THE NEXT COMMODITY SUPERCYCLE

October 2020

VARIANTPERCEPTION

A new dawn for commodities

Executive Summary

- We are on the cusp of a **new commodity supercycle**
- There are 3 big secular drivers of this supercycle:
  - The long era of monetary-policy dominance is over, leading to a heightening of inflation risks not seen since the 1960s
  - Investors are deeply underweight and will need real assets such as commodities as a hedge against inflation
  - Commodities are generationally cheap, both compared to themselves and to other assets

Source: CFA Institute

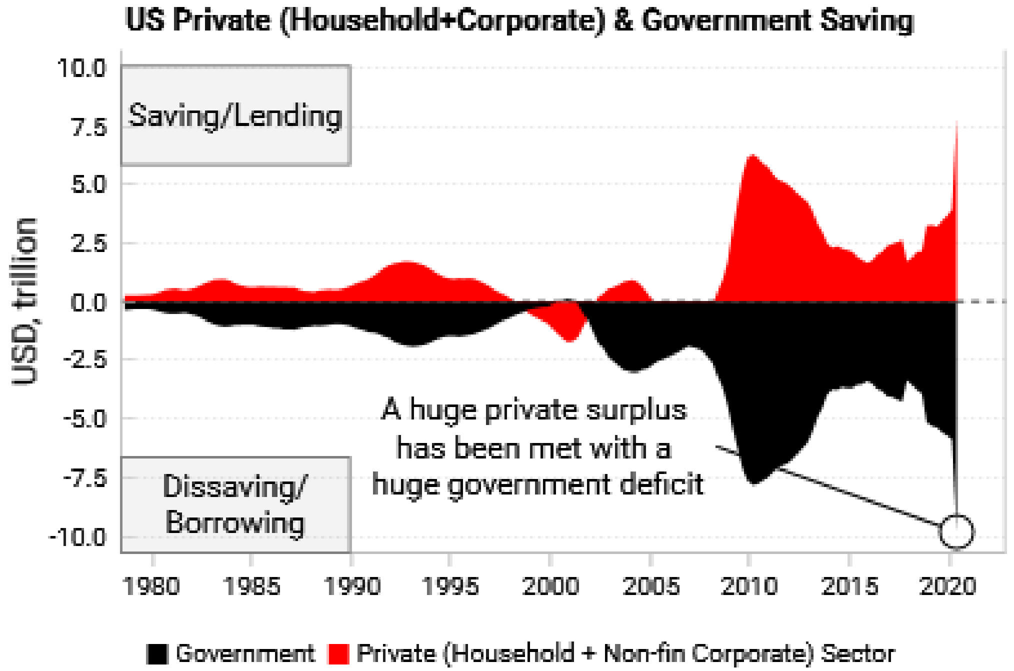
VARIANTPERCEPTION

Inflation and fiscal dominance

In world of heightened inflation risks, owning commodities is key

The coming fusion of fiscal and monetary policy

- There is a seismic shift away from monetary-policy dominance towards fiscal-policy dominance
- The private sector’s preference for saving – despite years of ever easier monetary policy – has meant the government needs to spend to make up the shortfall, supported by central banks’ government bond buying
- The pandemic has only magnified existing trends. **We are heading towards the fusion of monetary and fiscal policy**
- This has profound implications for investing and portfolio construction



Source: Bloomberg, Macrobond and Variant Perception

Lake and Ocean Regimes

- The blurring of fiscal and monetary policy creates a very different investing environment
- We have come from the “Lake Regime”, where rises in inflation are less likely to become disorderly
- We are now in the “Ocean Regime”
- In this regime, massively expansive fiscal policy and rapidly growing central-bank balance sheets means **garden-variety rises in inflation are more likely to lead to unanchored and disorderly moves higher in inflation**
- Lake-going vessels are not suitable for ocean travel, as are many portfolios not prepared for high inflation

Source: JMW Turner, Bloomberg, Macrobond and Variant Perception

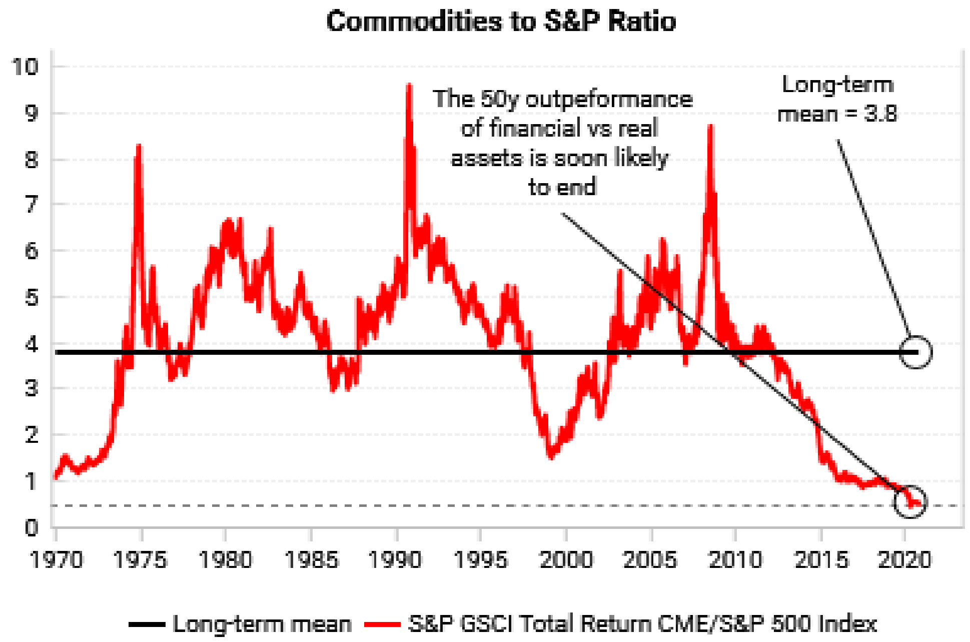
Ocean Regime => a new investment world

- The Ocean Regime does not mean high inflation and a weaker dollar is imminent, but it does mean the balance of risks have changed

- Once inflation becomes unanchored, it is too late to take action. Portfolios should begin to be made more inflation-resilient **today**

- There are 3 main implications of moving to the Ocean Regime:

  - rising cross-asset volatility
  - too much leverage becoming a dangerous game
  - the long boom in financial assets ending, and real assets and commodities outperforming



Source: Bloomberg, Macrobond and Variant Perception

VARIANTPERCEPTION

Demand and supply tailwinds

Positive dynamics for commodity demand and supply are lining up

Demand and supply imbalances drive the commodity cycle

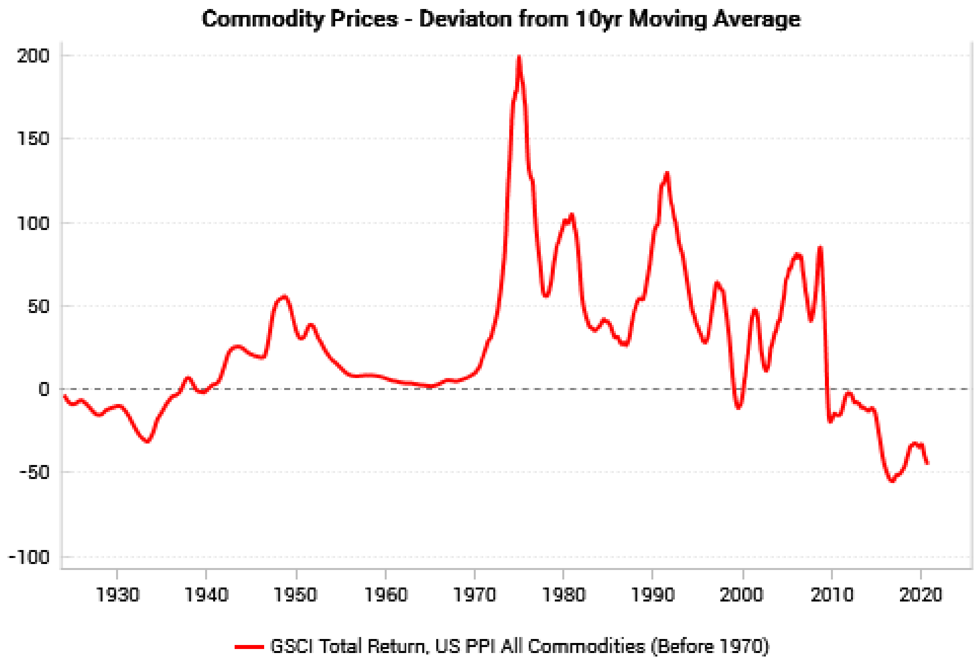
- Commodity prices can deviate greatly form long-run averages

- These imbalances take a long time to correct due to:

  - high start-up capex for new projects
  - time needed to bring new supply online as firms wait until they are sure of price upturns

- Previous demand-driven super cycles include global rearmament before WW2, and the reform of the Chinese economy and its accession to the WTO in 2001. The OPEC oil embargo in the 1970s was a supply-driven super cycle

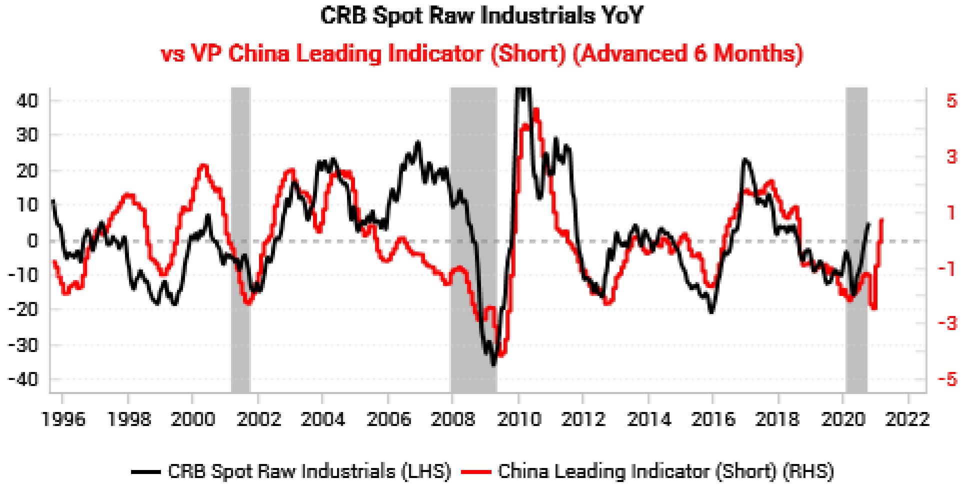
- **The next commodity supercycle will be driven by heightened inflation risks, supply destruction and recovering demand**

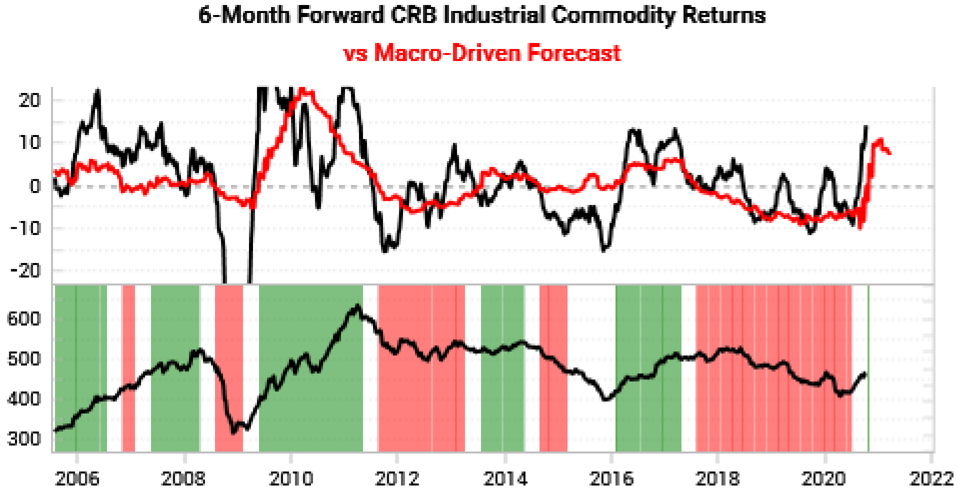


Source: Bloomberg, Macrobond and Variant Perception

Demand is set to pick up cyclically

- China's economic leading indicators are rebounding which points to a cyclical upturn for commodities
- Our macro-driven forecast for commodities has surged over the past 6 months and continues to show positive expected returns for commodities
- Liquidity and demand factors are boosting the commodity outlook
- In our report from May of this year, ***China Deleveraging Over***, we noted a China rebound completes the "bullish commodity puzzle"



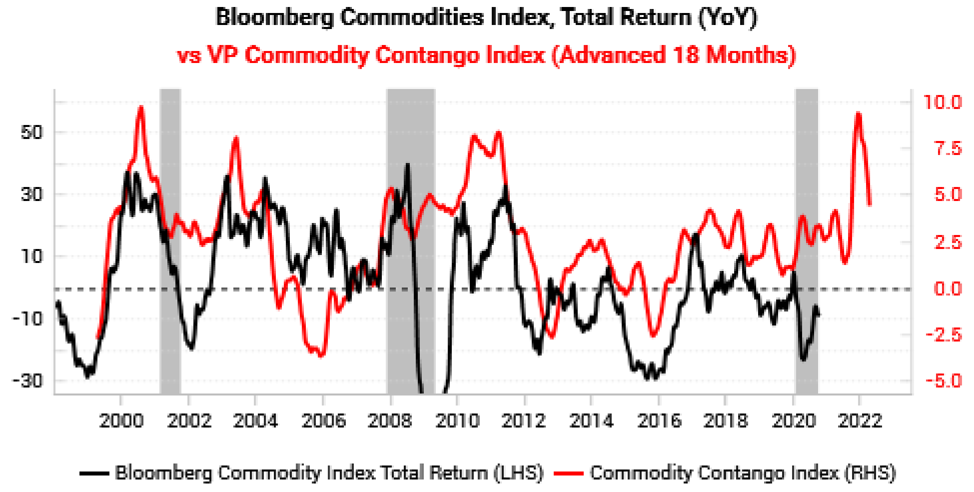


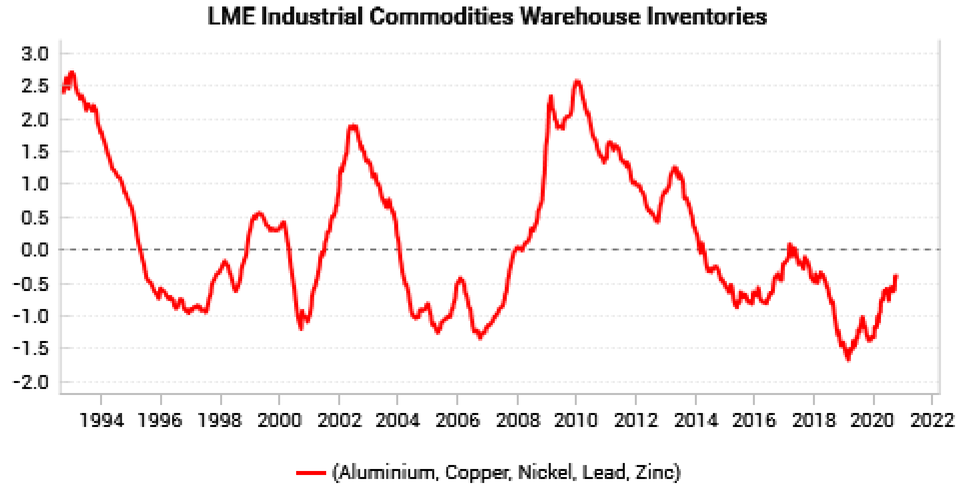
Source: Bloomberg, Macrobond and Variant Perception

VARIANTPERCEPTION

Supply conditions also cyclically tight

- The huge contango in commodity futures markets in the wake of the Covid recession showed a mounting supply glut
- This forces producers to cut production, delay new projects and thus supply shrinks
- **Large commodity price spikes become a likelihood over the following 18 months** after recovering demand runs into tight supply conditions
- Low inventories mean prices are more responsive to a demand pick-up
- There are long lags to bring new supply online for many commodity sectors, eg it can take more than five years for a new mine to generate cash flow after initial spending





Source: Bloomberg, Macrobond and Variant Perception

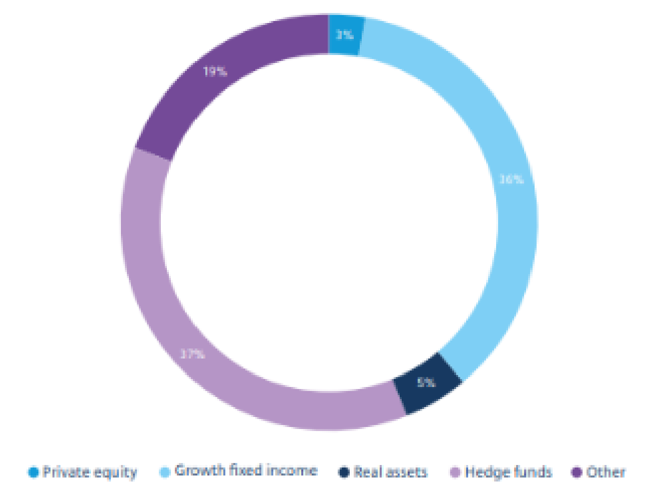
A huge investor underweight

The underweight in commodities will drive investor demand

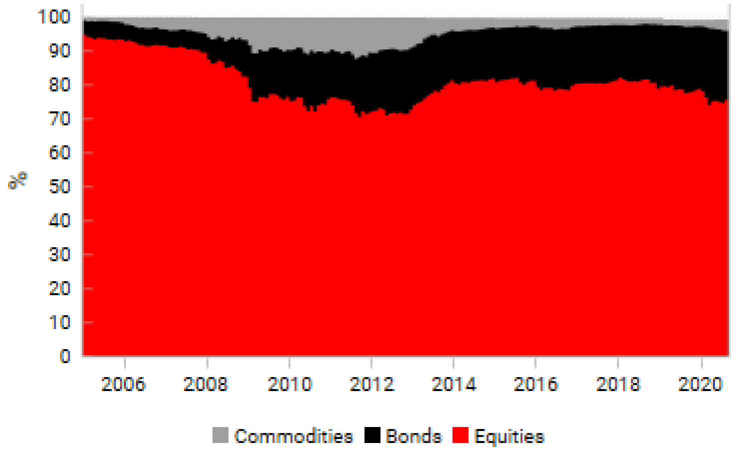
Investors are structurally underweight commodities

- The commodity asset class is massively underinvested
- The amount of capital in real assets is miniscule
- Pension funds prefer safety in fund vehicles (hedge funds, PE, etc) to fill their portfolios
- This is also playing out in the ETF world. Total commodity ETF AUM is a tiny proportion of the total AUM
- **There is a risk of a huge supply-demand imbalance in commodity markets as investor preferences shift towards real assets**
- Marginal capital inflows can lead to outsized price gains

Figure 5. Other alternatives allocation



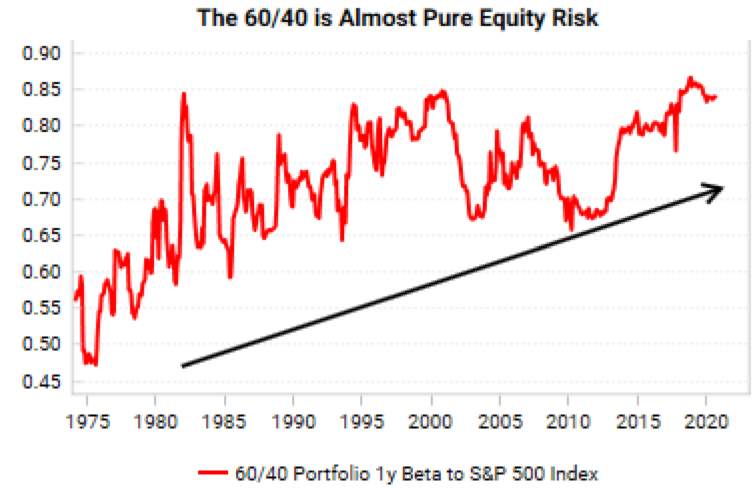
ICI ETF Assets as % of Total

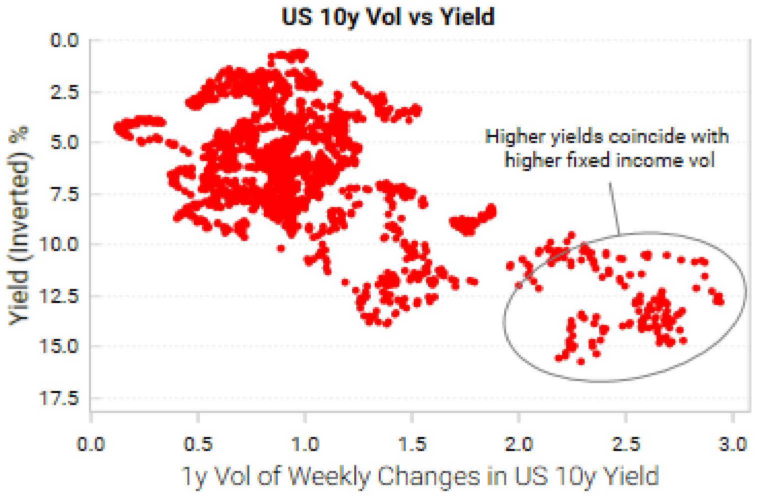


Source: Bloomberg, Macrobond, Mercer and Variant Perception

The end of the road for 60/40 portfolios

- Bonds are now a poor equity hedge given near-zero or negative yields
- **The traditional 60/40 portfolio is now riskier, and with lower return potential**
- Risk-parity solutions rely on equalising contributions to risk from different asset classes
- This means employing higher leverage on asset classes with lower volatilities – but leverage is a dangerous game in the Ocean Regime
- Risk-parity relies on a negative correlation between stocks and bonds to work
- **In the Ocean Regime, this correlation will likely become positive – making risk-parity much more risky**

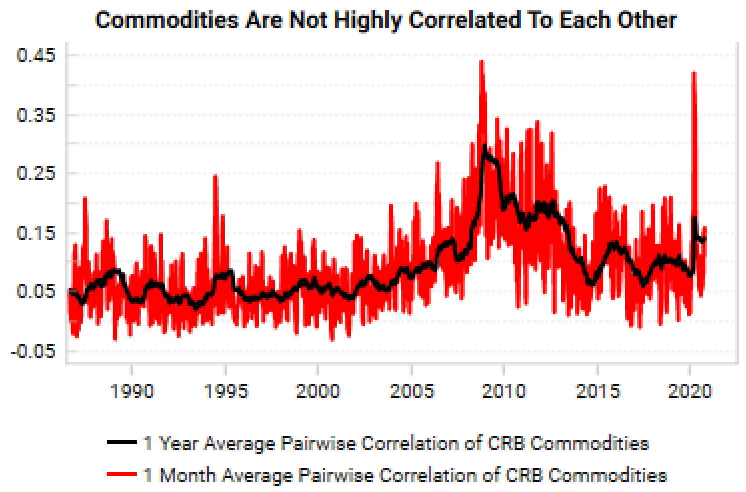


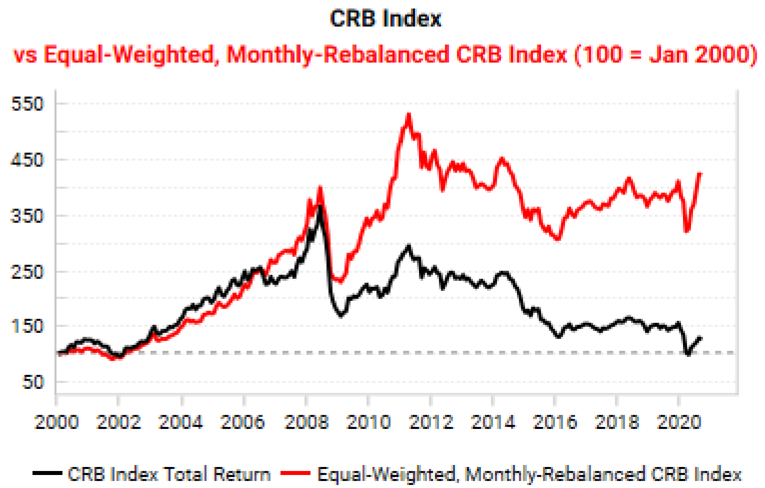


Source: Bloomberg, Macrobond and Variant Perception

Making the most of commodities in a portfolio

- A buy-and-hold portfolio of commodities has historically not served investors well, but an actively managed portfolio has
- Commodities offer a rebalancing premium in portfolios because they are volatile and are not correlated to each other
- Thus an equally-weighted portfolio of CRB commodities that is rebalanced frequently can enhance the value of commodity allocations in portfolios
- Rebalancing volatile commodities forces you to buy low and sell high
- See our report from July 2020, ***Portfolios for the High Seas***





Source: Bloomberg, Macrobond and Variant Perception

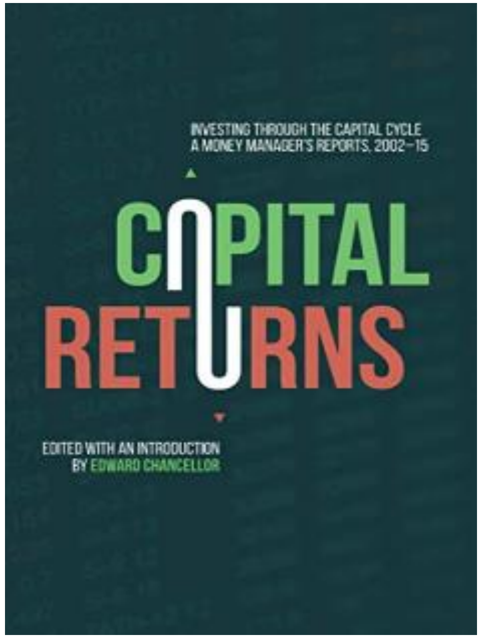
The capital cycle

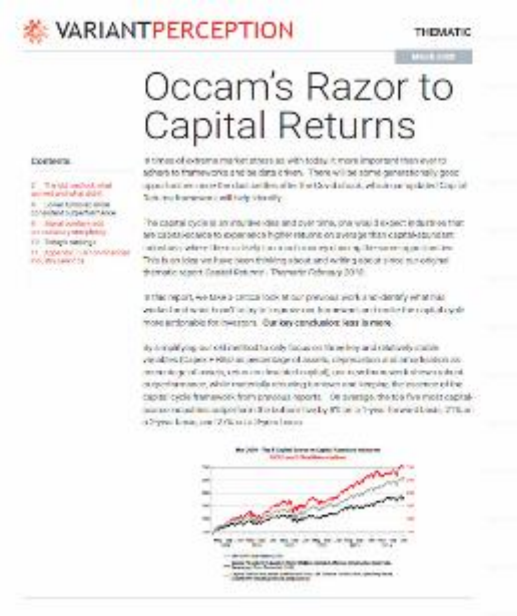
Finding the most capital scarce commodity sectors to invest in

The capital cycle tells us what to buy

Plenty has been written about the capital cycle over the years, but by far the best is *Capital Returns: Investing Through the Asset Cycle*, by Marathon Asset Management.

This inspired us to create our own Capital Returns framework to **screen for capital-scarce sectors that outperform capital-abundant sectors on a 1-3 year forward basis.**





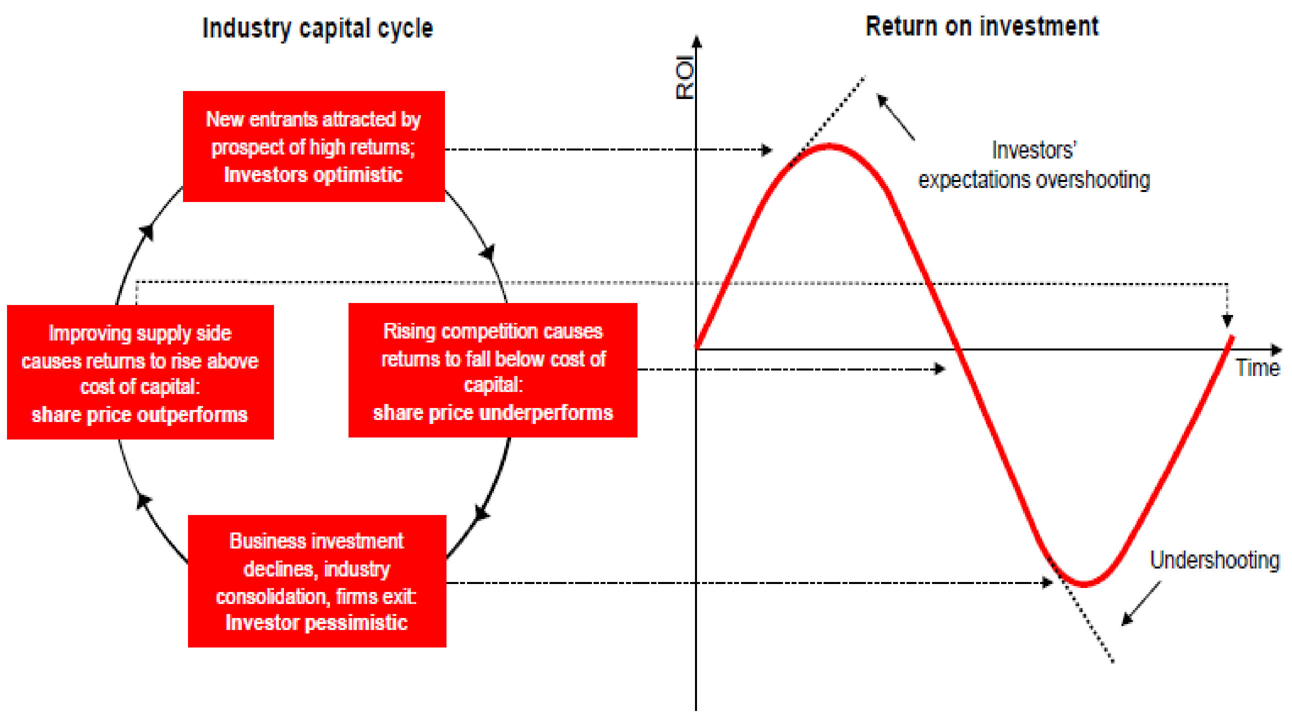
Source: Bloomberg, Macrobond and Variant Perception

Capital scarcity drives higher future equity returns

- The capital cycle follows a mechanical and repeatable process:

  1) large industry-wide investment coincides with a peak in investment returns
  2) this attracts new entrants, eroding incumbent company returns and become unprofitable
  3) firms exit and capital flows away, creating a much more profitable environment for the survivors

- This process typically takes 2-3 years for investment returns to materialise from the point of peak capital scarcity



Source: Bloomberg, Macrobond and Variant Perception

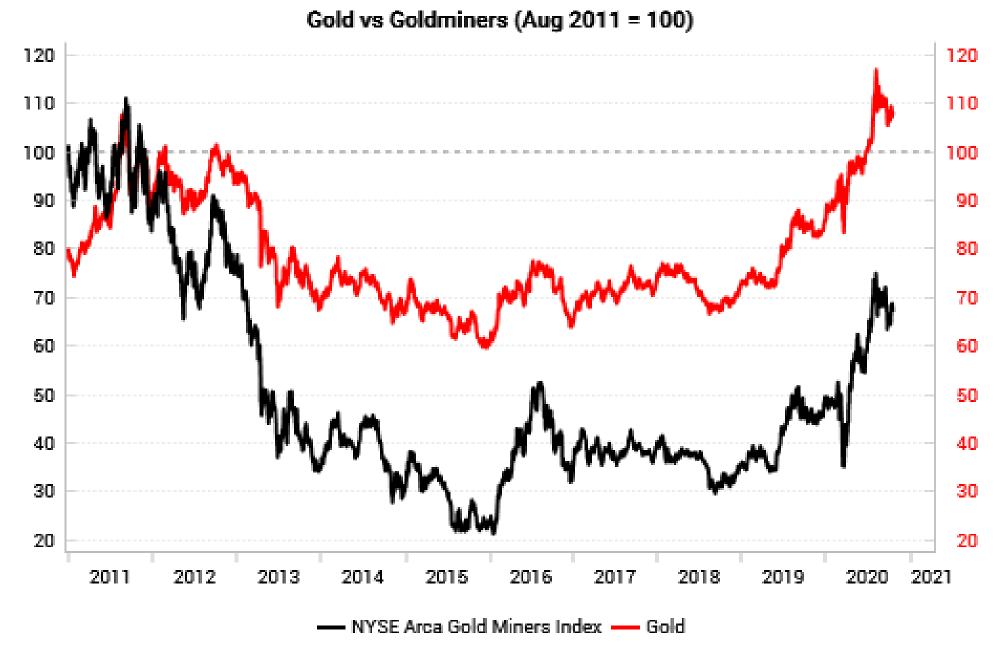
VARIANTPERCEPTION

Oil and Gas

No more hate

Energy reminiscent of goldmining bear market in the 2010s

- Goldmining equities saw a multi-year bear market after the 2011 peak in gold prices
- They then experienced a protracted bottoming process, lasting even after gold prices stabilised in 2016
- It was only the surge in gold prices from 2019 that propelled goldmining equities higher
- We see the potential for a similar dynamic to play out for the energy sector – currently in its sixth year of a bear market



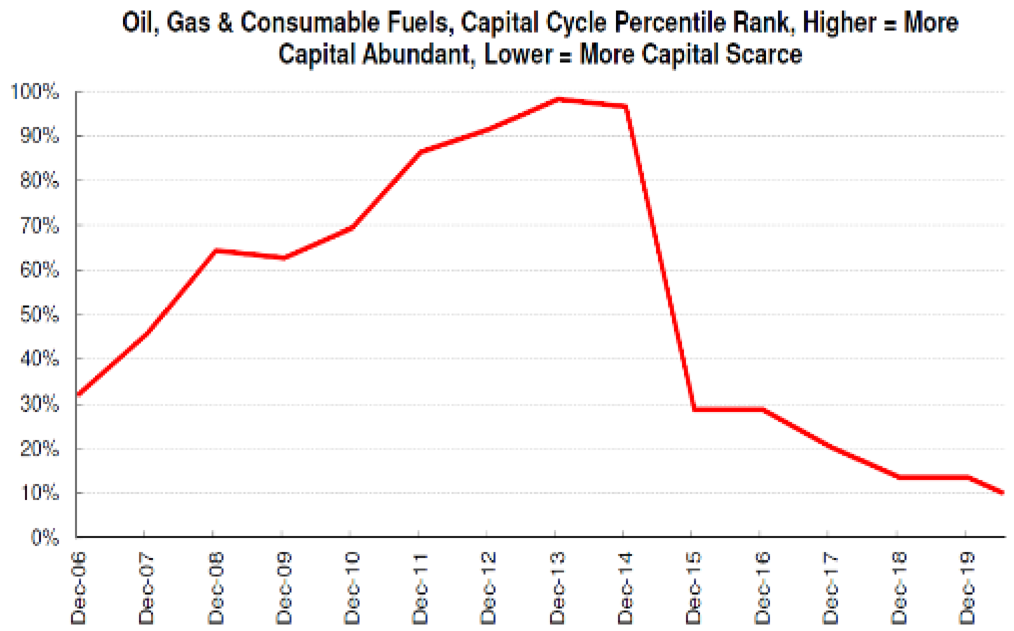
Source: Bloomberg, Macrobond and Variant Perception

Capital is very scarce for energy companies

- According to our **Capital Returns** framework, oil producers saw an extended period of abundant capital availability before the 2014 oil price crash

- After the crash, capital become increasingly scarce – **this is forcing the industry to rationalise, reducing competition for the survivors**

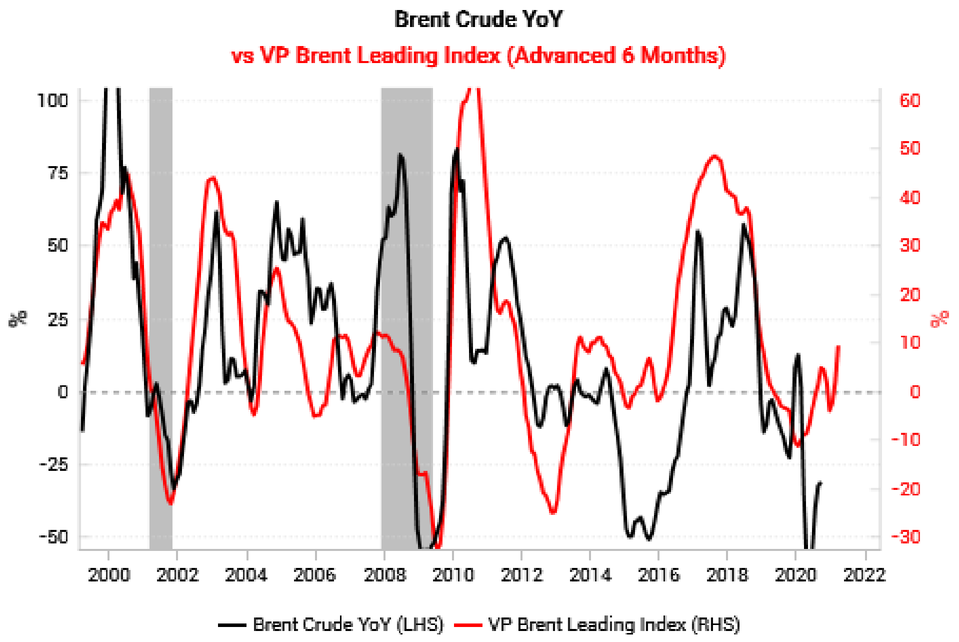
- We proxy for capital scarcity using Capex + R&D to Asset ratio, D&A to Asset, and ROIC



Source: Bloomberg, Macrobond and Variant Perception

Cyclical leading indicators positive for crude

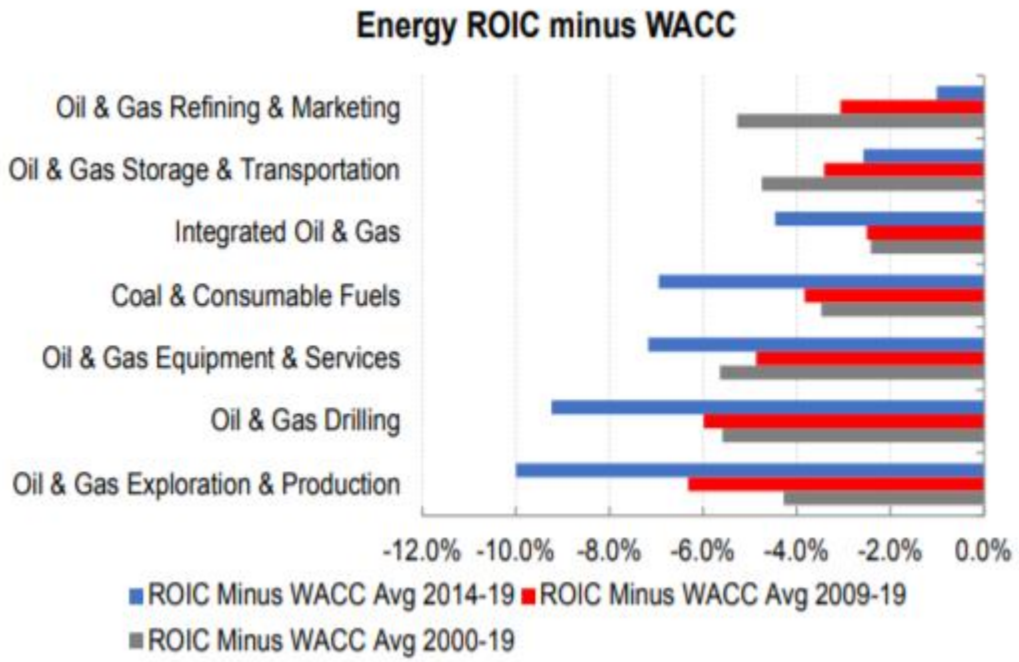
- **Cyclical as well as structural factors are starting to improve for oil**
- Our leading indicator for crude oil is rising and has turned positive
- This has been driven by signs of economic recovery - led by China - and tight supply



Source: Bloomberg, Macrobond and Variant Perception

Energy can be a minefield - stock selection is important

- It is important to differentiate different companies within energy and identify the best assets to invest in
- Capital-intensive industries like energy **are subject to large boom-bust cycles**
- As a whole, the energy industry has failed to achieve sufficient return on invested capital through the cycle for shareholders
- The chart on the right from our report: ***Improving Stock Selection - October 2019***, shows the aggregate destruction of value as boom turns to bust



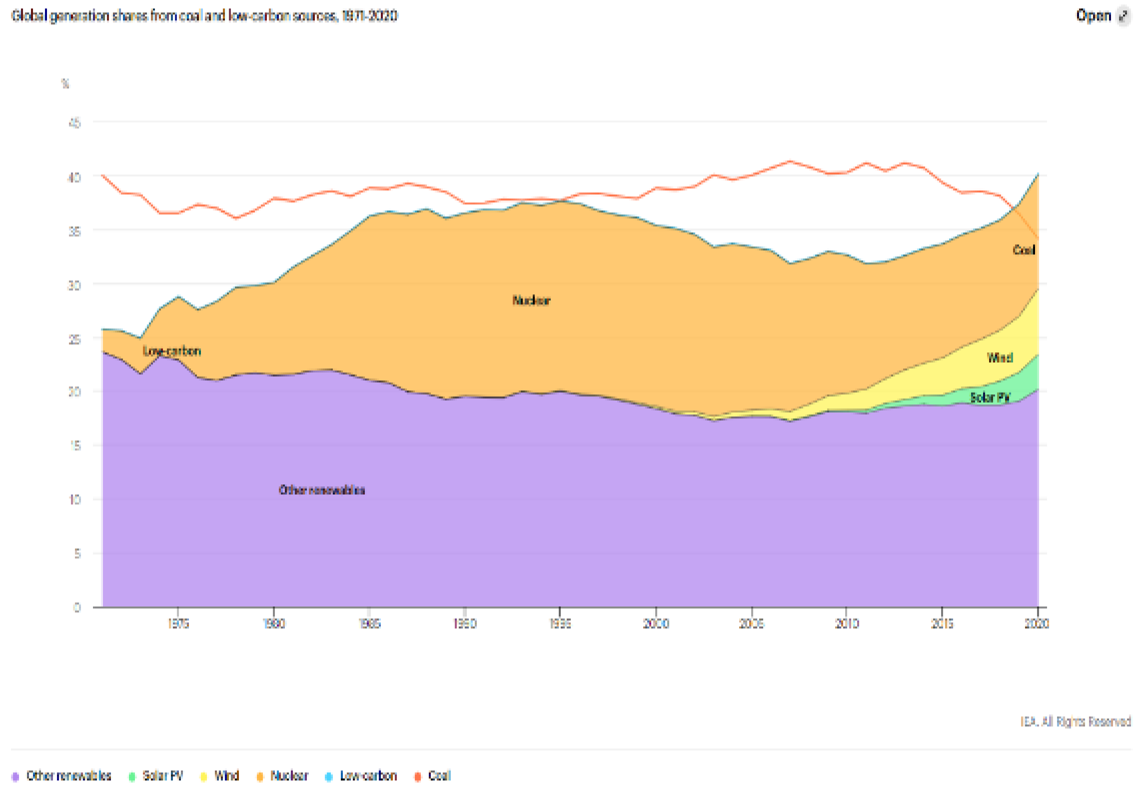
Source: Bloomberg, Macrobond and Variant Perception

Coal

One last puff of the cigar butt

Coal: vital for EM, a pariah in DM

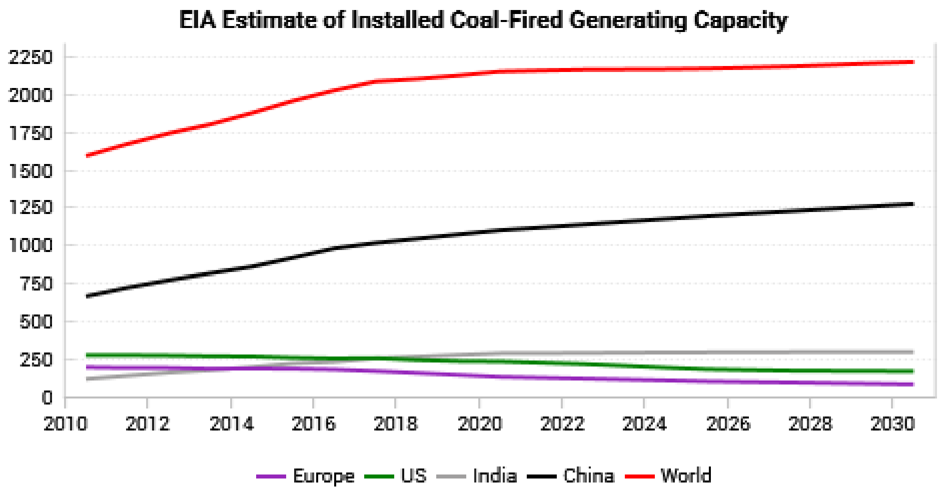
- Coal still accounts for **more than one-third of global electricity generation**
- Coal's share of electricity generation in EM countries like China and India is in the range of 60-70%. In the US/European union, the equivalent share is 10-15%
- Coal companies are treated as pariahs, given the ascendance of ESG investing
- Coal investing within DM fits into the "last puff of the cigar-butt" category
- In EM, the runway appears longer

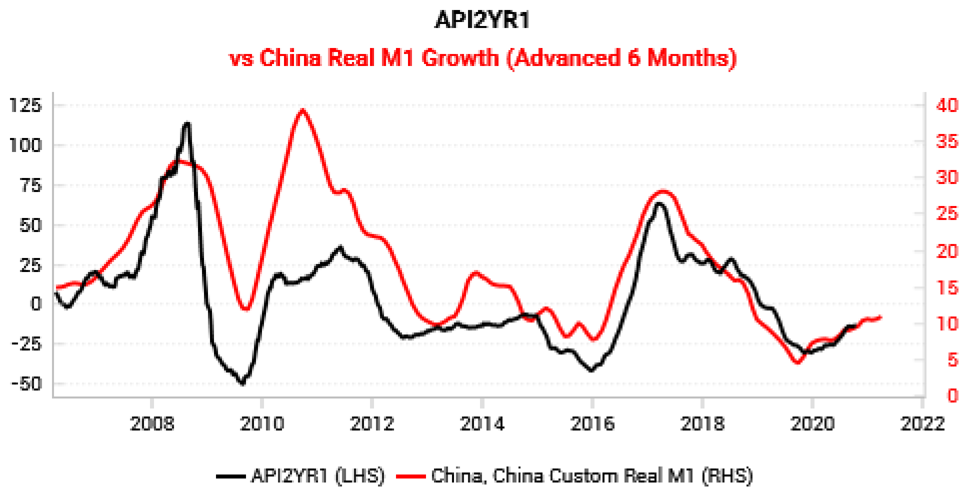


Source: Bloomberg, Macrobond and Variant Perception

Coal is a China story

- China's coal-fired generating capacity is 50% of the world total
- China coal-fired capacity is set to keep growing over the next decade and offset losses in DM countries
- The Chinese economic cycle has typically led export prices for coal
- Chinese real M1 growth has led API2 coal prices consistently

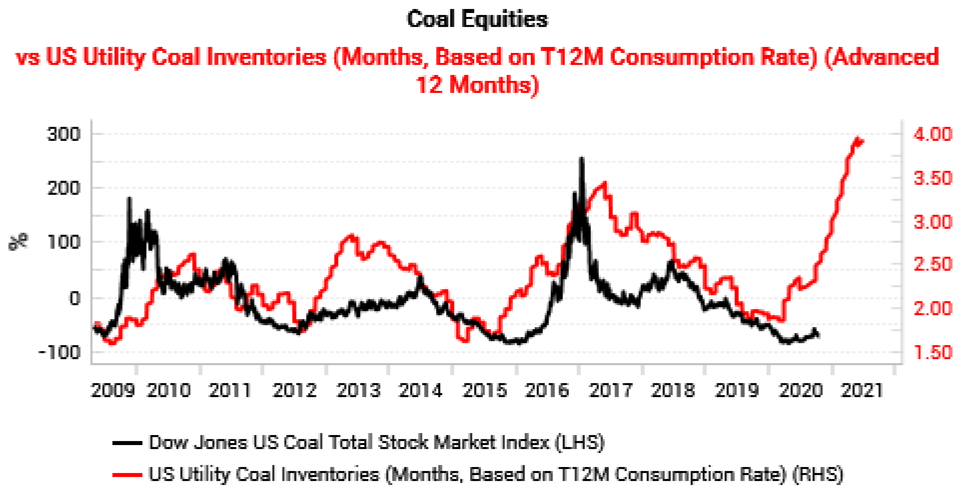


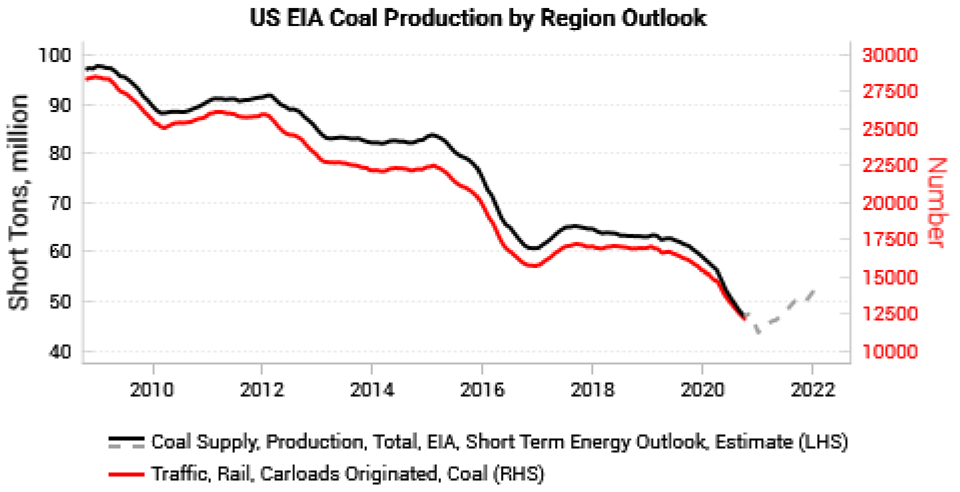


Source: Bloomberg, Macrobond and Variant Perception

US coal companies are at cycle lows

- The US natural gas glut has crushed the coal industry
- Low natural gas prices have accelerated switching trends toward gas-fired power plants away from coal
- Coal is relatively easy to store and remains important for utilities as a low-cost way to ensure grid resilience
- Surging US coal inventories have historically been a contrarian sign
- **More coal burning will be encouraged as natural gas prices normalise by rising over the next 12 months**





Source: Bloomberg, Macrobond and Variant Perception

VARIANT PERCEPTION

Gold and silver

The 1st and 2nd placed metals to invest in

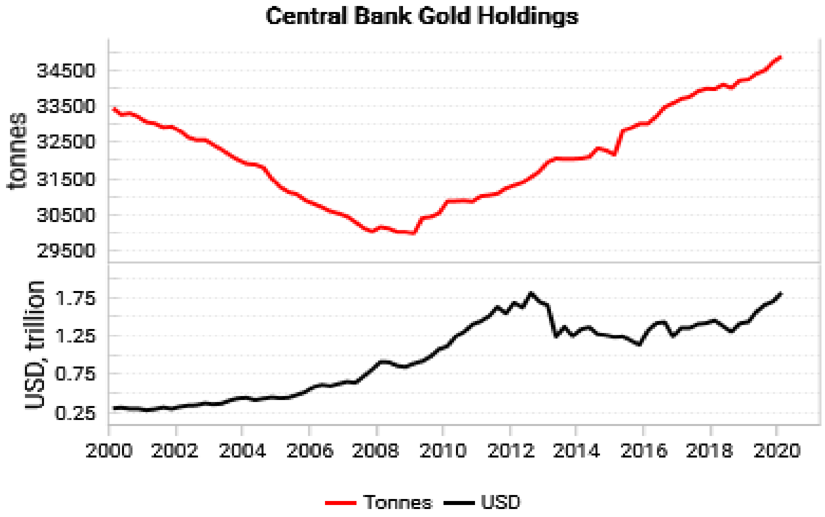
Own what central banks are short of

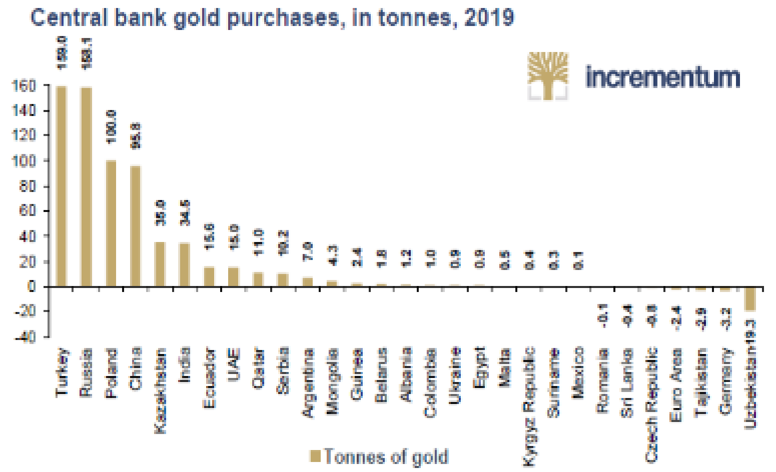
- After years of selling their gold, central banks around the world have been steadily increasing their gold reserves

- As the dollar is progressively devalued and inflationary risks rise, central banks are diversifying away from the dollar

- Moreover, as the US flexes its financial muscles and uses the dollar as a tool of diplomatic punishment, countries such as Russia and China are turning away from the USD, and increasing their gold reserves

- **Owning what central banks are short of will likely prove a highly profitable endeavour**



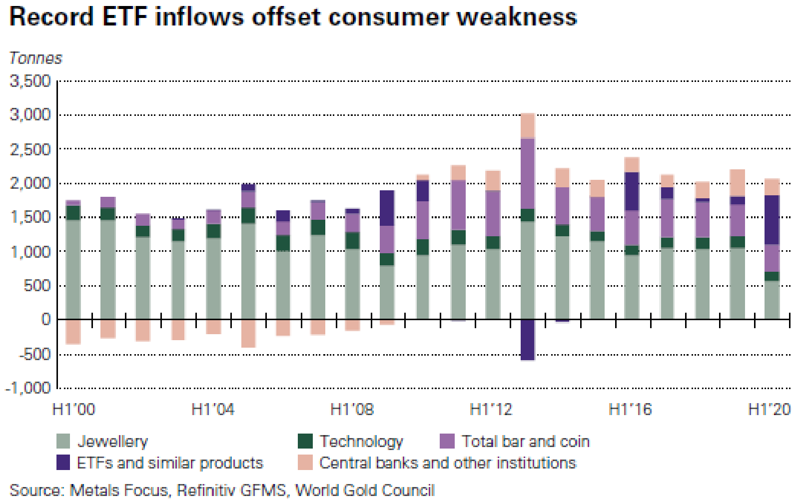


Source: World Gold Council, Incrementum AG

Source: Incrementum AG, Bloomberg, Macrobond and Variant Perception

Investment demand for gold soaring

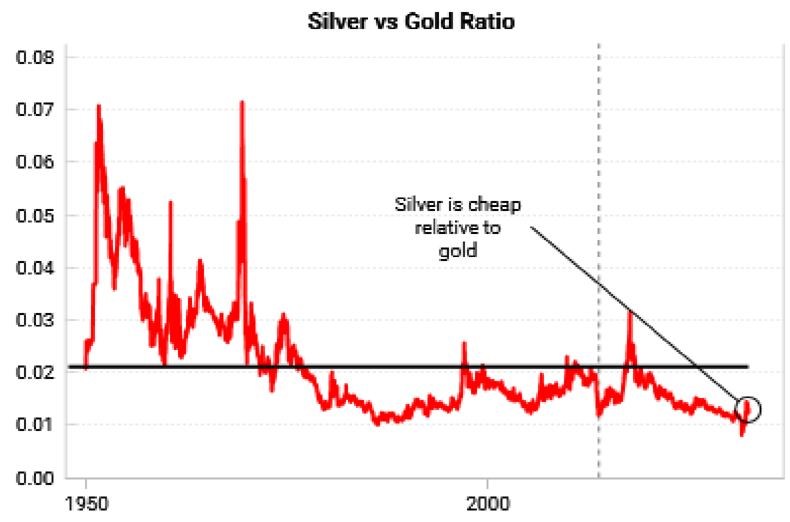
- Gold is not only a hedge for inflation, it is a hedge against uncertainty
- 2020 has seen investment demand for gold soar as the global economy grapples with the impacts and uncertainty from lockdowns
- Consumer demand, eg jewellery, has collapsed this year as recessions hit around the world
- However, demand for ETFs and other investment products has picked up the slack – accounting for an unprecedented 42% of gold demand in 1H20
- Investment demand for gold is likely to remain strong in the Ocean Regime of heightened inflation risks

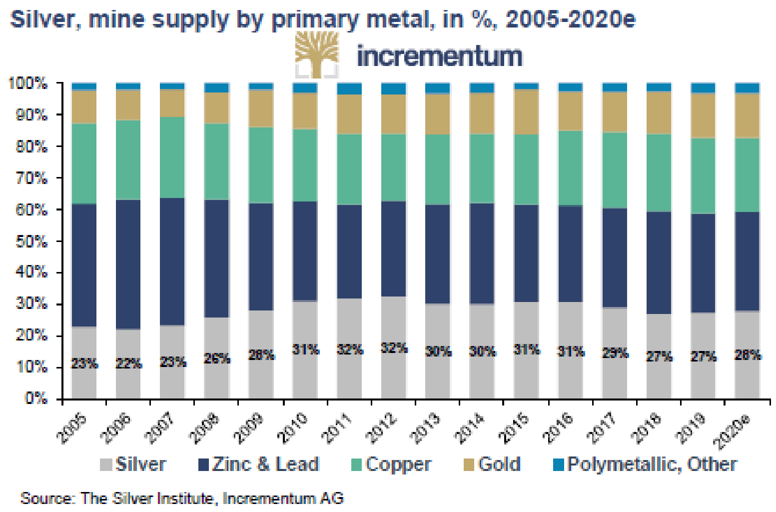


Source: World Gold Council, Bloomberg, Macrobond and Variant Perception

Don’t forget 2nd placed silver

- Silver is similar to goldminers in that it offers extra risk – but potentially greater reward – compared to gold
- Silver is cheap compared to the gold price, with one ounce of gold buying 77 ounces of silver. This was a low as 40 ounces in the early 2010s and 20 ounces in the early 1980s
- Silver is a “by-product” metal, with the majority of supply coming from mines whose main output is another metal – meaning supply is slow to respond
- **Supply constraints, relative cheapness and growing investment demand are a recipe for explosive silver growth in the coming years**





Source: Incrementum AG, Bloomberg, Macrobond and Variant Perception

Copper

Copper’s clean sheet

The Age of Copper

- **Copper will play a pivotal role in the clean energy revolution sweeping across the world**
- Policymakers are creating permanent demand in renewable energy and EV-related (electric vehicle) infrastructure
- EVs use 4x more copper compared to a normal passenger car's internal combustion engine. Solar panels and wind turbines require 12x more copper than previous methods
- Copper has many useful properties that make it a core input for manufacturing and electrification: high durability, high malleability, high electrical and heat conductivity, no loss of quality upon recycling
- It also has antimicrobial properties – an additional source of demand from the healthcare industry amid the pandemic

Source: Bloomberg, Macrobond, The Economist, Copper Alliance and Variant Perception

The Chinese copper whale

- China's dominance in the copper market has been growing

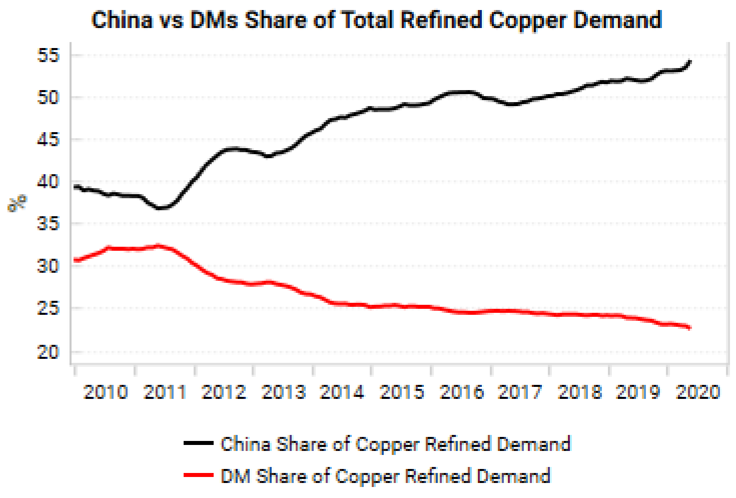
- **China consumes more than half of the world's copper but only owns ~5% of global copper resources**

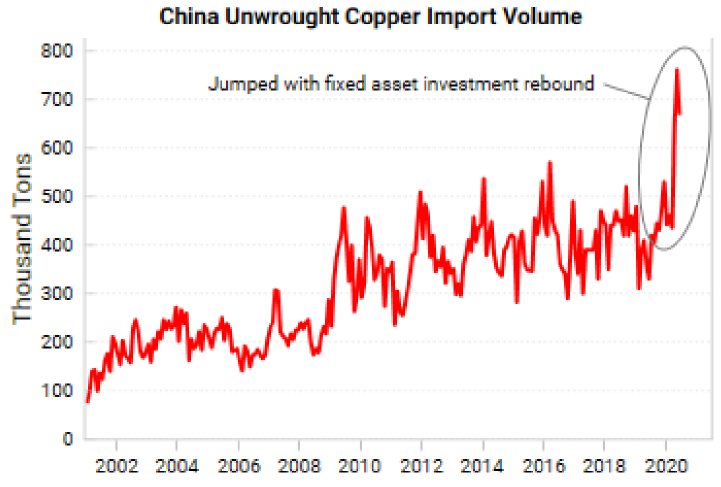
- The push towards self-sufficiency is clear with many Chinese miners recently acquiring stakes in overseas copper deposits

- Still, China's demand for refined copper is booming. The core driver comes from policy stimulus aimed at stepping up fixed-asset investment

- Western policy is shifting towards "Chinaficiation" with massive infrastructure spending on the horizon

- **The West will join China with an ever greater appetite for copper**



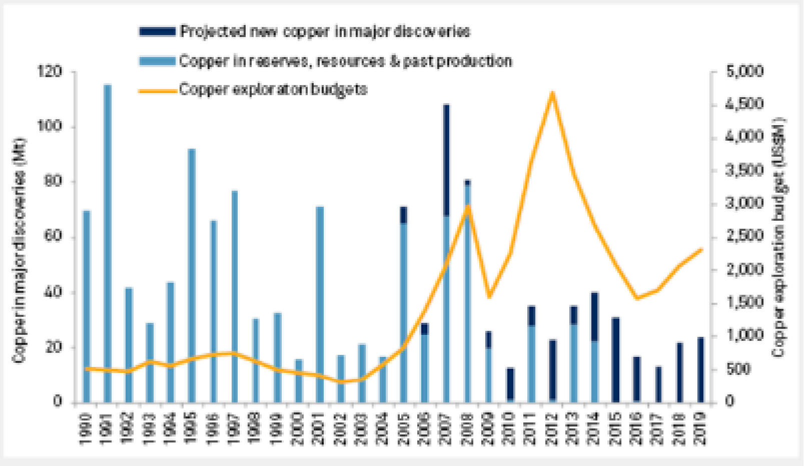


Source: Bloomberg, Macrobond and Variant Perception

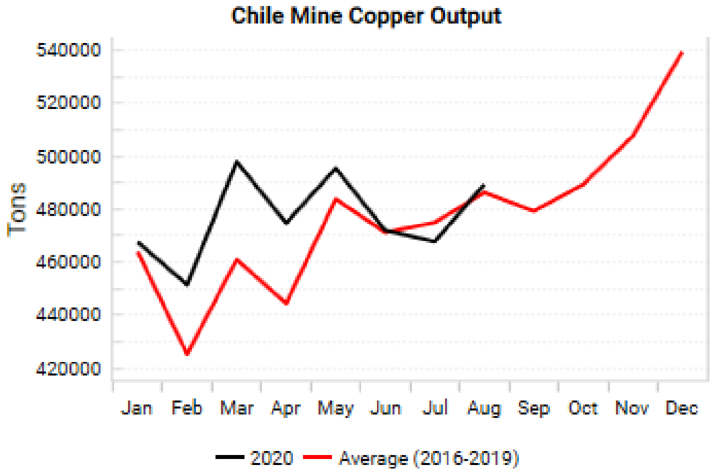
VARIANTPERCEPTION

Copper risks going into a huge deficit

- If copper demand starts to accelerate, then the dearth of new projects could push the copper industry into a huge deficit
- Even for projects that are due to go live, the potential to discover new copper is limited
- Only 102 million tons of copper has been discovered in the last 10 years (992 million tons was discovered between 1990-2008 with much less investment, according to SPGMI's Reserve Replacement Report)
- There are also copper supply risks in eg Chile – the world's biggest producer – due to worker protests and strikes

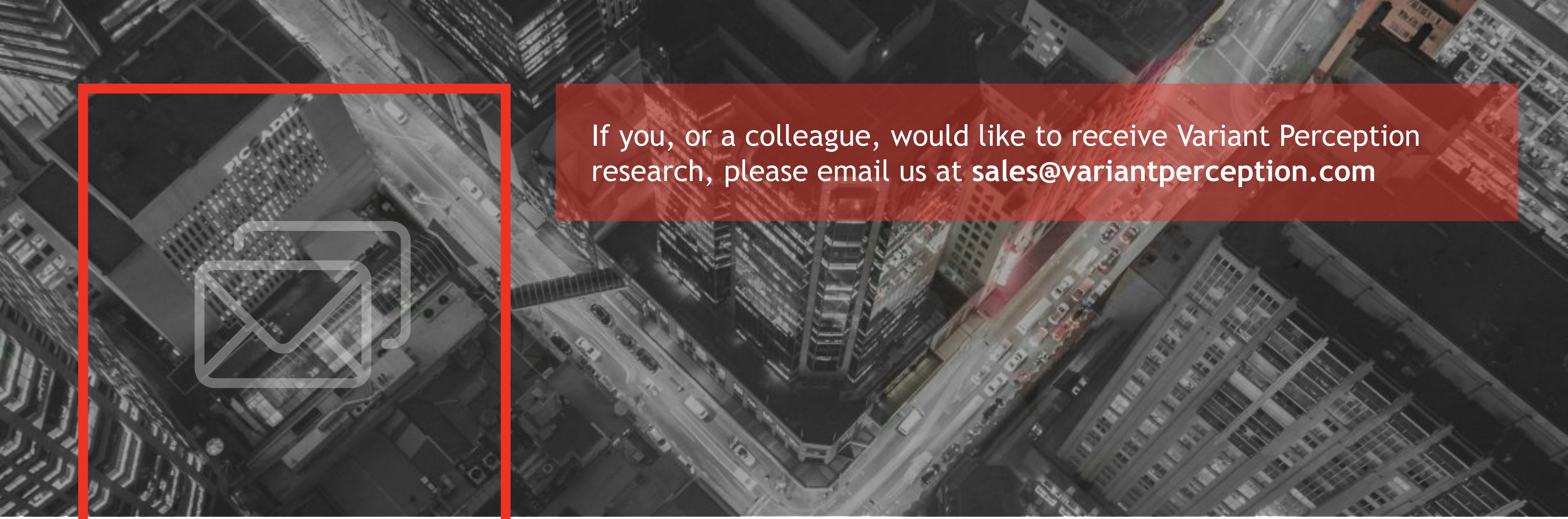


Data as of June 1, 2020.
Source: S&P Global Market Intelligence



VARIANTPERCEPTION

Source: S&P GMI, Bloomberg, Macrobond and Variant Perception



If you, or a colleague, would like to receive Variant Perception research, please email us at **sales@variantperception.com**

CONTACT US

VARIANTPERCEPTION