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Commodities hitch a ride on global growth

Highly favourable tailwinds give us confidence that commodity prices will push significantly higher in 2018. Stronger economic growth in developed and developing markets, a weak US dollar and further fiscal stimulus are just some of the factors that will increase demand. At the same time, supply will remain constrained as commodity producers favour returning cash to shareholders over expansion.

Prospects for base metals and oil-based energy look particularly positive, and we expect precious metals to be buoyed by higher inflation. The outlook for agricultural commodities is a tougher call, but overall the convergence of constructive factors should support price increases across the commodity market in the next 12 months.

As we enter 2018, it is possible to point to several noteworthy macro factors that should energise commodity prices. Firstly, and most significantly, economic growth is beating the forecasters' consensus in both emerging and developed markets for the first time since the global financial crisis. This is lifting capital expenditure and factory building, boosting demand for commodities.

Secondly, the US dollar weakened materially in 2017, increasing the appetite for commodities outside the US as prices measured in other currencies fell. In 2018, we expect the dollar to be steady, even a bit weaker. This will underpin demand, especially in emerging markets.

Thirdly, we anticipate more fiscal stimulus across developed markets, echoing tax cuts in the US. Commodities should gain from the shift away from monetary stimulus towards fiscal policy. We expect this to stoke significantly higher inflation of 3-5% year-on-year across developed market economies.

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Supply-side constraints

At the same time, inventories continue to tighten as producers appear to have little appetite to increase borrowing to boost production. During the six-year bear market there was a change of the guard on the boards of many commodity producers. In the past, at this stage of the cycle, commodity companies would have targeted expansion. Now they have a new religion. The new guard are focused on cutting costs and returning money to shareholders in the form of share buybacks and dividends. It is all about deleveraging balance sheets and delivering shareholder value, not increasing production.

These supply-side constraints are music to commodity investors' ears. The supply side failure to respond robustly to significant demand growth means that when commodity prices take off they could really take off.

That did not happen in 2017. The benchmark Bloomberg Commodities (BCOM) Index has disappointed over the course of the year. However, the flat index return hid areas of strength. Base metals including copper, aluminium and zinc have climbed around 20% at the time of writing, gold is up around 9% and parts of the oil-based energy market have also produced positive returns.²

The index was steady overall because of a decline in soft and agricultural commodity prices, which offset the metals and energy gains.

An active approach to investing also looks best suited to exploit the opportunities in the year ahead. So how have we positioned ourselves to take advantage of the positive outlook?

Varying outlooks

We favour base metals as synchronised global economic growth increases demand at a time of tightening supply. Focusing on aluminium, the extent of China's cuts to production remains unclear. However, we know that at the beginning of 2017 there was spare capacity for producing aluminium around the world. Aluminium's price rise in 2017 has a lot to do with China taking production per year off the market.

Turning to oil, the market has entered a period of political uncertainty. The reforms launched by Saudi Arabia's king in waiting, Crown Prince Mohammed Bin Salman, have made the Middle East less stable than it has been for a long time, which could impact oil production and increase price volatility.

Over the medium term, we are positive on precious metals. Gold is expected to be a beneficiary of higher inflation and is increasingly being bought as a hedge against an event that could cause a stock market correction.

¹ Financial Times: Aluminium emerges as top performing industrial metal in 2017, 24 April 2017.

² Figures as at 21 November; index returns.

Predicting the outlook for agricultural commodities is harder, as they are so dependent on the weather. But demand has been so high that despite wonderful weather for growing crops over the last three years, inventories have not been rebuilt. China's demand for agricultural commodities, especially oilseed, has continued to be surprisingly strong. Just one significant harvest-damaging weather event could push agricultural prices appreciably higher.

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Expecting a positive 2018

Across the commodity markets, favourable demand/supply dynamics are supporting prices, making us expect 2018 will be a positive year. However, there are also areas of uncertainty and potential volatility. Even against a benign backdrop investors will need to pick and choose commodities with care. Each individual raw material has its own fundamental and technical factors. In this context, active allocation decisions will continue to be key.

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