Northern Trust

WEEKLY ECONOMIC COMMENTARY

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312.557.8820
ct92@ntrs.com

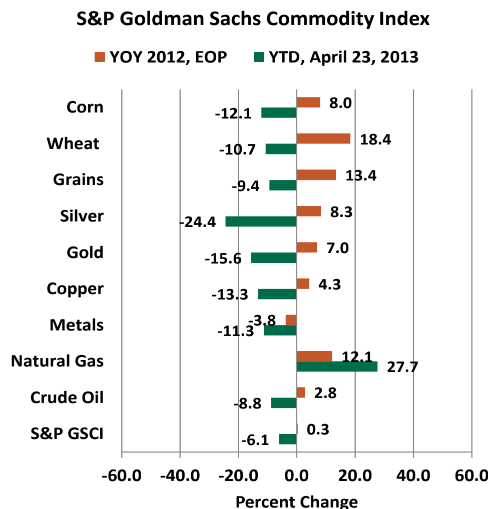
Asha G. Bangalore
Economist
312.444.4146
agb3@ntrs.com

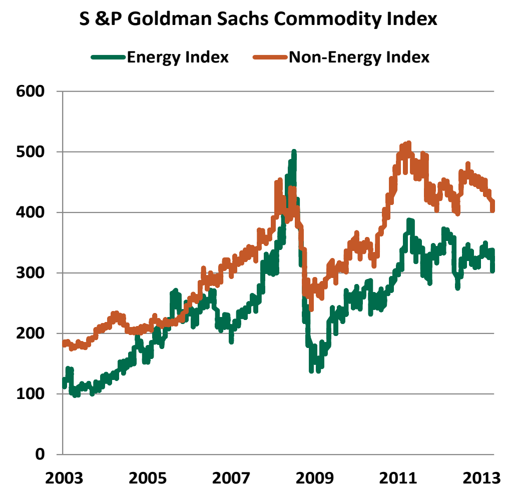
April 26, 2013

- **The yin and the yang of commodity price trends**
- **Gold prices are beating a hasty retreat**
- **FOMC meeting preview**

In recent weeks, financial press headlines have centered on the sharp drop in the price of gold. Of greater importance, however, are the significant price declines of oil, wheat, corn and copper. The S&P Goldman Sachs Commodity Index is down 6.1% year-to-date after a nearly steady reading in 2012 and gains exceeding 20% in both 2010 and 2011.

It is essential to recognize the different nuances buried in these commodities' price trends. For example, the rationale behind the downward price trend for gold is vastly different from that for copper. First we will focus on the implications of declining commodity price trends and then discuss gold specifically in more depth.





Sources: Standard &Poor's / Haver Analytics

From a bird's-eye view, the pattern of world economic growth in the last three years has a direct bearing on commodity prices. The world economy advanced 5.1% and 4.0% in 2010 and 2011, respectively, followed by a deceleration to a 3.2% increase in 2012. An important underpinning for rising commodity prices is the strong demand for commodities associated with these growth trends.

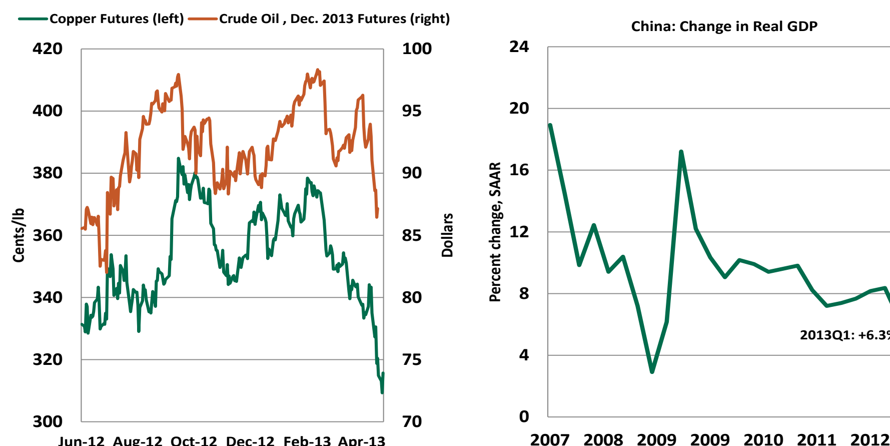
Digging into the details, growth in productive capacity of commodities has picked up only of late. Investment in new oil fields was lackluster in the 1980s and 1990s, as low oil prices did not make it viable. The recent upward trend of oil prices has encouraged investment in expansion of oil and gas production in the United States. An expansion of mining operations also gained noticeable momentum but only during the three years ended 2012. Essentially, supply of

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

commodities has been catching up with demand, only to encounter the possibility of soft-to-slowing economic conditions on the horizon.

Incoming economic numbers from around the world have one common underlying theme – softer economic conditions. Real gross domestic product (GDP) of China posted only a 6.3% quarterly annualized increase, the smallest gain since early 2009. The flash purchasing managers' indexes point to a deceleration of factory activity in China and the United States and a contraction in Germany. Industrial production has shifted to a lower gear in major economies.

Macroeconomic trends and microeconomic factors both hold the key to the future course of commodity price trends. China's economic growth trajectory will play a large role in determining whether the recent drop in commodity prices is a short-lived event or the beginning of an extended decline. China is a large importer of commodities, thereby guiding the economic future of the exporting countries. Demand from other economies is important but at the margin, the China factor is an important key to the course of commodity prices.



Sources: Wall Street Journal, China National Bureau of Statistics, Haver Analytics

Falling commodity prices have taken a toll on countries that produce them.

The most obvious outcome of lower commodity prices is the adverse impact on commodities exporters. Macroeconomic performance of nations that export commodities follows the commodity price cycle quite closely. Economic activity and external balance suffer during downswings of commodity prices.

Research indicates that energy and metal exporters experience larger setbacks compared with exporters of other commodities because both these items are more sensitive to global business cycles. In addition to emerging markets such as Brazil and Chile, industrialized Australia and Canada are likely to bear the brunt of lower commodity prices.

At the same time, declining commodity prices are a blessing in disguise for central bankers engaged in easing monetary policy to stimulate economic growth. The Federal Reserve, the European Central Bank and several other central banks have explicit inflation targets. Under current circumstances of sub-par to significantly weak economic conditions in the global

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

economy, fewer inflationary threats provide an easier economic landscape for quantitative easing.

At the microeconomic level, declining commodity prices are a boon to firms involved in the production of goods with a large input of commodities. On the other hand, they are a curse if firms are suppliers of commodities. Farther down the production pipeline, companies engaged in supplying equipment for the production of commodities are likely to experience lower sales and margin pressure. Caterpillar's recent disappointing profit report as its sales of mining and excavating equipment suffered setbacks is a case in point.

Over the long term, demand for commodities is expected to pressure their prices.

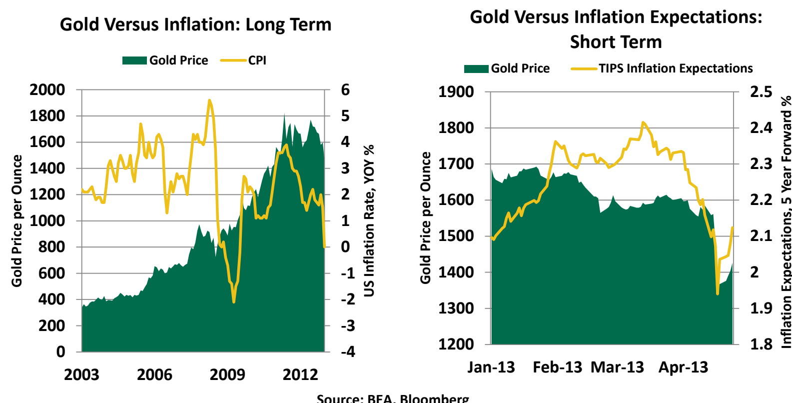
In closing, commodity prices rose rapidly in the last 10 years as result of broad-based global economic growth. Despite the recent retreat, forward momentum is still likely, albeit at a less-rapid pace than during the last decade. India, Indonesia, the Middle East, Africa and Latin America are still waiting in line even though China is moving on to a different phase. So the days of $20-per-barrel crude oil, $2,000-per-ton copper and $4 per-bushel wheat will remain in the history books.

All That Glitters

Through the years, my wife has quietly amassed an impressive collection of jewelry without my knowledge. When I confronted her about this covert effort, she reminded me that gold not only looks nice at parties, but it has been a store of value for centuries. Somehow, she persuaded me that her acquisitions were a sound investment strategy.

For quite a while, her "portfolio" was the best-performing element of our asset mix. In the last month, however, gold has lost some of its luster. As the price of bullion has retreated, analysts have taken a fresh look at how gold performs.

Gold enjoyed a long run of success. It became especially popular among some investors because of its reputation as a hedge against inflation. As a growing number of world central banks used quantitative easing (QE) to stimulate growth, the logic goes, concerns arose that all the reserves loosed within the financial system would create stress on the price level. This, in turn, would create hunger for "hard" assets like gold.



Source: BEA, Bloomberg

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Interestingly, though, gold rose steadily and substantially over the last decade even as the U.S. experienced a brief bout of deflation during the 2008 financial crisis. More recently, gold retreated during intervals where even greater global QE efforts boosted inflation expectations.

So on the surface, there is no great correlation between the price of gold and inflation or inflation expectations. Gold is not a significant raw material for the production of other products, so changes in its value aren't subject to the ebbs and flows of manufacturing. Absent fundamental drivers, it has been suggested that the unwinding of speculative positions in gold, fueled by cheap leverage, may be driving the recent correction.

The data over the long term don't seem to support the notion that gold is an inflation hedge.

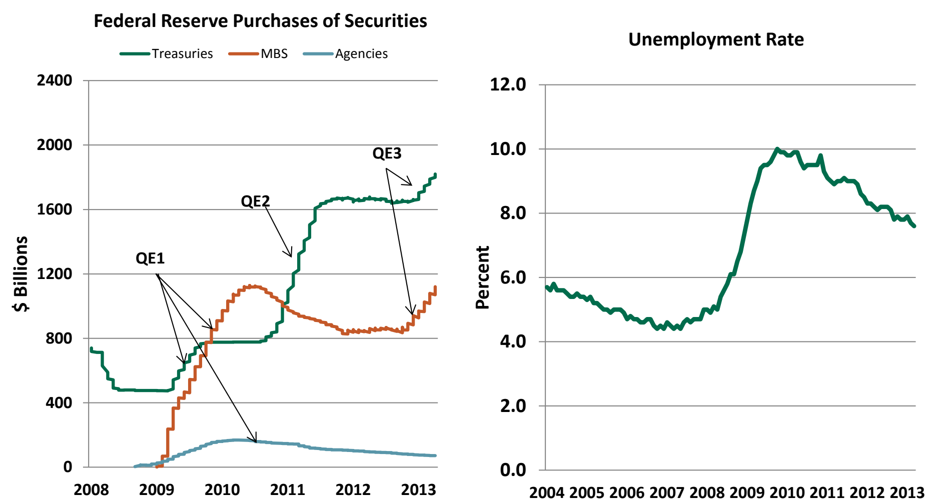
Gold has been in the news on another front lately, as some observers suggest that central banks consider a return to the gold standard. This, it is argued, would bring back some discipline to the conduct of monetary policy and limit inflation risk.

Yet when central banks left gold behind years ago, the shift recognized that this one precious metal isn't the only store of value that can be used to back a currency. The sources of national wealth are many and varied, and the world would be very much worse off if reserves were restricted to the stacks of bullion in the sub-basement. There are certainly other –and better – ways to ensure that monetary policy does not become reckless.

So while gold has attracted keen attention for millennia, its ultimate value and application remains something of a mystery. As it is in the markets, so it is in my home.

Upcoming Fed Meeting – Less Controversy Expected

The Federal Open Market Committee (FOMC) meets on April 30 – May 1. The policy statement will communicate the outcome of the meeting; it is not followed by a press meeting this time around. The statement should reiterate that "…with appropriate policy accommodation, economic growth will proceed at a moderate pace and the unemployment rate will gradually decline toward the levels the Committee judges consistent with its dual mandate."



Sources: Federal Reserve Board, Bureau of Labor Statistics, Haver Analytics

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Softer economic data will diminish calls for reduced asset purchases.

In our opinion, the Fed will not announce any marked changes to the current monetary policy stance at close of this meeting. The minutes of the March FOMC meeting indicate a willingness to reduce asset purchases, which currently stand at $85 billion a month, with varying timing preferences. However, the soft tone of incoming economic data, particularly from the labor market, has pushed forward considerations of tapering asset purchases until economic numbers are suitable to justify such action.

The March statement noted that "…**in determining the size, pace, and composition of asset purchases, the Committee will continue to take appropriate account of the likely efficacy and costs of such purchases as well as the extent of progress toward its economic objectives.**" Against this backdrop, although the Fed is somewhat uneasy about the accommodation it continues to provide, a majority of the FOMC views the benefits of asset purchases as exceeding the costs. In addition, "economic objectives" are yet to be fulfilled, particularly in terms of employment conditions. Therefore, an announcement about tapering of purchases is unlikely at the close of this meeting and can be expected only after the "outlook" of the labor market improves, possibly by year-end.

It should be borne in mind that the Fed requires consistent and sustained *improvements* in economic numbers – not strong data – to pare back asset purchases. Also, a reduction in asset purchase does not represent a tightening of monetary policy but stands for less-aggressive financial accommodation.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.