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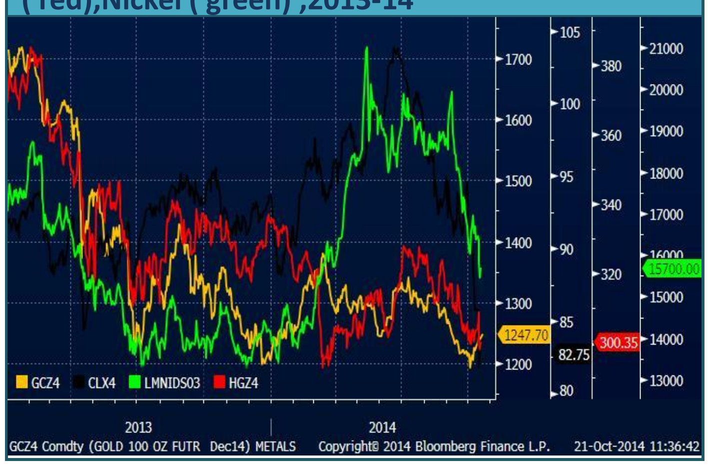
COMMODITIES:Good (bad ?) news for global inflation and growth

Summary	Investment Conclusions
The recent collapse of some commodity prices was a classic “good news-bad news” case. Bad news as these falls reflected to some, but not to a full extent, weak global demand, but at the same time was good news for the consumers of these commodities. However it is essential to differentiate soft from hard commodities, with the weather being the key supply determinants of the former. Overall, the lower prices, and that of oil in particular, is a “good thing” as it keeps inflation down and heralds the era where US oil production will become the swing factor. For the rest, the costs and benefits are divided fairly equally between consumers and producers.	The fall in commodity and oil prices are likely to persist and, hence, will impact inflation. Bad news for Japan and the EU with their higher inflation targets, but better news for the former in the alleviation its oil trade deficit, but then bad news with a possibly stronger JPY! Good news for most food- importing Asians, including China, and for India where interest rates my come down faster as food inflation falls. Bad news for the commodities-linked AUD. All these developments add pressure on the Fed to postpone hikes for later on in 2015, so it is good for equities.

Hard commodities and energy prices

Chart 1 shows the prices of some of basic metals, including gold, and also for oil. The collapse of the price of **oil** reflected three factors, the fall in demand led by China, the increase in US supply and exports as shale oil is coming on line, and the unwillingness of OPEC (read Saudi) to restrict supply in order to put a floor on the fall. There have been rumors that the Saudi inactivity was designed to lower prices enough in order to damage the still-high cost shale producers in the US. This would come as cold comfort to **Russia** which has seen the ruble depreciate since June by more than 20%, in addition to copping with the sanctions from the EU and the US, while the price of its most important export fell steeply. For oil importers such as India and Indonesia the falling oil prices will be good fiscal news as in both economies oil price subsidies are a major fiscal and political issue, particularly in **Indonesia** where the newly-elected president is already faced with the touchy political issue of reducing subsidies. In the case of **India,** anything which keeps the CPI on a falling trend brings nearer the time that the RBI will cut rates as it has promised to do once inflation is on target. The prices of copper (red) and nickel (green) reflect primarily the demand from China where the deceleration in the economy, and in the property sector, has reduced demand for copper (construction) and nickel (stainless steel). The Chinese economy is doing better than expected (7.3% GDP growth in 3Q.14) and this may put a floor in these price falls, but will not reaccelerate demand until well into 2015 when the economy would have likely bottomed. Gold is dealt with separately in the Factbox

Chart 1 Oil (black),Gold (yellow),Copper (red),Nickel (green) ,2013-14



Source: Bloomberg

Nature gives a hand

Exceptional good crops in the US have pushed the price of corn (maize) down, but may now be bottoming (purple, Chart 2), while wheat prices (red) and soybeans (green) have also come down although they may be bottoming out. China should be the main beneficiary as a key importer of soybeans and of corn. Other Asian economies with food sensitive CPI indices will also benefit, including the Philippines. The Thai authorities are trying to control their "rice mountain", accumulated through an unwise price support scheme. They have managed, however, to hike prices. The current rice prices are still well below the high levels of 2008 when the index hit 2200 compared to current levels of under 1400.Thailand is the second largest rice exporter after Vietnam while India exports, too, but gives priority to domestic needs. All this, is of course good news for importers of food but bad news for exporters. **Argentina**, still in the throes of its default process, will see no end to a weakening peso, being a major exporter of wheat and of soybeans. Perversely, the weaker peso will add to steeply accelerating inflation in Argentina while the lower food prices will keep inflation down elsewhere. **Brazil,** also an important exporter of soybeans, will also be impacted, but the election results may take priority in their impact on the local markets.

FACTBOX : Gold and the Fed, to be or not to be ?

If the Fed hikes, this is bearish for gold as it increases the carry cost. But at the same time, if the Fed hikes, this will trigger uncertainty and fear and hence, could support gold .If the Fed postpones the hike, then this is partially good for gold as rates stay low but then uncertainty subsides, and inflation too will also be low and that works, in general, against gold. All this sounds as if it comes out of the mouth of an economist "but on the other hand…"Gold prices (Chart 1, yellow) are unlikely to be boosted in an environment where rates,will,eventually, have to rise and where inflation outlook stays benign

Chart 2 :Wheat (red),Soybeans (green),Corn(purple),Rice (yellow),2013-14

Source: Bloomberg

Pulling the threads together

The last two weeks of high volatility in the equity and bond markets dragged down quickly the price of oil and, hence, focused attention on energy prices, while the prices of nearly all the other commodities we have been examining here have been falling with varying degrees of speed during 2014.

The falling oil prices, and also the pre-existing commodity price declines, then helped set the scene for a surge of concerns over the state of the global economy. These concerns might smack a little of belated awareness and, in reality, were a cover for the concern over the sorry state of the EU economy, and of the weak reaction of the ECB and, hence, on the refocused attention on the Fed. The response of the Fed was hardly unexpected- cautious and soothing sounds have been made over the pace of rate hikes. So the declines in oil prices may trigger a delay in the end of low rates. Our much broader conclusion should then be that these commodity price movements, and of oil in particular, may end up being bullish for equities, as well as for bonds if the Fed desists for now. It is a strange world indeed.

Andrew Freris (writing completed 21/10/2014)