A BULLISH OUTLOOK FOR COMMODITIES

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Last week, we had the pleasure of hosting Ed Morse, head of commodities research at Citi, on our Behind the Markets podcast to discuss his outlook for commodities.

Most commodities today have seen a lack of investment in new exploration, particularly across metals. The incremental demand, with supply constrained, pressures prices higher.

Commodities today are generally in contango, where the futures price is higher than the spot price, but Morse sees this changing to a case of backwardation, where the futures price becomes lower than the current price. This will change the environment for the monthly rolling of futures contracts, going from a cost to a net positive for investors in futures.

This was also the case for the last super cycle for commodities. We had a strong market that was in backwardation, so investors were paid to roll their contract positions forward each month, and commodities prices were going up.

The COVID-19 pandemic delayed this inflection point for roll yields from happening sooner, as it caused less demand for commodities, and transportation fuels in particular. Inventories built up significantly but are now drawing down. In Q4, the supply of oil is down 9%–10% from last year. Some of this production decline is the lack of investment and capital expenditures, particularly in the U.S.

In Q4, Morse sees demand for oil down 4%–5% year-over-year. With supply down 9%–10%, inventories will continue to draw down around five million barrels a day. This is particularly rare in September, when inventories are usually building following the driving season.

Gold's Rise Is Not Ephemeral: Bullish moves in gold and silver tend to be longer-lasting. Morse sees gold as an inevitable and attractive macro investment in a world of low interest rates, and consensus is this low rate environment will last for years to come. During all gold sell-offs, Morse sees a good opportunity to buy since holders are selling to create liquidity from other assets declining.

Morse also sees silver as a safer bet than gold, with an outlook for it to rise into the $45–$50 range based on the historic relationships between the two metals.

Long-Term Super Cycles: The last super cycle for commodities was driven by China, which had a 20-year period with fixed asset investment rising more than 20% per year. Morse is intrigued by the potential for Africa to contribute to a longer-term cycle. Africa is leading the globe in the number of 18-year-old workers entering the economy. Three percent of electricity generated in the world is in Africa, a continent where the population is growing tremendously, and household income is starting to grow. Raw materials should see higher growth from Africa.

Commodities with Bearish Outlook: Iron ore and thermal coal are two commodities Morse points out that have more d eflationary forces. When China built at least 10 cities with one million people or more annually for 20 years, there was huge demand for iron ore. That urbanization thrust is over. At the same time, a scrap market for steel is building. Demand is going down, while we have more than ample supply.

Trade Tensions: In 2017–2018, trade was booming at very elevated rates that came to a halt with the U.S. tensions with China. Trade growing again would be very positive for commodities. A Biden election victory could change our China relationship. The U.S. also would go back to a World Trade Organization (WTO) trade framework, which suggests that U.S. tariffs violated international agreements. We can then see trade growth going back to levels similar or higher than global GDP growth, which is good for commodities.

You can listen to our full conversation with Ed Morse below.

Behind the Markets on Wharton Business Radio · Behind The Markets Podcast: Ed Morse & Mobeen Tahir

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DEFINITIONS

Contango : A scenario when the futures price is above the spot price. .

Futures/Futures Contract : Reflects the expected future value of a commodity, currency or Treasury security.

Spot price : The current price at which a particular security can be bought or sold at a specified time and place.

Roll Yield : The yield that an investor in futures receives as the long position converges to spot. .

Bullish : a position that benefits when asset prices rise.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Deflation : The opposite of inflation, characterized by falling price levels.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.