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Global Perspective

Commodity prices and inflation – trends and implications

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1 December 2017

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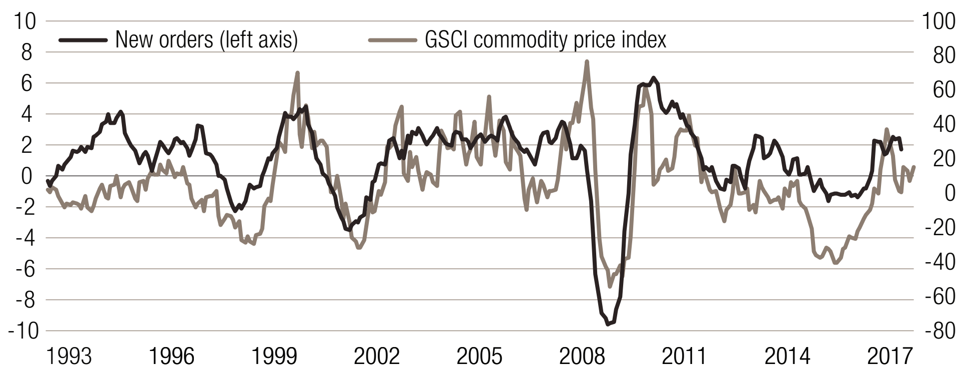
We expect the recent commodity price rise to continue through 2018. What does this mean for inflation and for investors? Here we discuss commodity price dynamics, their potential impact on inflation and the implications for investors. We argue that inflationary pressure is likely to be moderate and that equities and local currency debt in select emerging markets are best placed to benefit from a rise in commodity prices, in our view.

Commodity price dynamics

Commodity prices experienced a major correction in 2014 and 2015, falling by almost 60% as measured by the GSCI index. The driving forces behind this drop were varied: excess supply in many sectors; concerns over aggregate demand as economic growth remained anaemic in the post-global financial crisis world; and a strengthening US dollar all served to weigh on commodity prices.

Since then, commodity prices have remained low and are still well below their 10-year average, yet they have been on an upward trend more recently, increasing by more than 50% since the low point reached in early 2016. Approximately half of that increase took place over the last six months as investors' confidence in the global economic outlook has strengthened. We expect continued price rises in the coming year, supported by ongoing robust and synchronised global economic growth.

FIG. 1 DEMAND FOR COMMODITIES IS RISING AGAIN



Sources: Datastream, Bloomberg, LOIM. The new orders series is the GDP-weighted aggregation of US, Germany, Japan, Korea, Taiwan and Canada.

Demand drivers – rising global growth

The global economy has entered a phase of relatively strong and synchronised growth, with global growth in 2018 set to be the strongest since 2011, according to the IMF. And various indicators are confirming this strong growth outlook. Global Manufacturing Purchasing Managers' Indices remain well

above the 50 threshold that signifies an expansion, and in many cases they are at their highest levels in years, suggesting further improvements in the sector. This is also confirmed by global new manufacturing orders,[1] which continue to increase at a robust pace, and world trade volumes that are continuing to improve. This improvement in global growth will provide a positive backdrop and should support demand for commodities, in our view. More specifically, the strong manufacturing cycle could be particularly positive for industrial commodities.

China's changing role

Various developments in China's economy mean its contribution to commodity demand growth is likely to fall. Will this halt global demand growth for commodities? We think not.

China has certainly played an important role in the rise of commodity prices over the past fifteen years as the economy industrialised and invested massively into fixed assets, namely housing and infrastructure.

However, the rising relative importance of the service sector in the economy and the gradual moderation in fixed investment growth mean that each unit of GDP generated requires fewer commodity inputs than before. Moreover, the active policy of the Chinese authorities to reduce pollution, and the overcapacity in some commodity intensive sectors such as steel production also serves to moderate demand.

Despite this, we believe China will remain the main consumer of commodities globally and that growth will continue, albeit at a slower pace, to support demand of commodities.

Supply side dynamics

Despite the sharp decline in prices in recent years, the supply of many commodities has continued to increase, albeit at a slower pace in many cases. This is because the investment cycle in the commodity sector is long (counted in years, not months) and the sums involved can make it very costly to end an investment project midway; supply is relatively unresponsive to price in the short term.

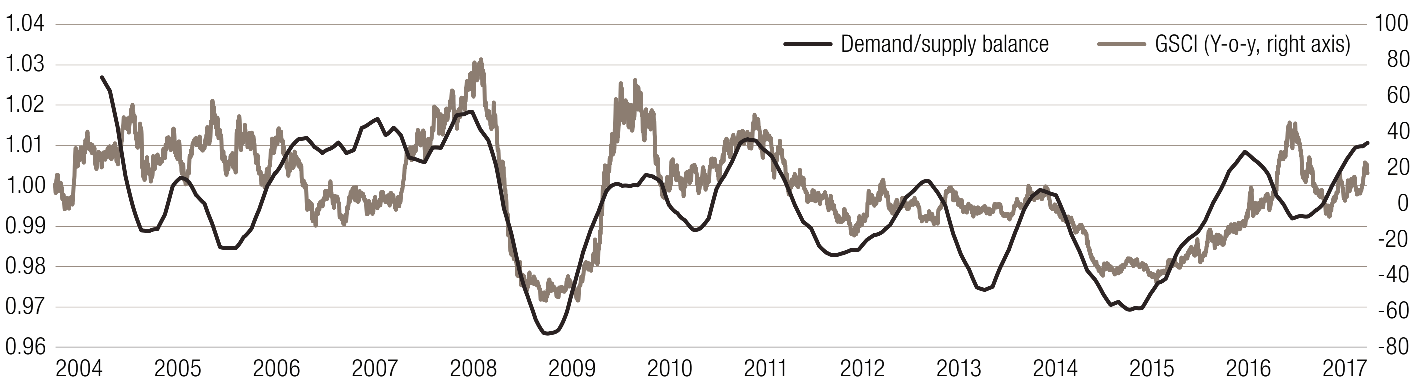
Nevertheless, lower commodity prices have led to a dramatic reduction in investment by commodity producing sectors and countries. As a result, the slower pace of supply growth is likely to remain for some time and this could put **upside pressure on prices in the medium term** if global growth remains strong for some years.

In the short term, we believe continued high levels of inventories in some sectors – notably industrial metals and oil – mean that price rises will not be abrupt in nature. However, we do not believe inventories are so high as to cause a sustained decline in prices either. Moderate is our adjective of choice here.

A reasonable balance of influences

On balance, when looking at various indicators of supply and demand for various commodities, we conclude that the market is roughly balanced, suggesting little immediate price pressure. However, with global growth set to remain strong, we expect the demand for commodities to grow faster than supply over the coming year, which could lead to some upside pressures on commodity prices. And we expect price rises to be moderated by high levels of inventories in some key sectors.

FIG. 2 EXCESS CAPACITY HAS BEEN ABSORBED AND DEMAND EXPECTED TO REMAIN STRONG



Sources: Bloomberg, LOIM.

[1] We use an average of new orders for the US, Canada, Japan, Germany, Korea and Taiwan.

Commodity price trends

Industrial metals

With high inventory levels for many metals in China, including iron ore, aluminium and copper, there are some concerns that a slowdown in fixed investment and the reduction in the production of steel and some other metals could lead to a price correction. However, we believe that Chinese demand for commodities will continue to grow, albeit at a slower pace. We believe this is backed up by Chinese import data that shows that commodity imports continue to increase at a modest pace.

Coupled with global growth remaining strong, we believe this means demand for base metals should remain well supported. However, compared to the same period last year, the sector has lost some support with the disappearance of the expectations of big investment in infrastructure, especially in the US.

One issue we are watching carefully is the tentative signs of credit tightening in China post the 19th Congress, given that rising private debt has been a big source of support for growth in recent years.

Oil

The inversion of the oil futures price curve (meaning that the longer end of the oil futures curve is lower than the shorter end) suggests that the OPEC and Russian production cuts are playing a role in driving up the price.

There is also some pressure from some short-term supply issues, like the closure of the Keystone pipeline in the US, and a geopolitical risk premium stemming from the continued tensions in the Korean peninsula and the corruption clampdown in Saudi Arabia, which is generating fears of instability and a resultant negative impact on future supplies.

Will supply drop to an extent that the oil price spikes? On balance we think not. Yes, we expect the inversion of the oil futures curve to reduce the incentive for producers to continue to build up their inventories (since the future price is lower than they can get on the spot market), and yes, we expect it to reduce the incentive at the margin for US shale producers to increase production further since they use futures to hedge their revenues. However, we believe that the current higher price will broadly continue to encourage shale production and that this will either limit or reverse any upwards pressure on the oil price relating to the continued OPEC and Russian production cuts. This all suggests a two-way pricing risk in 2018, in our view.

What do higher commodity prices mean for investors?

Higher commodity prices have the potential to positively impact emerging market equities and local currency debt – asset classes we already have a positive view on. Higher commodity prices would provide a boost for commodity exporters. As such, emerging economies like Brazil, Russia, Chile and South Africa and developed economies like Canada and Australia are likely to benefit and this improved outlook should support local equity markets in general, in our view.

Will higher commodity prices lead to higher inflation?

An important question for investors who have grown accustomed to low inflation rates, particularly in advance economies, is: will any commodity price rises create inflationary pressures anytime soon? First, it is important to note that what matters for inflation is growth rate of prices over the past year, not the absolute price level. In addition, for higher commodity prices to have a lasting impact on inflation, the increase needs to be persistent and not a one-off. And since commodities are imported in the majority of cases, the change in price in local currency terms is what matters.

Commodity prices are passed-through to inflation via two main channels:

1. Energy prices and their impact on consumer energy prices (primarily automotive fuels).
2. Industrial commodities prices and their impact on producers' input costs, which are ultimately passed on to consumers.

1. Consumer energy prices

Energy price increases tend to be passed to consumers quickly – usually within a few months. However, as mentioned above, when thinking about inflation, what matters is the growth rate of prices versus the same period the year before, not the level.

With this in mind, we used the estimated relationship between a change in oil prices and the energy component of CPI to forecast the impact of an oil price change on the change in headline inflation.

Taking the consensus forecast for oil prices (WTI crude) to fall to USD 53.50 by the end 2018, we find that for most countries energy prices would actually be a drag on headline inflation in 2018, since it means that oil prices would be lower than the current level of nearly USD 59.

However, if we assume oil prices continue to increase gradually to USD 70 between now and the end of 2018, we estimate a small positive inflationary pressure of +0.4% in December 2017 in the US, and +0.3% in July 2018 in the case of the Eurozone.

TABLE 1 ESTIMATED CUMULATIVE IMPACT OF OIL PRICES ON INFLATION BASED ON OIL PRICE REACHING USD 53.50 BY END 2018

	CUMULATIVE MONTHLY CHANGES (%)						
	US	UK	EUROZONE	JAPAN	CANADA	SWITZERLAND	SWEDEN
NOV-17	0.33	0.01	0.17	0.00	0.03	0.08	-0.03
DEC-17	0.40	0.06	0.06	-0.03	0.03	0.07	-0.03
JAN-18	0.14	-0.06	-0.19	-0.16	0.00	-0.06	-0.11
FEB-18	0.18	-0.11	-0.18	-0.21	0.02	-0.05	-0.12
MAR-18	0.15	-0.10	-0.11	-0.32	0.03	0.01	-0.05
APR-18	-0.03	-0.09	-0.15	-0.39	-0.01	0.00	-0.04
MAY-18	-0.05	-0.13	-0.04	-0.49	0.01	0.04	-0.01
JUN-18	-0.12	-0.10	0.04	-0.50	0.03	0.08	0.07
JUL-18	-0.06	-0.09	0.10	-0.49	0.03	0.11	-0.04
AUG-18	-0.19	-0.15	0.02	-0.50	0.02	0.03	-0.08
SEP-18	-0.54	-0.23	-0.08	-0.52	0.00	-0.05	-0.15
OCT-18	-0.27	-0.27	-0.16	-0.57	0.01	-0.11	-0.09
NOV-18	-0.46	-0.32	-0.31	-0.65	-0.01	-0.17	-0.13
DEC-18	-0.61	-0.37	-0.39	-0.72	-0.02	-0.22	-0.12
JAN-19	-0.61	-0.37	-0.39	-0.70	-0.02	-0.24	-0.12

Source: LOIM estimates.

TABLE 2 ESTIMATED CUMULATIVE IMPACT OF OIL PRICES ON INFLATION BASED ON OIL PRICE REACHING USD 70 BY END 2018

	CUMULATIVE MONTHLY CHANGES (%)						
	US	UK	EUROZONE	JAPAN	CANADA	SWITZERLAND	SWEDEN
NOV-17	0.33	0.01	0.17	0.00	0.03	0.08	-0.03
DEC-17	0.42	0.06	0.08	-0.03	0.04	0.08	-0.03
JAN-18	0.21	-0.04	-0.14	-0.13	0.01	-0.03	-0.10
FEB-18	0.30	-0.07	-0.10	-0.17	0.03	0.00	-0.11
MAR-18	0.32	-0.04	0.00	-0.26	0.04	0.07	-0.03
APR-18	0.19	-0.02	0.00	-0.31	0.01	0.09	-0.02
MAY-18	0.22	-0.05	0.14	-0.39	0.04	0.14	0.02
JUN-18	0.19	0.00	0.25	-0.38	0.06	0.20	0.10
JUL-18	0.31	0.02	0.34	-0.35	0.06	0.25	0.00
AUG-18	0.21	-0.02	0.30	-0.35	0.05	0.19	-0.03
SEP-18	-0.11	-0.09	0.22	-0.35	0.03	0.12	-0.10
OCT-18	0.22	-0.11	0.17	-0.38	0.05	0.08	-0.04
NOV-18	0.06	-0.15	0.04	-0.45	0.04	0.04	-0.07
DEC-18	-0.07	-0.20	-0.03	-0.51	0.03	-0.01	-0.07
JAN-19	-0.08	-0.20	-0.03	-0.49	0.02	-0.03	-0.07

Source: LOIM estimates.

2. Industrial producers' input costs

The impact of commodity price changes on input costs is a much slower process and depends on the extent to which companies are willing take a hit on their bottom lines or pass on higher prices to consumers. We find that there is generally a 12 to 18 month delay between an increase in commodity prices and its impact on core inflation. This suggests that given the rise in commodity price over the past year, we could expect some modest upward pressures to appear in core inflation figures in the second half of 2018.

Seeing the fuller picture

However, the above does not address causality or more precisely, whether it's the increase in commodity prices that leads to higher core inflation or a common source of inflationary pressure such as stronger aggregate demand. If stronger aggregate demand – rather than supply-side issues – is the driving force behind commodity price rises, the inflationary pressure will depend on the extent to which there is excess capacity in the economy to absorb the demand without increasing prices.

Important information: Please see important information at the end of this document.

In economies that still have a significant amount of excess capacity, like the Eurozone, higher commodity prices may not automatically lead to higher core inflation. And economies such as the US, with lower excess capacity, we believe that other factors holding back inflation in recent years, like technological changes, are unlikely to disappear, offsetting some of the impact on inflation that comes from higher commodity prices and making it unlikely that core inflation will sustainably breach 2%, in our view.

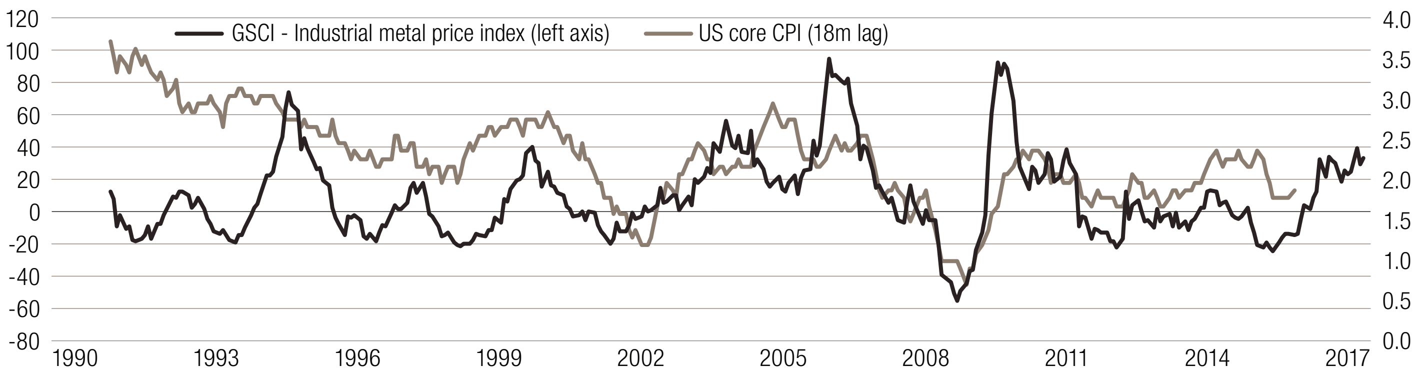
Conclusion

Considering the positive macroeconomic backdrop, we expect commodity prices to broadly rise in the coming year. We expect the price rises to be focused on industrial commodities with energy prices being more stable. That said, we are watching carefully for tentative signs of credit tightening in China post the 19th Congress as a big slowdown in Chinese growth could depress demand for commodities and put the brakes on any potential price increases.

The expected increase in commodity prices and continued strong global growth – which should continue to reduce the amount of excess capacity – are likely, in our view, to lead to some inflationary pressures in the second half of 2018, especially in the US where there is very little excess supply currently. But we expect these to be modest because structural factors such as technology that have been holding back inflation in recent years are likely to persist.

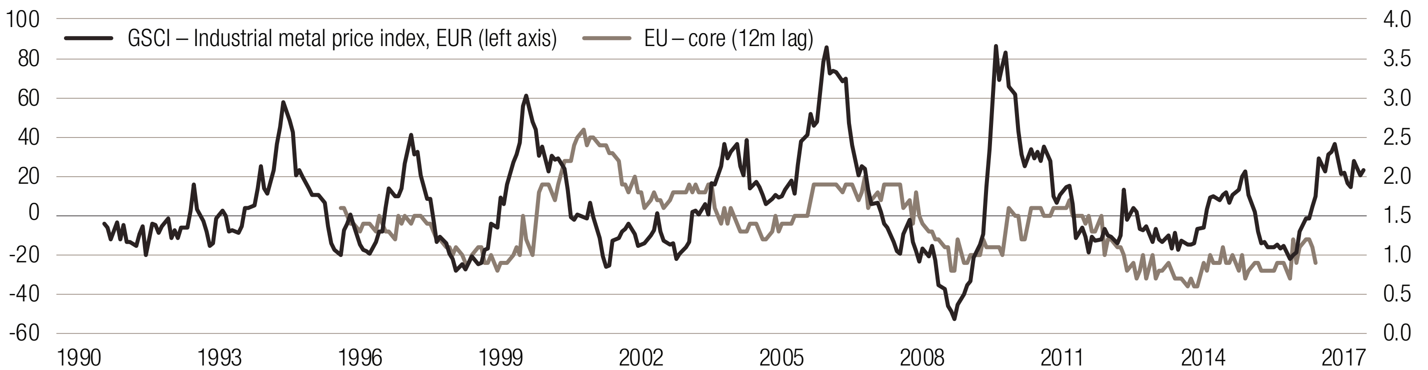
Higher commodity prices would likely benefit commodity exporters. This strengthens our view on emerging market equities and local currency debt.

FIG. 3 COMMODITY PRICES (YOY) AND US CORE INFLATION



Source: BLS, Datastream, Bloomberg, LOIM.

FIG. 4 COMMODITY PRICES (YOY) AND EUROZONE CORE INFLATION



Source: Eurostat, Datastream, Bloomberg, LOIM.

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