Commodity Markets

Commodity investing for the
decade ahead

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Commodities have delivered stellar returns so far this year. While future price gains are likely to moderate, the UBS Chief Investment Office (CIO) sees a number of structural factors—from climate change to underinvestment—that should provide tailwinds for commodities in the coming years.

After years of lackluster performance, commodities have delivered stellar returns so far this year, gaining over 30% and ranking as the best-performing asset class of 2021. The commodity-intensive rebound of the global economy from the 1H20 slump has pushed broadly diversified commodity indices—like the Bloomberg Commodity (BCOM) and the UBS Bloomberg CMCI total return indices—to their highest levels since 2014. Besides the strong cyclical demand lift for natural resources, other price-supportive factors have been at work too. Persistent supply challenges, ranging from COVID-19, logistics, underinvestment, weather variability, and power outages to high input costs, have quickened the surge.

Almost all commodities are now trading well above their marginal costs of production. As a result, and with global economic growth set to normalize over the course of 2022, returns are likely to be more moderate in the future. But CIO sees a number of structural factors that should provide tailwinds for commodities in the years ahead. Commodities can also provide diversification benefits for traditional bond-equity portfolios in scenarios where inflation proves more persistent than currently expected.

Long-term structural drivers of commodity prices include greater demand from emerging economies outside China, particularly India. The world’s efforts in reaching net-zero carbon emissions also require greater infrastructure investment, which should lead to higher demand for many industrial metals. Moreover, supply is unlikely to expand at any cost. Underinvestment in fossil fuel exploration and mining capacity in recent years may keep prices well bid in the coming years. Weather conditions, meanwhile, are harming agriculture and livestock supply as well as other sectors like energy.

Given the long length of bull and bear markets, structural trends, and the unique characteristics of individual sectors, CIO recommends that clients investing in commodities pursue an actively managed strategy. In the CIO Active Commodity
Strategy, they advise investors to structure their commodity exposure based on three pillars: a) enhance structurally low cash collateral returns by seeking alternative risk premia and higher inflation-linked fixed income yields; b) deploy a framework to dynamically manage bigger price swings and overshoots in general; and c) have an active sector strategy to benefit from the diverse return nature of the different commodity sectors. With such an active investment approach, CIO thinks investors can navigate commodity markets effectively and significantly improve the risk-adjusted returns of a broad commodity engagement versus a more passive strategy. CIO favors active rather than passive commodity allocations in the year ahead.

Read more in the report Reimagining commodity investing by CIO’s Dominic Schnider, Wayne Gordon, and Giovanni Staunovo.

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