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When Do Commodities Become a Hot Commodity?

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Anu Rajakumar: The commodities market comprised of oil, metals, grains, livestock, and more has been a crucial part of commerce for centuries. Commodity investments can play an important role in asset allocation. Its properties, based on historical data, have included a low correlation to equities and fixed income, in addition to being an important hedge against rising inflation. But, as our constantly evolving world shifts into the use of things like autonomous vehicles and decarbonization, what could that mean for the commodities market? My name is Anu Rajakumar. And to help me answer that question and more, I'm pleased to be joined by my colleague, Hakan Kaya, senior portfolio manager for the Neuberger Berman Commodity Strategy and asset allocation expert. Hakan, thank you for joining me today.

Hakan Kaya: Thank you for having me, Anu.

Anu: So as I mentioned in the opening, the commodities market in some form or another has been a part of global economies basically since the dawn of time. Hakan, tell us what makes commodities such an intriguing asset class?

Hakan: Yes, Anu, commodities are in general interesting asset class, but I think in these days they are more interesting and the reason being is when you look at the commodities, you have to think about supply and demand. And there are times when the supply and demand forces, they align and that's what we are seeing these days. On the supply side we see a lot of the miners and producers in not really good shape because after they take long pool returns they can't find investors; they can't find easy financing that they did in the past. And also we had these ESG issues that is coming off the supply issues that they are facing. And you know we also see these accompanied by the increasing demand for greenification, green evolution and the policy agreements as well that the governments are likely to be spending a lot more [on] in the next decade, either through infrastructure spending or just sending money to people to consume. So right now is a great time to be in commodities in my opinion, Anu.

Anu: Terrific. Well, we'll dive into some of the reasons why you think that, Hakan. You mentioned some interesting points that we'll dig into. The first one of those I want to talk about is ESG and the sort of trend that we've seen across asset classes. How have ESG issues impacted the commodity markets? If you could just touch on that, please.

Hakan: Sure. So you see ESG, again, both impacts the supply side of the equation and also the demand side of the equation. What we see on the supply side, ESG is rubbing salt on the wound. It's draining the productive capacity away from the markets, you know, making miners' jobs difficult and basically using money for increasing Capex or additional supply. So ESG net-net, draining the capital really from the producers. ESG is also creating a demand source. And how this happens is you see the need for decarbonize the world, you know, the goal, decarbonization. We are creating a demand source by metallizing the world at the same time. So when we think about ESG, we will be driving a lot more electrical vehicles. These are very metal-intensive activities. We will need a lot more wiring for cars or charging infrastructures. We will need a lot more nickel, a lot more lithium, cobalt for battery solutions.

We are also interested in reducing the emissions right now. And for reducing them, you will be using, for example, a lot more palladium, a lot more platinum in automotives. And we would like to get away from fossil fuels but switch into renewable biofuels and this will be creating a lot more demand, for example, for ethanol and implicitly for corn, sugar, and soybean oil that are used in biofuel generation. So net-net, we are seeing this demand for decarbonization and we are achieving it, you know, again by, for example, applying on tax on carbon. And what it does is it reduces these subsidies for producers. It reduces drilling permits for exploration and production firms. And in a sense it's creating this interesting environment while, you know, with supplies already is limited, we are limiting it even further. But at the same time, we need to feed this gasoline/jet fuel demand for the existing fleets, so it creates this interesting situation, especially for energy sector as well. So net-net I think the government and we all together are doing the right thing, decarbonizing. The pace of that decarbonization is important and at this pace we may see a situation where while we are consuming the fossil fuels, we are consuming the energy, we're limiting the supply even further by taxing carbon, limiting carbon, we may see a situation where energy prices, oil prices, may spike. And perhaps the governments at this time may not be as sensitive to such price spikes and they may be seeing these spikes as, in my opinion, collateral damage for the greater good.

Anu: Yeah, perfect. You know, something that I'd like to hear from you a little bit about is about policy, the effective fiscal policy on commodities and specifically I know you have some thoughts on sort of what the implication of stimulus has been on the commodity markets, particularly in this post-COVID era. Could you speak a little bit about that?

Hakan: Sure thing. So how I see is, like especially related to these COVID related policy responses - when I think about this I see, you know, commodities they got the COVID last year and they got sick for a while, but then the Dr. Fed they come in and the Dr. Fed injected the best vaccine possible, which is the liquidity, to the system and to the commodities. And commodities really recovered ever since. And these days, I think commodities are like sportsmen using performance enhancing drugs and this time injected by, not Fed, but fiscal authorities. So net-net I think this COVID at the end of the day hypercharge commodities and hypercharge commodity investments made them ready for to react for any inflationary impulses. And I this is a government incentive, the government choices, and the choice here is that the government needs to find solutions for certain social needs. One of them is income inequality. And I think they are going to be using as an opportunity to fight it and provide solutions for existing unemployment problems as well. And so that's why we are seeing a lot more infrastructure spent. And these types of infrastructure spends, I think will be important for, you know, increasing demand for commodities or commodity investments in the next year or decades. And also if you think about how the governments are reacting and the way that they are engineering these fiscal and monetary responses, and why it should be helpful for commodities, you have to think about what they did back in the GFC days in 2008, for example. At that time, we also had a very economic situation that needed liquidity and fiscal injections and which we have seen, but that kind of injections didn't create inflation. And I think investors should not mistake that era with the current era. At that time, the fiscal and monetary solutions were engineered to make the banking system afloat. The money really went into the banking reserves, from there to the companies who used that money to buy big stocks or to the pockets of high-income people who either saved the money or didn't spend the money. Today, money is directly going into the pockets of the income constraints and these income-constraint people have a higher propensity to spend. And when they spend, they spend it on more commodity intensive products, like they go buy SUVs, bigger cars. They probably eat more beef rather than fish or veggies, which is again a lot more commodity intensive. So very different situation compared to GFC, very much geared towards bringing the velocity of using money into the system. That to me, Anu, is very inflationary and, again, we are entering this summer period. It will be interesting to see where a lot of expectation is [where] we will see people come out and start spending these checks that they received.

Anu: Yeah. Terrific. Thank you. Some very interesting insights and the most unique analogy I think I've heard for commodities to sports enhancing drugs. Now another area that's really important for the demand of commodities is globalization. Would love to hear a little bit more about the impact on globalization just generally. You talked a little bit about some of the supply constraints and the increased demand. How does globalization play into the commodities space?

Hakan: Right. So it's a very interesting thing, and actually most people don't recognize this kind of macroeconomic trends how will they impact cocoa or coffee, you know, what is the linkage, right? But it's all about inflation. And you see globalization it created an era of this inflation. Basically in the past four decades we've been living in an environment where inflation was not a problem. And why it wasn't a problem? It's because after the Berlin Wall collapsed, we've entered a one-power hegemon world where, you know, labor became cheap and accessible and they unionized. So a lot of the inflationary sources of the 70's and early 80's it disappeared. Now you see looking at past few years of experiences, right? We are moving bit by bit more from this one power world to a multi-polar world. And usually the experience is when you look at human history when such one to multi-power hegemon shifts happen, those are the times where you see supply chains become not secure and those are the times when populism gets very popular. And those are the times when you see inflationary periods.

Anu: Perfect. Now, Hakan, as folks digest your comments they might be thinking about how commodities fit into their portfolios. What would you say are some of the key takeaways that listeners should be considering as they think about commodities from an asset allocation perspective?

Hakan: I think there are only a few things investors should think about. One is “am I getting the return from this asset class?” or “is it going to provide me diversification?” and “what kind of diversification it's going to provide me?” -- I think that requires you know -- my suggestion to the investors [is], don't look at what commodities did in the past 10 decades. Next 10 decades will be a lot more interesting in terms these kind of supply disruptions versus demand forces. I think commodities are right for producing returns and, in fact, you know, these days, the asset class, as a bonus, comes with a yield, what we call a roll yield, which is the dividend for investing in commodities. So that's the return part, but I think it's going to be supported and roll yielding. The diversification part, the second piece of the puzzle, is also going to be solid in my opinion. So you see, for example, if you look at stocks and bonds and usually people think I'm very much into stocks and I use bonds to kind of hedge it or produce income, and you know, that hedging argument doesn't necessarily hold these days. It didn't hold in the 70's, it didn't hold in the early 90's to 2000's. Treasuries and stocks were closely correlated and these days we are seeing the early evidence that that stock/bonds downside complement is happening. And the underlying factor for it is inflation surprises. And at the same time, when we observe it, we are also seeing around those decoupling down based for stocks and bonds we see commodities go up. So we have this negative correlation providing the diversification benefits. I think it's too early to tell perhaps with a few months of data points that we answered in such a regime, but I think that the probability of that regime is a lot higher than before. And I believe investors should, just because of that reason, it's worthwhile for investors to take a closer look at commodity investments.

Anu: Perfect. Now, Hakan, I have one last question. This is just a fun one, totally hypothetical. If you have a spare room in your home which you had to fill with one physical commodity, I know you don't invest in physical commodities, but if you had to fill it with one physical commodity from the 20-plus commodities that you typically invest in what would you put into that room, either something just for fun or for your personal enjoyment or to reap investment benefits?

Hakan: Well, I'm going to have pass here, Anu, because I don't know how to answer these, like, asking a parent which one is your favorite child. And I have like 28 of them, I hate to choose one, but you know joking aside I think if I have to choose one, it would be copper. Copper is the king these days. Copper has the green revolution sticker and copper is a lot more involved with this new technology, 5G. And so it's in the center of whatever we will be experiencing in the next decades and as a result it will be a strategic commodity, just like oil was a strategic commodity in the early 2000's. I think copper will be the strategic commodity of 2020's and 30's. So I would like to start thinking about where I could store copper in my small apartment here in Hoboken.

Anu: Perfect. Well, thank you. I know you're a coffee connoisseur. I thought you might have gone with coffee, but copper sounds like a good one as well. Hakan, thank you very much for being on the show today. This has been very enlightening and hopefully helpful to our listeners about commodities might fit into their portfolios. Thank you again for being here.

Hakan: Thanks, Anu. Thank you for having me.

Anu: And to our listeners, if you like this episode of Disruptive Forces, I encourage you to subscribe via Apple Podcast, Google Podcast, or Spotify or you can visit our website at www.nb.com/distruptiveforces where you can find previous episodes, as well as more information about our firm and offerings.