Commodity Caution

Richard Bernstein

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The overwhelmingly bullish consensus regarding the emerging markets should be worrisome to even the most stalwart enthusiasts of emerging markets. It's hard to believe that the consensus a decade or so ago was that the emerging markets were terribly risky and should be avoided. Today, emerging markets, and ancillary asset classes like commodities, have become the cornerstone of most investment strategies.

We have argued for many months that the significant monetary tightening in the major emerging markets could be bearish for emerging market stocks and bonds and for commodities, but could ultimately be bullish for US stocks. The markets appear to be coming around to our view.

EM monetary tightening

An increasing number of the emerging market economies are caught in a dilemma. They are trying to balance fighting inflation with maintaining robust growth. It is quite hard for an established economy to maintain such a balance, and we strongly doubt that as many emerging economies will be as successful as many observers currently claim.

The political stability of some emerging markets might be tested in the next several years. If these countries attempt to contain inflation, then they will necessarily constrain growth. Constraining growth might be politically unstable. If these countries try to promote further growth, then their inflation rates are likely to continue to increase. Rising inflation might be politically unstable. Thus, a growing number of emerging market economies appear "damned if they do and damned if they don't."

Because of escalating inflation, emerging market central banks are tightening and yield curves are flattening. In fact, yield curves recently inverted in Brazil and India, and inverted yield curves have typically been the early-warning signs for equity investors because inversion signals that a central bank may have tightened too much (see chart 1).

The significant tightening of monetary policies in the emerging markets demonstrates that central banks are focused right now on slowing growth in order to curtail inflation. Unemployment rates might increase in these countries.

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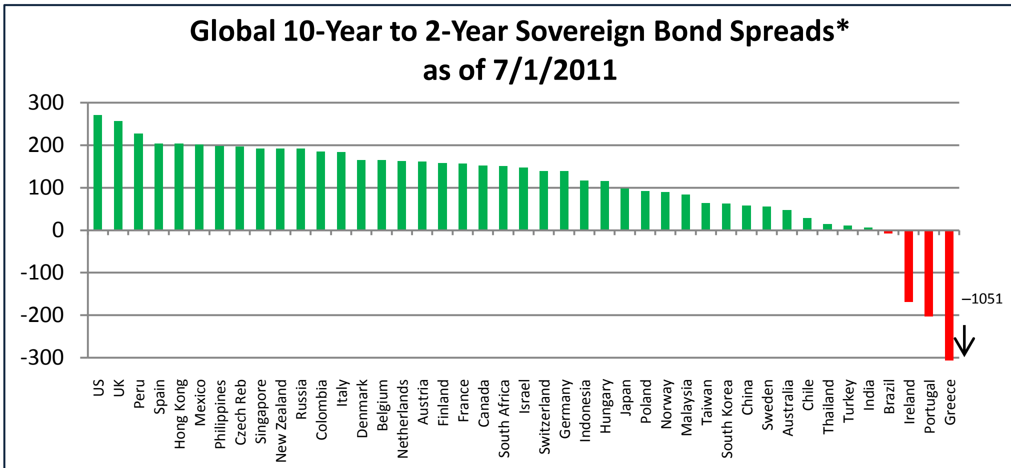
Chart 1:



Source: Richard Bernstein Advisors LLC, Bloomberg
* Current 10-Year Sovereign Bond *minus* Current 2-Year Sovereign Bond or Current 9-Year Sovereign *minus* Current 1-Year Sovereign Bond for countries with 10-Year or 2-Year data unavailable, in local currency.

US promoting growth

Investors may not want to hear the news, but monetary conditions in the US currently appear more conducive to equity investing than do monetary policies in the emerging markets. Whereas an increasing number of emerging markets are focused on slowing growth, the US's monetary policies are pro-growth. For example, chart 1 highlights that the US currently has the steepest yield curve in the world.

It seems quite ironic to us that investors are enamored with the emerging markets despite that current emerging market policies seem decidedly unfriendly to investors. Yet, investors look at US stocks disdainfully even though US policies appear quite investor-friendly.

Lower commodity prices ahead?

In an April commentary in the Financial Times (http://www.rba-llc.com/pdf/EMCentralBanksDoingFedDirtyWork.pdf), we argued that non-US central banks were effectively doing the Fed's dirty work, and that non-US central banks' tightening of their monetary policies would lead to lower commodity prices. We still feel that this is one of the dominant themes in markets today.

The Fed's policies were not to blame for this year's increase in commodity prices. The emerging markets have been the incremental demanders of commodities for many years, and their on-going credit bubbles (monetary growth in the BRIC nations is between 15% and 30%) fueled the surge in the demand for commodities. Commodity prices rose as a result during the first half of the year.

However, emerging market monetary policies have decidedly changed from promoting growth to constraining growth. As their monetary policies take hold, and we have no reason to believe that those policies won't be effective, the probability should increase that commodity prices will fall.

In fact, this seems to already be happening. Chart 2 shows that all the major commodity indices were down between 4% and 8% during the second quarter.

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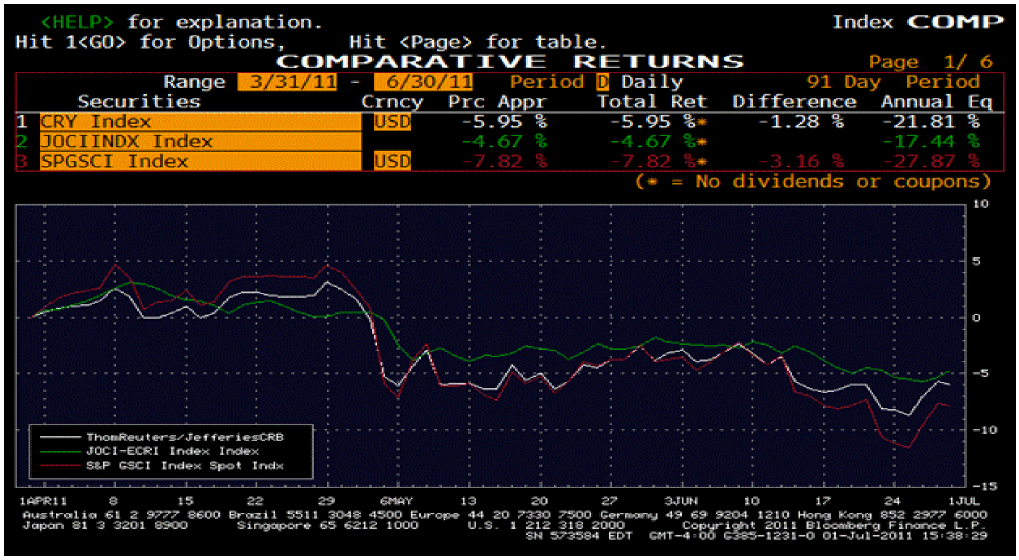
Chart 2:

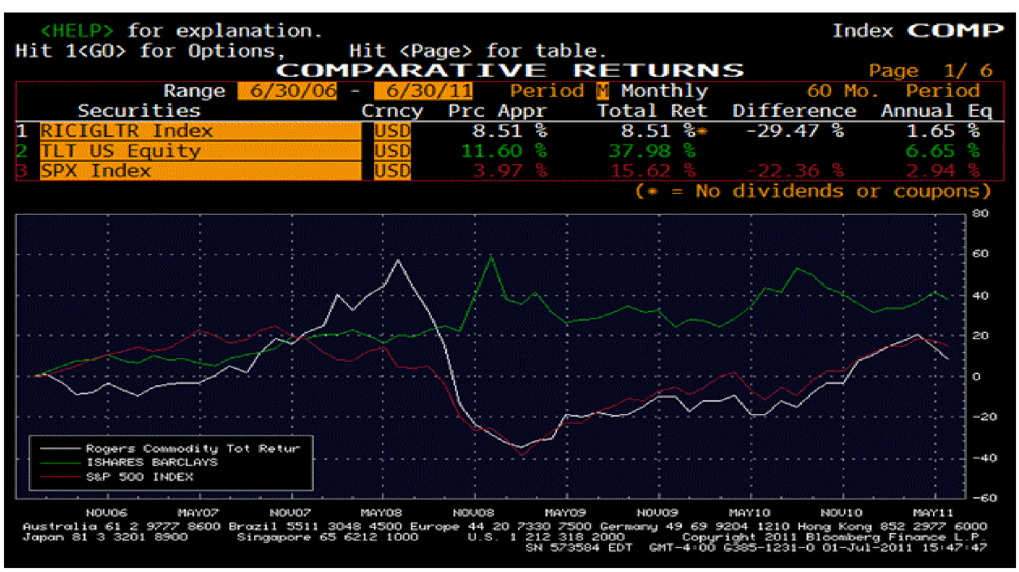


Buck the trend

Despite all the hoopla regarding the riskiness of investing in the US, both US stocks and bonds have outperformed commodities over the past 5 years. Chart 3 compares the returns of the Rogers International Commodities Total Return Index® with the returns of the iShares® Barclays 20+ Year Treasury ETF (TLT) and the S&P 500®.

Note that both Treasuries and US stocks have outperformed commodities over the past five years. In our opinion, the outlook for US financial assets remains better than most investors believe.

Chart 3:



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INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

Indices are not available for direct investment.

US: Standard & Poor's (S&P) 500® Index. The S&P 500® Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

Treasuries: iShares Barclays 20+ Year Treasury ETF. The iShares Barclays 20+ Year Treasury Bond Fund is an exchange-traded fund incorporated in the USA. The Fund seeks results that correspond to the price and yield performance of the United States Treasury market as defined by the Barclays Capital 20+ Year Treasury Index. The Fund invests 95% of its assets in US Government bonds.

Commodities:

Thomson Reuters/Jefferies CRB Commodity Price Index. The Thomson Reuters/Jefferies CRB Commodity Price Index is an arithmetic average of commodity futures prices with monthly rebalancing.

JoC-ECRI Industrial Price Index. The JoC-ECRI index differs from other commodity indexes in several ways. It is not a weighted average, but a pure reflection of prices. It does not include agricultural commodities or precious metals such as gold or silver, but only materials that are used in industrial production, such as nickel, tin, aluminum, plywood, benzene, cotton, burlap and crude oil.

S&P GSCI® Index. The S&P GSCI® seeks to provide investors with a reliable and publicly available benchmark for investment performance in the commodity markets, and is designed to be a "tradable" index. The index is calculated primarily on a world production-weighted basis and is comprised of the principal physical commodities that are the subject of active, liquid futures markets.

Rogers International Commodity Index®. The Rogers International Commodity Index® ("RICI®") is a composite, U.S. dollar-based, total return index designed by James B. Rogers, Jr. ("Rogers") in the late 1990s. RICI® was designed to meet the need for consistent investing in a broad based international vehicle; it represents the value of a basket of commodities consumed in the global economy, ranging from agricultural to energy and metal products. The value of this basket is tracked via futures contracts on 38 different exchange-traded physical commodities, quoted in five different currencies, listed on thirteen exchanges in six countries.

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