past three years. You'll see more doublings in many more commodities.

That's the Rogers view. And then there's economist Stephen Roach, the Morgan Stanley bear every bull loves to gore. He thinks Rogers is dead wrong. Roach says commodity prices could fall another third from here, putting an end to silly notions of a so-called supercycle of commodity increases. The culprits: slowing growth in China, a voracious buyer of commodities, and a U.S. housing recession that, he says, will slash demand for building materials like copper and weigh down the global economy.

If you've been distracted by whether the Dow Jones stock index will stay in record-setting territory, there's a less-noticed but raging debate about the future of commodities. This, by the way, is a debate that can get personal. Rogers says Roach "couldn't even spell 'commodities' two years ago." Roach wearily responds that, yes, he used to write "commodities" with one "m" before Rogers kindly set him straight. The sparring recalls a famous exchange a quarter-century ago, during another price runup, when the ever-optimistic economist Julian Simon bet doom-and-gloom environmentalist Paul Ehrlich \$10,000 that metals would fall over the next decade, ending 1990. Simon won. He wasn't a pessimist in the manner of Roach. His theory was that technology would eventually find a solution to any raw material shortage. We ran out of whale oil but found petroleum. Copper is expensive, but optical fiber is replacing a lot of it.

If the issue of resource scarcity is similar, the wagers today are a bit bigger. Hedge funds have put \$70 billion into energy, double the level of two years ago, says the Energy Hedge Fund Center. Investment banks have beefed up their trading desks with commodities experts. Merrill Lynch paid \$800 million for an energy trading unit after unloading a similar business a few years earlier. Bond investors are watching closely, too. Increased commodity prices usually mean inflation is right around the corner.

The peripatetic Rogers, 63, who once set a Guinness World Record by riding his motorcycle around the world, brings a lot of credibility to the bull case. A founder with George Soros of the legendary Quantum Fund, he started a commodities index in 1998 when investors were caught

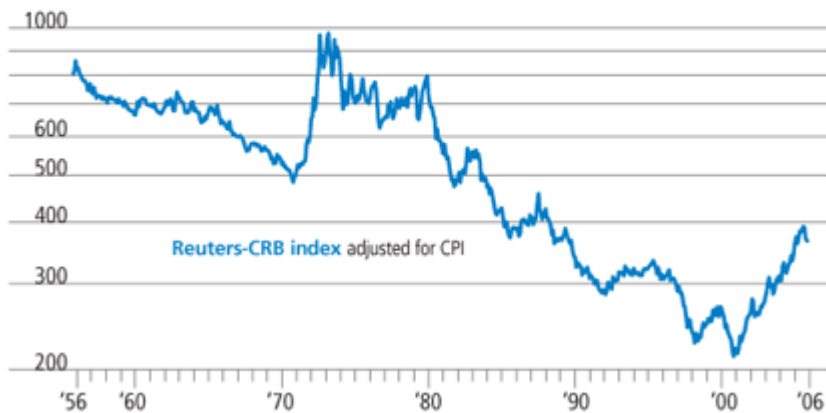
up in the dot-com frenzy. The Rogers International Commodities Index has since returned 16.9% annually versus 13.9% and 11.8% for rivals from Goldman Sachs and Dow Jones-AIG, respectively. This year the gap has widened. Rogers' is up 7% through August. Goldman's is down 0.4%, and Dow Jones-AIG's up 3%.

Rogers, author of *Hot Commodities*, says his optimism comes right out of the history books. The shortest commodity boom, which began in 1966, was 15 years, he says. The longest: 23 years. The current one: 7 years (forget the slump we're in now). The long trend reflects this fact: Lots of commodities can't be produced quickly. By the time miners or drillers or farmers realize that demand has outstripped supply, it's too late. New sources need to be found underground and regulators need to sign off before a shovel can even hit the ground. Food inventories are the lowest since 1972, he notes. Acreage devoted to wheat, for instance, has been falling for three decades. Cotton could also take off, he says, as clothesmakers switch to natural fabrics to avoid the rising cost of oil used in synthetics. Rogers says "soft" commodities like grains, oilseeds and fabrics, which have generally not shared in the boom, are likely to outperform. Rogers is relatively bearish on zinc and copper, however; they could drop like an anvil after having more than doubled in a year.

Then there's China. Sure, the country's economic growth could slow, but over the long term Rogers is an unabashed bull. So much so that he's taught his 3-year-old daughter Mandarin and, in preparation for moving to a "Chinese-speaking" city with her, has put his Manhattan manse up for sale for \$15 million.

Boom? What Boom?

Forget the recent run-up. Fact is, many commodities are still 80% or 90% off their highs, adjusted for inflation. Jim Rogers says that spells a bargain.



Roach's response: China will be slowing, and that's a big problem. The country is responsible for half the growth in purchases of aluminum, copper and steel and more than 85% of the growth in tin and nickel. Roach says bank reserve requirements and rises in interest rates, combined with Beijing's recent "administrative edicts" to rein in investments, will throw cold water on the "China mania" gripping investors who blithely assume 11% growth every year. It could also kill off a few of the mania's side effects--like Mandarin lessons for kids and uprooting families to Asia--what Roach calls "Rogers' whole schtick."

Roach says crude oil prices are more likely to head down than up; Rogers says they will approach \$100 a barrel before the commodity boom ends. Roach says cheap Chinese imports create "headwinds" against inflation and that rising U.S. bond prices wisely reflect that. Rogers

says inflation, far from retreating, is rampant, and he is shorting U.S. Treasury bonds. Roach says the influx of money into commodities means trading "technicals" with no relation to fundamentals can cause investors to "overshoot." Rogers notes that there are fewer than 50 mutual funds worldwide dedicated to commodities versus 70,000 for stocks and bonds, though he too fears man's tendency to overshoot. It's Roach's timing that's off, he says.

"Call me in 2019," says Rogers, which he considers a more likely peak-price year than today. "I will say, 'Sell commodities.' And you will laugh and giggle and say, 'Commodities always go up. You are an old fool.'"

Roach might be thinking something along those lines right now. He apparently sees opportunity in the coming real estate crash. He jokes that he put in a bid of \$1.5 million for Rogers' house (eight bedrooms, five baths). Roach says, "He hasn't gotten back to me yet."