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MARKET STRATEGY VIEWPOINT

Eye on Commodities

June 7, 2018

The long downtrend in the commodity market has reversed as prices have bounced off of a major technical price support level. Investors may want to take notice.

Supply Constraints / Geopolitics Lead the Complex

Improving price trends and supply constraints in key markets have prompted a more constructive outlook for the commodity complex over the intermediate-term. While the commodity view has improved, investors may seek to add exposure cautiously as recently-positive technical price trends could face some intermittent hurdles. The demand side of the market has improved modestly, given synchronized global growth, although there remains some question about sustainability. Still, with major commodity indices showing a willingness to emerge from a multi-year price trough, investor flows into the asset class have been notable. So far in 2018, energy and agricultural commodities have taken over the leadership industrial metals provided in 2017. This year's weakness in industrial metals prices, we believe, has to do with concerns that a slowdown in debt growth in China (by far the world leader in metals consumption) will weigh on metals' demand growth. This may be overdone in our view. Meanwhile, OPEC production constraints and rising geopolitical risk in the Middle East have put a bid under oil, and drought conditions in some Agricultural regions have helped prompt a corn, wheat, and soybean rally. The end result is a Bloomberg Commodity Index that has added about 3.6% for the year; outpacing many global equity indices. In our view, geopolitical tensions and supply constraints may support commodity prices through the balance of this year; although, as stated, investors may want to take a go-slow approach toward any added allocation.

Figure 1: Bloomberg Commodity Index
Source: Bloomberg

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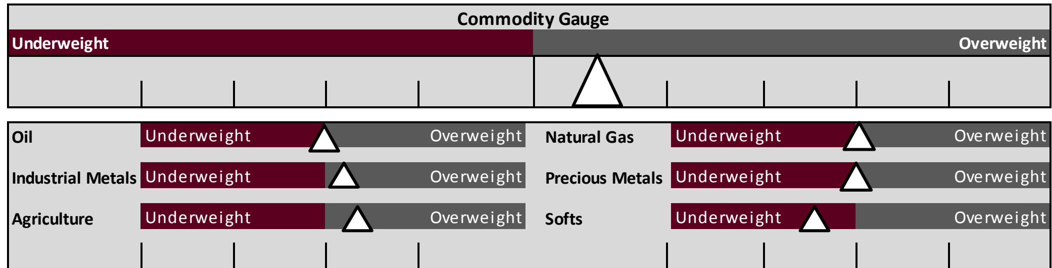
Table 1: Commodity View By Segment

Source: Bower Hill Capital Management



Oil: A Supply and Geopolitics Story

The West Texas Intermediate (WTI) spot oil price traded over $70 per barrel through much of May before recently giving back some gains. The ascent over $70 was largely due to expectations for new Iran sanctions, ongoing instability in Venezuela and Libya, and OPEC production restrictions. Global growth has also added a foundational underpinning to the market.

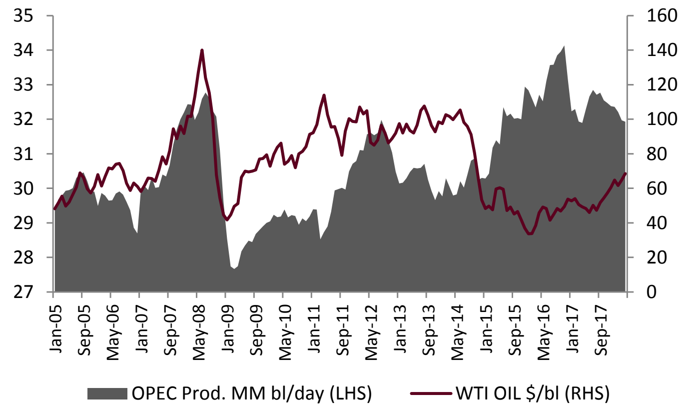
The supply constraints and geopolitical concerns have clearly led to the technical price momentum in oil, and $80 appeared to be a viable price target prior to the recent news about Saudi production (see comments below). Indeed, the biggest anchor on the WTI price is the potential future production growth, both here and abroad. U.S. wells are expected to add 1—1.5 million barrels per day to global production this year. The added supply may solely offset the anticipated growth in global demand and replace, in part, the oil being currently taken off the market by OPEC and other suppliers.

Meanwhile, U.S. crude oil stocks have been accumulated ahead of what is expected to be a demand-heavy summer driving season. Despite the accumulation, days of crude supply in the U.S. are materially below the glut levels of 2016 and early 2017. Also, cost and labor impediments, and more strict balance sheet management, are setting up for a more controlled U.S. production environment. The combination has been net supportive for the WTI price and these fundamental conditions could persist for some time.

The latest news indicates that Saudi Arabia may be re-thinking its previous oil production cuts. The developments have taken some steam out of the oil trade.

Downside risks to oil prices may have to do with OPEC and other geopolitical news. As we pen this report, talk of Saudi Arabia and Russia scaling back instituted production cuts has pushed WTI down below $70 per barrel. As reported by Bloomberg, the Saudi oil minister signaled on May 25th that the country's production could rise in the second half of the year, and Russia may follow suit. These developments have dampened oil's recently consistent rise and moderated our view on commodities in general (see Table 1). An OPEC meeting scheduled for June 22nd is expected to provide more clarity, but for now this new speculation could take some wind out of the oil market's sails.

Figure 2: WTI Oil Price vs. OPEC Crude Oil Production
Source: Bloomberg



Natural Gas

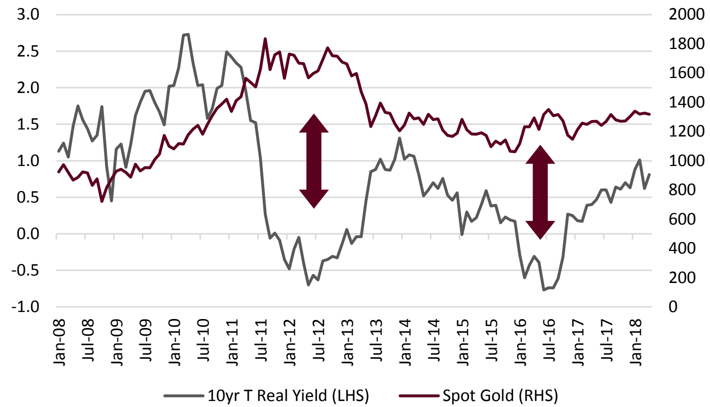
The extensive supply of U.S. natural gas has held down prices for multiple years.

Natural gas prices have been under pressure for an extended period, given the abundance of U.S. production. While estimated storage is at some of the lowest levels in the last ten years (given the elongated winter), production numbers are increasing. The steady supply has helped leave natural gas prices stuck below $3 MMBtu since late 2015. A growth in exports and/or higher cooling degree days in the summer may offer a boost to the price, but that is not our base-case. We believe a marked change in U.S. policy focusing on the increased utilization of natural gas may be the only impetus that meaningfully changes current prices. Otherwise, the abundant presence of U.S. production may act as an anchor on the commodity's price.

Precious Metals

Gold clearly is the key driver in this commodity segment, and the recent failed test of the $1,350/oz. level could signal some emerging softness in the gold price. While gold may make sense for investors using the commodity as a buffer against risk-asset volatility, gold and precious metals in general are unlikely to provide definitive upside, in our view. The reason: gold is typically inversely correlated to the level of real (ex inflation) market yields. In fact, over the last 10 years, gold's correlation to the real 10-yr Treasury yield is –0.35; indicating a material inverse relationship. Why? Over the last decade, a drop in real yields has been associated with economic disruption, a typically favorable environment for gold. Since the 10-year Treasury real yield bounced off mid-2016 lows, gold has traded fairly consistently between $1,150 and $1,350 and has given few signs a rally is in the offing. While this could change based on a geopolitical shock, we see higher real yields and steady economic growth giving few incentives for investors to own gold as a significant portion of the portfolio. Instead, we believe small allocations as a hedge against volatility may prove to be the best use for gold at this time.

Figure 3: 10-Year Treasury Real Yield vs. Spot Gold Price
Source: Bloomberg



Industrial Metals

Removal of excess metals production capacity is a bullish development for a market that witnessed excessive capital investment just ahead of the financial crisis.

More than other groups, this commodity segment is heavily influenced by the positioning of the business cycle and the global economic growth outlook. In particular, industrial metals prices are also heavily influenced by demand from China, as the country typically accounts for approximately 40%-60% of the global demand for key base metals. Meanwhile, production capacity for metals in China and elsewhere has been curtailed given the protracted retreat in metals prices since the financial crisis. We believe the demand/supply construct is more beneficial for the metals segment in its current state. Although sustainability of economic growth - and thus demand in China is a question mark - our base case is for only a modest deceleration in demand from the world's most prolific metals consumer. This view, coupled with more reasonable supply, informs our slightly bullish case for industrial metals over the intermediate-term. The primary downside risk to this view would be a downgrade in the global economic outlook and/or a demand shock in China.

Figure 4: China's Share of Global Consumption
Source: International Monetary Fund

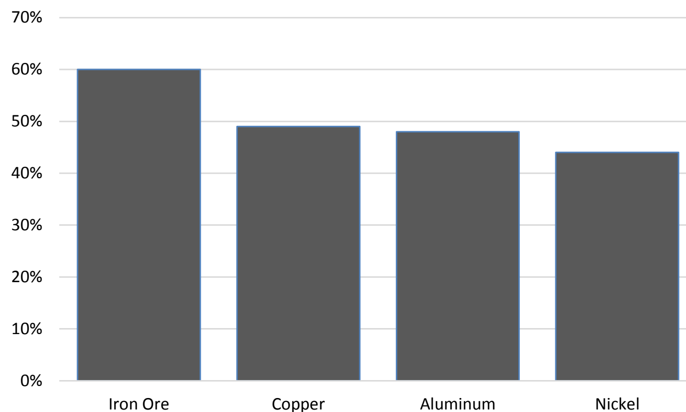


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Figure 5: Bloomberg Industrial Metals Sub-Index
Source: Bloomberg

Given the production right-sizing, industrial metals are seemingly breaking the shackles of a long-term downtrend.

Agriculture & Softs

The Ag segment is heavily influenced by weather and/or other supply bottlenecks. Drought conditions in various crop-producing regions, primarily in South America, have been key in driving up Ag prices so far this year, and a recent trucking strike in Brazil has added to the supply constraints. Meanwhile, emerging dry conditions and reduced plantings of key crops in the United States have also been supportive of prices year-to-date. Higher energy prices have exerted upward pressure on Ag prices via higher production and fertilizer costs as well. So far, this year's conditions have been a departure from the environment of high crop yields which has persisted through this decade. Increasing yields, due in part to improved technologies and research, have led to a steady fall in Ag prices since 2011. On balance, we see the supply-driven, bullish case for Ag commodity exposure enduring through the balance of this year. Summer weather conditions in the U.S. and world trade talk would be the primary upside and downside risks to this view, respectively. Our work shows that the Ag segment may be the most attractive for commodity investors in 2018, especially given the opportunity for the group to emerge from 10-year price lows.

Because of its impact on supply, weather is a key driver of Agricultural and Softs prices.

In the Softs segment (primarily Coffee, Sugar, and Cotton) the supply demand construct looks less bullish, and we are cautious as a result. While near term supply (Coffee, Sugar) has taken a hit due to the Brazil trucking issues and some drought effects, we expect these to be short-term issues and the market could then persist in its weakness. Also recent upticks in Coffee and Sugar may have been driven in part by some short-covering effect. Longer-term, a wealth of supply is expected to pressure the market. Meanwhile, Cotton has been on an unsustainable upward price swing of late (our view), given weather effects in the U.S. and Asia. While weather constraints could continue to impact the market for Cotton, we would be cautious of a technical price reversal on any contrary news.

Summary Commodity View

After taking a long-term hands-off approach toward commodities as the market unwound previous excesses, we have begun looking at the space more constructively. There are four primary drivers to this cautiously bullish view: 1) Current technical price support following the long-term drawdown in prices may be presenting a favorable asset class entry point. The Bloomberg Commodity Index price has bounced from last seen lows in 1998, so the risk/reward of commodity accumulation is balanced toward reward in our view. 2) The removal of excess capacity in many markets, primarily industrials metals, may be beneficial for the overall commodity complex. 3) Global growth, we believe, is now at a point that may be consistently supportive of commodity demand. 4) Finally, our work suggests that emerging inflationary pressures, however modest at this point, are historically a positive for commodity prices.

Recall that our commodity view is not decidedly bullish, but vigilant. We believe adding commodities back into an asset allocation may contribute diversification benefits over a stock/bond-only portfolio, and 2018 commodity returns may prove to be more favorable versus the fixed-income asset class.

Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

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