Commodities Corner
News & Commentary
Emerging-markets turmoil's set to buoy gold, sink oil; Commentary: What emerging-markets crisis might do to gold and oil

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1,135 words
31 January 2014
06:01
MarketWatch
MRKWC
English

SAN FRANCISCO (MarketWatch) — Growth in emerging markets was a key reason for gains in commodities in recent years, but as China's economic growth slows and currency woes hit developing nations, gold and oil are poised to go their separate ways.

Worries about the contagion risks for turmoil in emerging markets that's unfolded in recent days hasn't shaken up commodities trading too much. But if worries over developing markets spread or worsen, analysts expect oil to suffer and gold to benefit.

"Emerging markets had benefitted from strong investment inflows as monetary policy remained easy in the U.S. and other developed markets," said Sharath Sury, adjunct professor of economics at the University of California.

The iShares MSCI Emerging Markets exchange-traded fund's shares nearly doubled from the end of 2008 to late 2010.

But with an economic slowdown in China and expectations of higher U.S. interest rates as the Federal Reserve tapers back its bond-buying program, "investors have been shying away from the emerging markets," said Sury.

And naturally, a slowdown in the emerging markets has caused concern for commodities demand, he said.

Year to date, the EEM has lost nearly 9%, after losing 3.7% last year. Oil futures , meanwhile, are down about 0.2% so far this year, while gold's up around 3%. That follows a 2013 drop of 28% for gold and climb of 7.2% for oil.

Data from China Wednesday showed a contraction in the country's manufacturing sector in January.

Also this week, the U.S. Federal Reserve indicated additional support for a continued tapering of its bond-buying purchases. That, combined with the weaker Chinese economic numbers, have caused investors to pull assets from China, as well as emerging-market economies that are dependent upon China's economic growth, said Sury.

And developing markets from Argentina to Turkey, South Africa and Russia have been in the spotlight lately amid currency devaluation concerns.

Emerging-market nations will have to raise interest rates to protect their currencies, said Williams Gamble, president of consulting firm Emerging Market Strategies. Central banks in Turkey and South Africa raised interest rates this week.

“The combination of rising EM rates and Chinese rates will slow the fastest growing part of the global economy and hence the demand for commodities including oil,” said Gamble.

Doomed oil

Economic growth in emerging markets contributed to strength in oil demand, and prices, in recent years, so it makes sense to assume that trouble in developing markets can put pressure on oil.

“To the extent that economic conditions may weaken on the back of the recent turmoil in some emerging markets, there would likely be a reduction in the demand for crude oil, which would pressure prices,” said Mike McGlone, New York-based director of research at ETF Securities US.

Still, McGlone believes the Chinese economy is on pace for a 7% growth in 2014, which “should help maintain an underlying bid for economic-sensitive commodities like crude oil.”

Then there’s the camp that believes oil prices will fall no matter what happens in emerging markets.

“The oil outlook is a supply-driven story, so regardless of cooling in China and other emerging markets, oil prices are likely to decline in 2014 anyway,” said Matt Lasov, global head of advisory and analytics at Frontier Strategy Group. “Further cooling in China will only accelerate that trend.”

Lasov pointed out that global supply is outpacing demand, with technology like fracking helping the U.S. become the world’s largest energy producer.

The U.S. Energy Information Administration has predicted that the U.S. will become the world’s top oil producer in 2015, surpassing Saudi Arabia and Russia.

“Supply is not an issue and weaker emerging-market demand is an issue,” said Karim Rahemtulla, emerging markets director at Wall Street Daily. “Put the two together and you have no real catalyst for higher [oil] prices.”

“The U.S. is producing more and in the short term, China is importing less,” said Rahemtulla, who’s also investment director at Oil and Energy Daily. “That’s bearish when you consider that the U.S. and China are the two largest consumers of oil.”

Boon for gold prices

Gold has its own special relationship with emerging markets, especially China and India — two of the bigger emerging economies and the world’s top two gold buyers.

The precious metal benefits from economic growth in China and India, but a slowdown for those economies can also drive investors to seek refuge in gold.

A high in gold prices reflects the metal’s “safe-haven appeal as ongoing turbulence in emerging markets, including India, Turkey, Russia, Argentina and South Africa, and a greater-than-expected slowdown in Chinese manufacturing increases the risks and lowers the expected returns in these markets,” said emerging-market expert **Usha Haley**, professor at West Virginia University.

Prices for gold closed above $1,264 an ounce on Jan. 24, a day investors broadly sold off emerging-market assets. That was gold futures’ highest settlement in more than two months.

Turkey and South Africa hiked their interest rates to support their currencies, “fanning fears that an end to ultra-loose U.S. monetary policies will make emerging-market assets less attractive, thereby sending stocks falling,” said **Haley**, who’s also author of New Asian Emperors: The Business Strategies of the Overseas Chinese. “Gold provides a hedge in the midst of global stock-market selloffs.”

Eye on the market

That all said, maybe calling the turmoil is emerging markets a “crisis” would be stretching it.

“Turkey, Argentina, Venezuela and Hungary are all challenged because of current-account deficits and lack of substantial currency reserves,” said Scott Colyer, chief executive officer and chief investment officer at Advisors Asset Management. But “larger economies like India, China, Brazil and Mexico will fare well through the volatility.”

Of course, “gold reacts well during uncertainty and currency volatility,” he said. Colyer also believes that “global monetary policy is clearly pointed in generating growth and inflation” and that “should fare well for basic materials and energy.”

For the most part, “global central banks are and have been engaged in historic easy monetary policy,” he said. “Their focus is on economic growth and defeating deflation. The product of their efforts should equate in success in growing economic demand for materials.”

As China’s economic growth continues to slow and currency woes hit developing nations, gold and oil are poised to go their separate ways.|103

Document MRKWC00020140131ea1v000mb

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