WisdomTree Commodity Outlook - The commodity renaissance

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Our commodity outlook for the coming year will be shaped by three major drivers:

1.A higher inflationary environment than we have seen in recent decades

2.A structural increase in demand for commodities driven by an infrastructure boom

3.A renewed focus on the environment which will increase the demand for certain commodities and at the same time present challenges for supply growth

While none of these drivers is new, and we have been talking about them for the past nine months, in this outlook, we will provide an update on how each of these drivers is progressing.

Although we have been talking about inflation rising for some time, the market seems to have been caught by surprise. Figure 1 shows an Inflation Surprise Index, i.e. the extent to which actual inflation has come in higher than expected by the market. For the US, the latest reading is at a series high. While the Euro area may have seen bigger surprises in the past, the index is trending higher. At a global level, the index is just shy of its all-time high in 2008 and could reach a fresh high in the coming months.

Source: WisdomTree, Citi Group, Bloomberg, data from January 1999 to September 2021. They are defined as weighted historical standard deviations of inflation data surprises (actual releases vs Bloomberg survey median). A positive reading of the Inflation Surprise Index suggests that inflation releases have on balance been beating consensus.

Inflation higher for longer

We believe that the mantra of “elevated inflationary pressures are transitory” that central banks have been chanting for some time is getting harder to believe. However, at the same time, we don’t think that most central banks will be able to address the root causes of inflation through monetary policy alone. Supply-side shocks are responsible for a lot of the inflation pressure today, and tightening monetary policy either by tapering bond buying programmes or raising interest rates will do little to address the supply bottlenecks that are driving prices higher. Tightening monetary policy may dampen demand to a degree that matches the constrained supply, but we believe that engineering a recession simply to meet the letter of an inflation mandate will be difficult to justify. In short, investment markets, firms, consumers may have to get used to higher levels of inflation until supply-side constraints are under control. With many of the supply issues

being intertwined with Covid related disruptions, we may not clear that path until the Covid related issues are resolved on a global scale. That could take some time.

Investors looking to hedge against elevated inflation, especially unexpected inflation, would be wise to look at the commodity complex. Whether we talk about gasoline pipeline disruptions driving up the price of gasoline or drought conditions pushing up the price of food, there are many commodities whose prices will react, providing a natural hedge to the increasing price pressures felt in a consumption basket.

Has the inflationary dye been cast?

Even beyond the supply-shock induced inflation, we believe other inflationary pressures exist. For anyone sympathetic to Milton Friedman's view that "inflation is always and everywhere a monetary phenomenon"1, figure 2 below should give a reason to pause and think. Inflation has often followed the growth of monetary aggregates with some lag. The growth in the M2 money supply in 2020 and 2021 has been eye-watering. It is hard to imagine a world where this will not be providing some sort of inflationary pressure. Critics often cite the 2009 to 2012 period, where we saw a couple of spikes in monetary growth without associated gains in inflation. However, this was a period during the Global Financial Crisis and European sovereign crisis, when the banking system was broken, and despite central banks issuing lots of money, commercial banks were parking it in reserves at the central bank. Today, that phenomenon is not in play. With commercial banks passing their stress tests with flying colours, we don't expect the same disruption to credit dissemination as we observed in 2009-2012. Even if central banks tighten monetary policy in the near future, inflation could still remain elevated as it reacts to monetary growth that has already taken place.

Source: WisdomTree, Bloomberg. Commodity price based Bloomberg Commodity Total Return (BCOMTR Index), US CPI inflation, March 1972 to July 2021.

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

Infrastructure boom

Following the Covid pandemic, the political will to support infrastructure projects has strengthened. In Europe, a budget of close to €2.018 trillion2 in current prices has been devoted to the recovery. More than 50% of the budget will support modernisation through research and innovation, fair climate and digital transitions, and health preparedness development. All these initiatives will require some form of infrastructure improvements.

In the US, the Senate has just approved a US$1 trillion infrastructure bill3. While watered-down from the original US$2 trillion design from the White House, the approval was unusually bipartisan. Figure 3 highlights some of the infrastructure initiatives the bill contains. We believe that this will act as a strong catalyst for commodity demand in the US.

In China, although the Federal Government is trying to slow stimulus down and actively calm commodity prices, local governments raised more than RMB4.5 trillion of debt in 2020, mainly in Special Purpose Bonds (SPBs). Historically more than 80% of SPB funding is allocated to infrastructure projects4.

Infrastructure projects are commodity-intensive. And they tend to last a long time. Therefore, the impact on commodity markets may transcend more than a typical business cycle.

Source: https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/24/fact-sheet-president-biden-announces-support-for-the-bipartisan-infrastructure-framework/

A focus on the environment

Most countries around the world have signed up to the Paris Agreement to limit temperature increases to just 2°C above pre-industrialised levels. Over the coming decades, we think governments will more aggressively match their words with action. After all, they have signed up to a legally binding international treaty. The progress observed to date since the treaty was signed in 2015 appears insufficient to reach the goal. The Intergovernmental Panel on Climate Change (IPCC)'s recent assessment paints a dire picture of the consequences of missing the target5. There is little in their report to suggest we are on target. In other words, governments are going to have to double down on their efforts.

Energy transition

We believe an energy transition will take place, where we will move rapidly away from the consumption of hydrocarbons, which produce lots of greenhouse gas emissions, to renewable energy sources. All the materials that support renewable energy and technologies that enable the practical use of renewable energy, such as batteries, will be in greater demand. The electrification of road transportation will augment this trend. In the commodity markets, this will be broadly favourable for base metals, including copper, nickel, aluminium, and tin. An electrification of our energy systems is also likely to be supportive for silver given its use in solar panels and platinum, given its role in the hydrogen economy.

Source: WisdomTree.

The supply challenge

While it is clear that certain commodities are needed to progress the energy transition, it is less clear whether sufficient production of those commodities will take place. Investment in mining capital has been slow in recent years. Bearing in mind the long lead times between initiating investment and increased output from a mine, we could be building supply hurdles in the medium term.

Source: WisdomTree, Bloomberg. Q1 1996 – Q2 2021 Historical performance is not an indication of future performance and any investments may go down in value.

In addition, a renewed focus on environmental outcomes will push miners into better environmental practices. More careful dealing of tailings; avoiding mining in ecologically sensitive areas; reducing greenhouse gas emissions in the mining process. All of these will be welcome developments to make the industry more sustainable. However, we may find that mining activity slows while the industry makes this adjustment.

Since the start of this year, China's crackdown on its aluminium industry, which relies heavily on coal for its power needs, is an example of supply pressures arising from tighter environmental policies. With China being the world's largest aluminium producer, the metal could remain undersupplied for years as the industry transitions to cleaner alternatives for its energy needs.

Conclusions

Commodities entered a bull cycle in 2020 after the market started a recovery following the sharp drawdown in the initial phase of the pandemic. However, lingering Covid effects are hampering supply chains and driving inflation higher in addition to the traditional excess demand drivers of inflation. Commodities are a hedge for inflation and generally are likely to prosper, especially in the shadow of monetary largesses that are already in the system. Even if the inflation catalyst wanes as we move to the next business cycle, the boom in infrastructure and the energy transition will likely propel many commodities for years to come.

1 Milton Friedman, Inflation Causes and Consequences, Asian Publishing House, 1963.

2 https://ec.europa.eu/info/strategy/recovery-plan-europe_en#main-elements-of-the-agreement

3 https://www.reuters.com/world/us/us-senate-poised-pass-1-trillion-infrastructure-bill-debate-35-trillion-budget-2021-08-10/

4 Source: Moody's Investors Service China Sub-Sovereign Monitor, February 2021

5 See IPCC's Sixth Assessment Report, July 2021: https://www.ipcc.ch/report/ar6/wg1/#TS

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