AEGON Asset Management

Monthly outlook – May

Have the cooling fans been switched on in the commodities market?

What happens if China applies the brakes, or if the Australians slaughter their cash cow?

With the credit-rating downgrade that occurred in a number of the PIIGS countries, combined with the initial signs of an impending slump in the equity markets, commodity market indices have also begun to head south. All this is not at all surprising given that commodity markets are notoriously sensitive to economic circumstances and react immediately to trends in the equity markets.

The dramatic events in Greece and the postponement of the Greek rescue package until the very last minute shocked the markets, as did the frightening increase in sovereign risk represented by countries (Portugal, Spain, Italy, Ireland and the United Kingdom) struggling with similarly high public finance deficits and national debt in proportion to GDP. Other developments have also taken place, however, some of them supporting and others exerting a powerful negative impact on the commodities markets.

Let's take a glance, then, at the latest numbers from China, where inflation has accelerated significantly. In April this year, the CPI grew by 2.8% year-on-year, the largest increase seen over the past 18 months. Between April of last year and April 2010, Chinese real estate prices increased by a record 12.8%, the largest rise of the index, which monitors the property markets of 70 major cities, since its launch in 2005. The total of 774 billion yuan (USD 113 billion) of new credit granted in April also significantly exceeded earlier estimates. Consequently, the total amount of new loans in the first four months of the year is already approaching 3.37 trillion yuan, dangerously close to half the total amount of new credit of 7.5 trillion yuan planned for the entire year. In 2009 the corresponding figure was 9.59 trillion yuan. In addition, the monetary aggregates, the M2 (the broadly defined money supply) and M1 (the more narrowly defined measure of money supply), increased in turn by a respective 21.48% and 31.25% year-on-year in April. All these factors exert increasing pressure on Chinese decision-makers to use interest rate increases and other tools of monetary policy to somewhat cool down an economy that is showing signs of overheating. Although for the time being there has been no interest rate increase, in recent days the Chinese central bank has once again raised the reserve obligation of commercial banks – for the third time this year. The intervention, which has served to slow the economy, nevertheless generated misgivings on commodity markets, as the prices of oil and copper immediately began to plunge. Beyond this, the government also introduced restrictions on the purchase of second and third homes on top of primary residential properties.

Of course there are some who believe this is not enough. Nouriel Roubini, the economics professor with prophetic abilities who also fulfils a secondary function as a periodical harbinger of bad tidings, voiced his opinion in an interview with Bloomberg TV last Wednesday that monetary tightening is too slow in China.

Nineteen of 20 analysts questioned by Bloomberg expect an increase in the one-year lending rate that functions as a benchmark in China by the end of September this year, while ten analysts expressed the view that the increase will occur as early as this quarter.

The goal of the Chinese government is to maintain inflation below an annual 3% and to prevent the bubble that is threatening to take shape on the real estate market, although the Hong Kong-based Hang Lung Properties believes that genuinely strong demand exists for real estate. At the same time, investors are worried that the withdrawal of the stimulus previously pumped into the system (which largely helped the global economy regain its feet), together with a potential slowdown in the construction industry, may considerably slacken the pace of Chinese growth. China's gross domestic product (GDP) grew by 11.9% in the first quarter of this year compared to the same period of 2009. In keeping with the above, the Shanghai Composite Index has underperformed against the equity markets of the other BRIC countries since the beginning of the year, in recent days crossing the threshold of a 20% decline in the year to date, which can be interpreted as a bear market of sorts.

According to the local asset management group of Franklin Templeton, an upswing can be expected from this point onwards as increasing exports reduce the risks that now seem apparent in relation to economic growth.

According to data published recently by the Chinese customs administration (GAC), Chinese exports approached USD 120 billion in value in the fourth month of the year, an increase of 30.5% compared to one year previously and 6.3% up on the March figure. Imports over the same period exceeded USD 118 billion in value, a 49.7% increase compared to the corresponding period of 2009. The foreign trade surplus was USD 1.68 billion in April, some 87% less than a year previously. In the period from January to April, the European Union remained China's number one trading partner, as trade turnover reached USD 137.77 billion, some 34.6% more than the equivalent period of last year. In light of all the above, the EU's €750 billion euro zone rescue package came at a particularly good time: while it will not provide an immediate cure for the countries affected, it will provide temporary reassurance and hopefully allow enough time for necessary stabilization measures to be taken that will continue to have an effect in the long term.

Further pressure may be brought to bear on the global commodities market by the Australian government's latest tax increase planned for 2012, whereby the cabinet intends to levy a new 40% tax on the profits of mining companies operating in the country. In reality this would mean huge extra revenues for the budget, but is slaughtering the milk-cow really a smart solution? It was precisely the vast demand for raw materials of China and other high-growth developing economies that saved Australia from sliding into recession during the crisis. The new tax would considerably reduce the competitiveness of one of the world's most important commodities market players and hinder the realization of projects already under way.

In light of the above, a mix of both good and bad times lies ahead – or may lie ahead – for the commodities market sector. Despite the negative factors, we are counting on the considerable likelihood of a continued recovery from the "V"-shaped crisis, which, following faltering progress in the short term, may bring growth to commodities markets once more. The world market price of oil (WTI) in the next three months will probably remain below the maximum of recent times (in the region of approx. USD 80/barrel), given that risk avoidance has increased as a consequence of the considerable shocks hitting the global economy while American oil reserves can still be described as abundant. At the same time, the chances of a substantial further price decrease are limited (unlike in the case of essential industrial metals) as economic fundamentals would tend rather to induce an increase. The accident at BP's drilling rig in the Gulf of Mexico – which may develop into one of the most serious in history – may push prices further upwards, and could yet have an even greater effect on driving prices up in the short term. Increasing medium-term demand for oil and the influx of investment capital into the sector may result in prices of USD 85/barrel. For similar reasons, gas prices (NYMEX Natural Gas) may hover at around USD 4 on a three-month time horizon, rising to USD 5 in the medium term and USD 6-6.25 in the longer term. In the case of essential industrial metals (aluminium, copper, lead, nickel, tin zinc), price decreases may be on a greater scale than that of oil in the coming quarter. Here the growth in sovereign risk makes its negative effects felt more strongly. Price increases can similarly be expected in the medium term, partly as a consequence of the €750 billion stabilization package and the influx of capital induced by demand and the activity of investors, with copper set to perform the best. Of the precious metals, the price of gold will continue to rise, despite the possible further strengthening of the US dollar: in the current situation, gold provides a sort of safe refuge amid increased global risks. For similar reasons, the price of silver is also likely to rise and will probably even outstrip gold in the medium term in terms of percentage price increase, given the escalating demand for use of this commodity in industry. Of bulk goods, we have so far already seen a massive increase in the price of iron ore, and here it is much more likely that smaller price decreases will occur. Meanwhile, in the case of coking coal, continuous restrictions on the supply side will lead to price increases, reaching USD 225 per tonne in the short term, and rising to a level of as much as USD 290/tonne in the medium term. Among agricultural commodities, the price of corn may fall to levels of USD 350-360 due to substantial global reserves and an expected record crop. A price decrease is also likely in the case of wheat, for similar reasons.

Prepared by AEGON Global Asset Management / AAM CEE
András Cserháti – Senior Product Manager

All information contained in this document is intended for information purposes only. AEGON Global Asset Management / AAM CEE accepts no responsibility for any investment decisions made on the basis of this publication and for the consequences of such decisions, nor for any possible shortcomings or inaccuracies in the data in this document.