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Illustration by S. Kambayashi

THE supercycle is back. Raw material prices rose by nearly 20% in May, according to the S&P/Goldman Sachs Commodity Index, one of the biggest monthly increases on record. The surge has been widespread, with everything from copper to cotton moving higher. Meanwhile the Baltic Dry Index, an indicator of shipping activity, has risen more than sixfold from its December low.

It is not difficult to paint this rebound as a sign of economic recovery. The bullish story runs as follows. The collapse of Lehman Brothers was an enormous shock to global business. Firms reacted by cancelling orders and slashing inventories. That was why the numbers for industrial production looked so cataclysmic earlier this year. But the recession is not turning out to be as bad as executives feared. Companies are resuming production (the British arm of Honda is a case in point) and are building up their inventories once again. The rise in commodity prices is an early indicator of this improving sentiment.

Julian Jessop of Capital Economics, a consultancy, points out that the rally has been led by the industrial metals, like lead and nickel, which are most sensitive to economic activity, while the precious metals (gold and silver) have lagged well behind. But are commodity prices a leading indicator, or merely a coincident one? Businesses may be stockpiling raw materials because they have been convinced by the data that recovery is on the way. If the data falter, commodities will fall as quickly as they have risen.

Another point of view is that higher commodity prices may not signal recovery so much as strangle it at birth. In all the talk about the American housing market and banking misjudgments, the role of oil at $140 a barrel in sparking this recession has probably been underestimated. Last year, oil may have been sending a false signal to central banks by pushing up headline inflation when the economy was already weakening. David Ranson of Wainwright Economics says that the very high volatility of the oil price means it has a big impact on the headline consumer-prices index. Over the past three years, the correlation between the two has been 0.7 (where 1 is the maximum). That may have persuaded the European Central Bank to raise rates as late as July 2008, a decision that now looks very foolish.

Higher commodity prices transfer money from consuming to producing nations. Since the producers tend to save a large part of their windfall, the effect is to restrict global demand. This “tax” effect may be all the greater because the global economy is weak. Either companies will have to absorb the higher costs in their margins, or consumers will lose spending power, or both.

The impact on consumers may be more significant, because companies are keeping the lid on wages, their biggest single cost. According to David Rosenberg of Gluskin Sheff, a Canadian asset-management firm, the rise of 45 cents a gallon in petrol prices over the past month is the annualised equivalent of a $60 billion pay cut for American consumers. That in effect offsets the recent tax reductions for lower and middle-income workers in the economic-stimulus plan. Larry Hatheway of UBS says higher petrol prices come at a difficult time for consumers, because they have less access to credit than they did a couple of years ago.

Americans are already showing signs of caution. Figures released on June 1st showed that consumer spending fell by 0.1% in April, taking the saving rate up to 5.7%, a 14-year high. That is good news in the medium term, as America was too reliant on foreigners for savings. In the short term, however, sluggish consumption makes it hard for the economy to recover.

The commodity market may also be a long-term headwind for the global economy. Supply constraints were part of the bullish argument for commodities earlier this decade. Because it takes years to find and then exploit new reserves, demand can outstrip supply for long periods.

Even the high prices of the boom years may not have been sufficient to eliminate these supply constraints. For one thing, they were accompanied by big increases in production costs—everything from the cost of steel in oil rigs through to higher wages for mining engineers. Producers also suffered from the “Chávez effect” as developing countries seized control of domestic resources. And finally, the sheer volatility of prices over the past 18 months has made it very difficult for mining companies to plan. Higher commodity prices should be a cause for investor concern rather than celebration.

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