RECESSION MAY BE A RED HERRING FOR A MARKET FUELLED BY A SUPERCYCLE

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While broad commodities have outperformed most major asset classes year-to-date[1], the pressure of rising interest rates, a strong US dollar and fears of several large economies tipping into recession has led to a pull-back since the summer of 2022. In our Market Outlook, we argued that the current negative business cycle pressures on commodities are likely to be temporary and give way to the larger forces pushing the demand for commodities higher and constraining supply of those commodities.

Historically, commodities have been a cyclical asset class, generally declining when the business cycle turns negative. But even history illustrates that commodity prices can continue to rise long after a business cycle has turned if fundamentals are supportive. Oil price shocks in the 1970s and 80s are a case in point. Admittedly they are unusual cycles but, today, we are likely to be living in another energy price shock.

Energy price shocks continue

Since we published our Market Outlook, the Organization of the Petroleum Exporting Countries and partner countries (OPEC+) has announced a large cut to oil production from November 2022, amounting to 2 million barrels per day. As we expected in our Outlook, OPEC+ reacted to the price weakness in oil after the summer and sought to raise prices of Brent oil to over US$90/barrel (prices had fallen to US$84/barrel on 26 September 2022, just over a week before the OPEC decision). They have been successful in keeping prices above US$90/barrel since that decision but have laid the groundwork for further cuts by painting a pessimistic picture on demand forecasts (giving the group an excuse to intervene in the market again). Meanwhile, the Ukraine war shows no sign of improving and natural gas supplies into Europe from Russia have fallen to a trickle. The European Union has taken various measures to try to soften the shock. However, we view several of the proposals with scepticism. For example, introducing price caps on natural gas imports could simply divert natural gas to other countries and worsen the energy shortage for the EU. Interfering with price benchmarks, such as the Title Transfer Facility (TTF), could send incorrect pricing signals and lead to overconsumption of energy resulting in additional shortages[2].

Supply shortages of commodities extend beyond energy

A combination of rising energy prices and interest rates have driven many metal smelters to shutter production. High fertiliser prices (petrochemical product) are also constraining crop yields.

Looking across the commodity spectrum, all commodities have lower-than-normal levels of inventory.

	Current inventory relative to 5-year history	YTD performance
Energy		
Oil - US	-1.2%	6%
Oil - OECD Europe	-4.9%	13%
Natural Gas – US	-9.6%	81%
Gasoline – US	-0.3%	11%
Heating Oil – US	-12.6%	45%
Industrial Metals		
Aluminium	-68.7%	-23%
Copper	-51.2%	-23%
Nickel - LME	-74.1%	1%
Zinc	-62.4%	-1%
Lead	-38.4%	-18%
Tin	-21.2%	-47%
Agriculture		
Wheat	-6.4%	20%
Corn	-0.5%	14%
Soybeans	-1.8%	3%
Sugar	-1.2%	-2%
Cotton	-1.1%	-17%
Coffee	-4.9%	-2%
Soybean Oil	-0.5%	16%

Source: WisdomTree, Bloomberg. Data as of 30 September 2022. Agricultural inventories as reported by United States Department of Agriculture (USDA). US Energy inventories as reported by United States Department of Energy. Industrial metals inventory refers to exchange inventory summing stocks reported by the London Metals Exchange, Shanghai Futures Exchange and Chicago Mercantile Exchange. Price performance using the first generic futures contracts of commodities in the Bloomberg Commodity Index.

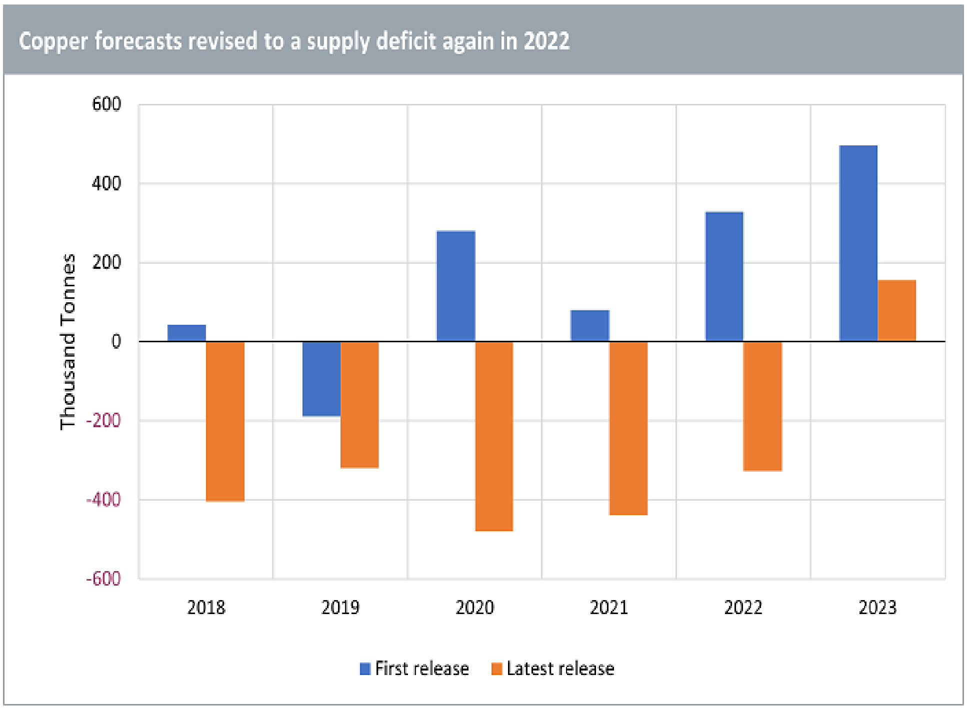
Historical performance is not an indication of future performance and any investments may go down in value.

Base metal supply is especially low

Looking at the table above, the inventory of base metals is considerably lower than their respective 5-year averages, yet base metals have seen the largest price declines of all the commodity sub-sectors. The markets are pricing in demand weakness from an economic deceleration. However, demand has not weakened yet. On the other hand, supply is declining fast.

Let's take the example of copper. The International Copper Study Group (ICSG)'s first forecast for 2022 copper balances (demand less supply), cast on October 2021, was for a sizeable surplus of 328 thousand tonnes. Its latest forecast (cast on 19 October 2022) is for a deficit of 328 thousand tonnes in 2022. Judging by historical revisions, their 2023 forecast of a surplus is likely to be revised down.

Their initial forecasts tended to assume no production disruptions. Yet, as we have observed this year, production disruptions can be very large.



Source: WisdomTree, International Copper Study Group (ICSG). ICSG's latest forecast from 19 October 2022.

Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties

China's economic deceleration is countered by policy support

China's zero-COVID polices have slowed economic growth and, thus, its demand for commodities. That matters because China is the largest commodity consumer in the world. However, its central bank has been loosening policy and President Xi has called for an 'all-out effort' to increase infrastructure spending (and given local governments free rein to raise debt financing to fund these projects).

However, the future course of China's policy will become clearer after we write this blog. At the time of writing (21 October 2022), China's 20th Communist Party Congress is still in process and will wrap up in the coming days. Xi Jinping is poised to clinch his third five-year term in charge of the nation. We expect national security to take a greater role in policy priority than the economy.

Commodity supercycle

An energy transition and a revitalised global infrastructure spend are likely to drive the demand for commodities significantly higher over the coming years. However, today, we are living in the down-phase of a business cycle. Even though many commodity markets are visibly tight, commodities are not sufficiently pricing the tightness. The Inflation Reduction Act in the US and the Infrastructure Bill are both strong tailwinds for commodity demand. In Europe, the sharp focus on weaning off Russian energy dependency is adding a new urgency to the energy transition, and we expect to see accelerated energy infrastructure plans take place.

Conclusion

As a headline, economies going into recession doesn’t inspire huge confidence in a commodity rebound. However, history does suggest that an economic slowdown combined with high inflation has been associated with positive commodity and gold performance. The energy price shock has set off a vicious circle of supply contraction from metals, fertilisers, and other energy intensive commodities. The energy transition and infrastructure led supercycle remains in play even if short-term business cycle phenomena dictate headlines today. As we emerge from this phase of the business cycle, we may find commodity markets extraordinarily tight.

Sources

[1] Year to date (31/12/2021 to 21/10/2022) performance of Bloomberg Commodity Index, 13.75%; S&P 500, -22.10 &; Bloomberg Global Agg Sovereign, -27.99%; FTSE EPRA NAREIT, -31.04%. Source: Bloomberg data in total return terms

[2] Commission makes additional proposals to fight high energy prices and ensure security o f supply, 18 October 2022.

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