COMMODITIES

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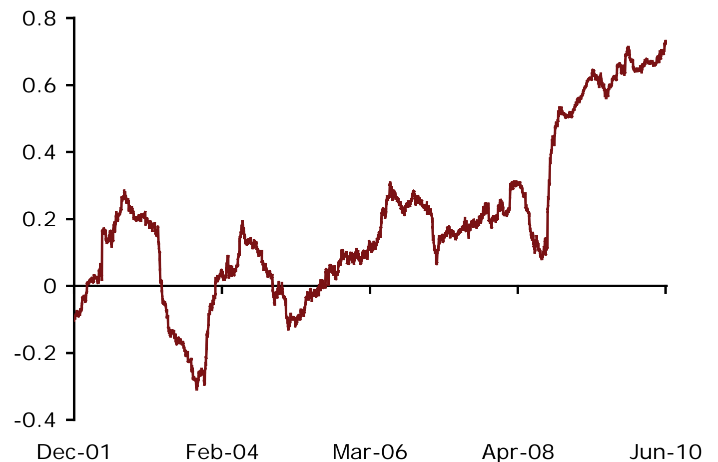
"Financialization" of Commodities: Implications for the Outlook

With oil trading back over $75/bbl and copper at around $3.00/lb, most key commodity prices remain well above their year-ago lows. The first half of 2010 has, nevertheless, proved disappointing for those who looked for a carryover of last year's strong momentum. Topping the global worry list and hurting sentiment are eurozone debt woes. Belt-tightening will restrain growth and resource demand there in the next few years—a larger potential obstacle for metals than energy markets, based on past consumption patterns (Chart 1). May's disappointing US non-farm payrolls numbers and China's efforts to restrain its ebullient property market in the meantime have also clouded prospects in two even-larger resource consumers, although recent strong export data suggest the trade side of China's economy is holding up. That's helped to ease, for now, fears of a hard landing there.

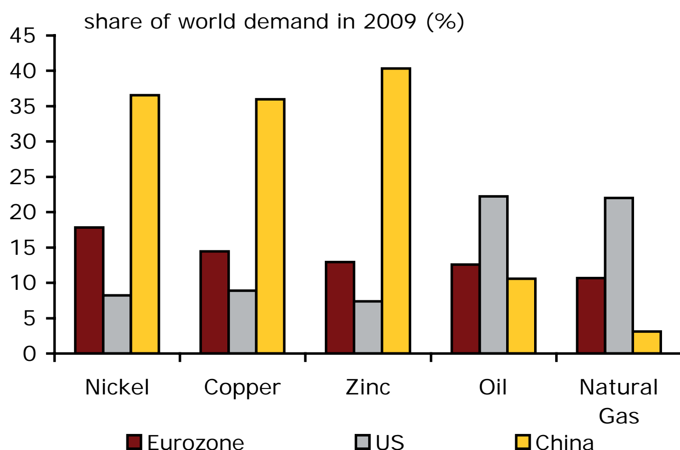
Chart 2—***Rolling One-Year Correlation Between S&P GSCI and MSCI World Equity Index***



Financialization Heightens Susceptability to Shocks Like Greek Tragedy

The eurozone crisis, while not to be underestimated, appears unlikely to match the systemic damage wrought by the collapse of the $10 trillion US mortgage market in 2007 and 2008, based on the evidence so far. The recent crisis does bear comparison, however, in that it combines a measurable economic shock with a material financial one—an all-the-more important development for resource markets, given the past decade's "financialization". That process has served to materially increase the level of correlation between the general level of resource prices and financial variables (Chart 2), including key equity market gauges and the US dollar.

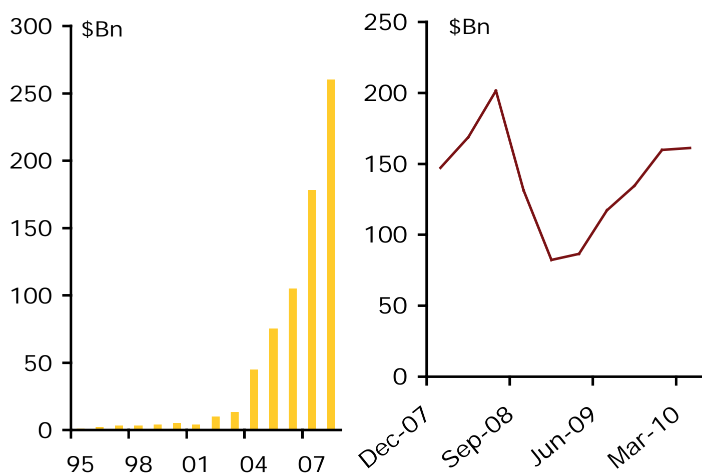
Chart 1—***Eurozone Slowdown May Be a Greater Negative for Metals Than Energy***



Widely cited research by Fund Manager Michael Masters, presented to a US Senate committee in 2008, showed that the total value of indexed investment exposure to commodities rose by a striking thirteen-fold in the half-decade preceding 2008 (Chart 3, left). That increase has been driven by a number of forces, including investors' pursuit of enhanced returns during a period of sub-par stock market performance, diversification considerations and a proliferation of new investment vehicles like indexed ETFs. That has reduced the cost, particularly for retail investors, of obtaining exposure to a broad commodity basket.

Index investment has several notable features affecting its general market implications. The first is that investors are typically motivated by the potential returns on the entire

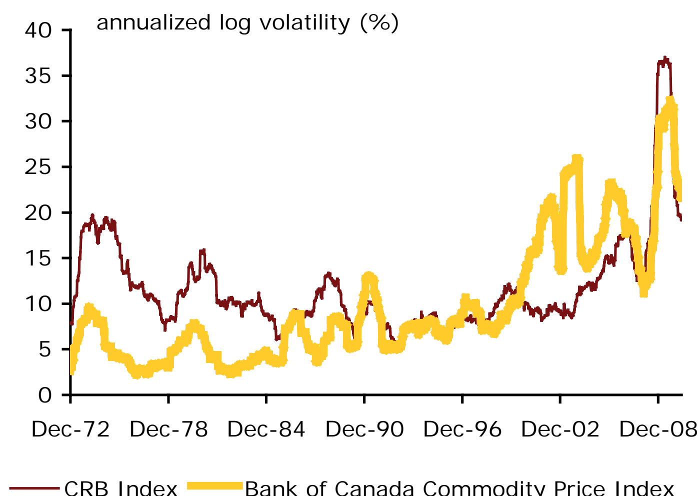
*Chart 3—**Commodity Index Investment Has Surged in Last Decade (L), Recent Developments (R)***



Source: M. Masters, Presentation to Committee on Homeland Security & Governmental Affiars, May 2008

Source: CIBC, Commodity Futures Trading Commission

*Chart 5. **Commodity Price Volatility Has Risen Markedly Since 2000***



"commodity class", rather than specific commodities. Moreover, until recently, index investors have been almost all long. Another apparent consequence of financialization is the much greater synchronization in price movements for individual commodities (Chart 4). Contributing to that is the fact that the passive investors who have helped to drive money flows in the last decade effectively hold positions in a broad range of major markets.

While there's always a danger in drawing strong conclusions from time correlations, it's noteworthy that the past decade's money inflows and growing view of commodities as an asset class has been associated with a strong rise in volatility (Chart 5). That trend was apparent, well before oil prices surged to historic highs in 2008.

*Chart 4. **Marching Increasingly to the Same Drummer***

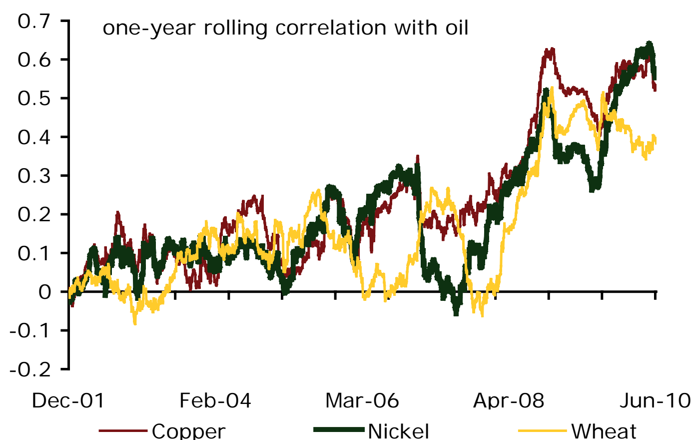
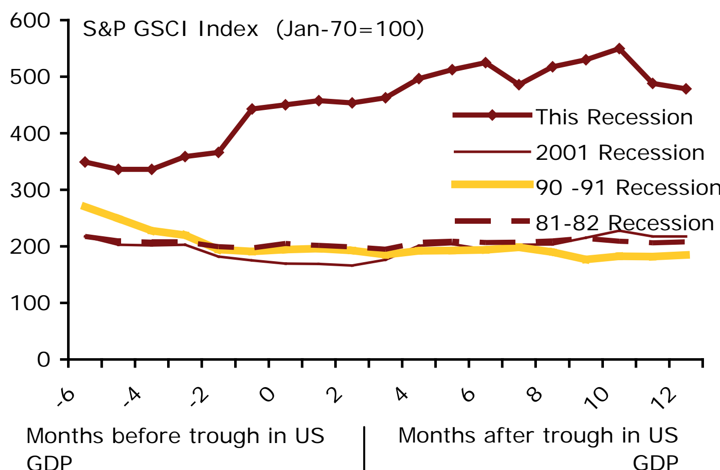


*Chart 6. **Resource Recovery Still Looks Strong Even with Recent Sell-Off***

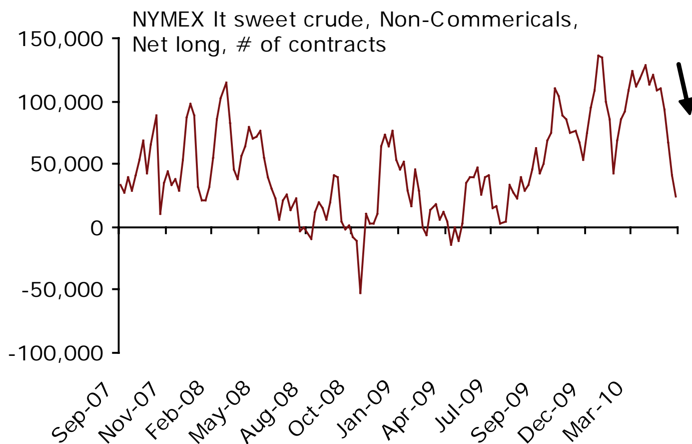


Recommendation Summary:

Buy Aug-11 Natural Gas (approx $5.41) — Time Horizon 12 months

Sell Jun-11 Nickel (approx $19,550) — Time Horizon 9-10 months

Chart 7. ***Speculators Pare Bets That Commodities Have Further to Climb***



Investors Aggressively Paring Long Positions Amidst Recovery Uncertainties

Our own investigation of the post-2008 period, drawing on published CFTC data—which differs somewhat from the Masters' data in coverage—shows that commodity index investment rebounded strongly in the early stages of the recovery (Chart 3, right), contributing to a vigorous rally in resource prices (Chart 6) despite the still somewhat uneven economic backdrop. Lately, the pendulum has swung the other way. Non-commericials or "speculators" have aggressively liquidated their sizeable long exposure to oil (Chart 7), copper and other key commodities, as financial and economic uncertainties have re-emerged.

Some observers have argued that speculative forces cannot lift spot prices without commensurate inventory-building, heightening pressure on supply. That ignores the potential for "in-ground" inventory accumulation by producers, who may hold back production if they expect prices to rise. Also obscuring the impact of speculative pressure, undocumented stock building means reported inventories may understate true levels.

Maintaining Bullish View on Natural Gas and Gold, Cutting Industrial Metals

What are some of the more specific implications of these and other developments for individual sectors? Risk is clearly back these days, after not such a long absence. Renewed safe-haven demand has helped gold set new highs despite the US dollar's stronger recent bid. Fiscal problems are unlikely to disappear entirely, fuelling ongoing demand for secure, alternative investments. We are consequently maintaining our bullish view on gold, at least for the next 9-12 months, with an upwardly revised $1300 target for the year's end (Table 1). The one clear consequence of the debt crisis is a deferred timeline for central bank restraint (see pages 2-4), which will lend support to the yellow metal.

Industrial metals prices have shown particular volatility recently. While prices have arguably now overshot to the downside in some areas, increased risk aversion and the prospect of data disappointments as fiscal austerity measures bite merit a more cautious view on performance in the next year or two. We have accordingly made downward revisions to our targets for copper and zinc, which we now see averaging $3.25/lb and $1.00 in 2010, and more modest ones to nickel and aluminum. China's authorities are unlikely to clamp down so hard as to kill the recovery. Copper demand there is likely to rise by 5%-10% this year—respectable, though only half last year's increase.

While oil prices could get some transitory lift from an expected active Atlantic hurricane season, fundamentals are likely to keep WTI prices from averaging much above $80/bbl this year and $85/bbl in 2011. OPEC has continued to lift production in recent months. Non-OPEC supply is projected to increase by 700,000 bbl/day this year, the fastest pace since 2004. As with other resources, demand could be hit if the expected global recovery does not progress as quickly as anticipated. Ample excess capacity means that development delays from a temporary US drilling moratorium are unlikely to have much impact until mid-decade, when markets are expected to be tighter. Moreover, the US accounts for only about a fifth of global deepwater production, so the fallout will depend on the extent to which other countries follow suit.

Henry Hub gas prices have defied selling pressures elsewhere, rising by as much as 20% from the spring's lows. We've pared our 2010 target modestly but continue to see prices averaging $6.00 mn Btu in 2011, about 10% more than the futures strip is currently pricing in. Prices should continue to draw support from curtailed rig activity due to the Gulf spill as well as, potentially the weather. Reviving industrial and power sectors account for 60% of US natural gas consumption and more normal summer temperatures could also support summertime demand. If fervor for tightening up on drilling spreads onshore, that could also lift shale gas costs.

Table 1. ***Spot Commodity Prices***

			Average				
		11-Jun	2007	2008	2009	2010 (f)	2011 (f)
Oil (WTI)	$/bbl	74	72	100	62	80	85
RBOB gasoline	$/gal	2.01	2.09	2.49	1.69	2.05	2.25
Heating Oil (NYH)	$/gal	2.00	2.03	2.86	1.65	2.10	2.20
Natural Gas (Henry)	$/Mn Btu	4.68	6.97	8.89	3.82	4.90	6.00
Gold	$/troy oz	1220	695	872	1088*	1300*	1150*
Copper	$/lb	2.93	3.24	3.16	2.35	3.25	3.15
Aluminum	$/lb	0.87	1.20	1.17	0.76	0.95	0.85
Nickel	$/lb	8.84	16.86	9.57	6.69	9.50	8.00
Zinc	$/lb	0.78	1.48	0.85	0.76	1.00	0.95

** end of period*

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