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## **Inflation and Some Potential Movers**

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By: Matthew Bradbard

At the fork in the road, the Fed chose Wall street over Main street. The Fed seems more concerned about the economy than current inflation readings, but that could be because government reports do not take into account food and energy. Calculating inflation excluding food and energy is like assuming no one eats food or consumes energy. With oil at an all time high and food prices moving violently higher, calculating inflation excluding food and energy is a serious blunder.

We wanted to touch on what our interpretation is on current inflation conditions and which potential markets we're playing to take advantage of. Let's first touch on inflation and then jump to markets that are on our radar and should be on yours.

I'm not trying to scare anyone, but inflation does exist. Prices of raw materials are moving higher and the value of our dollar is moving lower, so you do the math. Commodity prices are argued to be leading indicators of inflation through two basic channels. One channel is that they respond quicker to general economic shocks, such as an increase in demand. The second, is that some changes in commodity prices reflect individual shocks, such as a drought that decimates the supply of certain agricultural products, which are subsequently passed through to overall prices. Depending on the type of shock, the observed link between commodity prices and inflation would be expected to be different. Moreover, changes over time in the mix of shocks in the economy could affect the stability of a link between commodity prices and inflation. The strongest case for commodity prices as indicators of future inflation is their quickness to respond to economy-wide shocks to demand. Generally commodity prices are set in highly competitive auction markets and consequently tend to be more flexible than prices overall. As a result, movements in commodity prices would be expected to lead and be positively related to changes in aggregate price inflation, in response to aggregate demand shocks. In addition, to the extent that demand shocks are not sector-specific, the levels of commodity prices and overall prices also would be linked.

It has certainly been a spectacular ride for many commodities this year, with energies and most metals continuing their multi year march higher, and of late, the agricultural commodities that are joining the party. MB Wealth's understanding is that this increase in commodity prices and declining value in the US dollar signals a developing resurgence of inflation. What we mean by "inflation" is deterioration in the purchasing power of the US dollar and that materials we use are becoming more costly.

Although the US dollar has lost 8% ytd in 2007 and 16% from 2005 highs we will continue to play this from the short side – SELL RALLIES.



Now, it should be clear that there's a definite trend in this chart, in that a dollar bill will buy you a whole lot less oil than it did six months ago. Well, yes, but a bushel of corn or a board of lumber will also buy you a whole lot less oil than they would six months ago as well. And when a bushel of corn buys you a whole lot less oil, I want to describe that as an increase in the relative price of oil rather than as a pure monetary inflation. The reason we want to use this example is that we're mainly interested in whether the Federal Reserve may have been creating too many dollars and thereby contributing to the phenomenon of inflation as outlined above.

It is true that there is a broad tendency for many of these items, particularly the precious metals and commodities used in manufacturing, to move together. This type of progress suggests that there is some common cause behind the price surge. Besides the monetary inflation story, another popular explanation is that commodities are generally experiencing a speculative price bubble. One challenge for either the monetary inflation or speculative bubble view of commodity price movements is the fact that there is such diversity, with some commodities going up a great deal and others not at all. Indeed, these differences amongst commodities are actually much bigger in magnitude than the average movements common to them all.

Although not entirely discounting the potential role of monetary or speculative factors, MB Wealth is inclined to interpret much of the relative price movements resulting from the same factors that have always made commodity prices much more cyclically sensitive than other prices. Specifically, the long lead times in production and short-run demand and supply inelasticity mean the prices can be particularly sensitive to demand fluctuations. A broad increase in the level of economic activity can thus lead to a broad increase in the relative price of a particular group, though with huge differences across items reflecting the particular factors of supply and demand in each specific market.

**That's right a global growth story that is affecting the supply and demand balances expect more volatility and higher prices to come.**

One of the best ways we feel to play inflation is by trading Gold from the long-side. That is not to say just buy and sit on it but rather trade the market with a bullish bias – BUY DIPS.



Let us also point out some specific plays that we think you should take a look at that don't have to do with inflation but pure and simple...supply and demand.

### The run for acreage....

Corn needs to trade higher or it will lose acreage that it cannot afford to. Corn at current prices will not be planted by farmers that have the option to plant a more profitable crop like beans or wheat at these price points. Corn is set to give back a good portion of the acreage it stole from other crops last year. We would suggest buying a harvest break of new crop corn below \$4.00 and holding it into the New Year, looking for growing demand and a shift in acreage to support a price movement to new contract highs.



With cotton losing almost 20% in planted acreage last crop cycle, there is very little room for error. If world consumption picks up as expected this could quickly eat through stocks and cotton cannot afford to lose more acreage this coming year. Although prices have started to move, cotton prices are still historically cheap and we would not rule out a move to 80 plus cents to encourage increased planting. On a re-emergence of Chinese demand like we have seen on other commodities, expect cotton to benefit. Although the big picture has potential tightness in 08' look short-term for cotton to struggle lower, ideal for a long entry in December 08' closer to 70 cents.



Although Sugar has not been making any headlines the funds may soon find value in this sweet commodity. In fact funds have slowly been accumulating longs, presently at 13 longs for every 1 short. Prices in sugar have been cut in half in the last year as a 3 year sugar deficit turned into a sugar surplus. We are not capable of picking the catalyst, whether it will be a shift in supply, demand, weather, or a fund led rally; but owning Sugar near 10 cents seems to be a good bet with a favorable risk to reward dynamic. Even with a 50% retracement you would pick up roughly \$3000 per contract and the current margins are less than \$1000. It may be the sleeper in the commodities and a portion of your capital should be allocated to sugar. This is our hurry up and wait trade.



Heating oil may be the best kept secret in the energies sector. With current inventories 30% below last year levels and already reaching a record high before cold weather has arrived it could be a costly winter. Refiners have yet to fully switch over and are still devoting efforts toward RBOB gasoline while peak demand is fast approaching. We have to hope for a warm winter to avoid some real economic pain that could make this summer's gasoline prices look cheap. Currently we are looking for a pullback into our buy zone about 10-15 cents lower than current prices. Our advice here would be to buy pullbacks that hold support and look to build a position. Because of the extreme volatility in this contract you must be well funded, start small, and parlay the position.



These are just a few of the commodities that we feel merit your attention. If you are not receiving MB Wealth's Weekly Commodity Commentary yet you should be. Contact us today to open your trading account! Call Matthew Bradbard at 1-888-920-9997 or email me at <http://www.mbwealth.com/contact.html>

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