

# A long night's journey

An extended spell in the wilderness is consistent with the long-term trend of commodity prices though many analysts think otherwise



Ruchir Sharma

INVESTORS hoping to resume their love affair with oil and other commodities any time soon may want to keep in mind the plot of Gabriel García Márquez's classic novel, *Love in the Time of Cholera*. It took the protagonist, Florentino Ariza 51 years, 9 months and 4 days to reunite with his first love. The wait for the next major bull market in commodities may not be quite that long but the basic script is unlikely to be much different.

An extended spell in the wilderness is consistent with the long-term trend of commodity prices. Yet it runs counter to the view currently held by many economic and financial analysts who still believe commodities are in a 'super cycle' and the violent sell-off over the past few months represents a short-term correction in a secular bull market.

The super cycle theory is rooted in the view that emerging markets such as China and India will be large buyers of commodities for a long time to come, given their growth paths towards greater urbanisation and industrialisation. The conviction in higher future prices for commodities is the strongest for oil, which also finds support in the supply argument that the world is apparently running out of black gold. Almost every oil analyst believes the decline in reserves per well is a secular force at work, bound to drive prices only higher.

Expectations of ever rising oil prices are reflected in both the forward curve and in analysts' consensus expectations. For example, oil for delivery in three years' time is trading at close to \$70 a barrel compared to the spot price of around \$45 a barrel. Meanwhile, oil analysts forecast the price to be even higher at \$90 a barrel in 2012. The predicted path for other commodities from copper to coal is not as strongly biased on the upside but the story is essentially the same: expectations of rising commodity prices are firmly embedded in the forward markets and in analysts' estimates.

It's amazing how till as recently as 2005, the order was exactly the opposite. Spot prices were usually much higher than analysts' forecasts as well as the trend implied by the forward curve. The phenomenon of spot prices being much higher than forward prices — referred to as 'backwardation' — was long considered to be the norm on the marketplace. The most profitable aspect of investing in commodities was that investors could earn money by merely rolling over their expiring contracts at a lower price given the backwardation of the curve. Otherwise, commodities were seen as a losing proposition with prices mostly in decline.

Data running over 200 years suggest commodity prices adjusted for inflation fall over time as extraction costs drop due to technological progress while limited value is added in commodity production leaving selling prices to command little premium. Yet the parabolic increase in commodity prices following the extraordinary boom in global growth this decade turned all lessons from history on their head. Investors were more inclined to believe that commodity production would struggle to keep pace with permanently rising demand.

The world economy is now in its biggest growth slump since the Great Depression but many analysts find it difficult to shake off the bullish fervour that consumed them during the global demand boom. The 2003-07 period was an aberration for the world economy with too much easy money fuelling a liquidity-driven growth surge. With that era now over

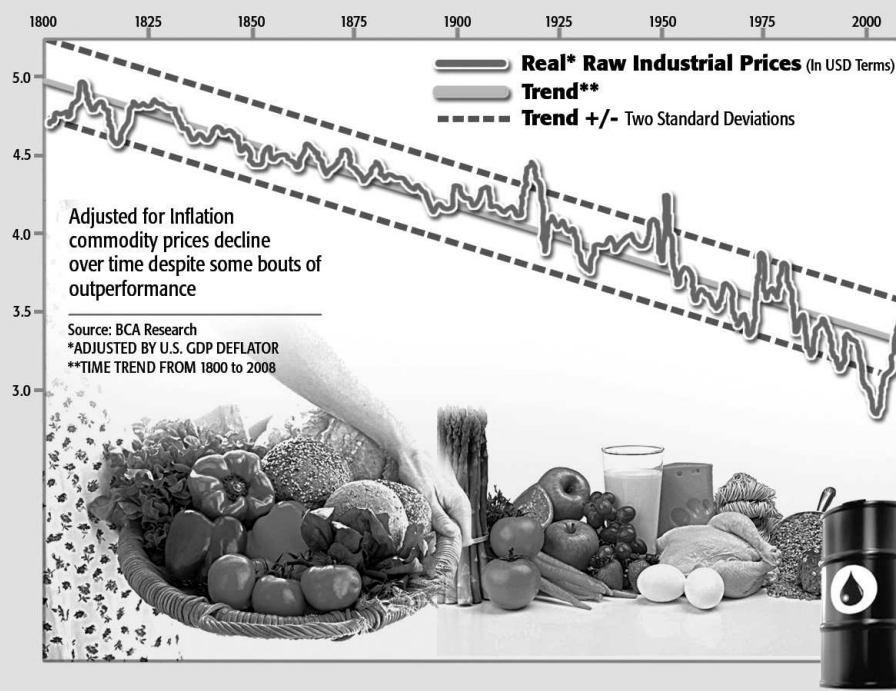
and unlikely to return anytime soon, the demand for commodities will not get back to the elevated levels of 2003-07 phase for the foreseeable future.

It's a myth that growing prosperity of emerging markets implies rising commodity prices. There have always been some emerging markets moving up the development chain at any point in time, and yet commodity prices have historically trended lower. The 1980s and '90s were a relatively strong period for the global economy and China too expanded at an average pace of 9%. But commodity prices including oil were for the most part confined to a trading range.

of the commodity marketplace and any sign of a revival in Chinese growth leads to instant celebration in the commodity pits. A pick-up in bank lending growth in China and a slower decline in economic activity revealed in the latest manufacturing surveys out of Beijing have led to some renewed optimism regarding commodities in the past few days.

However, China suffers from an over-investment problem, with an investment-GDP ratio running at a very high level of more than 40% for many years. Much of the investment is directed towards the sagging export sector and therefore Chinese investment demand is highly unlikely to re-

## COMMODITIES IN A LONG TERM CONTEXT



Commodity prices tend to outperform during the late stages of a boom when the global economy overheats and demand briefly exceeds supply or else in a period of high inflation. The latter environment is in fact favourable only for select commodities such as gold. The default path for commodities is otherwise south. Commodity prices often fail to gain traction even after an economic recovery is underway as it takes a long time for the excess capacity built in the previous boom year to be cannibalised.

Contrary to the current war cry of commodity producers that the sharp price falls is a disincentive for them to build new capacity and so likely to create shortages in the future, the current risk is that producers will just temporarily cut output rather than engage in permanent shut-ins. This would create a long-term overhang for prices. A case in point is the steel industry where production was slashed by a huge 17% in the fourth quarter of 2008, leading to capacity utilisation rates in the industry declining to well under 80% from levels close to 95% earlier that year. However, steelmakers are not getting rid of capacity from the market in the hope that demand will eventually return. As a result, capacity utilisation rates are likely to remain low for the foreseeable future, leaving producers to be just price takers with little pricing power.

The dynamics are similar for other bulk and base metals. Despite the waterfall-like declines of the past three quarters, many commodity prices remain well above their cash cost of production. In fact, inventory levels for most commodities have risen to five or in some cases 10-year highs but spot rates are in several instances still well above prices of a decade ago.

Commodity prices haven't fallen more on the hope that China will succeed in stimulating its economy with all the aggressive spending packages its government has announced. China is the 800-pound gorilla

vive anytime soon. China needs to reorient its economic model more towards domestic consumption and reduce its reliance on exports and investment. Japan was able to successfully make that transition in the early 1970s when its per capita income was similar to China's current levels. Regardless of whether China takes this route or not, it's likely the commodity intensity of its growth model will decline from the prevailing lofty levels.

For oil, where arguably the maximum residual bullishness exists, Chinese demand is not so paramount anyway. China consumes 9% of global oil production while the OECD area represents more than 50% of world demand. The demand for oil is highly sensitive to global growth and given the expected contraction in global GDP this year, oil demand is expected to shrink by more than a million barrels a day in 2009.

It's no surprise then that Opec spare capacity is fast rising back to 2002 levels, reducing the cartel's pricing power. While compliance regarding production cuts by Opec members has reportedly been good so far, the incentive for producers to cheat and increase revenues remains high in the challenging global environment. Outside of Opec, countries such as Russia would obviously like to produce at maximum capacity to earn some badly needed dollars and ride out their credit crisis.

Both the demand and supply outlook suggest the best days for commodity prices are behind us and any material rebound is unlikely to occur soon. Investors now have the choice of either letting go of their obsession with commodities despite all the 'super cycle' appeal or, like Ariza in Marquez's novel, being lovesick for a very long time.

(The author is head of emerging markets at Morgan Stanley Investment Management)

Both the demand and supply outlook suggest the best days for commodity prices are behind us and the next bull market in commodities is unlikely to materialise any time soon.