

## WCU: Commodities torn between recession and tight supply focus

By Ole S. Hansen // November 25, 2022

Commodity markets maintain a commanding lead over asset classes, such as bonds and stocks, as we head towards the final few weeks of trading in 2022. A year that, despite several headwinds, has yielded strong returns – with the Bloomberg Commodity Total Return index trading up close to 20% on the year. Following on from a strong finish to 2021 – driven by a post-Covid surge in demand for goods fuelled by a wall of fiscal stimulus and coordinated monetary support – the year started on a tear. With demand rising strongly at a time of under-investments, the attention abruptly turned to supply worries following the Russian invasion of Ukraine.

Sanctions against Russia and risk to supply of key food commodities from Ukraine led to price spikes across all commodity markets, not least energy, grains and metals. As a result of this, the Bloomberg Commodity Total Return index spiked by more than 25% during the first quarter before spending the following months slowly deflating. However, despite numerous headwinds, such as the strongest dollar rally in years, rolling Covid related lockdowns in China and central banks hiking rates in order to kill inflation at the expense of growth, the commodity sector has performed very well, as demonstrated by the near 20% year-to-date return.

Heading into 2023, four major themes will help determine the direction of the market:

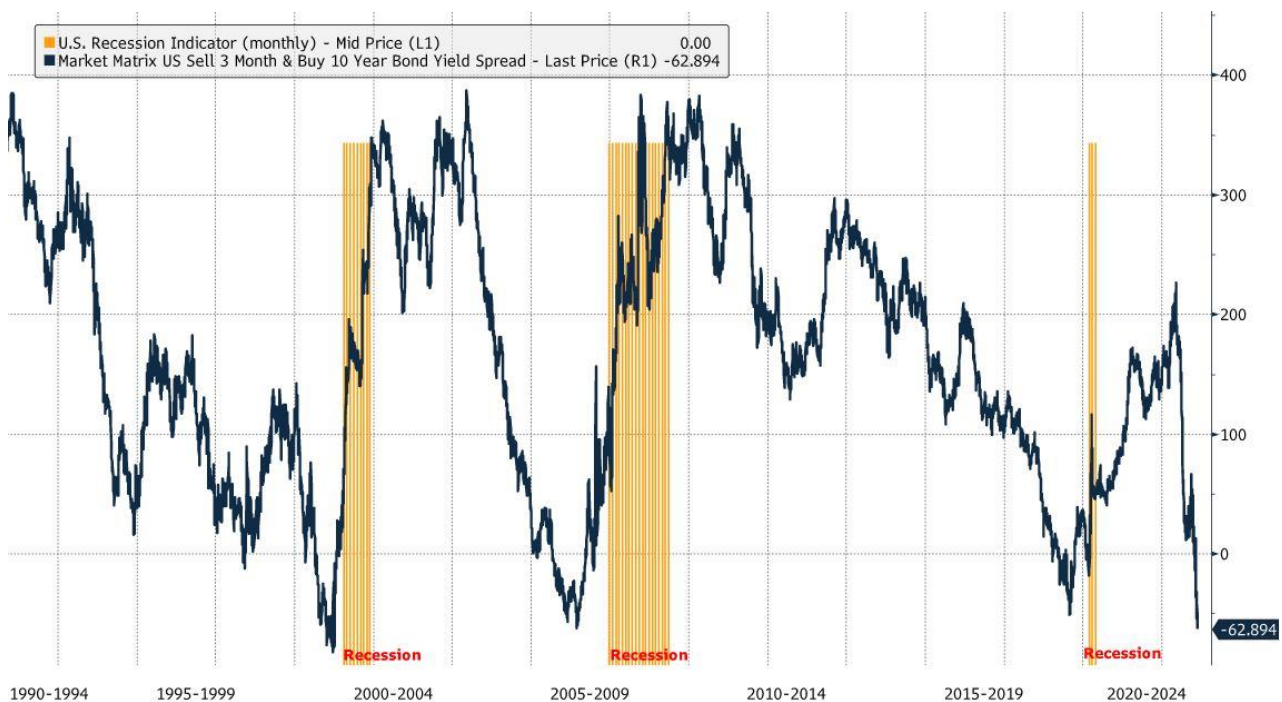
1. The depth of an incoming recession currently being priced in by the market through the most inverted US yield curve since the early 1980s
2. A recession forcing the US Federal Reserve to change its focus from rate hikes to economic support, potentially before inflation has reached a satisfactory low level, thereby supporting a reversal of the dollar and Treasury yields.
3. A reopening in China leading to a stimulus fuelled recovery in demand for industrial metals and energy.
4. The duration of the war in Ukraine and its potential impact on supply of key commodities from crude oil and gas to wheat and key industrial metals.

### **Recession versus tight supply**

The risk of an economic downturn at a time of tight supply of several major commodities will be one of the key battlegrounds that, together with the strength of a post-Covid recovery in China, will help determine the direction of commodities in 2023. Following months of aggressive rate hikes, the US Federal Reserve is now signalling a slowing pace of future rate hikes – with the eventual peak rate being determined by incoming data.

The US bond market is already telling the Fed that it may have overdone the monetary tightening, with the yield spread between the 3-month treasury bill versus the 10-year treasury note tumbling to a twenty-year low at minus 64 basis point. An inverted level of

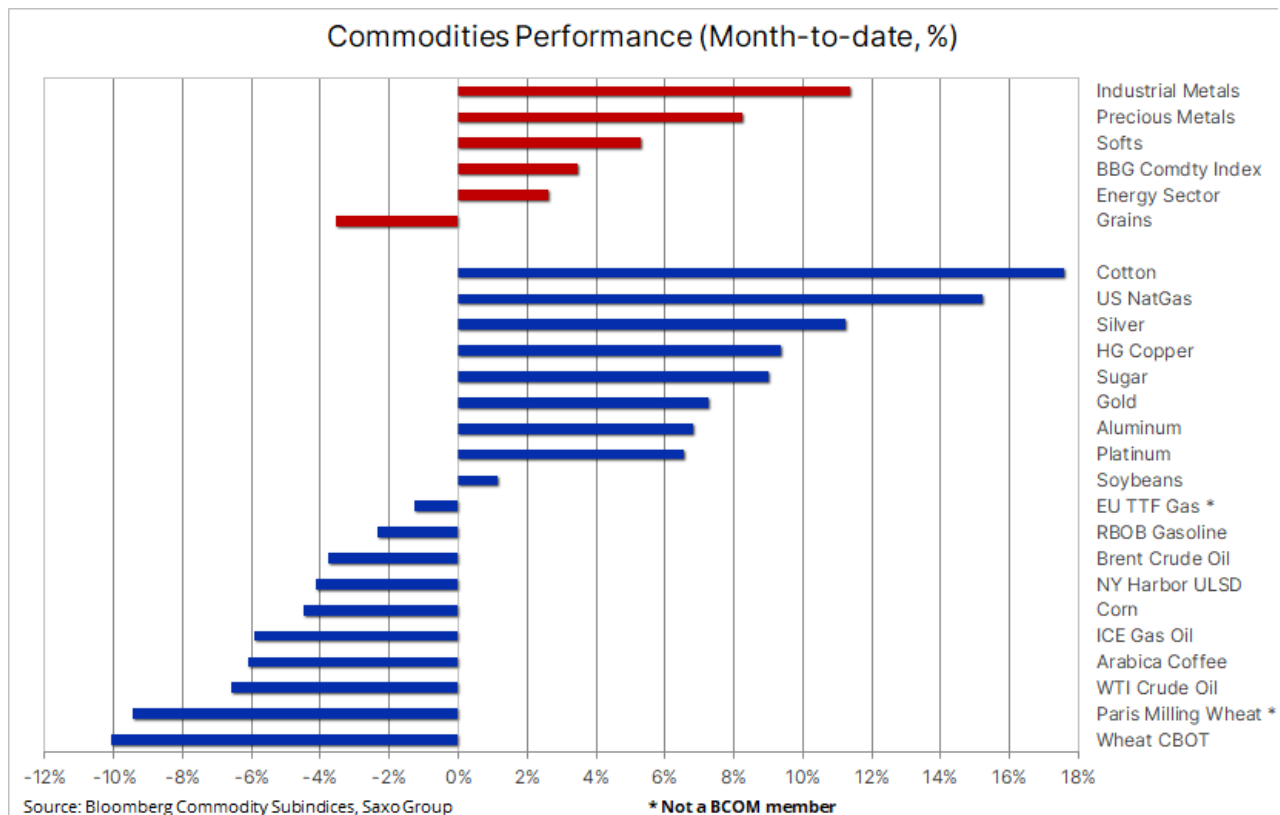
this magnitude has only been seen prior to three previous recessions. Short-term interest rates have been driven higher by the Fed's actions to raise the overnight Fed Fund rates, while longer-dated bond yields are lower on the prospect of slower growth (or even a recession) together with anchored long-term inflation. You can read more in this fixed income [update](#) from my colleague Redmond Wong in Hong Kong.



Source: Bloomberg & Saxo

Commodities have seen a strong November so far as the Bloomberg Commodity index trading up 3.4%, with gains being led by industrial and precious metals. This is despite the daily news of a worsening situation in China, where local officials battling with a record number of Covid cases are once again under pressure to implement President Xi's strict and increasingly unpopular Covid zero policy. In order to support the economy, the People's Bank of China, stepped in Friday and cut banks reserve requirement ratio by 0.25%.

While the energy sector has struggled amid a seasonal slowdown in demand that was increased by the developments in China, other markets, especially precious metals, have found support from the drop in long-end yields and a dollar which has softened by almost five percent this month. Driven by a lower-than-expected US CPI print earlier this month, emerging weakness in US economic data and the publishing of the minutes from the recent Federal Reserve meeting which discussed moderating the pace of future rate hikes.



### Cycle low in gold, silver and copper?

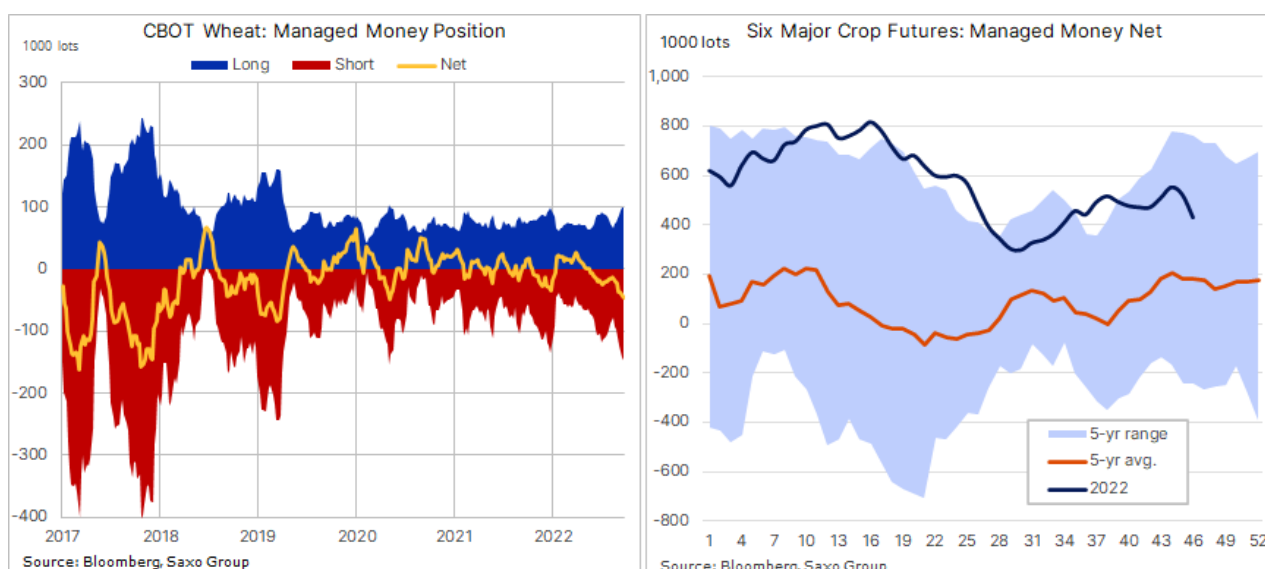
Following developments that have supported a strong rebound in gold, silver and copper, as well as the 170 dollar rally from what increasingly looks like a cycle low around \$1615, gold spent the past week consolidating before finding support in the \$1735 area. Overall, Saxo maintains its long-held bullish view on gold, and with that more so for silver. This is primarily driven by a combination of an incoming economic slowdown and major repricing as the market realises long-term inflation will settle at a higher level than the sub 3% currently being priced in.

However, with a continued lack of buying interest from ETF investor and increased competition from bonds as yields drop, a further gold extension above the important \$1800 area will likely require further declines in the yields and the dollar or some other catalyst that sees a run to safety. A technical update from Kim Cramer, our Technical Analyst, can be found [here](#).

### Grains sector weakness led by wheat

At the bottom of the performance table, we find the grains sector. Grains are heading for a monthly loss, primarily driven by weakness in wheat prices in the US and Europe. The weakness is driven by a continuation of the Ukraine grains corridor and a bumper Russian crop looking for a home around the world. Speculators have responded to the general weakness by cutting the total net long across the six major grains futures contract to a three-month low at 430k contracts. According to the latest [Commitments of Traders](#)

[Report](#) covering the week to November 15, speculators had the biggest one-week clear-out of corn longs since August 2019. Meanwhile, the wheat net short extended to a 27-month high at 47k contracts with soybeans and soymeal also suffering setbacks.



## Crude oil troubled by China lockdowns and recession worries

Crude oil trades lower for a third consecutive week as demand fears, especially from an increasingly locked down China, weigh on sentiment. A G7-sponsored price-cap plan on Russian oil looks dead in the water as EU countries struggle to agree on a level – the result being either no cap or a level so high that it will not have any meaningful impact on supply, led alone Russia's response. The 12-month futures spread in WTI and Brent have both weakened to the lowest backwardation since last December, reflecting a market concerned about recession and a seasonal slowdown in demand hurting the front month contracts.

In addition, the fact that the market is not pricing in a premium for oil ahead of the December 5 EU embargo on Russian seaborne crude exports highlights the impact of a sharp slowdown in China – the world's biggest importer of crude oil. Middle East producers have seen spot premiums for key Persian Gulf graded oil, decline sharply after commanding elevated premiums since the invasion of Ukraine when many buyers started to look elsewhere than Russia, thereby lifting demand for Mideast crude.

The slowdown in demand from China will be temporary but having unsuccessfully fought Covid outbreaks with lockdowns for months, the prospect for an improvement looks month away. This is unless Chinese officials start following the 20-point plan to ease Covid Zero policies that were issued earlier this month by the health authorities. Brent trades near the

lower end of its established range, but with multiple uncertainties related to demand and supply, the prospect of a downside extension seems limited in our opinion.



Source: Saxo



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