



>: Do Plunging Commodity Prices Signal End of Bull Market?

Tuesday, May 16, 2006 / Teeka Tiwari

Talk about taking a kick to the nether regions! Boy, they've been putting it on the commodity stocks. I guess that's it then ? the run's over ? we should pack up our toys and go home ?

NOT!

Momma said that there would be days like this, and so did your buddy Teek.

It seems that every trader on the planet suddenly realized that higher commodity prices equal higher inflation!!! Duh! Well of course it does!*How is this a revelation to Wall Street's best and brightest???*

So here's what happened, and here's what's happening:

As of Thursday morning, all was well in the land of commodities. Then, Friday morning, gold spikes to \$732 an ounce and the whole world starts suddenly getting paranoid about inflation. (Forget the fact that gold is trading at only 36% of its inflation-adjusted all time high. Apparently that fact was lost upon the Street.)

Then the International Energy Agency (IEA) comes out and forecasts a 15% decline in Global oil growth demand.

But that's not the whole story.

What you didn't read about over the weekend was that Friday's slide didn't start until the USDA crop reports came out, showing massive shortfalls of U.S. Corn and Wheat production.

This caused Corn and Wheat prices to soar 4.5% and 2.5% respectively. HUGE MOVES.

The real story here is that we're finally starting to see higher commodity prices show up in agricultural commodities, and that's what's got some of the fast money traders scared, because they feel that the FED will have to raise rates in June to help stave off inflation.

That's the background, here's the deal: Forget about the IEA.

I know they came out and forecast a 15% decline in oil demand growth (not aggregate oil demand as some people misinterpreted) ? but these guys have been so far behind the curve that it's difficult to place any faith in their prognostications. They completely missed the demand-side drive coming out of India and China, and so nothing they say carries any credibility with me.

There's a very good chance the Fed raises rates in June, unless we get a benign CPI (consumer price index) number this Wednesday. Anything between 0.1 and 0.2 should be enough to hold them off.

OK, reality check time: There is nothing that the Fed can do to stop this global boom in commodity prices.

Oh yes, they can slow it down, they can scare the big room traders, but at the end of the day if demand outstrips supply, prices trade higher, and the stocks that produce these commodities will trade higher as well.

The China and India genies are well and truly out of the bottle. They are not going back to their mud huts with no electricity ? would you?

You're going to hear a lot of people talking about \$70 oil creating "demand destruction." Demand destruction is the term used to describe oil prices getting so expensive that people significantly curb their usage (demand) for oil.

Demand destruction at these levels is a myth, an urban legend; it's an American centric view predicated upon skyrocketing global commodity prices. We feel the pinch more because commodities are priced in dollars, and our currency is weakening. For the rest of the world, their price at the pump for gas - or "petrol" as it's called by everybody else outside of America - have not moved that much higher.

Let me explain.

In England, wholesale prices of gas have risen approximately 25%, once you factor in the strength of the British pound over the US dollar, but the end user hardly feels it, because gas in England costs approximately \$7 per gallon, with \$5 of that being pure taxes and \$2 being the actual cost of the gas.

So if wholesale gas prices go up another 50% from here to three bucks, the end user in the UK sees his gas bill go from 7 bucks a gallon to 8 bucks a gallon - an increase of only 14%. And that, my friends, is not enough to derail this global economic boom.

The big risk here for us as investors is confusing a panic-driven and margin call-driven sell off with a change in trend.

I cannot count how many times we saw this sort of sharp, brutal pull back in tech stocks all through the 90's, only to be followed by gigantic rallies.

Now, how's this for a wake up call: I originally recommended going long the OSX back on November 22nd 2005 when the index was at 177. Since then, it's rocked and rolled all the way to a new high last Thursday of 238! A 61-point rally, or 34%. But get this: When I first recommended it, the entire index had an average P/E (Price/earnings multiple) of 32x earnings. Guess where it is today? Gotta be high

WRONG!

The current P/E of the OSX is almost 15% LESS!!

Its current P/E is 25.7 x earnings!! So even though the index has rallied more than 30% since November, it's actually cheaper today than it was seven months ago! That, my friends, is proof positive that earnings are continuing to grow at a faster rate than the stocks can appreciate ? which means that we are nowhere near a top.

Now I can't control what some room trader does on a day-to-day basis, but I can tell you point blank that we are seeing a buying opportunity of historic proportions.

And if we see a continued pullback in commodity prices and commodity stocks here, you must look upon it as a gift from the market just like the tech consolidation we saw back in 1994-1995 was.

For those of you who were trading back then, you may remember that the DOW was stuck in a range between 3,500 and 4,000, and the NASDAQ between 700-800, and the Fed was jacking up rates.

But it was this reload period that preceded the biggest bull move in history for US stocks. And, mark my words, the same will be true for energy/commodity players as well.

So it's all a matter of perspective. Don't forget - between 1994 and 1995, stocks like Dell, Microsoft, and Cisco all languished. Once the Fed was done raising rates at the end of 1994, we saw an explosion in stock prices. Dell went from the split equivalent of \$1 to over \$60, Cisco went from the split equivalent of \$2 to \$85, and Microsoft went from the split equivalent of \$4 to \$60.

Was it worth the wait? You bet it was!!

How can I be so sure we're going to see the same gains this time in commodity / energy stocks?

Several reasons. The first is that "far future" oil going out to 2011 is still trading in the \$69-\$72 range, March 2007 oil is trading in the \$73-\$75 range, and yet the average oil stock is still trading with a single-digit P/E, and Wall Street is still using \$45-\$50 oil in their earnings projections. Think about it logically. Does that sound like a group trading at irrational "peak earnings" multiples? Of course not.

This pause in commodity prices is the "pause that refreshes."

This commodity bull is going to try and buck you - but dig deep and hang tough. When you look to bottom-fish these names, use long term options, at least one year out to better manage your risk, and don't get scared. We've got underlying conditions on our side ? a resurgent Japan, a booming China, and booming India. Not to mention 300 million Americans that refuse to lie down and die just because a bunch of Wall Street room traders expect them to.

There are over 70,000 stock mutual funds out there, and less than 20 commodity equivalent funds.