minelife

WEEKLY COMMODITY REVIEW

Monday 14th May, 2018

Geopolitics and Economics Provide Support for Commodities Prices

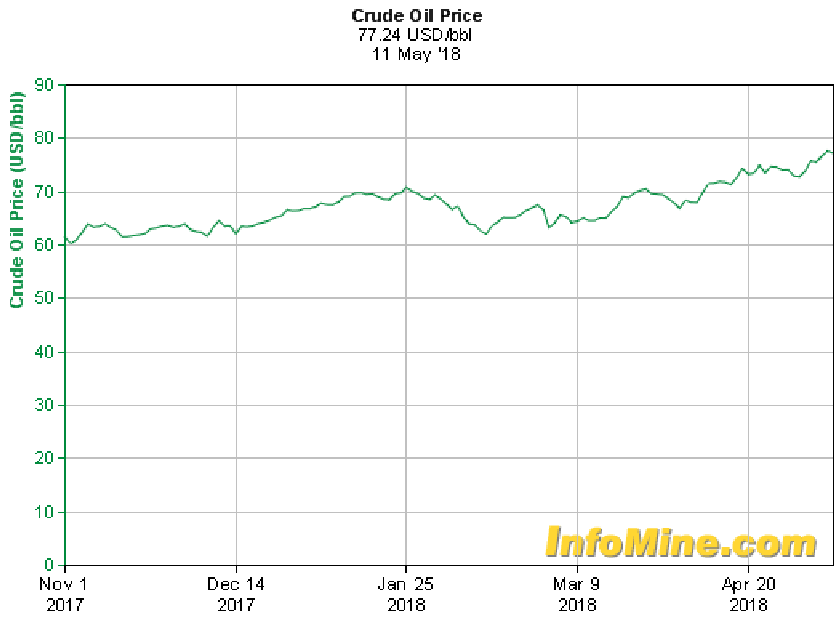
When it comes to microeconomics, commodities prices typically move higher or lower based on their supply and demand characteristics. However, commodities can be highly sensitive to macroeconomic factors such as overall economic growth or contraction, whilst inflationary pressures can cause all prices to move to the upside. Political events can also change the course of the price of a commodity for many reasons, whilst trade policies can enhance or restrict the flow of goods around the world.

While stocks, bonds and currencies have global appeal, commodities are assets that tend to transcend borders. Commodity production tends to be a local affair. Raw materials come from parts of the world that are rich in reserves in the crust of the earth or where the climate and temperature support and encourage crop growth. Meanwhile, consumption of raw materials is ubiquitous as every man, woman, and child on our planet require food, shelter, and energy each day. At the same time, increasing population and wealth around the world continue to increase competition for finite natural resources as more people with more money compete for raw materials. China is the world's leading commodities consumer because they are the most populous and fastest growing nation on the earth.

While supply and demand analysis is the primary factor when it comes to the path of least resistance for the price of any commodity, these days economics and politics could be playing a much bigger role than traditional fundamentals.

The Middle East and Oil

Politics in the Middle East is one of the primary factors when it comes to the path of least resistance for the price of crude oil – and prices have demonstrated significant strength over the past six months (as reflected in the graphic below). The political landscape in the Middle East continues to point to an increased probability of hostilities that could impact production, refining and logistical factors when it comes to the commodity that still powers most of the world today.



Asian Growth Means Demand

While the politics of the Middle East continue to support gains in the crude oil market, demographics and economic growth in Asia continue to increase the demand side of the equation for all commodities. With almost 1.4 billion people and economic growth at between 6-7% under the "new normal," the Chinese dominate many raw material markets. Infrastructure building and demand for food products in the Asian nation create ever-increasing pressures when it comes to global raw material supplies.

Many industrial commodities fell to lows during late 2015 and early 2016, as the Chinese domestic stock market suffered a severe correction. However, since the announcement of President Xi's "new normal" and his consolidation of power in the world's most populous nation, prices of commodities that are construction stables have come roaring back.

As the weekly chart of COMEX copper illustrates above, the red metal that is often a bellwether for all industrial commodities has rallied from lows during January 2016. Economic growth in Asia and the continued rise of China have been bullish factors when it comes to the commodities asset class.

European Growth Points to a Lower Dollar

The dollar is the reserve currency of the world and is the benchmark pricing mechanism for most commodities prices. The long-standing inverse relationship between the U.S. dollar and raw material prices has been highly supportive of the commodities asset class since the start of 2017 when the dollar hit its high and began falling.

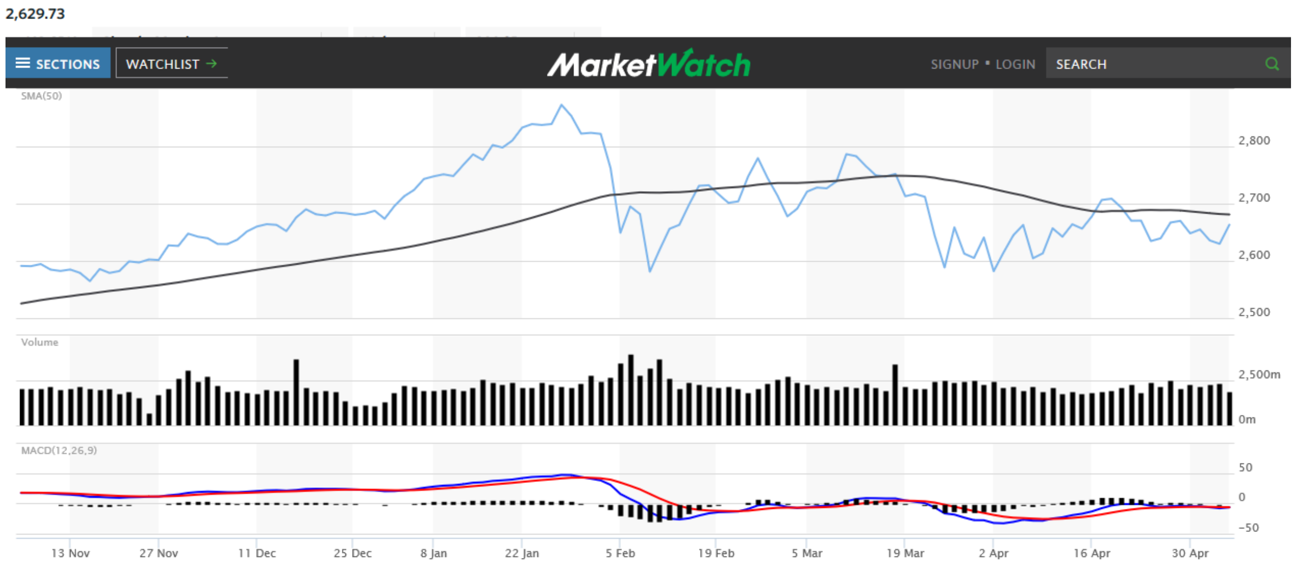
As the U.S. dollar index shows, the greenback index reached a high during early January 2017 and then declined to lows in February this year. There has since been a recovery, but I am doubtful as to the strength of the recovery. On a long-term basis, the dollar fell for seven years from 1985 through to 1992 and then rallied for nine years until 2001. A seven-year bear market followed, taking the U.S. currency to its nadir in 2008 before it experienced another nine-year bullish run that came to an end in early 2017. If the pattern of trading over the past thirty-three years holds, we could be in for a bear market in the U.S. currency until 2024.

Around 57% of the US dollar index depends on the value of the dollar-euro relationship and it might be just a matter of time until the European Central Bank shifts from accommodative to hawkish monetary policy. While short-term rates in the U.S. have been rising since December 2015, short-term euro rates remain at negative forty basis points. Given the economic growth in Europe, it is a matter of time until euro rates begin to climb, which could cause the euro currency to further strengthen against the dollar. It is likely that rising European rates could push the dollar index down to new and lower lows over the coming months.

U.S. Uncertainty

The S&P 500 index fell by 11.5% over the first six weeks of 2016, following which stocks rallied to new highs until January 2018. Equities rose to dizzying heights, but the potential for increasing rates caused the market to pause in February, and two-way volatility has returned to the stock market.

The U.S. is deeply divided when it comes to the political future of the nation, as the 2016 Presidential election was a deeply polarizing event. In 2018, mid-term elections could shift legislative control back into the hands of the Democrats, whilst the special prosecutor and many others in the country continue to attempt to undermine and move towards removal of President Trump. Domestic U.S. politics continue to provide a case for a continuation of volatility in the stock market as well as other asset classes. The graphic below shows the recent weaker trend in the S&P 500 index since the end of January 2018.



In the world of commodities, gold is often a barometer of fear and uncertainty in markets. The yellow metal is currently sitting less than $30 below its highest level since 2014. Aside from its role as a barometer for fear and uncertainty, gold has a long history as an asset that is responsive to and holds its value during periods of increasing inflationary pressures. The graphic below compares gold's performance over the past 12 months with the US$.

Inflationary Threats

After a decade of accommodative central bank policies following the global financial crisis of 2008, there are signs that inflationary pressures are creeping back into the global economy.

Central banks around the world slashed interests to historical and artificial lows. Programs of quantitative easing caused rates to move lower across the yield curve to further maturities as the monetary authorities essentially supplied the market with free put options or floors on bond prices through the program of buying debt issues. All of the liquidity that flooded the system ended up inhibiting saving and encouraging borrowing and spending, which helped to prevent recessionary pressures or worse from building in economies around the world.

So there is a price for all of the liquidity that continues to keep rates at the lowest levels in decades when compared to pre-2008 years in the U.S. and Europe. Correspondingly, the price of crude oil has rallied from lows of $26 per barrel in February 2016 and copper has moved from under $2 to over $3 per pound during the same period.

Inflationary pressures are on the rise, but the Fed and ECB have set their targets for the economic condition at the 2% level. The Fed has told markets that inflation continues to increase towards their target, but it is possible that it will overshoot as the trend in most raw material markets points to higher prices over coming weeks and months. Gold could be the best barometer for inflationary pressures.

Summary

There are many reasons to be bullish on commodities prices apart from the traditional demand-supply outlook, due to a combination of both political and economic factors. Political uncertainty in the US and the Middle East, combined with market uncertainty in the US are key factors, along with potential for a further weakening in the US dollar. The underlying price movements in key commodities over recent years – gold, copper and oil – is I believe a positive reflection of this situation.