What's Hot: Industrial metal cyclicality is only skin-deep

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Industrial metals prices are traditionally cyclical

Industrial metals have historically been cyclical. In this current downturn, we are finding that metal prices are suffering, as they have done in the past.

Source: WisdomTree, Bloomberg. Industrial Metals = Bloomberg Industrial Metals Subindex Total Return. January 2002 to August 2022. OECD composite leading indicator (CLI) is designed to provide early signals of turning points in business cycles, showing fluctuation of the economic activity around its long-term potential level. CLIs show short-term economic movements in qualitative rather than quantitative terms. CLI is amplitude adjusted, Long-term average = 100.

Historical performance is not an indication of future performance and any investments may go down in value.

However, the importance of base metals in delivering the energy transition has never been greater. We are currently living in an energy crisis exacerbated by the war in Ukraine. Europe wants to accelerate the energy transition to reduce reliance on Russian energy sources. That will place a higher onus on renewable energy sources coupled with battery storage to meet our energy needs. In short, that will require a lot more metals. However, the production of many base metals is declining. That's partly due to falling prices, making it more difficult to justify the capital expenditure. Also, high energy prices are making the smelting of metals uneconomical[1].

We believe there is a risk of supply destruction of base metals due to the energy crisis being greater than the demand destruction coming from a decelerating economy. So, while sentiment may be weighing on metal prices right now, the fundamentals may be tighter than the market assumes. That could pave the way for a substantial rebound in metal prices when the market refocuses on supply imbalance and sentiment turns.

Inventories are low

It is clear from the table below that industrial metal inventory is especially low. We do not believe the year-to-date price performance reflects that degree of tightness. And there is ample room for an upward correction.

Source: WisdomTree, Bloomberg. Data as of 20th September 2022. 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.

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Most base metals are in backwardation

With the exception of aluminium and nickel, all base metals are in backwardation. Backwardation is when spot or front-month futures contracts are priced higher than the price of contracts for delivery in later months. The fact that someone is willing to pay for immediate delivery rather than entering a contract for delivery in a few months' time indicates that they need the material urgently. Thus, the backwardation structure of futures markets is another indication of market tightness.

Source: WisdomTree, Bloomberg. Data as of 20th September 2022. Using London Metals Exchange contracts. Lines below '1' indicate a market in backwardation.

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Production is hampered

Surprisingly, aluminium and nickel are not in backwardation like the other base metals. The inventory table seems to indicate that metal availability is the worst for these two metals. Looking at European aluminium production data this year (to July 2022, the latest data point available) relative to production in 2021 over the same period, production is down 11%. A surge in China's summer temperatures in August 2022 has led to a power crisis, resulting in curtailed power supply to the industrial sector in Sichuan province. Aluminium is very energy-intense to produce.

Source: WisdomTree, Bloomberg New Energy Finance, International Aluminium Institute. August 2022. Using London Metals Exchange contracts.

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Inflation Reduction Act and European policy on energy transition

European policymakers are currently debating the path to secure energy independence from Russia. In her State of the Union speech on 14th September 2022, Ursula von der Leyen, President of the European Commission, emphasised investing further in renewable energy and hydrogen in particular. These investments will be metal demand positive.

In the US, the Inflation Reduction Act, which was signed into law in mid-August, sets out several initiatives to reduce inflation. The US also recognises that energy reform is part of the puzzle. The bill includes circa

$390Bn of spending/credits over the next ten years related to energy and climate change, with the goal of putting the US on the path towards 40% emissions reductions by 2030.

The bill takes steps to enhance energy security and provides credits to help tackle climate change. There are incentives for cleaner fuels (e.g. hydrogen), for consumers to electrify appliances/upgrade home energy efficiency, and tax credits for buying electric vehicles. We expect the bill will be metal demand positive.

Conclusions

We believe supply destruction is occurring at an equal or faster pace than demand destruction in the base metals space. However, metal prices are currently falling, mirroring historical cyclical patterns for industrial metals. When markets refocus on the fundamentals, we may find prices correct to the upside. Our long-term projections for industrial metal demand – underpinned by an infrastructure rebound and energy transition – remain firm.

[1] See Zinc and aluminium supply tightening amid energy price shock

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