ALLIANCE CAPITAL FIXED INCOME℠ | INVESTMENT RESEARCH AND MANAGEMENT

US WEEKLY ECONOMIC UPDATE

March 11, 2005

Joseph G. Carson

US Economist and Director
Global Economic Research

US Economic and Investment Perspectives

Fast Commodity-Price Cycle Looks Set to Ease in 2005

Over the past few years, Asia's enormous appetite for raw materials has made the region, and especially China, the dominant driver of world commodity prices. The strong run in commodity prices, now in its third year, has been an important by-product of the region's robust growth and inventory cycle. Indeed, industrial metals prices have increased 80% over the past three years, the largest gain of any cycle in the past twenty-five years.

Given the boom/bust nature of commodity cycles, several analysts have raised the prospect of a significant price break in 2005. Recent inventory and sales data for China, for instance, indicate that the pace of inventory investment has outdistanced growth in final demand and industrial production, suggesting that strong industrial-materials price gains have probably run their course. But this in no way implies an imminent collapse in prices. As long as economic and industrial-sector growth continues as expected, demand for commodities should remain firm. As a result, we expect that the rate of commodity-price increases will cool somewhat in 2005 but should not break meaningfully lower.

For the past two years, China's inventory building has outstripped growth in final demand. According to our analysis, inventory investment accounted for 18% of China's real GDP growth in 2004, up sharply from 10% in 2003 and 5% in 2002 (**Display 1**). Stated another way, China's inventory growth was roughly three times as fast as final demand in 2004 and roughly twice as fast in 2003. The rate of inventory growth in 2004 also outpaced industrial sales growth for the first time in more than three years (**Display 2**). The fastest inventory growth has occurred in mining and chemicals and in metals—two industries where China lacks adequate domestic supplies (**Display 3**).

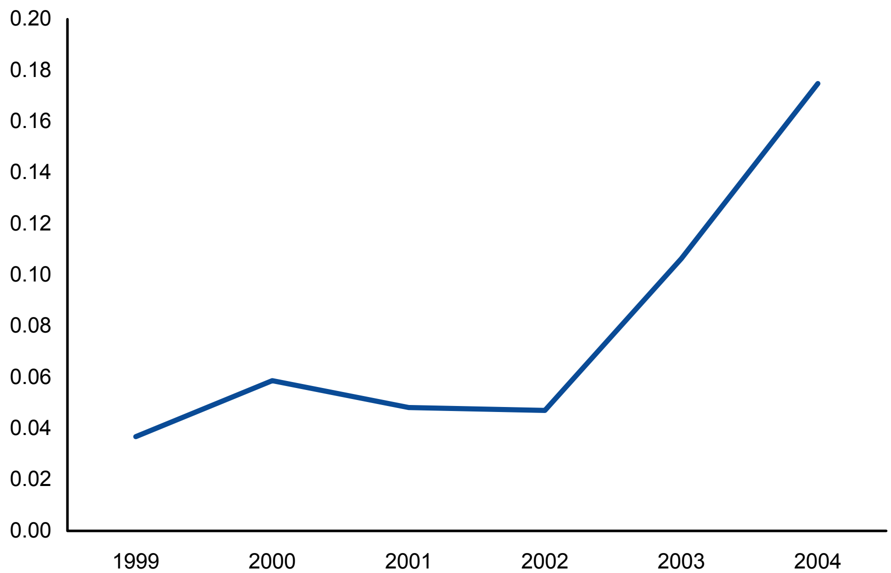
Historically, the pace of inventory investment has tended to lag growth in demand during the early stages of a cycle—as has been evident in China. More importantly, as the cycle advances and inventory investment matches or exceeds growth in final demand, firms do not automatically cut inventory levels—causing industrial-materials prices to fall sharply. Rather, at this juncture the outlook for inventory investment and commodity prices hinges on the outlook for demand.

The good news is that the outlook for demand remains robust, given the enormous economic momentum still evident in China. The 2005 consensus estimates for real GDP growth in China range from 8% to 9%, with industrial-sector growth several points above the GDP figure. This suggests that firms will continue to need more materials to feed their ever-growing production lines. This demand should be more than sufficient to maintain a high floor under industrial-material prices in 2005.

Joseph G. Carson
Global Economic Research
March 11, 2005

Display 1: Inventory Building May Have Run Its Course in China

Contribution of Inventories to China's GDP Growth

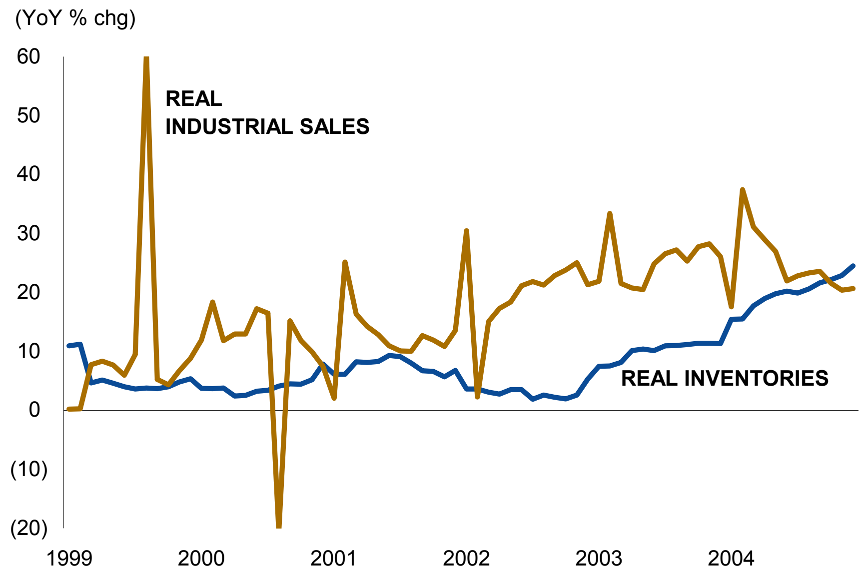


Source: CEIC data and Alliance Capital Fixed Income, March 11, 2005

The contribution of inventory building to China's real GDP growth has risen sharply in the past few years. However, we would not be surprised to see inventories build much more slowly in coming months.

Display 2: Inventory Building in China Is More Important to Global Economy

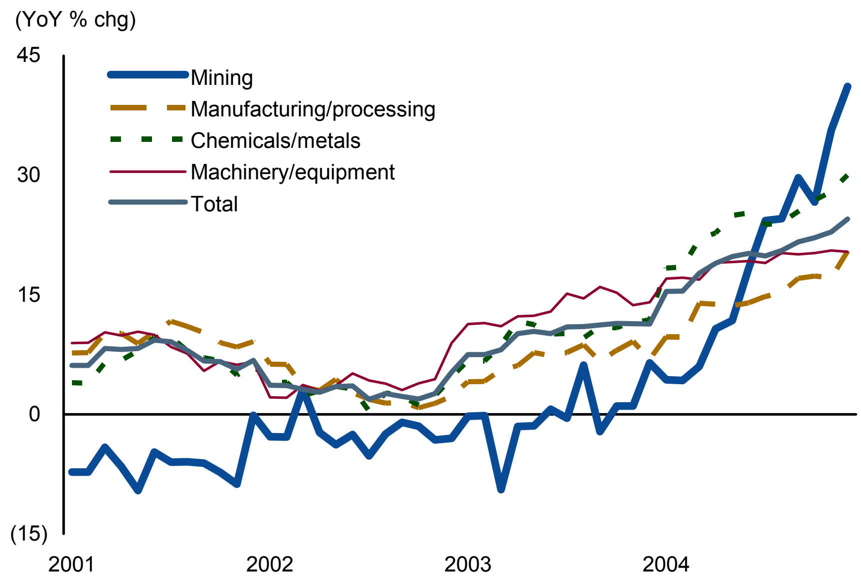
China Growth in Inventories and Industrial Sales



Source: CEIC data and Alliance Capital Fixed Income, March 11, 2005

For the first time in three years, real inventory growth has begun to outpace industrial-sales growth in China. While this does not mean that an inventory liquidation will occur any time soon, it does suggest that demand trends will be a key driver of commodity prices in 2005.

Display 3: China Has Seen Big Inventory Builds in Mining and Metals
China Real Inventory Growth by Industry



Source: CEIC data, March 11, 2005

In China, the largest inventory builds over the past few years have been in the mining and chemical/metals industries.