Mind the Gap

Soaring demand and constrained supply support a positive outlook for the commodities sector...

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The so-called Father of Economics, Adam Smith, may have introduced the theory of supply and demand nearly 250 years ago but it continues to underpin the effectiveness of commodities as a diversifying asset class. Whether gold, oil or agricultural products, commodity prices are often driven as much by extreme weather events, supply chain disruptions and geopolitics as prevailing macroeconomic conditions.

Due to these idiosyncratic drivers, the commodities sector has historically exhibited a low to negative correlation to bonds and equities. While global equities and bonds plunged in 2022, the Bloomberg Commodity Index delivered a healthy total return of more than 30% (in GBP). More recently, gold prices have hit a record-high as investors have flocked to 'safe haven' assets amid escalating conflict in the Middle East.

In the long run, the transition to clean energy and rising energy consumption from AI-related technologies are expected to generate significant tailwinds for the commodities sector, with the International Energy Agency (IEA) forecasting a quadrupling in demand for critical minerals by 2040 to meet net-zero commitments alone.

Leading the charge

China's economic growth fuelled the commodity 'super-cycle' of the 2000s and the country remains the largest global consumer of many commodities. Although growth has slowed, China's projected GDP growth of 4.6% for 2024 still significantly outpaces the forecast growth of 2.7% for the US and 1.4% for Europe, according to the IMF. The Chinese government also recently announced a bold stimulus package aimed at re-energising its sluggish economy.

China will continue to drive a significant increase in absolute commodity demand even with lower growth rates. There has also been a noticeable change in the underlying drivers of China's demand, from steel and iron ore for infrastructure-heavy urbanisation to copper, lithium and cobalt (amongst others) for renewable energy and electric vehicles. According to the IEA, China accounted for over 50% of global wind and solar power additions, as well as electric vehicle sales, in 2022.

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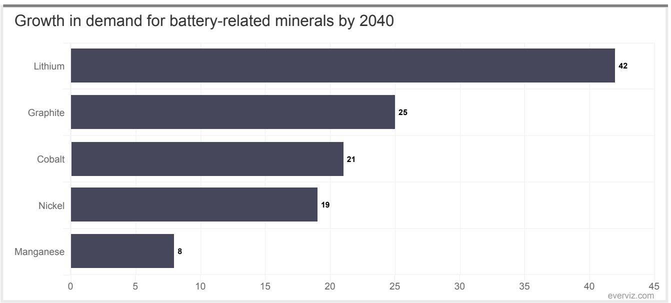
Beyond China, global infrastructure spending is also expected to contribute to the next wave of demand, particularly in terms of clean energy technologies. The IEA reports that electric cars require six times the mineral inputs of conventional cars, while an onshore wind plant uses nine times more minerals than a gas-fired power plant.

Meeting the goals of the Paris Agreement would require a quadrupling of current mineral requirements for clean energy technologies by 2040, rising to six times to hit global net-zero targets by 2050, according to current IEA estimates. The graph below illustrates that lithium is forecast to experience the highest growth in demand of 40 times, followed by graphite, cobalt and nickel, primarily due to demand for electric cars and battery storage.

Fig.1: Demand For Lithium Is Forecast To Grow By More Than 40 Times



Source: The Role of Critical Minerals in Clean Energy Transitions, IEA (based on the Sustainable Development Scenario to meet the Paris Agreement goals).

The transition to clean energy is also supported by significant sums of public investment, from clean energy tax credits in the US Inflation Reduction Act to €300bn of funding for the REPowerEU Plan in Europe.

Another key growth driver is the build-out of AI-powered data centres, as well as the supporting infrastructure to power these. According to HANetf, a single search query on ChatGPT uses 1500% more energy than a simple Google search which illustrates the substantial increase in energy consumption from the roll-out of AI technologies. Overall, the IEA is forecasting a doubling in electricity consumption from data centres from 2022 to 2026, which is equivalent to the current consumption level of Japan.

Interestingly, Microsoft has signed a nuclear power agreement for its Virginia data centre and Amazon's new data centre campus in Pennsylvania is powered by the adjacent nuclear power plant. This shift to carbon-free energy could therefore increase demand for uranium, in addition to copper for the electricity transmission infrastructure.

Looking at the supply side, current constraints are anticipated to largely persist for the next few years due to a lack of shovel-ready projects. Companies have focused on paying down debt rather than investing in exploration and production, and with an average lead time of more than 15 years for a new mine, supply constraints are unlikely to ease in the near term.

Mineral production is also highly concentrated, with the top three global producers controlling over 75% of production of lithium and cobalt. As a result, mining companies have to navigate significant geopolitical challenges such as political unrest, stringent regulations and resource nationalism, limiting access to key mineral reserves. Escalating social concerns and lengthy permit times have added further complexity.

Bringing both sides of the equation together, constrained supply and new secular drivers of demand for commodities should support a positive long-term outlook for the sector.

Back to basics

In addition to the favourable dynamics for the commodities sector, company fundamentals continue to look attractive: against a backdrop of rising operational costs, mining companies have strengthened balance sheets by paying down debt and returning capital to shareholders in preference to capital expenditure.

Valuations also look attractive relative to historic averages, particularly in terms of the divergence between underlying gold prices and the equity valuations of gold miners. With gold prices recently hitting a record high against a backdrop of heightened geopolitical conflict, a narrowing of this gap could prompt a re-rating in valuation.

Given the high cost of new projects relative to discounted company valuations, some mining companies are adopting a buy rather than build approach to increase production capacity arising from a lack of expansionary capital expenditure. As a result, there's been a noticeable pick-up in M&A activity with Newmont paying $14.5bn to acquire Australian gold miner Newcrest and BHP and Lundin Mining announcing a joint acquisition of copper mining company Filo Corporation.

Forging a path

The commodities sector is far from homogeneous and, as a result, lends itself well to active managers with the expertise to capitalise on its diverse universe of opportunities. The managers of **BlackRock World Mining (BRWM)**, Olivia Markham and Evy Hambro, have a combined experience of more than 50 years in asset management, supported by the extensive on-the-ground research capabilities of the wider BlackRock team.

One benefit of active management is the ability to capture the underlying cyclicality in the commodities sector, with Evy and Olivia having the flexibility to tactically exploit the most attractive opportunities throughout the cycle. The trust currently has significant exposures to gold (among the precious metals) and copper (in the base metals group), both of which have hit all-time highs this year on the back of strong demand and tight supply.

Active management also provides the opportunity to capitalise on earlier-stage or unlisted opportunities with the potential for outsized returns. BRWM has an investment in Jetti Resources, an unlisted company developing innovative copper extraction technology, with the trust recently selling part of its stake for more than 100% above its initial investment price in early 2022. Another potential source of alpha is BRWM's focus on ESG, which not only helps portfolio companies safeguard operational licenses but also restricts supply due to the higher operational costs associated with ESG compliance. Additionally, the 'brown-to-green' decarbonisation theme is likely to benefit mining companies with a strong ESG commitment and enhance their attractiveness to investors.

BRWM's returns are testament to the advantages of active management in the commodities sector, with an impressive five-year net asset value return of 82% (as at 19/11/2024). Although there is no progressive dividend policy, the trust is currently trading on a dividend yield of 6.6%.

While investors should be aware of the higher inherent volatility of commodities, we think the basic economics of supply and demand should continue to serve the sector well given supply constraints and the forecast growth in demand from the net-zero and AI mega-trends.

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