What to Do about the Big Commodities Sell-Off

Life just got interesting.

First, my essays on cash and bonds are provoking plenty of interest. Someone even told us that he’s planning on firing his financial advisor.

Second, commodities plummeted yesterday. Oil was down nearly 10%. Natural gas down nearly 7%. Copper down nearly 4%. Silver down over 10%. Gold down nearly 3%. (As I write on Friday, they have bounced back a little, but not much.)

Meanwhile, US dollar cash has been making a something of a comeback. The US Dollar Index – which measures the exchange value of the dollar against six other major trading partner currencies – rose 1.4% on Thursday. The stock market was down a little and bond markets were slightly up.

What caused all this excitement with commodities? Much of the move has been put down to Thursday’s figures for US jobless claims. These “unexpectedly” jumped, pointing to a weaker economy than supposed by many.

This is just noise. It’s the day-to-day rough and tumble of the investment markets. Prices go up and prices go down. But when prices are already high it doesn’t take much in the way of bad news to give the sellers an excuse.

We’ve been hunkered down for a while now at Bonner & Partners. Global stock market valuations look like a bubble in search of a pin. Many commodities too. We don’t know what those pins might be. But we know the world is bristling with them.
So in the short run you should expect the prices of our gold and stocks to fall. When we feel the time is right to move some of our cash across to buy some bargains, we'll let you know.

For those of you still building your position in gold, you should buy on the dips. If you have none, make it a priority to buy some straight away. You should have 5% to 10% as a minimum. The price might fall further from here, but there are very good reasons to believe it won't last. You can then build up to 20% over time. A little bit here, a little bit there. Buy on the dips.

For those of you who already have 20% in gold, sit tight. Remember it's the long run that matters.

I’d like to update you on silver too. We don’t have silver in the recommended portfolio. I told you why in my weekly review on April 15. Since then, silver has been on a wild ride.

At that time, silver was priced at $42.65/oz and gold was priced at $1,481/oz. This meant the gold-to-silver ratio was at 34.6 times. In other words, silver was at its most expensive relative to gold since 1983. I argued that silver could be in a mini bubble and that the gold-to-silver ratio could move all the way to 60 or 70 within a year.

After that report, silver continued to rocket for a while. It peaked on 29 April at $48.46/oz – up 13.6% from April 15. Gold also rose, to $1,531/oz, up 3.4%. The gold-to-silver ratio came right down to 31.6.

Since then, silver has plummeted. As I write, it’s trading at $36.12/oz. Gold trades at $1,497/oz, above the April 15 level.

So silver is down 15.3% since April 15 and 25.5% since its peak on 29 April. For comparison, gold is up 1% since April 15 and down 2.2% since its most recent peak. The gold-to-silver ratio has moved right back up to 41.4. Quite a change in just three weeks.

Here is a 30-day chart of the gold-to-silver ratio – up to Thursday’s market close – that shows the volatility of silver against gold:
In other words, silver has just plummeted relative to gold. This may continue in the coming days and weeks.

This is a perfect and timely illustration of why we prefer gold to silver. Gold is solid and dependable. Silver changes its mind every day. I won’t ever recommend a large allocation to silver. But if it falls hard enough then we might dip our toes in.

Of course, if commodities get hit, our commodity stocks will get hit as well. I issued a sell recommendation on Hess Corporation (NYSE:HES) on Monday, May 2, when the price closed at $85.12. I hope you were able to act on it quickly, as the price has now dropped to $79.43 – down 9.3%. But even at this level the stock would still have gained 36.1%, including dividends, since we recommended it in November 2009.

Our other commodity stocks – Sterlite Industries India Ltd. (NYSE:SLT), Chaoda Modern Agriculture (Holdings) Ltd. (HK:682)/(PINK:CMGHF), Petroleo Brasileiro preferred stock (NYSE:PBR-A) and Gazprom OAO (PINK:OGZPY) – have taken a bit of beating as well this week. This is not a surprise. You can find all the latest price details in our weekly summary here.

But don’t worry. These are all deep-value plays set to benefit from long-term trends. The big picture hasn’t changed. The trends are intact. I’m confident
these will be great investments in the long run. Big price falls are just a chance to buy more stock at lower prices. Just make sure you always stay diversified.

You might ask why we own any stocks at all, if we think markets are poised for a sell off? The answer is that we can’t predict the future, nor can we time the market in the short run. QE3 could be around the corner, igniting another spark under markets.

So we invest in stocks that we’re confident about for the long run. That means deep value stocks in strategic sectors.

We also hold a lot of cash because there are few bargains in the world right now. But we think there will be many more at some time in the future. Possibly the near future.

In the meantime, we must be patient.

**How to Hedge Annuities**

Some of you are concerned about annuities. When someone retires and converts their pension fund into an annuity, they are buying an income stream for the rest of their life. The details vary, but annuities are basically bonds with an uncertain maturity date: the day the holder passes on from this life. Many countries force pension fund holders to buy annuities.

Some annuities pay a fixed dollar amount. Others have inflation protection and pay a lower amount. You get less now, but your annual payments go up in line with some official measure of inflation, such as the CPI. Both are like bonds. The first is like a fixed-coupon bond. The second is like an inflation-protected bond.

A side issue with inflation-protected bonds is that the measure of inflation protection could be below your personal cost inflation. In fact, this is most likely the case. There’s plenty of evidence that suggests official inflation figures in most countries are below most people’s actual experience of rising living costs.

On the other hand, if there is no inflation protection, your fixed dollar income buys less each year at an even faster pace. Even if it started out higher in the first place.
So if you already have an annuity, or will be forced to buy one in future, you need to balance that out to diversify your bond risk. You need “anti-bonds,” in other words: something that does the opposite to bonds.

Since bonds lose value when there is inflation, you need something that will benefit from inflation. Gold is your first port of call. Commodity stocks, such as the ones I mentioned above, are another alternative to give additional diversification.

If you have funds outside your pension annuity, overweight them into gold and commodity stocks. If you don’t have significant investment funds outside your pension annuity, try to put aside a little of your income each month and invest it into these assets. It’s never too late to start diversifying.

As a general rule, if you have a lot of your wealth tied up in an annuity you should act a bit differently to those that don’t. You need to aim for more exposure in the rest of your investments to “anti-bonds” such as gold.

What about Swiss Franc Bonds?

Another member asked if Swiss franc bonds are a good alternative to cash. Long-dated 30-year Swiss franc bonds yield just over 2% in coupon income. And if inflation picks up in the world they could be just as likely to lose money as other bonds. So I’d still steer clear.

But what about short-term bonds? These don’t carry much inflation risk. If global price inflation goes up, and bond yields rise in general, the price won’t fall as much as for long-dated bonds. So you won’t lose a lot of your original investment and can sell them and move on.

But you won’t make much income either. Two-year Swiss government bonds yield just 0.75%. Their US equivalents yield 0.57% – also very low, but not very different. So by buying short-term Swiss franc bonds you’re really just speculating on the exchange rate between the Swiss franc and your home currency. That’s the US dollar for most of you.

Switzerland’s currency is better than most. In fact, as Bill has told you before, he keeps his cash in Swiss francs. That’s because he has a very international life, and it’s as good or better a place to park than many of the alternatives.
But it still has risks. In the banking crisis of 2008 the “Swissie” fell 16% against the US dollar. This was because Switzerland has a huge banking industry compared to the size of its economy. The country had to bail out UBS, its biggest bank, and many banks were in the danger zone. This could happen again.

Over a longer time frame the Swiss franc has gained value against the dollar. About 28% over the past five years. Working backwards and taking account of compounding, that’s about 5% a year.

But since the bulk of our cash is just short-term parking while we patiently wait for better investment opportunities, I’d still recommend you stay in your home currency or currencies. These are matched to your costs and liabilities. That is, your current and future expenses and any debts you might have like mortgages.

We aim to rotate most of our 35% allocation to cash into stock market investments and gold within a year from now…maybe sooner. That’s not guaranteed, but it’s likely. If you take account of transaction costs to buy and sell…and the risk of a short-term fall in Swiss francs…you’re better off sticking to your home currency and gold.

**Watch Out for Structured Currency Products**

Another member asked if foreign currency certificates of deposit (CDs) might be the way to go. A lot of these products have sprouted in recent years, as foreign currency investing has become fashionable.

The idea is that the US dollar is weak, so you’re better off putting money into a group of foreign currencies, known as a “basket.” Often this basket includes commodity currencies or high yielding currencies such as the money issued by Canada, Brazil, Norway, Australia and New Zealand. Some even have a capital guarantee. This says you won’t get back less than you originally paid.

Sounds pretty attractive, right? But there are some serious downsides.

These CDs are structured products. As regular readers will know this is code for one of what I call the “expensive mistakes.” Fees are usually high, typically falling into the 1.5%- to 2%-a-year range. As to the capital guarantees, there’s
no free lunch. You probably lose some or all of your interest income to the product provider in return. Or you pay for a financial derivative embedded in the structure that offsets the risk, such as a put option. Either way it eats into returns.

Then there are the currencies themselves. By buying foreign currencies you are taking a direct risk involving those countries’ monetary policies. In other words, you are injecting political decisions into the mix. There might be good reasons for, say, Brazil’s currency to go up against the US dollar. But Brazilian politicians might not want that to happen. In fact, they’ve been deliberately trying to prevent just that in recent months.

But if these currencies are backed by commodities, that should be good, right? Well, maybe. But if you want to invest in commodities, why not go straight to source? I recommend you buy stocks of commodity producers like oil and gas majors or miners instead. Why inject the vagaries of monetary policy into the mix? Most stock investments have some currency risk. I’d just prefer that it wasn’t the main one.

Finally, there is the small print to deal with. Most of these products lock you in for an amount of time, ranging from a few months to several years... If you want to leave early it can be totally at the product provider’s discretion. Even if they agree to cut you loose, you almost always have to pay a big penalty charge. Add that to the annual fees, and it starts to look like a bad deal. We may need our cash at any time, so we don’t want it locked up in a structured product.

Last year, I read in detail the small print on one of these fixed period currency basket CDs with a four-year term. The only way you could sell it before the four years were up was if you were dead or declared mad. And then you still had to pay a penalty charge! A great comfort to your loved ones, I'm sure.

Structured products are best avoided almost all of the time due to their high costs. Since we don’t recommend currency speculation at *Bonner & Partners*, this is even more the case with structured products based on currencies. And if you are still tempted, make sure you read the small print in detail.

There are a lot of other questions from you that I wanted to cover this week, including what to do right now if you’ve just come into a lot of money. But I’m out of time and space today. I’ll come back with more answers next time.
Until next week,

Rob

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