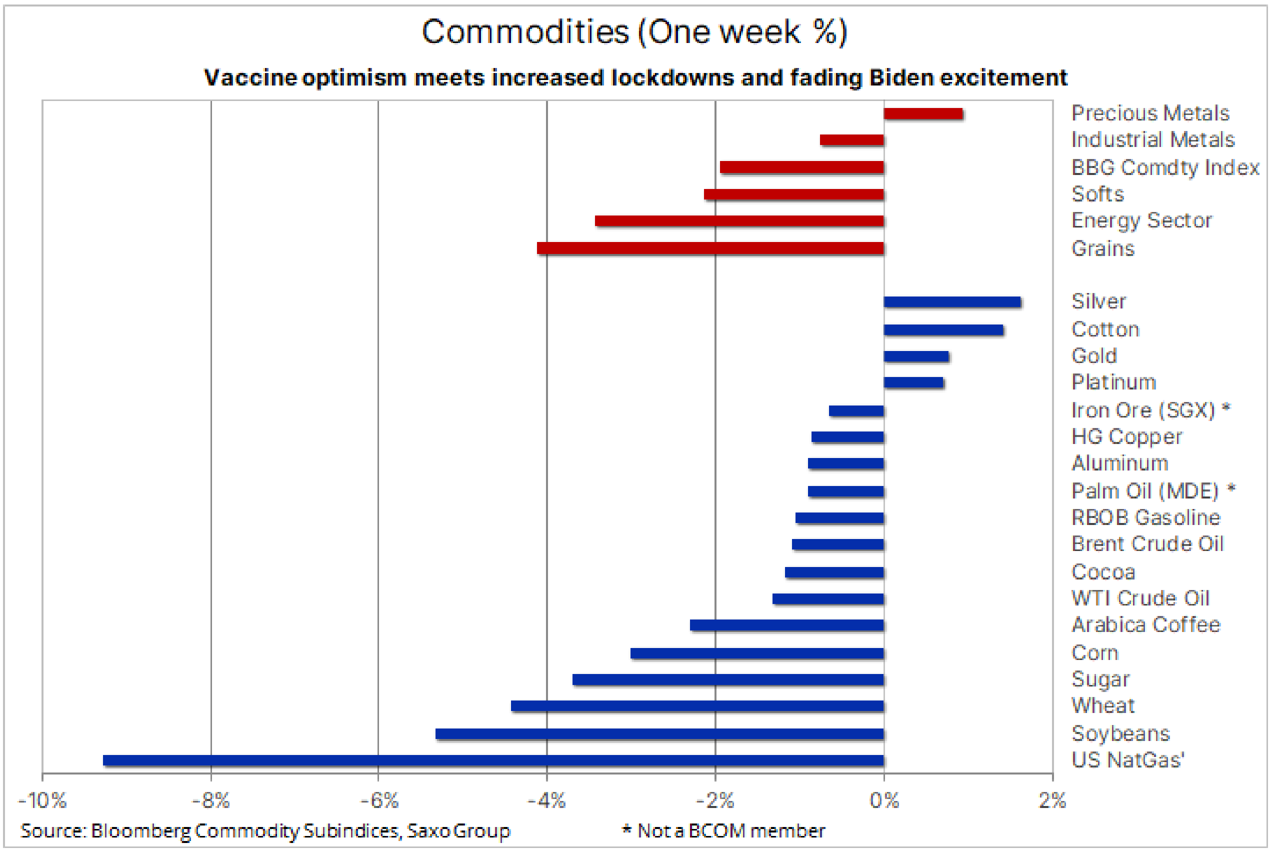
WCU: Commodity rally stumbles

By Ole S. Hansen // January 22, 2021

Into the third week of trading and we are increasingly seeing signs of several markets starting to fade some of the strong momentum that carried them, including commodities, higher during the past few months. Not least following the dual events in early November when vaccine optimism and the election of Joe Biden as the next president of the US raised market expectations for growth, inflation and a weaker dollar.

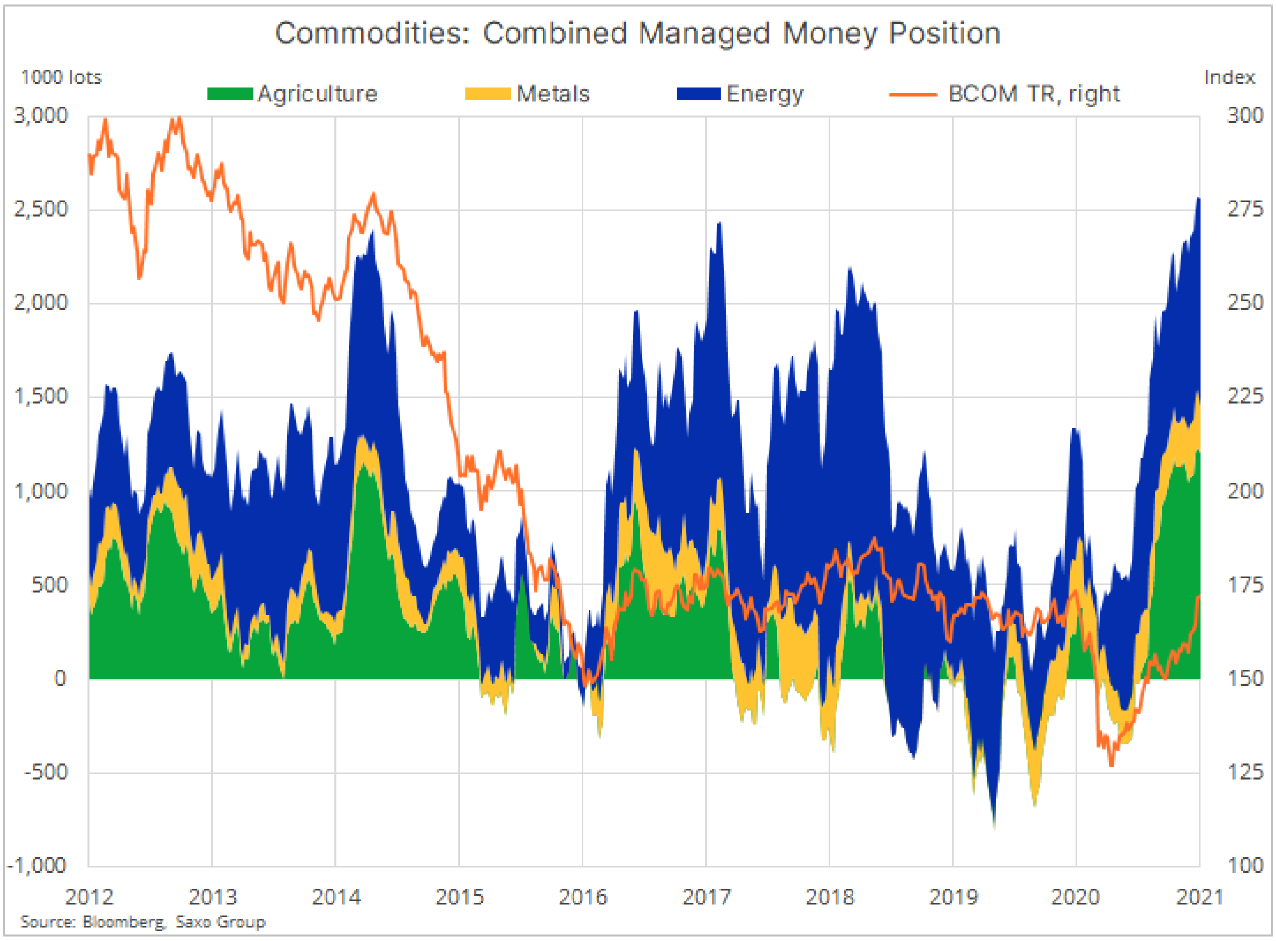
In our latest weekly commodity update we mentioned how momentum in commodities with a few exceptions, one of them being grains, had started to slow. This past week, the slowing momentum turned into outright losses led by the grains and energy sectors. However, having seen unusually strong gains across key commodities from crude oil to corn and copper, the risk of a setback or at best a period of consolidation has been rising.

Several factors may have influenced the latest change in sentiment towards one of caution. Following the peaceful transition of power in Washington, the Biden party seems to be over as reality sets in. A reality that will see +100,000 of Americans lose their fight against COVID-19 before the pandemic starts to loosen its grip into the second half of 2021. At the same time, hopes for fresh US stimulus to smoothly pass the Senate are fading as GOP opposition increases. Inflation remains subdued with an expected acceleration not a risk until the second half, once the base effects of last year's crude oil price collapse begin to fade. Adding to the unease has been the rise in US long bond yields and the stronger dollar.



Furthermore, on top of continued lockdowns across the world we are seeing outbreaks flaring up in at least three provinces in northern China, prompting new lockdowns. Thereby raising concerns about the short-term demand outlook from a country that almost singlehandedly, at times during the past year, helped support several key commodities from crude oil and copper to soybeans. Lockdowns and restrictions across the world are unlikely to ease anytime soon and with that we are likely to see the timing of the expected recovery continuing to be delayed which may further challenge the short-term outlook.

With these developments in mind, the focus turns to what risks a record speculative long pose to the short-term outlook. Months of reflation focus, expectations for a vaccine-led recovery in global demand for raw materials as well as emerging tightness in key commodities have driven a surge in speculative demand from speculators. In the week to January 12, they held a net futures and options long of 2.6 million lots across 24 commodity futures valued at $128 billion. It would have been a new record if it hadn't been for a 31% slump in the gold net long.



Gold and silver continue to struggle to find a fresh bid following the early January sell-off that was triggered by rising yields and short covering strengthening the dollar. Instead of a sprint, the prospect for further gains has turned into a marathon and investors will have to be patient with a supportive inflation pick-up not expected before the second quarter and beyond. While total holdings in exchange-traded funds backed by silver reached a record high this past week, speculators in gold have increasingly been voting with their feet and reduced length in gold futures. As mentioned, the week to January 12 saw speculators cut their net long by 31% to nearly the lowest exposure since June 2019.

Hedge funds are generally not 'married' to their positions and this often leads to a forceful response when they see a change in the technical and/or fundamental outlook. However, based on our continued bullish views on inflation, we maintain a positive outlook for precious metals but patience is once again being required.

Crude oil's resilience during the past couple of months has been a major feature and one that has supported stability across commodities. It reached the highest level in a year this past week despite pandemic-led demand concerns, now also in China where lockdowns are spreading ahead of the Lunar New Year holiday. Limiting the downside are the prospects for a vaccine-led recovery in mobility, US stimulus hopes, Saudi Arabia's unilateral production cuts and a continued strong investor demand for commodities, including oil.

We maintain a long-term bullish view on crude oil, but in the short term, the risk of a +10% correction continues to grow. With this in mind, we keep a close eye on Brent crude where a break below the uptrend from the November low may signal a reversal back towards $49/b.

Source: Saxo Group

Grains and soybeans, the best performing sector in recent months, also ran into profit taking with the Bloomberg Grains Index trading lower for the first week in seven. A +50% rally in corn and soybeans since August helped attract a very elevated speculative long position, currently some 50% above the two previous peaks in 2016 and 2018. A speculative long that is now being challenged by beneficial rains in key South American growing areas that may improve crop yield prospects and reduce worries about global supply.

Before running into profit taking, wheat prices on both sides of the Atlantic had rallied strongly with Chicago and Paris wheat prices approaching the highest levels in eight years. The latest surge was driven by Russia's decision to slap taxes on exports to curb a recent rise in domestic food prices. Being the world's largest wheat exporter, the move once again, just like in 2011, raised concerns about the potential political and social implications of a continued rally.

The WisdomTree Grains (AIGG:xlon) is a UCITS eligible exchange-traded commodity (ETC) that tracks the performance of the Bloomberg Grains Index. Since August it has surged by 56%, thereby increasingly raising the need for a period of consolidation.

Source: Saxo Group

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