

## Pricing power: signal versus noise

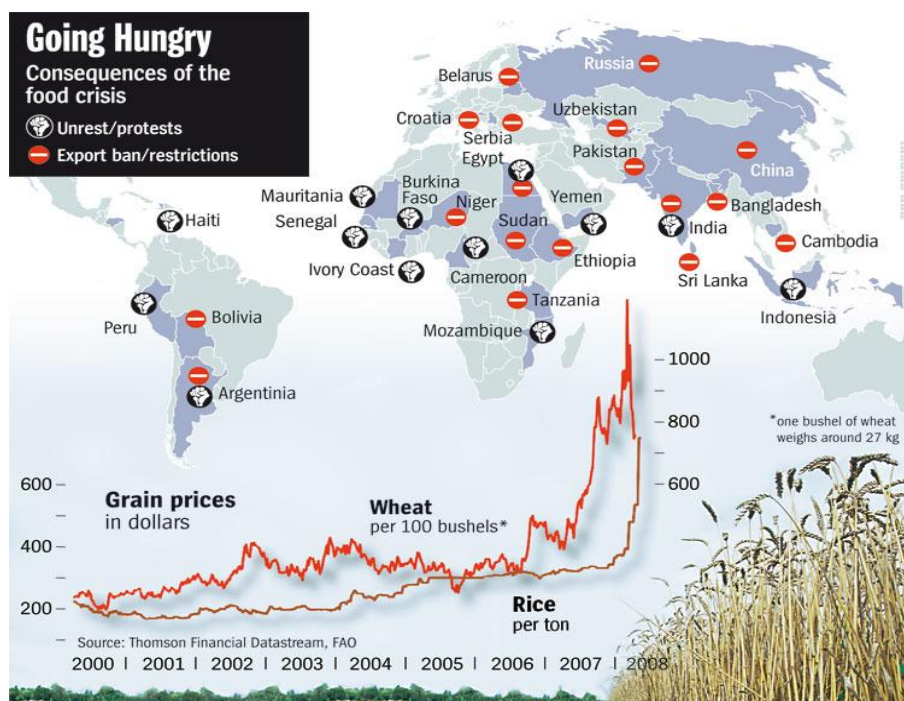
"The individual has always had to struggle to keep from being overwhelmed by the tribe. If you try it, you will be lonely often, and sometimes frightened. But no price is too high to pay for the privilege of owning yourself." – Friedrich Nietzsche.

It has become increasingly accepted wisdom that commodities prices now seem to be caught in something of a speculative bubble – that speculators, in other words, have steered commodities markets away from their economic fundamentals, and are in turn triggering the growing impoverishment and in some cases starvation of the peasantry in the developing world. (As Rio Tinto's chief economist [Vivek Tulpule](#) wrote earlier this week, high prices by themselves do not automatically constitute a bubble. It is difficult to argue, however, with Michael Jones of RiverFront Investment Group who suggests that commodities are near-term overbought.)

But could it be that commodities prices – those of oil, gold, industrial metals, foodstuffs – whilst evidently reflecting leveraged capital inflows are also, and more profoundly, reflecting a reality of decades of underinvestment now crashing horribly into a historic surge in global demand ?

To an extent, debates about the role played by speculators – whether leveraged or not – in the agricultural markets play a subsidiary role to the price action itself given the current and prospective human cost. As [RJH Adams](#) is surely right to claim,

"..the crux of the matter is that at these price levels the leveraged flows into grain are an imminent source of great harm. Expectations of price volatility or, where rough rice is concerned, straightforward price rises are promoting hoarding, export controls and a vicious cycle of more leveraged buying. Meanwhile, in Port-au-Prince and company, rising food expenditures have been reducing real wages by large, double digit percentage amounts.. For it does not take much of this to cause catastrophe – even though the end result, in due course, will be lower prices. The last grain boom in 1972-5 saw a major famine in Bangladesh triggered by a tripling of rice prices over a three-month period in 1974. A million, on some estimates, died."



(Source: Der Spiegel)

At times of volatility and human crisis, morality sits extremely awkwardly with consideration of the market. But if one is to take "speculators" to task – a definition that would have to include unleveraged individuals as well as traditional savings institutions, given the role played by exchange-traded vehicles in introducing commodities to a broader investment constituency – then one should rightly also point a finger of blame at governments themselves. As Jude Webber and Javier Blas wrote in a recent feature article for the Financial Times ("Farmers doomed to pay price for export restrictions"), moves by some countries to ban foreign sales are threatening to extend and even worsen the international food crisis. Countries from Argentina to Vietnam have either stopped farmers from selling their crops abroad or have imposed punitive taxes on agricultural exports. Given that the same farmers are beset by rising input costs (not least for diesel, seed and fertilizers), crop acreages – far from being increased as the natural response to price signals – are, counter-intuitively, being cut. As Tim Murphy wrote in response to the Webber and Blas piece, market intervention, like the proverbial flapping of a butterfly's wings in *chaos theory*, leads to unforeseen and sometimes unmanageable consequences in a highly complex system.

Keynes famously wrote of the dangers of financial (over)trading. Speculators, he said,

"may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism – which is not surprising, if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object." ('The General Theory of Employment, Interest and Money', p.159.)

Or in other words: **I** invest intelligently and pragmatically; **you** are a momentum-follower; **he** runs a hedge fund. It is certainly difficult to re-read Keynes' words above without an involuntary shudder at the activities that have brought the western financial system to such an acute crisis – not exactly from "directing new investment into the most profitable channels" so much as from fooling their customers – and, quite brilliantly, *themselves* – into believing that mortgage derivatives of the purest lead could be transmogrified into gold.

At what point speculative capital starts to outweigh macro-economic fundamentals and becomes the primary fundamental in its own right is a fascinating question. But we are also living in a dysfunctional market environment where multiple price mechanisms seem, for a variety of reasons, to have broken down. That leaves classic free-marketeters in something of a philosophical wilderness. As Deutsche Bank's Josef Ackermann commented, a little bleakly, in response to the then broadening credit crisis earlier in March,

"I no longer believe in the market's self-healing power."

When sovereign nations throw grit into the wheels of the market to "control" food prices, they at least have the interests of the disenfranchised at heart, even if the consequences are damaging or counter-productive. But when administrations in the developed world intervene in markets and suspend the natural pricing mechanism – most recently for mortgage-backed securities – businesses not privy to state-subsidised support (manufacturers, say, who produce things of tangible value that benefit society at large, rather than a relatively small constituency of highly paid financiers repackaging financial assets) will naturally cry "foul". The role played by exceptional remuneration in the credit crisis was alluded to by Bank of England governor Mervyn King on Tuesday, in what is likely to be an increasingly polarising debate between City apologists and sceptics. While the Bank evidently has a watching brief to maintain low inflationary financial stability, there is precious little it can or should do to control financial sector pay in a free market. Over the medium term the governor probably need not fret unduly – the City, as a consequence of market forces, is imposing its own price control mechanisms in the form of laying off bucketloads of staff. For as long as property prices and the availability of credit are pressured, animal spirits, and headline grabbing bonuses – at least at the banks – are unlikely to be haunting the Square Mile any time soon.



At a time when the tone of equity markets has been relatively subdued, one of the week's more prominent stock market stories was news of Mars' \$23 billion acquisition of gum-maker Wrigley. The deal was part-financed by Warren Buffett's holding company, Berkshire Hathaway. Some commentators seized on the deal as proof of some kind of bottoming process for stocks. Making that leap seems something of a stretch; if the deal carries any significance at all, it relates to the value of Wrigley alone rather than the broader market (and, in the case of Berkshire Hathaway and Warren Buffett, to the merits of having cash on hand). But it also serves as a reminder of an investment approach barely practised in modern times – that of owning businesses outright rather than merely trading stocks. Buffett's fortune is a testimony to business ownership and long-term stakeholding as opposed to the altogether more wildly popular practice of renting stocks. There is much to be said for owning and controlling an investment in entirety, rather than hitching a ride on the back of a tradeable asset whose momentum is ultimately in the hands of an unruly and somewhat feckless mob. That holds whether the asset is an agricultural commodity, a currency, a government bond or a glamour stock. With hedge funds controlling assets to the tune of \$2.5 trillion, and more conventional managers controlling assets many multiples of that number, individual investors would do well to consider just who is truly directing any portfolio that consists heavily of listed, public securities. With some fairly blatant intervention on the part of authorities in the normal price discovery mechanism, investors may come to appreciate that they have managed to fool themselves, twice.

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