

# RECESSION MAY BE A RED HERRING FOR A MARKET FUELED BY A SUPERCYCLE

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**11/08/2022**

While broad [commodities](#) have outperformed most major asset classes year-to-date,<sup>1</sup> the pressure of rising [interest rates](#), a strong U.S. dollar and fears of several large economies tipping into recession have led to a pullback since the summer of 2022. We believe that the current negative business cycle pressures on commodities are likely to be temporary and give way to the larger forces pushing the demand for commodities higher and constraining the supply of those commodities.

Historically, commodities have been a [cyclical](#) asset class, generally declining when the business cycle turns negative. But even history illustrates that commodity prices can continue to rise long after a business cycle has turned if fundamentals are supportive. Oil price shocks in the 1970s and 1980s are a case in point. Admittedly, they are unusual cycles, but today, we are likely to be living in another energy price shock.

## Energy Price Shocks Continue

Since we published our Market Outlook, the [Organization of the Petroleum Exporting Countries and partner countries \(OPEC+\)](#) has announced a large cut to oil production from November 2022, amounting to two million barrels per day. As we expected in our Outlook, OPEC+ reacted to the price weakness in oil after the summer and sought to raise the price of Brent oil to more than \$90/barrel (prices had fallen to \$84/barrel on September 26, 2022, just over a week before the OPEC decision). It has been successful in keeping prices above \$90/barrel since that decision but has laid the groundwork for further cuts by painting a pessimistic picture on demand forecasts (giving the group an excuse to intervene in the market again).

Meanwhile, the war in Ukraine shows no sign of improving, and natural gas supplies into Europe from Russia have fallen to a trickle. The European Union has taken various measures to try to soften the shock. However, we view several of the proposals with skepticism. For example, introducing price caps on natural gas imports could simply divert natural gas to other countries and worsen the energy shortage for the EU. Interfering with price benchmarks, such as the [Title Transfer Facility \(TTF\)](#), could send incorrect pricing signals and lead to overconsumption of energy, resulting in additional shortages.<sup>2</sup>

## Supply Shortages of Commodities Extend Beyond Energy

A combination of rising energy prices and interest rates has driven many metal smelters to shutter production. High fertilizer prices (petrochemical product) are also constraining crop yields.

Looking across the commodity spectrum, all commodities have lower-than-normal levels of inventory

	Current Inventory Relative to 5-Year History	YTD Performance
<b>Energy</b>		
Oil – U.S.	-1.20%	6%
Oil – OECD Europe	-4.90%	13%
Natural Gas – U.S.	-9.60%	81%
Gasoline – U.S.	-0.30%	11%
Heating Oil – U.S.	-12.60%	45%
<b>Industrial Metals</b>		
Aluminum	-68.70%	-23%
Copper	-51.20%	-23%
Nickel – LME	-74.10%	1%
Zinc	-62.40%	-1%
Lead	-38.40%	-18%
Tin	-21.20%	-47%
<b>Agriculture</b>		
Wheat	-6.40%	20%
Corn	-0.50%	14%
Soybeans	-1.80%	3%
Sugar	-1.20%	-2%
Cotton	-1.10%	-17%
Coffee	-4.90%	-2%
Soybean Oil	-0.50%	16%

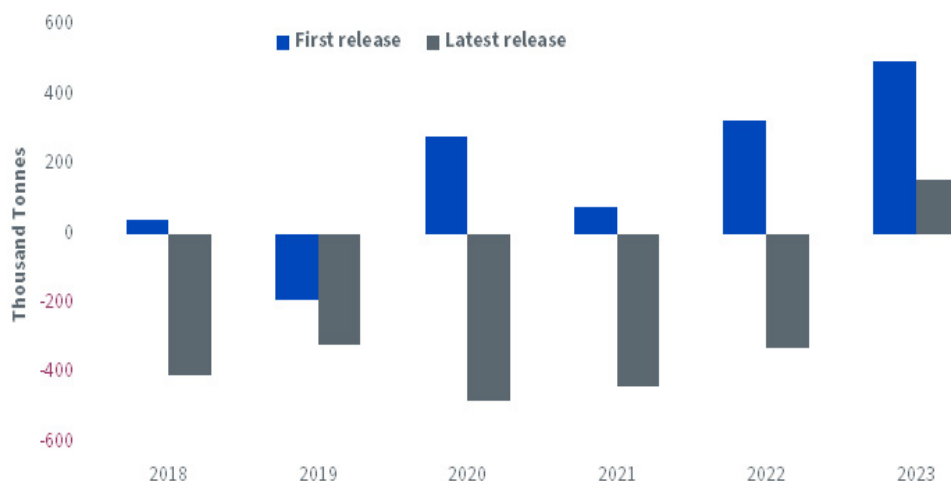
Sources: WisdomTree, Bloomberg. Data as of 9/30/22. Agricultural inventories as reported by the United States Department of Agriculture (USDA). U.S. Energy inventories as reported by the United States Department of Energy. Industrial metals inventory refers to exchange inventory summing stocks reported by the London Metals Exchange, Shanghai Futures Exchange and Chicago Mercantile Exchange. Price performance using the first generic futures contracts of commodities in the Bloomberg Commodity Index. Past performance is not indicative of future results.

### Base Metal Supply Is Especially Low

Looking at the table above, the inventory of base metals is considerably lower than their respective five-year averages, yet base metals have seen the largest price declines of all the commodity sub-sectors. The markets are pricing in demand weakness from an economic deceleration. However, demand has not weakened yet. On the other hand, supply is declining fast.

Let's take the example of copper. [The International Copper Study Group \(ICSG\)](#)'s first forecast for 2022 copper balances (demand less supply), cast in October 2021, was for a sizeable surplus of 328,000 tons. Its latest forecast (cast on October 19, 2022) is for a deficit of 328,000 tons in 2022. Judging by historical revisions, their 2023 forecast of a surplus is likely to be revised down. Their initial forecasts tended to assume no production disruptions. Yet, as we have observed this year, production disruptions can be very large.

### Copper Forecasts Revised to a Supply Deficit Again in 2022



Sources: WisdomTree, International Copper Study Group (ICSG). ICSG's latest forecast from 10/19/22. Forecasts are not an indicator of future performance.

### China's Economic Deceleration Is Countered by Policy Support

China's "zero-COVID" policies have slowed economic growth and thus, its demand for commodities. Despite a lot of speculation that China will ease on zero-COVID policies at the beginning of November 2022, on November 5th 2022, a spokesperson from the National Health Commission's disease prevention and control bureau said China will stay the course on coronavirus restrictions. That matters because China is the largest commodity consumer in the world.

However, its [central bank](#) has been loosening policy and President Xi has called for an 'all-out effort' to increase infrastructure spending (and given local governments free rein to raise debts financing to fund these projects). At China's 20th Communist Party Congress which completed last month, Xi Jinping clinched his third five-year term in charge of the nation. His speech pointed to national security taking a greater role in policy priority than the economy.

### Commodity Supercycle

An energy transition and a revitalized global infrastructure spend are likely to drive the demand for commodities significantly higher over the coming years. However, today we are living in the down-phase of a business cycle. Even though many commodity markets are visibly tight, commodities are not sufficiently pricing in the tightness. In the U.S., the [Inflation Reduction Act](#) and the [Infrastructure Bill](#) are both strong tailwinds for commodity demand. In Europe, the sharp focus on weaning off Russian energy dependency is adding new urgency to the energy transition, and we expect to see accelerated energy infrastructure plans take place.

### Conclusion

As a headline, economies going into recession doesn't inspire huge confidence in a commodity rebound. However, history does suggest that an economic slowdown combined with high [inflation](#) has been associated with positive commodity and gold performance. The energy price shock has set off a vicious circle of supply contraction from metals, fertilizers and other energy-intensive commodities. The energy transition- and infrastructure-led supercycle remains in play even if short-term business cycle phenomena dictate headlines today. As we emerge from this phase of the business cycle, we may find commodity markets extraordinarily tight.

Nitesh Shah is an employee of WisdomTree UK Limited, a European subsidiary of WisdomTree Asset Management Inc.'s parent company, WisdomTree Investments, Inc.

<sup>1</sup> Year-to-date (12/31/21 to 10/21/22) performance of Bloomberg Commodity Index, 13.75%; S&P 500, -22.10%; Bloomberg Global Agg Sovereign, -27.99%; FTSE EPRA NAREIT, -31.04%. Source: Bloomberg data in total return terms. For definitions of indices please visit the [glossary](#).

<sup>2</sup> "[Commission makes additional proposals to fight high energy prices and ensure security of supply](#)," 10/18/22.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

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## DEFINITIONS

**Commodity** : A raw material or primary agricultural product that can be bought and sold.

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

**Cyclical sectors** : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

**Organization of the Petroleum Exporting Countries Plus (OPEC+)** : A loosely affiliated entity consisting of the 13 OPEC members and 10 of the world's major non-OPEC oil-exporting nations.

**Title Transfer Facility (TTF)** : A virtual trading point for natural gas in the Netherlands.

**International Copper Study Group** : An intergovernmental organisation of copper producing and consuming States that functions as the international commodity board for copper.

**Central bank** : Refers to the the monetary authority of any country.

**Inflation Reduction Act** : The Inflation Reduction Act of 2022 is a landmark United States federal law which aims to curb inflation by reducing the deficit, lowering prescription drug prices, and investing into domestic energy production while promoting clean energy.

**Infrastructure Investment and Jobs Act** : The Infrastructure Investment and Jobs Act, also known as the Bipartisan Infrastructure Bill and originally in the House as the INVEST in America Act, is a United States federal statute enacted by the 117th United States Congress and signed into law by President Joe Biden on November 15, 2021.

**Inflation** : Characterized by rising price levels.