

Commodity outlook: late cycle performer stepping into gear

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Commodities are living up to their reputation as a late cycle-performer, with a 10.6% rally in the past four months (31/05/2023-30/09/2023). The rally has primarily been driven by energy but, as China continues to stimulate, we expect the gains to be broader.

As Figure 1 below shows, commodities perform the best late into a recovery period.

Figure 1: Asset performance in different phases of the economic cycle

Source: WisdomTree, Bloomberg, National Bureau of Economic Research, WisdomTree. January 1960 to June 2023. 'Early' is defined as the first half of an economic phase. 'Late' is defined as the second half of an economic phase. To account for different lengths of recessions and recoveries, monthly returns have been time weighted. Asset descriptions at the end of this blog. Historical performance is not an indication of future performance and any investments may go down in value.

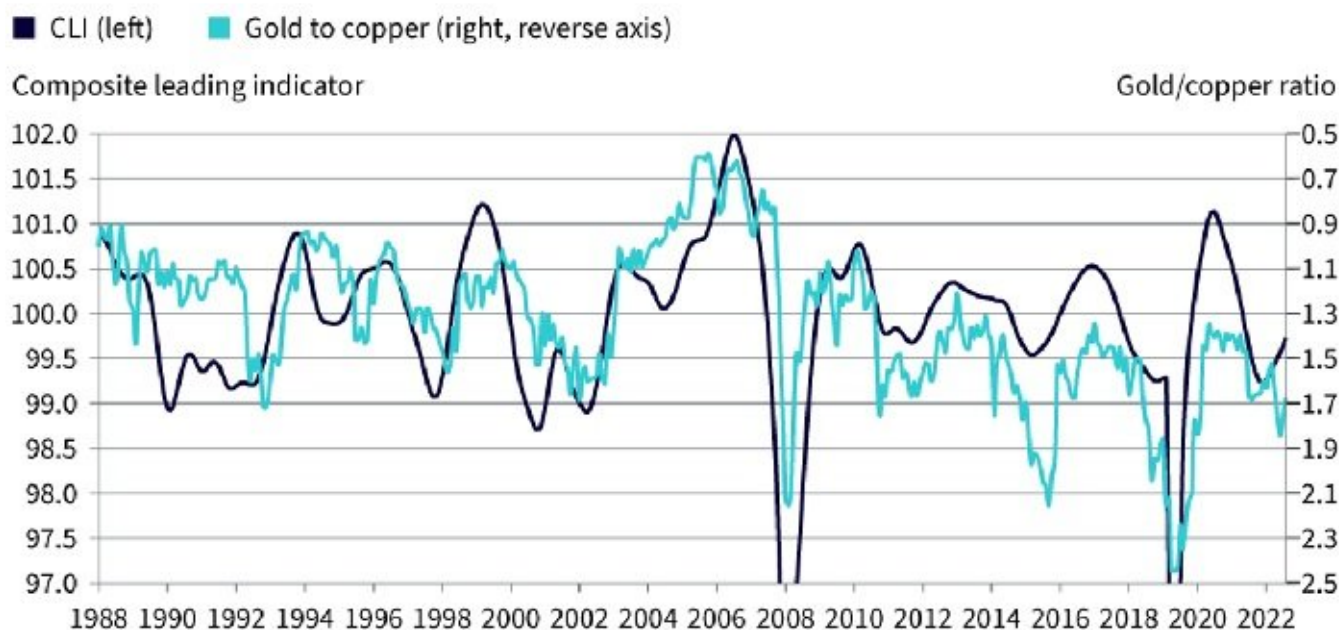
Higher for longer risks

While central banks seem to be nearing the end of their hiking cycle, they have adopted a 'higher for longer' stance, which has pushed bond yields higher and the Federal Reserve's (Fed) position, in particular, is keeping the US dollar strong. That is a headwind for commodities but, if these headwinds were removed, we could see commodities flying higher.

Rotation to cyclicals from defensives

Gold as a defensive asset has performed well in times of economic and financial uncertainty. Recession fears and a mini-banking crisis in the US and Europe drove interest in gold bullion and futures early in the year. However, gold has been overtaken by oil as the market looks for assets that benefit from a cyclical strength. Copper is still languishing behind gold but, if history is a guide, then it is poised to overtake.

Figure 2: Cyclicals to gain favour over defensives as market turns



Source: Bloomberg, The Organisation for Economic Co-operation and Development, WisdomTree. December 1988 to July 2023. Composite Leading Indicators (CLIs) for G20 nations. Gold to copper ratio indexed to 1 at December 1988. Historical performance is not an indication of future performance and any investments may go down in value.

No 'bazooka' but a long list of piece-meal stimulus in China is helping a turnaround

Chinese authorities have failed to produce a 'bazooka' of policy support for the economy since reopening. However, in recent months, the pace of piece-meal policy announcements has intensified. We are starting to see the fruits of this strategy come to bear:

- Caixin Manufacturing Purchasing Managers Indices are back in expansionary territory, with the August and September readings above 501 from below that demarcation in July.
- Industrial production accelerated to 4.5% y-o-y in August 2023 against market expectations of only 3.8%.
- Industrial profits jumped 17.2% y-o-y in August after dropping 6.7% in July y-o-y
- Retail sales accelerated to 4.6% y-o-y in August 2023 against market expectations of only 3.0%.
- Aggregate financing to the real economy rose to CNY3120bn in August from a disappointing CNY2690bn in July (and against an expectation of only CNY2690bn).

China's property sector woes are clearly not fully addressed and will remain a headwind, but we believe the cyclical stimulus action will lean against the wind. We believe the People's Bank of China (PBOC) will continue to ease monetary conditions. Following its quarterly policy meeting on 27 September, the PBOC released a statement saying it will "enhance macro policy adjustments and vows to work on counter-cyclical and cross-cyclical adjustments".

Critical raw material production challenges

Looking beyond the current economic cycle, we believe the energy transition will be a catalyst for higher metal demand. Efforts to secure the resources needed for the transition are already sowing the seeds for future 'greenflation'.

The Inflation Reduction Act (IRA) in the USA, REPowerEU and the current debated Critical Raw Materials Act in the European Union (EU) all seek to bring more of the energy transition supply chain to the US and the EU. Given that most of the refining capacity of the metals important for the energy transition supply chain sits in China, these policies threaten to spur a tit-for-tat trade war. It will be hard to pick winners and losers from this 'green arms race', but investing in commodities will be one way to hedge against the likely increase in prices that may come as a result of it.

The full outlook can be viewed [here](#).

1 A reading below 50 is contractionary and a reading above 50 is expansionary. Recent readings: July (49.2), August (51.0), September (50.6)

2 Bloomberg survey of economists, September.

3 Bloomberg survey of economists, September.

4 Bloomberg survey of economists, September.

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