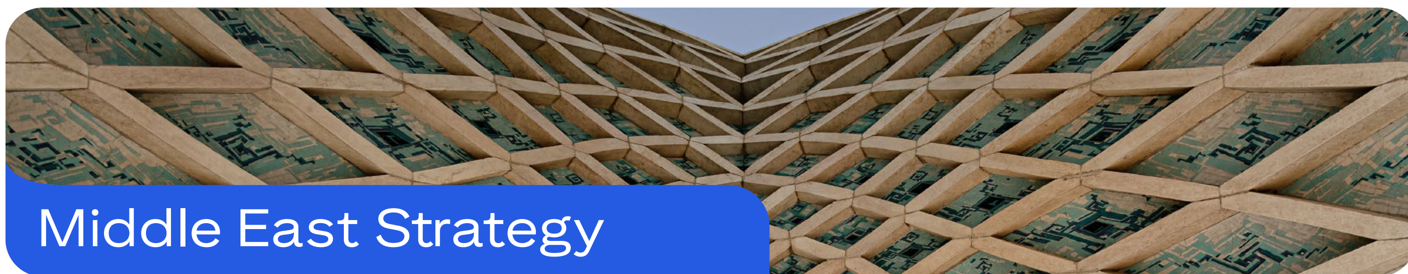

October 28, 2024

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Commodities: Balancing short-term risks with the longer view

Summary

- **Oil:** Remains sensitive to geopolitical developments, yet despite ongoing tensions, prices remain below this year's average. We believe the possibility of a serious supply disruption is limited and would instead draw focus to the longer-term decline in demand for oil.
- **Gold:** Earlier this year, we wrote about three main drivers for gold's bull run: central bank demand, China demand, and ETF flows. Months later:
    - Central bank demand has declined as central banks pause purchasing in the wake of price increases
    - China retail demand has fallen, a headwind which may be exacerbated by Chinese stimulus measures.
    - ETF flows have turned positive, but the trend isn't as strong as might have been expected, particularly given the aggressive 50bp rate cut by the US Fed.
- **Copper:** The rally (nearly 12% from trough to peak) in September was overdone, as markets priced in more impact from China stimulus than was reasonable. Accordingly, we see October's correction as healthy behaviour in a metal whose usage remains weak.

Portfolio Implications

- **Oil:** Suitable investors may wish to hedge against short-term volatility; however, in the long term, the fundamental macroeconomics will continue to drive oil lower to our expected level of $60/bbl by the end of 2025.
- **Gold:** As the price of the precious metal defies a weakening of its core drivers, our concern regarding a potential drawdown is amplified. Investors should be cautious not to treat volatile assets as a safe haven.
- **Copper:** For investors willing to be patient for a meaningful pickup in industrial activity, we estimate that current levels – near $9,400/mt at the time of writing – remain attractive.

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Oil remains susceptible to Middle East flare-ups

Oil prices remain sensitive to geopolitical developments in the Middle East. Yet, despite ongoing tensions, particularly around the Israel-Hamas conflict, oil prices are trading below this year's average of $81, with Brent crude hovering around $74/bbl (**FIGURE 1**). While concerns remain about the potential direct conflict between Israel and Iran, the likelihood of a significant escalation disrupting global oil supplies seems limited.

Oil fundamentals point to a $60/bbl average price in 2025. However, in the very near-term, any escalation in the Middle East that would lead to a disruption in flows could see prices surge to $100/bbl, perhaps beyond. According to Bloomberg, Brent options interest has surged 25% in October as traders seek to protect themselves from supply-related disruptions, with open interest topping 4 million contracts, equivalent to four billion barrels.

FIGURE 1: Brent crude trading below YTD average

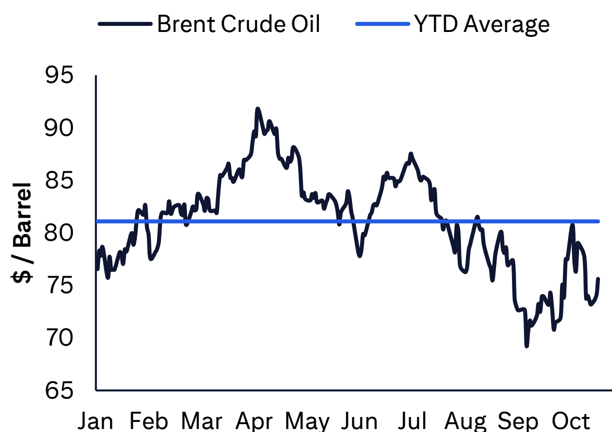
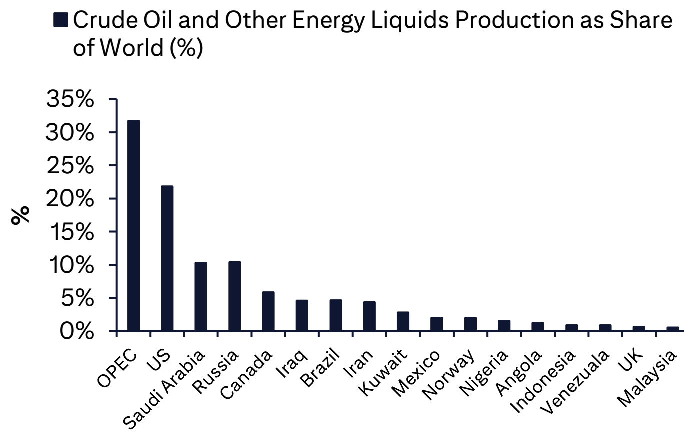


FIGURE 2: Production as % of Global Share



Source: Bloomberg, Haver Analytics, and Citi Global Wealth Investments, as of October 24, 2024.

Managing geopolitical risks in the Middle East: Saudi Arabia's oil facilities, while geographically close to the conflict zone, are well-protected and have demonstrated resilience in previous threats. The 2019 attacks on Saudi oil infrastructure caused temporary disruptions, but the country's swift recovery demonstrated its capacity to maintain stable production even under challenging circumstances.

While risks exist, the current environment suggests that a major disruption is not the most likely outcome. The broader Gulf Cooperation Council (GCC) countries are equipped with infrastructure capable of mitigating potential disruptions. Both Saudi Arabia and the United Arab Emirates (UAE) can reroute oil exports through pipelines that bypass the most vulnerable maritime chokepoints – namely, the Strait of Hormuz. This preparedness has provided markets with a sense of stability, as evidenced by oil prices failing to sustainably breach the $80/bbl level since August despite the proximity of conflict. Instead, the focus has shifted towards underlying macroeconomic factors, which we have long argued project a downward trend for oil prices.

In particular, concerns over a global economic slowdown, coupled with weaker-than-expected demand from China, have acted as counterweights to upward price pressures for energy markets. Meanwhile, one of the key elements helping to keep oil prices stable is the build-up of crude stockpiles, particularly in the United States. Cushing, Oklahoma – home to a key oil storage hub – has seen several weeks of inflows, providing a buffer against potential supply disruptions. This growing inventory provides reassurance to markets that any short-term shocks can be absorbed, minimising the likelihood of significant price spikes.

However, the US economy continues to outperform expectations, which has bolstered demand for oil and countered some of the concerns about a potential global slowdown. Lower-than-expected inflation in the US has further reinforced the view that a hard landing is unlikely in the near-term, which in turn supports stable demand for energy.

Potential shifts in US policy: Looking ahead, the possibility of shifts in US policy following the 2024 presidential election could have implications for global energy markets. A Trump win could see a return to 'maximum pressure' policies on Iran, aimed at reducing the country's oil revenue. However, it is worth noting that US policy shifts, while important, are typically implemented gradually, giving markets time to adjust. While such policies could introduce new risks for Iranian oil exports, they are unlikely to lead to sudden disruptions in global oil supply.

On the other hand, sanctions relief for Russia – a much larger producer of crude oil than Iran (**FIGURE 2**) – could be a possibility under a new Trump administration, which might allow Moscow to increase its oil exports. This could put downward pressure on prices, providing a counterbalance to any supply risks stemming from the Middle East. In either scenario, markets are likely to remain well supplied, particularly as other major oil producers, such as Saudi Arabia and the UAE, have both the capacity and willingness to increase output if necessary.

If Kamala Harris were to win the US election, her victory would place greater emphasis on renewable energy, climate action and reduction in fossil fuel dependence. Where traditional energy producers are likely to gain under a Trump presidency, clean-energy producers would benefit under Harris and the Democrats. An increased focus on clean energy technologies, which could negatively impact traditional fossil fuel energies, would boost demand for key input commodities such as copper, lithium and cobalt. The response in energy markets would depend on how aggressively a Harris administration implements changes and how effectively the US energy infrastructure adapts to a greener focus.

Long-term demand trends: While short-term market fluctuations are driven by geopolitical events, the longer-term outlook for oil demand is shaped by broader structural changes. The International Energy Agency (IEA) has projected that global oil demand growth will weaken over time, particularly as EV adoption accelerates and renewable energy sources gain traction. China, historically a major driver of oil demand, is also seeing a decline in oil intensity as it transitions to a more service-oriented economy and invests heavily in green technologies.

These trends suggest that while oil will remain a crucial part of the of the global energy mix for the foreseeable future, its role may diminish as the world shifts toward cleaner energy sources. For oil-producing countries, this presents both a challenge and an opportunity. The GCC countries, which account for around 25% of global crude output, have already begun investing in economic diversification efforts to reduce their reliance on oil revenues (See Middle East Strategy: Economic Diversification and the Reliance on Commodities). Saudi Arabia's Vision 2030 plan, for instance, aims to transform the country's economy by developing sectors like tourism, entertainment, and technology.

Stability with managed risks: Overall, while the oil market remains sensitive to geopolitical developments, the likelihood of a significant disruption appears low. The ongoing conflict between Israel and Hamas, as well as tensions involving Iran, have certainly raised concerns, but the measures in place – both in terms of regional infrastructure and international diplomacy – suggest that the risks are being effectively managed. Brent crude remains within a stable range, and markets are absorbing potential threats without overreacting.

In sum, while the oil market will always be sensitive to events in the Middle East, the prospect of a major escalation affecting oil flow remains less likely than not, and the global energy landscape appears to be moving toward greater stability in the long term. We expect oil prices to continue trending downward, ending 2025 around the $60/bbl. level.

Gold: All that glitters?

The marathon continues. Gold prices are notching further record highs as investors flock to the yellow metal seeking safe-haven as we approach what is expected to be a tight US presidential race on November 5, coupled with the conflict in the Middle East. Geopolitical risks continue to support demand for gold as a risk hedge. Strength in gold was evident even as the US Dollar reached its highest level in three months, with the precious metal rising above $2,750 an ounce on October 23rd (**FIGURE 3**).

Who is at the wheel? Earlier this year, we wrote about three main drivers for gold's bull run: central bank demand, China demand, and ETF flows. Months later:

- Central bank demand has declined as central banks pause purchasing in the wake of price increases; important to note, however, is that they are not selling. This is likely just a temporary pause, as we expect the strategic importance of gold reserves to cause central bank demand to be quite inelastic.
- China retail demand declined heavily in Q2-2024. While we don't yet have full Q3 figures, it's possible the path of policy easing the Chinese government recently embarked upon will cause demand to continue to fall.
- Bullion-backed ETF flows finally turned positive in May, peaking in July before falling notably in August and September (**FIGURE 4**). So far, October looks to be a positive month, yet flows are still far from what we'd expect given a rally of this magnitude. While we acknowledge that gold does have a momentum factor – people tend to sell after rallies – it's not only that outflows have increased, inflows have also decreased.

Where to from here? In the short-term, any escalation in the conflict between Iran-Israel should prove supportive for the precious metal, as the possibility of a wider regional conflict remains distinct. Furthermore, a Trump victory on Nov 5, widely expected to lead to more inflationary policies than under the alternative scenario of a Harris win, could see a spike in gold. Regardless of election outcome, we'd expect ETF flows to remain net positive, owing to central banks (almost globally) continuing a path of monetary policy easing. In the medium-term, we remain concerned about the downside risk. Rallies of this magnitude and longevity have often been followed by periods of stagnation or, worse, sharp drawdowns. And with the foundations for this rally looking shaky, we believe investors should remain cautious when entering the gold market, keeping in mind that our preferred vehicles for capital-preservation are US Treasuries, especially with the 10-year Treasury trading above 4%.

FIGURE 3: Gold's movements have defied the dollar

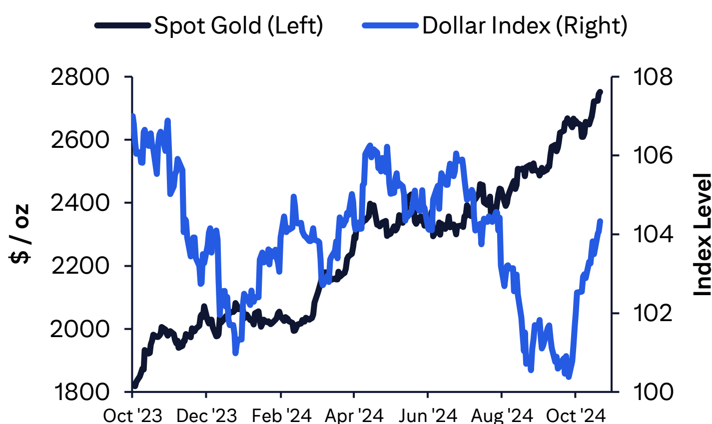
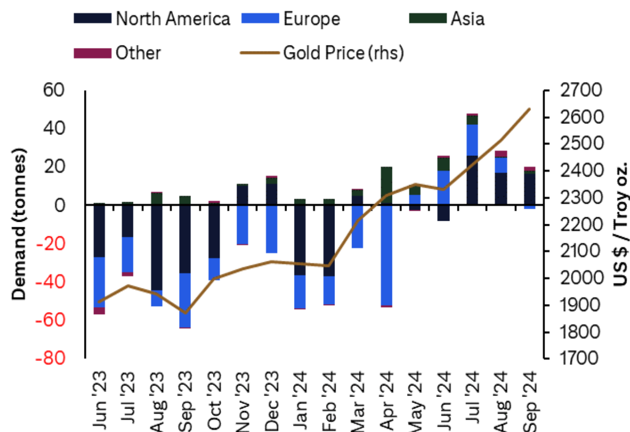


FIGURE 4: ETF flows are not as strong as might have been expected



Source: Bloomberg, Haver Analytics, World Gold Council, and Citi Global Wealth Investments, as of October 24, 2024.

Copper: Fed cuts, China stimulus, and the underlying fundamentals

As we've often repeated, the demand for – and thus price of – copper is driven *mainly* by one factor: industrial production – both its current level and sentiment regarding its direction. Investors saw a clear demonstration of this over the past several weeks. At the start of September, low manufacturing PMIs for major economies such as the US, China, and Germany caused copper's price to once again fall below the $9k/mt barrier (**FIGURE 5**), an event we covered in our last piece (Middle East Strategy – The lingering question of industrial production). At the time, we highlighted that those price levels represented an attractive entry point for long-term investors. It turns out we were half-right – it was *also* an attractive entry point for short-term investors.

Since then, copper has enjoyed quite a rebound, first rallying off the back of the Fed's 50 basis-point rate cut on September 18, as easing of monetary policy generally stimulates economic and industrial activity, followed by news of China's stimulus measures (which should also do the same, especially given support for the property market). This powerful combination caused copper's price to hit a 4-month high of $9,880/mt early October. Since then, however, copper's price retreated back down to around $9,400/mt, now trading on both sides of the $9,500/mt barrier.

It's understandable why investors are cautious about the base metal. It remains to be seen what impact the stimulus measures, which have injected liquidity and heavily boosted financial markets, will have on real economic activity, particularly on infrastructure. Moreover, the price increase – both of copper and general equities – was also due to expectations that the Chinese government would continue strongly on its path of policy support. When policy announcements began to slow, doubts crept in – and traders began to sell.

Far from disaster, we see this as a healthy correction after a rather optimistic rally, given that the fundamental driver of copper demand – industrial production – really hasn't shown any noticeable improvement, with major economies still in a manufacturing recession (**FIGURE 6**). As such, any softening in contraction – or a rebound into expansion – should bode well for copper prices. Until we see solid signs of a global manufacturing recovery – which Chinese stimulus may push along in the form of renewed orders – some volatility in the price of copper is to be expected. Moving forward, we estimate – as before – that current levels remain attractive for long-term investors who anticipate a manufacturing recovery in 2025 and are willing to weather possible volatility until then.

FIGURE 5: A succession of economic events in 2024 have led to volatility in the price of copper

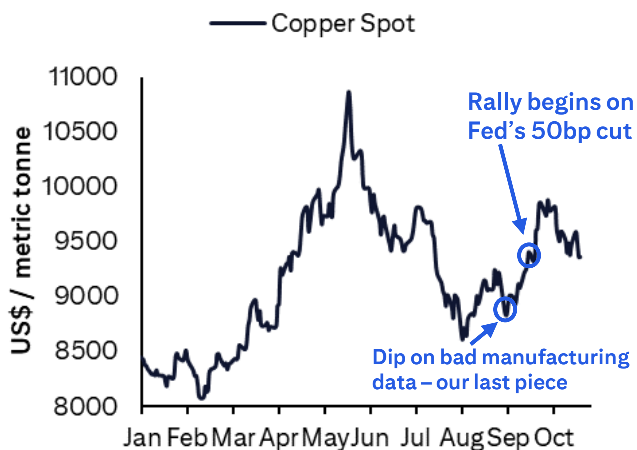
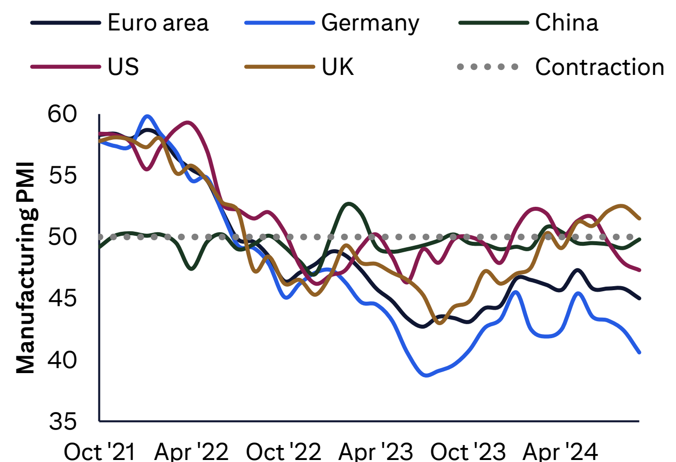


FIGURE 6: The world's largest manufacturing sectors remain firmly in



Source: FactSet, Bloomberg, and Citi Global Wealth Investments, as of October 23, 2024. A PMI value above 50 indicates expansion, while a PMI value below 50 indicates contraction.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

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