Commodities in 2013

The boom: where are we in the super cycle ?

China may soon enter a transition phase. When an economy's GDP per capita reaches 10,000, it generally begins to shift from industrialisation to a transition phase. The level of GDP per capita in the Chinese economy today matches that of Japan in the 70s, at which point it was still undergoing industrialisation. Japan thereafter entered a transition phase of about 15 years before moving into services-oriented growth. If China continues to follow its current trajectory, it will reach the 10,000 level in 5 years. Does this imply an end to the commodities boom? Not when we look at the volumes consumed.

When Korea entered its transition phase, its copper consumption per capita was approximately 8kg, which rose to 20kg before falling off slightly. Japan's consumption was at 11kg and rose to 13kg before stabilising. If we take Japan and Korea's economic maturing process as a guide to China's, whose current copper consumption lies at approximately 4kg, it can be concluded that China is likely to double its consumption. Therefore, there is a great deal of volume left to consume. Even though the significance of its industry in terms of GDP may be on its way to stabilisation, it will nonetheless continue to consume commodities as its economy grows.

On the supply side, production may struggle to match demand, implying that concerns about excess supply are of temporary matter. Simulating the future production and consumption of copper based on the following assumptions;

1. China's economic maturing is similar to that of Japan
2. The only source of consumption growth is China
3. Copper production grows at the same rate than it has since 1995 (3.5% year on year)

It can be deduced that consumption is there, and although production is catching up, it is not doing so fast enough to meet demand. Hence, from a fundamental perspective, prices should remain high. An apparent obstacle however is a reduction in the intensity of consumption.

The sovereign debt crisis and its repercussions on global growth has tempered China's industrialisation. Looking at an industrialisation index, the commodity boom caused an increase in speed of industrialisation, which has dropped off since the start of the subprime crisis in 2008. Chinese industrialisation was further dampened by the eurozone crisis which might explain the drop in prices. Although the demand and supply equilibrium will still be in favour of demand, due to the reduction in consumption intensity, the increase in prices may be less impressive than it was at beginning of the commodity boom.

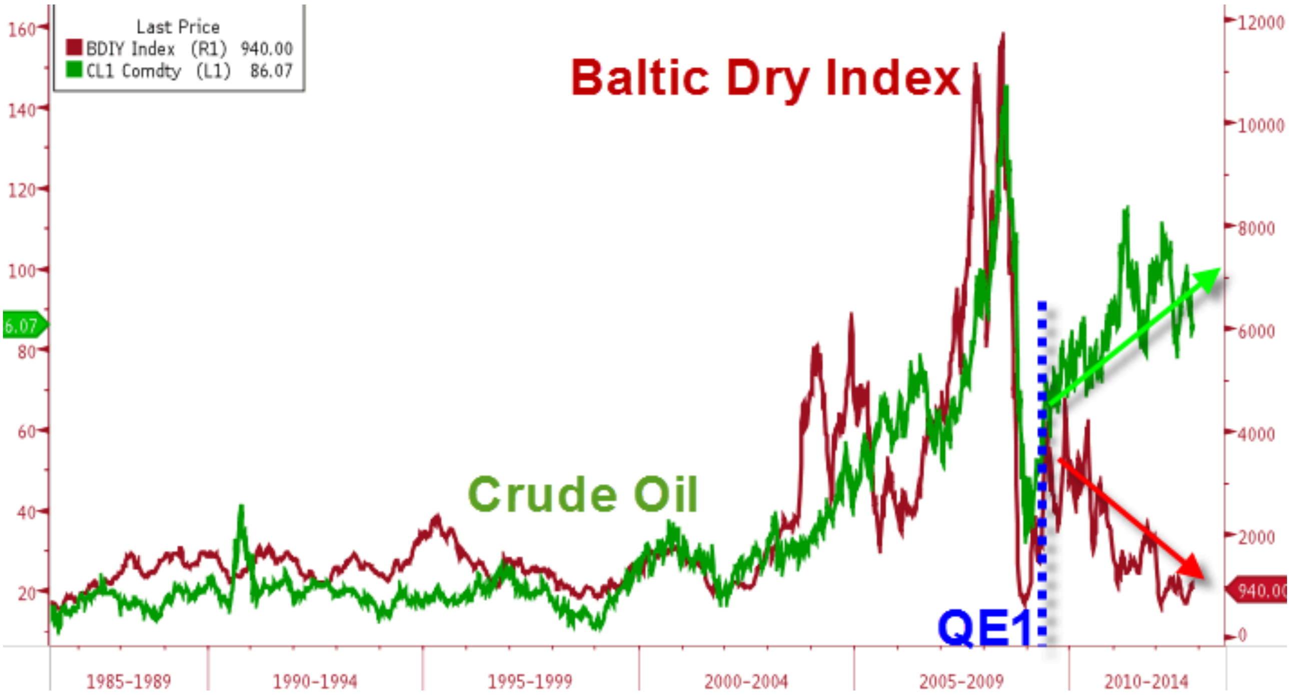
Thus, the boom is not necessarily over, but we may be close to a peak. The cruising speed may have been achieved, assuming that the main source of demand is coming from China. There is potential for India, Latin America and/or Africa to sweep in and pick up some demand. Can China's success story be repeated by other emerging economies? If so, then the commodities boom may not have reached its peak, and the downtrend in the asset class may be postponed for a few years.

The cycle: About China, QE3, and the sovereign crisis

How will the QE3 impact commodities? Preceding quantitative easing programmes had a varying impact on commodities. During QE1, the prices of industrial metals, gold and oil went up unanimously. They moderated in between QE1 and QE2, and only rose during part of QE2.

The reason for this disparity can be deduced from the macroeconomic figures. During the entire recovery of the US and American industry (over the period of QE1), commodities rose across the board. QE2 saw a weaker Chinese industry and a declining American industry, during which commodity prices saw weakness, and resumed their decline as the US Purchasing Manager's Index (PMI) fell off more flagrantly. Therefore quantitative easing is supportive for commodity prices, but its impact is reduced if it is not accompanied by an industrial rebound.

Concerning QE3, its impact on commodity prices may be limited if the eurozone crisis intensifies, as industrial commodities are sensitive to risk aversion. A renewal of the crisis could put downward pressure on cyclical commodities. Solely the yellow metal could continue to benefit from QE3, with a low interest rate environment, combined with high liquidity, risk aversion, and dollar weakness serving as a fertile ground for gold.



The current price of oil reflects its fair value, suggesting that demand and supply are more or less in equilibrium. The price of oil oscillated around $110, demonstrating substantial volatility by falling as low as $90 and rising as high as $130 this year. The primary reason behind the amplitude in variations is the tensions in the Middle East. Even though Iran only produces 3% of the global oil supply, if it were to go to war with Israel, 15% of the demand could be affected (without even taking into account disruptions in Saudi supply).

Saudi Arabia has been a strong player in the fight against an increase in the price of oil. It has stated its objective to keep oil price at about $100 a barrel. This is one third higher than its previous public target, demonstrating that Riyadh needs higher oil revenues to sustain a big rise in public spending. Nonetheless, there is a clear wish to stabilise the oil price and keep it at a level around $100 a barrel.

Outlook for 2013

In the first half of 2013, the deceleration of global growth is likely to weigh on industrial commodities whilst the vast injections of liquidity are likely to be supportive. The big puzzle is the trajectory of the eurozone crisis, as an escalation would bring back risk aversion. Industrial metals are likely to suffer from this environment, whilst gold is expected to benefit. The dominant risk factors driving the yellow metal are monetary policy (low interest rates and vast liquidity) and systemic risk (enhancing the allure of gold as a safe haven investment). The factor that could limit the rally of gold is the evolution of the dollar. Whilst risk aversion may support gold, it may also support the dollar as a safe haven currency. The price of oil is likely to continue to oscillate around current levels, unless tensions in the Middle East escalate.

The second half of 2013 should see an acceleration of the business cycle in the US and China. Europe may see a slight acceleration, but will lag behind. If the euro crisis sees progress, and interest rates begin to stabilise, this should be positive for industrial commodities. The reallocation of funds to risky assets as a result of increased confidence in the market is likely to have a neutral impact on gold, as it loses its allure as a safe haven asset but benefits from a potentially weaker dollar (as a result of investors switching to riskier currencies).

Thus, although short-term demand indicators suggest a possible rebound in industrial commodity prices by year-end, if a recovery does materialise, it is likely to be short lived. A better entry point could be in the first half of next year, where we may see a turning point in the market.