



Financial Columnists

Sell Commodities

A. Gary Shilling 03.10.08, 12:00 AM ET

The long and deep recession i've been forecasting has commenced, even though the statisticians haven't called it yet. It was triggered by the subprime mortgage market collapse, as predicted in my June 19, 2006 column. The zeal for high investment returns that was born in the dot-com mania of the late 1990s didn't vanish in the 2000-02 stock market bust. It came back to life in the housing bubble. Now we're paying the price.

After the subprime market disintegrated, markets for asset-backed commercial paper and collateralized debt obligations followed. The resulting shortage of credit translates into a crimp in spending. The recession will also be propelled by an extraordinary retrenchment among consumers who were financing their spending sprees on home equity extraction. Refinancings and home equity lines of credit are drying up. House prices are down 10% from their October 2005 peak, and I look for another 16% drop to reach my long-held target of a 25% peak-to-trough slide.

The recession will continue at least until December. It will probably rank with the 1957-58 and 1973-75 declines, the worst of the ten recessions since World War II. It will be global as exports sold to U.S. consumers shrink, thus slashing the primary growth source for the rest of the world.

The decoupling theory said that emerging markets and other foreign economies can keep growing while the U.S. dips. The theory is about to be disproven.

My firm's analysis and my recent two-week trip to China convince me that China does not yet have a big enough middle class of free spenders to sustain growth in the face of weak exports. Define middle income as a family with at least \$20,000 a year in the U.S. or \$5,000 in China. By that definition 80% of Americans are in the middle or upper classes, but only 8% of Chinese and 5% of Indians.

Don't expect either the recent panicky cut in rates by the Federal Reserve or the hastily enacted tax rebates to save the economy. Interest rates are irrelevant when a scared lender withdraws amidst unknown and perhaps unknowable further writedowns and trading losses. Some of the rebate checks will be spent, but too late--toward the end of the year when the recession likely will be bottoming. The rest will be saved by chastened consumers or used to reduce debt.

What to do? Sell or short commodities, perhaps via exchange-traded funds, stocks in companies that produce them or futures. Commodity prices, still high, are poised to fall hard as the worldwide recession takes hold.

Chinese demand, terrorism and talk of peak oil drove crude prices. Agricultural prices were hyped by biofuel's popularity, droughts and the prospect of a shift in demand in poorer countries from grain to meat. So institutional investors rushed into commodities, believing they are a relatively stable asset class like stocks and bonds. Individuals bought commodity-backed ETFs. That enthusiasm will soon be history.

With global recession, demand for industrial commodities and oil will fade. It will become clear that much of China's demand for commodities was not primarily to supply its citizens but to supply its export market.

No one will be talking anymore about how oil production is peaking. Look at Petrobras' huge oilfield discovery off Brazil and consider the gigantic energy supplies that will come from tar sands, nuclear, coal liquefaction and maybe shale. More supply equals lower prices.

Good weather and weak ethanol prices may knock down ag prices. A recent report in *Science* magazine has discredited many biofuel schemes as environmental salvations. We're going to stop fueling our cars with taco ingredients.

My favorite commodity to bet against is copper. This is an excellent proxy for global industrial production since it's found in manufactured goods from cars to computers to faucets. The worldwide housing collapse makes copper prices especially vulnerable, as does the shift from copper tubing to plastics in plumbing.

Copper's price on the New York Commodities Exchange was \$1.90 two years ago. The Comex March 2008 futures contract is \$3.56.

Unlike oil, copper has no cartel to prop it up. Because the metal is produced in developed countries and relatively safe emerging lands, no sudden shortage--as we've seen with rioting in Nigeria's oil-producing area--will suddenly tighten supplies and spike prices. Sure, earthquakes and strikes can threaten to disrupt copper mining, but these problems always have been temporary.

Other industrial commodities are interesting on the downside, too, but copper is my best choice for a swoon.

A. Gary Shilling is president of A. Gary Shilling & Co., economic consultants and investment advisers. Visit his homepage at

