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Do not overlook today's inflation risks
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Investors should not be complacent with another year of low inflation, because inflationary indicators are just beginning to sprout. Currently, with trade disruptions and global growth moderating, many policymakers have pledged further support to boost growth and inflation. There are different drivers of inflation, and investors ought to consider an allocation to commodity portfolios in order to mitigate consequences of supply shocks, which can potentially send inflation higher.

Inflation is usually driven by a demand-pull and/or cost-push effect. In the former, growing demand outweighs available supply for goods, which drives costs higher. One way that policymakers can stimulate more consumer demand and/or business spending is to either increase fiscal spending or money supply. Higher demand relative to supply may lead to more inflationary pressures. In addition, the knock-on effects of increasing money supply may potentially lead to a weakening of domestic exchange rates which can further increase the cost of foreign goods. This can be especially true for those economies which are more reliant on imports.

The cost-push effect of inflation relates to manufacturers passing on higher input costs to the end-consumer. These costs can rise or fall based on changes in wages paid to employees, changes that alter the cost to manufacture the good (e.g., increasing productivity, increased regulation/tariffs, etc.), or increases in the price of raw materials driven by inventory shortages. Supply shocks can have a material impact on manufacturers' cost structures as the reduction in supplies may elevate the prices paid by consumers. Institutional investors should be mindful of the increasing potential for commodity supply shocks occurring today and examine how an allocation to commodities in a diverse portfolio can protect against these inflation risks.

Energy
Over the last several years, a major headwind to higher crude prices has been the substantial growth of US oil production. More recently, however, US oil producers have begun to shift their strategy to improving profitability from focusing on maximizing oil output. This shift includes cutting back on capital expenditures and attempting to improve cash flows and balance sheets. As global oil demand increases annually, with the possibility of less production growth within the US, crude oil supply will likely have to be sourced elsewhere. Currently, market participants are expecting supply growth out of the North Sea to help make up for reductions in US crude output, but the capacity for quick production expansion remains limited outside of the OPEC Plus group.

Future developments within the Middle East will be a key driver of any geopolitical risk premium for crude oil and petroleum markets. Member nations of the OPEC-led consortium seem likely to maintain strong compliance to any pact in order to support higher crude oil prices, which are needed to fund domestic budgets. Meanwhile, the US exit from the Iran nuclear deal has caused rising tensions in the Persian Gulf and declining Iranian crude oil exports. In addition, civil unrest is increasing in many countries such as Iraq, Iran and Lebanon, among others. If tensions were to escalate further leading to political instability and/or military conflict, prices are likely to rise sharply for nearer-term barrels. Last September's drone attack on Saudi Arabia's oil infrastructure highlighted supply vulnerabilities within the region.

Agriculture
The 2019-2020 crop has been challenging for US farmers. Aside from trade headwinds, major flooding during the second quarter of 2019 delayed crop plantings and may lead to higher variability in acreage estimates that may increase volatility in these markets. An early cold snap in the US Midwest delayed some wheat plantings and also led the USDA to revise down its corn crop yield estimates in November. These challenges, paired with an already delayed spring corn planting season (an important development stage for the crop's yield potential), may lead to upside price volatility for grains if weather-related shocks persist. A prolonged monsoon season in India, one of the world's largest sugar producers, resulted in the country receiving the most monsoon rainfall in over 25 years. This had a detrimental impact on India's sugar harvest and helped drive forecasts for global sugar supplies to switch to a deficit in 2020 following years of surplus. The supply and demand balance for sugar may also tighten further if Brazil continues to divert more sugarcane for ethanol production.

Livestock
The African swine fever epidemic continues to persist in several Asian nations. As hog herds shrink, supplies will have to be sourced from elsewhere to meet steady demand. Although US pork inventories have the potential to fill this gap, ongoing trade tensions between the US and China may be limiting pork exports in the near term. With a substantial reduction in Chinese hog supplies already and higher pork price inflation, it is likely that China will need to expand purchases sooner rather than later to replenish depleted inventories.

Industrial and Precious Metals

Idiosyncratic supply risk has also affected base metals. Public protests in Chile, the largest producer of copper, have already disrupted mining operations and caused transportation delays. Prolonged unrest may hinder copper production into 2020. Meanwhile, policy decisions by the US Federal Reserve may continue to impact prices for gold and silver as an increasingly dovish Fed may cause the US Dollar to weaken while increasing the appeal of gold and silver as alternative stores of wealth. Prolonged global growth concerns accompanied by a heightened likelihood of geopolitical conflicts may continue to drive the precious metals sector higher.

Conclusion

While the current global economic back-drop has been weaker as a result of on-going trade tensions worldwide, many central banks remain committed to further monetary stimulus if economic measures continue to disappoint. Even though signs of inflation in recent times may be scarce, investors should always be aware of major threats to global commodity supplies and hedge accordingly. Today, the potential for supply shocks appears to be rising for certain raw materials in commodity producing regions that are experiencing increases in extreme weather patterns, geo-political risk or civil unrest.

*** Foot note:** This piece was originally published on Pensions & Investments on January 17, 2020.

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