MV CAPITAL MANAGEMENT

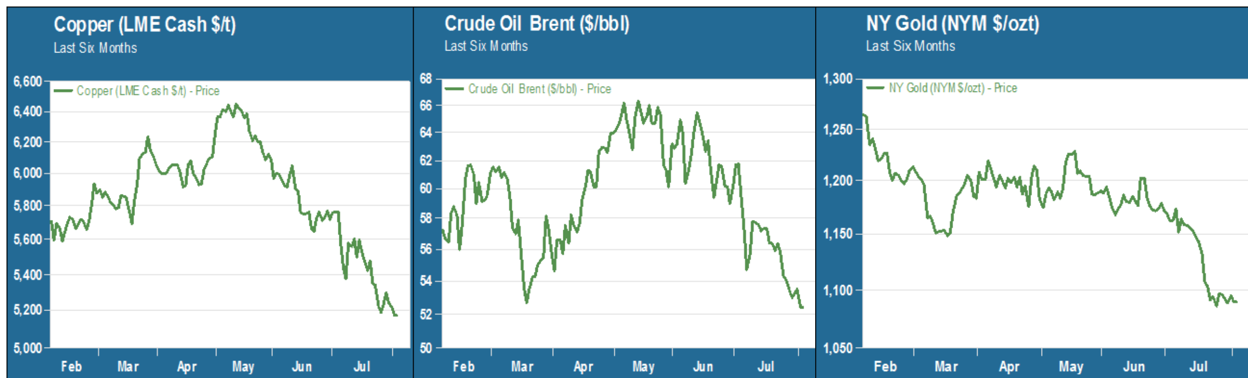
Weekly Market Flash

Summer of Misery for Commodities

August 7, 2015

"Every unhappy family is unhappy in its own way." The opening sentiment in Tolstoy's great novel *Anna Karenina* works just as well for commodities markets in the summer of 2015 as it did for Russian aristocratic clans in the 19th century. Every major commodities "family" – from precious metals to energy and industrial metals – is unhappy. And the reasons are quite specific to each. Oil suffers from a supply glut. Copper and nickel feel the brunt of contracting production in China. Gold has lost its luster as a safe haven – nobody went piling into gold during the recent turmoil in Greece, for example.

Oh, sure, there are exceptions to the rule out there in the byways and back roads of the commodities world. Traders put a "squeeze" on robusta coffee futures last month and bid September contracts up to a ridiculous spread versus July delivery. But by and large, it has been a long and hard summer for the global economy's major physical inputs. The chart below illustrates the shared pain.



Source: MVF Research, FactSet

As dismal a picture as this chart paints, it does not even tell the full story. From its last six years' high point in April 2011, Brent crude oil has tumbled 61 percent. Copper has fallen by nearly 50 percent over the same period, and gold's retreat has topped 40 percent. Imagine what the conversation would be if major equity indexes had spent the past six years falling on an order of this magnitude. When the S&P 500 gives ground in the high double digits, retirement nest eggs look fragile and the prospect of recession looms large. When oil prices plummet – well, we just pay less at the pump. Good news, right? Not necessarily. Commodities price trends give us important information about the world economy. Right now the news is decidedly mixed.

Awash in Supply

Oil bulls got sideswiped by a steady drip-drip of supply news in July, with accelerating OPEC production dominating the headlines. Saudi Arabia remained firm to its commitment articulated last November to gain share rather than support prices through restricted output. Production in Iraq reached record levels. And the prospect of Iran – holder of the world's fourth-largest proven reserves – reentering the market after years of sanctions added a further depressive element. Meanwhile, US shale producers still appear mostly determined to power through the downturn and find ways to further reduce their cost structures rather than let up on output.

The China Malaise

The unhappy story told by industrial metals is set in China, which is by far the world's largest importer of copper, aluminum, nickel and other key metals. Forget about all the eye-popping gyrations on the Shanghai and Shenzhen

stock bourses. The really important story in China is the slowdown in growth, punctuated by a sharper than expected manufacturing contraction in both June and July and coming on the heels of forty straight months of declines in the domestic producer price index. Whereas the oil story is mostly (not entirely) about supply, the plight of industrial metals has more to do with demand. And weaker demand from China has hit the export accounts of other emerging markets. It should come as little surprise that the MSCI Emerging Markets index is off by more than 12 percent from its June highs.

All That (Doesn't) Glitter

Then there is gold. It would be fair to say that the gold bugs who went running for the hills in 2009, worried about the inflationary tinderbox the Fed was supposedly opening with its quantitative easing programs, have not been rewarded for their excessive caution. But at least gold was a part of the "risk off" trade back in 2011 when we had our last really big pullback in equities. Fast forward to July 2015, with Greece once again on the front pages and consensus forming around the idea that a breakup of the Eurozone is a matter of when, not if. Over the course of this month, with Greek banks shutting down and Chinese stocks plunging into bear territory, the price of gold actually fell by six percent. This is perhaps a useful reminder of something we have said from time to time on the pages of these weekly commentaries. There is nothing magical or mythical about gold. It is a commodity, with a price that goes up and down like any other commodity. Lately, the movement has been mostly down.

Trouble Ahead, Trouble Behind

Unfortunately for gold bugs, oil bulls and any other species looking for commodities gains to ring out the year, the road ahead does not look much more promising than the road behind. First of all, neither the oversupply of oil nor the slowing of growth in China look set to end any time soon. Those headwinds are likely to continue. Secondly, those headwinds are likely to compound further still if the Fed goes ahead with its rate program, as expected sometime between September and December. Higher interest rates impose a natural cost on holding commodities – after all, investors do not get any interest or dividend income from storing bars of gold or barrels of oil. Now, if a rising Fed funds rate signals a faster tempo to global real economic growth, we would expect that growth to translate into higher commodities prices at some point. From where we stand now, though, that "some point" still seems to be some distance away.

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