

# THE THREAT OF HIGH PRICES

## BY RUCHIR SHARMA

IF THE TALKING HEADS ON WALL STREET ARE TO BE BELIEVED, THE bears have been lulled into hibernation and are not likely to resurface until at least spring of next year, in line with their normal habits. Historically, the period from November to April has been the best time for taking on risk, particularly when speculative juices are already flowing, as they are now. The popular thinking is that the markets are likely to keep rising until the Fed starts raising interest rates, but that is a very distant prospect given the weak condition of the U.S. labor market. With a mild economic recovery underway across the globe, the consensus holds that the bull run of 2009 will continue and that prices of assets from stocks to commodities will rise over the next few months.

The problem is that assets cannot continue to rise simultaneously without the prices of some assets starting to undermine others. For one thing, a sharp rise in prices of commodities such as gold and oil is usually not consistent with a broader stock-market rally. Normally, oil prices move up slowly in the early stages of an economic expansion, allowing central banks to keep monetary policy loose and give the economic recovery time to become well entrenched. This time around, oil prices have shot back up to more than \$75 a barrel, the levels of October 2007, when global economic activity was at its peak. Commodity bulls spin the story that prices are rising due to the improving growth prospects in China and other commodity-consuming emerging markets. Hard numbers just do not back that claim: inventories for oil and other commodities from aluminum to zinc are at multidecade highs, and spare capacity is ample as global industrial output is still more than 10 percent below its late 2007 peak levels.

Huge amounts of excess liquidity in the global financial system have led to a "paper demand" for commodities, with exchange-traded funds for various commodities attracting capital inflows of more than \$40 billion this year—more than twice the annual average pace of the 2003–07 boom years. Speculative turnover in the commodity pits is also running at new highs. The daily trading volume of energy-futures contracts is estimated to be a staggering 15 times underlying demand; the norm just five

years ago was four to five times underlying demand.

All this suggests that not all the money pumped into the system is finding the right home. Most models put the fair price of oil closer to \$50 a barrel, given the prevailing trends in consumption and inventories. The current "liquidity premium" of \$25 to \$30 a barrel caused by the Fed's hyperstimulative monetary policy is cutting a percentage point from U.S. growth.

Nor is the high price of gold cause for bullish joy. Gold is a negative barometer, a safe haven that goes up in price when faith in the financial system is in decline and down when the system is working. Its character reminds one of what Winston Churchill said of a colleague: "He has all the virtues I dislike and none of the vices I admire."

If prices for oil and other commodities continue to rise, policymakers in emerging markets—where commodities account for a larger share of consumption—will face an inflation challenge. Based on current commodity prices, inflation on average in the developing world will be close to 5 percent by the second quarter of 2010, and higher if commodity prices rally further. That will be bad news for the world economy as emerging markets are currently the engines of global growth. The panic tightening by central banks in several developing economies in the first half of 2008—in reaction to the commodity bubble and at a time when demand in the developed countries was still weak—set the stage for the credit crisis.

The world can hardly afford even a minor redux of that next year. Let us hope that the echo bubble in commodities starts deflating soon on its own accord. However, if, true to their nature, the amassing herds in the commodity pits require monetary authorities to whack them with higher rates to reverse course, then 2010 will soon start to smell of 2008. That will certainly shake the bears out of their slumber a lot sooner than expected.

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