The Global Commodity and Energy Rollercoaster

Richard Harris | July 2022

Most of us have been around for long enough to know the violence associated with commodity cycles, and that generally, investors are most bullish at the top and most bearish at the bottom.

Using 2020 and the oil price as an example; as the whole world came to a stop, demand for energy collapsed and oil prices and companies involved in the production and refinery of oil, sold off aggressively. At this point in time, we saw panic set in and the general consensus from market participants was that the world would no longer have signficiant reliance on fossil fuels going forward.

I remember clearly watching the price of Crude Oil plummet to negative $40/barrel as investors were unable to take ownership of the physical commodity (due to delivery and storage costs) and were actually paying willing buyers to take the commodity off their hands. We saw Sasol's share price drop from R330 to R25 (-95%) in a matter of weeks as investors questioned Sasol's debt structure with foreseen pressure on oil prices. For the first time since its establishment (in 1950), investors started to question the fact that Sasol would remain a going concern.

In 2015, we saw commodity prices collapse with concerns surrounding China's ailing economy and the fact that it would not be able to absorb rising supply from companies producing them. A situation which burnt the fingers of many said companies as they had spent $Billions on capital outlays to service this presumed demand. Much like with Sasol in 2020, those commodity producers with high levels of debt on their balance sheets, sold off aggressively. For example, diversified minor, Anglo American, sold off to R50 (now R560) and iron ore producer, Kumba Iron Ore, sold off to R30 (now R470).

The table below shows peak to trough movements of a selection of commodities over the last decade (2011 - 2021):

2011-2021											
Commodity	High 1	Low 1 (2015)	Diff	High 2	Diff	Low 2 (Covid)	Diff	Recent High	Diff	Current Price	Diff
WTI Oil (barrel)	$ 108.00	$ 28.00	-74%	$ 74.00	164%	$ -40.00	-154%	$ 125.00	413%	$ 95.00	-24%
Copper (Pound)	$ 4.60	$ 2.00	-57%	$ 3.30	65%	$ 2.00	-39%	$ 5.00	150%	$ 3.40	-32%
Aluminium (Ton)	$ 2 750.00	$ 1 460.00	-47%	$ 2 300.00	58%	$ 1 472.00	-36%	$ 3 500.00	138%	$ 2 430.00	-31%
Iron Ore (Ton)	$ 186.00	$ 37.00	-80%	$ 120.00	224%	$ 75.00	-38%	$ 220.00	193%	$ 106.00	-52%
Coal (Ton)	$ 125.00	$ 50.00	-60%	$ 120.00	140%	$ 150.00	25%	$ 420.00	180%	$ 410.00	-2%
Gold (Oz)	$ 1 900.00	$ 1 050.00	-45%	$ 1 550.00	48%	$ 1 450.00	-6%	$ 2 070.00	43%	$ 1 720.00	-17%
Silver (Oz)	$ 48.00	$ 13.00	-73%	$ 20.00	54%	$ 12.00	-40%	$ 30.00	150%	$ 18.60	-38%

What is clear from the above table is that it is very difficult for commodity producers to 'time' capital expenditure. Usually, when the price of what you are selling increases, you will increase capex and production so that you can take full advantage of these rising prices. The issue with commodity companies (as seen pre-2015) is that they increased capital expenditure and company debt as a result, only to see a drastic decrease in commodity prices that led to difficulties in managing the debt used to create this increase in production. What must also be noted is that new mining projects take years to establish themselves, which adds further difficulty to the timing of capital expenditure.

To a degree, we have seen the opposite of this during the recent post-Covid commodity surge, as companies are weary of repeating 2015. As a result, production of many commodities has stayed somewhat the same and thus, has created a floor to commodity prices in general.

Coupled with this underinvestment, the war between Russia and Ukraine has added further upward pricing pressure to Metals, Soft Commodities, and Energy, as they are both major producers and suppliers of many important commodities globally.

Such supply side shocks should ensure commodity prices remain higher than usual until we either see a significant increase in production or a resolution between Russia and Ukraine, which seems unlikely in the short-term.

The price of oil has also remained elevated since it's collapse in 2020 as a result of two major supply forces: (1) a premature global move towards clean energy. Consequently, oil production and fracking were slowed aggressively without political leaders considering the sheer energy demand from renewables that were unable to be met. (2) As with metal and agricultural commodities, the timeliness of Russia's invasion on Ukraine has exaggerated the supply shortage of oil and despite a recent 20% pullback, we are likely to see elevated oil prices as long as Russia and the West continue to impose sanctions on one another.

In essence, it is very difficult to time commodity cycles and many well-experienced investors and money managers have lost a lot of money by being too early on correct calls. Globalisation has decreased worldwide as a result of Eastern and Western factions. Geopolitics and country-specific macroeconomics are always a risk to taking a position in commodities, as we have seen with both China (in 2015) and Russia (earlier this year).

What we can be certain of, is that there is only a limited supply of certain commodities under the earth's surface and as populations increase and technology advances, there will be continued reliance on these. Fortune generally favours the brave in this investment theme and if timed correctly, can lead to significant returns.

Market Review

Global Markets (with the exception of Chinese Equities) traded higher in the month of July, which saw trading volumes significantly below normal levels as investors monitored the much-awaited second quarter earnings results from US companies.

The NASDAQ 100 (US Technology Index) led the way higher (+5%), followed by Japan's Nikkei (+4%); the local Allshare Index followed close behind (+2.5%). After a stellar performance in June, the Chinese Shanghai and Hong Kong's Hang Seng retreated 5% and 7%, respectively.

Commodities, in general, came off sharply this month as global recession concerns continued to make headlines due to monetary tightening from Central Banks. Natural Gas, on the other hand, was up 42% in July as supply issues came from Russia, slowing supply from its Nord stream pipeline due to "maintenance" as the East and West continue to enforce sanctions on one another in a massive power struggle.

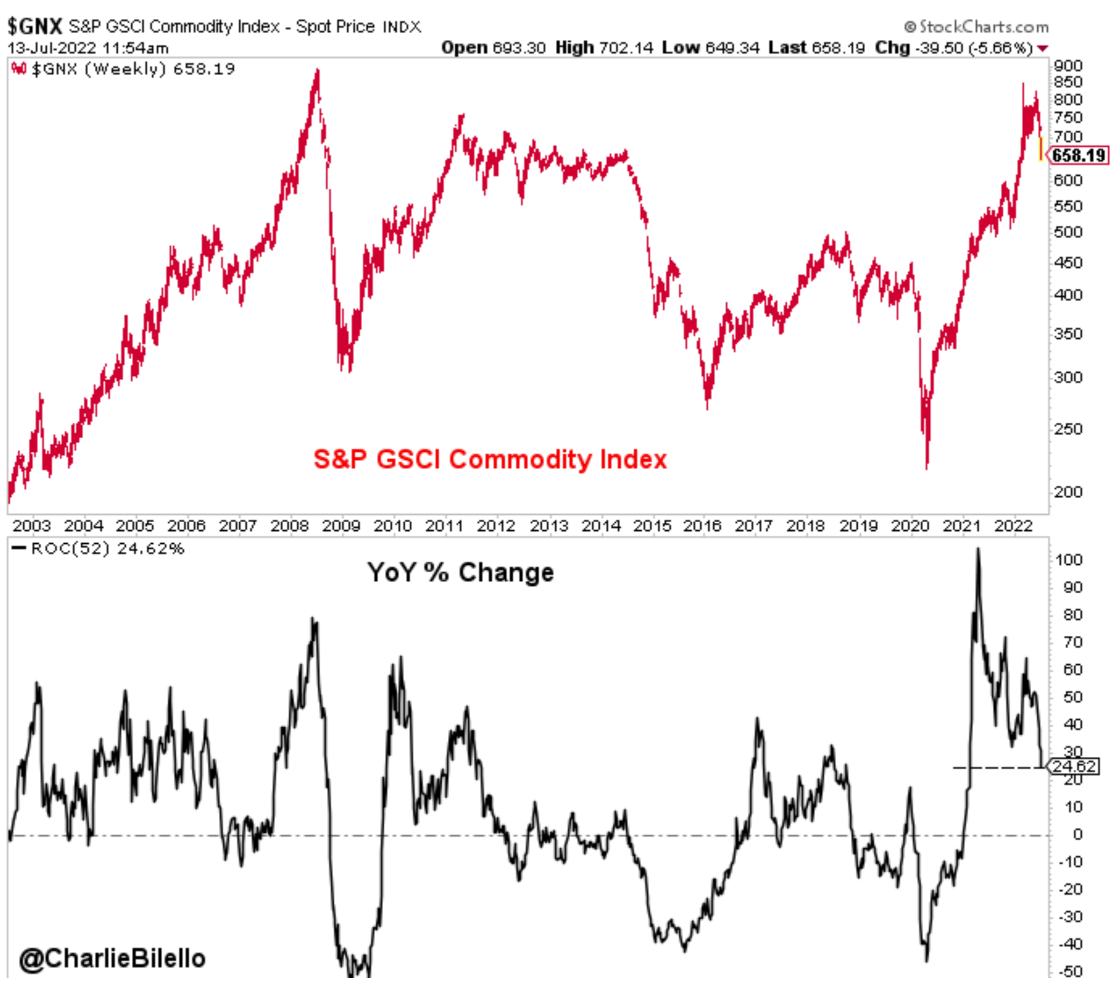
Unsurprisingly, the Rand plummeted to R17.20/$ at its lows, the worst level since 2020, as we saw increased loadshedding locally, commodity prices sell off, and a stronger US Dollar due to investors taking risk off the table. It strengthened 3.5% towards the end of the month to finish around R16.70/$, and it remains to be seen whether the Rand can find price stability having sold off more than 15% from its April lows of R14.50/$.

Our market outlook, both locally and offshore, remains cautious as we continue to monitor ongoing global developments and commentary from Central Banks. We are defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios. Although we believe that there is more volatility to come, we have started deploying capital to certain opportunities and will look to deploy further into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

Chart of the month:

The Rollercoaster that is Commodity Prices (as measured by the S&P GSCI Commodity Index)

The chart below needs little explanation. It shows how vicious commodity cycles have been over the past 20 years with moves of greater than 50% in a matter of years not being out of the ordinary.



"The cure for higher prices is higher prices" - Darren Woods (CEO of ExxonMobil)