



# In transition

Despite signs of stabilisation, the likelihood of a swift comeback in commodities remains slim as physical markets continue to grapple with a supply glut

BY STEFAN GRABER

**F**OLLOWING a turbulent year and heavy losses in 2014, commodities were given a breather at the beginning of this year. Despite apparent signs of stabilisation, we consider the likelihood of a swift comeback of commodity markets as slim as physical markets continue to grapple with excess supplies. Instead, we see 2015 as a transitional year during which new projects are being shelved, while lower prices should provide a lift to the economy and subsequently, demand.

However, this process will take time. Long lead times of commodity projects, reduced input costs and devaluing producer currencies cause supply adjustments to be slow. At the same time, lower commodity prices will lift economic activity only if businesses and consumers invest the windfall instead of just saving it.

This should be the case for the US and some oil-importing emerging markets, while taxes and price controls on end-products or the lack of confidence in other regions (for example, China and Europe) are diluting this potential catalyst at this point. Still, on balance, lower commodity prices are triggering a substantial shift of wealth from exporters to importers, with a net positive impact on the global economy.

## Displacement cycles are underway

At sector level, we find that a growing number of markets appear undervalued based on our valuation metric, suggesting that displacement cycles are underway. More specifically, this rebalancing mechanism appears more advanced in industrial metals and to a lesser extent in bulk commodities, where prices have been sliding for an extended period.

Oil markets are arguably at an earlier stage in this context, but technological progress has made shale oil operations, which can be ramped up and down more swiftly, more flexible. Precious metals form a category on their own as these metals are more sensitive to interest rates and inflationary dynamics, given the significance of investors on the demand side. Agricultural markets have shorter investment and production cycles than hard commodities, and we believe that the sector is in a bottoming process since last year's price declines appear deep enough to trigger a supply adjustment already in the upcoming season.

## Challenges for investors

Commodities have been a real stretch for investors' risk budgets amid elevated volatility and high carry costs. Against this backdrop, benchmark index return prospects (which are driven by spot returns, roll costs and collateral yields) remain subdued. Specifically, oversupplied physical markets are capping spot returns, while growing inventories are causing term spreads to widen; hence, roll costs are rising, and low interest rates are dampening collateral yields.

Initially projected Fed rate hikes later this year will not alter this situation greatly. Although inverse US dollar correlations are inconsistent across commodities, continued firmness of the US dollar provides further headwinds. Actively managed and dynamic strategies should thus prove the more suitable approach in this challenging market environment amid low intra-commodity correlations.

As an alternative to direct positions, investors can also look for related equity (or credit) exposure, particularly in commodity-intensive segments such as manufacturing, petrochemicals and refining, which have seen input costs being slashed. Consumer discretionary segments also appear interesting as consumers can spend their money at department stores instead of petrol stations. Opportunities can also be found among master limited partnerships (MLPs) or US high-yield bonds.

## The new 'normal' in oil markets

2014 witnessed tectonic shifts in oil markets with long-lasting repercussions. Efficiency gains facilitated by fracking technologies have triggered the North American shale revolution, which is shaking up old market structures, where the Organization of the Petroleum Exporting Countries (Opec) dominated market dynamics.

In the new world, US shale has become the marginal barrel, leaving Opec with the only sensible choice of keeping the taps open in an attempt to defend market share. Unilateral cuts would only facilitate further production gains outside of Opec, paving the way for it to be left with an even smaller share of the pie. However, only core-Opec members can really afford this strategy considering fiscal, debt and reserve situations. Other heavily energy-dependent exporters, including Russia, are facing even tougher economic challenges.

In the absence of producer restraints or an immediate

demand response, the supply adjustment will have to be triggered through lower prices in order to reverse surplus dynamics. Given the scope for further efficiency gains and deflating production costs, prices may have to stay low for some time in order to sufficiently deter capital.

That said, we consider prices around US\$50 as undervalued and too low to sustain the recent pace of output growth and importantly, to ultimately satisfy future demand growth – which, despite everything, is still positive. We see a price range around US\$70 as a more sustainable medium-term equilibrium. At least recent announcements of significant capex cuts by exploring companies suggest that this process has started. In the meantime, however, and until actual production slows more meaningfully, volatility is set to remain elevated.

At the same time, a sustained return to US\$100 per barrel seems highly unlikely or very distant as besides flexible North American shale production, considerable volumes of low-cost oil might become available again from Libya, Iran and Iraq at some point. This would be good news, at least for consumers.

## No sustained comeback for gold

Gold has been in a consolidation mode for some time, and we would link bouts of support to transient factors such as eurozone uncertainty, as well as recent policy experiments by central banks including the Bank of Japan, European Central Bank and Swiss National Bank. We still find that gold's broader fundamental backdrop remains lacklustre. Robust US macro data suggest that the Fed is likely to start hiking rates this year, which, in combination with muted inflationary pressures, should ultimately dampen investor demand.

Gold's desirable characteristic of not having any default risk is rendered less relevant by widespread asset purchase programmes, which help reduce the risk of paper instruments. Continued US dollar firmness bodes ill too. Neither physical markets (jewellery and bars/coins), nor central banks (falling FX reserves among emerging-market central banks signalling fewer diversification needs) appear able to compensate for subdued investment demand. Hence, we expect gold prices to ultimately drift lower. ▣

Stefan Graber is Head of Alternative Investment Strategy, Credit Suisse Private Banking and Wealth Management