Opinion: Commodities in the year of mayhem

Jean-François Lambert, Founder and Managing Partner at Lambert Commodities, discusses the complex impact of crises on commodity prices, and pins some hope on governments' abilities to adapt.

"This is the most complex, disparate and cross-cutting set of challenges that I can remember in the 40 years that I have been paying attention to such things."[1] Larry Summers, former US Treasury Secretary, certainly knows what he is talking about. This will most probably be remembered as a mayhem year, as multiple shocks, whether economic, climatic, social or geopolitical compound to create a very bleak and unsettling environment.

Commodities could not ride on such seas without damage. Brent crude oil jumped from $75 per barrel in January to $130 in March, only to drop back to $88 in later October. 'Doctor' copper is trading around $7,400 a tonne, some 30% lower than in early March when it was above a record $10,000 a tonne. Iron ore prices dropped by 50% from a $170 peak in March. Wheat prices jumped 70% in the first three months of the year, only to jump again as Ukrainian exports are yet again challenged by Russia[2].

Obviously, gas merits a special mention. European natural gas prices reached record highs, trading above $360 per barrel of oil equivalent or 15 times historical average prices with a peak at $580 per barrel. They were back at a more reasonable level of €136 per Mwh[3] in November. Still, this implies an oil price equivalent of $220 per barrel.

Jean-François Lambert

We could go on. The multiple prevailing factors affecting commodity prices so far in 2022 are well known, yet they are exerting contradictory pressures and making interpretation difficult. The Nobel prize for physics was attributed this year to scientists who worked on the entanglement of particles at a quantum physics level. Well, without attempting to link commodities and quantum physics, the concept of entanglement adequately describes current market conditions and fosters a feeling of discombobulation when it comes to anticipating where prices are going. Let's dwell on four shocks which have been interacting this year, the first two pushing prices up and the other two, down.

Post-pandemic shock

First, the post-COVID shock. The initial surge of demand triggered by the lockdowns of consuming countries two years ago was followed by an equally strong shock of supply, as demand exploded at a time when the commodity supplying countries had themselves been affected by the pandemic

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and supply chain logistics were still in tatters. While developed economies were catching up, commodity supplies kept being significantly undermined, either by logistics issues or because demand was simply too high to be met at any given time.

Disruptions of war

Second, the most unexpected and yet disruptive element of all is the war in Ukraine. The sudden invasion by Russian forces met a strong resistance and brought together many countries in support of Ukraine. Initially a bilateral crisis, it has soon morphed into a proxy war between Russia on the one hand and US and Europe (largely) on the other. Commodity prices jumped and remained highly volatile throughout the year.

Hitherto, Russia was the main supplier of energy to the west (and still is the main one for non-ferrous metals to European industries). Oil and gas were therefore strongly impacted. This was less so for oil as more options to substitute Russian origin oil exist than they do for gas. Furthermore, Ukraine is one of the largest exporters of maize and wheat and supply concerns pushed (and are likely to keep) prices sharply up. For good measure, nitrogen and potassium, key components of the fertilizer complex are mainly provided by Russia and its sidekick Belorussia and this, if the war lingers, may hit crop yields worldwide, thus building lasting supply tensions.

Inflation and its resilience

Inflation provided the third shock and paradoxically one which might pressure commodity prices down, eventually. What most economists deemed to be a temporary phenomenon is now widely seen as unfortunately resilient. This triggered, initially with hesitation, but soon with determination, the reaction of most central banks with their usual toolbox: hiking interest rates and balance sheet compression.

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The 'whatever it takes' to keep economies afloat during the pandemic has now become the motto for reining in inflation, at the risk of tipping the world economies into recession. The outcome of a short but severe medication leading to a swift recovery which could have worked in normal times is much more uncertain when war is at our door.

The other scenario, one of stagflation is therefore increasingly plausible. The combination of a surge of inflation and fear of recession could weigh on commodity demand. Prices of metals, for instance, are already affected by the anticipated slowdown in Europe, the US and China (which is quite concerning as this the country which accounted for almost all the global metals demand increase over the past 20 years[4]).

The strong US dollar

The fourth shock is a consequence of the strength of the dollar. Fuelled by the steep rise of interest rates and by the weakness of the euro as the European Central Bank was reluctant to follow the Fed's move initially, the US dollar has attracted investors throughout the world. As war looms in Europe the dollar has been hailed as the world's refuge, offering not only security but also yield.

Commodities have a steady inverted

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relationship with the dollar which is the currency of choice for most commodity trades. When the dollar is down, commodities are cheaper and demand is fostered. A strong dollar will make commodities more expensive but eventually will push demand down. This phenomenon is affecting the whole commodity complex.

Other factors in play – how to ‘read’ price movements

Granted, these four shocks do not explain everything. Weather conditions and climatic changes have been very influential, of course. As has the energy transition push. And these two dimensions in the background add further complexity. However, the entanglement of all these phenomena does offer some clues as to how to ‘read’ price movements.

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To illustrate this, consider non-ferrous metals. They are affected by fear of recession and the anticipation of a weaker Chinese economy (significant downward pressure). The dollar appreciation has put pressure on raw material prices (upward pressure initially), fuelling inflation, and therefore further threatening demand for finished products such as cars (feeding the downward pressure).

But, as energy costs are reaching highs, production at mills and smelters is slowing down, so reducing the supply (upward pressure on prices). Furthermore, the war with Russia may call for further sanctions notably on metals, hitherto largely preserved, thus reducing supply optionalities (additional upward pressure). And in the background, the energy transition dictates that demand for so-called electric metals will only keep rising (supply concerns, hence long term upward pressure). This is a complex picture indeed, which translates into high volatility as price expectations are affected at any given time by one or several of these conflicting elements.

What’s next?

So, what’s next? This is the million-dollar question. Of course, how the war pans out will largely shape the future for commodities and everything else. Another wildcard is the state of the Chinese economy, which is still largely dependent on exports to (now) slowing economies, but also for the new priorities set by the 20th National Congress. It is difficult to be optimistic at this juncture. But, to conclude on a (mildly) positive note, let’s reflect on the energy crisis.

In the recent World Energy outlook released in late October 2022, The International Energy Agency shows that “(it) promises to be a historic turning point towards a cleaner and more secure energy system[5]”. People and countries learn from crisis and the one we are facing is daunting. Already the dependency on Russian oil has sharply reduced in Europe. Gas remains the biggest concern, but it looks like that there may now be enough gas this winter to avoid shortages. As to the next one, time will tell, but we should remain confident of our ability to adapt. One thing is certain though: failure to do so is not an option. ■

Notes

1. At the IIF annual membership meeting in Oct 2022, quoted by the *Washington Post*.
2. Per early November 2022.
3. Futures TTF price end of October 2022.
4. Goldman Sachs quoted by the *FT* Oct 2021.
5. *The World Energy Outlook 2022* page 26, International Energy Agency Oct 2022.

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