

## DBrief



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# Harvest returns

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## If Thomas Malthus were alive today he might well be investing in soft commodities!

Our ability to produce food is failing to keep pace with population growth. Clearly, feeding all these extra mouths presents an enormous global challenge – and an investment opportunity.

We would argue that there are 10 reasons for going long in agriculture.

### 1. Population growth

First, of course, population growth. In 2005 the number of people on the planet was estimated to be 6.5 billion. The United Nations estimates that by 2050 the world's population will have grown to 9.5 billion. We expect the rise in population levels will lead to an additional 1 billion tons of soft grain consumption either directly as food or indirectly as feedstock.

### 2. Urbanisation

The growing world population has to live somewhere, and that means loss of productive land to urbanisation. (Since the 1960s the size of agricultural land per head globally

has been cut in half – though this has been offset to some degree by improvements in agricultural productivity.)

In China the urbanisation rate stands at just over 40%. We assume China's urbanisation rate will rise towards 55% by 2020–2025, in line with rates prevailing in Malaysia and the Philippines.\* This would imply an increase in China's urbanisation rate of approximately 1 percentage point per annum, the equivalent of 13 million people moving into urban areas every year.

### 3. Concentration of agricultural exports

In contrast to the energy and metals sector, agricultural exports tend to be concentrated in the hands of just two or three countries. For example, Malaysia and Indonesia together account for almost 90% of global exports of palm oil. The US, Brazil and Argentina combined account for approximately 88% of global exports in terms of soybeans, while Thailand, Vietnam and Pakistan represent 64% of the global rice market.\*

Last year was a good example of one or two key producing countries faced

with supply problems having a profound effect on price. Indeed, the rise in sugar and cocoa prices last year was attributable to supply problems in Brazil and the Ivory Coast respectively.

Consequently, country-specific events such as regulation or weather can have a powerful effect on agricultural production and hence global export markets.

### 4. Climate change

Climate change is also an issue. Less predictable and more violent weather patterns are resulting in greater supply disruption, which, combined with lower buffer stocks, is causing greater price volatility.

### 5. Changing diet trends

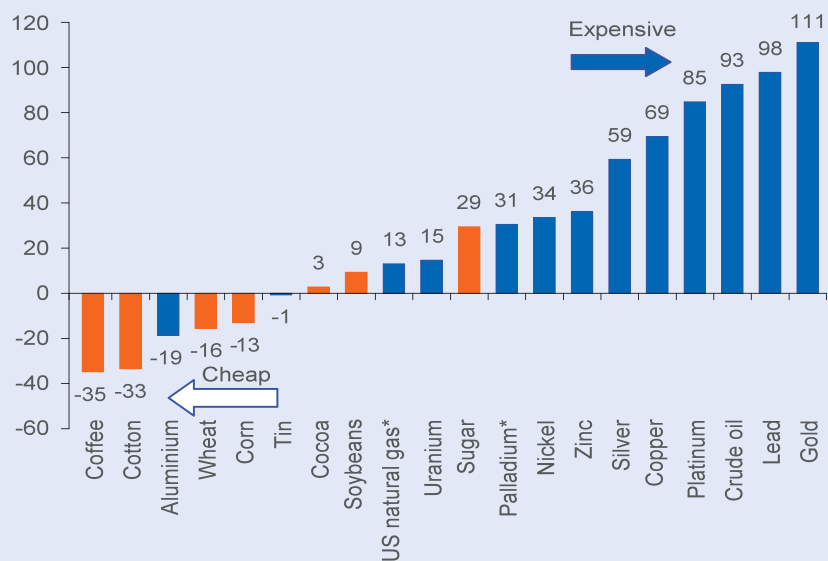
Then we have evolving dietary habits. As incomes rise in the developing world more people move towards higher-protein diets. We estimate that higher GDP-per-head levels should more than double global protein demand between now and 2050.

The reason is simple: as meat consumption rises the demand for



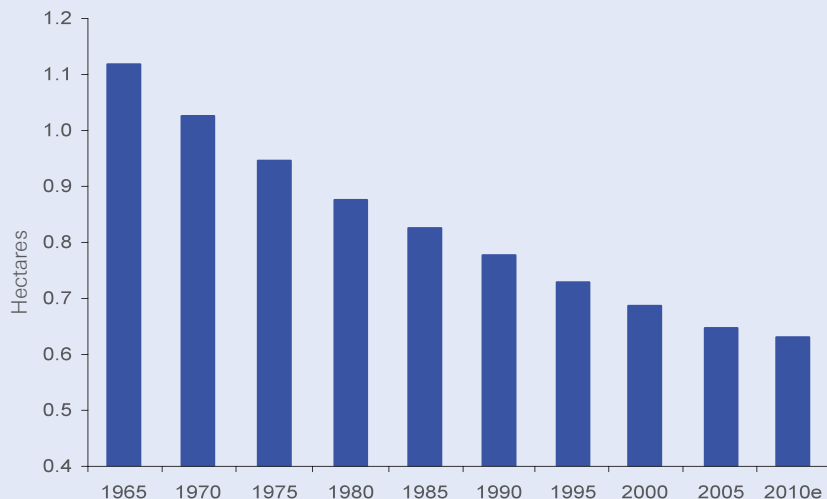
## Index of how far prices in real terms are currently trading compared to their average price since 1972

Coffee	-34.76
Cotton	-33.49
Aluminium	-18.66
Wheat	-15.56
Corn	-13.05
Tin	-0.66
Cocoa	2.84
Soybeans	9.27
US natural gas*	13.13
Uranium	14.72
Sugar	29.42
Palladium	30.50
Nickel	33.58
Zinc	33.26
Silver	59.37
Copper	69.48
Platinum	84.83
Crude oil	92.60
Lead	97.89
Gold	111.02



## World per capita agricultural area

1965	1.12
1970	1.03
1975	0.95
1980	0.88
1985	0.83
1990	0.78
1995	0.73
2000	0.69
2005	0.65
2010e	0.63



grain increases. It is said to take four kilos of grain to raise one kilo of chicken. It takes a whopping 10 kilos to raise one kilo of beef.

### 6. Biofuels

Another pressure on agricultural land will come from biofuels. The US government has made a strategic decision to increase the role of biofuels and specifically ethanol in the country's energy mix. The use of soybeans and corn as feedstocks for biodiesel and ethanol production globally has arguably had a powerful effect on demand-side fundamentals

in these agricultural markets. Today more than 30% of the US corn harvest is used for ethanol production. This could rise to as high as 40% by 2015 in light of US Federal government targets.\*

### 7. Valuation

Unlike other parts of the commodities complex, agricultural prices have failed to recover to the same degree as occurred in the energy and metals sectors during 2009. Gold, lead and crude oil are the most richly priced commodities, trading around 100% above their

real-term price over the 1957–2008 period. Meanwhile, prices in many parts of the agricultural complex are trading at or below their long-run historical averages in real terms.\* We believe this cheap valuation of the agricultural sector is inconsistent with bullish fundamentals across the complex.

### 8. Inventories

According to the US Department of Agriculture, inventories in a number of agricultural markets are low and set to fall further heading into next year. We find that global corn



inventories are now equivalent to just 60 days of consumption, versus an average of 88 days between 1960 and 2008.\* Though some caution is needed when reading this data, we find that many agricultural markets are in deficit, for example, in coffee and cocoa.

### 9. Diversification

Many commodities, like energy, precious metals and industrial metals, have become increasingly correlated with equities, US interest rates and the US dollar. Agricultural commodities seem less sensitive to these and may prove to be a relative safe haven unaffected by financial market volatility, taking a lead instead from acreage levels, crop yields and weather, among other things, which are broadly unaffected by financial markets.

### 10. Government action and stockpiling

Agricultural shortages and price increases would, in the absence of government action, tend to divert resources towards the agricultural sector and hence boost production over the medium term. However, during the rise in agricultural prices during 2007 and 2008 many governments in key producing regions, such as Argentina and Kazakhstan, introduced trade barriers

to restrict or even ban the export of agricultural products to limit price increases at home. This had the effect of depressing farm incomes and in the extreme lead to crop plantings being cut, so exacerbating the shortage situation.

Today attention has turned to the rice market following poor harvests in the Philippines, India and Vietnam. Given the risk of shortages heading into next year, some countries, such as India and Bangladesh, have banned rice exports. We believe any sign of agricultural shortages therefore increases price spike risk via government action.

Moreover, the threat of shortages is already leading some governments to build strategic inventories in key agricultural commodities. Indeed, the deterioration in China's agricultural trade position has already led the government to start stockpiling in grains and soybeans.

### Conclusion

Soft commodities were subdued for most of 2009 before staging a steady rally in the fourth quarter, driven in the main by investment considerations but also by adverse weather and lower harvest forecasts.

More recently prices have fallen back again, but we continue to

believe that the medium-to-long-term investment story is a sound one. Prices remain cheap, stocks are often low, spare capacity is limited, and small interruptions in supply can have a significant impact on prices.

Investing in commodities does require some expertise, and investors are warned that the asset class is volatile. Nonetheless, this is an asset class worth looking at closely.



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\* Data sourced Deutsche Bank Global Markets

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