Are We Poised for a Commodities Supercycle?

StoneX®

One of the fiercest debates in financial circles nowadays is whether the world is entering a new commodities supercycle. Some analysts, such as those at Goldman Sachs and JPMorgan Chase, have asserted that a prolonged commodities rally has already begun. Others see only a strong rebuilding effort following the purchasing lows of the pandemic. They believe the current surge in commodity buying will play out in a year or so.

And still others worry about the long-lasting effects of an unprecedented rise in government stimulus money. In their view, we may or may not be on the edge of a supercycle, but we could well see excessive inflation combined with stagnant growth (stagflation) such as the US suffered in the 1980s.

In this article, we will consider the likelihood of a supercycle by examining the factors that go into making one. We'll also take a look at the potential for much greater inflation. And finally, we'll reprise an alternative version of recent economic history presented in a 2021 paper by StoneX Financial Inc. strategist Vincent Deluard. For a few years now, Deluard has taken the position that much higher inflation is coming.

As always, it's important to note that economic forecasting is not an exact science, and unforeseen circumstances can alter any market environment. Still, an understanding of the forces that shape the global economy can be invaluable in making sense of the markets and developing safeguards.

SUPERCYCLES ARE RARE

The world has experienced only four commodity supercycles in the past 120 years. The first occurred in the beginning of the last century, largely as a result of American industrialization. The second was spurred by governments around the globe building up their militaries in the 1930s. WWII was also the primary cause of the third supercycle, as the world reconstructed its economies in the 1950s and 1960s. The fourth and last extended commodities rally was fueled by the rapid industrialization of the BRIC countries – Brazil, Russia, India and China – from the late 1990s to the mid-2000s.

The lesson of this quick jaunt through history is that supercycles are rare. They tend to be set off by an extraordinary set of circumstances, such as a multinational war or a tectonic shift in global economics. Today, that kind of sweeping change does not appear to be imminent. Moreover, these last four supercycles happened 25-35 years apart, and the world just came out of the last one a little more than a dozen years ago.

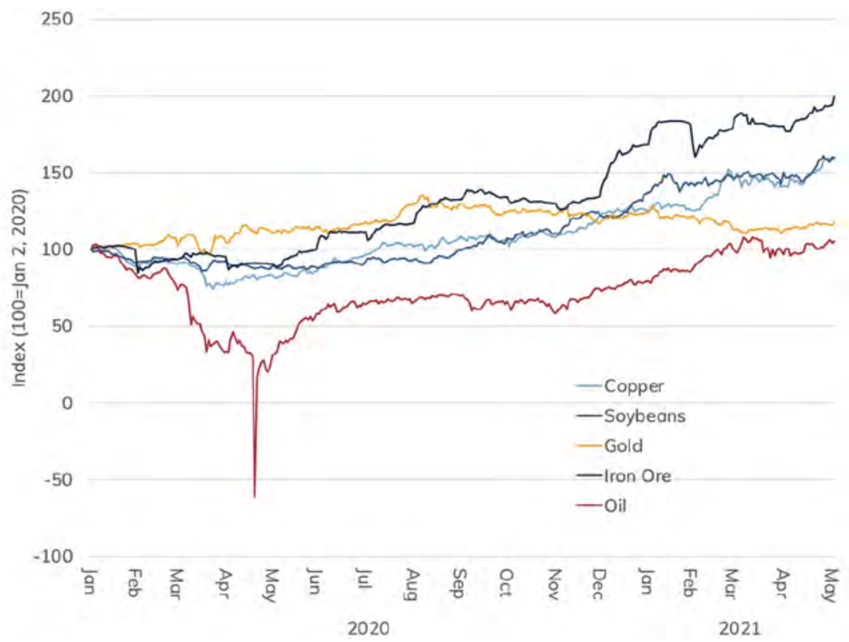
Nevertheless, a number of conditions could be pointing toward yet another supercycle. These include significant leaps in commodity prices, the unprecedented increase in money supply during the past few months, and major long-term structural changes, such as the disinvestment in fossil fuels as the world transitions to green energy.

So how can we get a better grasp on the prospects of a supercycle? One way is to look at the commodities themselves.

PRICE SURGES IN COMMODITIES

FIGURE 1: COMMODITY PRICE TRENDS

Source: Bloomberg



A good place to start is with copper. The reddish metal is often referred to as "Doctor Copper" because of its penchant for signaling market swings. Copper is used in everything from industrial machinery to consumer electronics to household wiring, so it is uniquely positioned to take the pulse of the global economy. And for more than a year now, the pulse of copper itself has been humming. Since March of 2020, the price of the metal has skyrocketed over 80%. As of this writing in early April, copper is at its highest point since 2012 and is pushing toward $9,000 a ton.

Oil is also a key commodity in taking the measure of the markets. During the last supercycle, it surged from $20 per barrel to $140. While oil prices collapsed in 2020, crude futures have rebounded since then and were hovering around $60 a barrel in early April, largely due to resurging consumption in India and China. Market bulls are even entertaining the possibility of $100-plus oil again.

Perhaps the most striking price rise has been in crops. Corn futures were up 47% year-on-year in March. Soybean prices have hit $14.50 a bushel, a seven-year high. And daily wheat prices have risen nearly 60% in the past 4-plus years. Looking forward, one analyst predicted that by 2023, corn could reach $19 a bushel, soybeans $30, and wheat $45, which are all multiples of their recent prices. (On April 5, wheat was selling at $6.18 per bushel, corn at $5.53.)

And then there is gold, often seen as a barometer of distressed markets. Last August, gold set an historic high of $2,000 an ounce, and as of this writing, it remains above $1,700.

As can be expected from these wide-ranging commodity price surges, the TR-CRB index has shot up from a low of roughly 110 in the second quarter of 2020 to over 200 a year later.

FIGURE 2:
TR-CRB INDEX
Source: Bloomberg

ON CLOSER INSPECTION

While these dramatic price leaps are impressive, the question remains whether they will continue for an extended period of time.

Copper, for its part, is closely tied to increased infrastructure spending, particularly in refurbishing the US electrical grid and in supporting the global movement toward electric vehicles. The situation in 2021, however, is different from that of the last supercycle. Copper was at a long-time low when the BRIC economies took off, and suppliers were slow to respond to increased demand. That combination of low cost and sluggish supply led to a huge upswing in price. Today, any further upswing will likely be tempered by the current abundance of copper, as well as additional mining sources coming on line in the next few years.

Oil looks even less promising as a gauge. Despite the recent rise in crude futures, as much as 10% of available supplies are still being withheld from the market by the Organization of the Petroleum Exporting Countries and their allies, a situation that the Wall Street Journal equates with being “on life support.” Moreover, any sharp increase in demand would likely be met with a wave of US shale oil entering the market.

The rise of gold in itself may not point to a supercycle. Unlike other raw materials, only about 10% of global supply is used for industrial purposes, while about 50% is bought to make jewelry and roughly 40% is purchased for investments. So it does not have the same multiplier effect as other commodities have on finished goods and products. However, gold’s rise in price does have some analysts concerned about hyper-inflation. The yellow metal has long been used as a hedge against inflation, and StoneX’s Deluard, for one, predicts that gold will rise to $4,000 per ounce by the end of 2021. (For more, see subhead below Alternative View of Inflation.)

As for the likelihood that agricultural commodities will facilitate a supercycle, much depends on a number of variables. In the short-term, the essential player once again is China. The world's second largest economy has been on a buying spree of soybean and corn, driving prices to their current highs, as it rebuilds its devastated pig herd following an outbreak of African Swine Fever. The country's need for feedstock has increased enormously because it must replace the roughly 30 million metric tons of human food waste that it once used for pig rations but which is now banned as a swine health precaution.

What seemed like a clear boom market, however, has been muddied by another outbreak of the ASF virus via a new strain. Although Chinese government officials say otherwise, demand for corn and soybeans has dropped significantly, according to Arlan Suderman, Chief Commodities Economist at StoneX Financial Inc.

"The numbers that we hear on the ground from China show that demand from hog feeding dropped 10-15% over the winter due to hog losses," Suderman noted. "Sow numbers of the breeding herd dropped 5% in January and another 5% in February."

Looking beyond the near-term markets, crop staples could very well be in for an extended rally. A United Nations report stated that worldwide food production must grow by 50% to meet demand in 2030. Complicating this looming shortfall, the US is reaching its limits in developing new arable land, while existing farming acreage continues to be threatened by urbanization, environmental degradation, alternative land use and diminishing returns from cross-planting.

The shortfall in production could be made up with greater yielding strains or by the expansion of farming in other countries. Thomas Dosdall, a futures trader with StoneX Group Inc. subsidiary Daniels Trading, believes that South American countries would likely step up agricultural output, particularly Brazil.

"The old saying is, 'Nothing cures high prices like high prices'," Dosdall observed. "As we saw with corn and soybeans in 2012 and 2013, tight supplies and high prices inevitably led to a major global expansion in production."

SURPRISING EFFECTS OF CLIMATE CHANGE

Climate change presents another challenge to meeting food demand. Ostensibly, a warming planet and the resulting rise in sea levels would degrade farming capabilities in several parts of the world, most notably in coastal lands. However, changes in weather patterns are also opening up new production regions in northern areas, such as Siberia.

The extent of the impact would depend on how much and how fast temperatures rise. One study found that an average rise in temperature of 1 degree Celsius over late 20th-century averages would actually increase US soybean production by 6% by the 2080s. However, a rise of 4 degrees Celsius would have the devastating effect of decreasing yield by 30% during the same period.

In the meantime, changing weather patterns are having a surprising effect on the American Midwest, according to StoneX's Suderman.

"If you look at the last 100-year data, we're seeing a trend toward increased rainfall in the Midwest Corn Belt and increased temperatures," the economist said. "Now much of that has been due to higher nighttime temperatures, because as moisture levels increase, nighttime temperatures don't fall as far. And we're seeing more cloud cover, which reduces the incidence of extreme highs. Overall, it's creating a greenhouse effect in the Midwest and increasing yields as a result."

South America is also experiencing bumper crops, Suderman added.

"We are definitely seeing a decrease of rain in key production areas, like the center-west region of Brazil," he pointed out. "But rainfall in that region had been extremely excessive. So we're getting rid of some of the excessive rainfall, and a good example is during the soybean growing season that Brazil just completed. They had one of their driest growing seasons in the last forty years, but their soybean crop set another record."

STIMULATING A SUPERCYCLE

As we noted earlier, supercycles are usually precipitated by an epoch-changing event, such as a major war or the rise of a new economic powerhouse. Although neither appears to be on the horizon, there is one common experience that has shaken the world and which could lead to a prolonged commodities rally – the outbreak of COVID-19.

"The pandemic itself is a structured catalyst for a commodity supercycle," asserted Jeff Currie, Global Head of Commodities Research at Goldman Sachs.

In a March 2 interview with CNBC, Currie noted that by targeting lower-income households, COVID-19 recovery programs are having a strong impact on consumption as lower-income households tend to spend more on staples. "We estimated that it's 50 cents on the dollar for lower-income [households], versus 35 cents on the dollar for higher-income."

Currie also cited a weaker dollar and the unusual synchronization of stimulus programs across major economies as additional drivers of a supercycle.

Another financial titan, JPMorgan Chase, agrees. Last February, its analysts predicted that COVID-19 recovery policies will bring about a "roaring 20s" economic expansion that will fuel a multi-year commodities rally.

Additionally, supercycle bulls point to promises from governments in Europe, China and the US to decarbonize industry and focus on renewable fuels. Such programs would be commodity-intensive and help bolster a prolonged rally.

Despite these upbeat predictions, press reports in the Wall Street Journal, Bloomberg, and other major journals have favored a milder recovery. As Ed Morse, Global Head of Commodities Research at Citigroup, told the Economist in January, “There is nothing on the demand side that is nearly as commodity-intensive as the first decade of the 21st century.” Morse pointed out that, unlike now, the last supercycle was sparked by historic transformations in emerging markets, such as the vast urbanization of China.

UNDESIRED CONSEQUENCES

While analysts debate the strength and length of the recovery, some observers are more concerned about the effects of the stimulus programs on inflation. A bout of excessive inflation would undercut any gains of a commodities rally, constrain the global economy and put added stress on social cohesion.

In a March 1 article in AgWeb, StoneX economist Suderman warned that economies around the world have pursued easy money policies for several years now, a situation that could culminate in hyper-inflation. “Ultimately, the risk is best illustrated by what we currently see in Argentina, where it’s struggling to contain runaway inflation, and that’s stifling production in its ag sector.” The country’s yearly inflation rate in March was 42.6%.

More recently, Suderman observed, “M1 money supply has just exploded. Last I checked, it was up 74% year-on-year.” (M1 money supply includes cash, checking accounts, traveler’s checks, demand deposits, and other checkable deposits.) Suderman added that currently the effects on inflation are being felt much more in the US than in Europe because Europe has been struggling to get the pandemic under control, delaying its recovery.

Jerome Powell, head of the Federal Open Market Committee, has vowed that the Fed has the tools and the know-how to control excessive inflation, but Suderman worries that the chairman’s confidence is based on Beltway mentality.

“There’s a kind of arrogance that’s developed in the Washington D.C. area that they can somehow manage economies,” he stated. “But economies have had a way of humbling that theory in the past.”

One strong piece of evidence of rising inflation, according to Suderman, is the yield on the 10-year US Treasury note. Since the second quarter of 2020, the rate of interest on the note has soared from 0.4% to 1.53%, a strong sign that investors anticipate higher prices.

FIGURE 3: 10-YEAR TREASURY YIELDS

Source: Bloomberg

By contrast, far from being worried about government stimulus, economist and Nobel Laureate Paul Krugman suggested in a New York Times column last year that the US should have a permanent stimulus program that is equal to 2% of gross domestic product. Krugman asserted that ongoing stimulus would boost yearly GDP growth by roughly 4%, while the added cost of servicing the new debt would be half that, or 2%. In other words, the program would pay for itself while insulating the economy against recession. His argument assumes that inflation would remain low.

In a March 22, 2021 column, Krugman reaffirmed his belief that any spike in inflation from the stimulus programs would be short-lived. He added that the double-digit rise in prices during the 1970s was the result of excessive expansionary fiscal policy, two oil shocks and irresponsible monetary policy by the Fed. As for the current rise in commodity prices, he asserted that some commodities can fluctuate wildly depending on market conditions – "oil and soybeans rose almost 40 percent [2010-2011]" – and that market costs which are adjusted only periodically, such as wages and salaries, are a better guide to inflation.

CONSENSUS OPINION

In terms of consensus opinions, a recent Wall Street Journal survey of 69 business, academic and financial forecasters predicted that inflation would increase to 3% in June, the most since 2012. However, the overall forecast was that it would slow to 2.6% by December. The survey respondents also predicted that the Fed would raise rates earlier than anticipated, in mid-2023 as opposed to 2024, as central bank officials have suggested.

Nevertheless, the very scale of the federal stimulus at roughly $6 trillion gave the survey participants pause.

“It makes it hard for a forecaster because I’ve not seen anything like this, ever,” admitted Allen Sinai, Chief Global Economist and Strategist at Decision Economics Inc.

In fact, any number of conditions could re-shape the recovery. If enough supply bottlenecks develop, consumers now flush with cash would be chasing after too few available goods, raising prices. Some bottlenecks are showing up already, such as the shortage of computer chips.

On the other hand, a so-called “output gap,” caused either by too few qualified workers or a lag in hiring, would have the opposite effect, tamping down inflation by squeezing demand.

Another outbreak of COVID-19, which Fed Chair Powell calls “the primary risk” to the US economy, would also reduce demand by delaying a full recovery.

ALTERNATIVE VIEW OF INFLATION

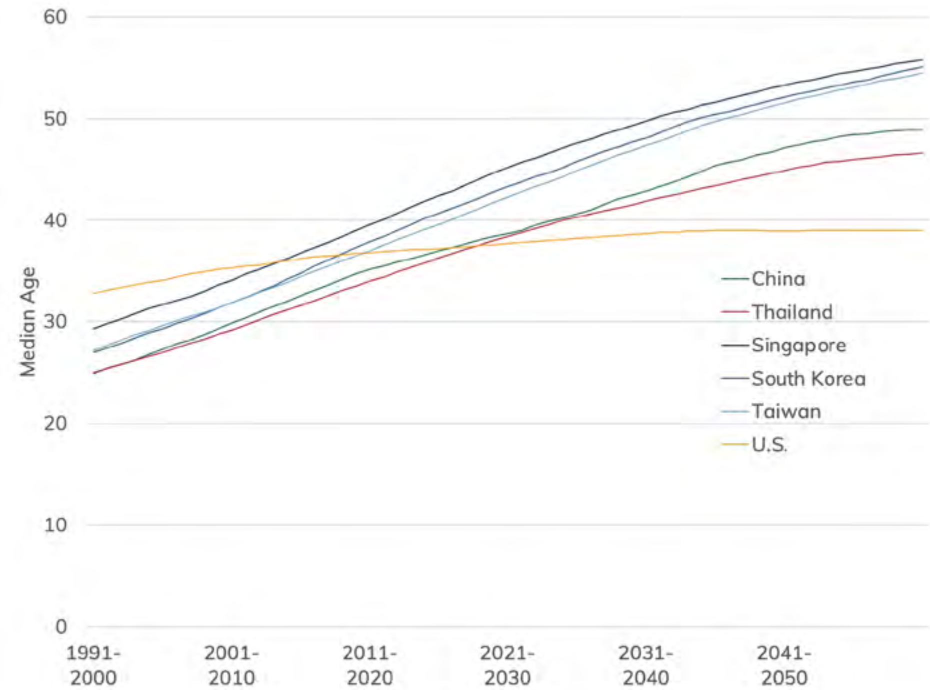
The fact that the US yearly inflation rate has stayed stubbornly low since 1990 is generally explained by two conditions. The first is globalization, whereby relatively open borders have allowed goods to be manufactured in countries with lower labor costs. Relocation of production has become a global pressure relief valve for rising prices, which is why a microwave oven or nearly any other appliance bought in the US today will likely have Chinese lettering on its protective wrapping.

The second condition is technology. The impact may not be as quickly felt as globalization, but if a commodity stays high-priced long enough, such as oil between 2005 and 2015, producers will find a way to deliver alternate supplies, as they did with the development of hydraulic fracturing. Today “fracking,” which taps into vast reserves inside dense rock formations, accounts for the majority of US oil production.

Against this backdrop, StoneX economist Vince Deluard has pushed for an alternative view of inflation. In a March 2021 paper entitled “Three Unconventional Arguments for Secular Inflation,” Deluard argues that inflation has been consistently low because China’s leaders artificially suppressed the value of the yuan in order to build its export economy. And they did that to provide employment for its young billion-plus population in order to keep the domestic peace and retain power.

FIGURE 4: MEDIAN AGES IN U.S. AND ASIA

Source: Bloomberg



But today, following a long-term governmental policy of strict birth control, the median age of its population is 47 years (versus 37 in the US). Other Asian powerhouses, such as South Korea and Japan, also have aging populations. Consequently, they must all focus less on manufacturing and more on providing services and life-style enhancements for their growing retiree sectors and their shrinking labor pools. To do this, they will build their service and consumption economies at home. They will also allow their currencies to rise and their enormous dollar reserves to melt to provide a better standard of living. In a few short years, this 30-year-old pressure relief valve on prices in which a vast pool of cheap labor produced low-cost goods will close, and prices will rise significantly and stay high.

The second inflation punch will come from US corporations. In every sector of our economy, a small group of major corporations has been allowed to dominate market share and gain outsized control over their industries. As labor costs rise, it's only a matter of time until these corporations use their relatively free hand to increase prices. (In late April, Procter & Gamble announced a wide-ranging increase in prices. The announcement by P&G follows a similar measure by its competitor Kimberly-Clark a month earlier.) This capability to raise prices at will is especially true of high-tech corporations that are basically monopolies. Although they offer free-to-users services now, they are well-positioned to introduce charges for services that have become essential for consumers and business, such as email access.

And finally, the meteoric rise in green investing is curtailing much needed investment in fossil fuel production, which is at a 15-year low. Even shale oil producers have failed to respond to the recent spike in oil prices by investing in new drilling. As a result, the oil shocks of the 1970s could well happen again, and with the same result – stagflation.

The threat of inflation, according to Deluard, is the “800-pound gorilla in the room” that economists and the financial media are ignoring. He believes that stimulus programs, stock market bubbles, excessive debt and tariffs are feeding that gorilla in the short-term.

However, he also sees “generational opportunities” for investing, such as in gold and Asian currencies, which he predicts will rise in value dramatically.

CONCLUSION – VOLATILE TIMES AHEAD

As can be seen, there are compelling arguments for any number of outcomes. And this white paper has by no means presented all of them.

Case in point: a well-received 2019 book, *The Great Demographic Reversal* by economists Charles Goodhart and Manoj Pradhan, argued that changing demographics around the globe would be a major factor in spurring inflation. As populations age, labor pools will shrink, and only Africa and India will have an abundance of youngsters to replenish an aging workforce. However, rising restrictions to migration would prevent them from doing so, resulting in sharply rising wages in the wealthier countries.

Here again, there are other trends that could alter this proposed future. Automation will likely replace many of the jobs once performed by humans. And the workforce may not shrink as much as anticipated if older workers remain on the job well beyond traditional retirement age, as is the case in Japan and elsewhere.

In any event, monetary, demographic and fiscal forces appear poised to stir up volatile times ahead. With so many variables to consider, even a hard-charging critic of the US stimulus program, such as ex-Treasury Secretary Larry Summers, is hedging his bets by couching alternate forecasts in probabilities. No doubt, all of those involved in the markets with less loftier perches than Professor Summers, who currently teaches at Harvard University, would be wise to hedge their bets as well.

As trader Thomas Dosdall noted, “I would strongly urge anyone who regularly engages with the equity markets, whether through ongoing purchases, commodity sales, investments or other interactions, to be sufficiently hedged. It’s like anything else in life. When there is no urgency, insurance is relatively affordable. But when an emergency is at your door, any decent insurance is very expensive, if you can get it at all.”

StoneX®

StoneX Group Inc. provides financial services worldwide through its subsidiaries,including physical commodities, securities,exchange-traded and over-the-counter derivatives, risk management, global payments and foreign exchange products in accordance with applicable law in the jurisdictions where services are provided. References to over-the-counter ("OTC") products or swaps are made on behalf of StoneX Markets LLC (SXM), a member of the National Futures Association (NFA) and provisionally registered with the U.S. Commodity Futures Trading Commission (CFTC) as a swap dealer. SXM's products are designed only for individuals or firms who qualify under CFTC rules as an 'Eligible Contract Participant' ("ECP") and who have been accepted as customers of SXM. StoneX Financial Inc. (SFI) is a member of FINRA/NFA/SIPC and registered with the MSRB. SFI is registered with the U.S. Securities and Exchange Commission (SEC) as a Broker-Dealer and with the CFTC as a Futures Commission Merchant and Commodity Trading Advisor. References to securities trading are made on behalf of the BD Division of SFI and are intended only for an audience of institutional clients as defined by FINRA Rule 4512(c). References to exchange-traded futures and options are made on behalf of the FCM Division of SFI. StoneX Financial Ltd is registered in England and Wales, Company No. 5616586, authorized and regulated by the Financial Conduct Authority. Trading swaps and over-the-counter derivatives, exchange-traded derivatives and options and securities involves substantial risk and is not suitable for all investors. The information herein is not a recommendation to trade nor investment research or an offer to buy or sell any derivative or security. It does not take into account your particular investment objectives, financial situation or needs and does not create a binding obligation on any of the StoneX group of companies to enter into any transaction with you. You are advised to perform an independent investigation of any transaction to determine whether any transaction is suitable for you. No part of this material may be copied, photocopied or duplicated in any form by any means or redistributed without the prior written consent of StoneX Group Inc. © 2021 StoneX Group Inc. All Rights Reserved.