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Sign of the times

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The end of the commodity party?

Adam Lewis, committee chairman and associate editor, Fund Strategy

Welcome to the second Fund Strategy Investment Committee. We are joined for our independent view by Cazenove chief investment officer Richard Jeffrey.

During a recent interview I did with a fund manager, it was suggested that after a decade of rising prices, the "supercycle" enjoyed by commodities is at an end. The theory went that 10 years of fast-rising growth meant it took a long time for supply to catch up with demand but now demand has slowed and supply has caught up. While not anticipating a collapse in prices, the manager said commodity cycles tend to last for a decade and the outlook for investing in commodity equities will remain difficult for at least another 10 years. So now is not a great time to invest in countries solely geared to commodities or commodity-related sectors. Can this really be true? One of the big investment stories last year was of how the US was expected to be energy self-sufficient by the end of this decade due to its rising shale output while gold was seen as the great diversifier, especially when investors took a risk-off attitude.

The fortunes of commodities have also been largely tied to those of emerging markets while oil and gas prices tend to react more quickly than other asset classes to macro-economics. Political concerns are also an issue. The Middle East is never far off the agenda and an Israeli strike on Iran would send prices higher.

So I ask these two questions: Are we at a pause in the supercycle or is the party over? And do some commodities offer better prospects than others and, if applicable, how are you getting exposure to those asset classes?

Mike Deverell, investment manager, Equilibrium Asset Management

"There is no doubt that many of the drivers of returns for commodities remain in place over the longer term. However, in the short term, commodities are highly cyclical and the direction is difficult to call.

Infrastructure spending in emerging markets will stay high and therefore demand for steel, copper and the like should be well supported in the medium term. Soft commodities are likely to increase in price with population growth and as the emerging middle class in developing countries demands more and better-quality food. Fuel prices could be kept in check by the shale revolution.

Rather than buying highly volatile commodity funds, we prefer to play these themes in different ways. We like the JP Morgan Emerging Markets Infrastructure fund and also use the Sarasin AgriSar fund, which will benefit from the advances in agricultural technology necessary to provide adequate food in 20 years' time.

I would not want to touch gold right now. Prices are impossible to predict but gold is no longer an inflation hedge or a store of value; the current price is simply a product of fear. If the global economy returns to anything near normality, it could slip dramatically.

Jonathan Davis, managing director, Jonathan Davis Wealth Management

"As far as we are concerned, 'it is all about the dollar'. It bottomed out vis-à-vis the other major currencies about two years ago. Not coincidentally, that (give or take) appears to be about the peak in most commodities since the reflation of 2009. Certainly, up to now, that included copper, precious metals, oil and even agricultural commodities. The WTI price, for example, is down about 20 per cent from mid-2011. This has been reflected in commodity equities. Gold miners (for example, GDX ETF) are down some 35 per cent from the 2011 highs.

As the dollar appears to be strengthening, this has the potential to push down even harder on the commodity space. Thus we will remain cool on this asset class until the dollar convincingly heads down. Medium to long term, we expect to return to being bullish. We think the dollar will eventually peak and then crash, which will occur when there is a huge and long-term sell-off of US Treasuries, envisaged in one to three years' time. With currencies everywhere being debased, long term, we want to return to commodities.

We expect to access these normally via ETFs such as GDX, Marlborough Commodity or DB Agricultural. We hope the FCA will allow exchange traded commodities (ETCs) and exchange traded notes (ETNs) to be treated as other ETFs from a regulatory point of view.

James Calder, head of research, City Asset Management

"Taking a very simplistic view, if one is positive on the outlook for emerging markets, which we are (we include China), one cannot be negative on the outlook for commodities. It is hard to envisage the oil price not being in a structural bull market.

Gas is a different story as it is highly dependent on geography. With the advent of US shale, the price has plummeted there, but for the rest of the world it remains strong. Gold is more of an inflationary hedge than a true commodity, but as inflation expectations remain, we continue to hold physical gold. We also consider the wider metals market and remain positive. The outlook for soft or agricultural commodities is more difficult to predict because of their seasonality and susceptibility to factors such as weather.

Within our multi-asset approach, we consider real commodities (metals, energy and softs) to be an asset class in their own right, but accessing them is challenging. It usually means an equity fund, which provides equity exposure as opposed to access to the desired commodity. Gaining access to real commodities requires a manager with specialist skills, knowledge of all commodity futures markets and the ability to take market views. Only a few funds offer this and the Threadneedle Enhanced Commodities fund is our choice.

After a decade of rising prices, the commodities 'supercycle' appears to be pausing for breath as it adapts to economic and geopolitical changes. The panel weigh up prospects for the sector

THE INDEPENDENT VIEW

Richard Jeffrey, chief investment officer, Cazenove Capital Management

I have a lot of sympathy with the idea that the commodity cycle is over, but I do not agree that these cycles take place over a set number of years. And it is important to recognise that the global economic map has changed considerably from 10 or 20 years ago.

The emergence of China as an economic power has proved a major supply-and-demand shock. However, given the now relatively prolonged upswing in demand, supply has had sufficient time to react. Consequently, for the foreseeable future it is unlikely there will be major upwards pressure on prices, even if we see a return to more broadly based global growth.

We have probably seen the peaks in industrial metal prices. While I would not rule out the occasional spike in individual commodities, the general trend for the next few years will be flat to downwards. Oil appears fairly stable but is more likely to go down than up. Long term, the changing situation in the US, which is likely to be energy-positive within five years, will prove crucial. It will change the global energy supply/demand balance, making it more likely that prices will fall than rise.

With no major inflationary pressures for materials and commodities likely any time soon, it is not an area we are excited about. Indeed, given recent geopolitical developments, we would have expected the gold price to react more than it has. It has maintained a downward trend, which seems to be a sign that investor demand for commodities is diminishing.

If we were to see significantly faster growth from China and the wider Asian region, we might reassess these views, but if anything, China has moved beyond its peak growth rates.

Ryan Hughes, portfolio manager, Skandia, part of Old Mutual Wealth

"To believe that the commodity party is over is essentially to take the view that global growth is over.

I do not think many people believe this but, with so much volatility in commodity prices, it is easy to have that "morning after the night before" feeling each time prices take a tumble. However, the long-term demand drivers remain firmly in place with emerging markets still expanding at a frightening pace. This will support underlying long-term demand for the key commodities but the markets are rife with short-term speculators, which creates the unpredictable element in prices and removes rational analysis of supply and demand.

I think that the key to the commodity conundrum is the time horizon. Thinking of it as a "party" plays in to the speculators' hands so I much prefer to view it as a "festival", which seems to go on much longer. With this in mind, investors should consider some exposure to commodities but, just like any other investment, patience will be the key. As long as the world keeps growing, I believe the commodity festival will be a profitable trade for many more years.

Tim Cockerill, head of collectives research, Rowan Dartington

"The question about the supercycle depends on timeframe. The growth in emerging markets and the developed world is not going to stop so the demand for commodities will continue to expand long term. What is long term? Five years plus, and definitely 10 years plus.

Given the huge potential in China and India for consumer goods, it is hard to see how the supercycle will end. Today it may be pausing for breath for all the reasons we know – financial crisis, recession in the eurozone, stockpiles etc – but these negative factors will recede. So the demand is there.

The flipside is whether the supply side is constrained. Although a lot of investment was poured into the sector in the past 20 years, there has been a slowdown in the past three or four years as the recession has hit and demand fallen. Adding capacity is a slow business. In the next few years, I suspect prices will remain subdued because the de-leveraging process in the West has a long way to go. During this period an equilibrium of sorts could be established between demand and supply (mines working under capacity) but further out I expect demand to resume a strongly upward trend.

Shale oil and gas may help the US but rising demand from the emerging markets looks likely to offset this globally.

Lee Robertson, chief executive, Investment Quorum

"In our view, we remain within a commodities supercycle although it is true that year-to-date base metals have been weak.

China's slowdown is having a well-publicised impact on metals, oil has been sluggish and even agricultural commodities look somewhat disappointing. Precious metals have also suffered as investors move back into equities at the expense of gold in particular.

However, in our opinion, we are in a mid-cycle correction with commodities only having a difficult time around the Chinese economy, over-supply in certain cases and climatic issues in respect of certain agricultural commodities. We think the long-term story remains positive.

The demand from emerging markets over the next decade will continue to be a positive driver of commodity prices as the scale of their ambition is simply breathtaking. Gold, while going through a weak patch, remains in demand from emerging market governments as they seek to build larger reserves, which will support prices.

In summary, we do not think the party is over but there is potential for a prices and valuations rollercoaster until the global