Time for separation

The US market may witness in a few weeks a climactic surge that leads to commodity prices also gasping higher to a breaking point

Ruchir Sharma

THE fundamental flaw with the current global bull market is that equities and commodities are far too tightly attached, just like conjoined twins. The overall survival rate of such twins is rather low, especially at the moment of separation when one or both don't make it. The time when equities and commodities too can no longer remain joined at the hip is now upon us.

Prices of equities and commodities have never been so highly correlated, even in previous bull runs. While industrial commodities such as copper have long been a barometer of global growth and consequently shared some sort of a loose relationship with stocks, food and energy have had a life of their own; a surge in their prices has often marked the end of an economic upswing, given the stagflationary consequences of such spikes.

That linkage changed slightly over the past decade following a sharp increase in demand from emerging markets. But even then, sudden spurts in food and energy prices resulted in at least a hiccup in equity uptrends; the last time oil prices breached $90 a barrel in late 2007, equities across the world got hammered.

The global economy may even be more vulnerable to any further climb in food and energy prices this time as prices are rising largely because of excess liquidity in the system than to overly strong real demand. Commodities are attracting record financial flows, with total assets under management in commodity products currently much higher than the previous peak of $250 billion in June 2008. That reflects the enormous weight of money as prices of several commodities, including oil, are far lower than levels that prevailed back then. The daily trading volume in energy-related futures has reached a staggering 19 times underlying demand compared to 14 times demand in 2008; a decade ago, it was just thrice the demand.

Speculative juices are flowing freely across the commodity universe with prices of silver and many agricultural products — from corn to cotton — surging as well. While the supply of some commodities such as copper may genuinely be short, supply and demand fundamentals can hardly explain the strength in oil prices, given the high level of inventories and large spare capacity among Opec producers.

The incredibly similar price action of all commodities suggests a major share of the excess liquidity out there is finding its home in that asset class. In fact, commodities have for the first time acquired the status as a distinct financial asset class. The negative correlation of commodities with the dollar has also weakened in the recent past with prices of many touching new highs despite a firmer greenback.

None of this seemed to bother equity investors until now as inflation was hardly an issue. The focus after the Great Recession was primarily on the growth side of equation and any sign of a revival in global growth prospects was celebrated with a simultaneous rise in all asset classes. But ever since the US Federal Reserve, or the Fed, went public this summer with its intention to engage in another round of quantitative easing, commodity prices began to increase at a faster pace than other asset classes including equities. At the same time, inflation began surfacing as a concern in many emerging markets.

> With commodity prices now breaching key threshold levels, the simultaneous bull market in equities and commodities cannot last much longer

From Brazil to Indonesia, inflation is surprising on the upside and breaching the comfort zone. Most emerging market central banks have moved firmly into tightening mode with an increasing number of rate hikes being priced in. Fears of further monetary tightening are haunting investors in China, where headline consumer price inflation is hovering at around 5%. Any good news on economic growth in China is increasingly considered as bad news on the stock market.

The main difference between the 2003-07 bull market and the current run-up is that many emerging market central banks did not have to worry about tightening monetary policy until 2006. The parabolic move in prices of food and energy that on average account for a third of the consumer's basket in developing countries occurred as late as 2007-08. End-demand in the developed world was much stronger then but now emerging markets are playing a disproportionate role in driving the global economy. Any policies that dampen domestic demand in emerging markets are negative for world growth and the latest moon-shot in commodity prices threatens to result in such a drag.

Speculators are willing to use any excuse to load up even more on commodities, from an upside surprise in otherwise low expectations for US economic growth to the prospect of some kind of quantitative easing by the European central bank. Trading is ever more formulaic with every percentage point increase in global equities matched by an even larger increase in commodity prices.

However, emerging market equities are finding it harder to advance much further in such an environment and it will not be too long before the US market runs into similar headwinds — where arguably food and energy prices matter somewhat less in setting the inflation picture. Every $10 increase in the price of oil shaves off 0.3% from US growth and adds 0.3% to the country's inflation rate. December and January tend to be favourable months for risk-taking and it is quite possible that in the coming few weeks, the US market witnesses a climactic surge that leads to commodity prices also gasping higher to a breaking point.

Liquidity sowed the seeds of the present bull market with central banks from the People's Bank of China to the Fed flooding the system with money in the wake of the Great Recession. The dominant role of liquidity explains why the current economic cycle has been so synchronous and how the correlations between various asset classes remain so elevated in a bull market. High correlations have historically been a sign of stress in the system and they typically tend to weaken in bull markets and increase in bear phases.

Increased globalisation does explain a part of the rising correlation story: over the past 40 years, global trade as share of the economy has swelled from about 25% to more than half today and cross-border capital flows have also become far more robust. But that still doesn't justify the recent uncanny resemblance in the price charts of corn and Columbian equities. From a macro viewpoint of trading patterns, all it takes is the price of one asset class to reveal how another is faring.

With commodity prices crossing the threshold of pain in terms of the inflationary challenge they are starting to pose for many high-growth economies, the relationship between equities and commodities will just have to snap for one of them to keep advancing. Given the usual time lag, higher food and energy prices of the past few months haven't yet fully made their way into consumer inflation data. Even higher commodity prices hereon will exacerbate the inflation situation next year, in turn triggering more aggressive monetary tightening in China and other developing economies. That then will increase the odds of a hard landing for the global economy.

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Simply put, if commodity prices keep accelerating, equities will be unable to sustain their bull run unless commodities get off their back. More probable though is the event that an attempted separation in the two eventually results in the death of the bull market in both equities and commodities as much tighter liquidity conditions are required to rein in the latter. To draw a parallel again to the real world, less than one in four conjoined twins survive and for even one to have any hope of carrying on the weaker twin often has to be sacrificed. Here's hoping that in the weeks ahead, somehow magically equities emerge as the stronger twin on the surgeon's table.

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