Stock Markets Throw a Party; Commodities Aren't Invited

By LIAM DENNING

The world is happier and no longer hitting the hard stuff. That is one way of reading a big divergence between two major asset classes: stocks and commodities.

The MSCI World index has rallied 13% since its mid-November low point. Hard assets have trailed in its wake: The Thomson Reuters/Jefferies CRB commodities index is up just 3.9%.

Correlation between the two has been falling. One reason is that fear has eased. Assets tend to march in extreme unison when investors think the world is going to hell. The past couple of months saw a reasonable amount of good news on the economy, including the avoidance of the U.S. “fiscal cliff.” That has fueled rallies in most major stock markets.

Yet, as the building blocks of the global economy, commodities ought to share in such optimism. That they aren’t likely is down to three things: the pace of global growth, the role of China and the longevity of the commodities cycle.

The International Monetary Fund forecasts the global economy will grow by 3.5% this year, a bit faster than in 2012 but weaker than in 2011. Stock-market investors who only last summer feared Europe was collapsing, the U.S. was stalling out and China was in trouble will take the news gladly. In part, that is because the forecast is positive but not a big-enough improvement to force major central banks to start raising interest rates soon to tame inflation—a sort of second-rate Goldilocks scenario. For commodities, often treated as an inflation hedge, this is less supportive.
China’s support for commodities also isn’t what it was. The country’s industrialization in the decade leading up to 2008, and the postcrisis stimulus splurge, underpinned the commodities boom.

But the model looks unsustainable. Chris Watling of Longview Economics notes that, of the major emerging economies, China’s has been the most reliant on credit growth while also suffering the lowest return on capital. As Beijing talks of the need to rebalance the economy toward consumers and away from just building things, Mr. Watling points out that residential construction appears to have peaked in mid-2011.

This, along with IMF forecasts suggesting a structural step-down in emerging economies' growth rates compared with precrisis levels, doesn't bode well for commodities. Even if growth picks up in the U.S. and Europe—which is good for stocks—such expansion isn't as commodity-intensive as in emerging markets.

The final piece of the puzzle is the age of the commodity cycle itself. The bull market is now roughly 15 years old and the usual response to higher prices, expanding supply, is starting to come through. This can be seen in the U.S. shale boom and a looming surplus in iron ore. This caps optimism on further big price gains.

It is no coincidence that, after years of being feted, mining executives are dropping like flies and overextended oil-exploration-and-production companies find themselves under siege by activist hedge funds. At least one corner of the stock market isn't feeling terribly happy.

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