THE MAKINGS of a commodity bull market

Commodities have had a mixed start to 2017. The Bloomberg Commodities Index is down 2.5% year-to-date (to 31 March 2017), after a substantial drop in the oil price in March pared back gains made earlier in the first quarter.

However, this pullback has not altered our view that a convergence of favourable factors will push commodity prices significantly higher this year.

An OPEC-production cap, strikes at the world's largest copper mines and stronger global growth are just some of the elements that will help to support price increases across the commodity market in 2017.

The prospect for base metals looks particularly positive, though we also expect supply discipline to keep the oil price on an upward trajectory. Precious metals will be buoyed by the return of inflation.

In this benign environment, we expect more investors to recognise the benefits of holding commodities within an investment portfolio.

Commodities tend to be lowly or negatively correlated with stocks and bonds making them a strong diversification tool. An allocation to commodities can also act as a hedge to geopolitical risks and inflation.

Supportive recovery

This year's positive commodities outlook represents a stark turnaround from the picture in the first quarter of 2016. The bottom of the commodity downcycle was reached in January last year when crude oil fell below US$30 per barrel.

At the time, companies in the energy and metal sectors were battling for survival, selling off assets and desperately restructuring their balance sheets.

Major mining companies Glencore and Anglo American were forced to liquidate significant parts of their overall businesses to reduce debt. They had to cut capital expenditures substantially just to stay alive.

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The acute pain felt then could now have a positive payback for investors. Even though conditions have improved, and the big miners are once again generating lots of positive cash flow, they are in no hurry to increase capital expenditures and bring on new projects.

Battered and bruised, miners are prioritising balance sheet repair, looking after shareholders and investing in maintenance.

Inventories are tightening at a time when we are expecting significant demand growth.

For the first time since before the financial crisis, economic growth is strengthening in both the developed and emerging markets.

This will translate into economic activity that is manufacturing or materials driven, increasing demand for commodities at the same time as supply remains constrained.

Maximising gains

That is the big picture for the commodity market. However, within our portfolios we seek to deliver performance by making active asset allocation decisions based on the merits of individual commodities and commodity sectors.

Investing via index swaps and futures, we also aim to add value from commodity curve and term structure positioning.

Our decisions are informed by a combined experience, trading physical commodities as well as derivatives, of over 50 years.

We are also able to leverage the wider resources of the Columbia Threadneedle Investments Fixed Income and Equity groups, combining structural and fundamental bottom-up analysis with the firm's macro, top-down insights.

So, what do we expect from the different commodity sectors and how have we positioned ourselves to take advantage of the upturn?

Oil down but not out

Oil has been in a tight trading range just above US$50 per barrel for most of this year.[1] However, prices fell around 10% in the second week of March.[2] There were several triggers for the correction, none of which were a surprise.

Firstly, the refineries' maintenance season temporarily slows down demand for underlying crude at this time of year.

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Secondly, hedge funds and other speculators had boosted their bullish bets in US crude futures and options to the highest level on record, making the market particularly vulnerable to any negative sentiment.[3]

Thirdly, while global inventories and oil in floating storage (oil stored in tankers) have been decreasing, data showed US crude inventories have climbed to a record high, raising concerns that excess inventories could persist.[4]

This view was reinforced by tensions between OPEC members and the US shale industry, which bubbled back to the surface.[5]

However, we expect this downturn to be temporary and used the recent correction as an opportunity to cover our underweight position in crude.

We think the growth rate for oil demand will continue to be strong in 2017 and that OPEC will do what it takes to bring inventory levels down to a normal five-year average.

The OPEC push is being driven by Saudi Arabia, which needs to raise an enormous amount of debt in the international markets – somewhere between US$50 billion and US$70 billion in the next two years.

In addition, it wants to list Saudi Aramco, the Saudi Arabian oil company, in what will probably be the world's largest initial public offering.

In order to make both of those transactions attractive to global investors, the Saudis need oil at US$55 a barrel and low volatility.

We expect that the Brent crude futures curve will move into backwardation this year, which will support prices and returns for investors.

In other words, its spot or cash price will be higher than its forward price, suggesting there is a supply shortage.

The last time the curve was persistently in a state of backwardation was between 2011 and the middle of 2014. This was a great time to own the Brent-based component of the index.

Our active approach to investing means we will exploit any further weakness to overweight oil-based energy.

Base metals shine

Out of all the commodities, we are most positive on base metals. Aluminium, copper and zinc all surged in price in the fourth quarter of last year and have delivered impressive returns year-to-date.

We expect the strong performance to continue. We anticipate base metals trading at significantly higher prices, with our biggest overweight in copper.

Labour issues are crucial to our conviction. Strikes have been called at the giant mines Cerro Verde in Peru and Escondida in Chile.

Freeport-McMoRan, the mining giant, has also been in dispute with the Indonesian government over its Grasberg operation.

These three large mines, representing close to 10% of global copper production, are not running at full speed.

While labour unrest is not biting into supply just yet, it has the potential to take significant production off the market this year. That will be positive for prices.

Going for gold

Turning to precious metals, gold has rallied this year in the light of heightened geopolitical risks and the expectation that the US Federal Reserve will raise interest rates gradually.

The latter feeds into our bullish view on precious metals, which is based on the return of inflation.

As more market participants become concerned about inflation, we expect them to look to precious metals as a source of return.

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The end of el niño

Weather will be crucial to the returns from agricultural commodities.

The El Niño weather cycle, which results in a stable weather pattern in the grain-producing countries of the Americas, has ended.

This means weather is likely to be more variable in growing regions, leading to crop disruptions. Significantly, even though we have had two years of abundant grain harvests, inventories have not been rebuilt because demand from the world's growing population has been so strong.

Also, low prices have led to some compromises in production, such as fertilisers or seed quality. If bad weather damages the harvest, agricultural prices will push higher.

The next bull market?

For all of these reasons, the outlook for commodity markets in 2017 is positive: the commodity bear market has well and truly ended. Now we are heading into a bull market driven by growth, inflation and a shortage of resources.

Yet the small price rises we have seen since commodities bottomed in early 2016 are only the beginning. While the Bloomberg Commodities Index rose 11.8% in 2016, that does not constitute a fully-fledged bull market. In my view, a commodity bull market is when we experience a significant increase in commodity prices. All the elements are in place for this to begin.

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