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The commodity cycle has turned

by Michael Heise

(English version)

The development of commodity prices, especially oil, is a major determinant of global growth and inflation. Since the spike in oil prices in 2012, and in non-energy commodities in 2011, the trend has been downward again: oil is 63 % below its peak and base metals by 45%, on average. This decline has been one of the most important drivers of low inflation in recent years. Commodity net importers, which account for the bulk of global GDP, have benefited since lower import prices have boosted private consumption and pushed down production costs. Future commodity price trends are not only important for global growth and inflation – they have also become a major investment theme: hundreds of billions of dollars have flowed into oil and gas, industrial metals, mining and agricultural commodities in recent years. Those investors who entered the markets during the boom five or six years ago are nursing heavy losses.

So the big question is whether the stabilization of oil and other commodity prices since early 2016 marks the turn of a commodity cycle, or whether it is just a temporary bounce-back after a steep fall.

Market dynamics have changed fundamentally in recent years. While in the past, the oil price was determined politically by OPEC, today non-OPEC suppliers like the US, Canada or Russia account for a major share of global supply. What is more, the evolution of non-conventional extraction technology, especially in the US, has allowed supply to react more quickly to price changes. The demand side is also seeing fundamental change. Attempts to reduce fossil fuel use – from renewable energy to e-mobility and energy efficiency – have weakened the correlation between oil consumption and GDP.

Given that oil demand is expected to grow only modestly over the long term, a recovery in oil prices to previous heights of over \$100 per barrel looks unlikely. But the oil market is also highly cyclical. When demand is high and oil prices rise, oil producers step up investments and exploration efforts to increase supply. Extra supply comes onto the markets with significant time lags, which can range from a couple of months in shale oil to many years in deep sea projects. Conversely, when prices fall, producers cut investments, which translates into lower future supply capacity. Eventually, the reduction in supply capacity stabilizes prices, or even triggers renewed price hikes when demand recovers.

Capacity reduction has been impressive in recent years. Major suppliers have halved their investment budgets. US crude oil production reacted most quickly, declining by 1.1 million barrels per day since the peak in 2015. Elsewhere, the effects will be felt only in years to come. What is certain is that the reactions of oil producers to the price decline of recent years will eventually rebalance the oil market, which has been in a state of over-supply with rising stocks of oil. Once inventories diminish, the market will receive signals that push prices higher again, above the \$40-50 levels of recent months.

This is where the greater flexibility on the supply side comes in. Price increases will trigger higher supply more quickly than they have done in the past. Therefore, prices will not overshoot as badly and the whole cycle will be less pronounced. Of course, supply shortages can always arise from political disruptions in important producer regions. But this is not our base case scenario. For now, conventional suppliers in the Middle East and Russia have strong incentives to keep their production levels high.

So in my view, oil prices will remain on a moderate upward trend. The flexibility of supply has increased, and the market dynamics have changed, but the basic consideration of a supply-driven cycle still applies. Nevertheless, oil price forecasts come with large margins of error. Geopolitical changes or internal policy conflicts like in Nigeria, Libya or Venezuela can impact oil prices in hardly foreseeable ways.

The prices of oil have in the past 15-20 years shown a fairly high correlation with other commodities such as base metals. Common driving forces, such as the enormous increase in manufacturing and construction activity in China over the past two decades, have pushed up demand for energy and non-energy commodities alike. Also, the production of industrial metals needs a lot of energy and thus their prices rise when energy costs do.

Similar to the oil market, non-energy commodities are also subject to supply cycles. The boom in the markets for base metals until 2011 triggered huge investments in mining and metal production. These came on stream only when demand – not least from China – was already slowing down. Prices then declined dramatically. The World Bank index for base metals is still about 45% below its peak in 2011, although markets have recovered in recent months. Lower prices have in turn triggered major cuts in production capacity. The big suppliers have put many of their large-scale investment projects on ice. Global mining investment has fallen by more than half since its peak in 2012, reports the World Bank. This is a fairly clear indication that prices will continue to recover as long as the world economy continues to grow. In this scenario commodities are a promising investment class.

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