COMMODITIES: A LONG-TERM INFLATION HEDGE

During the past week our team dialed into webinar discussions with Odey and BCA Research. The subject of medium-term developed-market inflation concerns was raised by both commentators which led to a discussion of potential higher inflation as Central Bankers are trying their very best to avoid economic collapse by providing liquidity injections, eased monetary policy and fiscal stimulus.

The biggest fear of a Central Banker is inflation. The only measure to combat inflation is to hike interest rates – an action that no economy can afford since lockdowns have derailed short term economic activity. But why could inflation rear its head in the future?

On 8 May 2020 BCA commented as follows on US inflation:

'The COVID-19 recession is causing a surge in government debt loads around the G10 and an explosion of central bank balance sheets. Historically, these dynamics have preceded significant increases in inflation. This time around, because private and public debt loads are already elevated, higher inflation would be an important contributor to any normalization of the debt-to-GDP ratio in the long run. From 1946 to 1955, US inflation averaged 4.2%, which caused a 40% decline in the debt-to-GDP ratio.

Can this happen again? After all, G-10 policymakers implemented similar policies in 2008/'09, yet inflation remained extraordinarily tepid from 2009 to 2020.

A key difference is global demographic forces. Back in 2008, the global support ratio, which is the number of workers per dependent, was rising. Now it has started to decline, which is a trend that is expected to continue as more people around the world age and retire. Retirees may not contribute to the global workforce, but they will continue to consume, even if it is healthcare services. This suggests that the global aggregate supply will lag behind aggregate demand. This kind of negative supply shock is inflationary.

Another difference is the response of the broad money supply. After the GFC [Global Financial Crisis], broad money supply growth collapsed. Today, it is strong, with US M2 growing at a record pace. In this context, the combined aggressive central bank and government actions are much more likely to raise inflation than they did after the GFC. However, it will take the exhaustion of the post-recession output gap before inflation can materialize itself. Asset markets are not ready for higher inflation. Inflation expectations remain near rock-bottom levels, with the US 10-year breakeven at 1.07%. Thus, higher inflation represents a great risk for financial assets. Commodity prices, as well as the industrial and material sectors, are trading at low levels compared to stocks like tech and healthcare that benefit in a low inflation environment. Thus, the former assets are likely to outperform on a long-term basis. Bonds will also greatly suffer once inflation rises again.'

Continued overleaf

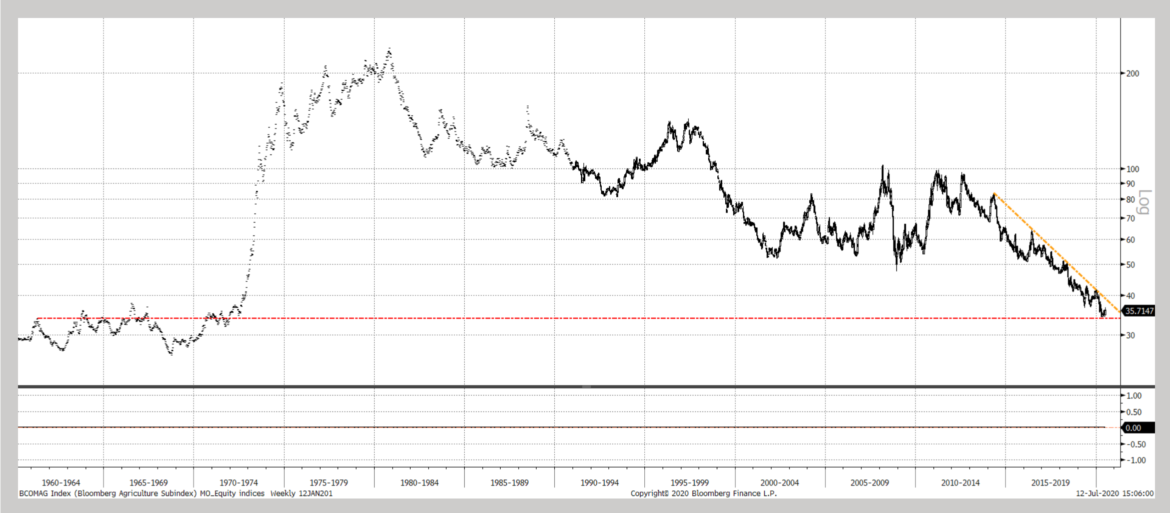
We do understand that despite all the quantitative easing (QE) since the GFC, developed-market inflation has been under control, but this time is different. Post GFC central banks had to guard against institutional collapse in the banking system, which meant that QE saved the system and did not reach the real economy at the time. This time the real economy needs fiscal stimulus and it will stimulate the developed-market consumer base.

Moving away from US market dynamics we note from reports that China credit growth remains strong which bodes well for the global industrial cycle. Chinese credit leads domestic capital expenditure and imports. Real Estate loans are accelerating which supports housing prices and construction activity. All these elements can increase demand for machinery and commodities. Now compare COVID-19 infection rates in China with the rest of the world and one can work out that increased economic activity is a more realistic reality in China. Couple this with a desire by some Western World leaders to enforce protectionism which will lead to increased cost of manufacturing, which is ultimately inflationary.

Now, let’s turn to commodity prices at present:

- In March 2020, the Bloomberg Commodity Index reached a 14-year low. It has since recovered mildly in line with other global risk assets, but it remains ‘early days’.
- The Bloomberg Agriculture Index now trades at the same level as in 1970 – the 50-year low is holding according to our trend analyst, Andy Pfaff.

Bloomberg Agriculture Index as supplied by Andy Pfaff



Source: Bloomberg

- Andy also shared a Bloomberg comment by Eddie Van der Walt that read as follows:

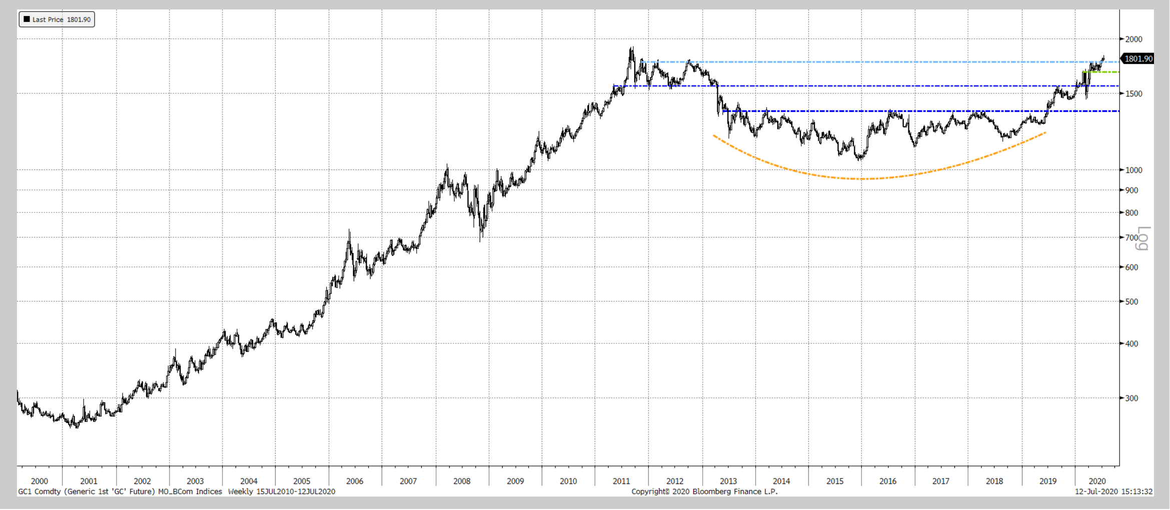
‘Even when hedge funds have a world of risk-protection products at their disposal, such as (i) going short the S&P 500 or (ii) going long the volatility of volatility, many still buy gold. Why? It’s gold’s bluntness as a tool that makes it useful. It offers broad insurance against the unknown, whereas e.g. a credit default swap offers protection against a very specific event. Gold correlates to the greatest fear in the financial markets at the time.’

- Corona-linked supply side issues in South America, falling stockpiles and recovering Chinese demand lifted copper prices recently. If COVID-19 infections continue into 2021, supply-side issues in many commodities will rear their heads. In SA, infections are increasing and could further limit platinum/rhodium and palladium production. However, COVID-19 infections are not the only issue in SA mines. Long-term power supply constraints continue to be a threat as Eskom cannot even keep the lights on during the current lockdown.

The writer could build more convictions to hold commodities (not just Gold) as a long-term hedge against inflation and portfolio insurance. Just think of the potential of a weaker US Dollar and what this could do to commodity prices.

Needless to say, we hold Gold Bullion, Gold Stocks, Silver and Rhodium in all our portfolios in SA and Gold Bullion in our International Managed Flexible Fund. We are considering topping these allocations up with more Spot Commodity ETFs and commodity stocks.

Bloomberg Gold Index as supplied by Andy Pfaff



Source: Bloomberg

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