

Oil on the Boil: Black Gold Has Done it Again

With the energy price shock offsetting the expansionary effect of easy money policies, oil is now the new interest rate, determining the fate of economic recovery



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Every environment these days makes investors frisky for commodities: stronger global growth implies more demand for this asset class while weaker economic growth raises the prospect of further liquidity injections by central banks that will also apparently benefit commodities.

But any such mindless orgiastic spasm has its consequences and the global economy is now paying the price. Growth momentum across the world is fading fast in most part due to the second major commodity price spike in three years. Most economists at the start of 2011 expected the US economy to expand by at least 3% in the first half of the year but growth is tracking a 2% path.

A weaker economic growth trend is evident in the developing world as well with manufacturing activity in May contracting on a sequential basis in many countries.

To attribute higher oil prices to strong demand in emerging markets or geopolitical factors such as the Libyan crisis just do not justify the surge. The benchmark Brent crude oil price was already trading above \$100 a barrel before troubles broke out in the Arab world in early 2011. All the traditional models that plot oil prices with global spare capacity, the marginal cost of production and inventories, have broken down, suggesting a substantial 'liquidity premium' is built into the prices.

The US Federal Reserve's plan of pumping more money into the economy to revive growth has been undone by market players who have taken much of that excessive liquidity and siphoned it into commodity-related products. Little wonder that Fed chairman Ben Bernanke is reluctant to talk about a third round of quantitative easing, or QE3 in market parlance. By now, he has probably realised that the moment he utters the term QE3, commodity prices will go parabolic.

The fundamental flaw of the current economic recovery is that very loose monetary policies have played a major role in the revival, but instead of just reviving credit growth — as the central bankers intended — the money has lifted everything simultaneously. Beyond a point, high prices of some assets begin to undermine others and the global economy is now in that Catch-22 situation.

Even if equity markets stage a relief rally, oil prices rise further. Many economists still forecast an economic rebound in the second half of 2011, but those estimates are predicated on a reduced drag from high oil prices. Those projections can easily go awry if oil prices are bid higher the moment there is a positive surprise on the growth front. Similarly, in emerging markets, the optimists are calling for

an equity rally in the coming few months hoping that inflation readings will improve as the mind-numbing 'base effect' comes into play. But a benign reading on inflation too is likely to drive commodity prices higher given the positive correlations between stocks and commodities. In short, the inflation problem will return quickly.

The relationship between commodities and other asset classes was never so tight in the past. In fact, the limited relationship between commodity investments and other asset classes such as stocks and bonds offered a portfolio diversification strategy for investors. Now it seems that commodities have stuck like leeches to stocks and until the two are separated for good, it will be hard to envisage a sustainable advance in equities.

So, what are prospects of commodities coming unstuck? The good news is that supply and demand dynamics for commodities have begun deteriorating that should help significantly lower commodity prices in the medium-to-long term.

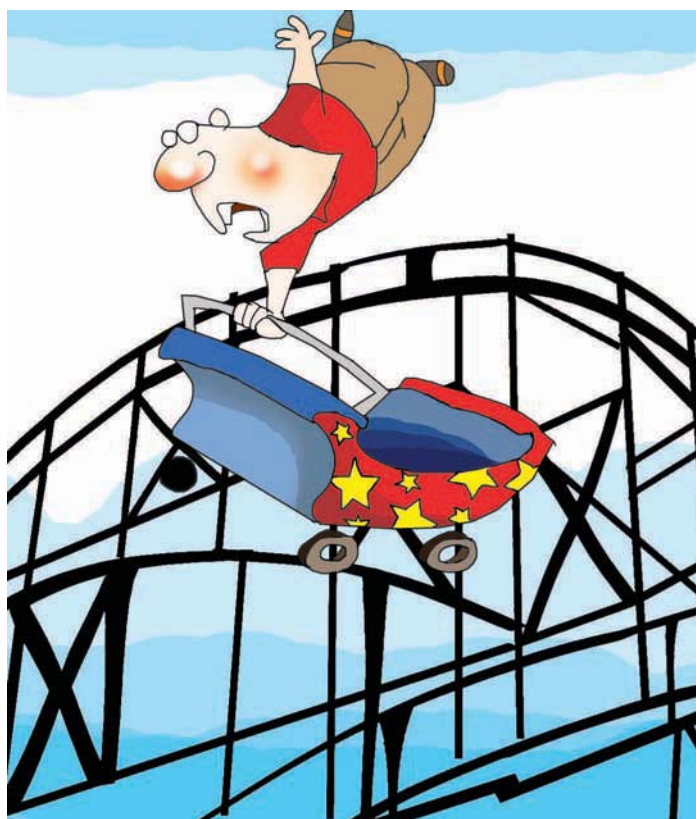
In the near future, however, squeezing out liquidity from the system is the only way to get commodities off our backs but lower liquidity could, in turn, result in some more collateral damage for both growth and stocks.

Central banks in emerging markets have indeed been tightening monetary policy, making the liquidity environment less favourable for commodities. For its part, the Fed may still be far from contemplating any policy rate hikes, it is at least not thinking of implementing another counter-productive step such as QE3.

Higher energy prices are eroding the monetary support and, in this regard, oil has become the new interest rate. While oil prices remain stubbornly high, nascent signs of divergence are showing up in other more economically-sensitive commodities, with prices of copper to zinc weakening.

Indeed, a commodity price spike tends to be self-limiting by sowing the seeds of its own destruction. The consumer of commodities can absorb higher prices only up to a certain extent, therefore making the asset class very different from stocks or bonds.

Whereas higher stock prices generally benefit the global economy



SALAM

and can keep rising without any negative side-effects, the same cannot be said of commodities.

Global spend on energy as a share of the world economy is currently at levels last seen at the peak of the 2008 boom, and demand destruction typically sets in at these levels. While prices have not quite returned to their 2008 peak, higher taxes on energy in the developed world and reduced subsidies in emerging markets imply consumers will flinch earlier. Demand for oil is already falling in many countries from the US to Russia.

Although data in China remains unreliable and fuzzy to ascertain whether oil demand is tapering there as well, it is only a matter of time before appetite for the commodity moderates given the mounting evidence of an economic slowdown in the country. China accounted for nearly half the increase in total global oil demand over the past decade, with its economy growing at a near double-digit rate driven by the incredible investment boom. Many of the growth drivers from housing to the massive infrastructure build-out of roads and railways are close to an inflection point. Its road network is almost as extensive as that in the US while the run-rate on housing construction in the coming decade cannot continue to increase at the 10-fold speed since 2000.

There is something anomalous about an economy that represents 10% of global economic output consuming 30-60% of all major industrial commodities, from aluminium to steel. The obvious implication is that a modest slowdown in China will strongly dent commodity demand as no other economy can pick up the slack. For instance, if Chinese demand for copper over the next year grows at even 80% of the pace of the last five years, demand in the rest of the developing

world will have to rise twice as fast than in the 2005-10 period to prevent a shrinkage in total demand.

While China's investment boom has been monumental in its scale — leading to the decade-long acceleration in commodity prices — the commodity cycle is still following the historical script. Data going back over 200 years shows that commodity prices broadly track a pattern where they rise for a decade and then fall for the following two decades, declining over time in value when adjusted for inflation.

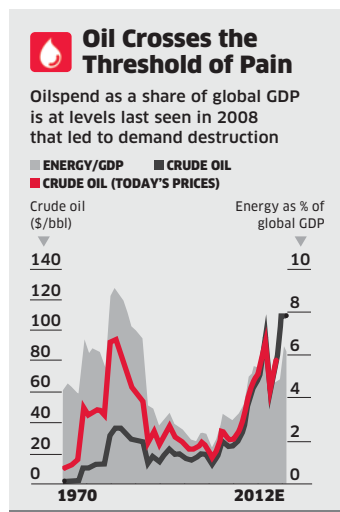
Many waves of urbanisation have occurred before, and when that happens after a long decline in commodity prices — and, therefore, underinvestment in commodities — it sets the stage for an upturn in the asset class.

Higher prices then trigger more capital spending and technological innovations, which is exactly what has taken place in recent times. As a result, current spot prices for commodities from copper to oil are far above levels that make extraction very profitable. The search is also on for alternatives from solar energy to electric cars to reduce dependence on oil.

These supply responses are still in the works and have so far been slow in coming. But the process is hard to stop once it begins and supply will just keep hitting the market despite slower demand, which is why prices will decline for many years after — as was the case in the past cycles as well.

Meanwhile, led by the Fed, central banks across the world thought they could stimulate growth by keeping interest rates abnormally low. But what they did not account for is a new regime where oil emerges as the new interest rate and rises to a point of choking growth.

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



Source: ISI Energy Research