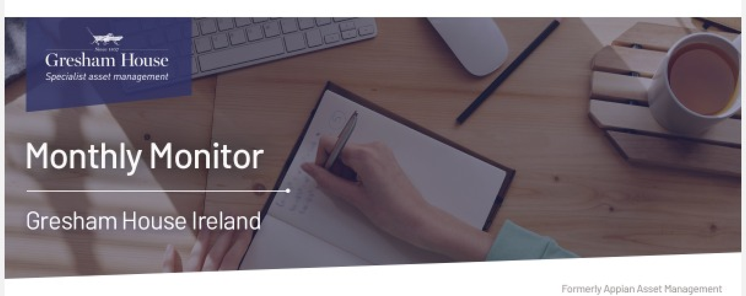

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Monthly Monitor
March 2022

Commodity price increases - the risks and opportunities

Rising commodity prices have been one of the key features within financial markets over the last twelve months. The initial strength came as demand recovered in line with economies beginning to emerge from the COVID pandemic.

However, there has been another move higher as supply concerns reared their head as a result of the Russian invasion of Ukraine. This has produced a spike in prices across most commodities. The biggest potential risk from this environment of higher commodity prices is that the inflationary pressures being generated could cause a recession.

The biggest opportunity, however, may lie with the commodity producers.

The risk: a catalyst for a recessionary environment

The risk of higher commodity prices is that they rise to a level that chokes consumption, inducing the potential for recession. A push back against this is that despite the recent advance in commodities, the real (inflation adjusted) increase in commodity prices is benign in comparison with previous inflationary periods.

Commodity prices are nowhere near as high in real terms as where they were in 2007 and therefore the economy may be able to live with higher prices. This is illustrated in the chart below, showing the evolution of a commodity index adjusted for inflation.

Chart 1: S&P GSCI in real terms

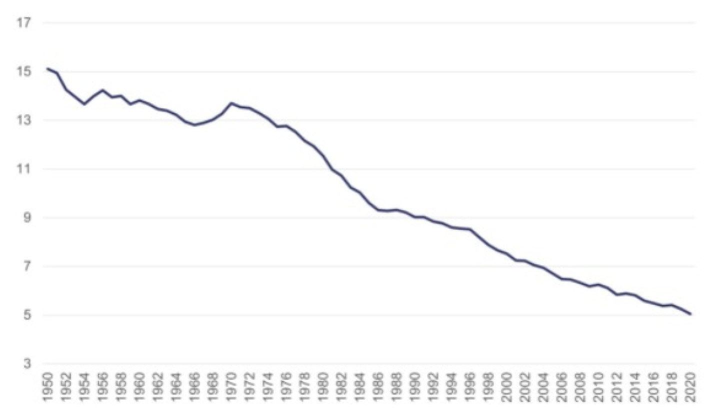
Source: Refinitiv Datastream, Gresham House Ireland

When thinking about the impact of rising commodities, the impact of oil prices always comes to the fore as it is the most important commodity for the global economy. Historically, rapid oil price increases have indeed lead to demand destruction and recession.

However, it looks as if oil prices may have lost much of their power in increasing the susceptibility of economies to recession.

Firstly, energy intensity as a percentage of GDP has fallen significantly over time.

Chart 2: US energy intensity (consumption per real dollar of GDP)



Source: Refinitiv Datastream, Gresham House Ireland

Secondly, households are in a much better position to absorb an increase in the oil price.

US households are also in a very strong financial position. Incomes are increasing while savings and net worth have also risen.

Chart 3 illustrates that the income effect of today's oil price increase is significantly lower than historical precedents - only 19% of the level of the 1980 oil crisis.

Chart 3: Oil price relative to US personal disposable income

Source: Refinitiv Datastream, Gresham House Ireland

The real oil price remains well below previous crisis periods.

Chart 4: Real oil price (adjusted for US inflation)

Source: Refinitiv Datastream, Gresham House Ireland

Undoubtedly, higher real oil prices can directionally increase recession risks. However, the counterpoints - lower energy intensity and the strong financial position of households - should negate a significant portion of the potential demand destruction. We will likely see a growth slump but not an outright recession should oil prices remain at current elevated levels for a prolonged period.

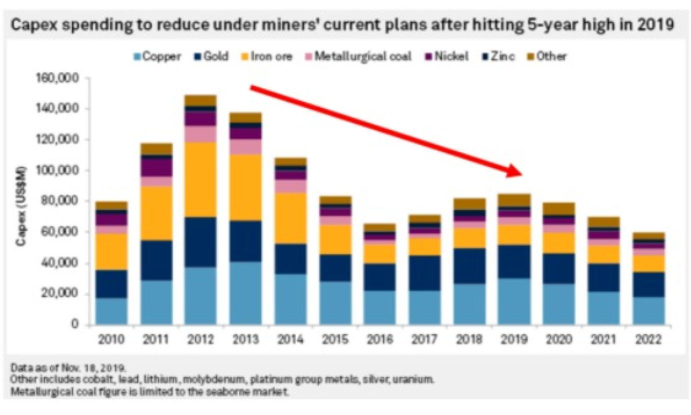
A further advance in the price of oil combined with inflation in other commodities would increase the probability of recession as corporate profitability and household disposable income become squeezed. However, this time around it isn't just the price of oil that matters but the prices of commodities in general and also the length of time that prices stay elevated.

The opportunity: commodity producers

Rising energy and commodity prices can also provide opportunities. We have been positive on commodity producers for the last number of years. Our belief has been that a very tight supply situation combined with a structural improvement in demand should lead to prices staying elevated for several years.

Firstly, on the supply side. The miners and energy producers have been underinvesting for seven years. In the words of Jeffrey Currie of Goldman Sachs, speaking in late 2020 **"every single commodity market with the exception of wheat is in a deficit today"**. The forecast for 2022 capital expenditure by the mining industry was less than 50% of the 2012 peak and that follows a decade of declining investment.

Chart 5: Miners' capital expenditures

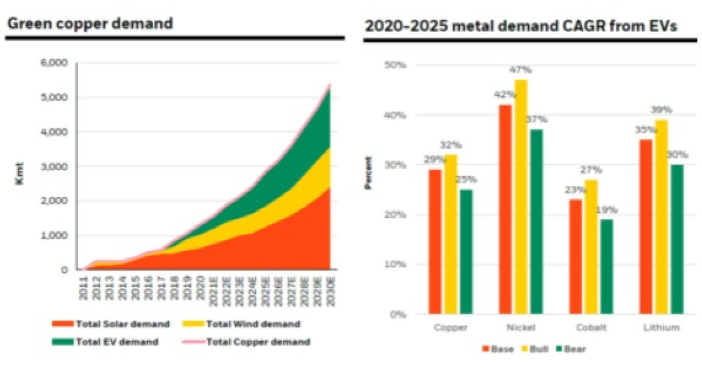


Source: S&P Global Market Intelligence

This tighter supply comes at a time of increasing demand.

Commodities will play a crucial role in the transition to a greener economy. The building blocks for many of the technologies used to mitigate or reverse the effects of climate change are industrial commodities such as copper, aluminium, and nickel.

Materials required for the green energy transition



Source: Woodmac, CRU, Goldman Sachs Global Investment Research

The impact on metals of switching from fossil fuels to renewables can be illustrated with an example. To replace a 100 MW natural gas fired turbine you will need twenty 500-foot wind turbines which require 100x the iron ore and 25x the concrete, and 10x more speciality metals and minerals (e.g. Copper). This pickup in demand combined with very tight supply should lead to commodity prices staying elevated for longer.

We have several holdings in commodity producers across our portfolios that should deliver significant cash flow improvements in the next few years should commodity prices stay elevated.

These companies have strong balance sheets, disciplined capital allocation, combined with valuations that do not reflect the positive supply/demand dynamics. Rio Tinto's current valuation implies that the iron ore price will fall from $133/t to $55t, while Shell's current valuation implies that long term oil prices will revert to $70 from over $100 currently.

Company	PE Ratio	Dividend yield	Primary commodity exposure
Rio Tinto	6.8	10.6	Iron Ore
BHP	9.2	8.4	Iron Ore
Shell	6.4	4.0	Oil and Gas
Eni	6.9	7.2	Oil and Gas
Antofagasta	14.0	4.2	Copper
Mosaic	6.4	1.2	Fertilizer

Source: Refinitiv Datastream, Gresham House Ireland estimates

Please visit our website for further information. The latest views and insights from the team can be found here.

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