MAERKI BAUMANN & CO. AG

PRIVATBANK

Commodity realities

Market Comment, April 2024

In 2022, commodities put in a much better performance than both bonds and technology stocks from the so-called "new economy". While the picture was different in 2023 and continues to be so in 2024 due to the potential offered by generative artificial intelligence, commodities have started on the road to recovery. "Old economy" sectors such as commodities and "value" stocks in general could be lent a helping hand by the still unresolved supply deficit for commodities that are important for the global economy and electrification. The decline in investments in oil or copper production, for example, which has been observed for some time now, shows that commodities deserve their place in an investment allocation despite volatility.

In the global commodity markets, the discussion regarding rising or falling demand has been the main topic of conversation for many quarters. While optimists point to a surprising spike in demand in the US for oil and other commodities, pessimists fear that both demand and commodity prices may fall in light of the recession risks in the Eurozone and below-average economic activity in China.

However, it is even more important to keep an eye on the supply situation in the commodities space. It is not only the Ukraine war that has shown that relatively low levels of production and sanctions can push commodity prices upwards and thus keep inflation above average by historical standards. The fact that too little has been invested in the extraction of raw materials in recent years for various reasons is a factor here. Environmental and climate protection, the prioritisation of dividends and a lack of investor interest in oil, gas and industrial metals are likely to have been some of the reasons for declining investments in commodity projects.

The result is an ever more apparent shortage of raw materials that are not only important for the national security of states, but also for consumers and companies. The energy crisis experienced in Europe in 2022 owing to the disruption in the natural gas supply was a prime example of this. Despite a renewed rise in commodity prices, real capital investment in crude oil and copper, which is so important for electrification, currently stands at its lowest point for around 15 years.

It is, of course, true that economic data and demand expectations formed on this basis can influence commodity prices in the short term. What will be more important over the medium to long term, however, is whether or not, for example, there will be an adequate expansion in the production of important metals and other raw materials to meet long-term requirements in the area of electrification. As things stand, most commodities are characterised by a foreseeable supply deficit, meaning that production capacities will be insufficient to meet conceivable long-term demand.

> "A continuing supply deficit may have a significant impact on various commodities."
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> Gérard Piasko, Chief Investment Officer

This is likely to lead to a decline in existing stocks in areas that are important for the transport industry and climate protection as well as for other parts of the world economy and may result in new bottlenecks and inflation-relevant fluctuations in commodity prices. This is because with a continuing production deficit, commodities will not only remain particularly vulnerable to short- and medium-term changes in demand, but also to changes in short-term supply levels, which could arise once more in the event of further tensions in the Middle East, for example. The situation is only likely to change when it is realised globally that there is no shortage of capital investment in technology, i.e. for the "new economy", but there is a lack of investment in the "old economy", i.e. the production of raw materials, on which we will be dependent for longer than we may think, as the war in Ukraine has shown.

For social or domestic political reasons, strikes and supply shortfalls occur relatively frequently in the area of global mining production, especially in Latin America. In the case of industrial metals, which are extremely important for the global economy, including the automotive and mechanical engineering sectors, capital investment in 2022 came in at only around 50% of the 2010 level, which highlights the medium-term risks. Not only copper, but also zinc and aluminium now also have a significant supply deficit in some cases, as do crude oil and energy products derived from it.

Commodity-related production bottlenecks are also being observed in the agricultural sector, which can increase prices. The reasons for this are higher fertiliser prices as well as more extreme and volatile weather conditions. The "El Niño" weather phenomenon (which brings warmer than average temperatures in the Pacific) could hit agricultural harvests in Latin America or Asia. As geopolitical risks are likewise unlikely to return to the lower levels seen in years gone by, it can generally be expected that supply risks will recur in part for many commodities – as the example of the current situation with cocoa demonstrates.

In conclusion, it can be summarised that a continuing long-term supply deficit can have a considerable impact on commodities. However, the volatility of this asset class, which has historically always been more pronounced than in other asset classes, is set to remain high due to uncertainties in terms of demand.

Gérard Piasko

Gérard Piasko is Chief Investment Officer and head of the investment committee of private bank Maerki Baumann. Before he was for many years Chief Investment Officer of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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