A Tale of Two Worlds

November 21, 2014

The U.S. markets enjoyed a strong open today but have experienced a slow bleed off the early morning highs. News of rate cuts in China and more serious discussion of quantitative easing (QE) as a policy tool in Europe have given a market leading bid to energy, materials, and industrial stocks today, leadership these sectors haven't enjoyed for months. In addition, OPEC meets on Thanksgiving Day next week with some traders hoping for production cuts that might help to stabilize the recent free fall in oil prices. While a trading opportunity may be in the offing, we doubt a long term change in the trend for commodity prices is in the works.

We are in a Tale of Two Worlds. One world's success is highly dependent on the outlook for oil and other commodities, while the other's is far less exposed and perhaps even a beneficiary of a more bearish climate. Commodity dependent countries like Russia, Saudi Arabia, China and Australia are hurt by falling oil prices, weak global demand and new sources of supply, while the United States, with a far larger consumer driven economy, experiences an overall net benefit, as perhaps seen in earnings from the likes of Wal-Mart, Best Buy, and Lowe's in recent days.

Sustained economic weakness in Japan and Europe not only restrain the overall demand for oil from what it may have otherwise been, but also creates an environment where the monetary authorities in these weaker areas do what they can to stimulate growth, often at the expense of their own currencies. With the United States economy in decent shape and the Fed far more likely to raise rates in 2015, a divergence in monetary policy emerges for the first time in years. The outcome may be one in which the dollar strengthens relative to the currencies of those who are easing, and, in a vicious circle, places even more pressure on the price of oil which is almost universally bought and sold in U.S. dollars.

The global supply of fossil fuel reserves, the development of alternatives, and falling demand associated with the new "sharing" economy have not only made the United States far less dependent on foreign oil, but a stronger economy relative to its peers. While next week's OPEC meeting and today's monetary news suggest a short term trade could be in the making, we maintain our belief that we are at the beginning of a long term downtrend in commodity prices, one which is likely to be measured in years rather than months. There will be hiccups along the way, but they should generally be faded.

For commodity exposed countries where governments have played an outsized roll in economic development in recent years, some, like China, are making efforts to broaden their consumer base as a means of economic diversification. Cutting down on government corruption may be a similar part of this process, as might be Russia's renewed interest, unfortunately, in its defense sector and Cold War style politics. Like our view of the commodity cycle, the transition to a consumer economy will take some time and likely be measured in years. Culturally speaking, command and control economies and state owned enterprises have rarely made the end consumer a top priority, so it will take some getting used to.

We’ll be sure to discuss the recent earnings season and our outlook for 2015 in the coming weeks, but until then, we wish you a Blessed Thanksgiving Holiday.

Gobble, Gobble -

Doug
Doug MacKay
CEO & CIO
dmackay@broadleafpartners.com

Bill
Bill Hoover
President
bhoover@broadleafpartners.com