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Commodities in the wake of the pandemic: unlocking potential

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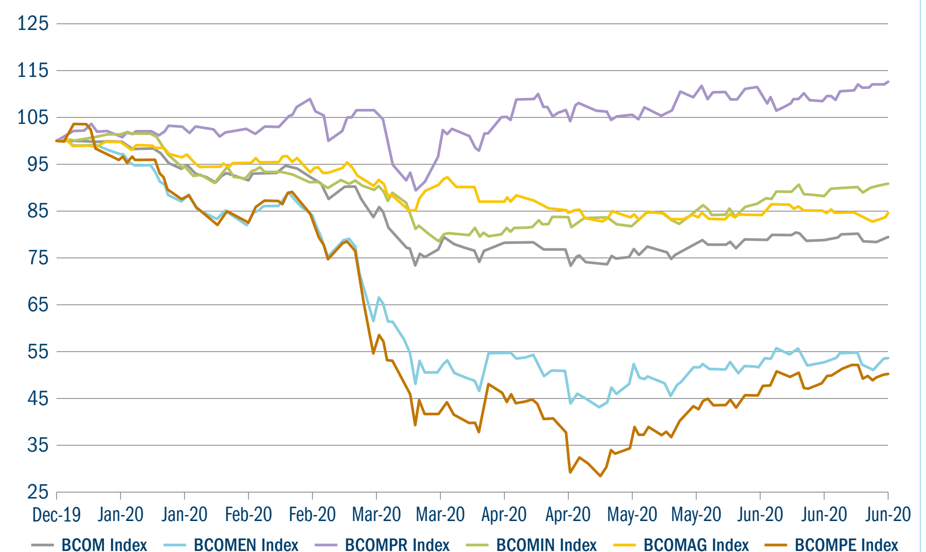
Like all asset classes, commodities were severely impacted by the Covid-19 pandemic. As the crisis starts to recede and we move into the second half of 2020, now is the moment to take stock.

The commodities universe is extremely diverse, from crude oil to precious metals. As economies rebuild, supply and demand will play out very differently across the diverse sectors. There are clear opportunities for selective, active investors who can carefully assess where markets may be under or overpricing certain assets.

As the pandemic's effects ripple across the world, the outlook will also vary by country. China could give some clues as to what lies ahead. The first country to be hit by the virus, China was also the first to initiate a strict lockdown. It is around two months ahead of many developed countries in its recovery.

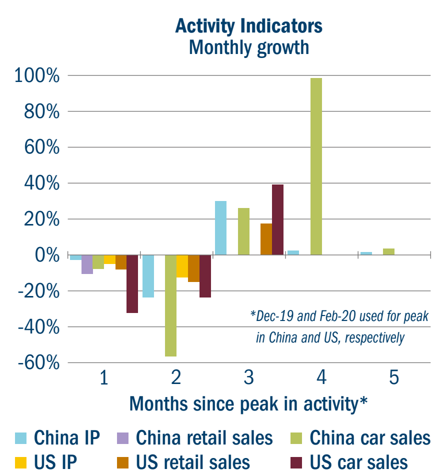
Figure 1: BCOM Index year to date: sector performance



Source: Bloomberg, Columbia Threadneedle, as of 30 June 2020.

The Chinese government was quick to take significant steps to stimulate the economy. Policymakers have targeted specific sectors where these measures will have the most impact. Many other countries have taken a similar approach. While macroeconomic data emerging from China has been volatile, the government has been able to drive the economy in commodity-intensive sectors, which is encouraging to us as investors.

Figure 2: The RoW lags China by about two months



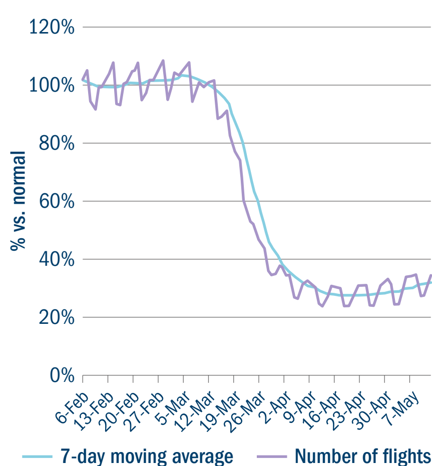
Source: Macquarie Bank, June 2020.

A slow return to normal

The pandemic has hit oil producers especially hard. As people stopped travelling and were encouraged not to leave their homes, demand for gasoline dramatically dropped. US oil prices fell into negative territory for the first time in history on the 20 April 2020. That day precipitated a cut in oil prices and production for May.

As lockdowns ease, the spectre of negative oil prices has evaporated. Demand has increased, as traffic has resumed across many regions. Consumption of gasoline in the US is only around 10% lower than usual. Oil producers are feeling more confident and production is picking up.

Figure 3: Global air travel is down by 70%, with a very modest rebound; IATA doesn't expect recovery to 2019 levels until 2023



Source: Citi, June 2020.

The normalisation of the oil market has begun, but we expect this process to take a few years. Global air travel is still down by around 70% and the International Air Transport Association does not expect demand for flights to return to 2019 levels until 2023.

In addition, China stockpiled significant amounts of crude oil in the first half of the year, while prices were at attractive levels. As a result, Chinese demand for oil in the second half of 2020 may be relatively low. Indeed, this could create a longer-term problem: following the 2008 financial crisis, oversupply in crude oil and oil products took years to clear.

Selective opportunities in agriculture

While many lockdowns were at their most severe in March and April 2020, we were concerned that closing borders could have dramatic consequences for key agricultural markets. However, demand has been stronger in recent months, creating opportunities for selective investors.

For example, China's hog farmers are in the process of rebuilding their herds following the 2019 swine flu epidemic. They are now having to turn to US suppliers for beans to fatten them up, giving us reason to be positive about bean prices. Conversely, we do not share investors' enthusiasm for corn, as this year's US corn crop could be impacted by bad weather.

In search of safety

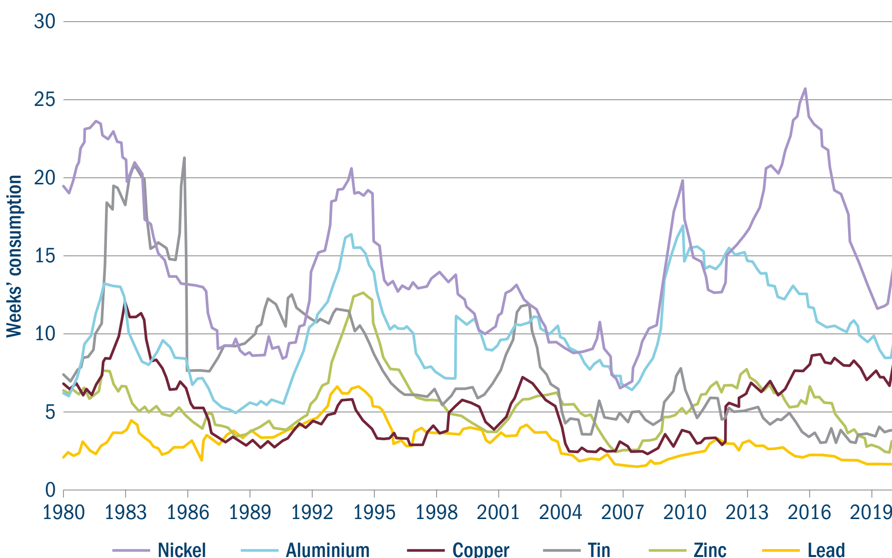
While other commodities have struggled, gold has approached all-time highs as investors seek safe havens, not least concerned that government stimulus programmes will spark inflation. Looking ahead to the second half of 2020, we believe that gold continues to offer some potential as a safe haven.

Base metals present more of a mixed picture. Demand for some, like copper and lead, is increasing among industrial companies as they emerge from the pandemic. However, there is a surplus of aluminium because manufacturers have kept plants open through lockdown if possible; once a plant shuts it takes a long time to start again.

Demand for clothing drops

Finally, soft commodities too present a mixed picture to investors. With many people now working from home, we expect to see less demand for clothing. For that reason, we are underweight cotton.

Figure 4: Base Metals inventories: there's excess to be cleared



Source: Macquarie Bank, June 2020.

While meat production decreased during lockdown, normal market conditions are re-emerging and we are trying to take advantage of that.

Looking ahead

The pandemic has triggered such a sharp drop in economic activity that demand for commodities such as oil could take a few years to return to normal. However, we are optimistic about the opportunity set open to us as investors.

Unprecedented levels of fiscal stimulus and the beginnings of economic recovery will support commodity markets, with industrial metals especially likely to benefit. The fiscal stimulus will also support precious metals, particularly gold, drawing investors to safe havens.

The commodities market has already staged a rebound, but there is more to come as economies recover. That bodes well for the performance of the asset class for the rest of the year and going into 2021.

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