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Thinking Strategically About Commodities

A laggard over the past decade, commodities appear, in our view, poised for continued strength in the years ahead.

It's common practice to look at the past 10 to 15 years and extrapolate how an asset class might perform moving forward. There's a certain logic to this—assuming that the underlying fundamentals supporting (or not supporting) the markets remain in place. But what if they don't stay the same? A look back at the past decade for commodities would suggest that you shouldn't ever touch them—they "burned many fingers" during the 2014 – 2015 commodity bust. However, we believe things are very different now, and would argue that—near-term weakness aside—conditions for commodities have rarely looked better.

What's different? This year, stocks and bonds have experienced what's known as a correlation surprise—when assets that are supposed to provide diversification from one another end up moving together. This happened in the first half of 2022, and was visible in the market's single-day setbacks in reaction to an 8.3% Consumer Price Index reading in mid-September. The reactions relate to the way assets are valued. Whether a stock or a bond, you use a discount rate to calculate the current value of its future cash flows. The rate you use is dictated by market rates—the higher they are, whether because of inflation or market uncertainty or both, the lower the value of your asset.

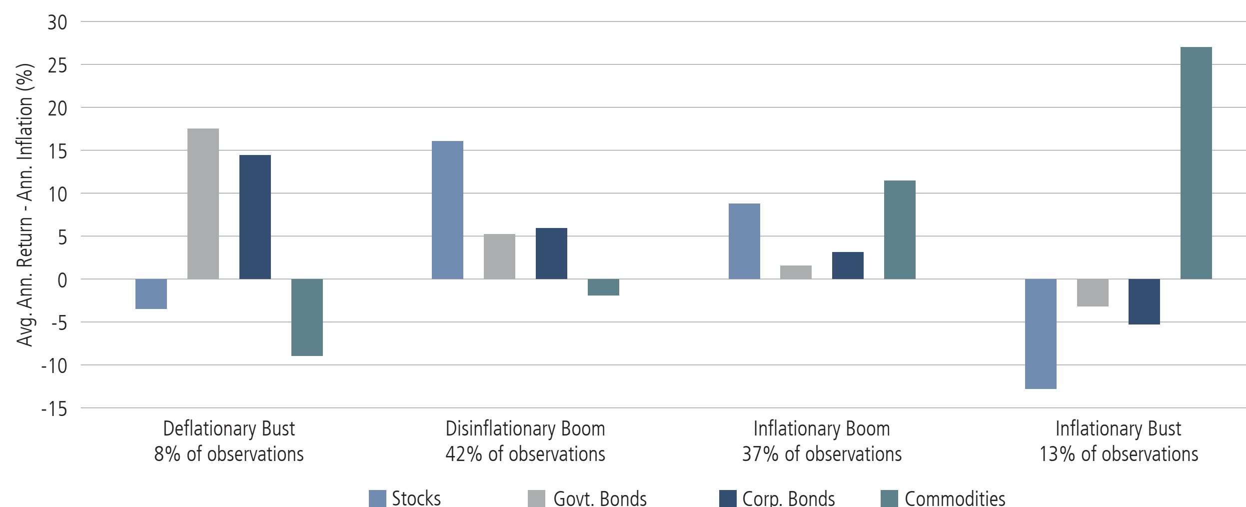
That heightened correlation is forcing many investors to look for new alternatives to traditional financial assets that could have more potential strength in the face of inflation. A variety of conditions exist today that we believe favor the commodity asset class—even in the wake of its first-half strength and subsequent setbacks.

Strategic Case for Commodities

In framing things for clients, we like to think about regimes—not investment time periods, per se, but whether the actual economic and market environment has changed in a fundamental way. By doing so, it's possible to outline when you believe commodities may have more opportunity than at other times.

FUNDAMENTAL REGIMES IN FOCUS

Average asset class real returns by growth and inflation regimes



Source: Bloomberg and Ibbotson. Data from January 1, 1970 to December 31, 2021. Stocks are represented by the S&P 500 TR Index (backfilled by Ibbotson prior to Feb 1970), Government Bonds by the Bloomberg U.S. Long Treasury Total Return Index Value Unhedged (backfilled by Ibbotson data prior to Jan 1973), Corporate Bonds by the Bloomberg U.S. Long Credit Total Return Index Value Unhedged (backfilled by Ibbotson prior to Jan 1973) and Commodities by the Bloomberg Commodity Index Total Return. CPI is the year-over-year percent change in the CPI Index. Unexpected inflation is the rate of change in CPI. Bust and boom regimes are defined by the change in the level of Gross Domestic Product (GDP) compared to the previous year. Should the current year-over-year (YoY) GDP minus the YoY GDP lagged one year be less than zero, [it is likely considered/ we consider it] a bust regime and vice versa. Inflationary and deflationary regimes are defined by the change in the level of the Consumer Price Index (CPI) compared to the previous year. Should the current YoY CPI minus the YoY CPI lagged one year be less than zero, [it is likely considered/we consider it] a deflationary regime and vice versa. For illustrative purposes only. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Indices are unmanaged and not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

According to this approach, the period when you most want to avoid commodities is in what's called a **deflationary bust**—something akin to the 1929 Great Depression, when there was a premium on relatively safe assets such as cash or bonds.

Then there's the **disinflationary boom** experienced over much of the past 30 years, when globalization trends and productivity gains contributed to very low inflation. During that regime, simply holding onto equities or a balanced 60/40 stock/bond portfolio was generally an effective strategy, and investors had little else to think about.

However, the reintroduction of inflation created new complications—and opportunities. The **inflationary boom** we saw last year, combining renewed inflation and growth, provided an environment where equities did well, but typically not as well as commodities, while inflation cut into those equity returns.

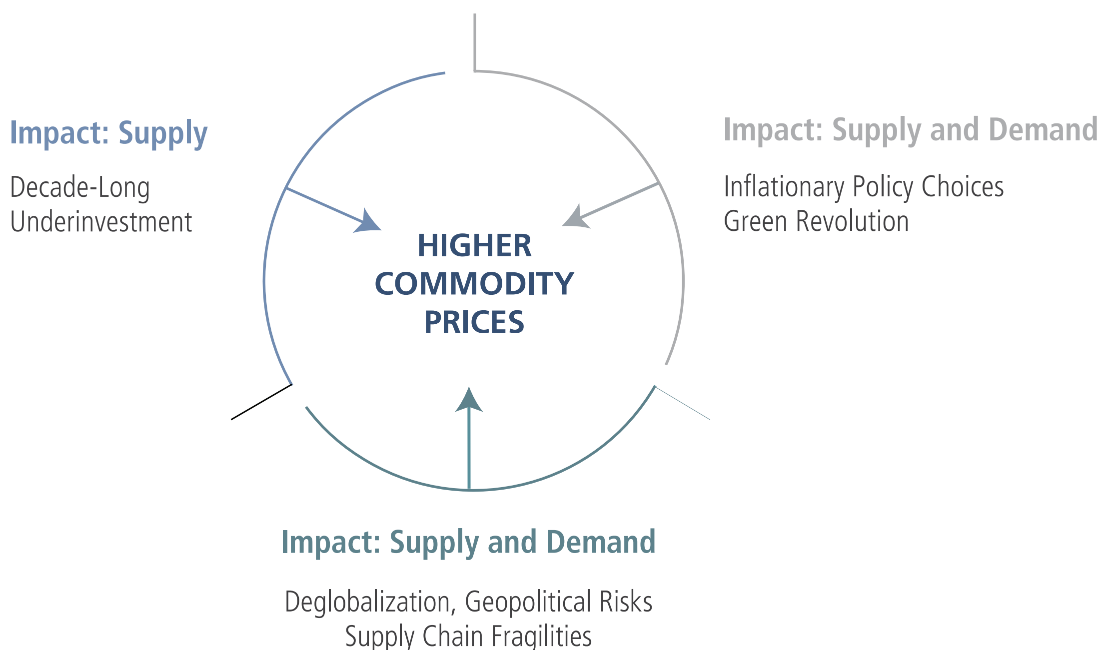
Finally, there's the **inflationary bust** scenario, of which the 1970s were a prototypical example. In that case, encouraged by the exogenous shock of the OPEC embargo, inflation proved persistent. In this kind of a regime, financial assets generally have suffered losses, while commodities have thrived. We believe the current environment most resembles this sort of scenario.

Our point, however, is not to suggest that we are entering a particular regime—that is notoriously difficult to determine. Rather, it is that, instead of getting exposure to particular asset classes, it may make sense for investors to seek exposure to multiple regimes so as to produce macro-resiliency in portfolios. Through this lens, we see a compelling case for commodities, both as a potential "real" return generator and as insurance (as a store of value) against unanchored inflation.

Tactical Considerations: Commodity 'Super-Cycle'?

That being said, we believe it's likely that we are headed into an inflationary regime in which commodities could be supported by major shifts on supply and demand, lasting over the next five to 10 years. Some have referred to what's called a super-cycle, and, in our view, we are in one of these longer up-cycles for commodities.

POTENTIAL DRIVERS OF COMMODITY PRICES



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Supply: Cash Flows, Clean Focus

Let's start with supply. Simply put, relatively little money is going into the commodity markets despite their recent success, with less investment than even during the 2009 – 11 period.[1] Moreover, commodity investors are generally focusing on risk, with a mantra that has changed from "invest in growth" (more mines, more production) to "cash-flow safety": Many investors want to see a safe near-term return rather than wait for more speculative returns far in the future.

This has encouraged a change in orientation among companies that is helping to limit production, and which appears to be present across energy, mining and agriculture. An increased orientation toward environmental, social and governance (ESG) investing has also tended to discourage capital flows into energy, metals and other "dirty" commodity areas. According to Goldman Sachs, based on Morningstar data, only 1% of all equity mutual fund flows have gone into companies with no ESG disclosures in their filings since the start of 2019. In our view, there are few signs these tectonic underinvestment trends will be changing over the next few years, creating a potentially broad-based shortage that could be supportive of prices over time.

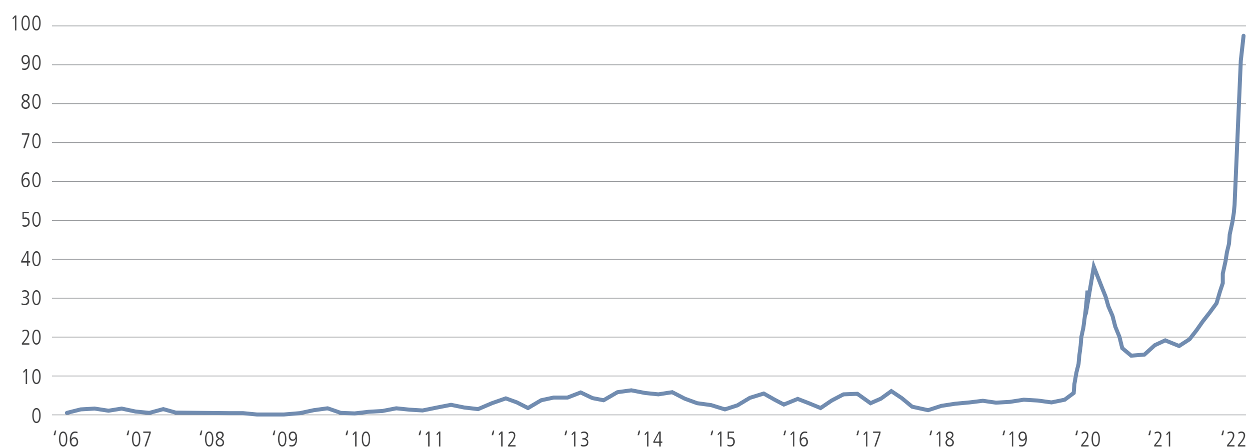
Demand: Policy Is King

On the demand side, we see a number of factors, tied to policy choices by businesses and politicians, that could prove supportive for commodity demand well into the future.

Deglobalization. For decades, one thing that many consumers and businesses seemed to count on was minimal inflation driven by the advantages of a global trade regime under the hegemony of the U.S. that allowed companies to identify the most cost-efficient ways to create and transport their products. Secure and dependable trade routes, just-in-time inventory systems and cheap global labor were all part of this. But in the face of a more multipolar world, globalization started to decline a few years ago, and this has accelerated in the wake of the pandemic and various geopolitical conflicts around the world, including most notably the Russia/Ukraine war. Now, countries and companies are busy trying to make trade routes and supply chains more secure, and building up redundancies to limit disruption. Within this trend, we are seeing a marked reorientation toward "re-shoring" (onshoring, near-shoring) of operations, as reflected in the minutes of recent industry meetings (see below). In our view, re-shoring is likely to be commodity-intensive and extremely inflationary, as companies will need to build additional facilities with more expensive raw inputs and labor costs. In addition, we are seeing more competition for resources and power, which has generated a hoarding orientation—particularly in Asia and Europe, which is living under the threat of a very cold winter without Russian gas.

RE-SHORING DISCUSSION HAS SKYROCKETED

Company mentions of re- or near-shoring (100 max.) 2006 to July 22, 2022



Source: Bank of America, as of July 22, 2022. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results.

New Reality of Geopolitics

Free trade has helped build trillions of dollars in wealth over the past decades, but we believe it could increasingly clash with ideologies tied to human rights, climate and intellectual property. We believe countries and investors will face key questions:

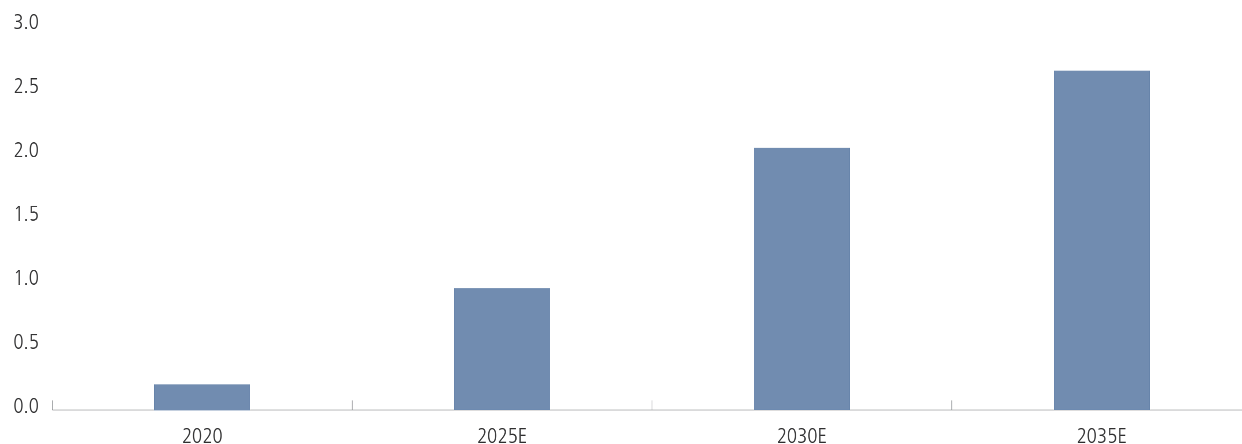
- Should we trade with regimes and regions where there are limited human rights, and local economies have an advantage as a result?
- Should we trade with those that do nothing about climate?
- Should we trade with those where cheap goods are made based on stolen intellectual property?

The answers may increasingly be "no," helping to reinforce deglobalization trends and the acceleration of re-shoring and supply chain diversification, which were already being encouraged by the vagaries of certain markets.

The Green Transition. Ironically, the move toward sustainable energy is likely to be heavily dependent on commodities. In terms of hardware, we interpret its trend toward "electrifying everything" to mean "metalizing everything," for example requiring an enormous amount of copper for rewiring. Think about New York: If everyone there buys electric vehicles, where could they be charged? Moreover, to build the infrastructure associated with sustainable energy will likely require additional use of fossil fuels and other traditional sources. So, in many ways the road to "clean" will be "dirty" until critical mass of the transition emerges. That is why countries today have to start viewing metals, the "green-ablers," as strategic resources. Toward this end, it wouldn't be a surprise to us if, just like oil and gas, countries start hoarding metals of all sorts in "strategic reserves," thereby creating additional "security" demand.

THE RESOURCE-HEAVY TRANSITION

Electric vehicle copper demand, 2020 – 2035E (million tonnes)



Source: Jefferies, Macquire. As of April 30, 2022. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results.

Redistribution. By general consensus, the policy reaction to the 2008 Global Financial Crisis was a political error, in which policymakers saved banks but left many individuals to struggle, resulting in some of the populist political changes we've seen over the past decade. During COVID, this mistake was not repeated, with an emphasis on people, not banks—in stimulus checks and support for rental payments, among other methods. Though these fund flows have dried up, other redistributive trends continue; for example, Germany is giving individuals help to pay energy bills, the U.K. has started doing the same, and the U.S. has provided gas subsidies—while there seems little political will to discontinue them. Taken together, such policies tend to boost demand at high prices rather than letting high prices "kill" demand to rebalance tight inventories. In a sense, the signaling power of prices in determining demand has faded away with substantial influence from policymakers.

So, despite monetary tightening, government continues to provide a source of basic demand. And funding lower-income people tends to be particularly inflationary and commodity-consuming, because not only they are numerically greater in size than the rich, but they tend to spend rather than save, and may focus that spending on commodity-intensive items. In some ways, the green transition itself is a redistribution policy, too, promising green union jobs to replace supposedly less productive jobs in the fading old-economy sectors.

Recent Dynamics/Differences From the ’70s

After a stellar start to the year, commodities retrenched over the summer amid concerns moving from inflation to slowing economic growth driven by interest rate hikes. However, in our view, the financial prices and physical commodities markets are saying very different things.

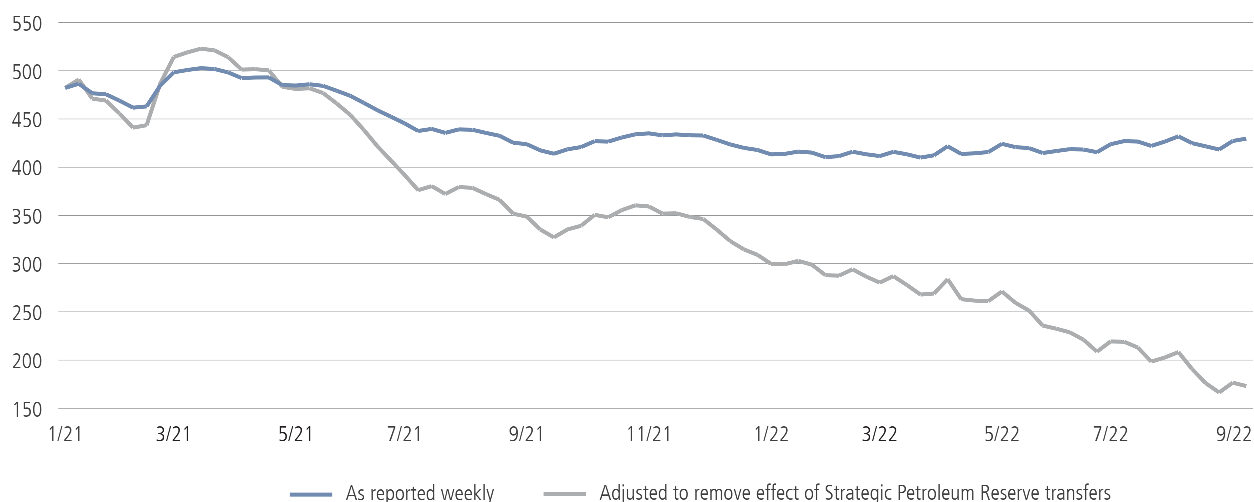
In the physical market, OPEC spare capacity is largely gone—something that helped trigger surprise product cuts in September. Meanwhile, China, an important buyer of metals, has been in recession—locking down inventories in the first half of the year, and largely ceasing consumption. However, it’s important to understand the difference between short-term volatility and long-term trends. Yes, demand-based worries in China could cause price fluctuations; global rate hikes could slow the expansion; and near-term economic concerns could curb the use of gasoline. But over the medium to long term, we believe the pendulum should swing back into favor of commodity prices. For those who can deal with the volatility, there is likely to be a risk premium generated as the current new regime extends over time.

One crucial point to make is that this isn’t the 1960s or ’70s. Back then, there were similar initial policy and investment choices: support for the poor and a preference for fast-growing stocks (e.g., the “Nifty 50”), at the exclusion of resource stocks, which were deprived of productive capital, in a situation made worse by the OPEC oil embargo. But given the lack of private incentives for investment, the U.S. government stepped in to provide supports for energy production in the form of tax subsidies, resulting in massive expansion of the oil patch.

Today, although production from existing wells has grown, the government is actively discouraging new capacity—limiting and slowing oil leases and red-lighting high-profile pipelines. Meanwhile, the orientation of investors is around existing cash flows. Overall, this is resulting in price inelasticity for the commodity market, such that oil, in our view, could reach as high as $200 per barrel and still not lead to new supply. If you were a CEO and knew that everyone at the end of next decade would drive electric vehicles, you would be unlikely to make new investments, too. Back in the 1800s, the whale business eventually gave way to the oil business, and hopefully fossil fuels will sunset with the advent of clean energy—but between now and then, there could be meaningful price risks in energy and a clear ramp-up period for metals and biofuels.

U.S. COMMERCIAL CRUDE OIL STOCKS

Million barrels



Source: Cornerstone Analytics. Data through September 9, 2022. Nothing herein constitutes a prediction or projection of future events or future market behavior. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Indices are unmanaged and not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Critically, across the board, commodity inventories are very low. Social subsidies by governments are not letting price destroy demand. In oil, drawdowns of the Strategic Petroleum Reserve offered some price relief to drivers over the summer, but those releases—amounting to the production contribution of a medium-sized company—are likely going be unwound this fall. Meanwhile, neither shale nor OPEC will be able to supply enough space capacity as a result of years of underinvestment, rising input costs and capacity limits of existing fields.

Emphasizing Secular Exposure

In our view, the current trends around commodities are long-term and global. Over the short term, news about weather in the Midwest, shifts in production, the Ukraine grain embargo and other factors may dominate price action, and create particular turbulence in what is a dynamic asset class. However, we believe the narrative investors should care about is the secular one: The overarching trends we have described are likely to favor commodities over multiple years, in light of the inflationary regime we anticipate unfolding. Gaining constructive access to that regime while maintaining exposure to more traditional asset classes will be a balancing act that investors face in seeking to generate attractive inflation-adjusted return opportunities in the years ahead.

Accessing Commodities Through Futures

In accessing the commodities market, the investor has various choices. In our view, a focus on direct commodity investing via futures contracts can make sense. Futures avoid the need to deal with storage and delivery of physical commodities, as well as the profit and social pressures facing natural resource company equities. However, they also require moving from one commodity future to the next, in a process called "rolling." Currently, to incentivize producers to bring on supply, markets trade shorter-maturity commodities at a premium to longer ones, so rolling (from maturing contracts to the cheaper "next" contracts) can be a way of generating potential yield—roughly 10% (the average across commodities) annualized in the current marketplace, in our estimation.

As managers, we also seek to understand the scarcity value of a given commodity and look for a tradeoff between that scarcity and the risk that may be involved. Natural gas is particularly volatile, and thus may be more risky than other commodities that may reflect similar fundamental "bets"; for example, natural gas may boost the price of heating oil, aluminum, corn or cattle, which may be less volatile avenues to generate potential return. As in any investment, diversification may be crucial.

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