Viewpoint

Commodities – March 2014

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OECD to drive global growth and commodities as emerging economies slow

While the rise of the emerging markets, and particularly China, has been the key driver of commodity prices in recent years, we believe that the recovery of the developed economies, and in particular, the US, will prove the main influence on global commodities in 2014.

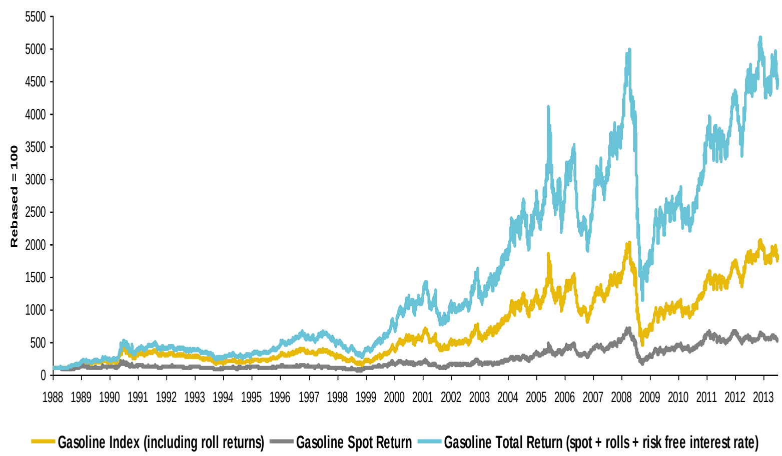
The economic recovery underway within OECD countries will result in a cascade effect within commodities with oil-based energy the first sector to experience positive price momentum and base metals among the last. This is because the advanced economies are not as infrastructure intensive as emerging markets and thus are more reliant on cheap and readily-available energy than on base metals.

Higher forecasts for US gasoline demand and prices

The US recovery will fuel increased demand for gasoline this year. According to the International Energy Agency, US oil demand rose by 390,000 barrels a day last year, or 2%, reversing years of steady decline and the US Energy Information Administration (EIA) has been increasing its forecasts for gasoline demand and retail prices in the US. Thus, in January 2014 the EIA said that gasoline consumption will average 8.78 million barrels a day this year, up 0.5% from its December outlook of 8.74 million barrels.

Consequently, we hold an overweight position in Crude Oil and products such as gasoline. Forward curves for Brent Crude, WTI, gasoline and heating oil are in backwardation, where the spot price is higher than prices for future delivery, so the curve is inverted as a result of strong upward pressure on current prices. We want to exploit that backwardation, the benefits of which can be seen in Figure 1 below, because it contributes towards the positive roll return that has been eluding commodity investors for a number of years.

Figure 1: Long-term gasoline returns: structural positive roll yield



Source: Threadneedle, Bloomberg, as of 30 September 2013.

Continuing support for US natural gas prices

Elsewhere within the energy complex, US natural gas prices at Henry Hub, the US benchmark, are likely to be resilient as inventories are rebuilt following the recent extraordinary cold weather in the US. A hot summer would also prove an impediment as natural gas is used to generate the electricity that powers air conditioning. Moreover, infrastructure bottlenecks could constrict supplies.

Thus, we could only be certain that prices would fall if we have benign weather between now and the end of the year and infrastructure in the US proves adequate to the task of refurbishing inventories. Given these uncertainties, we believe it is difficult to make predictions in this area with any confidence.

Corn and wheat prices unlikely to fall this year

We believe grains will be the next commodity complex to be affected by the cascade effect. There is speculation that corn and wheat prices will fall this year despite strong global demand. But we believe that this is unlikely given that such an outcome depends upon perfect weather conditions over the northern hemisphere.

In addition, a fall in prices would require the major producers in the southern hemisphere, namely Argentina and Brazil, to deliver their harvests flawlessly into markets. Given the instability we are seeing in Argentina this prospect is clearly in doubt.

Base metals to remain weak for much of 2014

Base metals and precious metals will be the final area to be influenced by the recovery in the developed world. Emerging markets are much more intensive users of base metals, reflecting heavier investment in infrastructure than the advanced economies and thus base metals will pick up as burgeoning demand in the OECD economies boosts the developing world and hence eventually infrastructure spending.

We may well retain our underweight in base metals for most of 2014 because of decelerating growth in China and a slowdown in the growth of infrastructure spending among the emerging economies in general. Infrastructure spending is certainly not growing as fast as the main suppliers of base metals had anticipated. Although these companies are now cutting capital expenditure, projects already underway will continue to boost capacity and that situation will not change until the end of this year. Production will subsequently start to level off slightly but further time will pass before demand and supply are balanced.

In terms of individual metals, we have a positive view on nickel, zinc and lead and a negative outlook on copper and aluminium.

Strong dollar to sap demand for gold

Turning to precious metals, a strong dollar will be the key factor. The US will lead the recovery in the OECD, boosting the dollar. Consequently, investors who were using gold as a safe haven are re-evaluating their positions and looking to redeploy into dollar-based assets, such as US bonds, equities and infrastructure projects. We believe that this investment shift will continue as the dollar strengthens over the next few years, reflecting the shale energy revolution. Consequently, we have a small underweight in precious metals, reflecting our view that the appeal of a strengthening US dollar as a store of value will challenge the price of precious metals.

Apart from being one of the key drivers of the US recovery, shale energy will have a dramatic impact on geopolitics and the global economy, and hence commodity markets, in the coming years as the US becomes increasingly energy independent.

In particular, the long-standing relationship between the dollar and commodity prices will change. Since fewer dollars will be spent outside of North America to support oil consumption and the US will see increased foreign investment in energy production and related industries such as chemicals and engineering, and amid the general US economic recovery, the dollar will likely enjoy a period of sustained strength. Given that this development will take place amid strengthening global growth, which will tighten commodity markets, we anticipate that this will result in a period of strong commodity prices together with a robust dollar.

Cheap resources laying foundations for global recovery and eventually higher prices

Following three years of negative returns, investor caution towards commodities is understandable. However, the availability of relatively cheap resources, such as oil and agricultural products, has been the key factor driving the global economic recovery. Put another way, equity portfolios have enjoyed such a strong performance over the past three years because of the absence of commodity prices from newspaper headlines. In order to see sustainably higher commodities prices, the incomes of the ultimate consumers also need to increase and that is a theme that we expect to see develop over 2014. Thus, in general, we are more constructive for 2014.

Finally, we remain firm believers in the benefits of active versus passive investment when accessing opportunities across commodity markets. We combine not only the use of curve strategies, which is a very popular way of investing in the commodities market, but also relative value trades, enabling us to raise and lower risk, as appropriate. Overall, we are positioned to exploit the conditions described above as they evolve.

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