THE COMMODITY RENAISSANCE

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01/27/2022

Our commodity outlook for the coming year will be shaped by three major drivers:

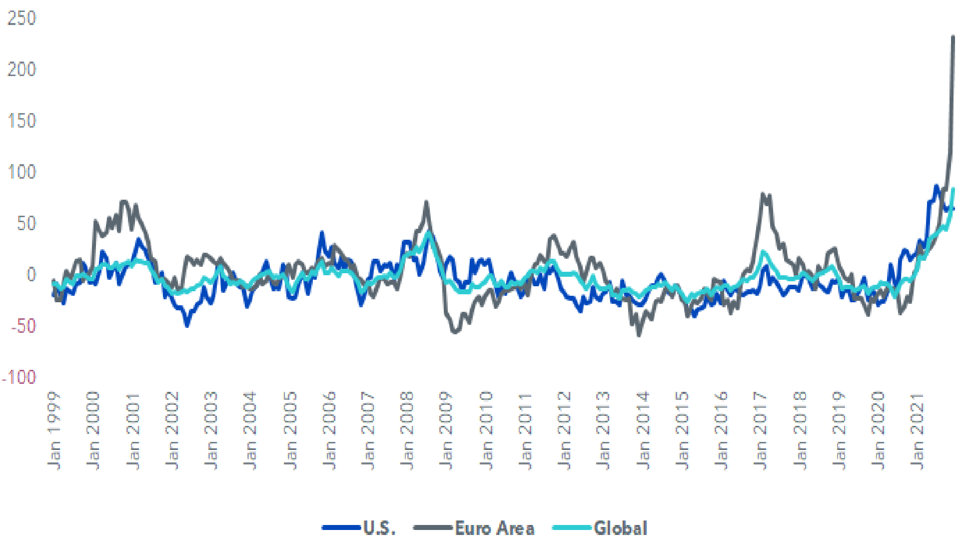
1. A higher inflationary environment than we have seen in recent decades
2. A structural increase in demand for commodities driven by an infrastructure boom
3. A renewed focus on the environment that will increase the demand for certain commodities and at the same time present challenges for supply growth

While none of these drivers are new, and we have been talking about them for the past year, in this blog post we will provide an update on how each of these drivers is progressing. In 2021, commodities were an outperformer, and we are entering 2022 with extremely strong momentum.[1]

Reflation

Although we have been talking about inflation rising for some time, the market seems to have been caught by surprise. Figure 1 shows an Inflation Surprise Index—i.e., the extent to which actual inflation has come in higher than expected by the market.

Figure 1: Inflation Surprise Index



Sources: WisdomTree, Citi Group, Bloomberg, data from January 1999 to December 2021. Past performance is not indicative of future results, and any investments may go down in value. They are defined as weighted historical standard deviations of inflation data surprises (actual releases vs. Bloomberg survey median). A positive reading of the Inflation Surprise Index suggests that inflation releases have, on balance, been beating the consensus.

Inflation Higher for Longer

Although central banks—including the U.S. Federal Reserve—have dropped their "inflation is transitory mantra" and are preparing to tighten policy, their actions can only impact demand growth. A key source of much of the inflation we have seen in the past year has been supply-side disruptions. As Omicron cases rise globally, there is a cogent reminder that supply-side frictions are not guaranteed to dissolve. So, as we get used to living with COVID-19, we may also have to get used to living with elevated inflation.

Investors looking to hedge against elevated inflation, especially unexpected inflation, would be wise to look at the commodity complex. Whether we talk about gasoline pipeline disruptions driving up the price of gasoline or drought conditions pushing up the price of food, there are many commodities whose prices will react, providing a natural hedge to the increasing price pressures felt in a consumption basket.

Infrastructure Boom

Following the COVID-19 pandemic, the political will to support infrastructure projects has strengthened. In Europe, a budget of close to €2.018 trillion in current prices has been devoted to the recovery. More than 50% of the budget will support modernization though research and innovation, fair climate and digital transitions and developing resources for health preparedness. All these initiatives will require some form of infrastructure improvements.

In the U.S., the Senate passed a US$1.2 trillion infrastructure bill . While watered-down from its original US$2 trillion design from the White House, the bill’s approval was unusually bipartisan. Figure 2 highlights some of the infrastructure initiatives the bill contains. We believe that this will act as a strong catalyst for commodity demand in the U.S.

Infrastructure projects are commodity intensive, and they tend to last a long time. Therefore, the impact on commodity markets may transcend more than a typical business cycle.

Figure 2: U.S. Infrastructure Bill Spending Plans

$109bn Roads, Bridges, Major Projects	$11bn Transport Safety	$49bn Public Transit	$66bn Passenger and Freight Rail
$7.5bn EV Infrastructure including 500,000 EV Chargers	$7.5bn Electric Buses/Transit	$1bn Reconnecting Communities	$25bn Airports
$16bn Ports & Waterways	$20bn Infrastructure Financing	$55bn Water Infrastructure	$65bn Broadband Infrastructure
$21bn Environmental Remediation	$73bn Power Infrastructure incl. Grid Authority	$5bn Western Water Storage	$47bn Resilience

Source: "FACT SHEET: President Biden Announces Support for the Bipartisan Infrastructure Framework," The White House, 6/24/21.

Energy Transition

We believe an energy transition will take place, where we will move rapidly away from the consumption of hydrocarbons, which produce lots of greenhouse gas emissions, to renewable energy sources. Driving this trend are the commitments to the Paris Agreement—a legally binding international treaty on climate change with a goal to limit global warming to well below 2 degrees Celsius and preferably to 1.5 degrees Celsius, compared to pre-industrial levels. All the materials that support renewable energy and the technologies that enable the practical use of renewable energy such as batteries will be in greater demand. An electrification of road transportation will augment this trend. In the commodity markets, this will be broadly favorable for base metals including copper, nickel, aluminum, zinc and tin.

The Supply Challenge

In addition, a renewed focus on environmental outcomes will push miners into better environmental practices: more careful dealing of tailings, avoiding mining in ecologically sensitive areas, reducing green-house gas emissions in the mining process.

All of these will be welcome developments to make the industry more sustainable. However, we may find that mining activity slows while the industry makes this adjustment.

In 2021, China's crackdown on its aluminum industry, which relies heavily on coal for its power needs, was an example of supply pressures arising from tighter environmental policies. With China being the world's largest aluminum producer, the metal could remain undersupplied for years as the industry transitions to cleaner alternatives for its energy needs.

Conclusions

Commodities entered a bull cycle in 2020 after what we believed was the worst of the COVID-19 pandemic was behind us, and this rally continued into 2021. However, lingering COVID-19 effects are hampering supply chains and driving inflation higher. Commodities are a hedge for inflation and generally are likely to prosper, especially in the shadow of a monetary largess that is already in the system. Even if the inflation catalyst wanes as we move to the next business cycle, the boom in infrastructure and an energy transition will likely propel many commodities for years to come.

[1] In calendar year 2021, the Optimized Roll Commodity Total Return Index (EBCIWTT Index) rose 27.3%, real estate (RUGL Index) rose 27.2%, world equities (MXWD Index) rose 16.8% and bonds (LGSVTRUU Index) fell 3.5%. All data sourced from Bloomberg.

[2] "Recovery plan for Europe," European Commission. https://ec.europa.eu/info/strategy/recovery-plan-europe_en Richard Cowan and Susan Cornwell, "U.S. Senate pivots to $3.5 trillion bill, key to Biden's agenda," Reuters, 8/10/21.

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DEFINITIONS

Commodity : A raw material or primary agricultural product that can be bought and sold.

Inflation : Characterized by rising price levels.

Growth : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.