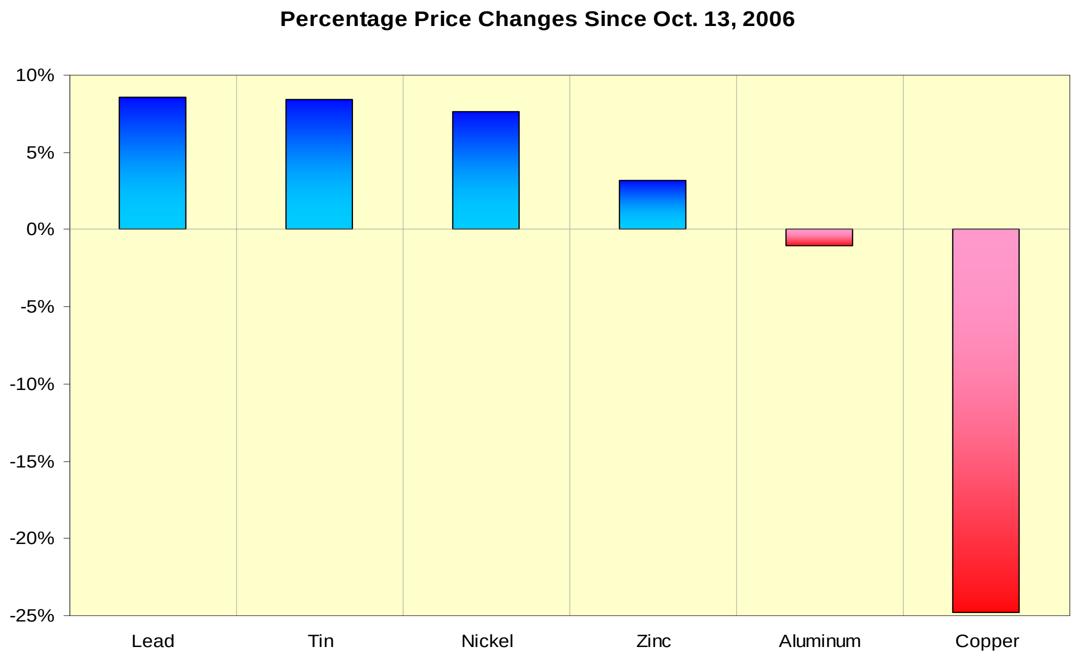
Commodities' Unhappy New Year

Michael Jackson and the late Steve Irwin both might have appreciated the showmanship exhibited by various commodity markets last week. Dangle the innocent in front of danger and people take notice, albeit simplistically and not always correctly.

As promised in a Columnist Conversation post last week, let's review the relationship between various commodity prices and selected financial markets, emerging markets in particular. First, it is interest to note I addressed a similar concern in mid-October after a similar downturn in commodity markets. The concern then was declining copper prices were signaling the demise of the global economy and, while we were at it, death and destruction in financial markets.

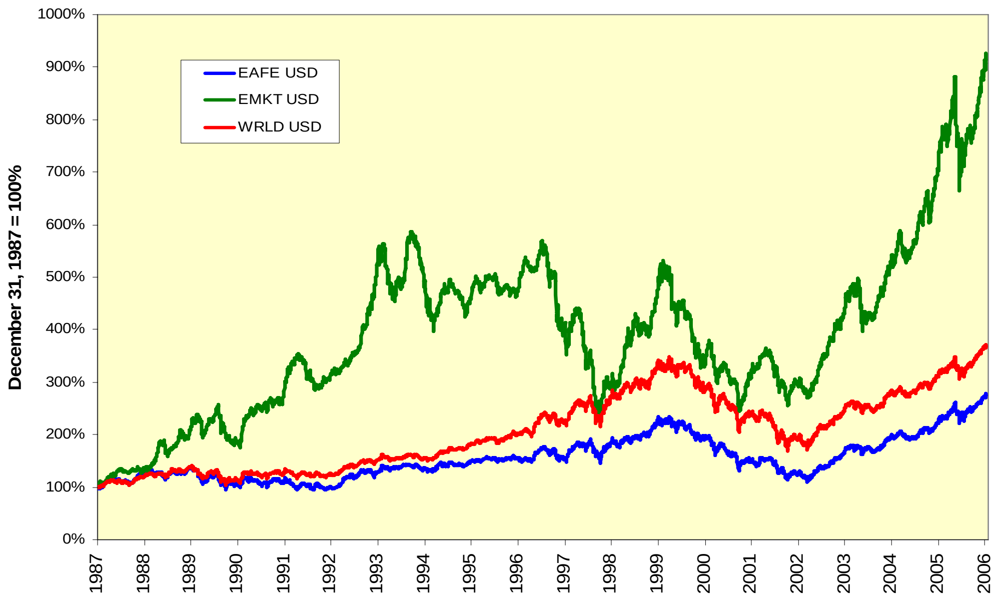
That article was penned using data through October 13, 2006. Copper prices have declined 24.79% since that time, while the total return on the Morgan Stanley World index was 6.1345% in dollar terms. Anyone who based their economic outlook or, worse, investment plan on copper prices reaped the just desserts of their own intellectual carelessness and sloth to boot. While copper declined sharply, aluminum was barely down over the period and other key industrial metals such as lead, tin, nickel and zinc all rose in price. Once again, it is a market of commodities, not a commodities market.



Impact On Emerging Markets

Now let's turn our attention to the question whether a downtrend in commodity prices will affect the performance of emerging markets as measured by the Morgan Stanley Emerging Markets Free index negatively. Over the past twenty years, this index has had two prolonged periods of outperformance against both the World index and the Europe, Australasia and Far East (EAFE) index, all expressed in dollar terms. The first ended in late 1994, the second is ongoing still. At the end of the holding period, an American investor able to withstand the volatility inherent in this index would have been well-rewarded in comparison to the alternatives.

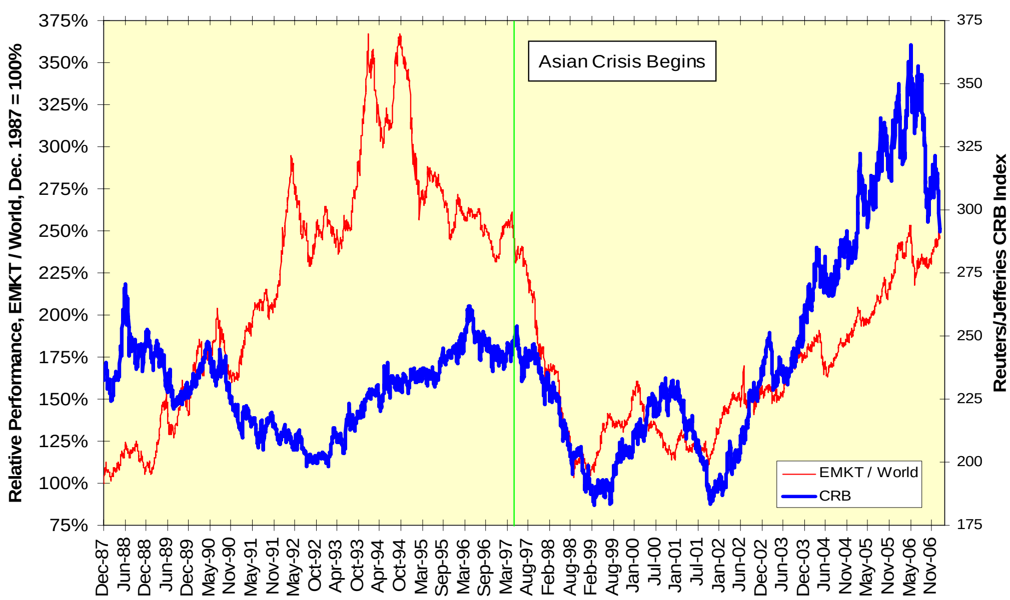
Relative Index Price Performance



How much of this relative performance path was dependent on commodity prices? Keeping earlier admonitions against commodity indexation in mind, we can compare the relative performance of emerging markets to the world index against the Reuters/Jefferies CRB index.

Several observations jump out of this chart. First, the rally in emerging markets from 1987 into 1997 occurred during a period of declining commodity prices. Second, the October 1994 peak in emerging markets' relative performance occurred 19 months prior to the CRB's 1996 May 1996 peak. Yes, markets are discounting mechanisms, but that seems a little too omniscient, does it not? Third, the period of tightest correlation between the two markets was during commodities' post-Asian crisis funk; once commodity prices took off in 2003, they greatly outpaced relative gains in emerging markets. Finally, emerging markets' relative performance neither anticipated the post-May 2006 break in the CRB index nor did it decline once commodities began to collapse.

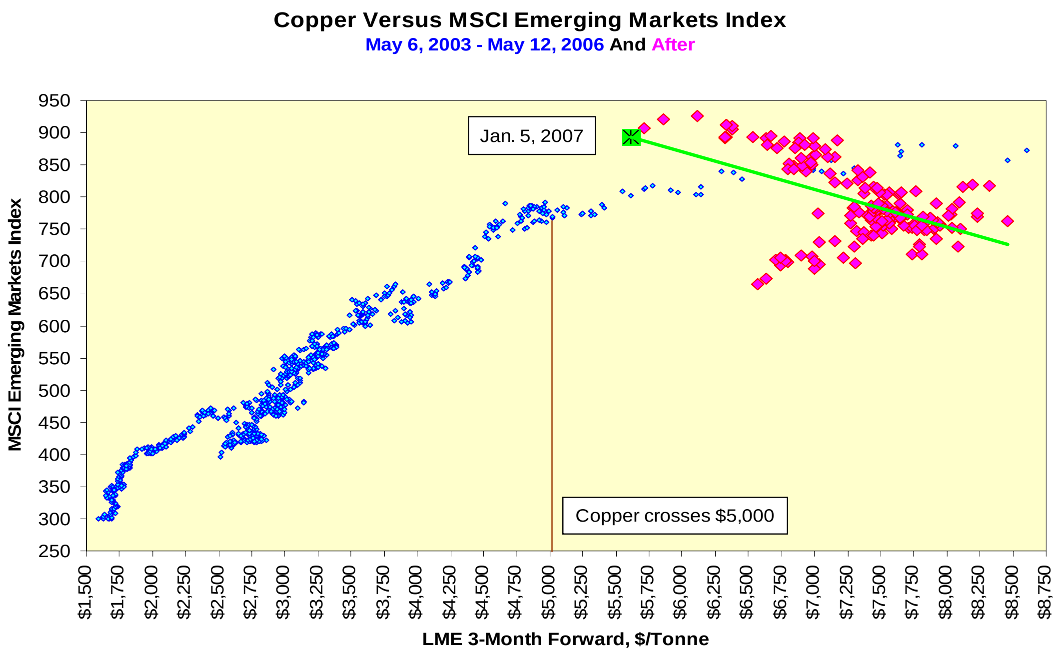
Are Commodities And Emerging Markets Correlated In The Long-Term?



Copper, Crude Oil And Emerging Markets

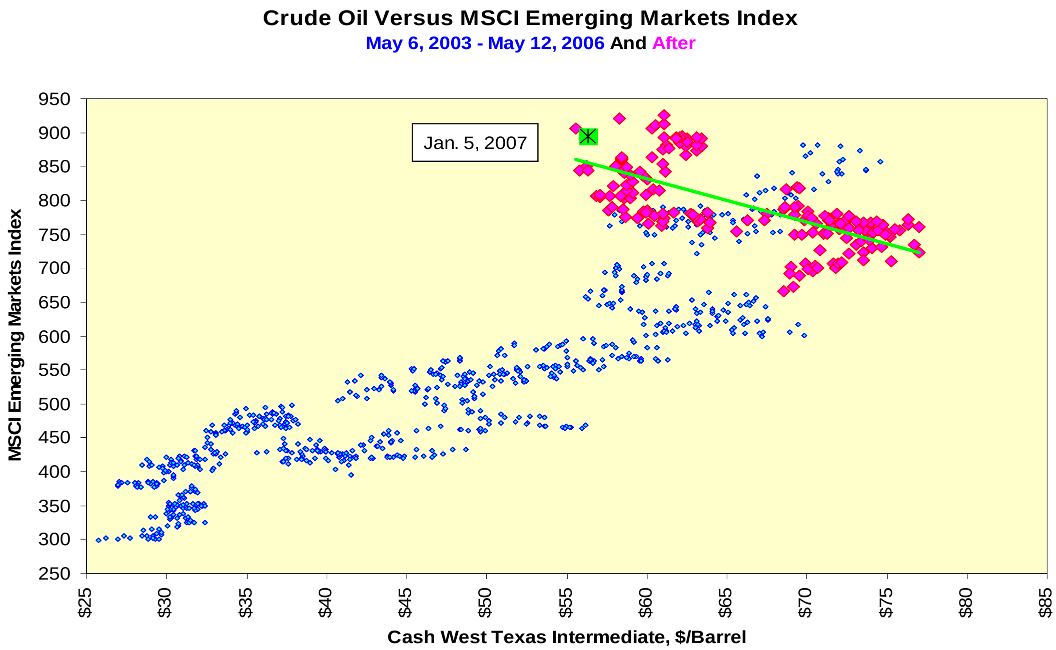
Let's update a chart from last October, comparing emerging markets to copper prices and add a similar one for crude oil. In both cases, the comparison period is split into two segments, one from the onset of the Federal Reserve's declaration of war on deflation on May 6, 2003 through the Bank of Japan's withdrawal of liquidity from its banking system in May 2006, and afterwards. The emerging markets index continued lower for another month, not bottoming until the Bank of Japan stabilized its withdrawal of reserves; this history was discussed last July.

Emerging markets have rallied fairly continuously, the May-June downturn notwithstanding, since copper's peak on May 11, 2006. Moreover, emerging markets rallied sharply between May 2003 and the final takeoff in copper in March 2006, noted in the vertical line. When did emerging markets have their slowest growth period? During the March-May 2006 period, the time when copper had its most irrational exuberance, a 70% gain in two months.



None of this should surprise anyone. Many of the world's largest copper producers, including the U.S., Canada and Australia, are nowhere to be found in the emerging markets categories. Other large producers, such as Congo and Zambia, are a little too emerging for most tastes. The currency exchange rate for the Zambian kwacha is 4,175 to the U.S. dollar; thanks for asking. This leaves China, Russia and Chile as major emerging market producers, and China, like the U.S., tends to consume all of its production domestically. So is all the fuss about Chile? It would appear so, unless you are one of those who believe copper is the perfect barometer for global economic activity.

We can see a similar negative correlation between crude oil and emerging markets after May 2006. As crude oil prices rose between 2003 and 2006, emerging markets rose. As crude oil prices fell after May 2006, emerging markets rose. See how important crude oil prices are to emerging markets?



Once again, most emerging markets are crude oil importers. We should expect lower crude oil prices to flow through to their national bottom lines, and this happens for the most part. No one should associate weaker crude oil prices with a slowdown in emerging markets' collective economies.

What, then, happened last week? The same thing we have cautioned about for years: The long-term constant-dollar price trends in non-energy commodities are negative. These markets got way ahead of themselves in 2005 and early 2006. Higher prices encourage production and discourage consumption. And, finally, the year-end and year-beginning tax considerations associated with Section 1256 of the tax code, which treats the unrealized profits in commodity accounts as a taxable gain, often roil markets at the start of the year.

Commodity markets, while sexy, are surprisingly small. The effects of much larger financial markets, interest rates and currencies in particular, should occupy your attention. Finally, those were persist in treating emerging markets and commodities as one and the same should be forced to stay after class and write "I will not blog in ignorance" one hundred times on the blackboard.