AMP Capital Investors Limited
ABN 59 001 777 591, AFSL 232497
AMP Capital Funds Management Limited
ABN 15 159 557 721, AFSL 426455

AMP CAPITAL

Sliding commodity prices

Canary in the coal mine or a blessing in disguise?

Nader Naeimi
Head of Dynamic Asset Allocation

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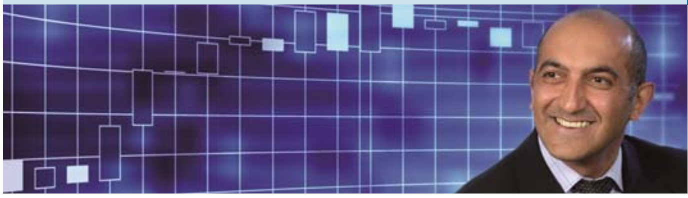


Overview

The rebound in equities in the midst of global uncertainty and growth weakness has been dismissed by many investment professionals as a rally driven by central bank liquidity lacking fundamental support. The flagging performance of commodity markets in recent months is cited often as evidence of falling real demand and the ineffectiveness of central banks' policy action. While commodity markets' correlation with equity markets and economic growth in recent years supports this view, falling commodity prices are likely to have vastly different implications to what is suggested by historical correlations. In fact, sliding commodity markets are likely to be a blessing in disguise with favourable implications for economic growth and equity markets.

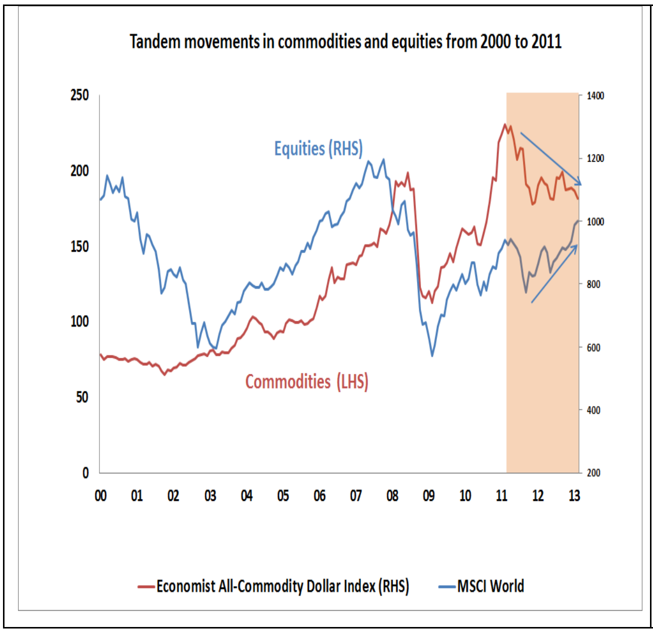
Under this view, commodity price weakness is not a result of failing economic growth when the impact of several structural factors driving commodity prices is analysed. Factors such as investment intensity of China's growth and the US dollar's downward trend played a significant role in the commodity bull market and as these factors turn from tailwind to headwind, commodity markets are likely to weaken. While this will have an adverse impact on commodity producers, its economic impact is likely to be a favourable one.

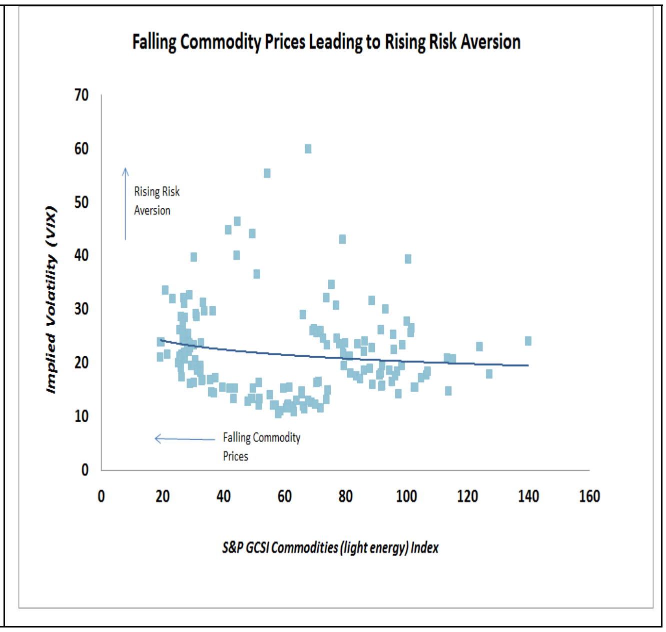
As commodities take the back seat, a significant tax on economic growth should to be lifted and economic volatility should recede. Equity market implications should be seen via a reduced equity risk premium. As economic volatility subsides, investors are likely to demand lower risk premium to hold equities over bonds which should lead to a re-rating of shares. Indeed, ballooning government debt and the extremes in monetary policy settings will continue to require a dynamic and flexible approach to investing but a major headwind to economic growth is likely to have passed.

Background

Commodity prices have played an important role in market and economic cycles over the past several years. In fact, several key turning points in commodity prices over the past several years were associated with a turning point in global equity markets. And at the same time high profile commodity markets such as Crude Oil and Copper provided great insights into investors risk appetite. These dynamics are shown in charts below.

The first chart shows that equities and commodities followed each other closely from 2000. The correlation, however, has weakened substantially over the past several months where equities and commodities have moved in opposite directions. The strong role of commodities as a measure of risk appetite over the past decade is shown in the second chart where commodity prices are plotted against implied volatility (VIX). Typically, a higher VIX level indicates elevated risk aversion while lower levels of VIX imply increasing risk appetite. The scatterplot shows a strong tendency for higher risk aversion as commodity prices fell over the past decade.





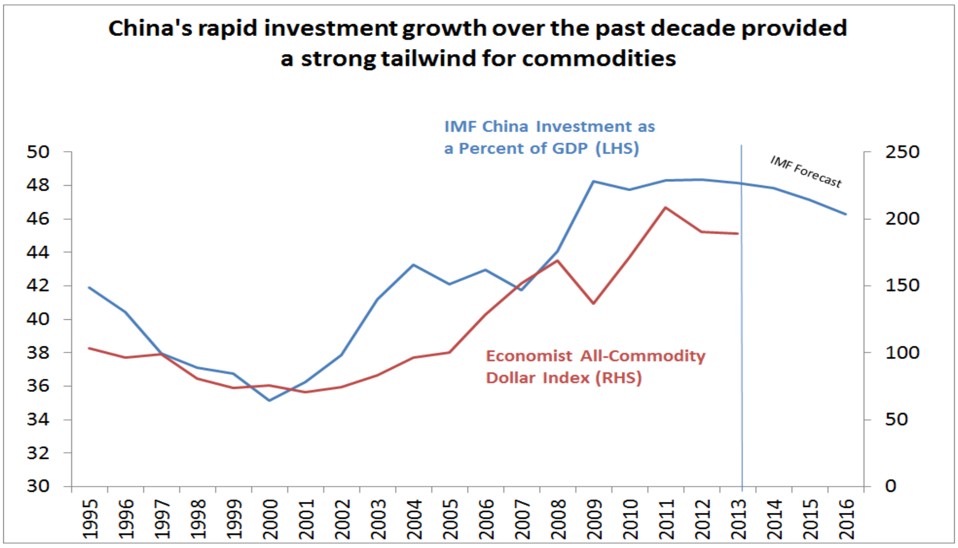
Source: Bloomberg, AMP Capital

The strong performance of commodities over the past decade was a direct result of many years of underinvestment in commodity exploration at the same time when Chinese industrialisation process shifted into top gear. While, the huge supply/demand imbalance has been a key (and the most cited) driver behind the strong performance in commodities, several other drivers can explain not only the strong performance of commodity markets but also the strong correlation with equities over the past decade. These are outlined below.

China's growth composition

As the 1990s came to a close commodity prices had suffered a two-decade bear market disincentivising investment in natural resources productive capacity. This had led to sharp falls in global active oil rig counts, sharply reduced mineral exploration expenditure and underinvestment in agriculture. At the same time China embarked on a rapid industrialisation and growth phase. This led to a sharp rise in investment and an equally sharp fall in consumption as a share of GDP over the period.

While this dynamic is commonly portrayed as an economic anomaly, it is a normal pattern during the industrialisation phase. In a traditional agricultural economy farmers consume most of their income, but once industrialisation gets under way a rising share of national income goes to owners of capital who invest it in factories, infrastructure and other capital intensive projects. Investment rises as a share of GDP, and consumption falls. Reflecting this, China's investment to GDP ratio rose from a low of 35 per cent in 2000 to 48 per cent in 2011. The rapid increase in investment and economic growth in China led to a significant inflection point in commodity demand and commodity prices. This is evident in the chart below.



Source: Bloomberg, Global Financial Data, AMP Capital

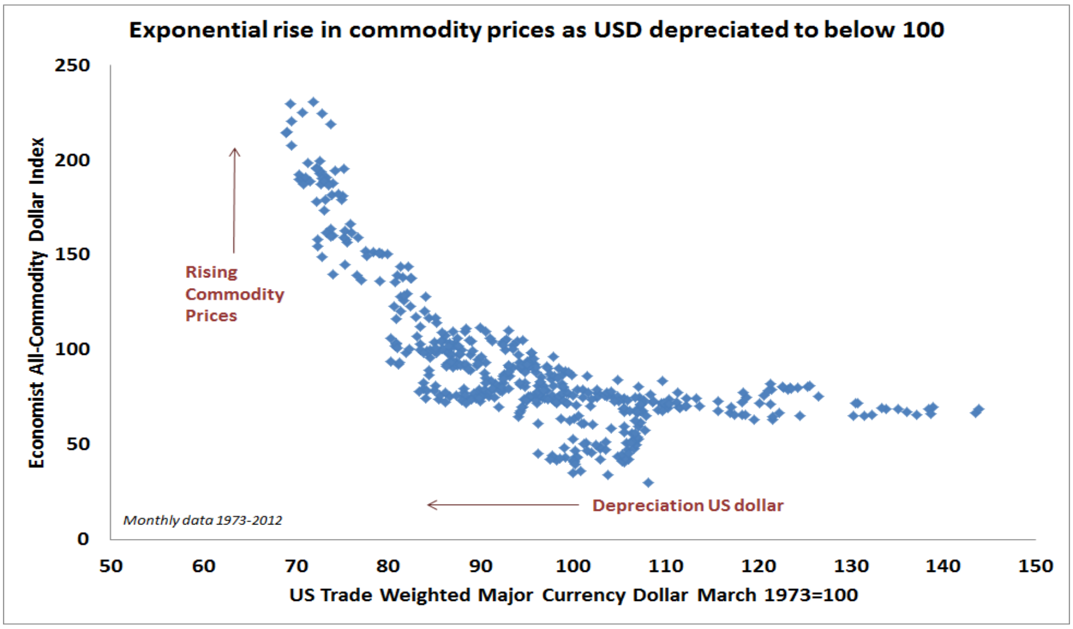
The investment intensity of Chinese growth, however, appears to have peaked at 48 per cent in 2011. According to IMF estimates, China's investment as a percentage of GDP should gradually fall over the coming years. Indeed, after several years of investment driven growth some rebalancing makes sense. Under China's capital-heavy model of growth, owners of capital have been getting much richer than workers. The main reason for shifting from capital-intensive production to the more labour-intensive, consumer-friendly type not only helps in achieving sustainable growth, but also reduces inequality. Workers could then enjoy more of the rewards of China's past investment.

The gradual slowdown in investment share of GDP is likely to take the wind out of many high profile commodities over the years to come. China's growth composition is far more correlated with commodity prices than equity prices and its slowdown points to a decoupling of commodity and equity markets. As a result, leading indicators of global growth and equity markets that rely on commodity prices are likely to produce misleading signals.

The US dollar impact

With a vast majority of commodity markets priced in US dollars, currency movements tend to play a strong role in commodity price trends. The dollar's peak in 2001 and its subsequent downward trend over the following decade was another major driving force for commodity prices over the past several years. The fall in the dollar saw a broad-based surge in commodity prices. Commodity prices, as measured by Economist All-Commodity Dollar Index, rose by a staggering 250 per cent from their 2001 secular low to their 2011 peak.

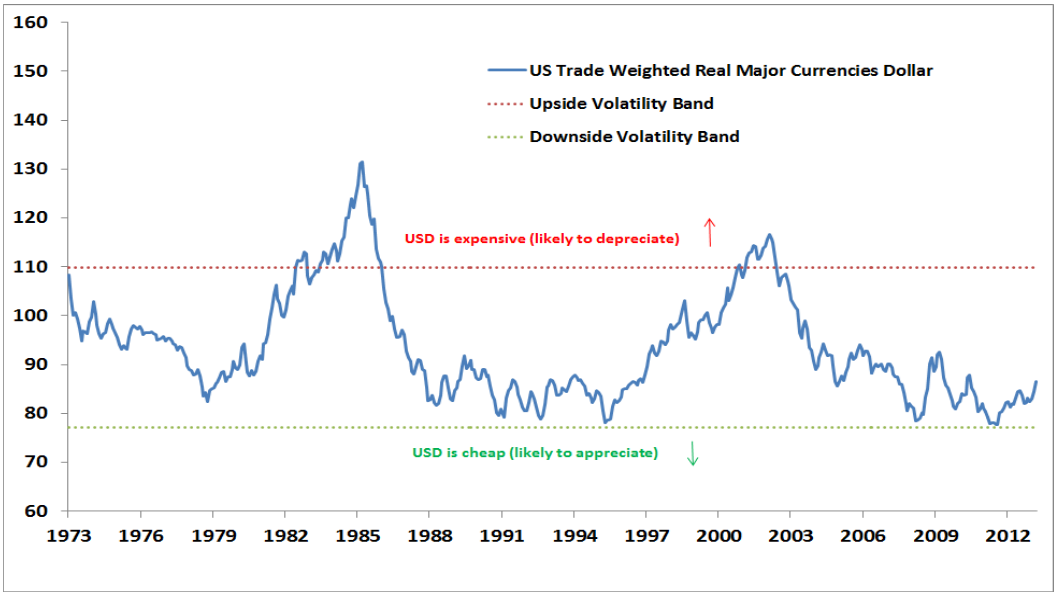
What has been impressive about the commodities bull market is not just the magnitude of the price increases but also the breadth of commodities price gains. From agriculture and live stocks to energy and metals, virtually no commodity has missed out. With the aftermath of the tech bust, accounting scandals and the bursting of credit and housing bubbles forcing the US dollar to fall by over 35 per cent over the same period, commodity prices were a major beneficiary. The strong inverse relationship between the US dollar and commodity prices is evident in the scatterplot below.



Source: Bloomberg, Global Financial Data, AMP Capital

While it makes sense for the US dollar to continue its downward trajectory given the large public debt levels and ongoing money printing by the Federal Reserve, a decade of deprecation suggests the USD bear market is likely well advanced. A cleansing process ranging from the tech bust and accounting scandals (eg Enron scandal) in early to 2000s to the credit and housing crisis in late 2000s has positioned the US economy to be well placed to reap the fruits of a looming recovery.

Meanwhile, large scale shale gas production and a path to energy efficiency together with increased competitiveness of the US economy following a multi- year decline in trade weighted US dollar should lead to an uptrend in the US dollar over the years to come. The potential for a new USD bull market is evident in the chart which shows that US trade weighted real major currencies dollar has reached its downside volatility band. A similar reading in 1995 led to a major uptrend in US dollar.



Source: Bloomberg, AMP Capital

A durable recovery in the US dollar is likely to be a major headwind for commodity prices over the years to come.

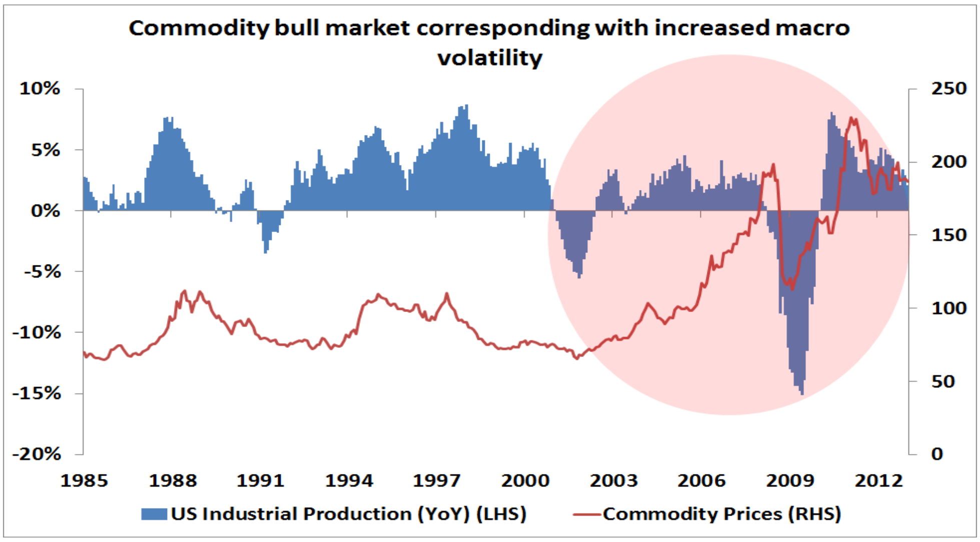
While China's growth dynamics and the downward trend in the US dollar have played a key role in the commodities bull market, several other factors added additional fuel to the commodities fire. These include terrorism, war and geopolitics, the rise of commodities as an alternative investment on perceptions of low correlation with equities as well as a hedge against inflation and food for fuel. These tailwinds have largely run their course and unlikely to be a strong driving force for commodities going forward.

Investment Implications

It would be an easy argument to suggest that the commodity market's failure to move higher in line with shares and their most recent plunge to yearly lows is a sign of a failing economic recovery and a harbinger for a renewed equity bear market. After all, commodities have been a great leading indicator of stock market performance in recent years. Extrapolating past relationships into the future blindly, however, comes with great risks. In fact, as demonstrated above, falling commodity prices is likely due to structural factors and can lead to a completely different set of investment implications. A few key investment implications are listed below.

Lower economic volatility

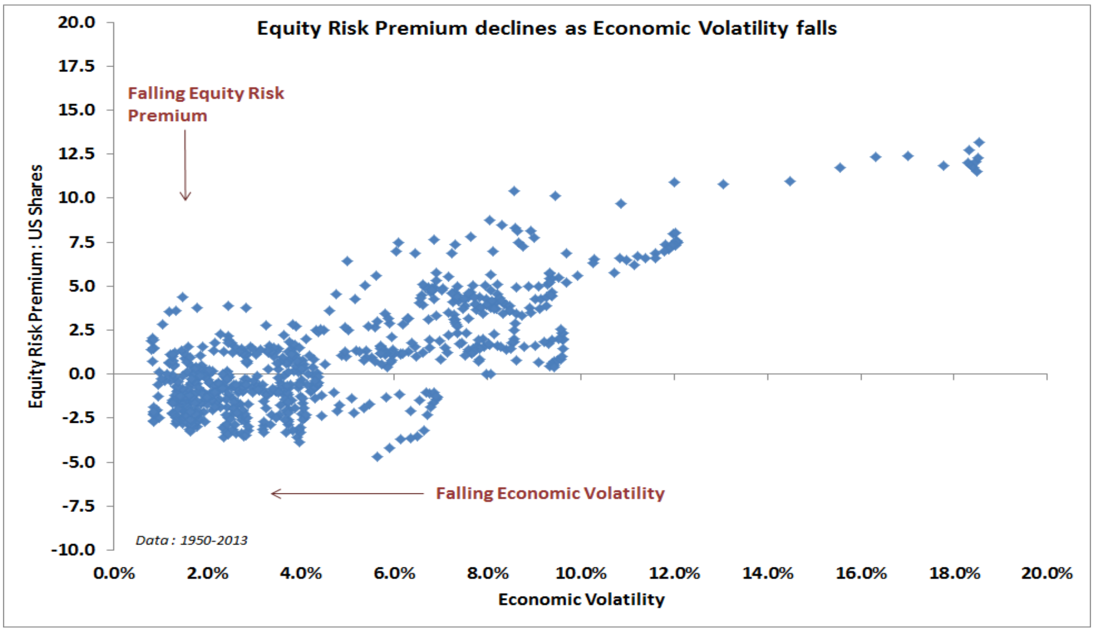
While rising commodity prices benefits commodity producers, it comes at the price of higher cost of living. This supply side inflation without a corresponding rise in wages reduces consumers' purchasing power, making them vulnerable to shocks. Rising commodity prices essentially becomes a tax on growth. Worse still, the vicious cycle of commodity price gains leading to increased speculation and feeding into higher prices is a damaging dynamic for economic growth. We saw this dynamic playing out in 2008. Increased speculation pushed the price of crude oil as high as $US147/barrels in mid-2008 despite a weak economic backdrop and falling demand. The demand destruction caused by rising commodity prices exacerbated the fallout from the housing and credit crisis in the second half of 2008. As a result, commodity markets made a significant contribution to economic volatility. The relationship between commodity price moves and economic volatility is depicted in the chart below. The chart shows year-on-year changes in US industrial production together with commodity prices. While the period from 1985 to 2000 was underpinned by low economic volatility and steady growth, economic volatility picked up momentum from early 2000s at the time that commodities embarked on a secular bull market.



Source: Bloomberg, Global Financial Data, AMP Capital

Therefore, it's a safe assumption to suggest that a peak in commodities' decade long bull market is likely to lead to lower macro volatility over the years to come. This does not mean economic volatility will revert back to 1990s levels. In fact, many other headwinds including ballooning public debt in the developed world, extremes in monetary policy settings and the increasing importance of highly volatile emerging world should continue to demand a flexible and dynamic approach to investing.

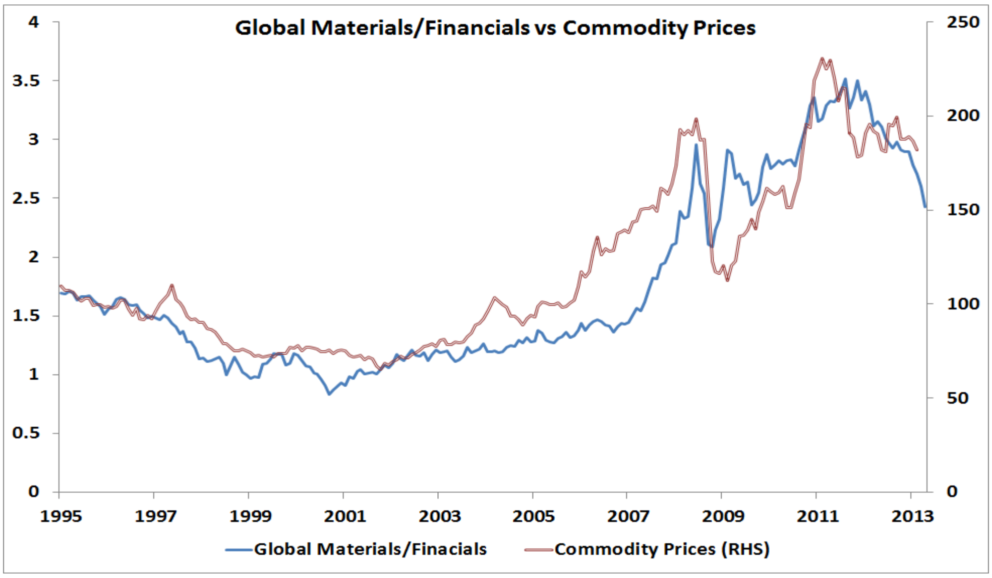
But a peak in commodity prices should turn a significant headwind to tailwind for global shares as lower economic volatility allows equity risk premium to decline. The impact of economic volatility on equity risk premium is demonstrated in the scatter plot below. The chart shows annual volatility in US industrial production against realised equity risk premium. It supports the view that falling economic risk premium should see equity risk premium to fall and equities to re-rate.



Source: Bloomberg, Global Financial Data, AMP Capital

Relative outperformance of financials vs commodity sectors

The onset of the secular bear market in developed world shares at the same time that commodities began their trend higher foreshadowed a long period of relative outperformance in materials and commodity stocks vs financial stocks. Global material stocks outperformed financials by over 280 per cent from their 1999 lows to 2011 peak. In valuation terms, relative price-to-earnings ratio of materials vs financial stocks rose from as low as 0.48 in 1999 to as high as 1.3 in 2011. Surging commodity prices, increasing economic volatility and a falling US dollar all contributed to commodity stocks' dazzling outperformance relative to financials. As the US dollar bottoms and commodity prices and economic volatility peak, financial stocks should outperform over the coming years.

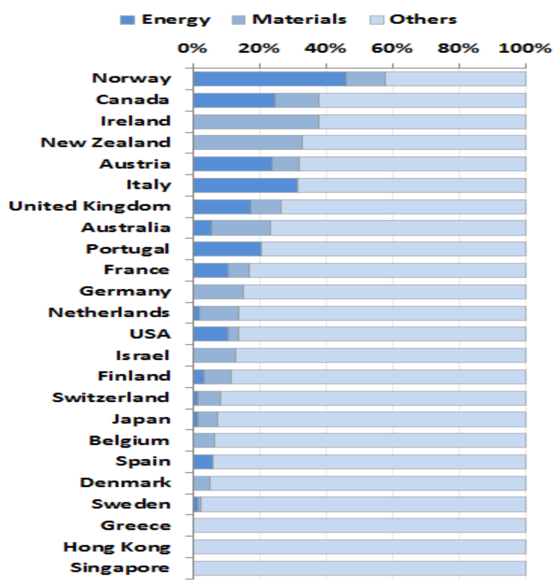
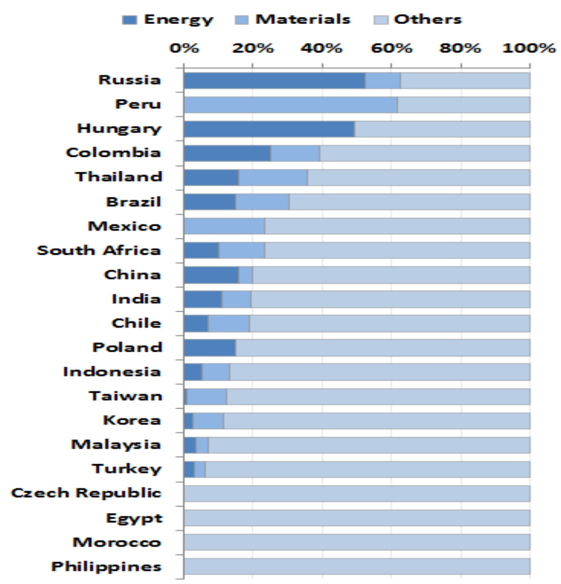


Source: Bloomberg, Nomura, AMP Capital

Additionally, lower supply side inflationary pressures in line with a fall back in commodity prices should increase consumers' purchasing power. This in turn should benefit consumer discretionary stocks.

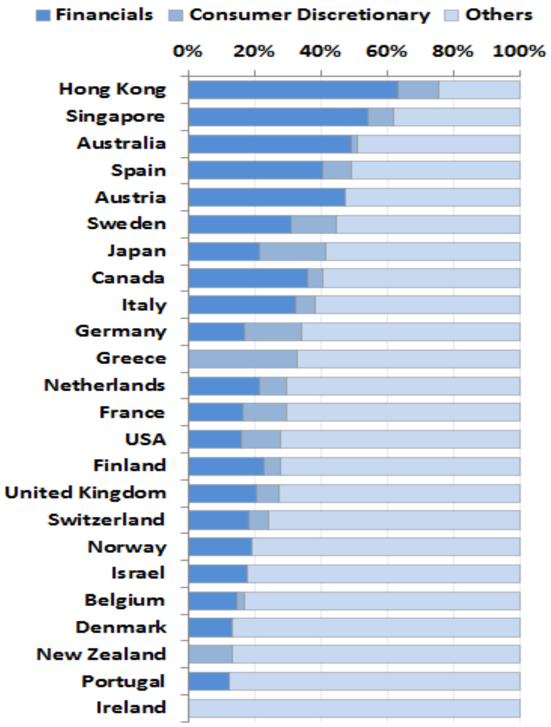
Relative country and regional performance

It goes without saying that a peak in material and commodity sectors' relative performance should see significant drag in the relative performance of commodity heavy/financial light equity markets. Several emerging market countries fall in this category including Russia, Peru, Hungary and Mexico and Brazil. Interestingly the Australian share market is well positioned for a change in market leadership from resources stocks to financials with over 45 per cent exposure to financials vs an 18 per cent exposure to materials. Tables below show developed and emerging markets' sector exposure to energy and materials vs financial and consumer discretionary sectors.

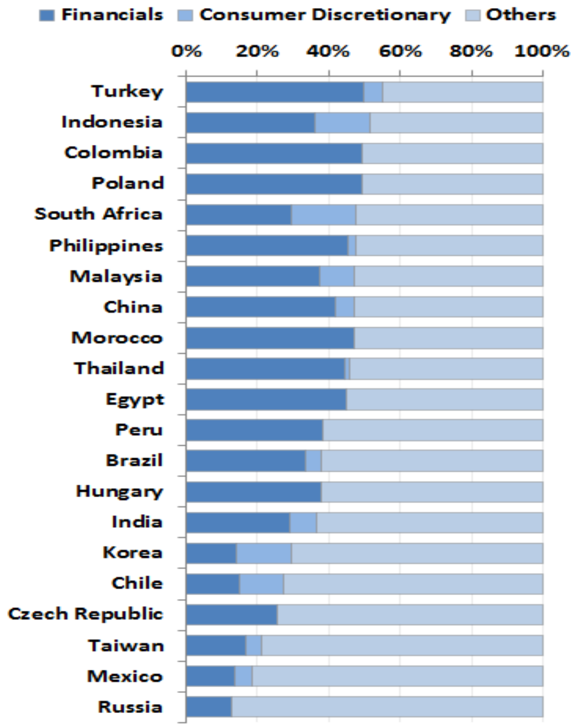
Country Sector Exposure to Energy and Materials	
Developed Markets	***Emerging Markets***
	

Country Sector Financial and Consumer Discretionary Sectors

Developed Markets



Emerging Markets

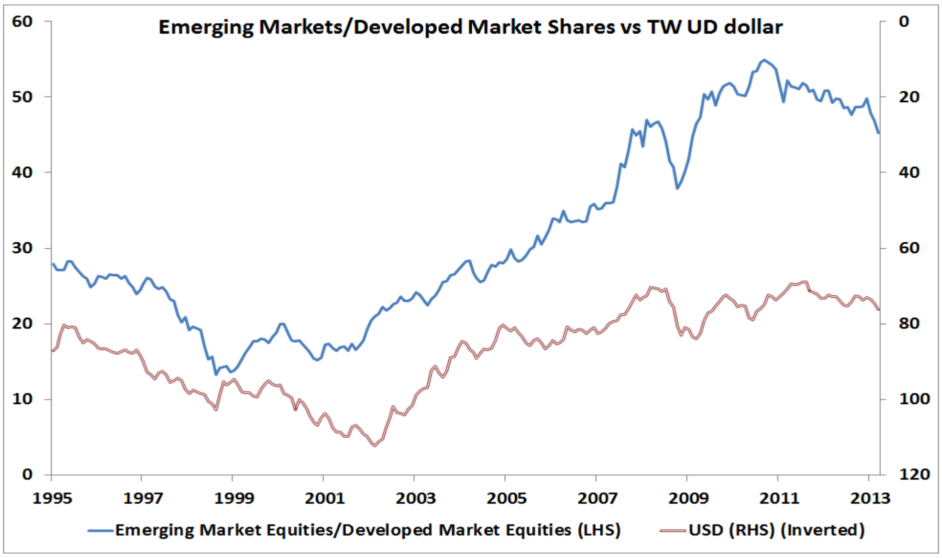


Source: Bloomberg, Nomura, AMP Capital

More broadly, as the emerging world's economic growth shifts away from a heavy investment focus to a consumer focused era, a leveraging process should start. With the developed world having already gone through several years of deleveraging, the resulting change in relative debt dynamics should see emerging markets (which are typically low in exposure to financial and consumer stocks) to underperform developed world. Currency market dynamics also support this view. Emerging markets relative outperformance vs developed world coincided with a weakening trend in US dollar. This makes sense and is likely to be more than just a coincidence.

The transmission mechanism is facilitated through emerging world's managed currency system. As the US dollar embarked on a downward trend from its 2001 peak, central banks in emerging economies were pushed to run stimulatory monetary policies to stop their currencies from appreciating too strongly against the US dollar. Foreign currency reserves ballooned in many emerging countries during this period. Meanwhile, appreciating currencies in many emerging countries reduced inflationary pressures. A reversal in US dollar downtrend can reverse the above dynamics.

The need for ultra-easy monetary policy settings in emerging economies should be reduced, foreign currency reserves should peak, emerging market currencies should depreciate and their equity markets should underperform developed world equities over the next one to three years. The strong relationship between trade weighted UD dollar and the relative performance of emerging markets against developed market shares is shown in the chart below. The chart shows US dollar in reverse order (as the line goes up US dollar is going down and vice versa).



Source: Bloomberg, AMP Capital

Summary

Commodity prices have played a strong leading indicator role for economic growth and equity prices over the past several years. Strengthening commodity prices was seen as a sign of increasing demand and strengthening economic activity. As a result, a diverging performance between commodity prices and equity markets was seen as unsustainable. If this continues to be the case, then the recent fallout in commodity prices can be indicative of failing economic growth.

As argued here, extrapolating past relationships into the future blindly can lead to misleading conclusions. In fact, sliding commodity markets are likely to a blessing in disguise with favourable implications for economic growth and equity markets. When analysing the impact of several structural factors driving commodity prices, it shows that commodity price weakness is not a result of failing economic growth. Rather, factors such as investment intensity of China's growth and the US dollar trend play a significant role. As these turn from tailwind to headwind, commodity markets are likely to suffer and while this will have an adverse impact on commodity producers, its economic impact is likely to be a favourable one.

The boom and bust pattern of commodity prices over the past several years has been a strong contributor to economic volatility. As commodities fall back, economic volatility should recede. Equity market implications should be seen via falling equity risk premium where investors likely to demand a lower risk premium to hold shares over bonds. This is turn should see a re-rating of shares. Of course, ongoing challenges such as ballooning public debt and the extremes in monetary policy settings will continue to require a dynamic and flexible approach to investing, but a major headwind to economic growth is likely to have passed.

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