FT.com
FINANCIAL TIMES

Commodity super-cycle is back in full swing

By Roger Jones
Published: February 1 2011 15:13 | Last updated: February 1 2011 15:13

Sovereign debt risks, high unemployment, the threat of deflation, regulatory uncertainty. Just a few of the anxieties currently keeping financial markets on edge and which set a less than auspicious backdrop for commodities to stage a strong performance in 2011.

However, raw materials markets are proving highly resilient to aftershocks from the financial crisis. In markets as diverse as copper, sugar, tin, cotton, gold, palladium and pork bellies, prices have now exceeded the peaks set in the bull market of 2006-2008; oil prices are again trading consistently above $90/barrel, while in the UK the cold snap pushed gas prices to almost double where they were in the run up to Christmas 2009.

Commodities usually perform best in the latter stages of economic recovery: it takes time for the spare capacity and excess inventories built up during a downturn to get worked off. But this cycle looks different. Raw materials shortages, infrastructure constraints and resource nationalism continue to hamper production growth for many commodities, while emerging market demand is already soaring. In the west, policymakers, are leaning heavily toward pro-growth monetary policy and appear unusually tolerant of inflation. The expansion phase of this economic cycle looks likely to exert even more stress on commodity supply than ever before.

The impact on demand is already evident. Global demand for many commodities hit all-time highs in 2010, much earlier than expected. The expansion in oil demand growth in 2010 was the second strongest of the past 30 years. An extra 10 per cent was added to global copper demand, taking it to its highest level ever. In agricultural markets, corn demand beat its all-time high by 4 per cent.

The future will see emerging market economies tighten further their grip on the global commodity markets. For the first time, using UN, International Monetary Fund and World Bank forecasts of population, living standards and urbanisation rates, Barclays Capital Commodities Research have quantified this trend. There are surprises.

Focus in metals markets recently has been on copper. China’s voracious demand for its rapidly expanding electricity network means its imports of the red metal will hit all-time highs again this year, in what looks like being an exceptionally tight market. However looking further ahead, the metal benefitting most from emerging market growth may turn out to be aluminium. Used in fast growing vehicles and packaging markets, its light weight makes it essential in an energy conscious world and its price differential with copper (it is currently less than a third of the price) means it may capture market share in some uses. A lingering overhang of spare capacity, means 2011 is a little early for aluminium to shine, but before long its price gap with copper should narrow considerably.

Wheat got more attention than other agricultural commodities in 2010, as bad weather hit supply. In 2011 the focus may shift. EM demand for corn and soyabean is growing more quickly than wheat due to their use in animal feed. Tellingly after years of self-sufficiency China turned into a large net importer of corn in 2010 and is already the world's dominant importer of soya. Recent bad weather in the US and Argentina has prompted sharp downgrades to both soyabean and corn harvests. These markets are likely to contribute further to food inflation concerns.

Energy efficiency and pollution reduction are key goals in emerging economies. But that is not preventing rapid growth in coal demand. China is poorly endowed with alternative energy sources and the speed of its coal-based electricity expansion has driven it to start importing coal for the first time. Bad weather has hit key coal exporters Colombia and Australia and the market is extremely vulnerable to more cold weather.

Oil demand in emerging markets is expanding less quickly than for coal, but provides the bulk of incremental growth. We expect non-OECD oil demand growth to expand at four times the rate of OECD growth in 2011. There are also plenty of geopolitical risks, with Nigerian elections presenting the biggest potential threat to supply. Expect oil to flirt with $100/barrel, but not materially exceed it, so long as OPEC spare capacity, currently at a fairly comfortable 5m barrels a day, does not get eaten into too deeply.

What about gold? In a mirror image of other commodities, demand for gold as a store of wealth in mature economies is strong, but jewellery demand from rural populations in places like India, is sluggish because of rising prices. Sophisticated investors have more options available to them than the average Indian farmer, however, so if financial market concerns do ease, gold could soon find itself out of favour. If so, the upward price trend in place since the UK finished halving its gold reserves in 2002, may be coming to an end.

This year promises to be a volatile one for commodities, with the hard evidence that the financial crisis only temporarily unseated the super cycle, becoming increasingly apparent.

Roger Jones is global head of commodities at Barclays Capital