Asset Class Investment Strategies

Commodities

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

Major Trends

Recent price surges have been driven by a spike in demand linked to post-COVID reopening combined with weak capital investment and geopolitical tensions. Energy and automotive supply chains in particular have struggled to keep up with the increase in demand. Separately, ESG initiatives have substantially increased the cost of capital for commodity extractors. This has meant that capex in base metals and oil/gas has roughly halved since its peak in 2014.[1] More recently, geopolitical conflicts have also contributed to supply concerns. Many of the above imbalances are expected to be resolved over the next 12-18 months. Separately, there is a prospect of additional energy supplies from the Middle East under a renewed JCPOA.

Over the longer term, a surge in demand for "green metals" is expected. The transition to green energy will create an increase in demand for copper, aluminium, lithium, cobalt and nickel over the coming decade. All will be crucial inputs into renewable technologies such as wind turbines, solar panels and EVs. The average EV requires roughly 4x the amount of copper compared to a standard internal combustion engine. McKinsey estimate that generating one terawatt-hour of electricity from solar and wind consumes two to three times more metals than generating the same terawatt-hour from a gas-fired power plant. Analysis by Goldman Sachs suggests that demand for copper and aluminium will rise by roughly 40% out to 2030.

Golden Rules

- Commodity markets are efficient. Profiting from commodity price movements requires having a differentiated view from the broad market. Everyone knows there is a green energy transition underway, so this is already reflected in the price. To profit further, you need to believe the market has underestimated the scale or speed of the transition.
- Both supply and demand are prone to unpredictable exogenous shocks from politics, weather, natural disasters and technological disruption and substitution. This makes fundamental research particularly difficult.
- Commodities do not provide an income stream and thus there is no long-term risk premium to be harvested or fundamental anchor to valuation beyond demand and supply speculation.
- These above factors mean that it is exceptionally difficult to generate alpha from trading commodities. This is borne out by the lack of any persistent alpha from active commodities managers.
- Commodities do typically provide some portfolio diversification benefits and may provide some inflation protection in certain environments.

1. Source: Energy Intelligence.

2022 Strategic Priorities

As outlined in our framework for investing behind the global energy transition (a sub-chapter in the Macroeconomic view), pockets of commodities may offer longer-term value. The increase in green demand for metals such as copper and aluminium appears to be a structural support. This must be weighed against demand destruction from other destinations, such as declining Chinese investment in property and heavy industry/infrastructure. Analysis from BCA research suggests that aggregate demand in 2022 will likely fail to increase substantially as industrial demand from China (over 50% of global copper demand) will slow significantly and offset much of the increase in green demand (only 5% of global copper demand today). Investors have already put a significant premium on "green" commodities such as copper and aluminium, and as such we are not recommending investment just yet, but monitoring closely for future investment.

Expected 12-Month Returns

Exhibit 1

Expected returns by scenario

	Recovery Falters (10%)	Stagflation (10%)	Gradual Normalisation (60%)	Reflation 2.0 (20%)	Expected Value
Commodities	-25.0%	20.0%	3.0%	10.0%	**3.3%**
Notes	In the base case we assume the market has accurately discounted supply and demand of key commodities over the next 12 months, resulting in a modest return of 3%, but uncertainty is high, reflected in the wide range of returns in our scenario modelling.				

Return assumptions are for the 12 months from 31 January 2022. These estimates of performance returns should not be construed to be indicative of actual events that will occur. Please see important disclosures at page 3

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