Morgan Stanley

INVESTMENT MANAGEMENT

Tales From the Emerging World

When Commodities Rise, So Will Emerging Markets

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It is no secret that we are skeptical of commodities, which over the long haul return nothing. In inflation adjusted terms, commodity prices have been essentially flat since records began in the 1850s.[1] Stocks, bonds… just about any other investment has generated better returns. Punctuating the fundamentally stagnant arc of commodity prices, however, are long boom-and-bust cycles, which create periods of opportunity. We are entering one now.

Driven by easy money, reduced supply and increased demand, commodity prices are poised for a comeback in the 2020s. That's a good sign for the many emerging economies that rely on commodity exports. At a time when the global pandemic is also forcing some positive change, including economic reform (Tales, November 2020) and an acceleration of the digital revolution, the coming revival of commodity prices is another reason to expect a good decade for emerging markets.

It is not that commodity prices are outright cheap. In absolute terms prices are in fact close to their long-term trend. It is that every other financial asset is so expensive. Pumped up by easy money pouring out of the Fed to fight the pandemic, our composite index of stock and bond prices has gone parabolic, and is now four times above the long-term trend.[2]

So in relative terms, commodities look hugely attractive. Investors are deeply underweight commodities, which have fallen to record low shares of both U.S. and emerging stock markets.

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[1] Source: The Economist All-Commodity Index, which starts in 1850 and covers agricultural commodities and metals, not oil; MSIM, Bloomberg, Factset, Global Insight. As of November 2020.

[2] Source: MSIM, Bloomberg, Factset, Global Insight. As of November 2020.

Compared to stocks and bonds, commodity prices are well below their long-term trend.[2]

Though market dynamics are different for each commodity, the big picture is that supplies are generally tight, and demand is likely to rise faster than the market expects. Government spending to fight the pandemic threatens to push inflation higher and weaken the dollar—an environment in which commodity prices tend to rise.

The overlooked demand driver is aggressive government stimulus and regulation. In China, much of the stimulus is going to new (commodity-intensive) infrastructure projects. Record low rates are fueling housing booms from China to the United States, further boosting consumption of raw materials. And with the Biden administration likely to commit to "net-zero" carbon emissions, countries representing more than half of global GDP will have made this pledge, providing another boost to demand for the materials used in low-emission homes, cars, batteries and other green infrastructure.

Moreover, rising demand will hit tight supplies for many commodities. Over the last decade, weak prices led to light investment and supply cuts in everything from oil fields to copper mines. In the oil industry, by one estimate, under investment could reduce global production by eight million barrels a day over the next five years.[3] Stocks of base and bulk metals are now at lows last seen in the early 2000s. Owing in many cases to disruptions caused by the pandemic, global supplies are expected to fall sharply this year for commodities ranging from platinum and silver to certain kinds of coal.[4]

Wise investors will choose commodities carefully. Broadly speaking, the increasingly rapid spread and sweeping impact of the net-zero movement is pushing every investor, large and small, to turn green. In energy, this new era frowns on oil and favors solar power, electric vehicles and hydrogen fuels. In agriculture, prospects are bright for soybeans, as a new U.S. administration is expected to revive support for biofuels. In metals we still see opportunity in gold and even more in its cheaper alternative, silver, driven by investors seeking a hedge against the threat that expanding government balance sheets will revive inflation. But we are particularly bullish on metals required for green electrification, including copper and platinum.

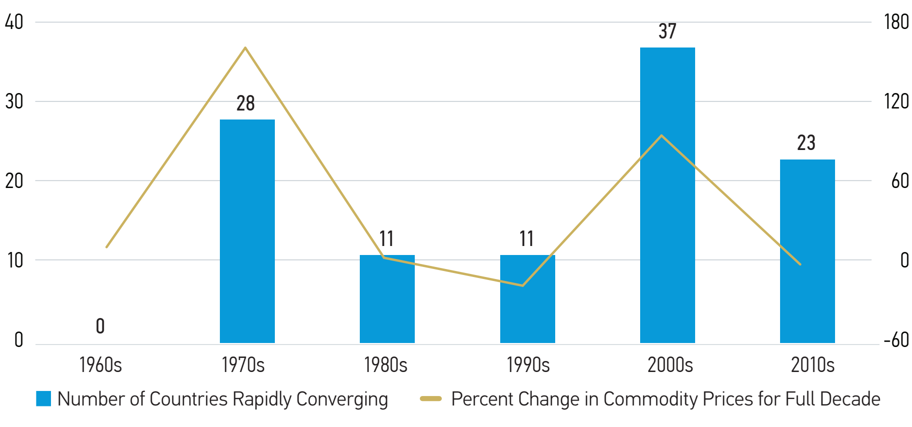
There is no substitute for copper, the most efficient conductor. Demand is expected to rise as the world rewires the economy in a greener image, and supply has been declining for years. Copper miners have been discovering fewer new veins, launching fewer high-return projects, and investing less in capital expenditure. Inventories are low. Over the next five years, rising demand for solar power, wind power and electrical vehicles could increase annual demand for copper by three million tons, or roughly 10 percent.[5]

Platinum meanwhile is critical to the future hydrogen economy. A durable catalyst, it is used in both the production of hydrogen and hydrogen fuel cells, now a leading alternative to the combustion engine. Compared to batteries, fuel cells are lighter and potentially more practical for long-range vehicles. They can be installed in existing cars and trucks, and emit only water. With more and more governments pushing to develop hydrogen power, demand for energy and transportation applications alone is expected to boost annual demand for platinum by around one million ounces, or roughly 12 percent.[6]

The wider implications for emerging countries are clear. Many developing economies tend to rise and fall with global prices for their leading commodity exports. The result is that they go nowhere in the long run. Brazil is a case in point. A major exporter of oil, copper and soybeans, its average income is essentially the same today, relative to that of the United States, as it was a century ago.[7]

DISPLAY 1

The Strong Link Between Commodity Prices and Convergence



Source: Penn World Tables 7.1, Commodity Research Bureau, IMF. Rapid convergence is defined as the top quartile of the distribution of changes in the ratio of a country's GDP per capita relative to that of the US from 1960 to 2010. This corresponds to an increase in the convergence ratio of 2.8% pts or greater. Commodity prices use the CRB Raw index as a proxy for commodity prices and refers to the change in prices over the defined decade. Data as of October 2020. **Past performance is not indicative of future results.**

[3] Source: Goldman Sachs, "Moving toward a structural bull market". As of October 2020.

[4] Source: Citi Research, Cochilco, Minem, Wood Mackenzie, Bloomberg, ILZSG, ICSG, INSG, Camimex, identified losses include price-related closures. As of November 2020.

[5] Source: MSIM, UBS. As of November 2020.

[6] Source: MSIM. As of November 2020.

[7] Source: MSIM, World Bank, GFD. As of November 2020.

In the shorter run, however, commodity price booms can redefine the fortunes of major exporters and raise prosperity across the emerging world. For each decade going back to the 1970s, we've looked at the share of emerging economies that were growing fast enough to "converge," meaning their average income was catching up rapidly with the United States (*Display 1*). The share converging has tracked commodity prices throughout—rising together in the 1970s, falling together in the 80s and 90s, rising together again after 2000 before slipping backward in the 2010s.[8]

Now, after a down decade, a revival in commodity prices could give a boost to many emerging economies. A diversified commodity exporter like Brazil will benefit from the general rise in commodity prices. Rising demand for green power will benefit in particular leading platinum exporters like South Africa and Russia, and copper producers like Chile and Peru. As the market for hydrogen fuel grows, demand is expected to rise particularly fast for "green" hydrogen, produced with renewable energy rather than fossil fuels. Because it is already a major source of wind and solar power, Chile is also expected to emerge as the low-cost producer of green hydrogen.

To be clear, rising commodity prices would not be enough to generate rapid, sustained growth in all emerging nations. Some will be held back by incompetent leadership, a bloated state and other factors. Few are likely to invest a commodity windfall wisely enough to continue growing once the price boom ends. But just as emerging markets suffered as a class in the commodity slump of the 2010s they will get a broad lift if, as we expect, commodity prices rise in the 2020s.

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[8] Source: Penn World Tables 7.1, Commodity Research Bureau, IMF. Rapid convergence is defined as the top quartile of the distribution of changes in the ratio of a country's GDP per capita relative to that of the US from 1960 to 2010. This corresponds to an increase in the convergence ratio of 2.8%pts or greater. Commodity prices use the CRB Raw index as a proxy for commodity prices and refers to the change in prices over the defined decade. Data as of October 2020.

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