Weak Commodity Prices in a Strong Economy?

Conventional wisdom typically suggests that in times of economic expansion the need for goods and services increases. This need may lead to a greater demand for raw materials and energy, driving their prices higher. Yet, in the current economic cycle, we are witnessing the opposite. U.S. gross domestic product (GDP) has been growing steadily, averaging a 2.1% increase annually since 2010. However, for the same period, commodity prices have steadily decreased by -7.6% annually, and oil prices have declined by -8.7% per year.

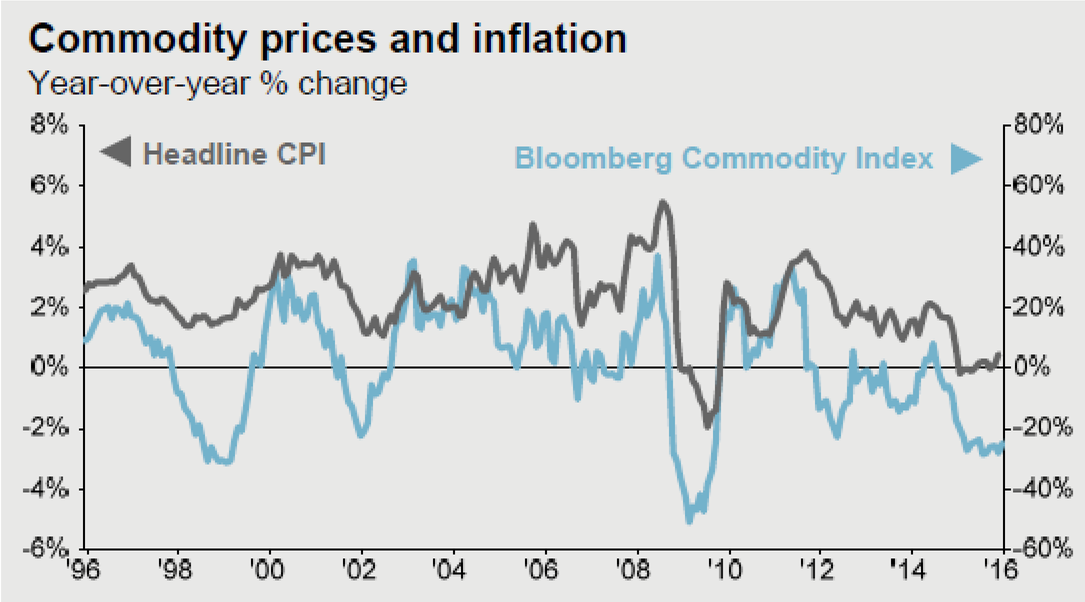
Several factors are driving this divergence in economic growth and commodity price trends. The global economy has changed and most developed economies, including the U.S., rely more on services and technology than on manufacturing, which lessens the demand for raw material inputs when the economy expands. As emerging markets, China in particular, start to shift from infrastructure and more toward services, the demand for raw materials declines further. However, the supply of commodities is less elastic, as it takes a long time for producers to adjust output increases or decreases. So when demand decreases, there is a period of oversupply which often results in depressed prices. In energy, new drilling methods have also added to production over the last several years, making the oversupply adjustment process even longer. As a result, commodity prices—and especially energy prices—have lagged in this period of economic expansion.

The strong dollar has also contributed to the length of this weaker commodity price trend. As U.S. GDP is growing faster than that of other nations, the dollar has been appreciating relative to other currencies. Expectations of higher interest rates in the U.S. compared to other developed nations have added to this strength. As most commodities are priced in dollars, its strength has hurt commodity prices.

Price trends eventually come to an end, and while a turning point cannot be predicted with certainty, there are signs that commodity prices may be finding a bottom. First, prices of industrial metals are trading at multi-year lows, and after several years of price weakness, there has already been a reduction in output in most mining and material sectors. This reduction is leading to lower supply levels. Second, the volatile equity markets have sent investors into safe havens, boosting the prices of gold and other precious metal. Lastly, energy demand has been slowly rising. If energy production slows in response to lower prices, it may result in a gradual increase in oil and other energy prices as well.

With respect to the strong dollar, a slowdown in the Federal Reserve's pace of rate increases may reduce the likelihood of higher short-term interest rates. Generally speaking, higher short-term U.S. rates increase the demand for dollars. Less demand for dollars would likely weaken the currency, which in turn may result in higher commodity prices. In our view, the U.S. economy continues on a slow expansion path, which may justify a slower rate of rate hikes.

Finally, as shown by the following chart, commodities tend to have a positive correlation to inflation. Their prices increase when inflation rises. Over the last couple of years, inflation expectations have been low and this fear has not been on the forefront for investors. However, bouts of inflation can be unpredictable, and exposure to broad commodities and energy within a portfolio may offer some protection against an unexpected inflation rise.



Source: JPMorgan, data from Bloomberg, BLS

We continue to believe that commodities offer a solid diversification benefit to traditional stock and bond portfolios. They may perform better in periods of a weakening U.S. dollar and protect in periods when inflation surprises to the upside, two risks that are substantially underpriced at present. While commodity performance may be volatile at times and the current cycle has been extended, the prices of many commodities are substantially below historical averages, trading at levels that a reversal to the upside is possible. This likelihood increases as the economy continues to improve and raw material production contracts. For these reasons, we continue to suggest that investors may include a modest allocation to commodities in their portfolios.

The market turbulence we have experienced in the opening months of 2016 has been higher than the experience from the last several years. Going forward, as monetary conditions begin to normalize, volatility levels may remain elevated. In these conditions, more broadly-diversified portfolios may offer a lower concentration of risk factors and an opportunity to benefit should underpriced assets revert to historical averages. In addition to commodities, real estate and other alternative investment styles with low correlation to traditional investments may help smooth fluctuations in portfolio valuations.

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