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Investing for a world of change

Turbulent times: where next for commodities?

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Ninety One Multi-Asset's view

- Recent developments in commodity markets add to the Ninety One Multi-Asset team's bearish outlook for asset markets: weak China + elevated developed market inflation + less accommodative central banks = potentially a stagflationary environment.
- Higher gas and oil prices imply still lower growth and higher inflation, given they are effectively a tax on consumers and businesses. This environment is bad for both bonds and equities generally.
- Are there echoes of 2008 for oil prices? It is worth noting that oil at US$80/barrel is nowhere near a level at which it curbs global growth. Recall that oil went to US$150/barrel in June 2008, and it averaged US$100/barrel from 2010-2015, when the global economy ran very hard.
- OPEC+ still has considerable spare production capacity, but the group of oil-producing nations has a chequered track record in managing escalating oil prices. So we can't rely on OPEC to bail us out, at least not yet.
- Recent moves in coal, liquefied natural gas (LNG) and electricity prices have been startling – and indicative of what can happen when the animal spirits of traders perceive exceptional supply/demand imbalances. Will oil prices follow coal prices? We note that the dynamics of the coal market – and the multi-faceted role of China in all of this – make it less likely that oil will take the same path.

Anxious times

Just when the recovery in commodity prices appeared to be moderating, with iron-ore prices halving within a few weeks and metals prices coming back from their peaks, energy prices moved sharply higher in September, led by natural gas in Asia and Europe. European gas prices had been rising since March, but they jumped 79% in September and are now trading at prices not seen since 2007. These rises have put upward pressure on the whole energy complex, with coal and oil also moving higher. Tightness in energy markets is now being felt globally, but particularly in China and Europe.

The concern now is what impact this might have on inflation and growth in the coming months. Weather will be an important factor but, with stocks of LNG and coal looking very low for this time of year, unless there is a very mild winter in the Northern Hemisphere prices look likely to remain significantly above normal levels for at least six months.

While oil prices have been relatively slow to rise compared to LNG and coal, they are also at new highs for the year, with Brent oil above US$80/barrel for only the second time since 2014. OPEC+ has decided not to increase supply by more than the extra 400,000 barrels/day already signalled, which is not a great surprise. OPEC has historically been much more effective at reducing supply to support prices than it has at adding supply to moderate price rises.

With logistical issues keeping freight rates elevated, labour shortages in many markets and now higher power costs, consumer prices look set to continue to rise and inflation could well remain above forecasts. With the US Federal Reserve (Fed) still looking to begin tapering soon, the risk is growing that the very strong growth seen in recent months will be curtailed faster than expected. The current slowdown in China – exacerbated by power shortages and the regulatory crackdown on heavy-emitting industries such as steel and aluminium – is a concerning signal for global markets.

In addition to severe and ongoing disruption of supply chains, governments are also beginning to tighten fiscal policy following the extreme looseness of the past 18 months. And while Europe and the US are unlikely to slow too sharply, central banks could be faced with weakening growth and rising, or at least high, inflation over the coming months. Consequently, uncertainty about the world economy remains high. This increases anxiety in a difficult period for equity markets – though it may signal a turnaround in gold prices, which have drifted lower recently. Below, we share insights into some key commodity sectors.

Energy stocks

Energy-related equities have reacted positively to the current squeeze, with gas and coal producers benefiting most in the short term. European oil majors also rallied in the second half of September as oil prices, held back by the threat of lockdowns over the summer, were boosted by the emerging energy crunch. With cashflows looking very strong going forward and European gas prices adding to earnings at the margin, investors – who had been deterred by the uncertainty surrounding COVID outbreaks and concerns over how these companies will transition away from fossil fuels – are returning. In respect of the clean-energy transition, the European energy companies have been much more aggressive in laying out their plans and beginning to transition, and are now benefiting from strong cashflows from their existing assets while capital expenditure moderates.

Metals

China's power shortages have boosted a number of aluminium companies in the West, as they have led Chinese provinces to cut back on energy-intensive aluminium production. China has been a large exporter of aluminium in recent years, so these cuts have left Western consumers short of the metal. China has also cut steel production to lower emissions and conserve power. Weaker Chinese demand has resulted in steep falls for iron-ore prices and iron-ore producers, but has also led to steel prices remaining at record highs in the US and Europe. Despite this, while aluminium equities continued to rally, steel equities in the US and Europe traded sideways in Q3, held back by concerns about future growth and announcements of new capacity in the US, worrying investors about the industry's capital discipline. With annual contracts currently under negotiation with automakers, steel companies are looking to see steep rises in contract pricing for 2022, which should help underpin cashflows even if order books soften somewhat from the extreme tightness seen this year. In any case, with President Biden still looking to get his infrastructure bill approved, any weakness may be temporary.

Agriculture

Agriculture has not been immune from the energy price rises, with knock-on effects on commodities such as nitrogen fertilisers, which are energy intensive. The shutdown of fertiliser plants in Europe due to high gas costs has led to sharp price rises for fertilisers and the equities of companies that make them. Potash demand has been boosted as a result, with prices for the commodity soaring to their highest levels in over eight years.

Those looking for clues as to the outlook for select agricultural commodities may find the recent history of the lumber market instructive. After lumber futures prices rose sixfold from their 2020 lows to peak above US$1,600 per thousand board feet (mbf) in May this year, they collapsed back to US$450/mbf before settling at around US$600-650/mbf in the past month. Over the past 25 years, lumber prices have averaged US$300/mbf in nominal terms and it looks likely that they are resetting to a higher level. Could we see a similar dynamic in steel and other commodities? If we do, the prospects are interesting for the related equities, as lumber shares have held at record highs despite the decline in lumber prices. While the equity market can look past temporary extreme moves in commodity prices, we don't see evidence that it is discounting structurally higher prices yet.

Steel

The history of the steel sector over the last 40 years has been one of poor returns and high volatility. And now decarbonisation looms. Steel is one of the highest carbon emitters, in absolute terms, of any industry, due to the volumes produced and because coking coal is required both as fuel and support in the blast furnace. This makes coking coal economically difficult to substitute. The lack of clarity on steel's pathway to decarbonisation has made investors, already wary of poor returns, even more reluctant to engage. As more investors ask for science-based emissions-reduction targets, the steel industry is finding it hard to respond.

So just as everyone is clamouring for steel to build the infrastructure required for the clean-energy transition, such as wind turbines, no one wants to invest in the metal.

This infrastructure-driven boost to demand comes at a time when steel supply has been consolidated and reduced. In the US and Europe, we have seen significant consolidation in recent years. With the increasing focus on CO2 emissions, steel-making companies have been reluctant to restart older, less efficient plants despite record margins. Crucially, China has been cutting production and reducing exports to meet tighter emission targets. As China is the marginal supplier to Western markets, this should push up long-run steel prices in the West.

Copper

Someone always seems to be making the bull case for copper these days. In clean-energy technologies from electric vehicles to wind and solar farms, copper is required to conduct and generate electricity. Intermittent and distributed power sources require more fixed capacity as utilisation is not 100%, while, in the case of vehicles, an extensive recharging network is needed – all of which will require a lot of copper.

With Western governments committing to spending money on renewable energy and its infrastructure, we appear to be entering a cycle where demand for metals such as copper will be strong not just in the emerging East but once again in the West. It is no surprise, therefore, that copper prices have recovered rapidly from the downturn in H1 2020, reaching record highs in recent months. Of course, in real terms, prices are nowhere near their historic peaks and many people expect much higher levels before this cycle ends.

However, as commodity analysts learn early on, it is supply as well as demand that determines price. All the large mining companies slashed their capital-expenditure budgets from 2015 under pressure from high debt burdens and low prices. But they all kept their copper projects going and over the next three to four years there is over 2.5Mtpy of capacity (10% of demand) coming on from large projects and more from smaller additions and increasing scrap supply. With investors keen to support decarbonisation and the transition away from fossil fuels, copper projects/companies have been the first to get the capital they need to develop. The trend is real, but it will still be cyclical and volatile. Long-term investors need not worry, as long as they really are long term.

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