

UOBAM Investment Insight – 28 January 2010

Outlook for Commodities – From Strength to Strength



Over the past year, prices for commodities and commodity-related assets have risen sharply, recovering much of the ground lost during the 2008 financial crisis.

In this article, UOB Asset Management's Robert Adair shares his views on commodities outlook for 2010.

During 2009, the broad-based Reuters Jefferies Commodity Index increased by 21%, while the HSBC Global Mining Index rose by 98%, in Singapore dollar terms. Improving economic indicators mean investors are anticipating similar strong performances in 2010.

A positive commodity outlook stems largely from the global economic recovery engineered by favourable government policies and unusually low interest rates. However, despite improving economic data in emerging market and OECD countries, policy makers remain haunted by Japan's experience in the 1990's. The "double dip" recession experienced by the Japanese economy at that time is now blamed on the early withdrawal of stimulus measures. Policy makers are intent on avoiding the same mistake. While Asian interest rates may tighten in 2010, US interest rates are expected to remain at low levels throughout the year. This should help commodity prices by producing a weaker US Dollar and rising global inflation.

Investors are also viewing commodities as an important asset class in its own right. Barclays Capital estimates that total commodity assets under financial management were almost US\$250bn at end-December 2009, having increased by a record US\$60bn during the year. A continuation of further financial inflows is likely to be positive for both commodity prices and for the share prices of commodity-producing companies.

Some commentators are even re-discovering the term "commodity supercycle". This term implies a prolonged period of commodity price strength as China, India and other developing countries become urbanized and industrialized. China has certainly been the main driving force behind last year's demand recovery, and has already become the leading consumer for a wide range of commodities.

While talk of a "commodity supercycle" may be premature, a continuing economic recovery should produce a positive outlook for commodity prices this year. Surprisingly, the main driver in 2010 may be stronger OECD demand. Even if China acts to prevent overheating in its economy, inventory restocking in the United States, Europe and Japan may ultimately supersede and offset the loss of Chinese demand.

In terms of which part of the commodity complex offers the best returns in 2010, here is our assessment of the four main areas:

Precious metals: A rise in inflation expectations should be positive for commodity prices generally and for gold in particular. We also believe that any return to financial market instability will see gold benefit from its "safe haven" status. Silver and platinum prices both look inexpensive when compared to their historic trading range against the gold price.

Base metals & bulk commodities: Base metals such as copper, zinc and nickel have seen strong price gains despite rising inventory levels. An increase in real demand is needed before

prices can strengthen further. The outlook for bulk commodities (iron ore, coal) is more favourable, particularly given higher steel production from China. In particular, Chinese producers have a preference for the higher quality of imported iron ore.

Energy: Crude oil prices are expected to consolidate below the US\$90/bbl this year, with current OPEC spare capacity still sufficient to meet a growing recovery in global demand. US natural gas prices remain relatively inexpensive and may offer trading opportunities during the year. Listed E&P companies look attractive, combining the potential for both pricing and production volume gains.

Agricultural commodities: Agricultural commodities can be volatile, and are often influenced by short-term weather factors. There has been a general price recovery in recent months, with a particular strong performance by sugar. One way to avoid potential volatility in crop prices is to invest in fertilizer companies, who produce a key input for improving crop yields. A generally low application of fertilizers last year means that increased fertilizer usage is required this year. This should result in higher fertilizer prices and sales volumes over the coming year.

The writer is director at UOB Asset Management.

(This article first appeared in TODAY paper on 28 January 2010.)

Disclaimers :

The information are based upon certain assumptions, management forecasts and analysis of information available and reflects prevailing conditions and UOBAM's views as of the date of this information. UBOAM does not warrant the accuracy, adequacy, timeliness or completeness of the information herein for any particular purpose and expressly disclaims liability for any error, inaccuracy or omission.