27th July 2016

Commodities will benefit from the IMF's U-turn

The IMF has given up austerity, and is proposing more expansionary budgetary policy. Paradigm shift for public spending. Positive prospects for commodities.

Key Points

- The IMF has abandoned austerity, and is proposing more expansionary budgetary policy
- The IMF believes that ultra-accommodating monetary policy has shown its limitations
- The time has come for a Keynesian recovery, increasing public spending
- IMF, USA and France in step
- Isolated Germany should take this paradigm shift into account after Brexit
- Commodities have already been influenced by a less pessimistic economic outlook
- China is propping up physical demand
- The fall in Capex will curb supply
- Global trade is recovering
- Commodities cycle boosted by fiscal stimulus in 2017

The IMF has done a U-turn, recommending expansionary budgetary policy, which will also prop up a rise in commodities

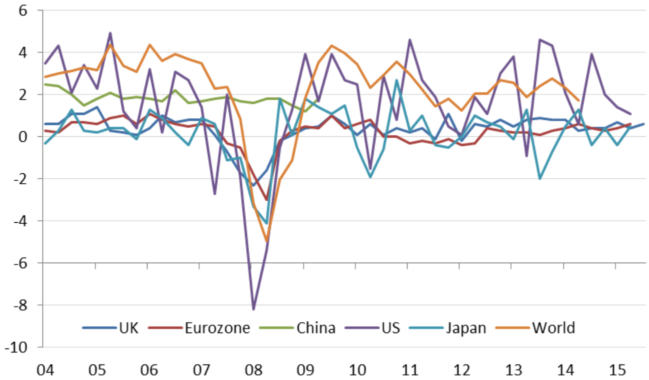
Despite widespread surprise, the change of tack has been announced. The IMF is now openly encouraging governments with sufficient wiggle room to abandon austerity for fiscal stimulus.

On 23rd July, the International Monetary Fund (IMF) showed no qualms in announcing a rather radical change in doctrine. This came just a few weeks after the historic vote in the United Kingdom, as if they had been waiting for a sufficiently credible excuse to significantly change their position and absolve political powers, who have become too well-drilled, and too accustomed to feeding their populations puritanical budgetary discourse, of their guilt.

Austerity is out… bring in the new doctrine based on fiscal stimulus and investment.

Brexit is de facto one of the main arguments used to support this radical change in policy, but it seems that anything is fair game in order to justify their change in tack. According to the IMF, the threats that could affect global growth in fact seem greater today. Even the rise of terrorism is given as a potential factor for economic uncertainty.

GDP Growth Rate
(World, USA, UK, Eurozone, China, Japan)



Sources: Bloomberg, BBGI Group SA

However, the world's largest economy, the USA, definitely seems to us to be growing, as demonstrated by the unemployment rate dropping from 10% to 4.7%, despite weak +1.1% GDP growth again in 1st quarter. In Asia, concerns raised at the start of the year as to China's economic health now seem clearly overblown given the latest GDP figures showing +6.7% growth year on year. In Europe, Brexit could have a negative impact on the economic trend, but the IMF and the ECB are currently only estimating this impact at 0.3%.

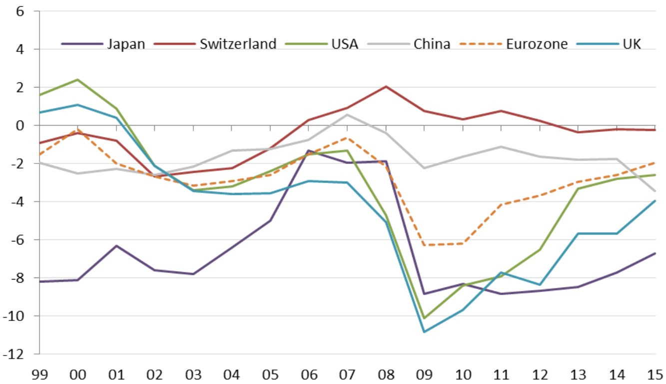
We therefore believe that the IMF is being surprisingly cautious in its global growth forecasts. These forecasts were revised slightly downwards a few weeks ago, to +3.1% for 2016 and +3.4% for 2017. Indeed, it is on the back of slightly less optimistic analysis of the global economic situation that the IMF wants to prod some countries into boosting public spending in order to prop up growth. It should nonetheless be pointed out that these growth forecasts sit at close to average growth over the last twenty years.

The IMF, USA and France are in step

The IMF's announcement is mainly intended for the G20 countries who have the greatest budgetary wiggle room, such as Germany, the United States, Canada, Australia and China.

In Europe, the IMF is almost certainly hoping to make Germany realise that they have greater political responsibility in the wake of Brexit. More than ever, the country must play a leading role in order to maintain and protect balance in Europe, just as disillusion is growing all over Europe, and the negative effects of excessive austerity are threatening cohesion within the European Union. The about-turn in the IMF's position currently seems to represent a change in the balance of forces in Europe. The budgetary austerity previously extolled by the IMF, and which Germany is historically very fond of is no longer gospel in Europe. From now on, Germany risks becoming rather isolated in trying to advocate too restrictive a fiscal stance.

Budgetary Deficit as % of GDP



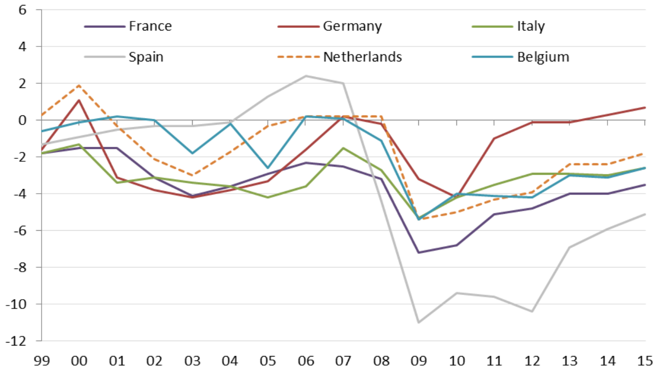
Sources: Bloomberg, BBGI Group SA

However, it is also in Germany's economic interests to ensure economic recovery in the Eurozone, as this would undoubtedly be of benefit to German industry.

The IMF is therefore very likely hoping that Germany will soften its position, particularly on the budgetary issue, by supporting a programme for recovery via investment and infrastructure development.

In the United States, Hillary Clinton had already promised 500 billion of investment in infrastructure in her election manifesto, pipping the IMF to the post. In China, in February the Prime Minister agreed to increase the budgetary deficit with fresh infrastructure spending. Japan and Europe will surely put forward similar recovery plans, adapted to their respective situations, over the coming months.

Budgetary Deficit as % of GDP (Europe)



Sources: Bloomberg, BBGI Group SA

Fiscal stimulus will pick up the baton left by negative interest rates

In our analysis of the global economic situation, we have already suggested several times that ultra-accommodating monetary policy has been somewhat effective, particularly in the United States. However, at a time when most interest rates are on negative ground, such policy is struggling to demonstrate its relevance, particularly in the Eurozone and Japan.

The situation now requires us to resort to a more conventional form of economic support, reinstating a Keynesian type recovery via a temporary increase in public deficits.

The IMF perfectly timed its proposal of a different, more proactive, strategy, directly targeting employment- and wealth-generating economic sectors. Its proposals will fall on fertile ground with many governments, particularly in European countries that fear the ripples of the Brexit may reach them. It comes as no surprise that Paris and Washington have already expressed support for the IMF's stance and that Germany has come out in opposition. The latter, will probably gradually change its position when it realises that the proposed budgetary spending could also potentially be of great benefit to its industries.

The United States allowed its budgetary deficit to fall to -10% of GDP in 2009. In 2015 it stood at just -2.5%. In the Eurozone, the aggregated public deficit is now just -1.8% of GDP. Clearly, the financial crisis enabled structural reform in southern European countries, but

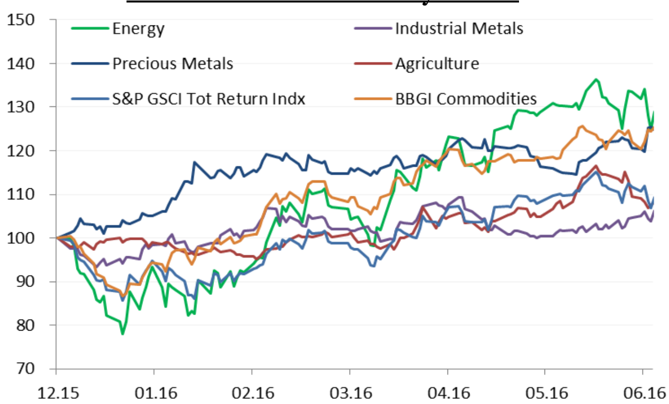
Germany's situation has remained entirely unique in this regard. German budgetary puritanism has asserted itself to a much greater degree throughout the crisis, with only a very slight drop in its ratio from 2009 to 2010, before it quickly corrected and rebalanced in 2012.

Germany now has the greatest room for manoeuvre for global fiscal stimulus. Although it is still too early to hope for a radical about-turn from Germany, pragmatism should eventually win the day. As such, on the evening after Brexit, the German finance minister was not opposed to establishing a budget for the Eurozone, with greater investment to overcome the financial crisis. Being prudent, he suggested greater integration was needed before that could be achieved. However, recovery via investment seems to once again be back on the agenda in order to give confidence a lift.

Commodities have already been affected by a less pessimistic outlook

The huge bounce back in commodity prices since mid-February doubtless partly reflects readjustment to less pessimistic growth forecasts.

Evolution of Commodity Prices



Sources: Bloomberg, BBGI Group SA

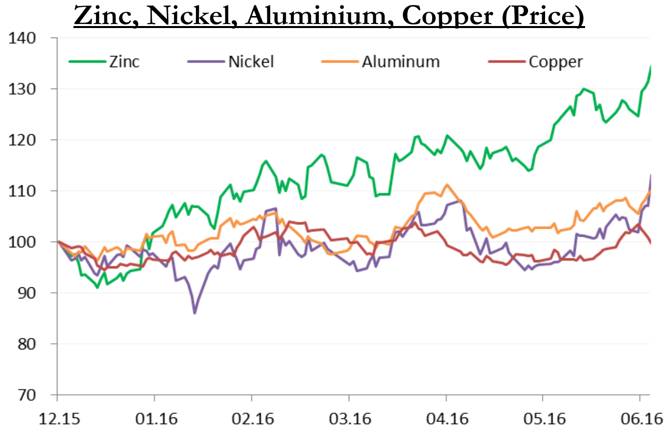
The rise in crude oil prices, combined with the approximately 1.2 million barrel/day drop in US production, also helps explain the improved sentiment with regard to commodities. However, all sectors will benefit from investors returning in 2016.

With the exception of corn (-7%), cocoa and wheat (-11%), all commodities are outperforming the global equities index (+3.9%), and most are posting increases of between +12% (coffee) and +42% (silver).

China is propping up physical demand for commodities

The rise in Chinese imports is also helping to improve positive sentiment regarding commodities linked to economic growth. Crude oil imports continue to grow in volume, staying north of 30.6mb/month. In terms of industrial metals, Chinese imports of nickel and zinc are in good shape, propped up by infrastructure spending. Zinc imports have more than doubled over the first half of the year, whilst Chinese production has remained stable. Zinc prices have also stayed steady thanks to a contraction in operating capacity supply (estimated at 1.5 million tonnes) and a drop in inventory levels. Chinese nickel imports have also jumped nearly +200%, just as the Philippines is set to decrease production levels. In June, Chinese copper imports rose +20% year on year. Copper prices are currently lagging behind zinc and nickel prices, and could benefit to a greater degree from the improvement in investor sentiment in the second half of the year. However, inventories still seem high, which could hinder this trend. Steel prices have also been on the up due to capacity reductions in China. Finally, surplus production of aluminium seems not to have stopped its price from rising, although the increase is comparatively small.

Zinc, Nickel, Aluminium, Copper (Price)



Sources: Bloomberg, BBGI Group SA

The fall in capex, and the reductions in production capacity are creating the right conditions to rebalance the market

On the gold market, for example, production levels would indicate that mining companies' activity levels have stagnated following on from the fall in gold prices over the past few years. These companies are still focusing on rationalising their production processes, aiming to reduce costs by focusing on production in the most profitable mines, and shelving operations at their least profitable mines. New mining projects have also fallen in number, and the fall in capex over the last few years will likely soon produce a market imbalance. Company rationalisations seem to be bearing fruit when you look at average production costs ("all in sustaining costs"), which currently stand at around US$ 850 per ounce. In the energy sector, production has nosedived in the United States, whilst the IEA (International Energy Agency) expects global demand to rise. It is believed that more than US$ 100 billion worth of investment per year has been withheld by crude oil companies due to the fall in crude oil prices. However, the fall in investment is not a factor which is exclusively applicable to these two sectors, it has spread to most energy and materials segments with the fall in prices. **In 2017, the rebalancing from the past few years could lead to a shortfall in supply.**

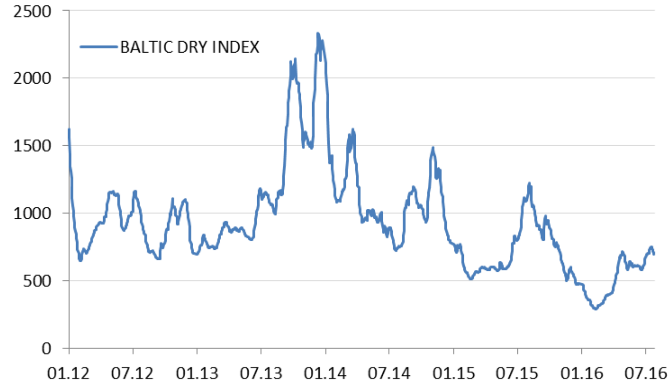
Global trade recovery… rise on the Baltic Dry Index

The Baltic Dry Index reflects changes in maritime transport costs for "dry" commodities such as industrial metals, grains, and coal. It is considered to be a yardstick for changes in international trade and the economic situation. It has leapt nearly +155% since mid-February and +58% since the start of the year. Although it is still way off the levels seen in 2008, its recent behaviour is showing a global trade recovery, still driven by Asian demand for the time being, particularly Chinese demand for iron and coal minerals, and by an increase in the transport of agricultural commodities.

Commodities cycle boosted by fiscal stimulus

The ongoing economic recovery is strengthening in 2016, and will by buoyed up by flatter than expected interest rate curves at the start of the year, especially in the United States. We believe the risks highlighted by the IMF and the Federal Reserve to justify their policy changes to be overstated, just as inflationary forecasts are on the rise, partly thanks to the increase in crude oil prices.

Baltic Dry Index



Sources: Bloomberg, BBGI Group SA

This will undoubtedly contribute to creating a more favourable environment for growth acceleration in 2017. Growth acceleration will also receive a boost from the fiscal stimulus advocated by the IMF. With interest rates remaining low, should there be even just a slight inflation recovery, real interest rates will be able to move back into negative territory and create finance conditions that are even more favourable than at present. This will prop up the economic growth trend.

Conclusion

Commodities will already be reaping the benefits of a better economic situation in the second half of 2016, but they then stand to gain in the longer term from the positive economic effects of a favourable new budgetary and political context, as well as negative real interest rates.

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