Commodities in strong demand

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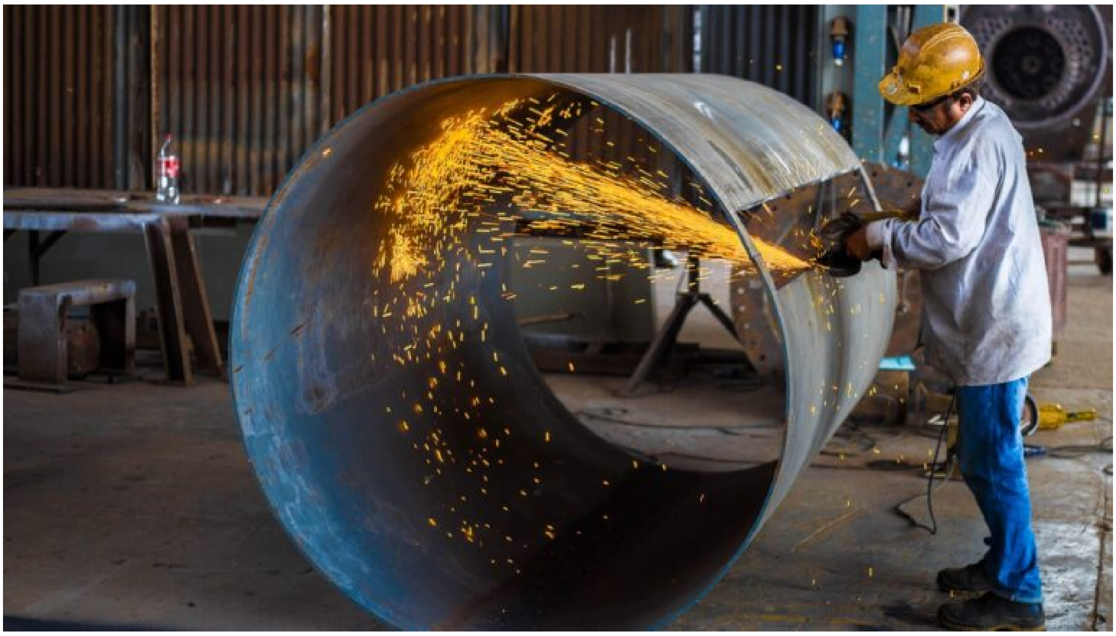

Whether you want to buy a house or buy a car, many private consumers currently deal with soaring prices for materials and unpleasantly long delivery periods.

This situation is directly reflected in commodity prices. The following chart illustrates the commodity market with the segments of energy, industrial metals, and precious metals. This is how we should want to interpret the chart: from 2016 to 2019, supply and demand were roughly in equilibrium, and as a result, prices did not change much. After the pandemic in 2020 that affected all commodities but particularly crude oil, prices started to rise significantly. The chart also shows that industrial metals – especially the important copper – are ahead, which should paint a positive picture as far as the global economy is concerned.

Performance of commodities

Source: Bloomberg; 08/2016-08/2021

Indices: Bloomberg Commodity Index Total Return; Bloomberg Energy Subindex Total Return; Bloomberg Industrial Metals Subindex Total Return; Bloomberg Precious Metals Subindex Total Return

Please note: past performance is no reliable indicator for the future development of the fund

How do we measure the performance?

The performance, i.e. the development of prices, of the commodity market is measured by referential indices, with the Bloomberg Commodity Index assuming a crucial role. At the moment, the index contains 23 commodities that are classified and weighted as outlined below:

Source: Bloomberg; as of 08/2021

Daneben gibt es weitere Referenzgrößen, etwa den S&P GSCI Index, der einen größeren Energieanteil aufweist, oder There are additional benchmarks such as the S&P GSCI index, which contains a bigger energy weighting, the CRB index, and the Rogers index.

What is the status quo of gold, copper, and oil?

Gold is known to often appreciate in times of crisis as was the case in the financial crisis 2008/2009, the euro crisis 2016, and the pandemic crisis 2020. This feature qualifies it as financial investment. It should be regarded as complementary to a core equity portfolio though, given that equities are indispensable to the portfolio in the long run when it comes to achieving one's investment goals despite intermittent setbacks. One of the factors driving the gold price is whether national central banks buy gold in order to diversify their portfolios.

The volume of purchases has fluctuated strongly in history. This year, central banks seem to be present in the gold market, and new ones have joined the ranks: Brazil, Hungary, and Thailand. For Russia, which has always been a major player in this field, the higher oil price should have created liquidity with which to become active (again). In other words, central banks as a driving factor should support the lower end of the gold price.

Source: Bloomberg; 08/2016-08/2021

MSCI All Countries World Index; Bloomberg Gold Subindex Total Return

Please note: past performance is no reliable indicator for the future development of the fund

Historically speaking, **copper** is strongly correlated with global economic growth. Most recently, China has become a relevant player in this area, given that it accounts for a large part of global growth and its industry hinges on commodities. In economies such as Europe and the USA, the service sector and the IT sector have already assumed more important roles.

To China, copper is a strategic metal, as the current five-year plan maintains. This results in the need for high levels of inventory, which caused substantial purchases already last year. The targeted level of inventory has not been achieved yet, which is why China should continue to drive prices, along with general global growth. Also, copper and industrial metals in general are indispensable – both for traditional production and product design (which have to be adjusted due to their high CO_2 emissions) and future ecological economies.

Source: Bloomberg; 08/2016-08/2021

MSCI All Countries World Index; Bloomberg Copper Subindex Total Return

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Crude oil has underperformed equities more significantly than copper, as the following chart highlights. This is due to the fact that during the pandemic, not only was industrial production reduced sharply, but supply also clearly outstripped demand. On the one hand, the relevance of oil for the global economy will decline in the long run in order to facilitate a more environmentally friendly approach. On the other hand, this process requires a gradual transition that takes time. Also, oil reserves, once tapped, provide declining revenues; after a while the investments in the development of new reserves fall short of the required volume. This could instil the oil price with temporary upward potential.

Source: Bloomberg; 08/2016-08/2021

MSCI World All Countries Index; Bloomberg WTI Crude Oil Total Return

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How do commodity investments work?

Companies that process commodities have to be able to physically buy them. For financial investors, this is not practical for reasons of logistics (storage). Therefore, financial investors access this market via so-called commodity futures. A commodity futures contract obligates the parties to transact a commodity at a predetermined future date and price; the future buyer can thus already participate in the development of the price until the transaction.

Futures contracts are available with a wide range of maturities from very short (a few months or even weeks) to long-term (several years). The contracts with shorter remaining time to maturity tend to reflect the development of the price of the physical commodity (i.e. the so-called spot price) more directly than contracts with end of maturities that are farther off. Therefore, investors tend to buy futures contracts with relatively short remaining time to maturity; once one expires, the end of maturity is pushed back to a new one. This is called “rolling”. As pointed out, financial investors want to participate in the price performance but do not want delivery, because they have no way of storing the goods while trying to sell them on.

An interesting aspect is the ratio of the price of futures contracts with shorter remaining time to maturity and those with longer remaining time to maturity. If the price of the shorter futures contract is higher, this suggests a supply shortage because the industry that processes the commodities needs them right away. It is not possible any longer to order commodities and wait for delivery.

How significant is the current demand overhang?

The conclusion is that the shortage in commodities is the most pronounced one since 2007, as the following chart illustrates as well. The so-called backwardation is the ratio of short-term to long-term futures maturities. 2009 was clearly a phase when the demand for commodities was limited in the wake of the global financial crisis, as was 2020 as a consequence of the pandemic. Since 2021, the “shortage index” has been pointing upwards.

Extent of demand overhang for commodities

Source: Bloomberg; Berechnung von Bloomberg

Please note: past performance is no reliable indicator for the future development of the fund

Interestingly, this situation makes it easier for investors to invest in commodities, because the mechanism of the frequent switching of futures becomes cheaper. It also makes sense that a phase where demand is outstripping supply is a good time for investing.

Will commodity prices be fuelling inflation in the future?

We have seen unexpectedly high levels of inflation in particular in the USA, which then also affected the financial markets (especially government bonds). Later, the situation relaxed again. Inflation expectations – i.e. the rate which well-informed investors envisage for the future – declined a bit. It is not particularly high by historical standards. The dominant interpretation that we have seen suggests that it was not commodities and wages that were driving inflation, but components that were going through a turbulent yet transitory development in the wake of the pandemic: new and used cars as well as tourism (hotel, flight tickets). The so-called core inflation, on the other hand, has not changed much since the end of 2019.

Conclusion

Dass Demand for commodities exceeding supply is a fact that both business owners and consumers are well aware of at the moment. Whether the commodity prices remain high will depend on whether the global economy continues to grow strongly. Prior to the pandemic, the stage we were in was deemed a low-growth, late stage of the economic cycle. Now, the sharp recession in 2020 may have changed the framework to such a degree that a new growth cycle may be imminent.

Commodity prices affect the following funds in particular:

ERSTE STOCK COMMODITIES

ERSTE STOCK COMMODITIES invests globally with a focus on companies from the commodity sector. The investment process of the fund is based on fundamental company research. The investment strategy hinges on a balanced portfolio from basic materials and energy and on a stronger weighting of companies from the developed markets. As a matter of principle, we tend not to hedge foreign exchange risk, although the terms and condition of the fund would allow it. Environmental, social, and governance factors are integrated into the investment process.

ERSTE REAL ASSETS

ERSTE REAL ASSETS invests mainly in the asset classes of equities, commodities, precious metals, real estate, infrastructure, and inflation-protected bonds, which overall means a focus on real assets. Global equities, and gold, and real estate account for the majority of assets under management. The capital is invested directly or indirectly via investment funds or derivatives. The allocation in precious metals, especially gold (e.g. as exchange-traded commodities, i.e. debentures), is capped at 40% of assets under management. Real estate funds may account for up to 20% of the fund’s assets under managements.

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