

# The outlook for commodities

## What is driving commodity prices?

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Real assets – such as commodities – have the ability to improve portfolio performance for many investors. These assets (defined as having value in the absence of a monetary system) have historically been a typical storage of wealth. They now comprise a material portion of the global economy and represent multi-trillion-dollar industries. However, real assets continue to be under-represented in many portfolios possibly due to their perceived risk, inaccessibility, and illiquidity. The market is evolving however, and there are numerous ways to access real assets like commodities – and thus access attractive growth potential and effective portfolio diversification – and their inclusion can help investors' portfolios outpace inflation in the longer term.

### Introduction

Commodities continue to attract the attention of investors, market commentators and politicians, and discussions on the subject tend to embrace a wide range of issues including:

- supply constraints in the face of global development
- the sustainability of pricing
- environmental and geopolitical issues
- the challenges of global wealth distribution
- the effect of financial investors on commodity prices

The financial crisis of late 2008 and beyond has given rise to further issues, notably the potential for accelerating inflation (as governments around the world try to reflate their economies), and its likely effects on commodity prices, particularly the cost of food and energy. We look at the outlook for commodities and the key drivers of growth for this asset class.

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*The oft-quoted “green shoots” of recovery, the inflationary pressures resulting from sizeable fiscal and monetary activism and a weakening US dollar have all served to support positive momentum in the commodities market.*

## Current market conditions

Commodities enjoyed a very strong run prior to the global financial crisis of late 2008, driven by sustained global economic growth, and sharply rising demand from developing “tiger” economies like China and India. Prices of many of the key raw materials then retreated sharply as the crisis evolved into a worldwide recession that dominated the latter half of that year and beyond. Global demand and spending slumped and investors became more risk averse and repatriated their funds from riskier, less developed markets.

However, the persistent and concerted central bank intervention that followed across the globe served to restore investors’ appetite for risk, to the benefit of commodity-related countries and currencies. Money has poured back into commodity rich emerging markets – particularly those that are key suppliers of raw materials to China – in the belief that their economic fundamentals are stronger, and that their financial systems are better-capitalized and less leveraged than Western counterparts. Policymakers in Asia also have previous experience of navigating similar periods of economic turbulence.

Commodity indices have rallied sharply, on mounting speculation that the global recession is easing. The rally has, perhaps surprisingly given the steep decline in global output, been led by industrially-linked commodities such as crude oil, copper and base metals. Commodities that were widely expected to outperform – precious metals and agriculture in particular – have made much more modest gains despite being insulated from the global industrial cycle.

## The key drivers of commodity strength

A return to more normal conditions in financial markets, indications of greater stability and a sense that prices are renewing their relationship with market fundamentals, has helped commodities emerge as one of the better-performing asset classes of 2009. Relative valuations continue to diverge (increasing the opportunity set for active managers to pick the right commodity), with many raw materials trading at well below their global marginal cost of production figures, causing investors to supplement their long positions.

We expect commodity markets to continue to grow strongly, and address several of the key reasons for our conviction below:

### Emerging market demand

**China’s ascent** – China’s share of global commodities demand has accelerated markedly. China is the world’s biggest metals consumer, and its share of global steel demand reached 43%, compared with 39% at the end of 2008. In copper, its share has risen from 27% to 38%. In its other most significant market, soybeans, the Chinese share has increased to 53% in the current harvest year. The US is the world’s biggest exporter of the crop, and has seen its sales to China rise 40% after droughts in Brazil and Argentina limited South American supply. Soybean prices have risen on speculation that China will continue to purchase US supplies that are cheaper than oilseeds from domestic inventories.

China has focused its attention on making significant inroads into Latin America’s resource rich economies. It has undertaken a wave of mergers and acquisitions within Chile, Peru, Brazil and Mexico. Its construction and energy companies have sought out companies involved in the production of iron ore and of copper in particular and

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*China has confirmed that it expects to hit its growth targets in 2009, despite the recession elsewhere in the world. Annual GDP growth accelerated in the second quarter to 7.9% from a year earlier.*

have begun stockpiling the materials needed to construct ports and build the infrastructure required for the next commodities boom. The Chinese Development Bank has helped fund Brazilian state-controlled energy company Petrobras' exploration of the Tupi oil field off Brazil, one of the Western hemisphere's largest discoveries. The country has also signed an energy co-operation agreement with Venezuela, amounting to 80,000 to 200,000 more barrels of oil per day. This comes after an agreement last year to jointly explore reserves in the Orinoco river valley via a project called Sinovensa.

**Asian expansion** – as Asia's "tiger" economies continue to develop, their demands for infrastructure – and the raw materials necessary to meet this demand – will increase markedly. The Asian Development Bank concluded that developing economies in East Asia will need to spend an estimated total of \$165bn per year between 2006-2010 in certain infrastructure sectors, namely electricity, telecommunications, major inter-urban roads, rail routes, water and sanitation.

**The "petrodollar"** – in the Middle East, the flow of petrodollars is driving a huge amount of investment. In Russia natural resource revenues flowing from the country's deep oil and natural gas resources look set to be funnelled into diverse infrastructure projects, including improving access to the Black Sea resort of Sochi in time for the 2014 Winter Olympics. Substantial work is also under way on Russia's railways and the country's "second electrification".

#### The financial crisis

**Quantitative easing and inflation** – the outlook for raw materials prices strengthened after policymakers adopted aggressive fiscal and monetary policies in an attempt to avert a deflationary slump. These mechanisms – most notably "quantitative easing" (whereby a central bank buys assets in exchange for money, effectively printing money) helped restore investors' appetite for risk and increased expectations of a period of higher inflation – although we expect central banks to be able to limit its effects in the longer term.

A period of higher inflation could be good news for hard assets, such as commodities, and especially good news for gold. The precious metal has been a prominent addition to investment portfolios throughout the global financial crisis, given its perceived negative correlation to most asset classes and the appeal of its so-called safe haven status. Demand could continue to harden as investors continue to buy gold as a hedge against inflation and a weakening dollar.

**Public sector intervention** – the global financial crisis and the resulting unprecedented volatility in financial and credit markets may also spark renewed public sector funding on a huge scale. Increased spending on upgrading outdated infrastructure is likely in several of the world's major economies – meaning raw material inventories may need to be replenished.

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## The evolution of a new world

**Demographic change** – the expansion of the middle classes in developing markets like China and India has seen growing consumption of proteins, meats (particularly pork) and processed foods in the former, while the latter's 'fats and oils' consumption has increased. The rise in hogs prices was arrested by an outbreak of swine flu in April, but the focus simply shifted to alternative foodstuffs, like salmon.

**Climate change** – despite the fall in commodity prices late in 2008, strong economic growth has granted resource-rich governments' significant capital to dedicate towards infrastructure investment, potentially to the detriment of the environment. Climate change represents both a challenge and an opportunity to emerging market development. Fuel consumption has increased, particularly in the Asia Pacific region, but these economies, where infrastructure is typically immature, do not suffer from a "carbon lock-in" and can lead the way on the absorption of more environmentally friendly technologies. As an example, the US now devotes more than 15% of its corn production to produce ethanol, a less harmful fuel. The adoption of such biofuels by an increasing number of nations could give further impetus to the soft commodities sector.

**Agricultural challenges** - desertification and increasing contamination of water tables is likely to put pressure on agricultural commodities. Ever-increasing demand has weighed heavily on outdated production technologies in the developing world, leading to food shortages, rice riots and so on. Food prices will increase as arable land is squeezed amid the urban sprawl. These developing economies generate disproportionate demand, needing hard commodities such as steel, nickel, tin and copper, for their industries and soft commodities, such as cocoa, coffee, soybeans, potatoes, wheat and barley, to feed their increasingly urban population.

**Alternative energy** - concerns over the sustainability of fossil fuels and the security and efficiency of power generation have sparked further debate on the merits of 'clean' nuclear power, with many observers arguing that alternative energies, such as wind and solar, will never be able to deliver the power needed for the ever-expanding population. Global population growth is such that electricity consumption is expected to double by 2030 – while newsflow on harmful carbon emissions, oil price volatility and concerns over the security of energy supply has led to an upsurge in interest in the alternative and renewable energy sectors. In oil markets, a significant amount of the world's proven reserves – around 80% – is held by national, state-run companies and many of the oil producing countries have either policies (e.g. the stark anti-US rhetoric of Venezuela, Iran) or production climates (e.g. the kidnappings of oil workers in Nigeria) that expose the world commodity markets to abrupt price changes.

**Technological advances** can have a material impact on energy prices. Oil supplies are diminishing and prices could increase as extractive processes become ever more complex in challenging conditions, making alternative energy more necessary, and ultimately more viable. This would require sizeable investment as production technologies are currently expensive to implement, but could potentially put upwards pressure on prices for materials associated with the production of nuclear power and the manufacture of solar panels and wind turbines. As production technology and thus supply improves, the pressure on prices for fossil fuels may ease over the longer term.

While we are agnostic on what the popular press has termed 'peak oil', it appears that the world's access to hydrocarbon-based energy resources is increasingly found in more challenging geological environments. Chronic under-investment in developing new sources of supply has been exacerbated by the 'credit crunch'. Exploratory or expansion projects have been delayed or mothballed. For example, the Baker-Hughes rig count (a measure of natural gas drilling units in current use) has dropped by over 50% since the end of 2008.

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*“As the global economy goes toward growth as opposed to a recession, you are going to see further increases in commodity prices especially next year. There is now potentially light at the end of the tunnel.”\**

## Outlook

After the robust gains the market has already achieved this year, price appreciation may slow in the latter half of 2009. However, we expect the downside to be limited due to healthy fundamentals (Chinese stockpiling, declining inventories – such as US oil – and limited supply following output cuts), an improving global economy and an overhang of excess capacity and inventory that is much lower than in previous cycles.

Raw materials cannot remain reliant on Chinese demand (which may be unsustainable at current levels) meaning OECD commodity demand will need to pick up the slack. Recent data have displayed some tentative signs of improvement in the OECD, notably US gasoline where year-on-year demand comparisons are back in positive territory for the first time since early 2007. Leading indicators for base metals have also shown a marked improvement recently, helped by steep reduction in inventories – which may now have reached unsustainably low levels.

## Conclusion

The long-term outlook remains very positive for a broad range of commodities as the global recession abates. The extent to which the strong upward trend persists is dependent on the evolution of market fundamentals, and continued improvement in the macroeconomic backdrop. Commodity prices are likely to prove vulnerable to any faltering in the economic recovery story.

In the medium term, those commodities for which Chinese demand is growing should strengthen, driven by increasing fuel consumption and infrastructure development.

In the short term, the potential for volatility remains, as those markets such as steel, base metals and soybeans, which have become heavily reliant on China this year, may prove very sensitive to any signs that demand is slowing.

\* Professor Nouriel Roubini July 2009. Professor Roubini is the New York University economist who has gained fame having predicted much of the turmoil that engulfed the global financial system.

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