GLOBAL COMMODITIES: STILL IN A HOLE

AVIVA INVESTORS
January 2016

Key points

China's transition to a new economic model has led to less direct demand for oil and metals and triggered lower growth in other emerging markets

Today, there is a significant excess supply of commodities at a time when demand growth has stagnated

As most commodity markets are nominally priced in dollars, the continued strength of the US dollar is also curtailing commodity prices

Lower prices have increased the pressure for producers to improve productivity, adding to the excess in supply

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Ian heads our Investment Strategy Team and is responsible for formulating our 'House View' and the risks to that view. He joined in 2014 as a senior portfolio manager in the multi-asset team, focusing on our multi-strategy range known as AIMS.

Previously he spent over ten years at Standard Life Investments.

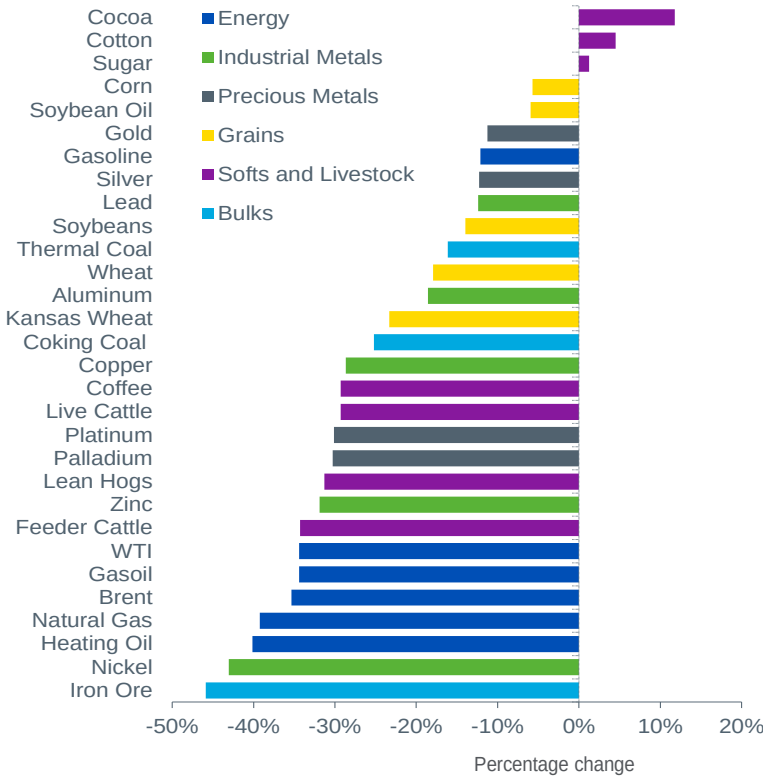
Plummeting prices are leading to a wholesale reassessment of the global commodities complex. But with continued downward pressure from oversupply and US dollar strength, there seems little prospect of a recovery in 2016, writes Ian Pizer.

It is difficult to ignore China's influence on global commodities. While its transition to an economic model that is driven less by commodities, and the ongoing slowdown that has accompanied it, has led to less direct demand for oil and metals, it has also contributed to lower growth in other emerging markets.

A decade or so ago, commodity producers of all kinds began a period of aggressive capital investment based on assumptions that China's economy would continue to grow at an annual clip of around ten per cent. But while annual Chinese GDP growth averaged almost 11 per cent between 1989 and 2011, it has averaged closer to seven per cent in recent years and is on a gradually slowing trajectory that we expect to continue for several years.

Initially, the positive assumptions on China's growth helped spark the so-called commodities 'super cycle', where ever-rising demand was matched by rising capex. However, due to the time required to develop assets like new oil and gas platforms and mining operations, we are now witnessing the down leg of that same cycle. Today, there is significant excess supply at a time when demand growth is either falling or stagnating. As the chart shows, this has sparked a collapse in commodity prices that shows little signs of relenting.

Chart 1: Commodity price changes in 2015



Source: Citigroup Global Markets as at 17 December 2015.

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The problem facing commodity producers is how to remove excess capacity from the system. A good example is provided by Saudi Arabia, the world's most important 'swing' producer of oil.

Endless analysis has been devoted to the idea of a Saudi-led oil price war, ostensibly aimed at combating the impact of a vibrant new shale oil sector and the fact that crude oil is now priced far below the budget 'break-even' levels required for oil-producing states. The fact is, however, that Saudi Arabia, like its OPEC counterparts, can no longer afford to stop pumping.

For most state producers, oil is the premier asset in their portfolios. As long as it remains cash flow positive, they have little choice but to ignore the 'sunk' costs that account for such break-even figures and to continue pumping as much oil as they can. Indeed, for many, falling prices oblige them to pump more, not less. This partly explains why oil production is now at record levels in both Russia and Saudi Arabia, with total OPEC output also nudging close to an all-time high.

The story is the same for private sector commodity assets. Regardless of whether a government or corporation owns the asset, the need to generate cash flows is paramount. Absent a major political shock, there seems little to halt the imbalance between demand and supply.

History and politics

These issues are not new. Historically, the commodities industry has always struggled to keep capex aligned with likely future demand. And while Saudi Arabia continues to generate headlines, its focus on maintaining market share is not surprising. Its leaders learnt a painful lesson back in the early 1980s by supporting an artificially high oil price that resulted in their effectively subsidising the growth of competitors.

This time, prolonged oil price strength prompted the emergence of the shale oil sector which, thanks to recent technological advances, has rapidly become a major threat to traditional producers.

Meanwhile, Canada's massive tar sand oil fields continue to produce, despite being barely cash-flow generative due to the difficulties of mothballing. Tellingly, commentators no longer talk of how the world will run out of oil.

International diplomacy is also having an impact. Fresh from its summer announcement of a rapprochement with Cuba after six decades of trade sanctions, the autumn of 2015 saw the US government push ahead with a programme to normalise relations with Iran.

Despite Republican unease, the Obama administration's efforts to negotiate the dismantling of Iran's nuclear infrastructure have resulted in the lifting of international trade sanctions on Iran. This will bring some of the world's largest oil and gas reserves back into play.

A few dollars more…

The other factor keeping commodity prices contained is the strength of the US dollar. As most commodity markets are nominally priced in dollars, a rising dollar naturally tends to curtail prices.

The US Federal Reserve has taken its first modest steps to raise US interest rates. It may turn out to be the slowest tightening cycle on record but, along with the relative strength of the US economy, it is likely to be sufficient to maintain the relative strength of the currency – especially with quantitative easing continuing in Japan and Europe, and most emerging-market economies still struggling.

While the dollar's strength has helped supress commodity prices, the consequent fall in commodity currencies, which wrong-footed most observers, has reduced both operating and capital costs in many emerging markets. The upshot is that production of both oil and metals has been far more resilient than market participants had expected.

Although plant closures are rising and new capex is being shelved across the commodities complex, it will take time for this to materially impact supply dynamics. Lower prices have increased the pressure for producers to generate greater efficiencies and improve productivity, meaning cost deflation and higher productivity levels still have some way to go. Most likely smaller, high-cost producers will need to be forced out of business before any persistent price recovery can begin.

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