March 2020

Commodities Market Commentary

Thus far in 2020, commodities have experienced a sudden and significant negative demand shock. Initially, Chinese economic activity slowed materially in January. As time passed, restrictions on movement and activities continue to be put into place globally. The largest impact thus far has been felt in the Energy, Industrial Metals and Livestock sectors. The global resumption of economic activity, currently anticipated to begin in the second half of 2020, will depend on nations' abilities to effectively identify and care for those infected, to promote on-going separation in order to spread out the pace at which people are afflicted and to provide financial resources to those companies as well as employees that have been suddenly and adversely impacted by the slowdown. In addition, an unknown factor that may help or hinder the re-acceleration of economic activity will be the severity of potential future waves of infections that may occur once economic activity resumes.

In addition to sudden demand shocks, the oil and petroleum sector experienced a positive supply shock as the OPEC+ alliance fell apart after Russia indicated it would not agree to the additional proposed crude oil production cuts. This prompted OPEC (and Saudi Arabia in particular) to switch from a strategy of controlling output in order to stabilize prices at higher levels to one where members looked to garner market share through lower prices while maximizing production. This move was largely unanticipated by markets, and oil and petroleum commodities were repriced lower rapidly to reflect the new world order. As Saudi Arabia ramps up production and secures crude tankers to export its additional output, it is likely that a contango will remain between near-term oil prices and longer-dated futures contracts as on-shore and off-shore storage capacity is taken up.

In examining the markets within key segments of time throughout 2020 thus far, the CSAM Commodities Portfolio Management Team noticed the following observations:

- The decline in commodities that took place from the beginning of the year up through January 31st when the Chinese equity markets reopened after the Chinese Lunar New Year suggested: (a) lower commodity demand expectations (especially for petroleum and base metals) and (b) the potential of market participants using commodities as a rough hedging instrument as prices fell while Chinese equity markets were closed.
- From January 31st through the OPEC meeting on March 5th, broad based commodity markets declined less than equities (excluding China equities, which were higher over this period due to policy makers enacting strong monetary and fiscal stimulus measures).
- After the OPEC meeting and the resulting positive supply shock, oil and petroleum prices adjusted down rapidly to reflect the immediate potential for higher supplies as spot prices declined and the market moved into contango.
- Had the OPEC+ partnership with Russia not fallen apart, the Commodities Team believes commodities would have outperformed equities by a wider margin in February and March.

Now, given the unforeseen supply shock to Energy, the question remains: "Where do we go from here?"

- Given the significant movements in oil prices, oil hedging structures used by certain producers are not effective in protecting these entities from the severe downside price moves that the market has observed, which may help to accelerate the supply response in oil. The Commodities Team believes this will take place over the next year and half.
- With volatility in financial markets and tighter credit conditions (especially for energy producers), the Team expects rig count cuts and lower capital expenditures.

- The oil industry, as well as other major industries in the US, will likely benefit from a large-scale policy response that is designed to help support these companies through this crisis. Depending on its implementation, this could go a long way to
- be supportive of oil prices. What remains unknown is whether there will be any differentiation between companies that operated under a more “risk controlled” manner versus those that took on more leverage and risk.
- The extent of the demand outage will largely be dependent on how effective each nation’s ability is in putting controls in place to slow the spread of the virus. The sooner the controls are implemented, the lower the cost in terms of monetary and fiscal support. The extent of the support is likely to grow exponentially, just like the number of COVID-19 cases, if the spread of the pandemic is not controlled.
- The strategy employed by Saudi Arabia is not without risk to the country’s current leadership, and oil markets remain very sensitive to geopolitical risk as evidenced by events throughout 2019 in the Middle East. Saudi Arabia will likely be facing increasing deficits of $30 billion - $70 billion versus initial budget projections due to oil price declines. This is dependent on whether oil prices average to $25 or $35 per barrel for the rest of the year combined with Saudi Arabia’s higher production. The current Saudi leadership has been enacting many fiscal reforms to shift its economy away from oil, and this move in prices could potentially reduce their ability to enact these measures rapidly.
- While Gold has been largely viewed as a safe haven play, the Commodities Team has recently seen liquidation in gold in conjunction with the sell-off in all financial assets. This appeared to be a situation where investors were selling exposures broadly to raise cash and liquidity, and the Team believes gold may be a good store of value in the current downturn, especially in an environment where global interest rates continue to recede to lower levels and many governments will be expanding deficits to support their respective economies through this difficult period.
- While the rally in the US Dollar relative to other currencies has been a result of a flight to safety as well the US Dollar’s status as the world’s reserve currency, the ability to stem the pace of the spread of the coronavirus will likely determine the cost of battling this disease, as mentioned above. To the extent that the cost is much greater than initially expected, the status of the US Dollar may erode and elevate the value of hard assets.
- As in the oil sector, declining prices of base metals may also have similar effects in the mining industry. As prices fall below the cost of production, depending on the age and productivity of the mine, a supply response may be elicited here as well. In addition to forced coronavirus-related mining reductions by countries including Peru, numerous large mining companies have already announced reductions in production for price reasons.
- Transportation and supply logistics will play a key role for commodity buyers versus producing nations. Already, some countries may be limiting personnel involved in the loading, off-loading, transporting and shipping of raw materials and goods for safety reasons. To the extent that COVID-19 affects key port cities, it could introduce significant bottlenecks and costs into the system. If this were to happen with food related items, then food price inflation in conjunction with already lower economic conditions, especially in emerging nations could bring about civil unrest.

In summary, given the uniqueness and suddenness of the economic downturn, there were very few places to hide as correlations among all risky assets, and even among historical safe havens, have experienced significant volatility. In such instances of high uncertainty, where there are many avenues to a possible outcome, none of which is more important than solving for the slowdown of COVID-19’s infection rate. A better-than-expected outcome of a quicker reduction in cases is likely to lead to a sharper reflation of many risky assets, including both equities and commodities. However, there are also scenarios where the lack of progress combating the illness, or even the poor timing or failure of government policy, could lead to positive supply shocks for commodities. Over the past few days, central banks globally have cut interest rates, pumped liquidity into the markets and enacted additional stimulus measures as substantial COVID-19 containment measures impede economic activity world-wide. In the short-term, the CS House View believes these easing measures may not prevent a short-term recession but may provide a strong lift afterwards. Market volatility may likely continue, and worsening headline risk regarding the severity of the COVID-19 spread along with growing mortality rates may lead to deeper troughs in the weeks to come. However, expectations are for the markets to recover during the second half of 2020.

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