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Regulation will drive commodity prices up regardless of global outlook

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Copper smelting © Getty Images

Over the past year, virtually every commodity across the composite index — metals, minerals, energy and foodstuffs — has suffered a notable decline in price. The one-year return on gold is down roughly 8 per cent, copper prices have declined more than 13 per cent and oil has fallen nearly 50 per cent.

Every year since 2011, the worst-performing asset class has been commodities — under-performing stocks, bonds, real estate and even cash. And they are down once again in 2015. Moreover, mining and oil companies have sustained enormous losses and writedowns — the mining sector alone, led by the poor performance of gold, copper and iron ore, posted impairments of close to $100bn for 2014. Recent performance is a far cry from the 150 per cent surge in 2009 in the aftermath of the financial crisis.

Now, however, commodity prices are poised for an appreciable rise due to changing regulation rather than traditional supply and demand dynamics.

In the run up to the recent sell-off, the bullish case for commodities had largely revolved around three structural factors.

- First, it was expected that unprecedented global economic growth — led by China and the major emerging market economies, where 90 per cent of the world's population live – and increases in wealth would add 2bn people to the middle class by 2030. Rising wealth and steadily improving living standards would support demand for better food, access to clean water, cars, mobile phones, white goods and superior infrastructure, and this would drive commodity prices higher. Even in the wake of the 2008 financial crisis, some forecasters were anticipating a solid global economic recovery that would see a rebound in demand for all manner of commodities.
- Next, burgeoning population growth was also expected to support rising commodity prices. The world population has increased from approximately 3bn in the 1960s to close to 8bn, and is likely to plateau in 2100, stabilising at close to 11bn. Demographers have stressed the uniqueness of the current shifts, but whatever the trajectory, many economists point to the current rapid global population growth (flow) as well as the sheer numbers of people (stock) on the planet today as catalysts for greater demand-led commodity price increases.
- Finally, urbanisation — where policymakers move large proportions of their populations from rural areas urban centres — has been a hallmark of the development agenda. The idea is to improve access to better quality public goods: education, healthcare and broader infrastructure (such as indoor plumbing, electricity and telecommunications). Such mammoth undertakings require significant commodity inputs. For example, China has committed to have about 221 cities (up from some 100 today) with populations of 1m people each, and eight with 10m each by 2020. In comparison, the US has nine cities with 1m people each, and Europe has 18. More generally, the 2014 UN World Urbanization Prospects sees 41 cities globally with populations of 10m or more by 2030.

The fact that the supplies of commodities are finite, scarce and depleting supports this story. For example, leading oil producers stress that the majority of oil discoveries have already been made, adding more pressure to the supply picture of traditional energy, such as

fossil fuels. Even with energy substitutes (eg shale), demand is expected to outstrip supply over the longer term.

In reality, while these factors have indeed been seen, as the global growth outlook has deteriorated considerably over the last few years commodity prices have suffered, and market consensus sees this continuing.

However, shifts in the regulatory landscape will almost certainly provide support for the commodity markets, even if it is for the wrong reasons, and are likely to be enough to counteract the negative growth outlook.

Already, new and expected rules and reforms, such as those requiring more onerous capital requirements, have forced large liquidity providers (such as banks) out of the markets. For example, according to Institutional Investor, JPMorgan, Morgan Stanley, UBS, and Deutsche Bank have sold off or shut down most of their commodities units in the last two years. The withdrawal by bigger financial institutions is leaving market-making to smaller and increasingly unsophisticated market participants. While greater regulatory oversight in commodity markets is not entirely unjustified as watchdogs seek to close loopholes in the derivatives trading of oil and futures, there are broader, negative effects that can come with a hefty price.

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As the banks retreat, commodity markets suffer reduced liquidity and widening bid-offer spreads – that is, the difference between the sale and purchase prices — which makes for higher and more volatile prices. Moreover, relatively illiquid price environments and fewer counterparties can squeeze speculators out of the markets. Yet, speculators do play an important role: they add liquidity and help maintain the efficient and orderly functioning of the financial markets, and keep the marketplace in balance by signalling when shortages or surpluses are likely to occur.

It is true that for every clarion call on higher commodity prices — such as Malthus in 1798, Hubbert's Peak Oil Theory in 1965, and the Club of Rome's 1972 "Limits to Growth" report — technological advances and the advent of substitutes (such as shale) have bailed society out and dampened price pressures by boosting growth and productivity.

For now, the chorus of anemic global growth forecasts — for example, the IMF's global growth downgrade and the International Energy Agency report earlier this week, and the World Bank's gloomy June growth publication — remain behind the commodity sell-off story.

However, Fundamental Global Investors reminds us that since the second world war, there has never been a consecutive five-year decline in commodity prices. Furthermore, tactical, short-term factors that continue to disrupt supply such as loose monetary policy (quantitative easing) and geopolitical instability in major resource supply regions, such as the Middle East, place a floor and support higher prices. More generally, without any significant detour in the regulatory path in sight, those who can stomach the volatility should stay long, and maintain an exposure to commodities.

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