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Commodities Unleashed: 3 Leading Indicators of the Next Wave Higher | April 2024

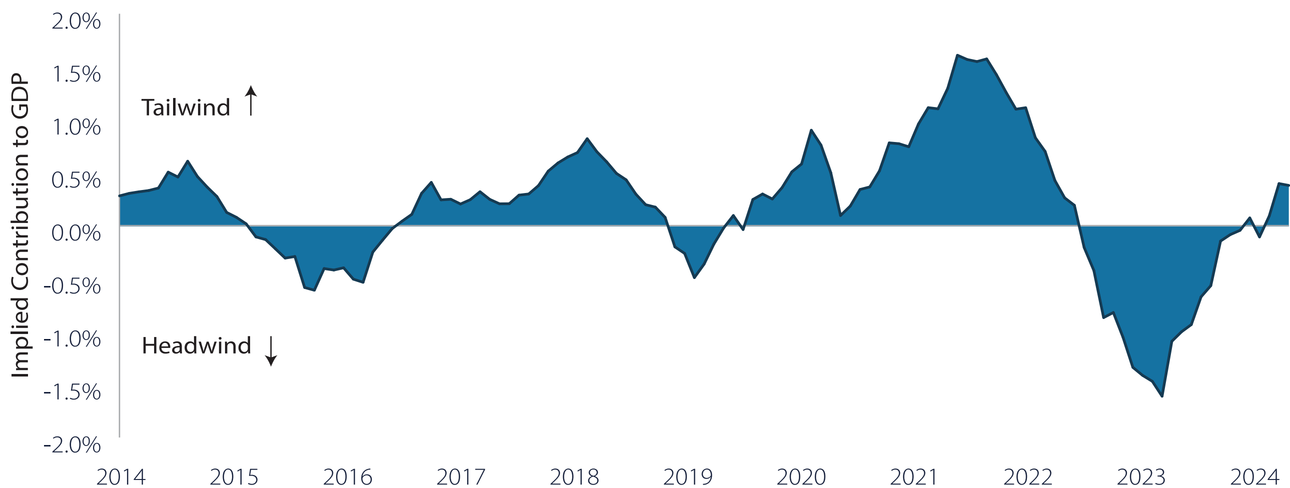
Commodities as an investable asset class are well-known for certain ongoing benefits. Inflation protection and diversification, rightfully so, are among the top two. Here we will discuss three pillars that are specific to the current market and, in our view, strengthen the case for a commodity allocation: (i) improving growth expectations, (ii) diminishing inventory and (iii) challenges to future supply. Together, these pillars form the value proposition and foundation of a positive outlook for commodity futures and natural resource equities.

Pillar One: Improving Growth Expectations

Contrary to popular belief that the world would enter a synchronized recession, most economic readings have decidedly turned upward in recent months. At the end of January, the International Monetary Fund (IMF) upgraded its forecast for global economic growth to 3.1% for 2024. Despite higher financing costs, there are numerous reasons why the economy has resisted a broader downturn. Among the leading causes are the US consumer, Chinese stimulus, financial conditions and government spending.

At the beginning of 2023, financial conditions represented a headwind to GDP of -1.5% (Figure A).[1] Today, the landscape has shifted dramatically, with the composite now representing a noticeable tailwind to growth. Financial conditions measure market liquidity by aggregating asset prices and interest rates. In the past, looser financial conditions and easier flow of credit were typically associated with higher levels of demand for natural resources. Over the last five cutting cycles by the Federal Reserve (the "Fed"), commodities rose an average of 9% in the nine months leading up to the first cut and 14% in the nine months immediately following the first cut.[2] Now that markets are pricing in expectations of easier monetary policy, commodity prices are likely to benefit.

Figure A: Financial Conditions Transition to a Growth Tailwind[1]
Contributions to GDP over the next 12 months (%)



Past performance is no guarantee of future results.

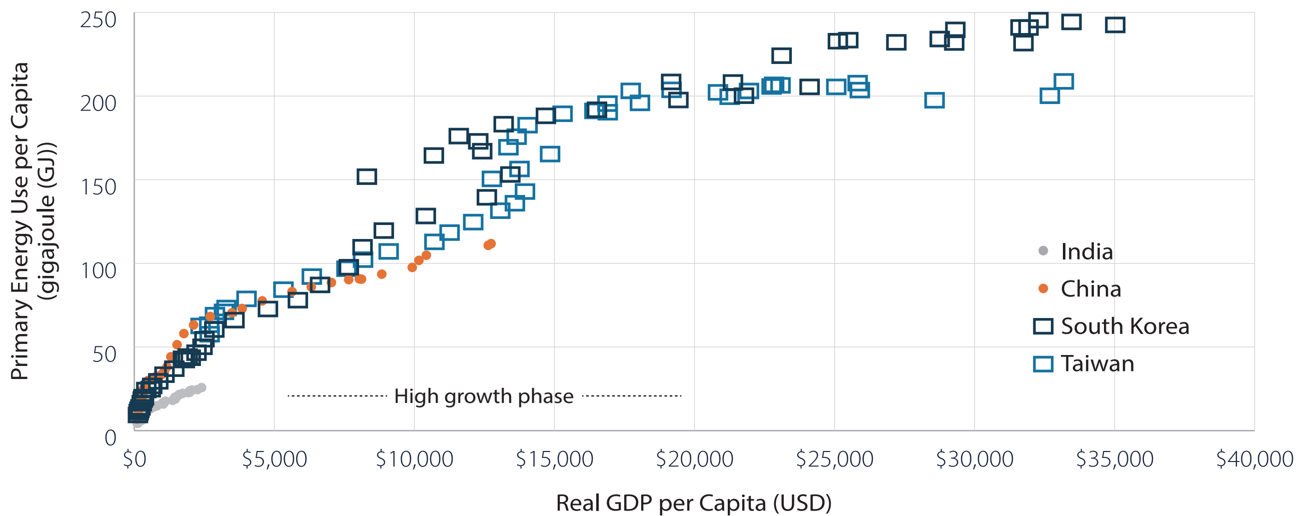
[1] Source (Figure A): New York Federal Reserve, Jan 2014 - Jan 2024. Data represents the Financial Conditions Impulse on Growth (FCI-G) Index. The sign has been reversed to better visualize headwind/tailwind to GDP.

[2] Source: Bloomberg, CoreCommodity. Represents the median total return of the Bloomberg Commodity Index during Fed cycles of 1989, 1995, 2001, 2007 and 2019.

The economy has also strengthened from an increase in consensus forecasts for government spending. National elections in 2024 will comprise at least 64 countries and nearly 50% of the global population.[3] Election years have typically created incentives for fiscal expansion. Downstream, greater government spending has already triggered an inflection point in the manufacturing sector. The global manufacturing Purchasing Managers' Index (PMI) increased to 50.3 in February, marking its first expansionary reading since August 2022. Additionally, the latest gauge of industrial production out of China signaled the fastest pace in nearly two years, and investment in American manufacturing has surged to a new 50-year high.[4] Rising American investment due to strategic onshoring (e.g., semiconductor fabrication) and the energy transition should continue to create a potentially potent combination for commodity demand.

Aside from the recovery in US manufacturing, perhaps a more powerful demand driver going forward will likely come from the emerging corners of the world. With fewer efficiencies, emerging markets require nearly twice as much energy per unit of GDP as developed markets.[5] As lower rungs of the global economy add wealth and climb the socioeconomic ladder, their influence has a leveraged effect on commodity demand growth (Figure B).[6] Intuitively, it makes sense. As communities are brought out of poverty, bicycles become automobiles, apartments become single-family homes and grains become proteins. Historical relationships indicate the most energy-intensive phase of economic development occurs between $5,000 and $20,000 per capita GDP (for reference, India: $2,000, China: $12,000, US: $63,000).[5] Below that range, countries primarily focus on subsistence. Above that range, consumption growth decelerates to a more sustainable rate.

Figure B: Greater Emerging Market Wealth Drives Energy Use Higher[6]



At the turn of the century, just before the 2000s commodity bull market, 10% of the world population fell within that "sweet spot". Since then, it has increased rapidly to 33%. At roughly 2.6 billion, never have so many people resided in the high-growth phase of economic development. Supported by sequentially lower funding costs and accommodative policy, we believe historic wealth generation will incite a structural up-swell for energy consumption over the coming years.

Pillar Two: Diminishing Inventory

The second pillar of our thesis concerns available inventories, which play a crucial role during periods of heightened demand and disrupted supply. Stockpiles serve to stabilize temporary imbalances in such scenarios. However, in today's landscape, most visible inventories, whether held for strategic purposes or on exchange, have dwindled to multi-year lows. This depletion has been exacerbated by ongoing physical shortages and the burden of high financing costs.

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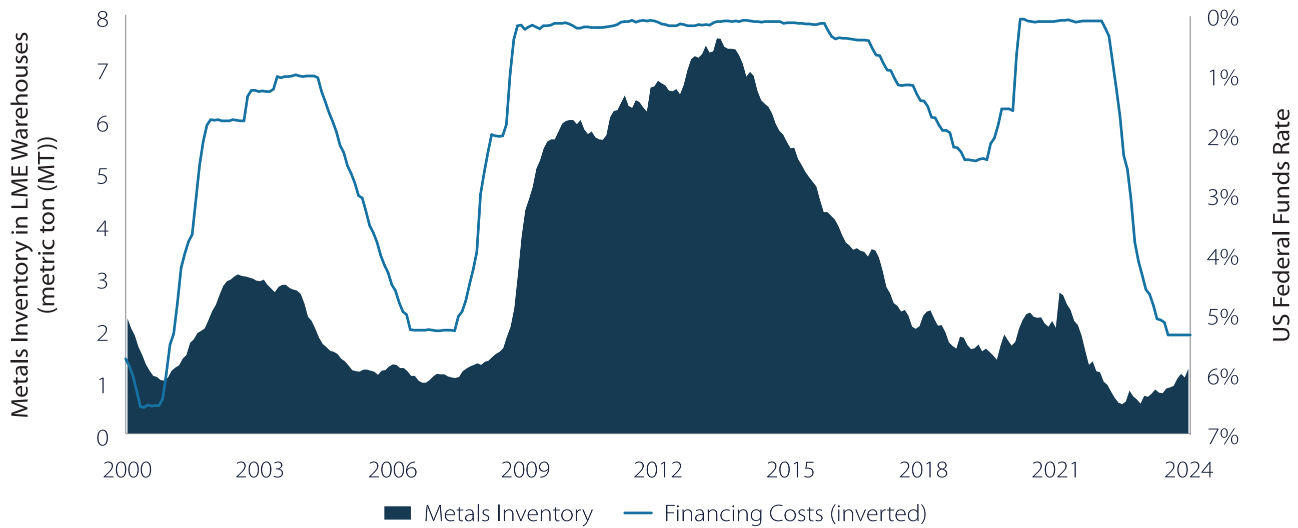
[3] *Source: Time, "The Ultimate Election Year: All the Elections Around the World in 2024", Dec 2023*
[4] *Source: U.S. Census Bureau, Jan 2024*
[5] *Source: World Bank, Goehring & Rozencwajg, 2022. GDP per capita adjusted for inflation and reported in USD.*
[6] *Source (Figure B): Energy Institute, World Bank, CoreCommodity, 1965 - 2022*

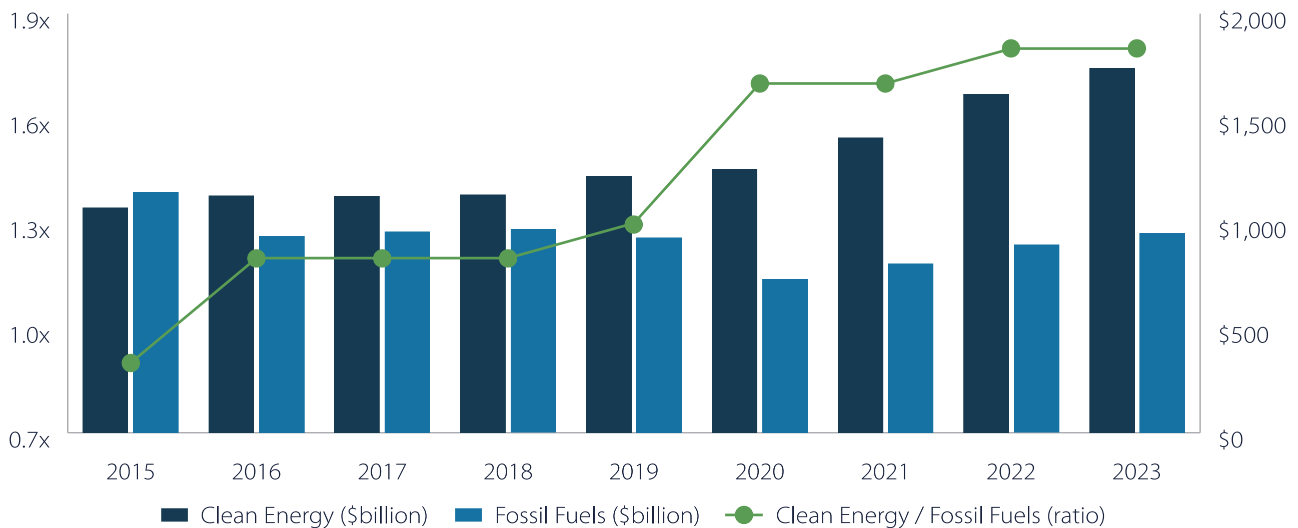
The historic global rate hike cycle spanning from 2022 to 2023 triggered a significant de-stocking campaign across the energy and industrial metals sectors. As interest rates climbed, companies sought to unload physical inventory to mitigate the impact of rising storage expenses. This resulted in a collapse of combined oil inventories within OECD member countries and industrial metal stockpiles held on exchange (Figure C).[7] Both sets of reserves are currently at, or near, 20-year lows.

Figure C: Interest Rates Signal an End to Metals De-Stocking[7]



Another significant reason for the substantial drawdown in inventories has been the persistent underinvestment in new production capacity. Without adequate supply growth, physical shortages have steadily depleted reserves over time. In the case of energy, money is flowing, but it is increasingly being redirected to alternative sources. Figure D illustrates this shift, depicting the ratio of clean energy investment to fossil fuel investment.[8] Since 2016, more money has been channeled towards an electrified future than one reliant on carbon-based fuels. It is worth noting that despite the increase in clean energy investments, over 60% of global power generation and 80% of primary energy use still stem from fossil fuels.[9] Rushing to abandon capital investment in oil and natural gas prematurely could lead to a tumultuous transition for energy consumers.

Figure D: Clean Energy Investment Surpasses Fossil Fuel Investment[8]



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[7] Source (Figure C): Bloomberg, CoreCommodity, 2000 - 2024. Represents combined London Metal Exchange (LME) inventories on warrant for aluminum, copper, lead, nickel and zinc. Federal funds rate inverted to better show relationship.

[8] Source (Figure D): IEA, 2015 - 2023

[9] Source: Energy Institute, "Statistical Review of World Energy", 2022

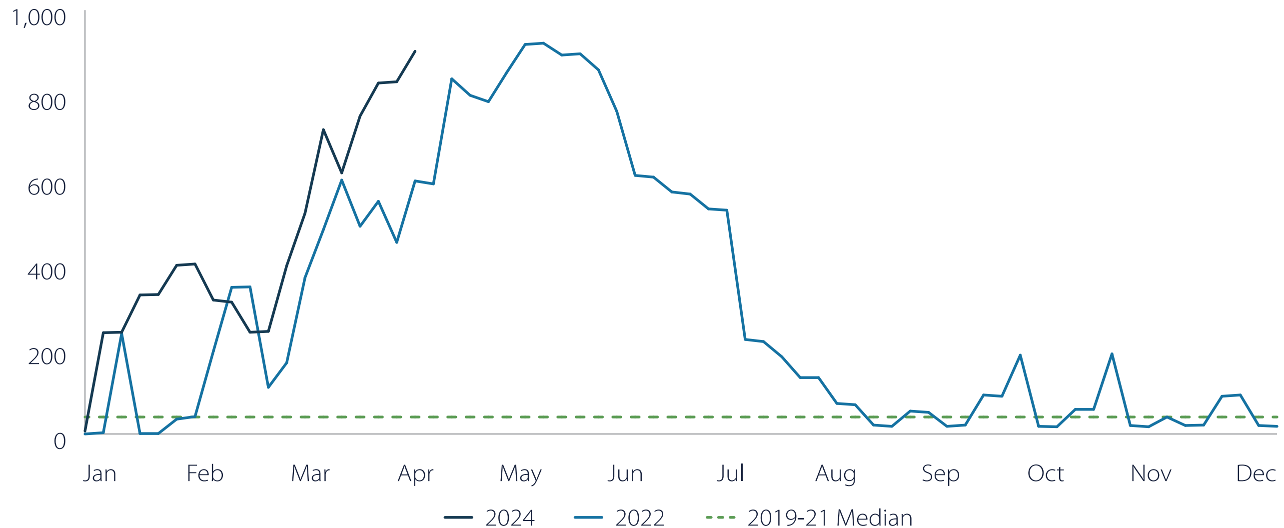
Pillar Three: Challenges to Future Supply

The final pillar of our argument factors in the supply-side of the equation. A growing list of variables have made supply additions less attractive, both in terms of cost and perceived risk. Among those most cited include rising wages, high interest rates, exorbitant regulation and extreme weather. In 2023, the number of billion-dollar natural disasters to impact the US jumped threefold versus the long run average.[10] Last year was also the hottest in recorded history, capping a string of record-breaking years. Together, powerful storms and severe heat have influenced crop yields, encouraged export restrictions and raised power demand.

In addition to greater weather volatility, a rising geopolitical cost is also starting to materialize for global commodity production and trade (Figure E).[11] While Sino-American relations have splintered on economic and technological grounds, other relationships are becoming challenged for more existential reasons. Russia-Ukraine, Israel-Hamas, Venezuela-Guyana and Armenia-Azerbaijan all represent regional proxy wars that may threaten the fabric of global commerce.

Figure E: Russian Refinery Outages Climb on Ukrainian Drone Strikes[11]

Thousand barrels per day



We anticipate greater militarization of this type may be inflationary, whether via damaged supply (e.g., Ukrainian grain), economic sanctions (e.g., Iranian oil) or afflicted trades routes (e.g., Suez Canal). While it is unclear if worsening geopolitical tension is a direct response to waning US influence, it is readily apparent that growing conflict points to a more contested and more unstable global order. In that type of environment, safe-haven and strategically vital assets like gold, oil and critical minerals are likely to benefit.

Final Comments

In light of these growing trends, supply-demand balances have tightened across many commodities as evidenced by the current level of backwardation priced into futures curves (Figure F).[12] Despite the emergence of physical shortages, there is little appetite for companies to increase production, even in certain corners of the industry enjoying record levels of free cash flow. Both spot prices and company valuations are low compared to the post-COVID-19 era, which may be discouraging greater capital expenditures. Whereas the broader S&P 500 Index is trading at price-to-earnings (P/E) and price-to-book (P/B) ratios of 23x and 4.7x, respectively, a diversified basket of natural resource equities exhibits notably lower ratios, averaging 11x and 1.5x.[13]

[10] *Source: National Oceanic and Atmospheric Administration (NOAA), 1850 - 2023*

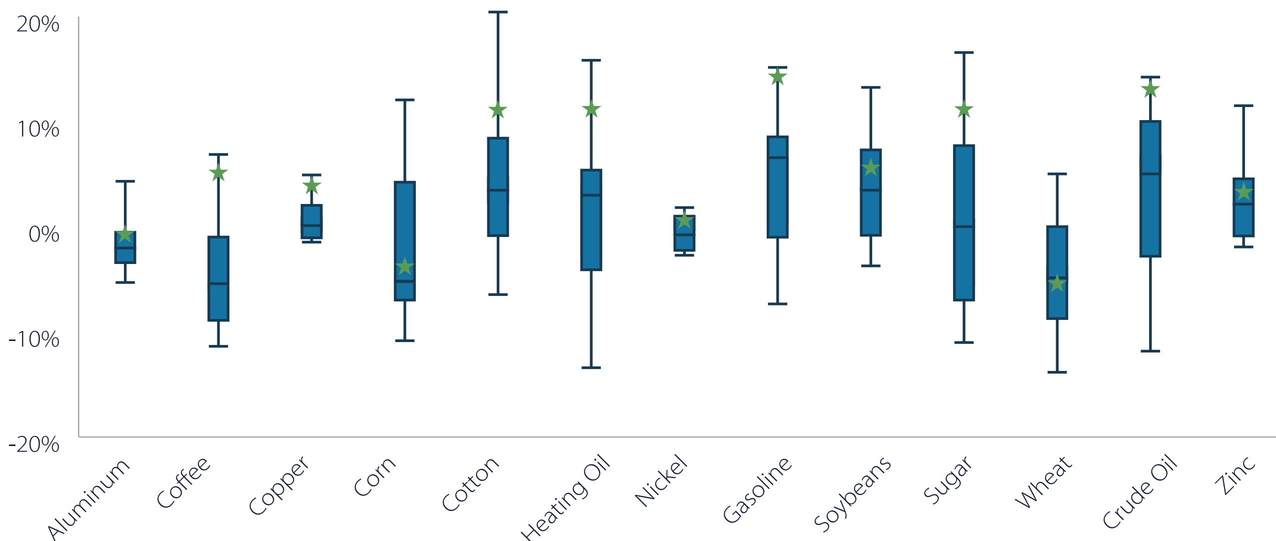
[11] *Source (Figure E): ICE, Platts, CME, Goldman Sachs Global Investment Research, 2019 - 2024*

[12] *Source (Figure F): Bloomberg, CoreCommodity, 2014 - 2024. Markers indicate values on 3/22/2024. Implied roll yield represents the average 12-month calendar spread plus the prevailing US 90-day weekly auction high rate. Outliers have been removed.*

[13] *Source: Bloomberg, 2/29/2024. Natural resource producers are represented by the S&P Global Natural Resources Index.*

Figure F: Backwardation Indicates Physical Shortages[12]

Implied roll yield; 10-year distribution



Given the considerable discount, most companies in the commodity production business have channeled their profits toward shareholders (e.g., dividends and share buybacks) and away from new greenfield projects. Global upstream spending for the mining industry remains more than 30% below its peak around 2014, while spending within the oil and gas industry is still more than 40% below the previous high.[14] Against this backdrop of a rapidly emerging middle class, higher global economic growth, increasing supply risks and greater capital discipline among commodity producers, we believe investors may benefit from an allocation to commodity futures and natural resource equities.

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[14] *Source: BofA Global Research, Citi Research, 2023. Oil and gas capital expenditures (capex) adjusted for inflation. Mining capex represents total outlays, in nominal terms, of the world's top 30 mining companies.*

Important Disclosures & Definitions

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The commodities markets and the prices of various commodities may fluctuate widely based on a variety of factors. Because the Fund's performance is linked to the performance of highly volatile commodities, investors should consider purchasing shares of the Fund only as part of an overall diversified portfolio and should be willing to assume the risks of potentially significant fluctuations in the value of the Fund. The Fund invests in commodity futures related investments, which are derivative instruments that allow access to a diversified portfolio of commodities without committing substantial amounts of capital. Additional risks of commodity futures related investments include liquidity risk and counterparty credit risk. Liquidity risk is the risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss. Counterparty risk is the risk that a party to a transaction will fail to fulfill its obligations. The term is often applied specifically to swap agreements in which no clearinghouse guarantees the performance of the contract.

Another principal risk of investing in the Fund is equity risk, which is the risk that the value of the securities held by the Fund will fall due to general market and economic conditions, perceptions regarding the industries in which the issuers of securities held by the Fund participate or factors relating to specific companies in which the Fund invests. The Fund's investments in non-US issuers may be even more volatile and may present more risks than investments in US issuers. Equity investments in commodity-related companies may not move in the same direction and to the same extent as the underlying commodities.

Backwardation: when the futures price of an underlying asset is lower than the spot price/current price.

Bloomberg Commodity Index: an unmanaged index used as a measurement of change in commodity market conditions based on the performance of a basket of different commodities.

Federal Funds Rate: the target interest rate set by the Federal Open Market Committee (FOMC). This target is the rate at which the Fed suggests commercial banks borrow and lend their excess reserves to each other overnight.

Financial Conditions Impulse on Growth (FCI-G) Index: assesses the extent to which financial conditions pose headwinds or tailwinds to economic activity and explicitly considers the lags through which changes in financial variables are estimated to affect future economic activity.

Purchasing Managers' Index (PMI): an index of the prevailing direction of economic trends in the manufacturing and service sectors. It consists of a diffusion index that summarizes whether market conditions, as viewed by purchasing managers, are expanding, staying the same, or contracting.

S&P 500 Index: widely regarded as the best single gauge of large-cap US equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

S&P Global Natural Resources Index: includes 90 of the largest publicly-traded companies in natural resources and commodities businesses that meet specific investability requirements, offering investors diversified and investable equity exposure across 3 primary commodity-related sectors: agribusiness, energy, and metals & mining.

Roll Yield: the amount of return generated in the futures market after an investor rolls a short-term contract into a longer-term contract and profits from the convergence of the futures price toward a higher spot or cash price.

Price/Earnings (P/E) Ratio: a valuation ratio of a company's current share price compared to its per-share earnings.

Price/Book (P/B) Ratio: the weighted average of the price/book ratios of all the stocks in a portfolio. The P/B ratio of a company is calculated by dividing the market price of its stock by the company's per-share book value.

One may not invest directly in an index.

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