Maerki Baumann & Co. AG

PRIVATE BANK

INVESTMENT COMMENT

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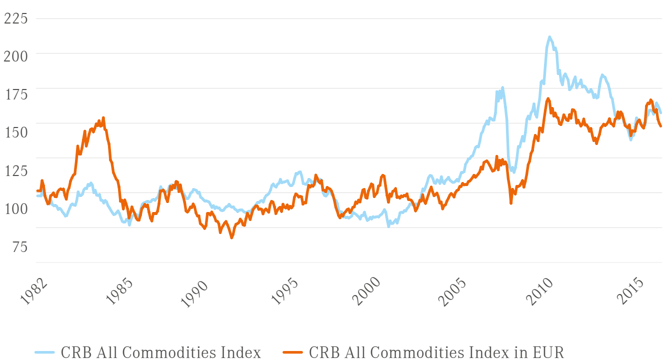
Commodity prices at the crossroads

Whereas commodity prices were something of a "dull affair" in the decades prior to 1970 – when viewed on the basis of long-term, inflation-adjusted developments – they embarked on a rollercoaster journey at the start of the 1970s that has continued until the present. Many older investors will recall the two oil crises, during which the price of crude oil shot up from around USD 3.50 per barrel to almost USD 40.00 per barrel (+1,040%). Even when adjusted for the significant inflation experienced during that decade, the rise in the oil price between mid-1973 and mid-1980 still comes to over 500%. But it wasn't just energy prices that went up during the 1970s. At the beginning of the decade, the prices of agricultural commodities such as maize and soya rose by multiples of 4 and 6 respectively within just a few years – or an impressive 170% and 400% on an inflation-adjusted basis.

Prices in USD and EUR



Source: Bloomberg

The inflation of the 1970s was successfully combated by the monetary policies of the world's leading central banks at the beginning of the 1980s, with the consequence that commodity prices fell sharply in the 1980s and 1990s. However, it was actually not so much monetary policy that lay behind this decline in commodity prices, but rather the fact that they had been so high in the previous decade. Indeed, commodity experts are fond of explaining the long-term development of prices with the bon mot "high prices are the best cure for high prices". This phrase is a reference to the behaviour of both producers and consumers, as the former increase production against a backdrop of high prices, while the latter reduce demand by switching to other goods (substitution) and increasing consumption efficiency.

Looking at the situation in the years prior to the 2008/09 financial crisis, a phenomenon common to every commodity boom becomes apparent: the perception that the world is running short of certain commodities because the ongoing rise in demand from the emerging markets (particularly China) will outstrip expected growth in production. The oil price is a good example: From a record low of USD 10 per barrel in 1998, it rose to more than USD 147 by mid-2008, which equates to a rise of almost 31% p.a. China's impressive growth and its significance for global commodity consumption can be illustrated by the following statistic: In 1998, Chinese oil consumption stood at 4 million barrels per day, whereas ten years later it amounted to almost 8 million – essentially double. During this period, the term "peak oil" (the maximum global oil production rate) was very much in vogue. This concept dates back to a hypothesis put forward by an American geophysicist in the 1950s, and expresses the idea that from a certain point in time no further oil reserves of note will be found, whereas demand for this fossil fuel will continue to grow – the classic Malthusian trap.

With the help of Google Trends (trends.google.com), the frequency of internet search queries can be analysed over time, albeit only back to 2004. Interestingly, the term "peak oil" was at its most popular in mid-2005 (normalized value of 100) – whereas by mid-2008, when the oil price had surged to an all-time high, the equivalent figures was still 75. The figure today is just 2, i.e. the term is searched some 50 times less frequently on Google than it was back in 2005. This is hardly surprising given the dramatic 75% decline in the price of oil between mid-2014 and the start of 2016 – which is attributable to strong growth in US oil production on the back of modern fracking technology. Indeed, according to analysis carried out by Norwegian company Rystad Energy in 2016, the US now has greater oil reserves than any other country.

"Low prices are the best cure for low prices." The commodity boom during the first decade of this century – or to be more precise, the rise in commodity prices by more than 170% between the start of 2002 and the end of 2008, according to the Bloomberg Commodity Index – was ultimately the consequence of the steep decline in commodity prices over the previous two decades. Supply was scaled back dramatically, many mines were closed, and exploration was reduced to an absolute minimum. When demand then began to rise again at the start of the last decade, it rapidly became apparent that production was unable to keep up.

So what is the situation now? The sharp decline in the Bloomberg Commodity Index from mid-2011 onwards – amounting to some 60% up to the nadir of early 2016 – has not come close to being fully reversed (+20% since the start of 2016). By way of comparison, against the backdrop of the financial crisis commodity prices declined by almost 60% between its mid-2008 peak and its low in the first quarter of 2009, only to bounce back by 70% by the middle of 2011. In particular, the pronounced slump in global financial markets in 2015, which was attributable to fears of a "hard landing" by the Chinese economy, prompted global commodity producers to slam on the brakes on exploration and slash investment. The repercussions of this phenomenon for the mining and oil production industries will be felt for a number of years yet. At the same time, China's leadership has been taking steps to reinvigorate the Chinese economy, and has made it clear that China intends to keep growing briskly over the next few years too, even if the economy will have to undergo a transformation from an investment-based economic structure to a more consumer-based model.

Conclusion

One important factor driving commodity prices – the external value of the US dollar – has not yet been mentioned. The commodity boom of the 2000s was accompanied by a 40% decline in the value of the trade-weighted US dollar. The outlook for the greenback will certainly play an important role for commodity prices going forward – and we believe its prospects are rosy given the more advanced state of the US economy in the economic and interest rate cycle. This could prove a significant obstacle to the upward march of commodity prices, which are quoted in USD. In other words, the rollercoaster is set to continue. That said, we see significant potential for commodities over a horizon of two to three years. In our view, the segment with the greatest upside price potential is that of precious metals, which will benefit from persistently low real interest rates, while on a short-term basis industrial metals look susceptible for a correction following a price rise of 20% within three months. A de-escalation of tensions in the Middle East (Iraq/Kurdistan, Qatar, Iran) could also see the oil price give up some of the gains of recent weeks. Finally, we believe that agricultural commodities, which are currently languishing at their lowest level since 1991, have a very appealing risk-return profile.

MAERKI BAUMANN & CO. AG
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EDITORIAL
Daniel Egger, Chief Investment Officer
Reto Cavelti, Senior Investment Advisor
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ZURICH
Dreikönigstrasse 6
CH-8002 Zurich
Phone +41 44 286 25 25
info@maerki-baumann.ch
www.maerki-baumann.ch