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Downunder Daily

Copper Cum Cropper?

Slower US growth appears to have had an imperceptible impact on the rest of the world – except, perhaps, for industrial commodity markets. For now, investors haven't noticed or cared – the mining sector has surged through the past year – but there are warning signs of a serious set-back if we see a broader global slowdown in 2008.

The first point to note is that commodity prices are now being flattered because they are priced in US dollars. Prices are more muted in other currencies. Exhibit 1, for example, shows the LME base metal index priced in dollars, euros and a basket of Asian currencies. The noteworthy point is that in euro terms metal prices are around the bottom of the range seen over the past 15 months.

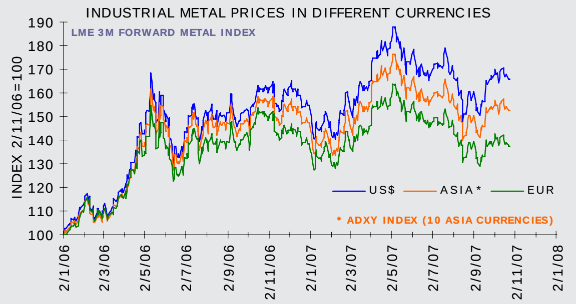
The relative stability of metal prices (at least in non-US$ terms) is remarkable given the strength in global activity through the period.

My hunch is that it reflects the impact of slower US growth, particularly in housing. Of course, US housing is fairly small relative to global GDP. But investors should remember one of the special features of commodity markets (indeed, of any market where supply is restricted in the short term): when approaching those supply limits, prices are very sensitive to small fluctuations in demand. This is captured in 'pinch point' charts, such as Exhibit 1. The vertical axis shows price, and the horizontal a measure of supply/demand balance.

The second point to note is that the leveling out in prices is having an impact on companies and economies that depend on commodities. Of course, earnings and income remain elevated, but for most purposes investors focus on growth rates, not levels.

Exhibit 1

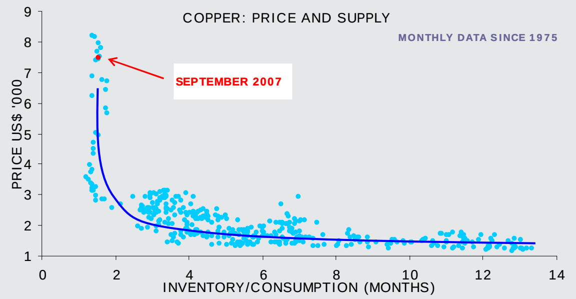
Flattered By The Dollar



Source: Bloomberg; Morgan Stanley Research

Exhibit 2

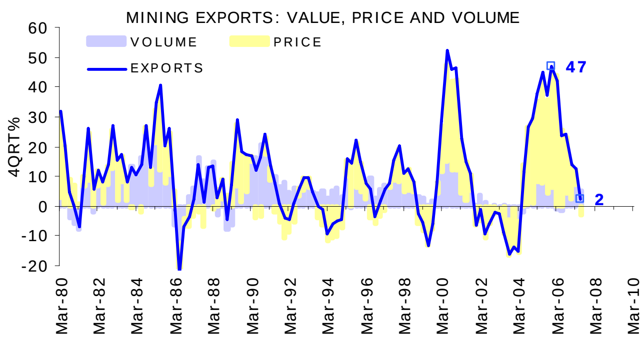
Just A Little Easing In Demand…



Source: LME, Bloomberg; Morgan Stanley Research

More to the point, it means that the boost from commodity prices for commodity-producing economies may have past an inflection point. Australia is a good example. Exhibit 3 shows the 12-month growth in Australia's mining exports. Growth over the year to June was only 2% (admittedly, affected by some supply problems), down from a peak of near 50%. The key point is that, even after allowing for likely acceleration in volumes, mining export receipts are not likely to return to the growth seen earlier in the cycle.

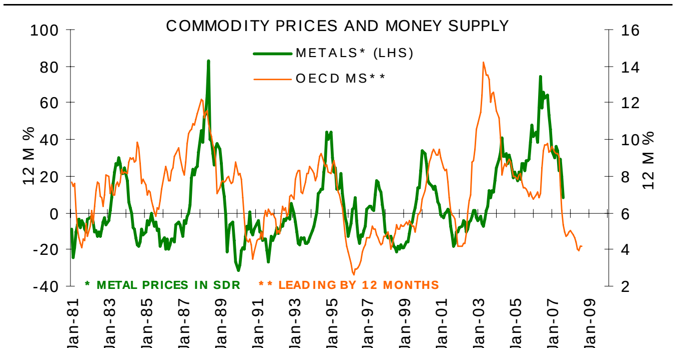
Exhibit 3
The Delta Is The Driver



Source: ABS; Morgan Stanley

Thirdly, while it's a statement of the obvious that the outlook for commodities depends on global growth, the deceleration in metal prices over the past year suggests that you do not have to be bearish on China (or Asia) to have concerns about the outlook for commodity prices next year. If a slowdown in US housing can stabilize metal prices, then a broader developed-world slowdown – extending beyond the US to Japan and Europe – could see significant falls in spot prices in my view.

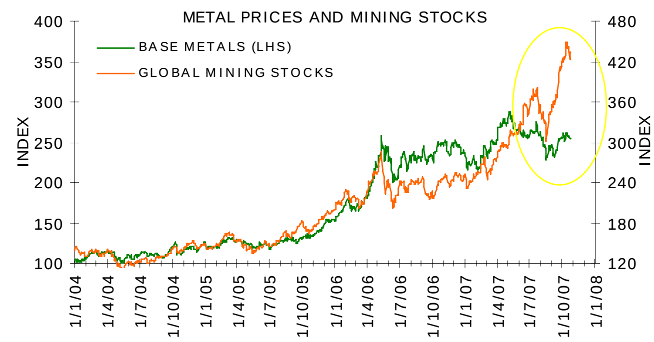
Exhibit 4
Heading For A Fall?



Source: IMF, DataStream, OECD; Morgan Stanley Research

The other message from pinch-point charts, such as Exhibit 2, is that forecasting these things is difficult. But my view is that spot prices could easily fall 30% next year. This also roughly fits with the recent decline in OECD liquidity measures, which have in the past provided some leading-indicator guidance on metal prices (Exhibit 4).

Exhibit 5
Stocks Break The Spot



Source: Bloomberg; Morgan Stanley Research

Such a decline would obviously bode ill for commodity producers. Stock prices have recently – and unusually – performed far better than spot prices (Exhibit 5). Stock specific factors may partly explain this: the upcoming negotiations for bulk commodity prices (iron ore and coal) are likely to see substantial (30-50%) price increases, something not captured by the spot metal price indexes. Nonetheless, these stocks would likely suffer if we saw a substantial fall in spot metal prices.

Finally, the economic decoupling debate is now very important to investors. My own view is that the emerging market economies would be affected by slower growth in the developed bloc. The income impact of falling commodity prices is one important transmission mechanism. The commodity-producing emerging market economies have recently enjoyed stellar export growth (as has Australia), but a moderation in prices would almost certainly offset the prospective increase in production volumes next year. In fact, the ironic point is that much of the reason for the sharp rise in price in recent years has been the non-response in supply. If supply increases next year, just as demand decelerates, then some producers may actually be worse off.

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