Commodities

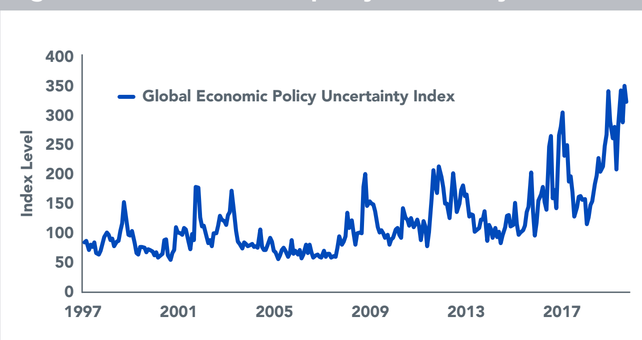
Gold shines amid global macro uncertainties

- ***We expect gold to continue to shine in the year ahead given elevated levels of macroeconomic and policy uncertainty keeping investors' demand for historically safe haven assets high.***
- ***Oil markets have been fixated on the destruction of demand growth this year on account of trade wars. We believe a reasonable level of geopolitical risk premium has been missing from oil prices and expect it to be priced in gradually in the year ahead.***
- ***Environmental regulation has had, and will continue to have, a direct impact on commodity prices as policy makers are becoming increasingly cognisant of implementing environment-friendly policies.***

Gold gets the gold medal: A world marred by trade wars and negative interest rates

The trade dispute between US and China could continue to be a headwind for broad commodities for most of next year. Policy uncertainty, as measured by the Global Economic Policy Uncertainty Index (see Figure 1), is at very elevated levels with the escalation in the spat between the two countries since the start of last year being an important driver. While we remain cautious about a meaningful resolution on this front in the coming months, we expect there to be some respite in trade attrition as we approach the US presidential election in November 2020. If that is indeed the case, and some form of trade settlement is agreed between the two countries, it would prove fruitful to both industrial metals and agricultural commodities, which have taken a direct hit from trade tariffs, as well as oil if a trade deal translates into a more optimistic global economic outlook.

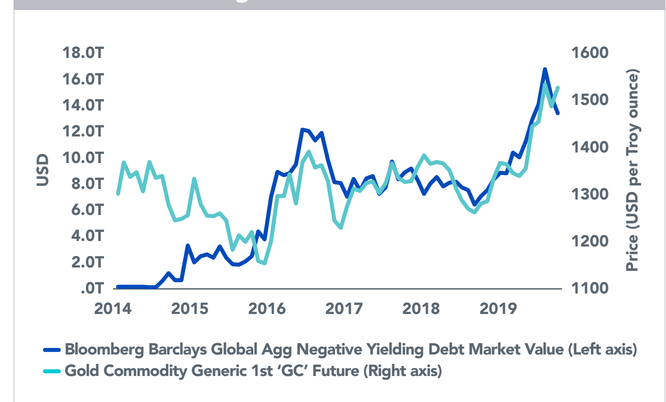
Figure 1: Global economic policy uncertainty is elevated



Sources: WisdomTree, policyuncertainty.com. Data as at 30 September 2019. ***Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly within an index.***

But they say gold makes the ugly beautiful. As the outlook for the global economy remains humdrum and trade disputes remain unresolved, gold as a safe-haven asset will continue to be an investor favourite. Gold's appeal is exacerbated in a world where investors pay governments to borrow their money, i.e. negative interest rates. Among antifragile assets, gold's non-existent yield is more attractive than negative yields on government bonds. With monetary policy from central banks likely to remain accommodative next year, we are unlikely to witness a meaningful decline in the amount of negative yielding debt. This will continue to be supportive of gold (see Figure 2). Even central banks, particularly those in emerging markets, have recently been increasing their gold reserves to hedge their exposure to fiat currencies. The wide appeal and lure of gold is therefore here to stay.

Figure 2: Gold's appeal in a world of negative interest rates



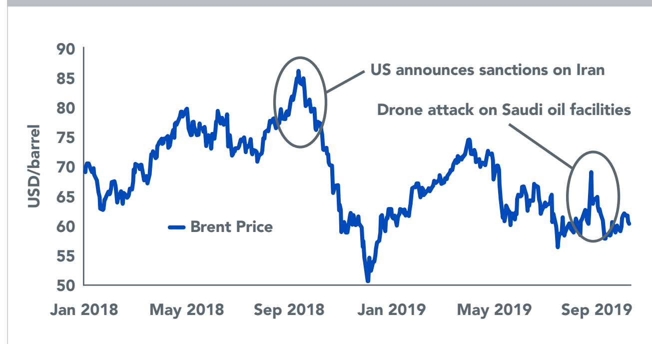
Sources: Bloomberg, WisdomTree. Data as at 31 October 2019. ***Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly within an index.***

The missing geopolitical risk premium

On 16 September this year, Brent prices spiked 12% following a drone attack on Saudi oil facilities igniting fears of a sustained supply shock. The rally was wiped out quickly when supply concerns were quashed by Saudi authorities who reassured markets that the damage had been contained and the situation was under control. But why did the price of oil move so significantly and return to lower levels again so quickly? In our view, this is because a reasonable level of geopolitical risk premium has not been priced into oil by markets since the start of Q2 this year. Brent was trading around $85/barrel back in October 2018 when the US first announced its sanctions on Iran (see Figure 3). Since then, markets have been fixated on decelerating oil demand growth taking little heed of potential supply disruptions from the sensitive geopolitical situation in the Middle East. It is for this reason that a geopolitical 'event' such as the attack on Saudi oil facilities suddenly raised supply concerns and had such a profound impact on prices. Once Saudi authorities assured markets that the extent of the damage was much less than initially anticipated, complacency returned in markets and prices fell again.

Even though material supply disruption, such as that caused potentially by the Strait of Hormuz becoming inaccessible to a third of global oil volume which currently flows through it, is not part of our central scenario, we believe investors need to demand a higher risk premium to reflect the heightened tensions in the region. We expect this to happen over the next year drawing the price of Brent to a fairer range of $70-$75/barrel.

Figure 3: Geopolitical risk premium has vanished from oil prices



Sources: WisdomTree, Bloomberg. Data as at 31 October 2019. ***Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly within an index.***

Monetary (and fiscal?) policy to the rescue:

Commodities are likely to find support from accommodative monetary policy next year. Low to negative interest rates will not only help gold as a haven asset but, if policy stimulus translates into improved growth in the real economy, the broader commodities complex can be expected to benefit.

Governments also typically introduce fiscal measures to induce growth when the economy is slow. It is possible that promises of fiscal support are made as we approach the US presidential election in November 2020. Similarly, China appears prepared to employ both monetary and fiscal measures to manage the growth slowdown. China's fiscal stimulus in 2008 played an important role in driving commodity demand and consequently commodity prices.

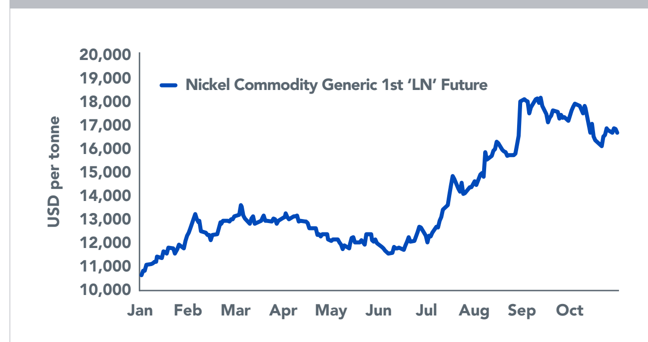
While a major economic crisis is not a central scenario in our outlook for next year, and thus the scale of fiscal stimulus is unlikely to match what was injected in 2008, we believe low rates will encourage governments to borrow to facilitate more fiscal accommodation. China is already committed to its belt and road initiative which aims to develop communication and connectivity across continents with planned infrastructure projects in excess of $1 trillion between 2017 and 2027. These projects aim to bridge a global infrastructure gap and will keep the demand for base metals and energy alive. Other countries may follow suit giving commodities a much-needed demand boost.

The impact of environmental regulation!

Changes in environmental regulation are not only expected to impact the dynamics of commodity markets in the long run, e.g. the shift towards electric cars, but are also having a direct and immediate impact on commodity prices. This theme is likely to remain relevant in the coming year as governments and regulators endeavour to engage more actively in devising policies to protect the environment.

Philippines, which is the second largest producer of nickel ore in the world behind Indonesia, closed half of its mines in the first half of 2019 due to maintenance or environmental reasons. The country's Department of Environment and Natural Resources suspended the operations of several mines when audits revealed that they were breaching environmental regulations. This capped the growth in the supply of nickel, which is an integral component of electric vehicle batteries. Nickel's price rally this year, driven primarily by Indonesia's decision to stop nickel ore exports from January 2020 (two years earlier than expected) to process more at home, has been further supported by actions taken by Philippines (see Figure 4).

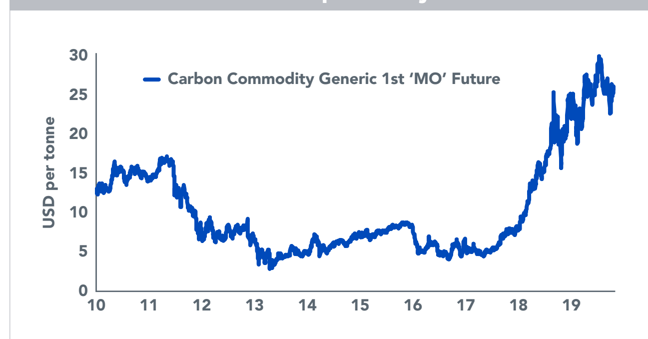
Figure 4: Year-to-date rally in Nickel prices



Sources: WisdomTree, Bloomberg. Data as at 31 October 2019. ***Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly within an index.***

Carbon has been another beneficiary of environmental regulation since last year experiencing a strong price rally (see Figure 5). Under the EU Emissions Trading System, businesses are required to obtain allowances for their carbon related emissions. The EU has been pushing up the price of these carbon allowances since last year in a bid to encourage businesses to switch to cleaner sources of energy.

Figure 5: EU regulation has strongly supported the carbon price rally



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All data from Bloomberg unless otherwise stated.

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