

January 2010: Report to Socrates

Introduction

This is a quiet time in markets. My coverage is a review of the year, commodities, markets, and peak water.

1. A Year of Uncertainty

Analysts when looking ahead usually see increasing prosperity ahead. They could be likened to cuckoos, which, in both the northern and southern hemispheres, who migrate to follow the sun. Their skies are blue, there is no sorrow in their song, and there is no winter in their year. The cuckoo is noticed because of the nasty surprise raids it makes on other birds nests, leaving them the burden of child-raising. The cuckoo reminds us to expect the unexpected, and that situations that look healthy are actually malignant (sub-prime, asset bubbles)

The equivalent of a cuckoo's egg could appear in China. There are plenty of nests to disrupt there, including a bubbling stock market and over-capacity in many industries. Difficulties in the US property market (notably commercial) and European and Japanese debt are too predictable to qualify as a cuckoo effect but they are real enough, along with long odds on a second recession.

Global economy

The global economy is expected to grow by 2% this year, but, optimistically, I favour about 3%; fully 2% below its long-term average. This is a dull recovery in contrast to previous experience. The motive force is still the effects of the massive stimulus packages both in the western world and China. The western economies will grow at a rather slow rate and the merging counties will provide the most positive returns. Among the emerging markets, growth in China is expected at 10%, India 8%, Russia 5.3% and Brazil 4.8%.

Does this Emerging Market growth have staying power? Probably. Although most have an export-led growth model, an increasing amount of production will be internally consumed, either in massive infra-structural development (as in China) but also in satisfying the burgeoning middle classes. There also several new free trade arrangements in Asia which began operations in January 2010 and these

will attract investment and more trade opportunities. The emerging markets may have too much cheap foreign capital spurring bubbles as in Dubai.

The US, EU and UK economies are enduring credit less and jobless recoveries. The US normally emerges rapidly from recessions with booms in car and house sales driven by pent up demand. The case is now different with housing and car sales depressed and consumer confidence low. Banks are reluctant to lend because retail banks continue to fail owing to soured loans. Moreover, the business sector is borrowing less, having found alternative funding sources. With the weak dollar, and strong tech industries, the US is looking particularly to export markets for growth. Joblessness is high and will remain so as the recent crisis has accelerated a structural change which is removing jobs to lower wage regions.

US has shed jobs most aggressively, but business may demand more labour with more stable demand and increased government incentives to employers. Growth in The US will exceed Europe's, partly because European business has traditionally been more dependent upon bank-lending than the US. Europe has been hard hit by an appreciating Euro, and Germany had lost its primacy as the world's leading exporter.

Bank loans and M3 money supply have severely contracted in Europe thereby risking the recovery. The head of Germany's industrial federation says there is a danger of a credit crunch with banks failing to roll over loans to businesses with good track records. Banks have chosen to restrict loans to grow their capital rather than dilute their shares. The problem is not entirely of their making: they are expected to increase capital requirements while increasing loans. This is repeating problems of the 1930's.

In contrast to other writers, I suggest that British growth could exceed that of the US and Europe. I am persuaded by Goldman Sachs that Britain's devaluation could attract investment and stimulate exports. Its financial sector is skilled and could exploit opportunities. Its big problem at present is inflation of 2% and the Bank of England will be pressured to raise interest rates although this will be disastrous for debt-funding and could lead to an appreciating pound. The greatest uncertainty lies in currency, but as US growth stabilises; it seems probable that the US dollar may rally and this will affect almost everything else,

including commodities. If the US currency continues its depreciation, it will strangle growth in European and Australasian economies and retard growth everywhere by stimulating increases in oil prices.

Interest rates.

Governments are expected to claw back some of their outlays on stimulus packages. Securing a viable exit from stimulus is delicate as the recovery is fragile and the politicians involved have a dove-ish bias. There will be no appetite for the necessary tax increases anywhere, especially in the UK and US which have elections. The US may reduce stimulus in some areas, but promises to extend it too to tackle the jobs scenario.

Nevertheless, It is expected that the US, EU and China will increase interest rates during the year. The tightening bias began in Australia, and China imposed a surprise increase in the Reserve Requirement ratio for depositary institutions. Further increases in official rates are expected. Commentators expect interest rate rises soon in India, Taiwan and Korea. The US and EU may give precedence to reducing liquidity before raising interest rates.

Canada and the UK will also tighten. New Zealand is unlikely to tighten forthwith given its hesitant recovery and fears of an appreciating currency. Nevertheless, market forces, and inflationary tendencies, may raise other rates on bonds, mortgages and corporate debt.

Wobbles can be expected in financial markets for several reasons. Several governments have adopted punitive stances to banks and bonuses and politicians could inflict surprises. A tightening stance may lead to a bond sell-off. But tightening will not be robust and asset appreciation should continue. This extends to equities which may become over-priced and subject to snap corrections. Moreover, tightening by China will reverberate on all equities, especially Australian and will weaken the commodity currencies while strengthening the dollar and weakening gold.

Fixed interest markets will be nervous because of the inflation and sovereign default risks. Bond holders do not have nerves of steel, and they are in a constant state of apprehension. The loose fiscal policies of almost all states are as disturbing as defaults and credit down-grades. Moreover, the incredible

increase in government debt and liquidity causes the appalling spectre of the erosion of real values. Although gold has retreated from its recent highs, I suspect that it will increase in price again during the year, partly because output is still inadequate to meet demand.

The recovery is not yet ensconced and head-winds remain. The greatest problem is handling massive and rising government debt without another inflationary outburst. But there will be other crises, perhaps arising out of debt.

2. Commodities

A mild recovery accords with commodities outperforming other assets. As I understand it, demand will come from Emerging Markets and restoring inventory throughout the world. However, a large rally would be extraordinary as prices leapt in 2009. While the Chinese and Indian super-cycle continues to operate, it must be remembered that much of China's imports were to create stockpiling at bargain prices. China dominates the base metal market; accounting for 38% of global consumption of copper, zinc, nickel and aluminium (the US consumes 10% of these). BHP reports strong price recovery across all commodities, but their report (and one expects them to have the best intelligence in the world) stresses that the speed of the recovery is uncertain, especially given the withdrawal of government stimulus and China's loan tightening: "Consequently we expect some degree of volatility in the short term outlook for commodities".

The top performers in 2009 were Lead 146%, Copper 126%, Zinc 116%, nickel 78%, Crude oil 75%. It would be unrealistic to expect their spurt to continue unabated, and the top recent performers are coking coal, potash, and lumber. BHP, the great commodity expert is increasing exposure to Potash. Copper is still favoured by one respected source, although China has large stockpiles of about 800,000 tons. Chinese imports remain high. Coking coal prices are increasing to about \$170 spot as against contract prices, negotiated last year of \$130. (E.g. BHP-Mitsubishi). Japanese Steel production is increasing and they are the biggest coking coal importers. China's steel production is also increasing. Coking coal is in tight supply. Commodities are also being lifted by the on-going demand from G7 countries as well as China/India's robust expansion, and investor attention. Investors are getting more involved. At one time they were happy with exposure through hedge funds or passive investment in indexes. Now

they move to ETFs and recent changes in ETFs have given a great boost to platinum and palladium.

Potash is widely tipped to do well, but it is priced at about half of its 2008 levels and production has fallen. Existing producers in Canada could expand production, so BHP's move is a long-term commitment. China and Brazil are increasing imports.

Spot uranium has eased from \$53 to \$49 lb as the US is releasing stockpile in return for a clean-up. Utility demand this year is only about 4.5 million pounds, but note my "Peak uranium" in previous reports, the market expects demand to increase to 18 m. lbs. In 2011, as in china alone 24 new reactors will come on-line. India is commissioning reactors too.

Lithium. Tokyo Tsusho shares have surged as it has secured long-term supply, possible along with Orocobre. China and Japan are in a ruthless war to secure supply.

Oil and Gas

Oil has doubled in price since 2008, and is presently at around \$80; already up since \$73 in my last report. It may be headed for \$90, given increased demand in G7 but especially in the Middle East. Demand appears to be increasing by 1.5 m.b.d. but supply increases are smaller. Non-Opec increases are 0.3 m.b.d. (Russia, Alberta, and Brazil). China's demand is increasing as its car sales are now greater than the US (14 million v.11.8). India's car sales increased by 34% in 2009.

Natural Gas prices have rallied, helped by a cold winter, but a price above \$6 will bring a supply response from low-cost shale basins in the US. Natural Gas may be increasingly preferred as an electricity generator with US climate change legislation expected. Exxon has bought companies in respect of this.

Food. Oilseeds are expected to outperform. Soy and canola have rallied but are still down on 2008 prices. Corn demand is increasing faster than production, but the moves are not dramatic. Wheat fell 8% in December, while sugar increased 15% (the top performing commodity).

Gold

Having gained 24% in 2009, gold has been subject to a bear attack, in conjunction with a US dollar rally. SPDR Gold Shares ETF (the biggest EFT) has retraced 7% this month, but Barrick lost 17%. A study of 1000 stocks shows a weighted average fall of 15%. Investors have been selling for several months along with silver and uranium while they have bought other metals. Close to 100 listed stocks have lost a third of their value in the year. Miners have battled for cash-flow, faced increased capital and operational costs. While many commentators are bullish on gold there is a probability of further stock declines. The competition with ETF's is important and stocks are not just responsive to bullion price, but have to contend with exchange rates, quality of management, and risks arising from mining, geography and politics.

(<http://www.mineweb.com/mineweb/view/mineweb/en/page33?oid=96073&sn=Detail>)

Nevertheless, the London researcher GFMS group says “there is a large amount of money poised to enter the gold market in 2010”. But the market will need it as there is a surge in supply including much scrap. Jewellery demand could increase. GFMS also warn about possibility of a “major correction”

London bullion Market Association poll predicts a high of \$1,394 and an average of \$1,199. My favourite site on gold Mineweb is opting for \$1,480 but it is reader driven.

The Swedish Raw Metals Group is predicting mean metal prices to be below 2009, and plumbs for a correction in 2010. Its forecast for gold is \$1,050. It is bullish on copper and zinc especially. The Swedes say that the three driving prices for gold are now history—weak US\$, insecurity, low gold supply. But interest is high in China and India so prices will not fall too far.

Ross Norman, who has a record as the best forecaster in the London bullion exchange, says gold spot price will average \$1,236 in 2010, up 27% on the 2009 average of \$972. He sees strong investment demand overcoming weak jewellery demand. Norman says investors are horrified by quantitative easing and fiat currencies. He suggests that ETFs take gold out of the market, thereby tightening supply.

Summing up: Gold has temporarily backtracked. Admittedly, there has been more security in equity and bond markets which had reduced demand for gold,

and the issue of ETFs for Platinum has diverted funds. Most of the authorities I cite favour a strong performance this year. I give weight to China being the biggest producer and consumer (having just overtaken India). Indian demand has slumped but could revive. China's consumption increased by 15% last year. I believe China is keeping most of its production in reserve and buys more for private consumption on the market. While there could be a protracted consolidation in the gold price I believe it will rally.

However, it appears that mining shares are not the best way the realise gains, ETFs seems superior.

3. Markets.

The US, UK (+4.4) and EU markets rose in December. UK GDP was 5% down in the year, EU industrial production was 11% lower than 2008. French equities rose by 6.7%, German 5.7%, Norway 6.5% and Holland 10.7%. Greece was down 5.8% while Turkey outshone with a 17% increase. In most markets materials, industrials and health outperformed while financials and telecoms lagged.

Equity markets remain quite strong, aided by low interest rates (which reduce competition from fixed interest) and a mass of liquidity. As a mild recovery is in place, albeit vulnerable, equities could prosper. Many firms in IT, e.g. Intel and IBM, have found increasing consumer demand. The market will be slack for housing and household items (Walmart is not prospering) but some retailers like Tesco will do well because they are better managed than their rivals.

This writer was always sceptical of the 2009 rally and is inclined to think that Washington directly stimulated the market in March. Thereafter it has grown on the flood of liquidity. A correction is still on the cards given the fragility of the recovery, poor employment and weak property. The China market is an obvious bubble. There has been an unbelievable crash in US housing start and consents. For a terrific graph see:

[http://www.westpac.co.nz/olcontent/olcontent.nsf/content/FM_Weekly_20100118/\\$FILE/NZWC1801.pdf?Open](http://www.westpac.co.nz/olcontent/olcontent.nsf/content/FM_Weekly_20100118/$FILE/NZWC1801.pdf?Open)

Interest Rates/Currency. .The US 5-year treasury rose 70 points in December, I do expect tightening this year, and this will exacerbate currency

differentials. I expect the Euro (at present at a record low against NZ\$) to remain weak because of the precarious nature of Greek, Portuguese and Irish debt problems. Japan will move heaven and earth to weaken the yen. The US will try to keep the dollar weak to solve its current account deficit problem.

I believe the commodity currencies will be strong, especially Australia and New Zealand. The Kiwi will respond to interest rate rises. Westpac believes the 90 day rate will be 6.10% in March 2011 and the Kiwi/us at 77c.

For the record, speculation of tightening prompted a rise of the US\$ in December by 7% and 4.5% against the yen and euro: both the Aussie and the Kroner depreciated by 2%

4. The Economy (not covered in this report beyond first section)

5. Peak Water

It is obvious that oil and gold are finite resources, but so is water (desalination is no more than a local option). The water crisis is with us, and as over-looked as population growth. World population has trebled in my lifetime! Demand for water is increasing exponentially.

A World Economic Forum recently observed that “water is the gossamer that links the web of food, energy, climate, economic growth and human security challenges the world faces over the next two decades”. It argues convincingly that we cannot manage water the same way we have in the past or the economic web will collapse.

This may seem rather extreme, but water scarcity will increase dramatically in many parts of the world. Just as businesses look to energy security, many in future will be asked to provide details of their water-related risks to investors and their water-use efficiency to the public. Investors will be attracted to countries with sound water management policies.

Although the focus of this report is upon global water issues, there will be inferences that New Zealand lacks sound water policies. It is treating water as a free resource and using it inefficiently and tolerating pollution. Managing and conserving water should be a priority.

➤ Existing water scarcity

According to OECD data, 44% of the world's population lives in areas of high water stress and this will threaten the very livelihood of about a third of the world population by 2025. If existing practices are unchanged, by 2025 water scarcity will affect about 30% of global cereals. For example, India's harvest could be depleted by 255 due to falling ground water levels. Overall, 55% of the world's population will be dependent upon food imports as a result of lack of sufficient water.

Yet food demand will increase to feed a growing population so change is necessary especially as much of the increased demand for grain will be due the dietary changes, especially a desire for more meat. A meat eater's diet is calculated to require over 5000 litres of water each day, approximately double that of a vegetarian. Global production of meat in 1999-2001 was 229 million tons and it is projected to increase to 465 m.t. by 2050, particularly to meet the Asian market.

As water is scarce, there is a looming problem in several middle-eastern and Asian economies of allocating water to agriculture or to urban, energy or industrial sectors. It is estimated that once 40% of usable water is devoted to irrigation, societies will prefer to allocate water to non-agricultural sectors. This is important as by 2030 under present policies, North Africa and the Middle East will devote 58% of water to irrigation and all of South Asia will reach the 40% threshold.

Inevitably, the percentage change in demand for water for non-agricultural use will crowd out irrigation. In Asia, it is predicted that industry will require 65% more water by 2030 and 30% more for domestic use. The situation is similar in the Europe, and the Americas.

There is serious pressure on aquifers around the world. Major ones have vanished in Texas, and in wide areas in the Middle East, India and North China water tables are falling by more than one meter a year.

➤ **Environment**

Over-extraction is compromising the environment in many counties. It is a factor in Canterbury, NZ now as many rivers have minimal summer flows. The situation may be reversible in New Zealand by vigorous action, but many global areas

have sustained great damage and cannot be expected to cope with increased food production, poverty reduction or climate change.

The Millennium Ecosystem Assessment found that river was the most degraded natural resource. More than 70 major world rivers were at maximum extraction levels. These include the Nile, Colorado, Ganges and Tigris Euphrates. The Yellow River in North China is an extreme case. It needs a 25% minimum flow but in 1997, 600 kms were dry for 220 days. In Australia, the Murray-Darling needs a 30% minimum flow but irrigation takes 80% and it rarely gets to the sea.

Melting glaciers are putting pressures on many rivers. The Tibet-Himalaya glaciers are the origin of 7 great rivers but at the present rate the glaciers will have gone by 2100. Many people will lose their livelihoods owing to water scarcity, and 150 million people could become refugees because of environmental degradation.

➤ **Trade.**

The fast-growing but water- short economies of the Middle East and Asia could save water by importing more of their food requirements. But agricultural trade is falling and in need of reform. Moreover, 3 of the top 10 food exporters are already water-scarce and 3 top importers are water-rich.

There is a new trend where water-scarce countries are acquiring land to grow crops. Saudi Arabia is looking to Pakistan, China is acquiring land in Africa and Korea is leasing land in Madagascar. Other countries are reportedly considering making similar moves and I have met a Swiss businessman looking at cropping land in Canterbury

➤ **Energy**

The US and EU are also trying to improve their energy security which is, in effect, a switch from reliance on oil to reliance on water. This increases the competition for water. Energy is a huge water user. Energy production at present accounts for 395 of US water withdrawals and 31% of the EU's. Both intend to increase their energy production by 50% by 2025 and this could increase by more than 100% their water needs.

➤ **Utilities**

Providing water for cities, energy and industry is urgent. Already economic growth is hampered and problems will increase as cities grow. Massive capital investments are required, and a role for private capital is essential.

China has particular problems as 60% of its cities suffer water shortage and 50% wastewater treatment. In some cities, many people are unconnected to a municipal supply. Massive investments of about US\$400 bn a year are needed in water infrastructure.

➤ **Economics**

Water is a key factor in economic development. Australian drought reduces GDP by at least 1% p.a. and water issues are hampering China's development. Water security is a growing concern for investors. They increasingly ask companies to give assurances about their water security and risks. Water reform is a winning strategy: it retains and attracts business as well as private investment in water. Moreover, tightening by China will reverberate on all equities, especially Australian and will weaken the commodity currencies while strengthening the dollar and weakening gold.
