Investment insight

The dawn of a new super cycle

Executive summary

- We are now entering a structural bull market for commodities thanks to the pandemic.
- For the last decade, commodities have been a difficult investment.
- Shares have out-performed commodities.
- Structural under-investment over a long period of time has limited physical supply of some commodities.
- Governments now have the social licence to spend and this spending will translate into commodity-intensive economic growth.
- Central banks want to see a degree of inflation which is positive for assets where supply is inelastic.
- Over the last year NZ Funds clients' have had exposure to a wide variety of commodities including copper, iron ore, coffee, gold and carbon credits.

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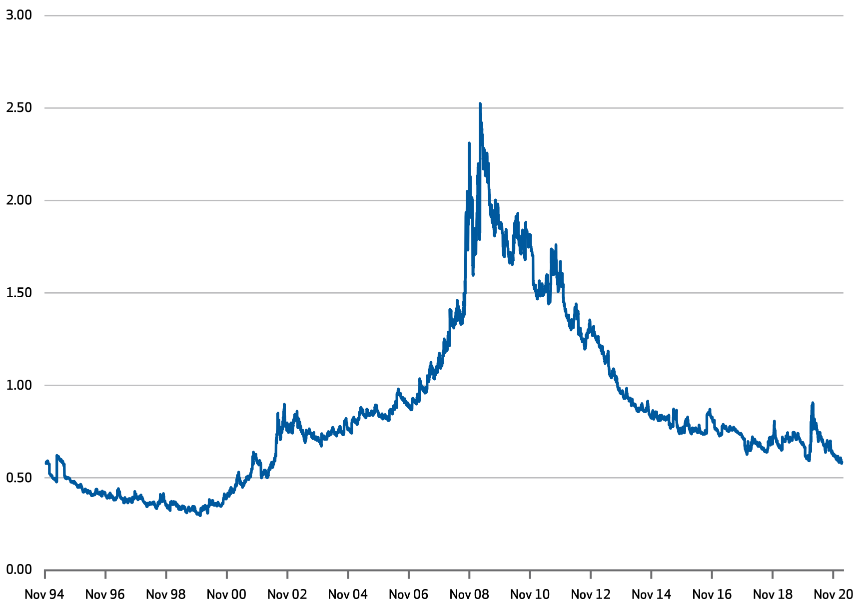
Ratio of Bloomberg commodity index to S&P 500



Source: Bloomberg, NZ Funds calculations.

The early 2000's was a golden period for the commodity industry as rapid growth in China and Latin America meant that demand continually outstripped the available supply.

However, for the past decade commodities as an asset class have been a difficult investment. From January 2010 to December 2020 the S&P Goldman Sachs Commodity Index declined around 35% while the Bloomberg Commodity Index fell by 52%. At the same time the United States share market increased 266%.

The COVID-19 pandemic may have brought this long period of poor returns in commodities to an end. A wide range of commodities should benefit from the demand pickup as the global economy reopens. We believe this is the beginning of a long-term structural bull market for commodities thanks to the following three dynamics.

Structural under-investment

Decades of poor returns have been a disincentive to reinvest capital into new production. This is particularly true in energy where Environmental, Social and Governance (ESG) issues have further reduced the available capital.

This general trend was accelerated during 2020 in response to COVID-19 as any reinvestment/growth activity was halted. This has left many commodities at best with balanced supply and demand dynamics. Unlike technology business which can scale up almost instantaneously, bringing on new commodity supply can take years to respond to excess demand.

This suggests there will be a significant shortage of production capacity to meet the stimulus-fuelled recovery.

Government policies

In the wake of the pandemic, governments around the world have the social licence to spend. Much of the spending is aimed at addressing social needs. This will likely create cyclically stronger, more commodity-intensive economic growth.

Policies aimed at social need and redistribution benefit lower and middle-income households that are larger in number and in turn consume more goods. In other words, stimulus aimed at social need is likely to create more growth than stimulus aimed at fixing a financial crisis like we saw in 2009.

Furthermore, environmental policies promoting a less carbon-intensive economy are now (back) on the table. These will reduce the supply of some commodities and increase the demand for others. In both cases, this is likely to push up prices.

The last point around government policy is that this is happening in unison around the globe. COVID-19 has had the unusual impact of synchronising the global business cycle thanks to the coordinated stimulus and monetary policy actions of governments.

Reflation/Inflation

Over the last ten years inflation has remained stubbornly below the 2% targeted by policy-makers. As a response, central banks around the world have altered their approach to inflation management.

Rather than looking to react to forecast inflation, central banks will now wait for actual inflation above 2% to occur. We will therefore see higher inflation outcomes in order to achieve higher rates of growth and full employment.

This creates demand-pull inflation which will be particularly beneficial for the commodity sector given the inability of supply to respond quickly. During times of inflation you want to own assets that have a scarcity factor and it is hard to bring on new supply – commodities perfectly meet these criteria.

ESG and energy commodity futures

By not investing in fossil fuel businesses we are restricting the funding available to these businesses. This should create a positive self-reinforcing cycle. In time limited funding will reduce the supply and increase the price of these fuels. In turn, this will encourage alternative fuels as an economically viable option. This presents two opportunities for clients. In the short term, clients should be able to profit from owning the raw commodity as it increases in price as this is a logical consequence of their choosing not to fund future exploration. But more importantly, over the long term we will look to ensure that clients have exposure to these new forms of energy production as they begin to fuel the global economy.

While the focus is often on energy commodities, the asset class comprises a wide range of sectors including carbon credits and basic materials such as copper and iron ore, processed materials such as aluminium, precious metals, and agricultural commodities such as cotton and coffee. Over the last year clients' portfolios have had exposure to each of these commodities at different points in time.

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Mark is responsible for management of the Income portion of clients' portfolios at NZ Funds. This encompasses both New Zealand and Global fixed income securities.

After beginning his career with NZ Funds, Mark spent five years during the early 2000s in London managing a portfolio for a European credit hedge fund.

Since re-joining NZ Funds in 2007, he has built a strong track record of performance for clients across both local and global income.

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