Investment Insights

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TANDEM
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Should I be Concerned about Falling Commodity Prices?

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During the past 12 months, prices for many different commodities have not only declined, but in some cases have collapsed. Aside from the obvious effects on companies that are directly engaged in producing these commodities, investors are questioning if there is a larger effect.

The slide in commodities from crude oil and gasoline, to metals like copper, iron ore and gold have some pundits calling for an increased period of very low inflation. After all, with the raw input costs for many products declining, it is difficult to see how overall inflation could move meaningfully higher. While true, we believe the rapid and significant decline in commodities is more a message about decreased prospects for global economic growth rather than the US inflation rate.

At its core, the simple reason for the commodity price declines is a lack of demand. Weaker global economic growth has reduced demand for oil along with most industrial metals like copper and iron ore. All eyes have been focused on emerging markets - particularly China - as investors try to discern the level of global growth. After more than a decade of very strong economic growth, economic growth in China has slowed drastically in recent years. This has a direct impact on commodities because for most of the past decade, China's voracious demand for natural resources made it the world's "swing consumer." China's consumption of metals and coal surged to roughly 50 percent of world consumption earlier this decade. As demand slows in China, it is clear that overall demand should decline meaningfully and hence prices would follow lower. Economic growth in China during the first half of 2015 slowed to the weakest level since 2009. Although we view the Chinese economic data warily - based on China being a controlled economy - it cannot be argued that Chinese economic growth has slowed dramatically in the past 24 months. The follow-on effect is hurting the economies of other emerging markets that are reliant on commodity production. Brazil, Australia and Russia are among the larger economies seeing slower growth due to the weaker commodity prices.

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While many investors lament the relatively slow economic growth in the US, compared to many other economies, the US is doing fairly well. Also, the Federal Reserve has ended its Quantitative Easing while many other countries are still focusing on aggressive monetary stimulus programs. This has caused the US Dollar to strengthen significantly versus many other currencies in the past 12 months. We believe the strengthening US dollar is of equal importance to the declining commodity prices.

To summarize our viewpoint and its effect on client portfolios, we believe there are two issues on which to focus. The first is overall global economic growth. The second is the significant appreciation in the US Dollar versus the Yen, Euro and other major currencies. These two factors are the most critical when attempting to discern stock valuations. A strong US Dollar makes US exports relatively more expensive, crimping sales potential for multinational firms based in the US. Additionally, slower global economic growth pressures all companies as they seek to increase revenues. Combining these two factors, the simplistic view would be to focus on companies that get the vast majority of their sales in the US. This leads to a focus on smaller, less established concerns. In fact, we have seen small-cap stocks outperform over the past year. However, we believe this is a short-sighted view and leads to more trading and short-term investing. Both of these have been proven to hurt long-term returns in numerous academic studies. Large-cap, multinational firms that have strong balance sheets, the ability to ride through several quarters of weak demand, while continuing to invest in their business and pay dividends to shareholders should come out of this commodities rout in good shape. Smaller companies may provide better short-term returns but do not have the balance sheet strength to withstand an extended period of slow growth. At Tandem, our focus on larger-cap companies, along with proper asset allocation and risk management means investors are not overly exposed to commodity price swings.

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