If It’s in the Ground, It Can Only Go Down

Ruchir Sharma   NEWSWEEK

As playwright Arthur Miller once observed, "An era can be said to end when its basic illusions are exhausted." And most of the illusions that defined the late global economic boom—the notion that global growth had moved to a permanently higher plane and housing prices from Miami to Mumbai would rise indefinitely—are now indeed exhausted. Yet one idea still has the power to capture imaginations and markets: it is that commodities like oil, copper, grains and gold are all destined to rise over time. Lots of smart people believe that last year's swoon in commodities prices represented a short pause in a long-term bull market.

It's a view rooted in powerful and real trends, like the growth of China and India, the decline in global reserves (many of the world's biggest and best oilfields are tapped out), fears over resource nationalization (independent oil firms now control only 20 percent of global reserves) and long-term underinvestment in energy and agriculture, which hampers supply.

Yet the fact is that the world has faced all these issues before, and for the past 200 years, commodity prices have been trending downwards, thanks to new technologies, greater efficiency in extraction and the substitution of one commodity for another (which explains the high correlation between commodities prices). Bank Credit Analyst, a research firm based in Montreal, has data showing major industrial commodity prices are 75 percent below where they were in the year 1800, after adjusting for inflation. Despite all the worries over "peak oil," the fact is that the major bear markets in oil have been demand, rather than supply led. And when demand eventually picks up, there's usually some new alternative (nuclear energy, natural gas, green technologies) waiting to pick up some of the slack. The real price of oil today is now at the same level as in 1976 and, before that, in the 1870s, when oil was first put to mass use in the United States. This long-term price decline is due mainly to the constant discovery of new fields and greater energy efficiency, making nonsense of the idea that the world is rapidly running out of oil. The experience of the 1980s is instructive in the current context as well.

Japan and Europe continued to grow strongly in the 1980s, and yet oil consumption remained essentially flat through that decade as both the regions strived to achieve better fuel efficiency and switched to alternative sources of energy, such as nuclear power. Similarly, 90 percent of the growth in new oil capacity since 2004 has come from biofuels, synthetic oil and natural-gas liquids. As countries get richer, their per capita consumption of commodities declines. It's a myth, then, that the boom in China and India will inexorably drive up oil and other commodity prices.

At any point in time, there are always new economic powers emerging on the global scene, yet commodity prices have continued to fall. The 1980s and '90s were a relatively strong period for the global economy, and China was growing at an average pace of 9 percent. But prices for most commodities did not follow: oil, for example, never broke through the upper limit of $40 a barrel.

The reason oil prices did not spike higher is simple: demand for any commodity is price-elastic, which means that once the price goes too high, consumers stop buying it or make heroic efforts to find a substitute. In the 1960s and '70s, the revival of manufacturing in Japan and Europe propelled prices for industrial metals like copper and nickel higher, until the buyers couldn't take it anymore. Total spending on copper peaked at 0.45 percent of the global economy in the mid-1960s, and on nickel at 0.2 percent in the 1970s. Once copper prices got too high, aluminum was used as a substitute in many functions. As commodities are inputs in themselves, they can justify only a certain share of the total costs before it becomes prohibitive to consume the end product.

There is good reason to believe that the world just passed a similar turning point. The last boom in the oil prices collapsed in 1979, when total spending on oil exceeded 7 percent of global GDP. Last year, spending on oil hit a similar share of global GDP, and the price has since fallen by more than two thirds. Last year prices of other critical commodities, including copper, zinc and lead, also reached peaks not seen since the 1960s or '70s, before falling back to earth.

Yet markets are still betting that the price of oil is poised to spike again. Oil for delivery in three years' time is trading at close to $70 a barrel, compared with the current spot price of about $50 a barrel. Some analysts predict $90 a barrel by 2012. Prices of other commodities, from copper to rice, are also expected to rise.

It's worth noting that until as recently as 2005, the markets acted on the exact opposite assumption. For years, spot prices ran much higher than futures prices, because most investors assumed prices would follow the historic trend line: down. They made money by simply rolling over their oil contracts at a lower price. Commodities were otherwise seen as a losing proposition—and for good reason. But the long view died with the commodity price boom of this decade, and it has yet to return. Today investors are still reacting to any sign of health in the global economy by pouring money back into commodities, producing the erratic upward price swings we've seen in recent weeks.

This bullishness is misplaced. The world is now in the biggest growth slump since the Great Depression, and the era of exceptionally high global growth that led to a surge in demand for commodities from 2003 to 2007 is unlikely to return any time soon. Yet for the most part, analysts, no matter what their view on the global economy, agree that commodity prices will rise. Optimists say a revival in consumer demand will drive up oil and other commodity prices, while pessimists are buying commodities as a hedge against a feared outbreak in inflation, given all the money central banks are printing across the world.

Both scenarios ignore history, which shows that only one commodity rises in an inflationary environment: gold. Other commodity prices tend to bloom only during the mature stages of a boom when the global economy overheats and demand briefly exceeds supply. At the moment, supply for nearly all commodities far outweighs demand, and likely will decline for at least the next couple of years.

The hopes of producers could also deepen the slump. The oil men, copper miners and steel barons clearly expect the recent price declines to be temporary, because they are making only short-term cuts in factory output, rather than taking more permanent steps like closing factories. A case in point is the steel industry, which has slashed production by 40 percent worldwide since September, leaving mills operating at 65 percent of capacity, down from 95 percent last year. However, steelmakers are not closing plants, which means mills will run at partial speed for the foreseeable future, leaving producers with little pricing power.

The dynamics are similar for other metals. Despite the recent fall in prices, many commodities still trade well above their cost of production, so prices need to come down further before producers feel the kind of pain that forces plant closings. Instead, inventories for most commodities have risen to five- or, in some cases, 10-year highs, even though spot rates are still well above prices of a decade ago. That implies prices will have to decline as the excess inventories need to be cleared out.

The only reason the fall in oil prices hasn't been deeper already is that many people expect a continuing boom in China, driven by Beijing's aggressive stimulus plans. These days any hint of good news out of China—even a slowdown in the decline of manufacturing—can unleash whoops of joy in the oil trading pits.

They come too early. China suffers from an overinvestment problem. It has been investing at a rate equal to 40 percent of GDP for nearly a decade, a level unprecedented in the history of economic development. Much of the money goes to export industries, which are sagging in the global downturn. Investment demand is not likely to revive soon, nor should it. China contributes 10 percent of global economic output, but has been consuming 25 to 50 percent of most industrial commodities, a pace that can't be sustained. The pace should slow in coming years, as China moves to reduce its reliance on exports and investment, and to build an economy driven by local consumers. Beijing is also working to create more-efficient factories that run on less energy and require fewer raw materials. Meanwhile, in nations other than China, demand for commodities is falling at an annual rate of 30 to 60 percent, which will put intense downward pressure on prices.

China's impact on oil prices is greatly exaggerated, anyway. China consumes 9 percent of global oil production, while the rich nations of the Organization for Economic Cooperation and Development consume more than 50 percent. Demand for oil is highly sensitive to global growth and the IEA expects it to shrink by 2.4 million barrels a day or 2.8 percent as the world economy is now estimated to contract by 1.4 percent in 2009.

That will greatly reduce the power of the oil cartel to raise prices. OPEC has always found it difficult to dictate price trends when its spare capacity exceeds 5 percent of total demand, and right now it is at 8 percent and rising. The cartel has ordered three production cuts in the last six months, and while its members are now meeting 80 percent of the targeted cuts, the incentive to cheat will only grow.

At some point, of course, commodities will spike again, but only temporarily. To date, the centuries-old slide in prices has been marked by long bear markets and short bull runs. Data from CSFB shows that the average bull market in oil has lasted from four to nine years, and the average bear market from 11 to 27 years. The bull market that ended last summer saw prices rise tenfold over nine years, mirroring the duration and magnitude of the previous bull market, which ended in 1979. That was followed by a bear market that lasted 20 years. If history is any guide, we're only at the beginning of another long one.

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URL: http://www.newsweek.com/id/193499
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