BearBull
Global Investments Group

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Are we heading for a new positive commodities super cycle?

An incredible 2020 for commodities. Focus on the last two super cycles for commodities. Rapid inventory reduction. Four main factors supporting increased demand.

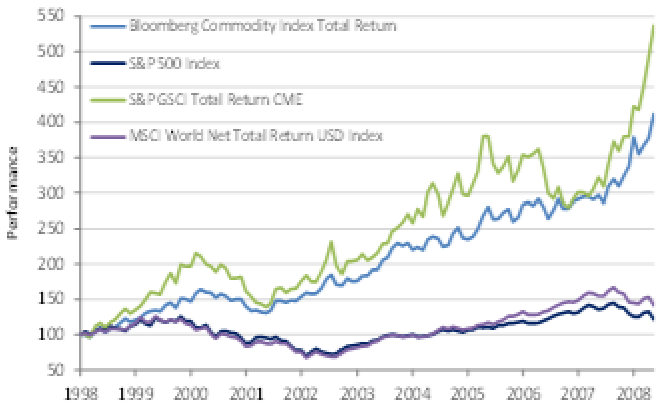
Key points

- An incredible 2020 for commodities
- Focus on the last two commodities super cycles
- Are we heading for a new positive commodities super cycle?
- Rapid inventory reduction
- Four main factors supporting the increase in demand
- Possible emergence of a new super cycle
- Time to invest in commodities

An incredible 2020 for commodities

Commodities had an exceptional year in 2020. The various indices measuring the performance of commodities overall achieved impressive performances not seen for many years. The overall performance for the year was negative, but price movements were particularly erratic throughout the year. The most striking phenomenon was the shift of crude oil prices into negative territory. Although this episode was only short-lived, it greatly unsettled investors' views and their risk perception for commodities in April. The fall in commodities (-23%) in Q1 2020 was not so different from that in the equity markets (-21%) if we exclude the fall in crude oil prices (-67%). The following nine months were exceptionally positive for oil prices, which rose by 113%, as well as for commodities overall (+26.3%). The events of 2020 need to be seen in the longer-term context of commodity price shifts to understand the significance of these price movements in 2020 and of this extreme volatility and what it may portend for the coming years. Since the 1970s, commodities have recorded a compound annual increase of +8% to +9% depending on the benchmark index and its composition. Compared to the performance of the US (+10.9%) and international (+9.1%) equity markets, commodities have experienced periods of cyclical outperformance and underperformance. The last decade was more of an underperformance cycle, stretched to the extreme until 2020 with exceptional volatility. The performance of commodities in H2 2020 and the beginning of 2021 merits consideration as a possible reversal of the trend and as the potential emergence of a new long-term cycle favorable to commodities with a return to outperformance vis-à-vis equities in particular.

Performance of raw materials VS US and international equities (1998-2008)



Sources: Bloomberg, BearBull

Focus on the last two commodities super cycles

First of all, let us recall some key elements to understand what the term super cycle means for commodities. The notion of super cycle tends to apply to a period of time that exceeds a traditional economic cycle. In this logic, a super cycle must therefore be longer than a classic theoretical cycle of about five years. From the standpoint of duration, a super cycle may therefore last a decade or more. In this sense, the last super cycle for commodities dates back to the 1998-2008 period, thus spanning about 10 years of rising prices during which diversified commodity indices recorded gains of about +15% per year (Bloomberg commodity index: +16%, S&P Goldman Sachs commodity index +19%). During this period, US and international equities performed modestly at +2% per annum for the former and +3.7% per annum for the latter. After this positive super cycle, commodities then experienced a negative super cycle of value destruction between 2008 and 2018. The above-mentioned commodity indices fell by -9.6% and -13.8%, respectively, while equity markets posted an annual increase of +8.9% for the S&P500 and +5% for the MSCI World Index.

Are we heading for a new positive commodities super cycle?

The fundamental question today is indeed whether commodities are now about to start a new positive ten-year super cycle, after two positive and then negative ten-year cycles. In other words, after ten years of bear market and underperformance, are commodities about to start a new phase of long-term and widespread price appreciation?

Performance of raw materials VS US and international equities (2008 – 2018)

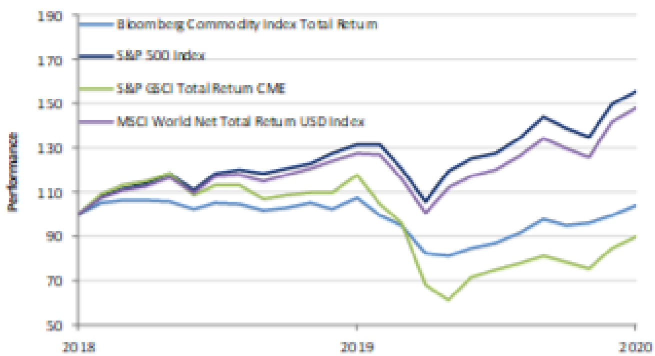
Sources: Bloomberg, BearBull

In order to answer this question, we must analyse the fundamental parameters of supply and demand for commodities, seeking to identify the structural aspects and the cyclical elements. Firstly, with regard to the structural aspects that prevailed before the outbreak of the Covid-19 pandemic in 2020, it appears that, in many segments, capital expenditure and research were being steadily reduced. Capex contractions were indeed numerous and logical in a global context of falling commodity prices. Oil and gas producers and mine operators had no reason to invest in increasing their production capacity in a financial environment of extreme price competition. In a phase of falling prices, supply therefore remained rigid and oriented rather downwards, with available production capacity being under-utilised. The fall in demand for oil and industrial metals during the first few months of the year put brutal pressure on prices, but hopes of economic recovery quickly triggered a new positive trend. The prospects for economic recovery in 2021 certainly warrant a reappraisal of the opportunities and risks for all commodity markets and for oil in particular. Historically, a recovery typically takes hold in a period of recession, which marks the turnaround in the cycle. Therefore, it is likely that the sustained global economic recovery of around +6 to +7% in 2021 will quickly restore demand for commodities after a long period of declining capex and reduced production capacity. In the oil sector, a distinction must be made between the decline in capex in conventional crude oil operations and the investments made in the development of shale oil production capacity.

Rapid inventory reduction

The global pandemic has also highlighted the fragility of global production chains that are too heavily dependent on the transport of products, materials and commodities from distant regions. This is likely to quickly change the behaviour of purchasing managers who are now expected to favour more secure and stable forms of supply, but it also means the likely return of inventory build-ups to better absorb any potential future shocks of the same nature. Commodity inventories swelled with the fall in demand during Q1 2020 and remained higher on average before being able to take advantage of the return of global and Chinese demand in particular. However, it is surprising to see a net decrease in these surpluses already now. Crude oil inventories have already declined significantly thanks to the fall in shale oil production and production cuts by OPEC countries. A return to economic growth in H2 2021 in all major economies will have a significant impact on commodity inventories. With production remaining relatively stable, prices are primarily driven by significant movements in demand. The convergence of economic cycles and demand for commodities will allow the cycle that is beginning to unfold to clear surpluses and inventories more quickly. The absence of capex spending will constrain supply, which will not be able to adjust easily to a return of demand.

Performance of raw materials VS US and international equities (2018 – 2020)

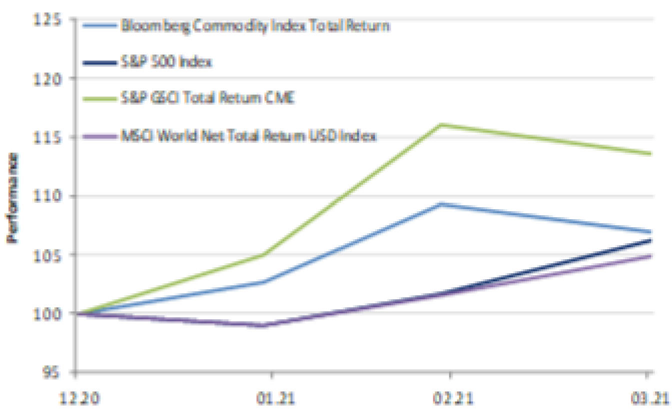


Sources: Bloomberg, BearBull

Four main factors supporting the increase in demand

The first factor is cyclical and is essentially the readjustment of supply and demand parameters in the short term. In other words, a recovery in consumption and economic activity in H2 on a pre-Covid basis will increase demand and allow for a reduction in inventories. However, we believe that this first cyclical factor will have an early impact on prices due to simultaneous regional demand, as all countries seek to secure sufficient supply as their economies recover. The second factor is the desire to secure this supply in the longer term by building up crisis inventories to cope with future international tensions. This additional demand for commodities will have a cumulative effect on global demand and will also support higher prices. China, the world's largest consumer of commodities, has already taken advantage of the specific conditions of 2020 to implement a policy of rebuilding strategic stocks. It is expected to continue to pursue this strategy, to be followed in turn fairly soon by the US. The third factor is related to investment and portfolio diversification. Commodities have been gradually pushed out of diversified asset allocations during the phase of falling interest rates and inflation. The previous commodities super cycle lasted ten years, which is long enough to no longer consider this asset as a positive contributor to portfolio diversification. And yet, recall that commodities perform particularly well in times of accelerating economic growth, rising inflation and rising interest rates. If the stimulus packages deliver on their promises, there is every reason to fear that inflation will accompany growth that is well above the historical average. Commodities are therefore likely to make a gradual comeback in portfolios as a new investment, uncorrelated with traditional assets. Investment demand will strengthen the overall demand for commodities and support the upward trend in prices. For example, the demand for ETFs investing in physical gold or silver is always correlated with price movements. This third factor can have very important consequences on the reduction of inventories and on price growth. Finally, stimulus packages can significantly increase the level of demand for commodities, particularly industrial metals. The amounts announced by governments to support a lasting economic recovery with regard to the energy transition and infrastructure investments are exceptional. Governments are committed to implementing this energy transition, which will take time, but which will provide regular funding for many projects that generally require new commodities. This fourth factor is essential and will have a steady impact on demand by adding excess demand to the base demand. The trillions promised for this transition will support commodity prices.

Performance of raw materials VS US and international equities (2020 – 2021)

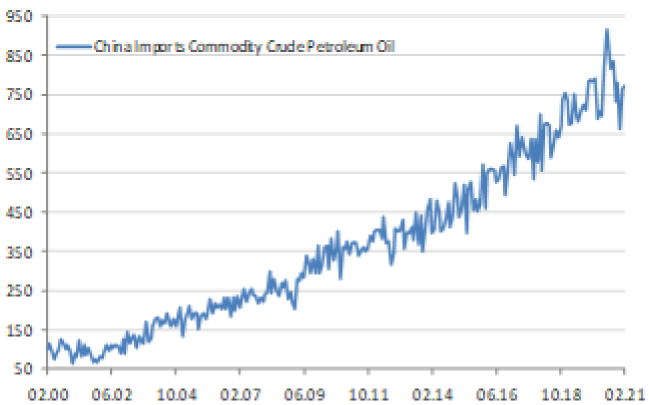


Sources: Bloomberg, BearBull

Possible emergence of a new super cycle

It is certainly too early to say that these main factors will be sufficient to form the basis of a new commodities super cycle. However, it already seems that a lasting period of imbalance between supply and demand for commodities has begun. Production capacity cannot be increased quickly due to the fall in capex in recent years, so the supply of commodities will only be able to adjust imperfectly to a significant increase in demand. That being said, a lasting commodities boom will have to be based on a long-term increase in demand. In our view, the four factors mentioned above should all contribute to an increase in overall demand and create the conditions for an imbalance conducive to higher prices. The energy transition is likely to be one of the most important factors in the lasting increase in demand for commodities, but it may not be sufficient to sustain a price growth super cycle. In conclusion, we believe that many factors are already in place to drive commodity prices higher in the coming years. But it is also too early to estimate more precisely what strategies commodity producers will develop in a more favourable economic environment. A return of investment and production capacity could eventually have an impact on supply and prices, but given the current situation, this would only have an impact in several years.

China Imports Commodity Crude Petroleum Oil

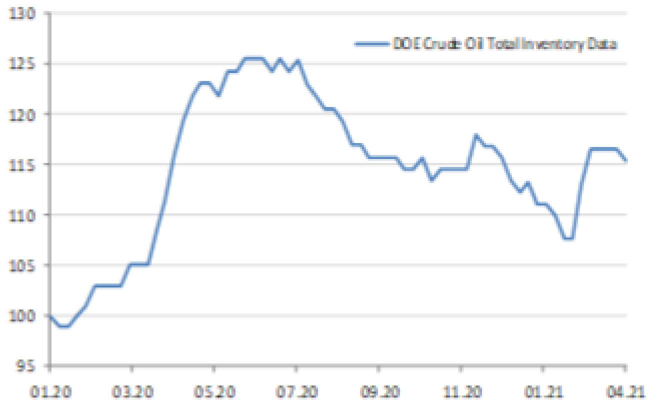


Sources: Bloomberg, BearBull

Time to invest in commodities

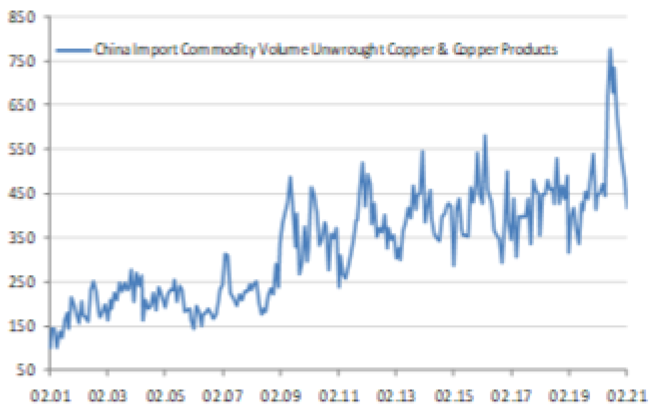
If the economic environment develops in line with our expectations, lasting growth above the historical average and higher inflation are positive factors and provide an ideal environment to include commodities in portfolios for asset diversification purposes.

DOE Crude Oil Total Inventory



Sources: Bloomberg, BearBull

China Import Commodity Volume Unwrought Copper & Copper Products



Sources: Bloomberg, BearBull

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