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Goldman Sachs Asset Management

Viewpoints

FROM THE OFFICE OF THE CHAIRMAN

Can Equities Rally Without Commodities?

What a week! In last weekend's Viewpoint, in addition to highlighting the historical tendencies of markets in May, I suggested that commodity price strength didn't make much sense to me. One week later, after the stunning correction to many commodities, I am struggling to get my head around the question: why does commodity price weakness go hand in hand with equity weakness? Put another way, if equities are to develop another leg to the rally that has been taking place since 2009, it will probably have to be led by something other than commodities.

ECONOMICS, EQUITY AND COMMODITY MARKETS.

There was a day when commodities, as an asset class, were seen as an alternative to both fixed income and equities. I know that many of my colleagues from various parts of the GS family can statistically prove that this remains the case. However, at times during the past decade, it has seemed that commodity prices have been a "bellwether" about the world. Furthermore, strength in commodity prices has been related to strength in many equity markets (as well as a major influence on some other markets such as some currencies).

From an economic perspective, at its most basic level, the price of any commodity is determined by its supply and demand and expectations about both. An increase in the price of a commodity can happen because of a rise in demand relative to supply, or a decline in supply, or some combination of both. In the years before the global credit crunch, it was often perceived that commodity prices were rising because of very strong global growth and limited supplies. Post credit crunch, the same general mood has prevailed.

Linked to this thesis, application of the GS long term 2050 growth projections and the potential rise of the BRIC economies suggest a general environment of very strong demand for commodities relative to supply. The GS Economics, Commodities and Strategy (ECS) department have published a number of articles to show this. In particular, Global Paper Number 118, October 12th, 2004; Crude, Cars and Capital, authored by D. Wilson, R. Purushothaman and T. Fiotakis applied the original 2050 projections to the crude oil markets, and one of its conclusions was that there was likely to be a major supply and demand imbalance between 2005 and 2020.

Many market themes that have played out over recent years often relate to the basic tenet of this paper. Simply stated, Mr. Market seems to regard strength of commodity prices as a symbol of world economic strength, and weakness of commodity prices as a symbol of economic weakness.

THINGS ARE CHANGING?

Many market participants appear to have forgotten the days of the 1980's and 1990's where economic strength was not symbolized through rising commodity prices. During that time, we had two decades of declining commodity prices and, while there were periods of recession, we experienced two decades of global economic expansion. Could such days ever return?

Over the past 12 months, three different economic issues have developed in my mind that lead me to wonder whether things might be changing.

First, as commodity prices recovered sharply post the global credit crisis, headline inflation has, in turn, risen in many countries. And, in those less wealthy nations, including many of the Growth Market and emerging countries, rising commodity prices are a real challenge. In some developed economies that were most challenged after the credit crisis, rising commodity prices are quite a burden for those societies too. A feeling of unsustainability about this has been going through my mind for much of this year.

At a minimum, we are likely to encounter more mini periods of volatility, where rising commodity prices, food and energy in particular, choke off some economic activity as consumers and business adjust to the higher costs. In countries where overall inflation rises more because of these rising prices and central banks tighten monetary policy, subsequent tightening financial conditions will slow down growth and probably lessen their contribution to the demand for the commodities in the first place. It appears as though we might be going through such a period right now. Suddenly, economic data in many economies has disappointed, and while there could be a number of explanations, it seems quite feasible that the degree of increase in energy and food prices might be a guilty culprit.

Second, and linked to the first point, as I mentioned last week, the role of China in particular is key. GS has a proprietary GDP indicator for China called the GSCA, the GS China Activity indicator. In recent years, it has had a very good relationship with commodity prices, presumably signaling the critical role that Chinese demand plays in the commodity markets. In recent months, the GSCA has slowed a lot, and yet, commodity prices – at least until the past week – hadn't. This suggests to me that commodity prices could weaken further.

More broadly, softening in key global leading indicators following the release of many May PMI and ISM indices would suggest the same trend.

Third, bringing it back to China, and getting really specific to energy and oil in particular, China's long term economic planning is increasingly based on a world different from the one modeled by ourselves in 2004. If you reanalyze global oil demand assuming that China will deliver on the energy consumption plans it has unveiled as part of its latest 5-year plan, their oil demand will not grow even close to the magnitude shown in Dominic and team's 2004 paper. Indeed, Anna Stupnytska and I showed in another paper, Global Paper Number 192, The Long Term Outlook for the BRICs and N11 Post Crisis, December 2009, if you substitute the Chinese plans into the same equations as the 2004 paper, 2050 global oil demand would be 20 pct less.

If I think about all three of these things together, what happened in commodity markets last week was not surprising at all, and more weakness in the near term wouldn't be that surprising either.

MARKETS NEED TO BEHAVE FOR THEIR OWN DETERMINANTS.

As this relates to other markets, it doesn't necessarily follow that any additional weakness in commodity prices will translate into more equity market weakness, except in the obvious cases where commodity companies are a major market component. It certainly shouldn't follow that correlated risk reduction on the back of commodity price declines should have lasting consequences for other market prices, for example additional Yen strength. This would seem somewhat ludicrous and, if needed, I suspect G7 policymakers may have to act again.

As it relates to the directional trend of equity markets, however, the last week's events do draw me to a conclusion that if equities are to develop another leg into higher prices, it probably won't be sustained if it is simply the result of commodity prices recovering. If commodity prices go straight back up, it will add renewed pressure to headline consumer prices in China and elsewhere, probably resulting in additional monetary tightening.

If commodity prices don't move back up, one of the beneficial consequences is that it will make it probable that a number of central banks won't need to tighten as much as otherwise, possibly not at all, including China and maybe also the ECB. It is interesting that ECB President Trichet didn't utter the magical phrase "strong vigilance "at this week's press conference.

Can equity markets rally without leadership of commodity companies and prices? Of course they can, but I shall leave the sectors most likely to all of you to ponder.

EURO WOES.

There is one other topic that I need to touch upon. After already showing a big response to Trichet's less hawkish stance than expected, the Euro took another hit late Friday as rumours circulated of a special meeting to discuss Greece and a possible debt restructuring and even talk of them exiting the Euro. Not surprisingly, these rumours were denied but, despite this, the Euro ended close to its lows for the week, having given back 6 big figures of its latest strength. I am not overly surprised by this Euro decline either, as the case for the ECB tightening further has just been weakened. And, it continues to seem to me that some risk premia is warranted, as Europe's leaders struggle to come to grips with the immense challenges of creating a more credible and successful European Monetary Union. In my book, even with the likelihood that the Fed will remain friendly post QE2 termination, the Euro belongs in a 1.20-1.40 range.

THE BEAUTIFUL GAME.

Actually there is one other topic too, my usual favourite. May 28th will now see arguably the two best European football clubs slugging it out again when Manchester United meets Barcelona at Wembley. What an evening in prospect and what a build-up the next 3 weeks will be. Will it attract as many viewers as the Royal Wedding? Apologies to all those of you asking me for help with tickets, it is exceptionally difficult.

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