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The $200 question: is oil mania about to end?

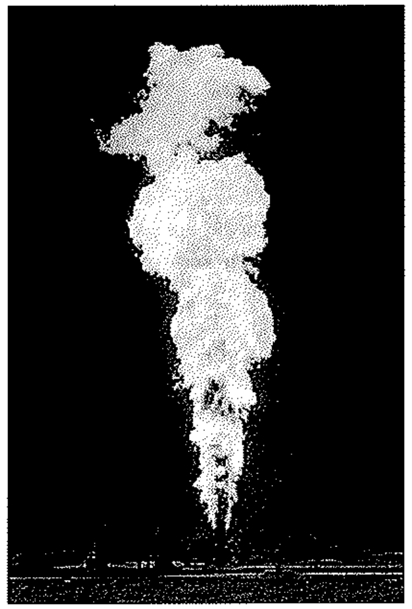
What Gordon Brown has described as the most serious financial crisis since the 1930s, appears to be over as suddenly as it began.

While the slowdown in Britain and Europe has only just started, the US economy now seems likely to avoid an outright recession as Washington's huge tax cuts, interest rate reductions and bank and mortgage bailouts appear in the nick of time over the economic horizon, just like the US cavalry riding to the rescue in a classic cowboy film. As these measures start gaining traction we should see fewer of the panicky headlines about a return to the Great Depression, even if the worst is still to come for the British housing market, the City of London and indeed the European economy, as I think it is.

But looking beyond our parochial concerns at the global prospects, there is now only one key uncertainty marring the signs of improvement: the huge increase in energy, food and other commodity prices since the start of this year. This now poses a far greater danger to the world economy and financial system than the correction in US and British housing markets and the related credit losses suffered by leading banks.

Commodity inflation is worse than housing and bank deflation for three main reasons.

First, rising prices of food and energy hit poor people hardest and therefore provoke turmoil among groups that would otherwise be politically apathetic, as well as causing greater losses in consumer purchasing power than falling house prices. Secondly, inflation is inherently harder for governments



Oil: not such a burning issue

and central banks to deal with than deflation — any politician can cut interest rates and taxes to prevent a financial collapse, but counteracting inflation requires higher interest rates or taxes, which are always more painful to implement and damaging to growth. Thirdly, the countries most exposed to the risks of commodity inflation — China, India and other large consumers of energy and food — are precisely the ones that the world economy now depends on for most of its growth.

To make matters worse, the political pressures caused by energy and food inflation in developing countries is provoking panic reactions such as trade restrictions, price controls and credit rationing schemes that now seriously threaten the progress towards global market liberalisation and will almost certainly make commodity shortages even worse in the long term.

To set against these scary features of global commodity inflation there are, however, three items of good news. The first is that the recent bout of food and energy inflation does not seem to reflect a permanent imbalance in global supply and demand any more than did the price spike of the 1970s. The recent doubling in rice prices does not mean that the world is running out of food and this week's prediction by the chairman of Opec that oil prices may soon rise to $200 per barrel has less to do with careful analysis than with greedy wishful thinking.

The Chinese and Indians are not eating any more rice today than they were three months ago. The doubling of rice prices cannot therefore be explained by a sudden shift in supply and demand. And the same is true of oil, since the global growth of oil output in the past two years has been substantially faster than the growth of consumption. The key factor, as in the last great commodity inflation of the 1970s, appears not to be any immediate supply shortage but panic buying by consumers, governments and financial investors, in anticipation of possible future shortages of supply.

The second item of good news is that the recent run-up in commodity prices may already be reversing, even as the public protests and panic headlines intensify. Such a contradiction between market behaviour and public perceptions would be perfectly normal in speculative markets, as implied by the stockmarket adage, "buy when there's blood in the streets". Wheat prices, for example, have fallen by 25 per cent since their March peak, wholesale pork and beef prices have corrected sharply and even rice is down 10 per cent from its recent high.

Meanwhile, gold is languishing 15 per cent below the high it hit at the worst point of the credit crunch, nickel and lead are down almost 50 per cent from their speculative peaks and the most important industrial metals such as copper and aluminium have recently failed to break through the levels they set in 2006. It is really only energy and corn-related agricultural products, whose prices have been driven up by the US and European bio-fuel subsidies, that are still hitting new highs.

The last piece of good news relates to the other two. If commodity prices are being driven mainly by financial speculation and panic buying rather than a sudden shift in supply and demand, there are several reasons to believe that this trend may soon reverse. As demonstrated by the panic buying of technology stocks in the late 1990s, market behaviour in such phases of price overshooting cannot be explained by "fundamentals" such as the long-term outlook for supply and demand. What happens in such overshooting phases is that a one-way market develops, in which investors who look at fundamental values lose so much money that pricing is determined entirely by so-called "momentum investors" who buy more of whatever assets or commodities are rising the fastest, trusting in the slogan: "the trend is your friend".

Could it be that commodity speculation will now reverse?

Such trend-following behaviour cannot last forever but it can continue for a long time, as demonstrated by the trend-following manias in housing and technology stocks. One of the most intriguing — and potentially encouraging — features of the present commodity speculation is that it has coincided with similar trend-following speculations in three other important financial markets. The dollar-euro exchange rate, the yield on US Treasury bonds and the interest premiums demanded on loans to virtually risk-free borrowers such as General Electric or the US government-backed mortgage banks.

It seems quite likely that all four of these trend-following speculations have been related and that all four of them would turn at around the same time. This now appears to be happening. About a month ago, the market for high-grade credit began to improve after the rescue of Bear Stearns. Two weeks later the yield on US Treasury bonds suddenly began to rise. Last week the dollar seemed to make a low against the euro and has since risen sharply.

Could it be that the commodity speculation will now also reverse? Nobody can say for sure, but one way to try to understand speculative markets is to use the psychological techniques of following price charts, known as "technical analysis". This is ridiculed by economists but regarded with respect by most professional investors.

This week Brian Marber, one of London's most experienced technical analysts and one who has been consistently forecasting higher oil prices, told his clients that the trend was probably reversing. Let us hope he is right.