

The Downside of Commodity.com

Even after the latest correction, faith in the commodity super-cycle remains intact. However, commodity.com is sowing the seeds of its own destruction



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Even as most of the illusions that defined the global economic boom of the last decade have faded, the assumption that commodity prices will continue to rise over a prolonged period still has the power to capture investor imagination even after the latest correction.

I call this illusion, commodity.com. It has some striking similarities to the dotcom mania for tech stocks that gripped the world a decade ago. At the height of the dotcom era, tech stocks were drawing 30% of all the money invested in global equity markets. When the bubble burst, commodity stocks — energy and materials — rose to replace tech stocks as the investment of choice, and by early 2011 they accounted for 30% of the global stock markets.

But the commodity.com mania has had a much bigger and more negative impact on the global economy; while rising prices for stocks — tech ones included — generally boost the economy, high prices for staple raw materials like oil impose unavoidable costs on businesses and consumers, and act as a drag on the economy. Average citizens feel commodity.com, as a heavy anchor weighing down their every move, not the exciting froth of the hot new thing. The excitement about rising commodity prices is limited exclusively to investors, financiers and oilmen who can gain from it. The only popular manifestation of commodity.com is complaints about rising oil prices, and outbreaks of unrest over rising food prices in emerging markets. It is well-justified unrest. The negative impact of spiking commodity prices on the larger economy is underestimated. Oil price spikes preceded 10 of the 11 postwar recessions in the United States. Oil prices rose 57% in the 12 months before the Great Recession of 2008, and by more than 60% before the US economy lost momentum in mid-2011.

The strongest common thread that the dotcom and commodity.com eras share is the fundamental driver of all manias: the invention of 'new paradigms' to justify irrationally high prices. We heard all sorts of exotic rationales at the height of the dotcom boom, when analysts offered gushy explanations for why a company with no profits, a sketchy business plan and a cute techie name should trade at astronomical prices. Over the past few years, we have heard the outlandish rationales again, for why the recent spike in commodity prices suggests a 'new higher normal.' Indeed, the current frenzy ignores the long-term trend of a secular decline in commodity prices. Over the last 200 years, the prices of commodities have not only declined steadily, they have fallen along predictable lines. Prices rise continuously for a decade, which inspires inventors to come up with ways to conserve, to extract the



commodity more efficiently, or to invent cheaper substitutes. Then prices fall for two decades.

This pattern of one decade forward, two decades back has pushed prices of major industrial commodities 70% below where they were in the year 1800, after adjusting for inflation. There are exceptions to the rule such as gold, and to some extent oil and copper, which have at least retained value over time, but even these are now moving in almost perfect sync with the other commodities. And only China and easy money seem to be responsible for the price rise. Today, we are nearing the end of a decade of sharp increases in the price of oil and we are already seeing huge gains in efficiency. Demand for oil is falling across major industrial countries, down over the past year in the United States by 4%, in Germany by 8%, and even in super-efficient Japan by 2%. China is pushing to create green cities, electric cars, energy efficient homes and factories that are less energy-intensive. It is also delivering on these goals as perhaps only an aggressive command economy can. Inflated oil prices, however, carry the seed of their own destruction, because the higher they rise, the more likely they are to stall the entire economy. In a way, oil prices have become the new interest rate — effectively capping growth when central banks refuse to act. This is exactly the point we reached in mid-2011: with oil prices well over \$100 a barrel, global spending on oil was 8% of GDP, when the price starts to destroy demand. The hype about the manufacturing prowess

of China and its exploding oil demand misses a basic point: what

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17%, the manufacturing share of the global economy has fallen in the same period, from 23% to 17%, largely at the expense of Europe, Japan and the US. Over the past decade, American multinationals have shed two million jobs and moved an equal number overseas, but mainly in service industries; the manufacturing jobs are just gone. In the manufacturing sector, China is rising as a big fish in a shrinking pond, which does not imply insatiable global demand for oil.

Since 1990, China's share of global demand for commodities ranging from aluminum to zinc has skyrocketed from the low single digits to 40%, 50%, 60% — even though China accounts for only 10% of total global economic output. In the case of oil China accounts for only 9% of total demand, but nearly half of the growth in demand, which is the critical factor driving up prices. The extent to which the commodity boom is all about China becomes clear when you run some possible slowdown scenarios. For one, if China's annual demand for copper slows by even 20% over the

next five years, demand growth in the rest of the emerging markets will need to double from 7% to 14% to make up the difference.

In 2000, the major commodity producers were investing very little following a 20-year secular decline in prices and hardly anyone foresaw the coming boom in demand from China. When it arrived unexpectedly, the spike in prices led to windfall profits. Now producers of commodities from iron ore to oil and copper have been spending tens of billions expanding mines based largely on projected demand from China that may not materialise. The global mining companies are expanding iron ore mines so fast, ore shipments are expected to rise 60% by 2015, which assumes Chinese demand will double over that period, despite the clear message from Beijing that the investment surge will slow.

Commodity.com is driven by fear and a lack of faith in human progress: fear of a rising phalanx of emerging nations led by China with their insatiable demand, fear of dwindling oil fields and drought-stricken farms, and lack of faith in the human capacity to come up with answers, to find alternatives to oil, or ways to make agricultural land more productive. It's a Malthusian vision of struggle and scarcity: of prices driven up by failing supplies, and wages pushed down by foreign competition. But now with both physical and financial demand slowing for commodities and supply coming on stream, this Malthusian scare too looks set to pass.

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