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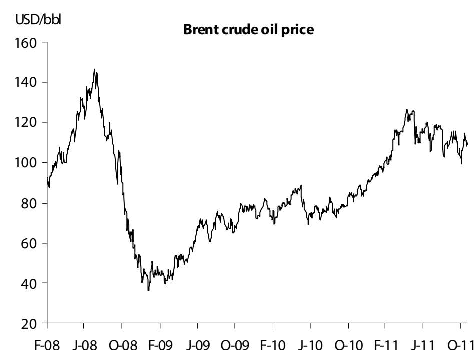
Commodities: Lower prices across commodity complexes, but upside risks persist

- The steady increase in commodity prices over the past year has been followed by a meaningful correction over the summer, due to concerns over weaker global growth prospects.
- However, most commodity prices remain relatively high compared to historical levels mainly due to tight supplies.
- We believe that commodity prices should remain around current elevated levels through the end of 2011, supported by robust demand from emerging economies and the persistence of tight supply/demand fundamentals in most commodity complexes.
- Precious metals have the highest upside potential, due to investment-related factors.
- Tight supply and demand dynamics are expected to keep oil prices at historically relatively high levels and leave the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks.
- In the agricultural sector, factors such as low inventory levels, elevated oil prices, increasing frequency of extreme weather events, geopolitical turmoil and structural changes in consumption patterns in emerging economies are expected to continue to exert upward pressures on agricultural prices in the medium term.
- Robust growth in emerging economies is expected to provide a floor to downside risks on base metal prices.

Since mid-2010, commodity prices have risen significantly, mainly on the back of strong gains in global demand and disruptions to global supply. Brent crude oil prices have soared above US$ 125/bbl in early April 2011 (Figure 1), while gold prices hit an all-time nominal high of $1895/toz (Figure 2). Agricultural prices as well as industrial metals also performed well, reaching new multi-year highs. However, in early May, concerns over weaker global growth prospects, which had been steadily growing over the summer, finally manifested in equity markets. In particular, mounting fears that the US will slide into recession and that emerging economies will eventually be affected triggered excessive liquidations in equity markets across the globe. The heavy liquidations also spread to commodity markets amid worries for the economic outlook of emerging economies, which have been the

Figure 1



Source:Bloomberg

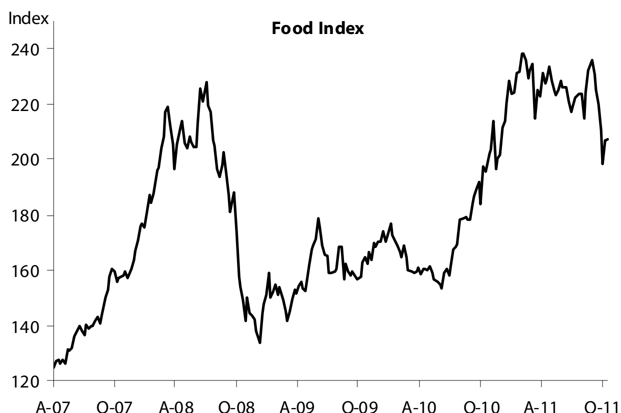
main source of accelerating commodity demand growth in recent years. The sales in commodity markets are also attributed to a large extent to investors taking profits, in order to offset losses in other asset classes. As a result, the steady increase in commodity prices has been followed by a meaningful correction over the summer.

Figure 2

Source: Ecowin

However, most commodity prices remain relatively high compared to historical levels. Brent crude oil prices are about 35% above its levels a year earlier. Although gold prices slipped to below $1700/toz at the end of September, their gains for the year to date are standing at about 20%. Food prices are more than 10% higher than a year ago and close to their 2008 highs (Figure 3).

Figure 3



Source: Ecowin, The Economist Food Price Index

In most commodity complexes, tight supplies help explain why some commodity assets such as oil and gold have proved very resilient in the face of recent economic and financial uncertainty. The 2008-2009 recession along with the current financial meltdown has had significant implications for capacity expansion in many commodity markets and has played a significant role in reducing the pace of supply growth. The latter has also taken a hit from extreme weather events and the escalation of geopolitical turmoil in the Middle East.

Looking forward, we believe that commodity prices should remain around current elevated levels through the end of 2011, though should remain particularly volatile, due to the high level of uncertainty surrounding the global economic environment. Robust demand from emerging economies and the persistence of tight supply/demand fundamentals in most commodity complexes are expected to support high levels of commodity prices. Particularly, downside risks on commodity prices from the weakening demand in developed economies will be more than offset by emerging economies, the major driver of commodity demand. In fact, the emerging world accounts for about half of global oil and gold demand, while China is today the largest consumer of a number of base metals. In these countries, despite the ongoing slowdown, growth is expected to remain robust for several reasons. First, there is still room for fiscal easing to support growth, given that emerging markets' (EM) fiscal situation is relatively healthy compared to advanced economies. General government gross debt in emerging and developing economies was 39.3% of GDP in 2010, well below that of advanced economies (100% of GDP in 2010). Second, the end of the monetary tightening cycle in emerging economies is expected to ease some of the headwinds that interest rate hikes brought to real incomes and private consumption since the tightening cycle in EM has started, approximately a year ago. Third, domestic demand in EM is particularly strong and a number of EM, in particular China, have already indicated policy reforms aiming at rebalancing their economies from foreign to domestic demand and, thus, supporting steady improvements in private consumption. Meanwhile, the abovementioned significant implications for capacity expansion in many commodity markets are likely to continue to contribute in reducing the pace of supply growth over the coming years. The recent surge in both the frequency of extreme weather events and geopolitical threats, in combination with low inventory levels and falling surplus capacity contribute to increased upside risks on commodity prices.

Concerning the main commodity complexes, we believe that precious metals have the highest upside potential, due to investment-related factors. In particular, gold will continue to benefit from safe haven demand from both the private and the official sector, given the still heightened uncertainty concerning the extent of the sovereign debt crisis and, most importantly, the potential spillovers to the real economy. It is worth noting that, according to the World Gold Council (WGC), in 2010, the official sector became a net buyer of gold for the first time in 21 years.

This switch of the official sector is in itself a positive factor for gold price dynamics, given that the sector has been a significant supplier of the metal over the period 1989-2007 at an average release of 400-500 tones/year. Furthermore, the US Federal Open Market Committee's (FOMC) announcement of "Operation Twist" attempts to reduce long-term US interest rates by changing the composition of its balance sheet. Under such a scenario, real long-term yields are likely to decline, due to the dual effect of lower nominal rates and an increase in future inflation expectations. This suggests upside risk to gold prices, as the long-term opportunity cost of holding gold declines. Looking at the demand side of the gold market, according to the latest Gold Demand Trends report from the WGC, demand for gold in Q2 2011 was 919.8 tones –the second highest quarterly value on record, with India and China the major contributors. In line with our expectations, the WGC expects gold demand to continue to be supported by China and India for the remainder of 2011.

Regarding the energy complex, tight supply and demand dynamics are expected to limit downside risks to oil prices, stemming from declining demand from developed economies. Indeed, tight dynamics keep oil prices at historically relatively high levels and leave the oil market rather sensitive to potential supply disruptions from geopolitical or other kinds of risks. On the supply side, non-OPEC oil production has proved disappointing since the beginning of the year. According to the latest US Energy Information Administration's (EIA's) forecasts, non-OPEC oil production, which accounts for about 60% of world oil supply, is projected to increase by 490 thousand bbl/d (0.9% y-o-y) in 2011. This represents the lowest annual increase since 2008 in terms of both absolute and percentage change. As far as oil demand is concerned, solid Chinese demand should continue to provide support to oil prices. China's economic performance is expected to remain robust and steady growth rates should continue, underpinning both consumer and industrial demand growth. EIA's latest forecasts suggest that China's oil consumption will increase by 9.0% y-o-y in 2011, which is the third largest annual growth rate since 2004. Increased demand for oil is also stemming from Japan in the aftermath of the Tohoku earthquake, since the latter forced the shutdown of oil refineries and nuclear power plants in Japan. A boost to Japan's oil demand is expected during the period of reconstruction which is more likely to take place mainly over the end of the year and in 2012. Following Japan's earthquake, Germany has decided to close its nuclear plants, suggesting that the ongoing substitution of more conventional sources of energy for nuclear power will constitute a significant factor for upside pressures to oil prices.

In the agricultural sector, factors such as low inventory levels, elevated oil prices, increasing frequency of extreme weather events and geopolitical turmoil are expected to continue to exert upward pressures on agricultural prices in the medium term. Furthermore, expanding income and population growth and structural changes in consumption patterns in developing countries (e.g. rising incomes boost meat and dairy consumption) suggest increasing demand for agricultural products and, therefore, elevated global food prices in the long term.

Base metals have been proved the weakest commodity sector as it is the most economic growth-sensitive commodity complex (Figure 4). The LME (London Metal Exchange) Metals Index has fallen by about 30% since its peaks in April 2011. With the risk to the global economic outlook still elevated, vulnerabilities across base metals are on the upside in the short-term. However, economic weakness is mainly concentrated in developed markets, which are not the key driver of base metals demand growth. In contrast to developed markets, emerging markets' and particularly China's demand for base metals has been the main determinant of increasing prices over the past years, given that these economies are undergoing a phase of industrialization and infrastructure building. Hence, we believe that the expected resilience of emerging economies is likely to provide a floor to further downside in base metal prices.

Figure 4

Source: Ecowin

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