Philequity Corner (February 7, 2011)
By Valentino Sy

The Good, the Bad and the Ugly

Commodity prices have risen significantly the past seven months due to the following reasons:

1) Strong demand coming from emerging markets, especially China and India
2) Prospects of continued recovery in the US and in parts of Europe
3) Continued accommodative policies by major central banks
4) Acceleration of money printing by the Fed through QE2
5) Supply tightness in most commodities and the inability of capacity to expand fast enough to meet demand.
6) Extreme weather conditions that have disrupted production of agricultural commodities and major mining areas such as Australia (which recently experienced floods and devastating cyclones)
7) Increasing demand from hedge funds and sophisticated investors which uses commodities as portfolio diversifier
8) Increasing geopolitical risks in the Middle East and North Africa

The basket of commodities measured by the Reuters/Jefferies CRB Index (shown in the chart below) has risen 31 percent since the start of the 2nd half of 2010.

Source: www.stockcharts.com

As investors, we have to watch closely what is happening to the commodities market because of its potential effects on inflation and ultimately, interest rates. Note that movements in commodity prices can be wild. They have the tendency to overshoot on the upside and undershoot on the downside like what we experienced in 2008.

In today's article, we will highlight "the good, the bad and the ugly" effects of rising commodity prices to the Philippine economy. This is very timely because rising commodity prices (particularly agricultural or food prices) is a key factor in the current protests and uprisings in the Middle East and North Africa.

The Good

Rising metal prices is obviously "good" for the country which is considered the 5th largest mineralized country in the world. Located in the Circum-Pacific belt of fire, the area where the earth's tectonic plates collide, the Philippines is blessed with abundant formation of important minerals (13 metallic and 29 non-metallic). Gold, copper, nickel, and silver can be found in economically feasible quantities ready for extraction.

In recent months, the prices of precious metals like gold and silver have been on an upswing due to the continued ultra-loose policies of major central banks, the Fed's QE2, and higher inflation expectations. Silver and gold prices have expanded 56 percent and 8 percent, respectively, since end-June 2010.

Industrial metals like copper and nickel face significant supply deficits this year. Supply disruptions due to extreme weather conditions in key mining regions like Australia will likely increase prices further. Copper prices have already risen by 56 percent since end-June 2010, while nickel prices have gained 43 percent over the same period.

Aside from the mining sector, another beneficiary of high commodity prices is the coconut industry. Coconut oil prices have risen 122 percent since end-June 2010 due to a shortage in copra and the rise in prices of competing oils. This is more than enough to offset the considerable drop in coconut oil exports this year due to poor weather conditions. According to the Philippine Coconut Authority (PCA), coconut oil exports may reach $1.217 billion in 2011, up by more than 50 percent from last year's $588 million. The Philippines is the world biggest exporter of coconut oil.

		Price		%Chg since
The Good	**Unit**	**Current**	**end-June 2010**	**end-June 2010**
Gold	$/oz	1,348.85	1,245.50	8.3%
Silver	$/oz	29.14	18.67	56.1%
Copper	$/lb	4.5795	2.9360	56.0%
Nickel	$/ton	27,775.00	19,425.00	43.0%
Coconut Oil	$/mt	2,220.00	1,000.00	122.0%

Source: Bloomberg

The Bad

Crude oil represents the "bad" in this analogy because of its significant impact to the economies of oil-importing nations like ours. While the surge in oil prices has not been as strong compared to price increases of other commodities, its impact to the Philippine economy and to the Filipino consumer is widespread.

Stronger than expected recovery in the US economy, insatiable demand from emerging countries especially China and India, stock depletion and tight supply have driven up crude oil prices the past year. The recent unrest in Egypt and the potential disruption of supply delivery passing through the Suez canal and the Sumed pipeline (equivalent to 5% of world supply) have caused prices to rise further.

Higher oil prices normally lead to increased input costs, higher electricity prices & costs of transport, swelling food costs and mounting wage pressures. Fortunately, crude oil prices are just up 4 percent since end-June 2010.

Over the past two weeks, a taxi fare hike and a jeepney fare hike were already implemented by the Land Transportation Franchising and Regulatory Board (LTFRB). Next in line is a bus fare hike now being reviewed by the LRFRB.

The Bad	Unit	Price Current	end-June 2010	%Chg since end-June 2010
Crude Oil	$/bbl	89.03	85.64	4.0%

Source: Bloomberg

The Ugly

What is "ugly" right now is the rising cost of food which is regarded as a major issue in the going unrest in North Africa and the Middle East (see *What does Tunisia and Egypt have to do with Philippine stocks?*, January 31, 2011). The prices of agricultural commodities extended their gains last month after rising throughout 2H10 as droughts and floods damaged crops from Russia to Australia. The problem is set to worsen after a massive snowstorm covered most of the US.

The prices of wheat and sugar have risen 84 percent and 81 percent, respectively, since end-June 2010. Wheat and sugar are major components of a Filipino staple, the "pandesal". The price of rough rice, another Filipino food staple, is up 67.6 percent over the same period. Coffee prices are up 51.8 percent since end-June 2010. Meanwhile, soybean oil and corn which are used in both food manufacturing and in livestock feeds are up 61.8 percent and 87.1 percent, respectively, since end-June 2010.

The Ugly	Unit	Price Current	end-June 2010	%Chg since end-June 2010
Corn	$/bu	678.50	362.62	87.1%
Wheat	$/bu	853.75	464.75	83.7%
Sugar	$/lb	32.64	18.03	81.0%
Rough rice	$/cwt	15.80	9.43	67.6%
Soybean Oil	$/bu	58.89	36.4	61.8%
Coffee	$/lb	249.30	164.20	51.8%

Expectedly, January inflation registered 3.5 percent – at the high end of Bangko Sentral ng Pilipinas' (BSP) forecast. The BSP is now expecting inflation rate to average 4.2 percent in 2011 instead of the revised forecast of 3.6 percent due to rising food and energy costs.

The Philippines is Resilient

The Philippine stock market has corrected and the peso has declined because inflation, especially food and fuel inflation, has been going up. High inflation poses a serious threat to the government's high growth target of 7 to 8 percent GDP growth in 2011.

As commodity prices continue to rise and inflation pressures build up, the BSP will have to start tightening. But just like in 2008, we believe that the market will be able to adjust and survive. Back then, the Philippines experienced a rice crisis when rice prices surged to 34-year highs. During the same period, the price of gasoline rose as high as Php60 per liter when Nymex crude hit an all-time high of $145 per barrel.

Today, all governments are struggling with rising cost of food globally. We are quite fortunate that our country has ample trust in our President and confidence is still widespread, unlike in some countries where dictators are being blamed for high food prices and have to be toppled.

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