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Research Strategies Solutions

2014: Turning point in Commodities fundamentals and in inflation?

EXECUTIVE SUMMARY

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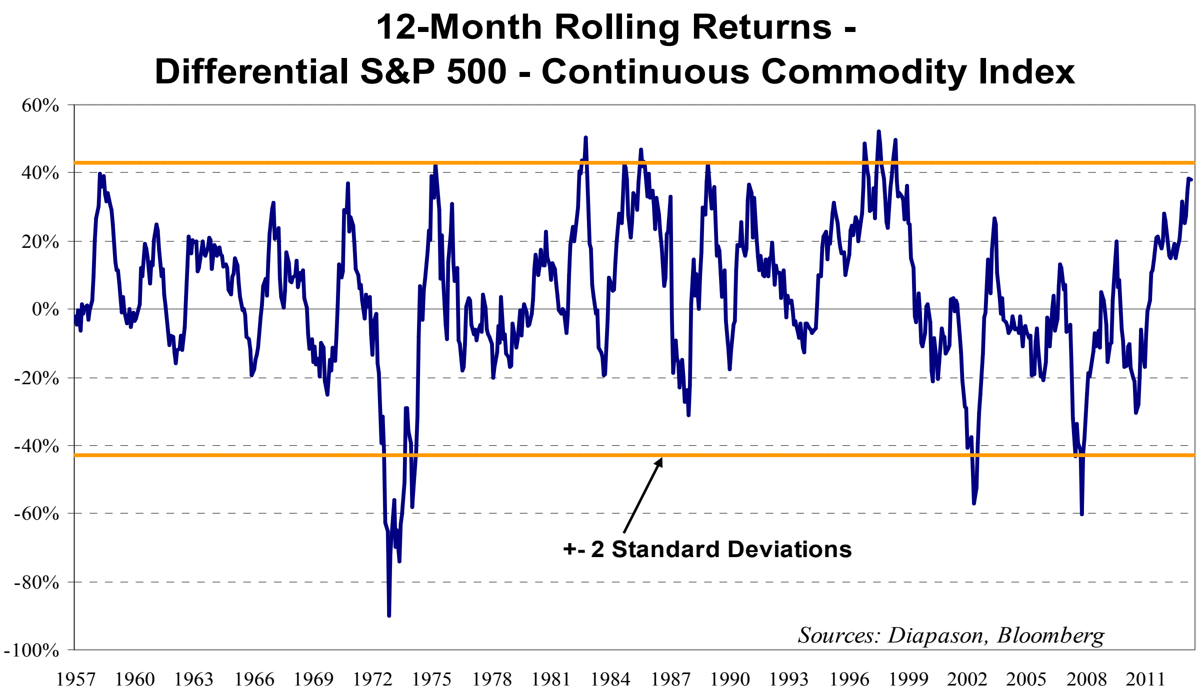
Plan

Introduction

Commodities as per the Diapason Commodities Index were down 4%, which was not a substantial drop. However, they suffered greatly in relative performance to the star-performer equity market. The performance differential over 12 month is at the highest level since 1998. This divergence, allied with macroeconomic uncertainties, has prompted many to burry the decade-long commodity super cycle and has dragged sentiment levels on the sector to their lowest level since the summit of the financial crisis.



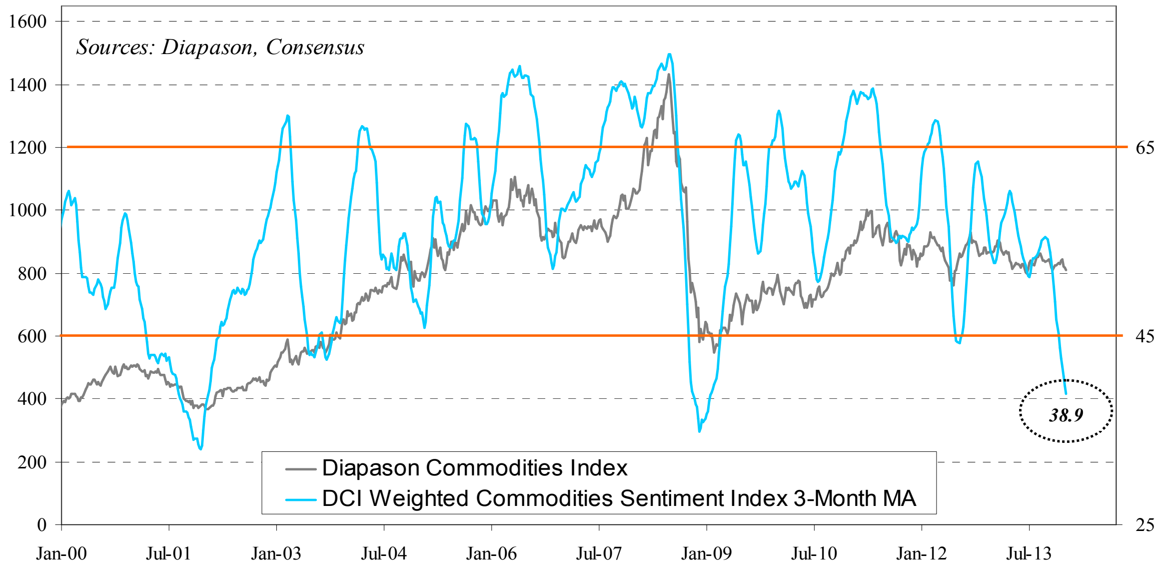
We have identified several factors, on the fundamental and macroeconomic sides, that could inverse the 2013's trends this year and allow a strong recovery in commodity markets, which we expect will outperform equities in the coming months. As prices remain mostly depressed and as sentiment is weak, commodities offer very good value at the moment.

1. Depressed sentiment on commodities

Sentiment on commodities has hit historically low levels: it now seems there is not a single commodity bull left of the planet. The consensus is now only 39.8% positive on the sector; and it is only the third time we witness such a depressed sentiment since start of the commodity super cycle in the early 2000's. Previous experiences were in 2001 and in early 2009, during the height of the financial crisis, not long after the Lehman Brother's collapse.

There are a number of reasons behind this depressed sentiment: fears of hard landing in China and claims that the commodity super-cycle is over arose along concerns over the Fed's tapering plan. These have prompted several investment banks to spread the idea that the end of the commodity bull cycle is a given certitude.

Diapason Commodities Index and Commodities Sentiment Index



As a direct consequence of this depressed sentiment and struggling prices, investors pulled their money out of commodities. According to a recent Reuters article, commodity exchange traded products (ETPs) suffered record outflows in 2013, with $42.9bn withdrawn from these products last year. Historically, these over-pessimistic views tend to offer, as in early 2009, attractive investment opportunities.

2. Unrealised fears of China's hard landing

Fears, that the Chinese economy could crash, have severely affected commodities in the past two years and was one of the main reason behind the depressed sentiment on the commodity sector. However, China's growth will likely be stronger than many "commodity peak" analysts have supposed.

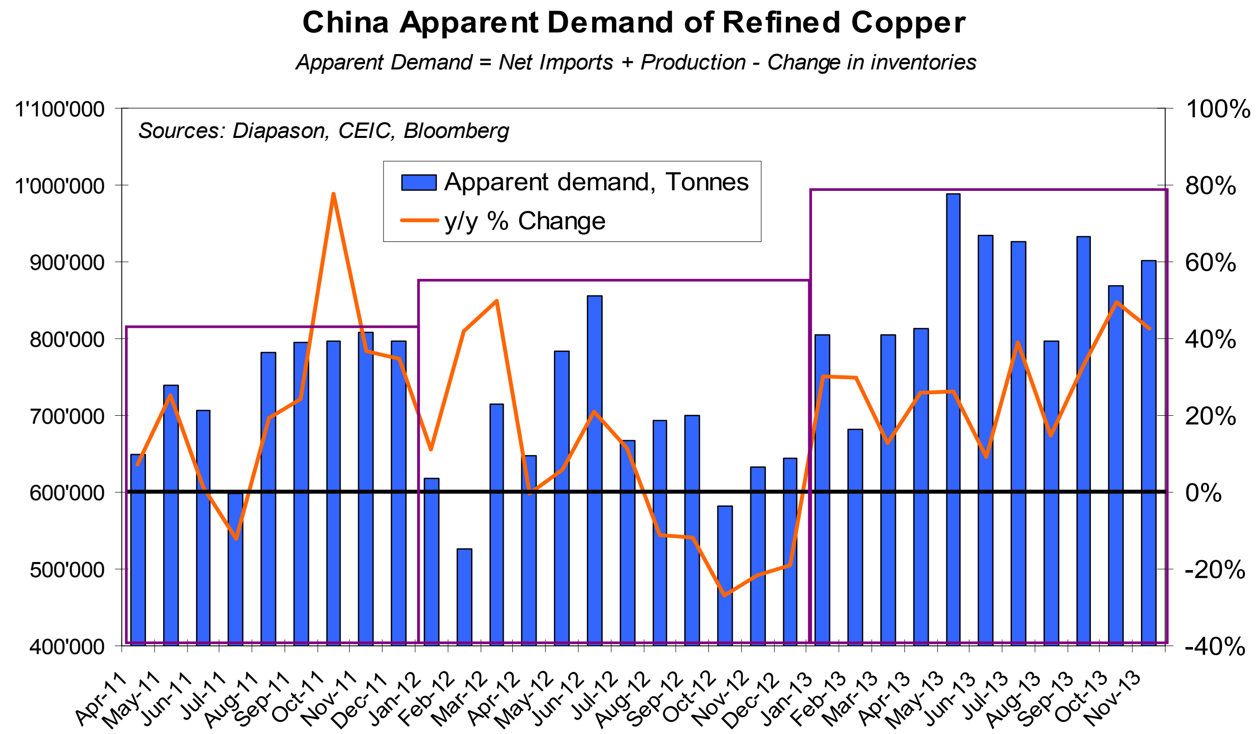
True, the Chinese GDP growth is decelerating, but not as fast as many have believed. China's real GDP growth moderated to 7.7% y/y in the final quarter last year, from 7.8% in Q3 2013; but these numbers were actually higher that the market expectations of 7.6%, and above the official 7.5% target. Full-year GDP growth was 7.7% y/y, also exceeding the target of 7.5%. We project that GDP in H1 2014 would be above 8.0%. In turn, cyclical commodities are likely to benefit from this situation as reflected by the recent strong performance of base metals prices such as copper (+4.2% since December 1, 2013), nickel (+8.5%), zinc (+10.1%), lead (+5.8%) and aluminium (+2.5%).

Many analysts have pointed that GDP growth rates are lower now than during the 2000-2009 period: but actually, when the nominal GDP increases as much as during the previous decade, the growth rate is lower because the nominal starting point is higher. But in fact, it remains additive to commodity demand: given the same intensity of usage, a larger economy requires more commodities (volume) relative to a smaller one.

Also, the anxieties over the rebalancing of the Chinese economy towards a consumption-oriented economy (from an investment-based one) have been exaggerated to our opinion. Firstly, it would lead to an expansion in commodity-derived consumer goods, such as cars for instance. In 2010, China had 46 passenger cars per 1,000 capita, close to Namibia's level but significantly weaker than South Korea (276 cars per 1000 capita) or the European Union (474 cars). The increase in the passenger car fleet will translate into stronger gasoline, zinc, steel and aluminium demand growth.

Secondly, recent data suggest that the rebalancing of the economy will be a matter of years, not months. In the final quarter last year, investment became the major contributor to GDP growth (4.2 percentage points vs. 3.6ppts in 2012), in contrast with smaller contribution from consumption (3.9ppts vs. 4.2ppts in 2012). Actually, the past months have witnessed an acceleration in cyclical commodities demand. In the final quarter of the year, imports of unwrought copper and copper semis were up 25% y/y.

As production of copper was also at record high after the summer 2013 and as domestic inventories (SHFE + bonded warehouses) only increased slowly, China's apparent demand of copper (production + net imports – increase in inventories) reached an historical high level in September 2013 and remained near record in the following months. Similarly, iron ore imports hit a record high in November 2013, pushing total 2013 imports to an all time high too, despite the December slowdown.



3. Commodity Fundamentals

The fundamentals of most commodities are signalling that a more elevated price structure is needed. As previously discussed, China is unlikely to be a drag on commodity prices but in fact is likely to be a major contributor of global demand growth for commodities this year.

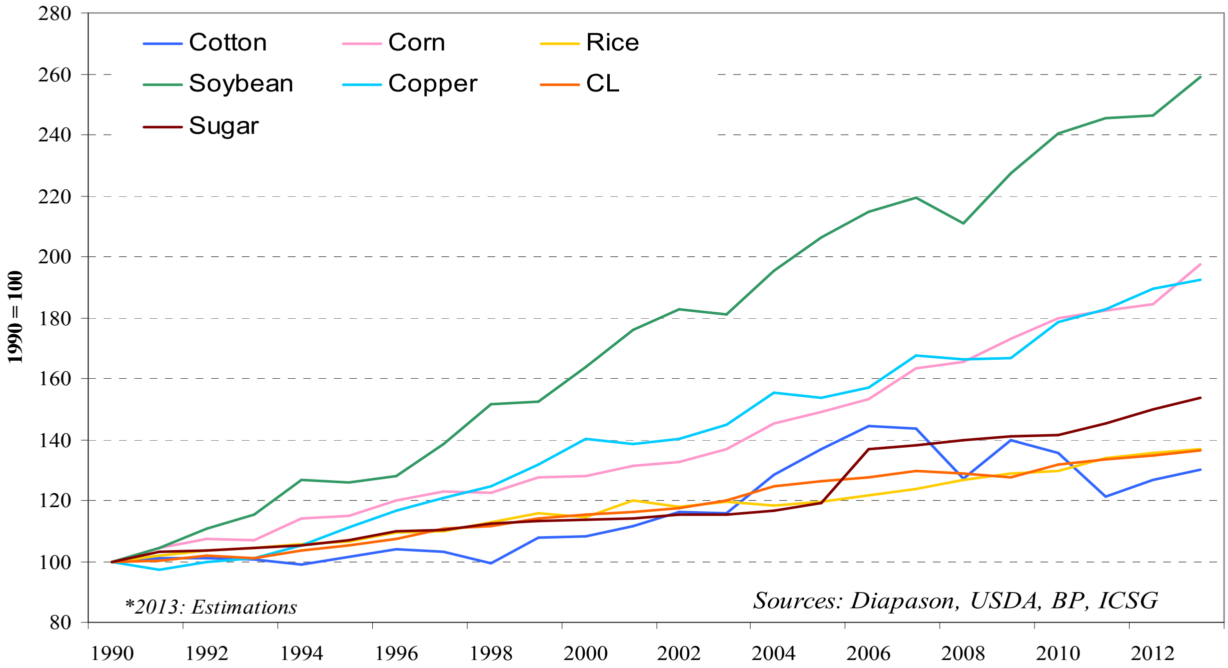
Moreover, the acceleration of global economic activity, which is now growing at a synchronous pace for the first time since 2010, is likely to boost commodity demand. Unlike demand for base metals which mainly comes from China, about half of the global demand for oil comes from OECD countries. The improved economic situation in both Europe and in the US should therefore contribute to a significant improvement in global oil demand growth this year.

While demand for commodities is improving, the supply side has also been supportive for commodity prices. The base metals and the energy sector are experiencing important supply disruptions amid low supply growth from the expensive and complex greenfield projects.

LME inventories of Tin, Zinc and Copper have declined sharply by respectively 33%, 10% and 46% since June last year, as supply failed to keep up with demand growth. Moreover, even if the production of copper-ore is expected to rise significantly this year, the limited smelting capacity is likely to keep the refined copper market in a narrow supply/demand balance.

In the oil sector, unusually high supply disruptions (at 3.0 million b/d, 3.3% of global oil demand) in Libya, Iran, Nigeria, Syria, Yemen and Nigeria have offset the rise in crude oil production in North America. Thus, weak supply growth in non-OPEC ex-North America countries is barely meeting global oil demand growth, forcing Saudi Arabia to keep its crude oil production at a high level. The relatively low level of Saudi spare capacity reflected the tight oil market. Thus, the fundamentals are supportive for prices of the most cyclical commodities.

World consumption in commodities
1990-2013*

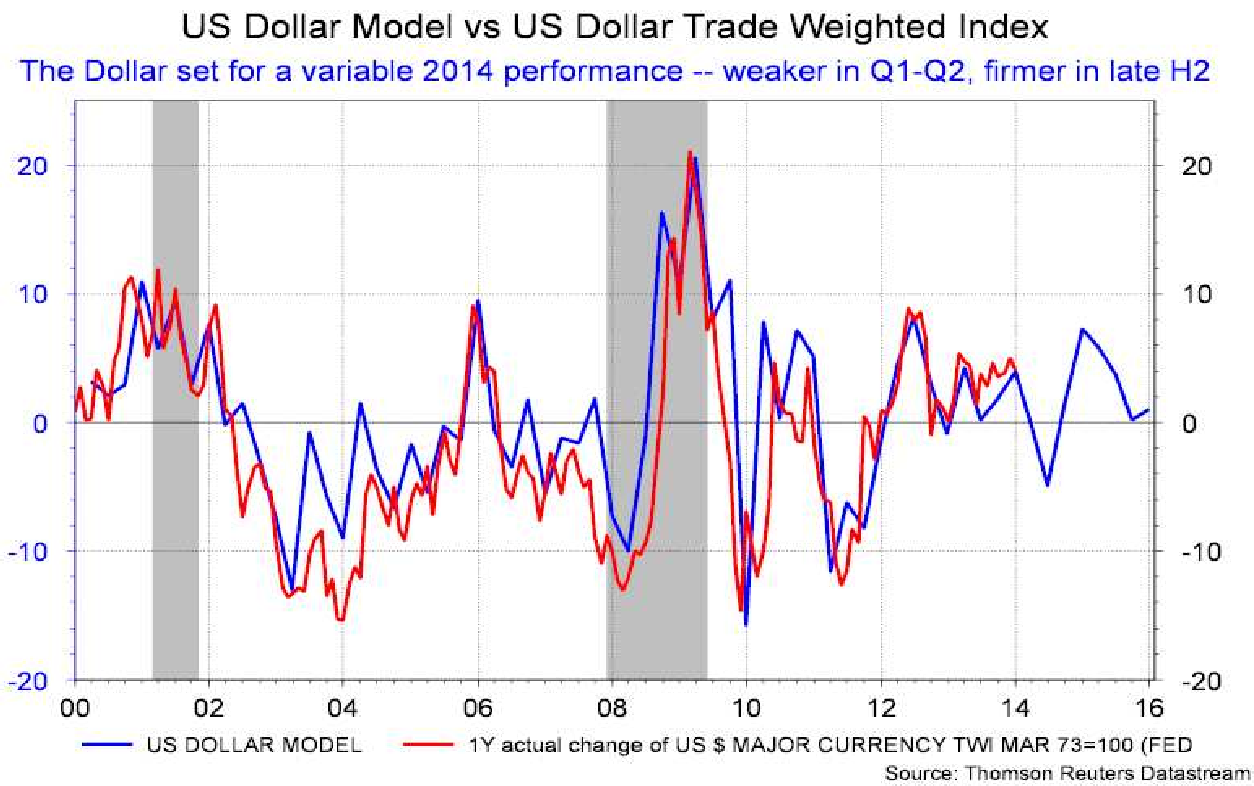


4. Monetary policies and the US Dollar

Similar to the bottom-up approach, the macro-economic environment is favourable to commodity prices. Loose monetary policy from the main Central Banks is indeed having a positive impact on the commodity sector. One critical issue for global monetary policy is whether or not the US Federal Reserve can manage to convince markets that rate hikes are still a distant threat, despite the tapering process which was initiated last month. Furthermore, the continuing benevolence of the other developed economy central banks in attempting to foster growth should moderate the price impact on risk assets of a progressive tapering trend.

Take the Bank of Japan, for instance. We believe the BoJ will carry out another easing to counteract the anticipated deleterious, short-term impact of the VAT hikes which will take effect in April, and to impart further momentum on the Abenomics initiative. In the Eurozone, falling inflation, slow progress on bank reform and slowing growth will be the focus for investment risk in 2014. But we believe that the ECB will respond to the threats to the recovery robustly.

The US Dollar has been strengthening in the past few weeks (as we expected) and will likely firm further in the very short-term. But there are risks to the currency in the short-term. The most significant driver for its recent strength is the perception that the Fed will continue to taper its QE3 securities purchases progressively. Interest rate differentials or differentials in money supply also counts (only now, money supply has been supplanted by central bank balance sheets' change rates, not changes in nominal amounts). This accounts for short-term variability.

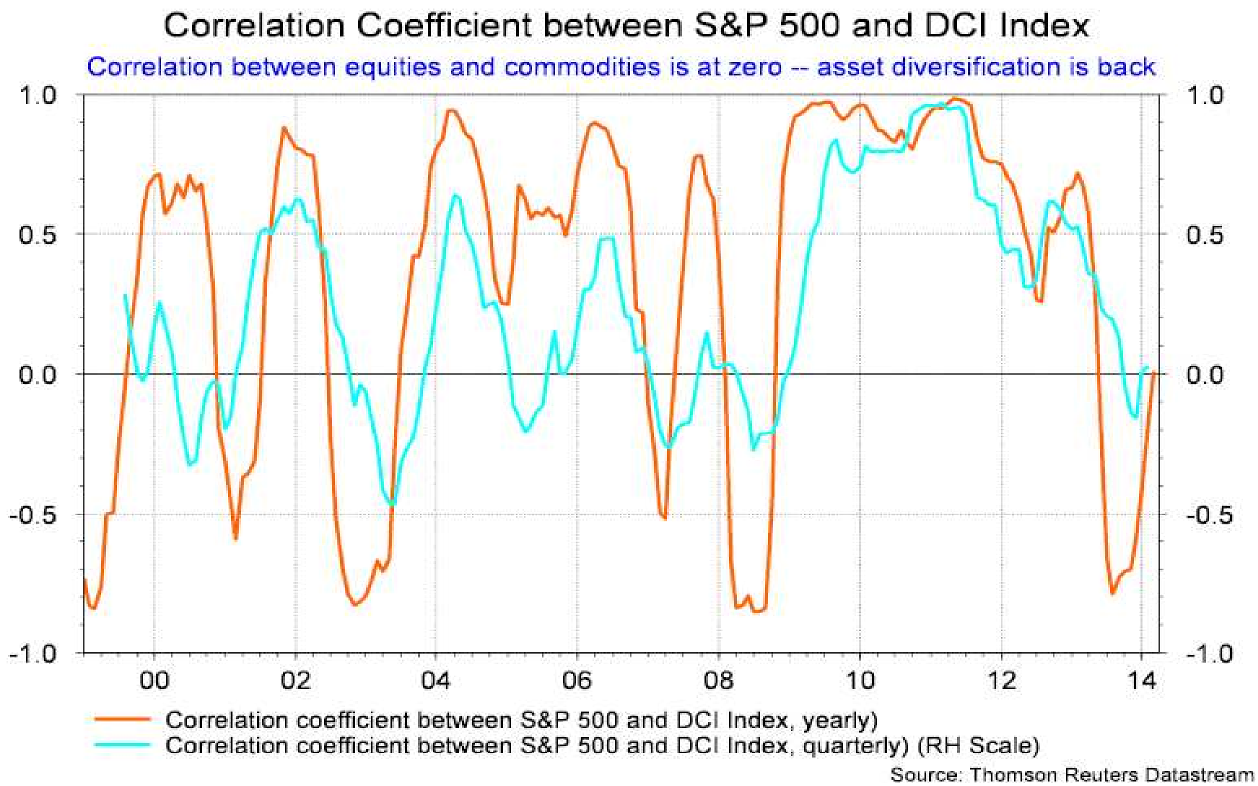


However, with Janet Yellen taking over the chairmanship of the Fed, this trend may not necessarily go on a straight line. Stanley Fisher, another "dove" like Yellen, will also assume the vice-chairmanship mantle — making two "doves" at the head of the Fed. There is a chance that disappointing growth, which we expect in early H1, will cause the Fed to reconsider the taper. Even the hint of stopping the taper should weaken the US Dollar (as we expect) in H1 2014. The weaker dollar would then have a positive impact on commodities.

5. Where are we in the Business Cycle / Relative Value

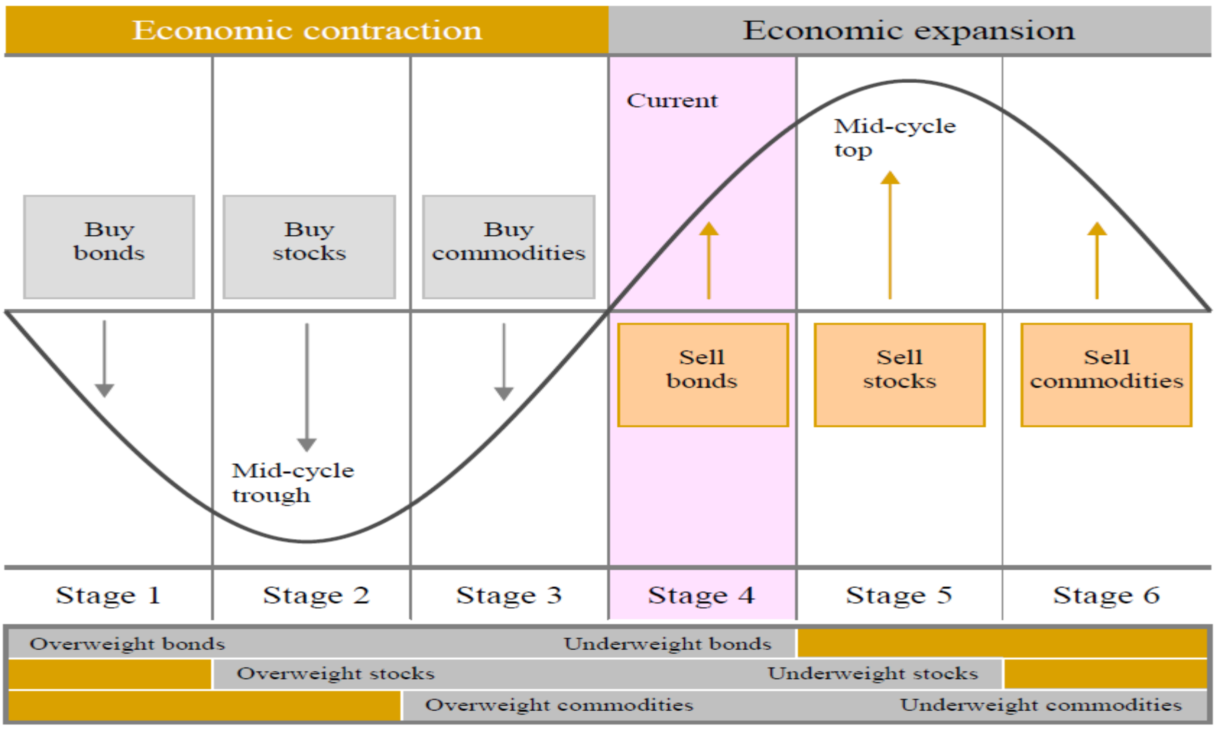
Worries of hard landing in China, so far unrealised, and exaggerated beliefs that the supply side of the equation has significantly increased, were the main reasons behind the lagging relative performance of commodities. However, the former now poses in our view the strongest potential outperformance over all other asset classes in 2014.

The decline in correlation with other asset classes can be viewed as the end of the peculiar mono-dimensional risk-on/risk-off behaviour generated by fear of a global economic collapse. Indeed, the strong rally of the equity market implies an improving global economy, which according to the business cycle asset rotation model should benefit commodities soon. The divergence between equities and commodities would also then imply that asset classes have returned to a normalised business cycle, which was interrupted after the financial crisis in 2008.



The latter suggests that a sector rotation is slowly taking place due to the structural rotation of asset classes in response to the changes in the phases of the credit/growth (business) cycle.

Asset class leadership rotation during the various stages of the business cycle



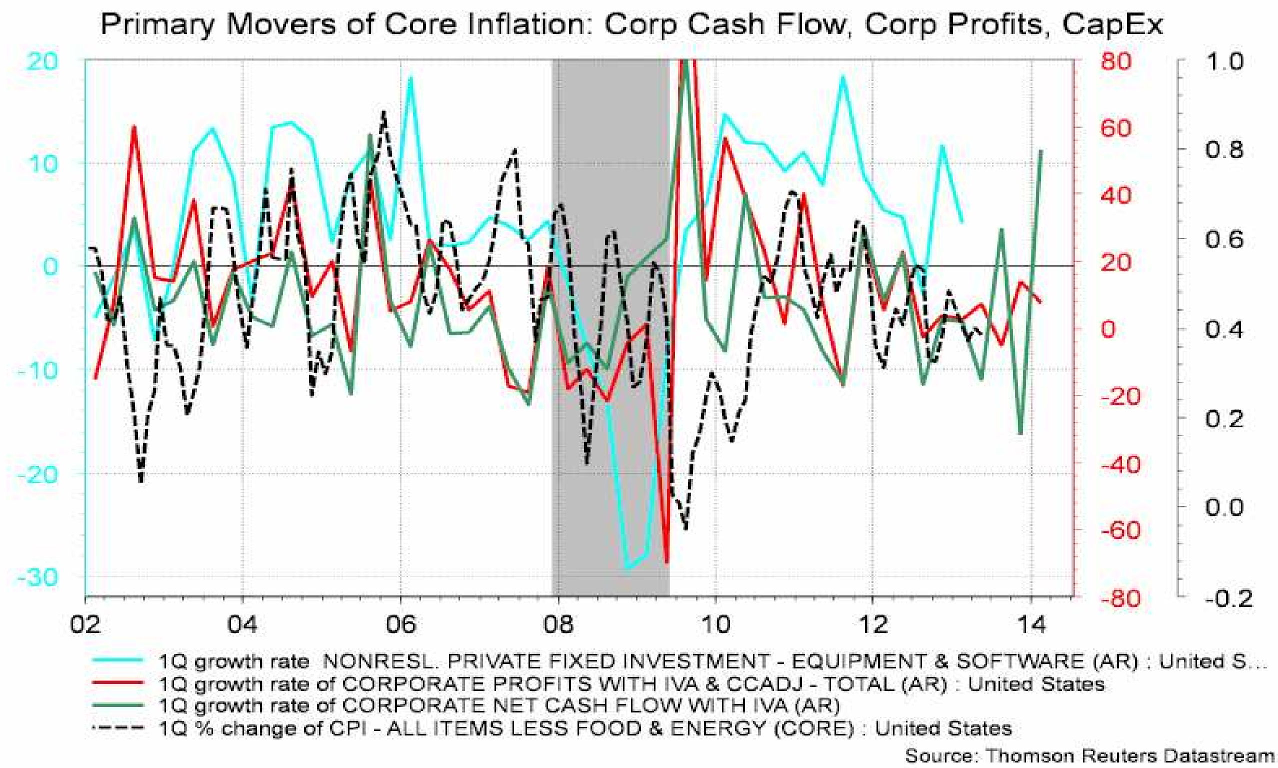
Sources: Pring Turner, Diapason

But this year, we may see the beginning of a shift in outperformance — as the sequential changes imply, it is commodities turn to lead the pack. If this is the case, (and we will soon see if our hypothesis gets the timing right), equities and commodities should rise together until the peak of the half-cycle, which we believe will occur in Q1 this year. But commodities will likely outperform at the late part of the plateau, while equities start to decline.

This is the sequence which we saw in late 2007, at the start of the Great Recession. As a matter of interest, we also point out that the same sequence was seen in 2001, after the top of the Technology Bubble. We may see that same commodities outperformance late in the current cycle sometime by Q2 2014, implying that commodities offer significant relative value against equities.

6. Portfolio construction and inflation: cheap inflation hedge are available now

Strong deflation risks, resulting from the financial crisis, have put aside fears of inflation these past 4 years. However, 2014 could well prove the year when inflation starts to increase. Several factors are indicating that this could be the case from loose monetary policy to the rise in real estate prices. Moreover, the acceleration of global economic growth combined with those factors has triggered a rebound in inflation expectations.



In this environment, commodities as a hard asset should naturally perform well as the rise in inflation affects commodities through two channels. First, the rise in inflation has usually a negative impact on the US Dollars, which in turn adds upside pressure on commodity prices. Second, money flows into the commodity sector usually accelerate when fears of inflation are rising as commodities are considered as an inflation hedge. A rise in commodity prices then feedbacks into higher inflation.

Most of the conditions are here to see a rise in inflation. Moreover, as previously discussed, commodities offer at this same time interesting value in absolute and relative terms. The asset class, for which sentiment remains depressed, can now be considered as a cheap hedge against an uptick in inflation.

In the environment described above, the asset allocation metric should lean heavily towards the deep cyclicals within the asset class. Moreover, the continuing dominance of China's requirements for commodities also becomes an important consideration when drawing up tactical allocations within the sub-sectors.

The combination of a global-wide recovery and China's continuing demand for raw industrials tips the scales in favour of base metals as lead sub-sector. Energy should come as a close second, and precious metals and agriculture should alternate between 3rd and 4th place as the year unfolds.

7. The End Game could be a policy mistake late in the year

As the economy shows more evidence of moderate recovery, fiscal and monetary policy makers begin to worry more about possible inflation and the growth of the federal deficit rather than on the ability of the economy to sustain the current recovery. The deficit has been cut rather sharply in the past two years (by 24% from October 2012 to October 2013 alone), and the Fed started to taper its purchases of securities under the QE3 program last month. These twin trends are reminiscent of the recovery setback in 1937-1938 due to both fiscal and monetary policy mistakes, which added five quarters to the recovery period.

So with recent economic data suggesting the current recovery is not strong enough yet to achieve escape velocity, there is considerable concern from us whether the economy risks a replay of a 1937-38 style recession due to policy mistakes. In the 1937-1938 period, the mistakes fell into three broad categories: (1) a shift in monetary policy that caused a credit contraction in 1937; (2) a premature end to fiscal stimulus (i.e., deficit spending by the government) before the private sector was strong enough on its own to sustain economic growth; (3) regulatory and legislative reform programs enacted by the Roosevelt administration, which led to uncertainty and fear on the part of business and a reluctance to continue hiring and investing (American Century, October 2010).

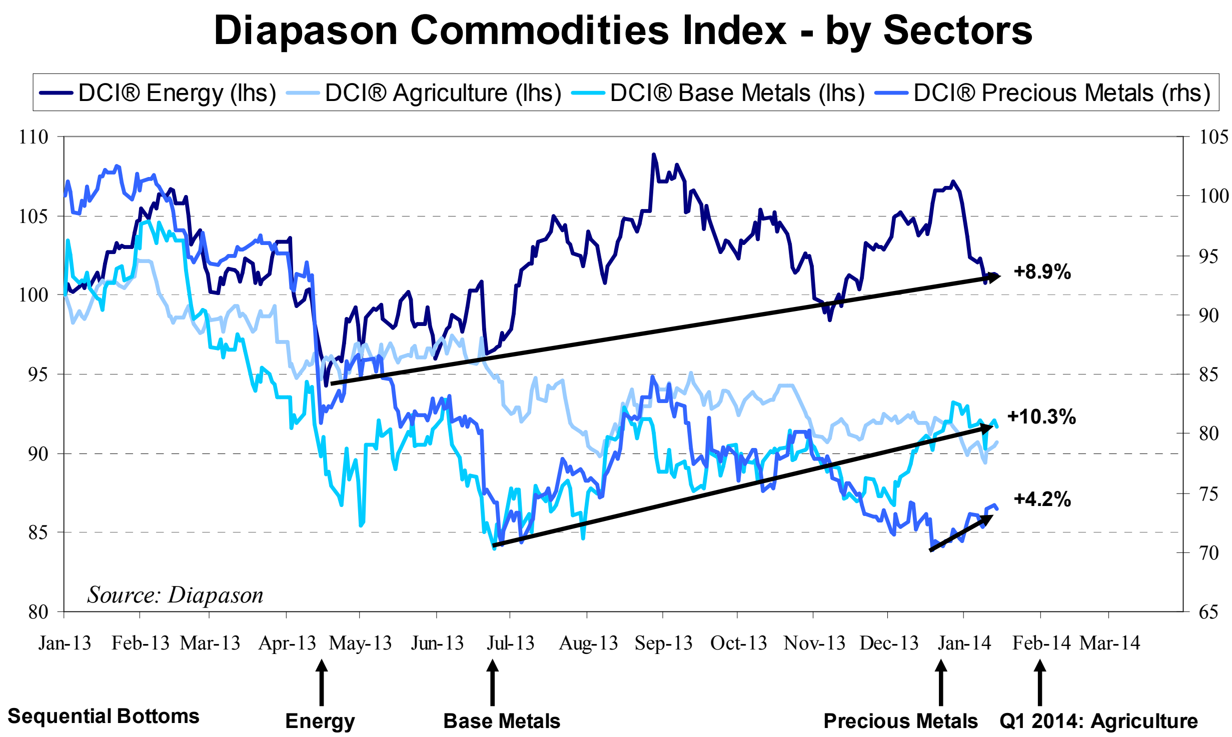
What's interesting about these arguments is they are also in the news today as criticisms or concerns beset current fiscal and monetary policy. The budget deficit has been cut sharply in the past two years, the Fed is tapering its security purchases (a de facto tightening by any measure), banks are reluctant to lend and US corporations are sitting on a $5 trillion cash hoard as they await a resolution of uncertainty over the consequences and costs of major new legislative and regulatory initiatives such as the Obama Care, the Dodd-Frank financial reforms and the Consumer Protection Act.

The fiscal situation for us is close to a tipping point, and if the Fed likewise tightens prematurely late in the year due to hopes raised by a "false dawn" in the recovery, then all the elements that had given rise to the Recession of 1937-1938 would be present.

8. Market structure and sequential bottom

The slight decline of the overall commodity sector masked the relative good performance of some commodity sectors. In fact, the most cyclical commodity sectors have made their bottom in the second quarter of last year. The energy sector made a low in April 2013, followed by the base metals sector at the end of June 2013, driven by the acceleration of global growth.

The sequential bottoms continued in December 2013, with the precious metals sector's bottom. The agriculture sector is expected to reach its low in the first quarter of this year. The fact that sectors have been bottoming one after the other is the main reason why commodity indices have stayed in a base last year and do not give the best picture of what is happening.

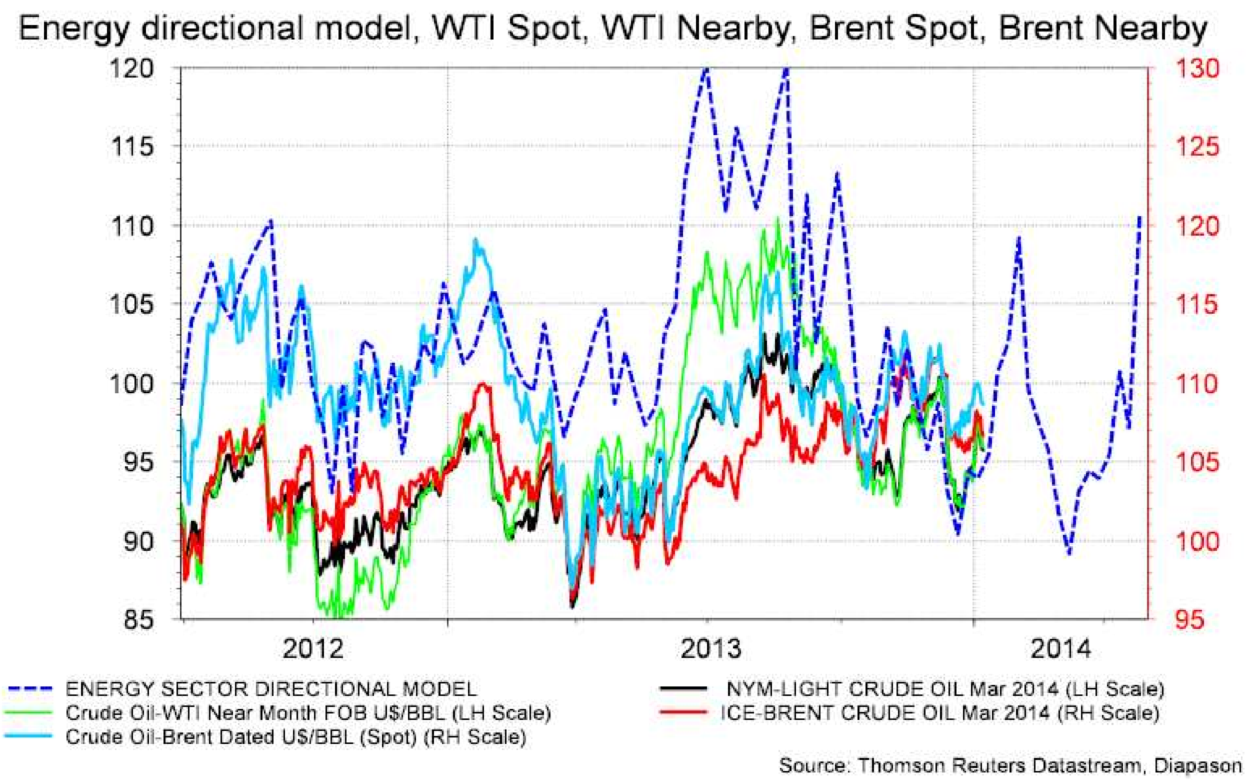


Conclusion

Last year, the commodity sector underperformed by a large extent the equity markets due to unrealised fears of China hard landing and the possible end of the commodity super-cycle. This contributed to bring the sentiment to depressed levels. Yet the commodity sector is not dead. In fact, underlying fundamentals and the macro-environment are being more supportive for commodity prices today than last year.

The Chinese economic activity is accelerating and new policy measures implemented by the new leadership are likely to be supportive for commodity demand growth amid supply issues in key commodity markets. Growth-oriented monetary policies and the expected weakness in the US Dollars would also add upside pressure on commodity prices. The normalisation of the business cycle also indicates that commodities are set to outperform other asset classes. In sum, the commodity sector offer now significant value relative to the equity market and can now be considered as a cheap hedge against the uptick in inflation.

In our opinion, commodity prices could increase by 15%-20% between Q1 and Q3 2014. Within the commodity complex, energy is expected to lead the pack, followed by base metals, precious metals and agriculture during the EM turmoil. But once this episode passes over which should be soon, base metals should dominate as the cycle reasserts and China rebounds.



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