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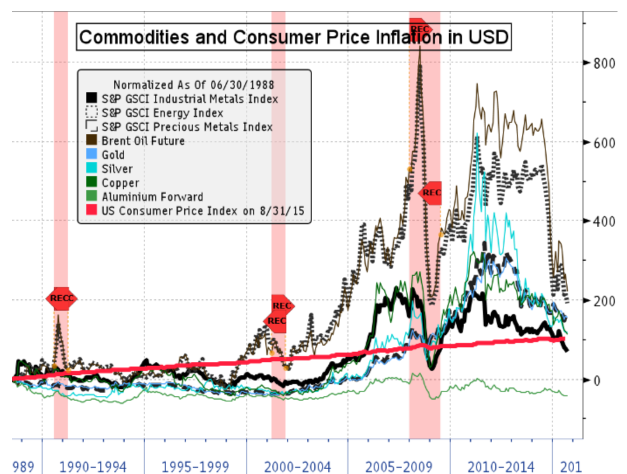
Briefing from the ARVEST Investment Committee

The Greek debt crisis was still dominating the headlines in early July. Our last investment commentary focused instead on China. Beyzade Han described the internal tensions of the Chinese economy and the rise of the Chinese stock market that occurred free from fundamental factors.

This bubble burst in only three months. The helpless-seeming stock market intervention by the Chinese authorities and the surprising devaluation of the Yuan on August 11 alarmed global financial markets. The financial community now raises the big question; what dangers does China present to the global economy? This uncertainty was, according to FED Chief Yellen, an important reason for the US federal bank not to hike rates for the first time in nearly ten years on 17 September but instead to await further data.

The ARVEST Investment Committee notes an overall weak but still solid growth of the world economy in its macroeconomic analysis. However, great variance is shown regionally and between sectors. The current growth is driven mainly by the developed economies in the US and Europe as well as by services and consumers worldwide. Industry and trade, in particular the heavy industries and raw material and energy sectors, however, are under tremendous price pressure. Where the quantities sold cannot be increased, sales drop and usually also profits.

This development is related to the greater integration of China and other developing countries into the world economy. Global commodity prices illustrate this best.



The chart shows that commodity prices started to soar at the new millennium. The rapid growth of China's industrial capacity increased demand for global commodities. Because of low Chinese wages goods exported from China remained cheap. As a consequence developed countries showed no significant inflation.

Attractive commodity prices led to heavy investments in mining and exploration across the world. But the full commissioning of production capacities takes years or even decades. Only

in the last two or three years supply can keep up with a slower growing demand. Since then commodity prices have fallen and put significant pressure on producer and consumer prices (disinflation).

This longer commodity super cycle superimposed the past and current economic cycle. The economic cycle itself also has an impact on prices. Typically, demand in the course of the economic cycle increases which leads to rising prices. Conversely a recession forces commodity prices down, as happened in 2008/2009, for example. Now, where are we in this commodity super cycle and what does it mean for economic development and the financial markets?

Future prospects

The ARVEST Investment Committee still sees further potential for lower commodity prices. The supply of raw materials is still increasing due to the long project lead times. Thanks to technological advances, favourable loans as well as decreasing costs (e.g. for energy), many producers can stay in business even with lower revenues. The downward price pressure of the decaying commodities super-cycle seems to be greater than the price increase pressure coming from economic growth. The self-reinforcing cycle is in full swing. But the development over the last 30 years shows that the dynamics of the price declines are expected to ease in the next few years when commodity prices once again will follow long-term inflation trends.

The ARVEST Investment Committee also notes the positive effects of falling commodity prices on the economic cycle. Central banks can stimulate consumption through extremely low to negative interest rates without raising inflation expectations of market participants. Furthermore, the risk of recession in consumer-oriented economies is historically very low in an environment of falling commodity prices and expansive monetary policy.

Ten years ago revenue growth dominated entrepreneurial activity in China. In the meantime improvements in productivity gained in importance. This is connected with the steady rise in wages in Chinese cities. Also in China the tertiary sector is growing. But the transition to a consumer and service economy will still need many years. The Chinese government has adequate financial resources and instruments to smooth the grossest distortions in this transition. We therefore maintain a comparatively positive attitude towards China. Things are more difficult for emerging countries that specialized exclusively in the production of raw materials particularly where financed in foreign currencies.

The ARVEST Investment Committee prefers equities versus bonds in this area of falling prices and low interest rates (financial repression). Historically, commodities have, in the best case, beaten inflation. They remain an uninteresting investment category over the long-term. Equity market valuations became more attractive again since last spring. They are more favourable in Europe and Japan than in the United States, as corporate profits have more potential to be increased in the former. Investments in emerging markets should be made with great diligence as foreign exchange losses are still likely.

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On behalf of the Investment Committee
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