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Why wheat is luring the breadwinners

Speculators are poised to cash in on crop failure by driving up prices. Patrick Collinson explains why

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It's the dark side of environmental investment. After making millions from pumping up the price of copper, zinc and other metals to record levels last year, speculators are piling into "soft" commodities such as wheat and corn amid drought warnings and global shortages.

Wheat, according to the commodity dealers, is the new gold. In October, prices for wheat on the world's major trading exchange, the Chicago Board of Trade, suddenly escalated, with the main "futures contract" rising from \$250 to \$370 (£127-£188) in a matter of weeks. Since then, it has slipped back to \$350 but some hedge fund managers believe we are at the start of a "supercycle" - a combination of failing harvests, low stocks, growing population and demand from bio-ethanol projects that will see the price of wheat spiral upwards. If they are right, they will be making loads of dough while we pay loads more for a loaf of bread.

The harvest is going on this month in drought-stricken Australia, the world's third-biggest wheat exporter. Predictions are that it will collapse to just 9.7 million tons, down 61% from last year's total. Meanwhile, Britain's chief grain marketing body, the HGCA, says: "A good crop in 2007 is needed to boost [global] stocks which have been falling for all but one of the past eight years. World wheat stocks are still low enough for any significant crop problems in 2007 to threaten supply."

While output and stocks are flagging, demand is rising - ironically because of the same global warming factors that have hit production in Australia. The UK is currently a net wheat exporter but may soon become a net importer with the opening of a giant bio-ethanol plant on Teesside in 2008.

US investment guru Jim Rogers - co-founder with George Soros of the legendary Quantum Fund and later creator of the Rogers International Commodities Index - has been bullish on soft commodities for several years. This week he told Guardian Money he is convinced that prices for agricultural products will keep rising.

"The fundamentals will continue improving. There will be consolidations along the way, but we have years to go. Everything in a bull market makes new all-time highs and the same will happen again [with soft commodities]. Usually the new highs are far above the old all-time highs."

So does that mean food prices are about to shoot up? Yes, says Rogers. "We will be paying more for everything. In fact, we already are and it will get worse."

His predictions have echoes of early 1970s food inflation when the sugar price rose five-fold in a few months amid shortages and panic-buying.

It's not just hedge fund speculators who are jumping on the wheat wagon. In September the London Stock Exchange launched a series of "exchange traded funds" which for the first time allowed private investors to invest in commodity indices - and even put the investment in a tax-free Isa wrapper. Wheat contracts have been the big draw, outselling any other of the 29 commodities available for investment. ETF Securities says more than \$100m has already been traded in the contracts since launch.

Graham Tuckwell, chairman of ETF Securities, says: "We have seen a high-level of interest in agricultural products, as currently this is the first time agricultural products have been available on the exchange, and agricultural commodities are below historical highs. In comparison, many energy and metal equities exist and these sectors have outperformed over the last few years."

Some of the UK's biggest pension funds are also opting for soft commodities. Hermes, which runs the £34bn British Telecom pension fund, has invested £1bn into tracking the Goldman Sachs Commodities Index, which has 15% in agriculture, mostly wheat and corn. It says the investment is largely for diversification reasons, not because it believes in a sudden hike in food prices. But as other pension funds follow (ironically, the Sainsbury's fund is also an investor), then a "wall of money" argument could help push up prices.

But before anyone is tempted to become a speculator in commodities (and below we show you how even small investors can become dealers), it is worth listening to the flipside of the story, which says that the price of "softs" will go rather soft over the next few months.

Australia may be deep in drought but other big exporters are predicting decent harvests. The US Agriculture Department is forecasting a 3.8% increase in Canada's wheat crop and a 7.2% gain in Argentina. It also expects unsold wheat supplies in the US to rise in 2007 and depress prices.

Mike Wolverton, a grain economist at Kansas University, the state at the centre of US wheat production, says farmers have already responded to higher prices by planting dramatically more wheat. He says short-term supply issues may force futures prices up, but the new crop will be priced at lower levels.

The El Niño weather system - changes in Pacific sea temperatures which have an impact on the global climate - was predicted this week to be bringing another long hot summer to Britain this year. But in the key US wheat growing areas, it is expected to dissipate by March and bring much-needed rain. If so, warnings about shortages may prove wide of the mark. The hedge fund managers hoping to make a killing could see their profits fall flat - and, thankfully, the rest of us will see prices kept down.

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