



# The metals supercycle is intact

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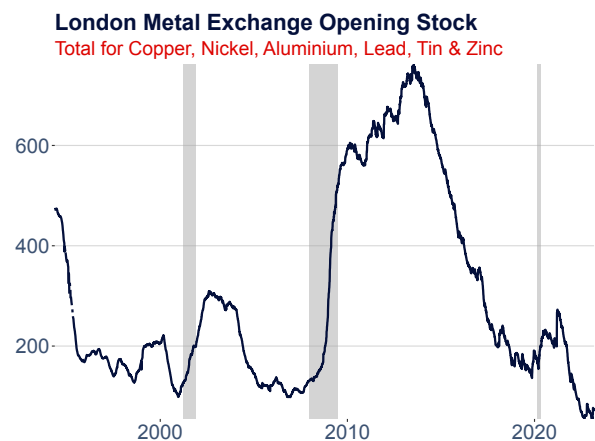
- Following the powerful bull market in 2020 and 2021, commodities have come under pressure during the past quarters.
- A hawkish policy stance by the Fed, prompted by stubbornly higher than anticipated core inflation has clouded the economic outlook and increased the opportunity cost of holding inventory.
- However, the longer-term thesis of a metals boom is intact as mining companies maintain tight budgets and the energy transition will support lasting elevated demand.
- Commodities have a high beta to the slightest changes in prevailing supply and demand dynamics, rendering near-term price forecasts difficult. In the longer run, we would stay overweight.

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**A** new metal supercycle is underway. This supercycle will primarily be driven by the transition to a carbon-neutral world that intensifies demand at a time when the supply side is restricted by years of under-investment. Base metals are down 37% since their peak reach in March 2022 and have not recovered so far in 2023 despite the reopening of the Chinese economy. We believe that the supercycle thesis for industrial metals is intact despite this lacklustre short-term performance. Supercycles are not linear, and we expect the next leg up in commodities to be fast and furious once the FED pivots. Despite the uncertain timing of the FED pivot, we advocate to overweight commodities and commodities-related equities.

## 1 Demand for metals boosted by the energy transition

Massive plans launched by China, Europe and the US will have a direct positive impact on metals demand. Following Ukraine's invasion by Russia, Europe has almost doubled its green energy target through its RePower EU action plan. The IRA (Inflation Reduction Act) in the US, a program of USD 738bn over the next ten years, is centred around clean energy and electrification. Solar and wind installation will grow massively in China and in Europe. For instance, it is expected that installed solar capacity in China will more than double to 1200GW between 2020 and 2030. Simultaneously, it will increase by about 2.5x in Europe based on the given production targets for wind of 480GW and solar power of 600GW. Renewables require significantly more industrial metals than conventional coal or gas-fired power plants. Beyond this, the electrification



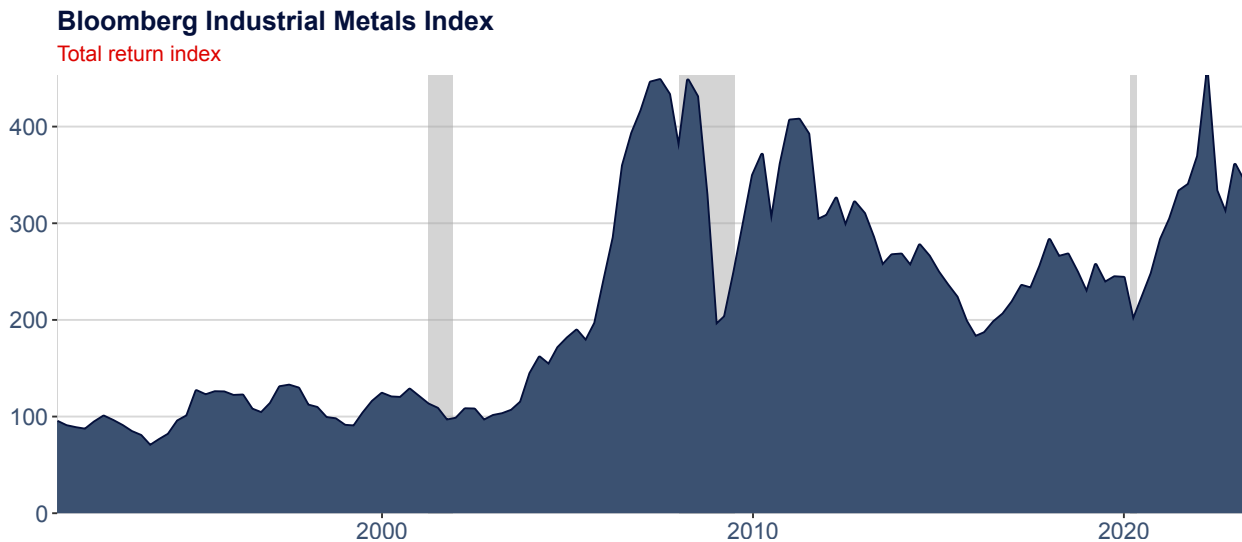
**Figure 1:** Opening stock levels at the London Metal Exchange have fallen to the lowest level on record.

of individual transportation will continue to contribute to elevated demand as an EVs requires around 80kg of copper, almost four times as much as a car with combustion engine.

According to the specialists at JP Morgan, 'green' demand for industrial metals will increase 4-fold in the case of Copper and Aluminium and 7-fold for Nickel by 2030, compared to 2020. As the expansion of renewable energy production, the growth of the EV fleet and grid upgrades are becoming dominant demand drivers the share of 'green' demand for Copper is set to quadruple from 5% to 20% over the next ten years.

## 2 Lack of Capex on the supply side

While structural demand for metals is expanding, **the supply side appears to be inelastic after a broad-**



**Figure 2:** Recently, industrial metals have been hurt by economic uncertainty triggered by the Fed’s aggressive policy tightening. However, in the medium-term we expect prices to be driven higher by the secular decarbonization trend paired with continued conservative capital allocation by miners.

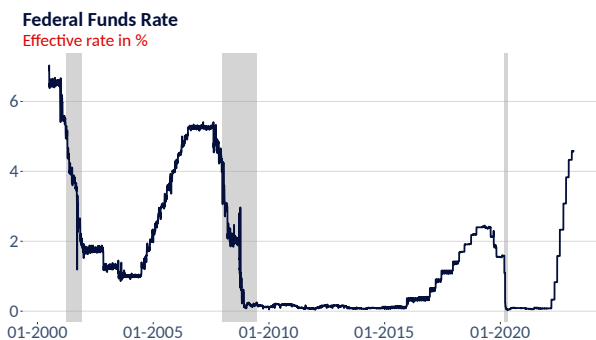
**based lack of investment activity in the past years.** Overall, since 2006 the average annual Capex level has nearly halved compared to the previous decade, significantly hurting production capacity. **What’s worse, investment activity across commodities continues to fall in real terms.** Higher prices during 2021 and the beginning of 2022 had only a limited impact on capital allocation decisions by energy and metal producers. Ironically, ESG practices have negatively impacted Capex as investing in commodities doesn’t score well in terms of carbon emissions, which is now delaying the energy transition due to prolonged scarcity and high prices in some metals. Lower Capex is also explained by low financial participation as well as an uncertain economic outlook. Metal prices need to go higher to incentivize more investments on the supply side. Richard Adkerson, CEO of Freeport, the leading

In the copper industry, the long-term narrative, therefore, remains constructive, and only expanded mining activity will prevent prices from settling at much higher levels.

### 3 Unfavourable influence of the FED

Higher interest rates make physical commodities more expensive to finance and, therefore, lead to a decline in inventories which implies temporarily lower demand for commodities and a negative impact on commodities prices. Financial investors also tend to divest commodities in a rising rates environment as other investment opportunities, most importantly Fixed Income, become more appealing.

U.S. 2 Year Treasury Notes are currently yielding more than 5%, an attractive proposition for investors indeed. The FED pivot has been postponed with the recent increase in core-inflation measures. Moreover, the market’s repricing of the Fed Funds futures since the beginning of 2023 has harmed the whole commodities ecosystem. As a reminder, markets are now pricing in more than four more rate hikes until December 2023. This matches the Fed’s objective to depress aggregate demand in order to fight inflation. **As long as the FED keeps on tightening, a sustainable rally in commodities is not likely.**



**Figure 3:** The rapid rise in interest rates has increased the opportunity cost of holding inventory or making financial investments in commodities.

copper producer, very clearly expressed this month that the world can’t produce enough Copper even in the medium to long term to support the energy transition.

### 4 China’s recovery is more important than a potential U.S. recession

China’s reopening has been a positive catalyst for commodities in the first two weeks of 2023 but the initial push has faded out since. Nevertheless, all statistics

indicate a substantial recovery of mobility including a rebound in outbound flights, which is very positive for oil demand. The latest PMIs also bode well for the Chinese economy suggesting a significant expansion in production activity. We note that the manufacturing PMI rose to 52.6 in February, a level not observed since April 2012. The demand for metals in the country since the Chinese New Year has started to show some signs of strength. In the coming weeks, sentiment may still be negatively influenced by the disappointing growth target of only 5%, recently set by China's National Committee. However, we emphasize that the GDP target is subject to political considerations and not a binding constraint. It is, therefore, likely that we will nevertheless see a recovery of Chinese demand for metals.

On the other hand, the US economic slowdown negatively impacts the sector, and the slowdown should continue as long as financial conditions remain restrictive. We want to stress, though, that China plays a crucial role, accounting for about 60% of the world's demand for Aluminum and Nickel and about 55% for Copper. **Once the FED pivots, thus removing one dragging factor and strengthening confidence in the global economy, we believe that industrial metals have a good chance to rally.**

## 5 Commodity prices are not correctly discounting the coming boom.

Contrary to equities, which discount expected cash flows, commodities depend very much on the spot market and are, therefore, very sensitive to existing supply and demand conditions. This makes the asset class very difficult to forecast in the short run, as small supply or demand shifts tend to translate into large price swings. However, medium and long-term, commodity prices are more predictable as underlying supply and demand trends are easier to anticipate. Nevertheless, it is crucial to keep in mind that this unique feature makes commodities sensitive to supply or demand shocks. For example, the demand collapse induced by the Covid crisis in the spring of 2020 led to a brutal crash in oil prices and even pushed spot prices below zero for a short period. And the break-out of the war in Ukraine, which intensified a negative supply shock, led inversely to a spike in oil prices.

Being primarily driven by contemporary market dynamics, commodity prices currently do not sufficiently reflect the foreseeable supply and demand conditions. Spot prices are, therefore, a poor predictor of the coming strength of demand for all metals involved in the energy transition that will meet scarce supply. Once confidence in the global economy returns, another surge in metal prices could be fast and furious. The FED pivot is key.

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