Commodities

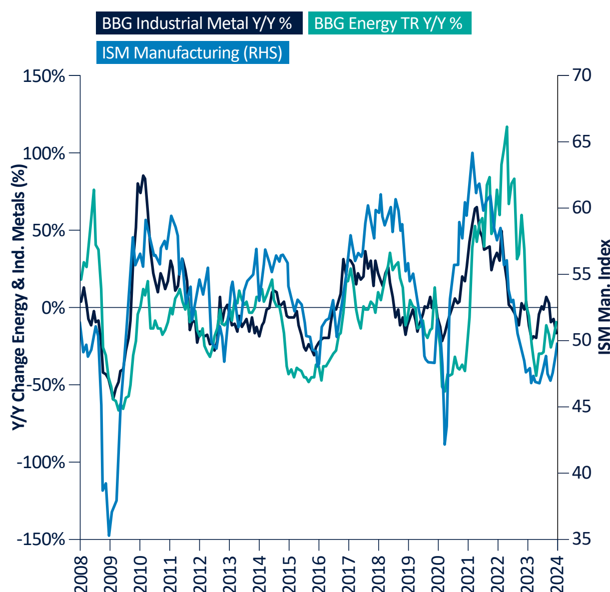
Major Trends

Monetary policy easing could provide a tailwind to commodities but only under the right circumstances. In 2024 the consensus expectation is that central banks will begin to reverse some of the rate increases they have implemented over the previous two years. All else equal, lower rates should provide a tailwind for commodities by reducing financing and storage costs, both of which discourage inventory building. If an easing cycle were to begin as a result of moderating inflation pressures combined with solid economic growth, this would likely provide support for commodity markets. However, if easing was in response to economic weakness this would create a more challenging environment for commodities, particularly for cyclical commodities like energy and base metals. Spot commodity prices have on average declined c. -35% during the last five US recessions.

Economic growth in China, the world's largest commodity consumer, remains challenged but there are some signs of life in the global manufacturing cycle. Demand for cyclical commodities such as energy and base metals are particularly sensitive to the Chinese construction/ property sector and the global manufacturing cycle (Exhibit 1). The former, which accounts for roughly c. 27% of global copper demand, remains structurally challenged in the midst of a deleveraging cycle. However, there are some signs that 2024 could mark the beginning of a recovery in the global manufacturing sector, with analysts noting that global goods inventory levels have normalised to a degree post-COVID, and PMI manufacturing indices are close to levels which, outside of deep recessions, usually correspond to cycle lows.

Geopolitical risks are elevated, but commodity markets are also discounting the elevated levels of spare capacity which could be deployed to absorb any potential shocks. Despite the outbreak of war in the Middle East, a series of attacks on commercial cargo ships by Houthi rebels in the Red Sea and the seizure of an oil tanker by Iran in the Persian Gulf, oil prices remain relatively subdued. Brent is trading at c. $80/barrel in early February, well below levels

Exhibit 1
Cyclical commodities usually move with the trend in the manufacturing cycle



***Source:** Bloomberg*

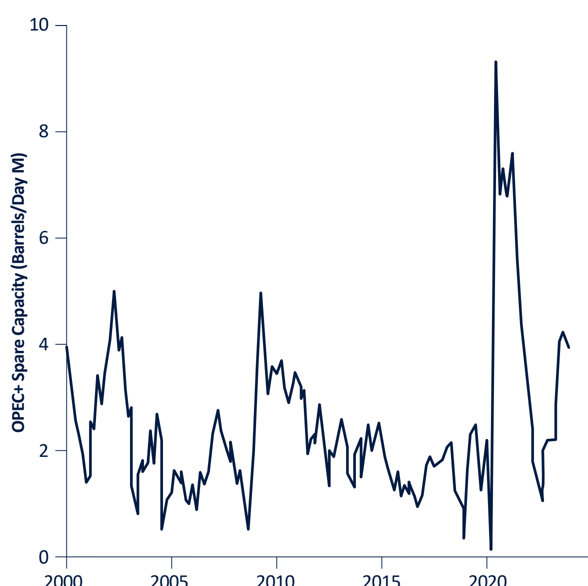
that preceded the October 7th attack on Israel. The calculus from analysts appears to be that any future disruption in supply, as a result of an escalation, will be met by an increase in production by OPEC+ given the degree of spare capacity available following the production cuts announced in 2023. Exhibit 2 shows that OPEC+ has over 4M barrels of spare production capacity. This analysis assumes that the Strait of Hormuz between Iran and the Arabian peninsula, through which c. 20% of globally-traded oil travels, will remain relatively unimpeded in any escalation. This shift in marginal pricing power from US shale producers back to Saudi Arabia and OPEC+ is a significant change from the previous decade and has been driven by increased levels of capital discipline by the US shale producers. In contrast to oil, Gold has risen c. +10% since the October 7th attacks. However, it is difficult to disaggregate this gain between an increase in geopolitical risk premia and

1 Brent had traded above $95/barrel in late Sep 2023.

Commodities
continued

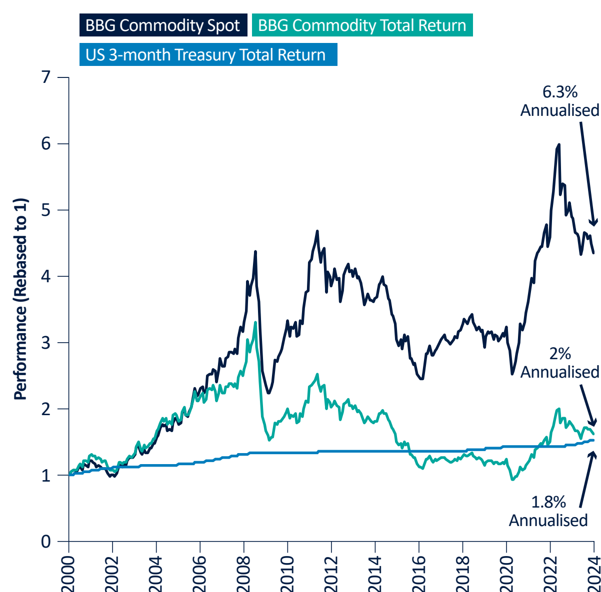
the impact of a significant decline in real rates over the same time period.

Exhibit 2
OPEC+ is sitting on over 4M barrels of spare production capacity, close to a record outside of the COVID period



Source: *Platts and J.P. Morgan Commodities Research*

Exhibit 3
Total return from commodity investments is far lower than what is reflected by changes in spot prices (Dec 1999 - Dec 2023)



Source: *Bloomberg*

Golden Rules

- Commodity markets are generally efficient. Profiting from commodity price movements requires a differentiated view from the broad market. For example, the fact that there is a green energy transition underway is well understood, hence it will already be reflected in prices to some degree. To profit further, one needs to believe the market has under- or over-estimated the scale or speed of the transition and the resulting demand/supply imbalance. This is illustrated by the difference in the performance of the Bloomberg Commodity Spot Price Index and its Total Return Index. Exhibit 3 shows that while spot prices have compounded by c. +6%/annum on average since 2000, the actual total return accrued by investors after storage, insurance and contract roll yield has averaged only +2%/annum, a return which is comparable to 3-month Treasuries (Exhibit 3).
- Both supply and demand are prone to unpredictable exogenous shocks from politics, weather, natural disasters, technological disruption and substitution. This makes fundamental research particularly difficult.
- Commodities do not provide an income stream and thus there is no significant long-term risk premium to be harvested or fundamental anchor to valuation beyond demand and supply speculation.
- The 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.

2024 Strategic Priorities

Our extensive work on the global energy transition in recent years has helped us to identify commodities as one area that has the potential to be affected by the transition, particularly in light of the estimated $5T/annum investment that will be required. This includes both "green" commodities such as copper and aluminium which are key inputs for the renewable technologies and fossil fuels that will be required to bridge the transition period, but where there has been structural underinvestment in supply over the last decade. Despite the upside case for both "green" commodities and fossil fuels being clear, the last two years have demonstrated the importance of other factors both macroeconomic and geopolitical. China is responsible for 50-60% of global demand for copper and aluminium and while its green demand has been stronger than anticipated (for example, solar demand increased +145% YoY[2]) the structural problems facing the property construction sector have been a significant drag on demand. In energy markets the evolving conflicts in Ukraine and the Middle East, the aggressive supply response from the US and the production cuts from OPEC+ have led to flat but volatile returns.

We continue to explore all means of investing in the global energy transition, including in commodities, both passively and via active managers with a discernible and persistent ability to understand and take advantage of trends in the energy transition landscape. However, in a world where real interest rates are greater than 1.5% it creates a relatively high hurdle for investment in assets like commodities with no fundamental yield. Commodities, as measured by the Bloomberg Commodity Total Return Index, have had an annualised total return of c. -1% over the last decade while real interest rates have been close to zero (0.3%).

Long-Term Expected Return

Exhibit 4

Based on our 10 year forecasts, we target the following long-term expected returns for Commodities

	Commodities
Risk-free Rate	4.0%
Risk Premium	0.5%
Illiquidity Premium	—
Manager Alpha	—
Total Return	**4.5%**

Commodities' expected return marginally outpaces cash over the long term.

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.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.

2 Goldman Sachs estimate.