



June 2021

Supercycle or not?

- Why commodity markets have done so exceptionally well

"Commodities tend to zig when equities zag."

Jim Rogers

Setting the scene

The last 12 months have been truly remarkable for (most) commodity investors. Industrial metals, energy – whether fossil fuels or green energy – most agricultural commodities and lumber have all enjoyed extraordinary price gains. Take for example a look at the Bloomberg Industrial Metals Subindex below and pay particular attention to early 2020 (Exhibit 1).



Exhibit 1: Bloomberg Industrial Metals Subindex

Source: The Daily Shot

Ravaged by COVID-19, the global economy started to close down in early March last year. Thousands of people died every day, and the global economy underwent the worst few months any living soul had ever experienced before. How could that possibly be the recipe for the mother of all bull markets in commodities? That is what this month's Absolute Return Letter is about but, before going there, allow me to drop a brief note on ARP+.

As I have said before, the laws of this land don't allow me to be explicit on investment recommendations in a free publication like the Absolute Return Letter. If I make any recommendations, the letter will be classified as investment research, and that can only be made available to paying clients of the firm. That is precisely why ARP+ was established,

and the extraordinary bull market in commodities is why we have decided to make it the topic of the next ARP+ webinar. In other words, if you are an ARP+ subscriber, I urge you to tune in on the 3rd June at 3pm BST which you can do [here](#), as I am going to share my current investment recommendations to do with commodities. If you are not a subscriber, you can subscribe [here](#).

What is a commodity supercycle?

Commodity supercycle is the term used to describe a major move in commodity prices which is longer-term in nature. Typically, a commodity supercycle unfolds over several decades. Commodity supercycles have existed since the early days of the Industrial Revolution and probably for even longer, although I don't have any data going further back than 1795.

Work conducted by Daniel Sullivan, Head of Global Natural Resources at Janus Henderson, suggests that we have been through six such supercycles since the early days of the Industrial Revolution with the most recent peak occurring in June 2008, and that a new supercycle may be forming as we speak (Exhibit 2). As you can see, only four of the six supercycles have led to a new all-time high in inflation (the red dots in Exhibit 1). In other words, a supercycle peak is not necessarily equivalent to a peak in inflation, although the two often coincide. According to Daniel Sullivan, inflation won't peak again until 2045 or thereabout.

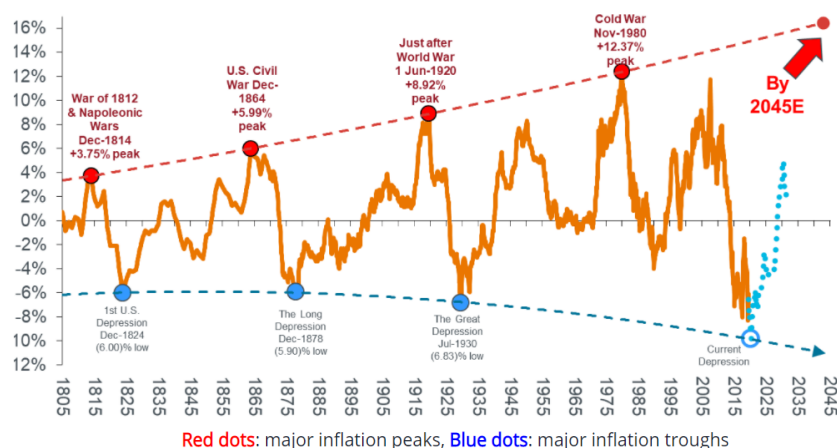


Exhibit 2: US commodity price index since 1795

Source: [Janus Henderson](#)

Another common denominator of recent commodity supercycles (and my source on this is Goldman Sachs Global Investment Research) is the large redistribution of income and wealth that takes place in supercycles. If real metal prices are a proxy for income and capex' share of global GDP a proxy for wealth, as you can see in Exhibit 3, the last two commodity supercycles – the one that peaked in 1980 and the one that peaked in 2008 respectively – have both been characterised by a significant redistribution of income and wealth.

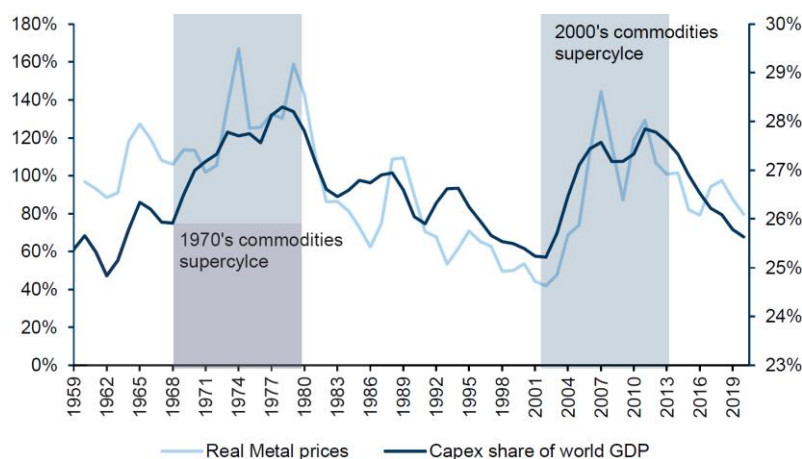


Exhibit 3: Real metal prices (LH) & Capex share of world GDP since 1959

Source: [Goldman Sachs Global Investment Research](#)

Even if you don't buy the argument that we are now in the early stages of a new commodity supercycle (and I am not 100% sure myself for reasons I will come back to in a moment), it is hard to disagree with the bulls' argument that commodities are cheap at present. Take a look at Exhibits 4 and 5 below. As you can see, in absolute terms, many commodities are cheaper today than they were 120 years ago when measured in real prices (Exhibit 4). Relative to equities, commodities are the cheapest they have been for over a century (Exhibit 5).

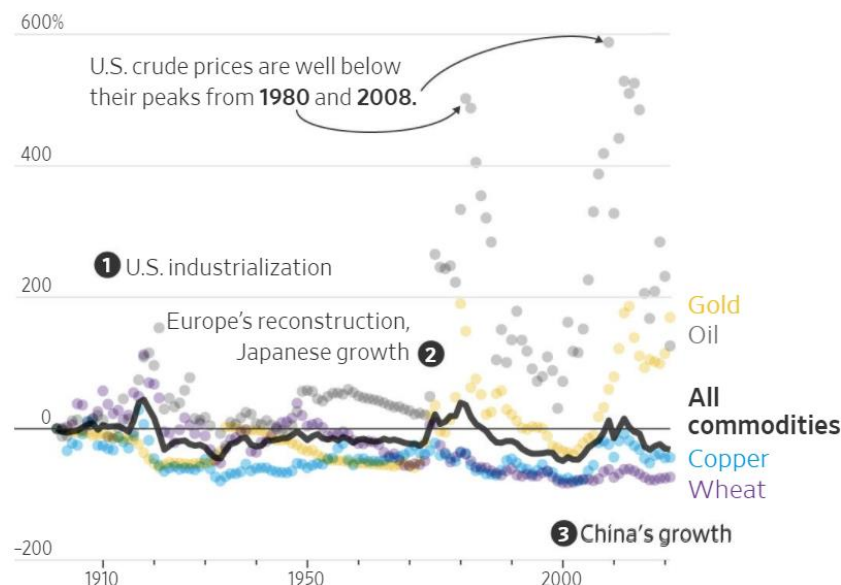


Exhibit 4: Real metal prices (LH) & Capex share of world GDP since 1959

Source: [Wall Street Journal](#)

Supercycle or not, given all the ongoing structural changes that many commodities stand to benefit from, I don't see why the next 5-10 years (at least) couldn't spell more good news for commodity investors. One such structural change is urbanisation, and that is a trend not only unfolding in emerging markets – it is happening *everywhere*. Another noteworthy trend is rising living standards in almost all emerging markets. With rising living standards always follows more protein (meat) consumption, which affects many commodities – mostly positively. And then, of course, there is the ongoing energy transition from fossil fuels to green energy forms – probably the most powerful trend of them all.

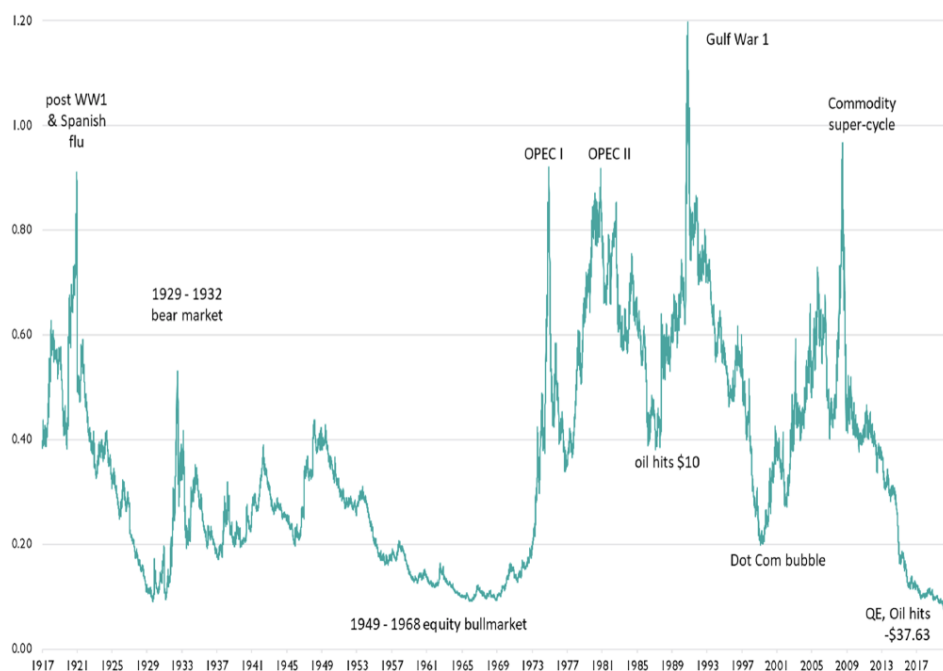


Exhibit 5: GSCI commodities index relative to DJIA

Source: [MacroStrategy Partnership LLP](#)

Having said that, the nature of the energy transition is also the reason I am not convinced that what is unfolding now is a proper supercycle. In *all* prior supercycles, commodity prices have appreciated *in tandem*, and fossil fuel prices may not participate in this feast. Not everybody agrees with me on this, but I am of the opinion that fossil fuels will be completely phased out in my lifetime (assuming I survive at least another 25 years). Coal will be the first to go and oil the last, but the final destination for them both is inevitable.

What I find hard to assess is the impact the fossil fuel implosion will have, not only on the economy but also geopolitically. At what point will OECD countries pull the plug on fossil fuels? When will OPEC's powers begin to wane (if that hasn't started already), and when will OPEC cease to exist? Which countries will replace OPEC in a new economic order controlled by copper and lithium? Is copper actually more important than lithium in the energy transition, even if most of the talk is about lithium? Given Chile's dominant role when it comes to both copper and lithium mining, is Chile the new Saudi Arabia?

All these questions plus a few more will be addressed in the July Absolute Return Letter. For now, suffice to say that, at the end of the day, it doesn't really matter if it will go down in history as a supercycle or not. What is important is that the opportunity set is big enough to be taken advantage of, and I believe it is.

The inflation outlook

Inflation has, not surprisingly, gained momentum in almost all previous commodity supercycles and is doing so again, whether this is a proper supercycle or not (Exhibit 6). As you can see, US consumer price inflation is now back to the levels last seen immediately before the onset of the Global Financial Crisis.



Exhibit 6: GSCI commodities index relative to DJIA

Source: [Trading Economics](#)

It is very tempting to turn 'bullish' on inflation – particularly in the US. Most commodities are on the run, and President Biden is working overtime to get a spending programme totalling a whopping \$6Tn (~30% of US GDP) through Congress (see details [here](#)) with less than half of it going to be financed by higher (corporate) taxes.

Meanwhile, many big US corporates are under growing pressure from the institutional investment community to introduce minimum wages (driven by ESG), and the labour market, both in the US and elsewhere, continues to be unsettled after more than a year of Covid-19 with demand for labour exceeding labour supplies in a growing number of industries. All of these factors translate into higher inflation.

On top of it all, excess savings are booming *everywhere*. Excess savings are defined as savings in excess of real GDP growth. In practical terms, excess savings are savings in excess of the savings you need to settle your bills every month. It is no surprise that, over the past 14 months, consumers have struggled to maintain their normal spending patterns. When that happens, excess savings rise (Excess 7). Rising excess savings lead to more buying power amongst consumers, i.e. the war chest is well loaded for a full re-opening of the global economy. Furthermore, a spike in spending will almost certainly affect inflation – data from the US suggests that there is a pretty powerful link between excess savings and consumer price inflation, which is yet another reason to be 'bullish' on inflation.

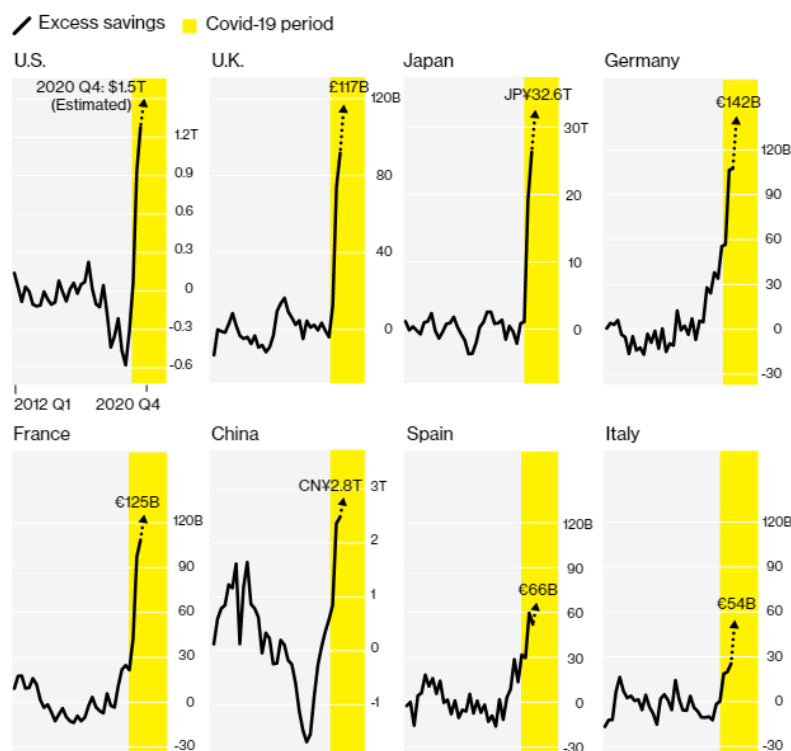


Exhibit 7: CPI vs. Deposit growth in excess of real GDP growth (%)

Note: US data

Source: MacroStrategy Partnership LLP

Having said that, my inflation expectations are very much a function of the time frame in front of me. Will inflation accelerate further in 2021? Almost certainly. Will it also be a problem in 2022? The answer is “no”, if you listen to Fed Chairman Jerome Powell, who seems convinced that the current spike in inflation is transitory, but I think the jury is still out on that one.

Should inflation continue to rear its ugly head next year – and the probability of that happening is rising in my book – scenario 3 in Exhibit 11 of the May Absolute Return Letter (which you can find [here](#)) will suddenly turn into the most likely scenario. Let me repeat what scenario 3 was all about:

“At first, policy makers consider the coming rise in inflation a one-off change in price levels and only belatedly realise that it is more serious than that. Afraid of ending up in scenario 2 [late 1970s all over again], they will therefore act quite firmly, pushing the economy in to another recession.”

In other words, unless Jerome Powell is spot on in his analysis, the probability of another recession is rising uncomfortably fast – not in 2021 but in 2022/23 when (if) central bankers realise that the spell of inflation in 2021 was not as transitory as they first thought.

Going back to Exhibit 2, as I mentioned earlier, a peak in inflation tends to coincide with a peak in commodity prices. It has happened in four of the six previous commodity supercycles. If a combination of decarbonisation, higher living standards (more so in EM than in DM countries) and urbanisation are going to drive commodity prices higher in the years to come, and wages continue to rise relatively fast, it doesn’t seem unreasonable to me to expect higher inflation as well – at least for the next year or two. The consumer war chest, also known as high excess savings, will, in that context, only add to the problem.

Having said all of that, for more than ten years, I have been of the opinion that, over the next few decades, underlying structural forces will prevent inflation from becoming a serious problem. Although I am not going to change that view today, the many issues just referred to that could drive inflation higher in the short-term do concern me. Therefore, I am going to hedge my bets today by saying that a commodity supercycle (ex. fossil fuels) will probably result in higher inflation than would otherwise be the case in a structurally disinflationary environment. How much higher is too early to say, though.

Going back to Exhibit 2 for one more time, you may recall that Daniel Sullivan doesn't expect inflation to peak until 2045. In other words, assuming you subscribe to his conclusions, even if the combination of rising commodity prices, massive government spending, unsettled labour markets and high excess savings are likely to drive inflation *somewhat* higher in the short-term, there are probably other things to worry more about if you look further out than 2022.

In that context, I should add that there is only one way out for a global economy drowning in debt, and that is for much of that debt to be destroyed. Now, debt destruction can only happen in two ways – through default or through inflation. *There is no other way to destroy debt.* As we learnt in 2008, debt destruction through default is rather painful, so you shouldn't be surprised if central bankers all over the world choose to stay (a little bit) behind the curve in the years to come. They would probably like to see *some* inflation again and, therefore, interest rates may not be raised as much as the latest news on inflation would otherwise imply. The good news is that such an approach will almost certainly be less painful than the damage widespread default would cause.

How to hedge inflation risk

Let's assume inflation is going to become a noteworthy problem – at least over the next 1-2 years. Let's also assume that you have a desire to hedge that risk away. What do you do then? As I have frequently pointed out, using gold to hedge inflation risk only works if the inflation in question is unanticipated. Hedging anticipated inflation risk with gold has typically not been a winning strategy, and the current spike in inflation is very well advertised.

Having said that, after I had finished the first draft of this month's letter, the chart below landed in my inbox. MacroStrategy Partnership plotted US consumer price inflation (CPI) against an equally-weighted portfolio of gold and oil and found that CPI is highly correlated with year-on-year percentage changes in a portfolio consisting of 50% oil and 50% gold (Exhibit 8). As you can see on the extreme right-hand side of the chart, the oil and gold model confirmed the recent, explosive rise in CPI. In other words, even if the rise in both CPI and PPI was well-advertised, gold still behaved as if the rise in inflation was unexpected. The only conclusion I can draw is that investors were still surprised *how much* inflation actually increased.



Exhibit 8: Equal-weighted oil & gold vs. US CPI

Source: MacroStrategy Partnership LLP

More generally, though, and given the current circumstances where inflation is on everybody's lips, I would still advocate plenty of caution, if you are tempted to use gold to hedge inflation. So, if gold is not the answer, what is? Goldman Sachs have recently produced a research paper on the hedge effectiveness of a large number of investment objects (Exhibit 9). If you go down the list, you can see that, according to the research conducted by Goldman Sachs, the precious metals sub-index (i.e. mostly gold) has only been assigned a hedge effectiveness of 16% – in other words, not a conclusion which is dissimilar to mine.

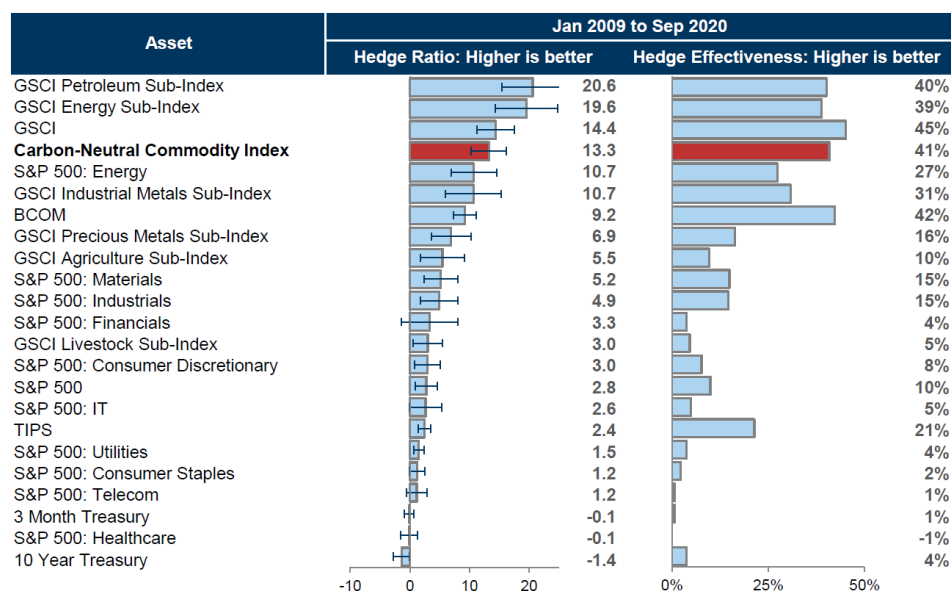


Exhibit 9: Hedge ratio & Hedge effectiveness vs. inflation

Source: Goldman Sachs Global Investment Research

Not surprisingly, commodities (ex. precious metals and agricultural commodities) do much better in Goldman's research – they come out at the very top in terms of hedge effectiveness. As you can also see, TIPS, which are used quite extensively to hedge inflation risk, provide only half the effectiveness most commodities do.

The bottom line

It is therefore not entirely unthinkable that the current rally in commodities is not so much about investors suddenly having fallen in love with commodities, as it is a logical response to rising inflation and the desire to hedge that risk away. Only time can tell if this is indeed a proper supercycle or not.

The best argument against the current rally being hedging-inflicted is the stellar performance of most agricultural commodities more recently. As you saw in Exhibit 9, agricultural commodities are not your best choice if the objective is to hedge inflation risk, and agricultural commodities have done exceptionally well more recently.

This suggest to me that the current rally is probably about a little bit of everything – the energy transition's impact on 'green' commodities, rising demand for steel, lumber, etc. as a result of continued urbanisation and the growing demand for protein-rich food, driven by rising living standards. If you combine all that with a mounting desire to hedge inflation risk, you have the recipe for a bull market in commodities – supercycle or not.

Niels C. Jensen

1 June 2021

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