MONACO ASSET MANAGEMENT

Global Research
Investment Strategy

MAM Insight No. 9

In this Issue

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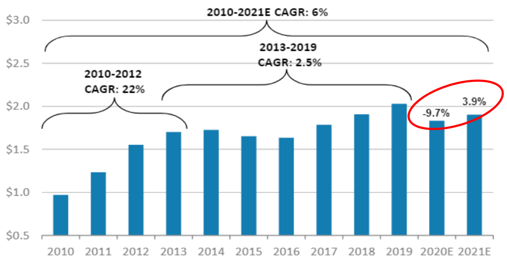
Commodities - Early Outlook

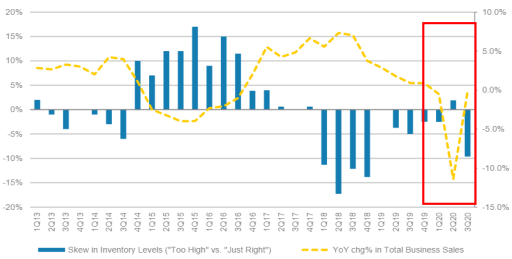
The fundamental backdrop is very bullish for commodity prices looking at the next 1-3 years. Globally, there has been far too much capex contraction and destruction this year for supply to meet demand on the back end of the pandemic. The pandemic brough years of capex contraction in just a few months by forcing companies to quickly reassess investments needs and delay some projects. As such, we saw a -9.3% drop YoY in capex in 2020 **(Chart 1)**. 2021 should be seen as a recovery year. However, capex investments are unlikely to reach pre-crisis levels until 2022. Stock levels are becoming an issue. Multiple sources hint inventory levels remain too low as sales continue to bounce off from their depressed level and as economies re-open globally. This trend should support commodity prices over the next few quarters as inventory levels require a replenishment while demand continues to strengthen off of the bottom **(Chart 2)**.

Chart 1. Total Capex 2010-2021E



Source. Company Data, MS Research

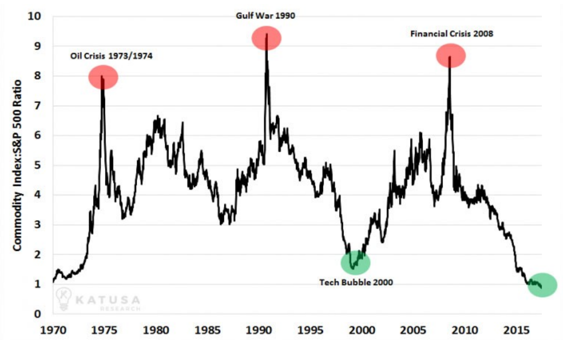
Chart 2. Inventory Levels vs. Business Sales



Source. US Consensus Bureau, MS Research

The supportive macroeconomic backdrop (i.e. vaccine, stimulus) could be the catalyst driving exceptionally high returns over the next 1-3 years in the commodity complex. The starting point is extremely attractive. Valuations are cheap. The Bloomberg Commodity Index is down -88% relative to the S&P 500 Index since the 2008 Financial Crisis **(Chart 3)**.

Chart 3. Commodities / S&P 500 Index



Source. Bloomberg, MAM Research

In the previous "MAM Insights No. 8" we argued that 2021 could be a similar period than 2002-2006 when "value" outperformed "growth". Looking back at the same period, the Bloomberg Commodity Index outperformed the S&P 500 Index by +53%. Commodity prices are setting up for a secular bull market. Portfolio exposure to commodities is highly recommended.

Agriculture Commodities

Agriculture prices are breaking out of a 12-year downtrend **(Chart 3)**. In November, agriculture and livestock commodities were up +7.3%, marching returns of equity markets. The following factors have been in the driving seat and will continue to weigh on prices in the foreseeable future. First, China is adopting a series of new steps to bolster consumption in commodities and other sectors, tapping rural consumption potential. Then, reports are pointing to a weather-constrained supply for next year. La Niña could hit crops around the world. Last, the monetary and fiscal policy backdrop in the US will continue to pressure the dollar lower and jump start a rise in inflation in the second half of next year, thus further supporting prices.

Wheat reached its highest level since 2014. While stocks increased this season, it could be offset by an increase in global demand driven by the pandemic with countries looking to secure strong supply. La Niña is also likely to pose a challange to global wheat crops developments.

Soybean was the worst performing commodity heading into Q4 2020 after 2-years of oversupply and trade-war induced low prices (below cost of production in the US). However, China has been importing increasing amounts to feed its recovering livestock sector. With it expected to continue into 2021, prices should continue to edge higher. Watch for how it will pivot back to Brazil though.

Wheat, soybean, and corn prices should remain high and edge higher with farmers taking advantage of the production and exports tailwinds. The effects should be persisting and carried into next year.

We continue to like exposure to agriculture commodities via the Invesco DB Agriculture ETF.

Chart 3. Invesco DB Agriculture ETF (Monthly)

Source. Bloomberg, MAM Research

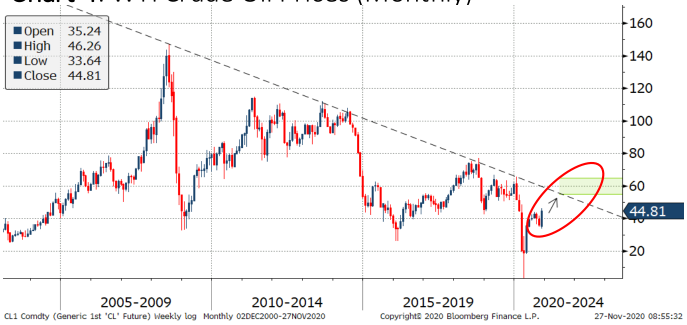
Energy Commodities

Crude Oil. The supply-destruction thesis should remain intact in the short-term as minimal capital spending has returned to the sector. In addition, the capital-intensive business of maintaining a large base of global production is also coming under pressure. There has been a steady increase in delayed final investment decisions ("FID") spending over the past five years, thus drawing a poor picture for new supply in the medium-term. The longer cycle oil supply is looking bleak. Little attention has been given to it just yet, but as short cycle oil supply becomes a problem, the longer cycle will only accentuate the imbalance and could lead to a global oil crisis. According to data from *The Bear Trap Report*, oil supply declines at 3.5% (excl. shale) and up to 7.5% (incl. shale) per year. In essence, we must find 2 Canada worth of production every year just to maintain the supply levels flat. Today, we cannot offset short-term declines with the severe drops in the Permian. More importantly, we are now at risk of being unable to offset medium-term declines based on FIDs delays. The pandemic-driven destruction lead total committed FID spending to drop to \$53bn from \$101bn in 2019. This should force a spending catch up to avoid an energy crisis.

In the meantime, demand remains rather resilient and recent vaccine developments should only accelerate the recovery through 2021. The new waves of infections are only temporary and measures more accommodative, making oil demand interruptions less problematic. The number of crude oil stocks in excess of last year's levels has roughly halved in size. Global floating storage fell another 9.5m bbl. last week, meaning current floating storage volumes are 100m bbl. lower than at June's peak. In India, total product demand reached the highest-ever level for the month of October (+7% YoY) with refineries working at full capacity. Money managers net positioning in WTI oil futures increased last week with the total number of long positions rising by 44.5m bbl. Mostly driven by shorts covering. We view this as a positive development for the direction of Crude Oil prices in the near-term.

Supply destruction at both the short and long cycle, a weaker dollar, demand growth increasing following vaccine developments, potential fund flows from growth to value trades, and a bottom cycle valuation are some of the key catalysts making the energy commodity attractive. We believe WTI Crude Oil is currently undervalued and would expect prices to revert back close to historic valuation in the $55-$65 range by mid-2021 **(Chat 4)**. However, most of the attention in the near term will be given to the OPEC+ meeting. Members are facing a tough decision of rolling production cuts into next-year in front of a persistently low oil price environment. Most member countries heavily rely on oil revenues to fund their budgets. We view this event as a key short-term source of headwinds investors must be wary about. However, any price dip in WTI oil is a buying opportunity in our view. The best instrument to gain exposure to WTI oil prices remains longer-dated futures as time spreads remain tight.

Chart 4. WTI Crude Oil Prices (Monthly)

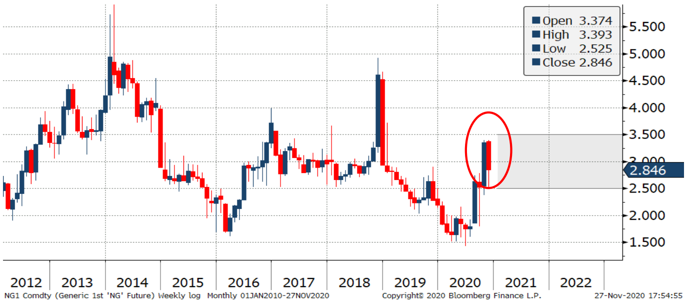


Source. Bloomberg, MAM Research

Natural Gas. Today, the natural gas outlook is not as bright as crude oil. Prices are a function of seasonal factors affecting supply and demand like weather. Typically, prices rise during the winter, when demand for heating is at its peak, and fall over the summer. This year, prices hit a two decades low in the spring with a pandemic-driven demand destruction. Earlier this quarter, prices edged higher as an active hurricane season put pressure on production in the US and demand rose in the region.

The EIA estimates gas injections into storage were 6% lower than the 5-year average and 26% lower than the near-record net injections seen in 2019. Declines in gas production account for the majority of net injections reduction this year, according to HIS Markit. However, prices have fallen off from their October highs due to warmer than forecasted weather in the US. With the winter off to a wrong start for natural gas, what's next? Despite lower refills, storage levels were already high. Hence, there should be ample supply heading into 2021. If temperature edge lower in the winter, prices should find a way to recover. Otherwise, expect prices to trade within a $2.5-$3.0 range until early Q2 2021 **(Chart 5)**. We prefer exposure to natural gas equities such as Devon Energy instead of outright natural gas.

Chart 5. Natural Gas Prices (Weekly)



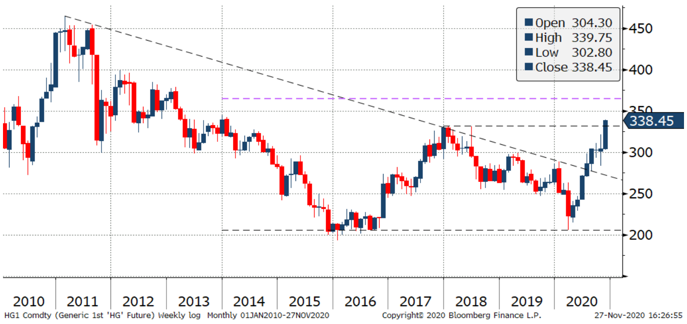
Source. Bloomberg, MAM Research

Industrial Metals

Copper. A series of market dynamics makes investing in metals very interesting today. The supply side is already seeing high utilization rates and low inventory. In 2021, we continue to expect a material economic recovery. Paired with an improving demand outlook, metal prices should outperform due to supply bottlenecks.

Copper is heading for its longest run of monthly gains since 2011 **(Chart 6)**. A strong demand outlook from China, the world's top copper consumer, will bring forward those imbalances, especially as global copper inventories are at the lowest since 2014, according to BloombergNEF. The metal plays a centerpiece role in the renewable energy transition. President-elect Biden pledged to boost spending on copper-heavy renewable energy and EV infrastructures, thus supporting demand growth. Exposure to Copper is best done via futures.

Chart 6. Copper Prices (Weekly)

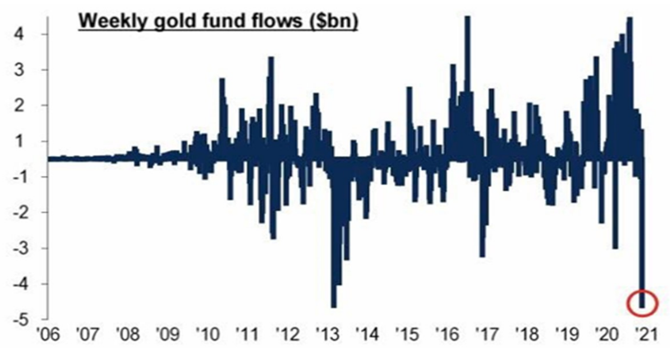


Source. Bloomberg, MAM Research

Precious Metals

Gold. The surge in vaccine optimism has put the rally in the yellow precious metal on hold since the end of the summer. Rising prospects of a global economic recovery are threatening to put an end to the metal's two year bull market. Gold spot prices are already -14.3% off from their August highs, at $1,776/oz. Structurally speaking, a high growth environment with subdued inflation in the first half of next year could send gold prices lower. Investors are likely to take a risk-on approach by moving out of "safe-heavens" into risk assets, thus diluting the relative attractiveness of gold which offers no to negative income (accounting for the cost of carry). The pain would likely be accentuated with recuring positive vaccine and reopening news. The lion-share of the adjustment has already occurred with gold outflows greater than in 2011 and 2013 **(Chart 7)**, the previous peak.

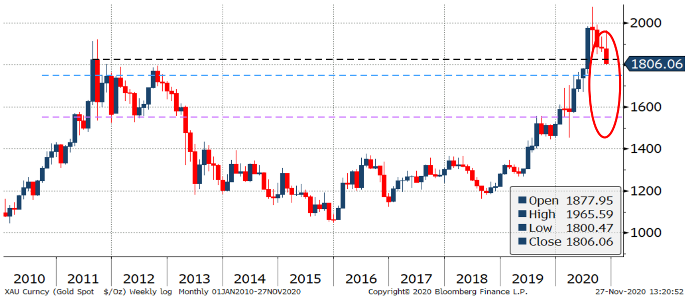
Chart 7. Gold Fund Flows in $bn (Weekly)



Source. BoA Research

However, longer-term, the yellow metal's attractiveness is intact as inflation rises and real interest rates remain depressed. While we do believe rates have seen their lows in the current economic cycle, we expect inflation to pick up faster due to the monetary and fiscal policy backdrop. The Fed already expressed its willingness to let inflation run higher for longer, or until the economy reaches full employment, to reach its long-term average inflation target of 2%. Real interest rates will remain depressed, supporting gold prices. Investors should expect prices to continue to decline in H1 2021 to potentially re-test the $1,750-$1,550/oz. range, before prices begin to pick up again as the Biden administration eases trade tensions, a stimulus deal is signed, the reflation trade comes into play, and the US dollar continues to weaken **(Chart 8)**. Our price target of US$2,300/oz offers 30% upside potential. We are buyers of Gold (currency and futures) on price dips. The sale of put options may be an intermediate strategy.

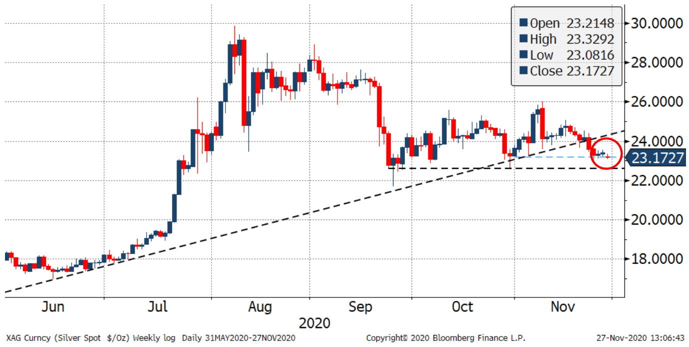
Chart 8. Gold Spot Prices (Monthly)



Source. Bloomberg, MAM Research

Silver. We continue to have a relatively constructive and bullish outlook on the silver metal. With many inflation assets beginning to weaken in recent days, silver is in the midst of breaking the support trend from the March lows and its most recent support near $23 **(Chart 9)**.

Chart 9. Silver Spot Prices (Daily)

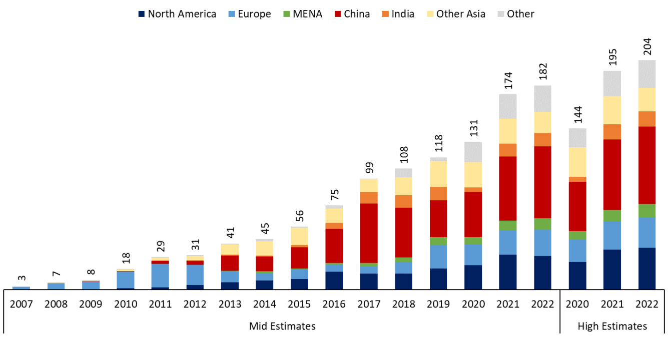


Source. Bloomberg, MAM Research

However, we believe the recent weakness seen in the commodity has more to do with its precious metal attributes and correlation to gold prices rather than fundamentals. Industrial and speculative demand for the commodity currently outweighs annual supply. If you remember per some of our older research notes, industrial applications (incl. electronics and photovoltaic cells) account for about 55% of demand. For the first time, BloombergNEF analysts are forecasting over 200 gigawatt of new solar installation before the 2030s, bringing the year forward to 2022 due to increasingly better clarity on the path to net-zero carbon emissions in Europe and China. The latter will first be looking to displace fossil fuel in the electric supply. Additionally, there is increasing certainty on strong builds coming from North and South America, and South East Asia as solar is more widely recognized as the cheapest source of utility-scale electricity supply. As a result, this year has been another record year for solar addition despite shortages of glass creating bottlenecks meanwhile rising aluminum and silver prices troubled manufacturers. However, bottlenecks should improve heading into next year as capacity is scaled up.

One of the headwinds for the commodity could come from module manufacturers who continue to work on improving the technology, efficiency, and facilities in an effort to push down materials use (i.e. silver) and costs. In our view, this is not a major source of concern. Demand growth for new solar modules should continue to outpace technology-driven demand destruction. From 2009 to 2019, the amount of silver used in each solar cell dropped from 521 to 111 grams, -14.3% p.a. However, most of these improvements were achieved in the earlier years of the decade. From 2015 to 2017, the rate was much slower with only a sub-10% decrease (Fischer et al., 2011). Moving forward, we believe these improvements will continue to evolve on a single-digit basis. Meanwhile, photovoltaic capacity will continues to grow in the double digits **(Chart 10)**. Additionally, these numbers exclude existing capacity replacement needs when older modules are taken offline. Hence, our positive outlook on silver. We are buyers of Silver (currency and futures) on price dips. The sale of put options may be an intermediate strategy.

Chart 10. New Solar Build (GW/Year)



Source. BloombergNEF, MAM Research

Investment Implications

We have a constructive bullish outlook for commodities heading into 2021. We continue recommending a 10% allocation to this asset class in portfolios. For portfolios that cannot have direct exposure to single commodities, we recommend adding exposure through diversified ETFs (i.e. *Bloomberg Ticker: DJP US, CMOD IM*). However, for portfolios able to select single commodity exposure, we recommend the following:

1. **Gold & Silver:** Keep current allocation as a portfolio diversifier and add to allocation in the current price correction. The sale of put options with a 5% Out-of-the-Money strike and a 3 months maturity should be considered. We are also buyers of Gold equities through the ETF (Vaneck Vectors Gold Miners ETF) or single stocks such as AngloGold Ashanti.

2. **Oil & Gas:** Add exposure to WTI oil prices through longer-dated futures (6-12 months) as time spreads remain low and a limit price of $43.5/bbl. In addition, this bullish view on oil prices has direct repercussions on our single stock picking recommendations. Oil & Gas companies are still trading at a steep discount. We will be looking to add exposure in the equity pocket of the portfolios to Oil & Gas ETFs and companies such as Royal Dutch Shell, Devon Energy, and Technip.

3. **Industrial Metals:** Add exposure to Copper prices through longer-dated futures (6-12 months) as time spreads remain low and a limit price of $330/t.

4. **Agriculture prices:** Add exposure via the Invesco DB Agriculture ETF.

As always, please let us know if you have any questions.

Bests regards, MAM Investment Team

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