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## Poised for significant improvement in 2014

*It's likely that 2013 will mark the third consecutive year of declining commodity prices. However, we believe that commodity markets are well positioned to improve significantly in 2014 as demand recovers in line with the global economy.*

Growing demand is the most important driver of increasing commodity prices, and global economic growth is the essential pre-requisite for a rise in demand. Growth expectations for 2014 have recently been revised upwards and this improvement will underpin demand for commodities. The OECD economies and in particular the US will drive global growth, which supports our view that oil-based energy will be the strongest sector next year. This is because these economies are not as infrastructure intensive as emerging markets and thus are more reliant on cheap and readily-available energy than base metals.

However, we anticipate that a number of those emerging economies, which are most aligned to the recovery in American and global growth, will also gain strength through 2014, thus boosting demand for base metals later in the year. The fact that grain prices are substantially lower than was the case a year ago (inventories have been replenished in 2013 reflecting more settled weather in both the northern and southern hemispheres) will also support consumer demand in emerging markets. This creates the possibility of positive surprises to growth among the emerging economies.

### **Pricing and availability of resources to support global growth**

In our view, abundant and relatively affordable natural resources are an essential precondition to a resumption of strong and sustainable global growth. Following three years of declining commodity prices, there is enough spare capacity in resource production to facilitate a return to bottom-up, real economic growth.

There are of course concerns about the effects of "tapering", when the Federal Reserve decides to scale back its programme of asset purchases. The impact of quantitative easing (QE) may be debatable, but it has supported a number of economies during the hiatus before the global economy returns to bottom-up growth while also avoiding a massive worldwide depression. Consequently, we believe that when QE is tapered, economic growth will not be affected. Indeed, tapering is likely to support business confidence since it will imply that the economy is returning to health, and that business conditions are normalising.

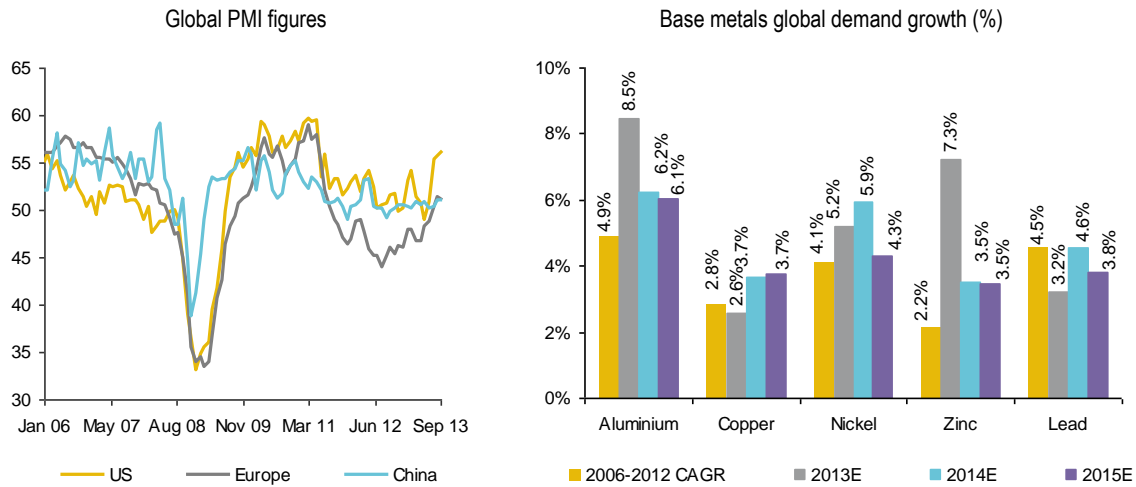
We are most constructive on oil-based energy where the fundamentals are strongest and supply is just about keeping pace with demand. Any oil price weakness will boost demand and OPEC will strive to prevent any significant declines in oil prices.

Soft commodities are already trading significantly below their cost of production, a situation that is resulting in falls in production, while low prices are creating robust demand that is steadily consuming inventories. Thus, we anticipate that soft commodities prices will stabilise and even rise over 2014.

### **Base metals to lag overall rally**

Base metals will rally later than other sectors because, although we have seen significant increases in demand through 2013, the production surge that was signalled five years ago is now in full swing, and will, in fact, abate through 2014. Indeed, we could see significantly tighter metals markets by the end of next year.

**Figure 1: Demand growth for base metals has remained strong...**

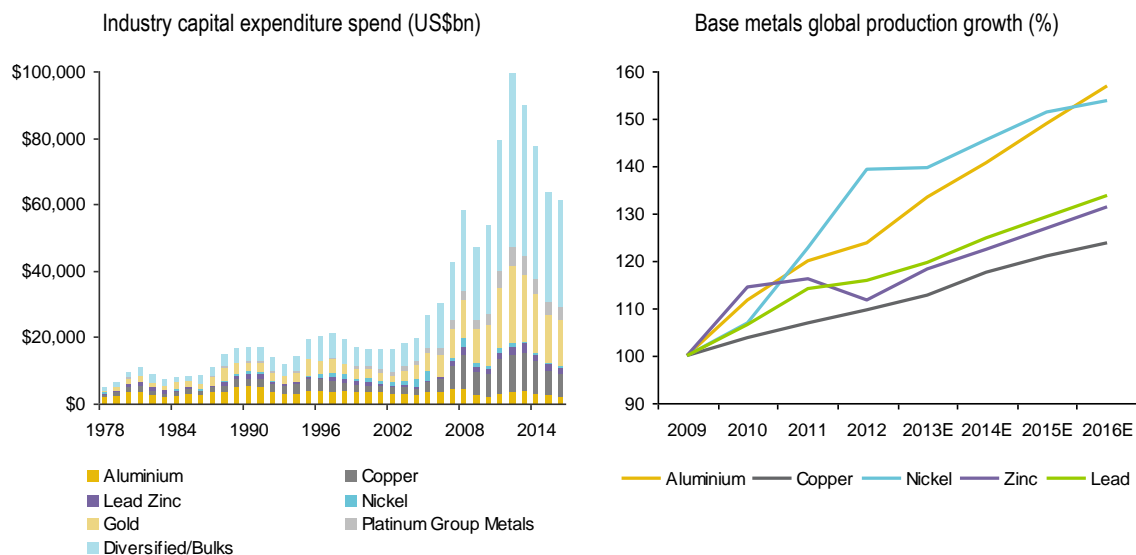


Source: Bloomberg, Threadneedle, Citigroup, October 2013.

Grains have returned to very affordable levels and strong producer profit margins are only found in wheat and soybeans. At current levels, grain prices should be stable through next year, but weather-related disruption could quickly send these markets soaring again. Livestock prices should remain steady and even strengthen as global growth boosts incomes, driving demand for high quality protein across all markets.

Lastly, precious metals are likely to face headwinds over the next few months as an improving US economy, combined with a decreasing appetite for oil imports (reflecting the impact of shale energy), translates into a stronger environment for the US dollar. Importantly, the rapid increase in US oil production, declining demand and strong economic growth, means that a strong dollar and rising commodity prices are no longer mutually exclusive. Commodity markets are continually evolving and developments over 2014 are likely to prove highly interesting.

**Figure 2: ...but supply growth has been more robust**



Source: Bloomberg, Threadneedle, Citigroup, November 2013.

## Conclusion

We have identified four key themes, which will drive commodity markets in 2014:

- The US economic recovery will boost OECD economies first, with emerging economies benefiting later. Improving global growth will propel the next wave of growth in demand for commodities with prices also lifted higher.
- Geopolitical risks in key oil-producing regions are increasing.
- Although the growth rate of the Chinese economy is slowing, absolute demand for commodities continues to increase.
- Given the current low prices for many commodities, investment in new supply is unlikely to occur quickly.

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