THE DAILY CHECK-IN WITH GOLDMAN SACHS

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Liz Bowyer: Hi Damien.

Damien Courvalin: Hi Liz. How are you?

Liz Bowyer: Good, thanks.

Liz Bowyer: You cover commodities for Goldman Sachs Research. We've seen a significant rise in commodity prices recently after a multi year slide compounded by the challenges of the pandemic. And what you and your colleagues in Goldman Sachs Research have argued is that what we're actually seeing is the beginning of a new structural bull market for commodities. What's driving that view?

Damien Courvalin: There really are three drivers here. The first one is in the short run - vaccines. Right? They will help commodity demand recover further, especially oil as people start to travel again. We expect that to play out this year and really over the next few months.

The second driver is also on the demand side. But it's here to stay. And reflects the shift in government response to the COVID shock. It's a focus on income redistribution and on a greener economy. Now what does that mean? Well, income redistribution actually helps commodity consumption because at the bottom end of your income distribution most of your spending is actually on food, energy, and capital goods. So, such policies help.

Now the build out a green economy is inherently capex and it's commodity intensive. Now, it's clear for metals, like copper, which go straight into electrification. But initially, you [UNINTEL] need all those trucks as well, which today still run on diesel, and so it's also supportive of oil demand. So, that's the second driver of this kind of medium-term policy support.

The third one is supply. And if you look back at the last ten years, commodity supply has mostly been about oversupply, excess investment. This is changing, first because of the very low prices last year. But also, because producers are [UNINTEL] responding to solve the capital destruction they've done for a decade and investing less to return more cash to shareholders. And that third supply driver will also contribute to the structural appreciation in commodity prices.

Liz Bowyer: And you've recently updated your forecast to reflect a 12-month commodity index return of 15.5 percent. What's behind the change in your forecast?

Damien Courvalin: The key really is just that the evidence for this structural bull market case is, you know, surprisingly strong already. Okay? Let's start on the demand side, right? You know, vaccines do appear to work. We have four now and likely more to come. And you know, it's helping transportation, mobility already. And when you look at spending decisions by people who have been vaccinated, it points to this big uplift in travel, especially people flying that we expect going forward. So, that's the first source of evidence.

Now, the second one is just outright consumption of goods. Right? You know, this pandemic is ultimately a restriction on services. But that's actually led to more goods demand. So, you can see it in retail sales, in volumes of goods shift. And that's also a surprise to the upside. Now, the second evidence has been on the redistribution side. Right? We've just had a significant stimulus package passed in the US above pretty much everyone's expectation. And we actually see it in the consumption data driving this commodity demand. If you look at spending by lower income, you know, in the US it's already above pre-COVID levels. As I mentioned, that's a lot of commodity demand.

Now finally, supply. Well, the illustration there is South America. We continue to see mine disruptions due to COVID, but also weather. The same excess rains are delaying harvests for crops. And in the case of oil, we're seeing continued growing evidence of a lack of response to higher prices. It's shale discipline, other producers, and ultimately OPEC realizing that, you know, this gives them an opportunity to overtighten the market. When you put all that evidence together, and what you get is a confirmation of the bullish thesis, but actually even more upside than we expected. And we had to raise our copper, oil, and grains forecast as a result.

Liz Bowyer: You've also written that the policy backdrop represents a tailwind for commodities. What's the evolution there?

Damien Courvalin: I think the key first is the structural break from the last ten years. Now, if you go back to the policy response to the financial crisis, it's austerity at the government level offset by easing, quantitative easing by central banks. That ultimately led to savings accumulation, rise in asset prices. But it wasn't that supportive of commodity consumption, outright consumption. And it left GDP growth pretty much stalled around 3 percent.

The COVID shock is the break that brings in this new policy response. One, whereby pretty much every economy is stimulating at the same time. And using excess spending and debt issuance instead of austerity. So, you know, when you put numbers on it, what you get to is, okay, now we've seen the stimulus in the US, but this income redistribution focus is global, right? It's in Europe. It's in the UK. It's in the next Chinese five-year plan. It's embraced by the Fed, by the EC. So, this one is here to stay.

The second one is on climate. Right? So, we've seen a significant shift as well in focus there. And I think the capex numbers are important to point out. When you look at the next ten years in terms of policy and company announcement, our equity analysts grow that up to about 16 trillion dollars. That's more than China and the BRICs spent in the 2000s. And that's a significant increase in capex intensity of the economy.

And then, really, third to illustrate, again, those drivers, is what we see on the supply side, right? ESG is becoming a key, central focus of investors. And it translates into a shift of capex spending by producer. Right? Less investment in oil and gas. More focus on renewables. And as a result, more demand for metals. This ESG flow is ultimately increasing the cost of capital for oil and gas. And again, contributes to that increase in commodity prices.

So, I think the core really point is the structural break with the previous policy mix. And then second, the broad-based nature of that shift, it's across economies and it implies both changes to supply and to demand.

Liz Bowyer: Another point that you make in your research is around the diversification value of commodities. They are, in fact, the best performing asset class this year. Describe the philosophy there.

Damien Courvalin: The core concept here is commodities are real assets. Now, let's think about equities first, right? As you see the rebound in activity last year, investors start to extrapolate into better growth in '21/'22. They model it in their companies. And as a result, the share price goes up initially, right? Because this is simply the discounted future cash flow.

Commodities don't work that way, right? You know, last year in the fall, oil demand was still weak. We had excess inventories. Excess supply capacity. Even if I knew for certain that oil demand would be strong a year or two or later, it really wouldn't help in the short run the supply/demand fundamentals and the overhang of the oil market.

However, as the business cycle evolves today, you know, we're finally hitting that strong growth rate, and anticipatory assets like equities have to start considering a future where growth rates slow, potential risks of inflation compressing margins, and that becomes a more challenging mix to value equities going forward.

But let's go back to commodities. This is an environment where commodity demand is finally strong. Look at copper. We're above pre-COVID level in terms of consumption. And that's hard to create upward appreciation and pressures on commodity market. As demand levels are high enough to start to stress productive capacity. And that's the key diversification component of commodities. They're a real asset. They will reflect today's conditions rather than reflect forward conditions. So, they underperform initially coming out of a recession. But now, you know, they're poised to outperform.

And you know, case in point, if you went back to 1999-2000, periods of a strong commodity market, strong underlying consumption, those markets rallied by 30 percent when the tech bubble sold off and those stocks came down by 50 percent. So, that's when you start to see the benefits of diversification from commodities in a portfolio.

Liz Bowyer: Well, finally, Damien, you've written about commodities as both a reflation trade and an inflation hedge. Explain those dynamics.

Damien Courvalin: So, let's start with reflation, right? Reflation is a policy support to get growth back to trend. As we discussed, that supports consumption, enhance commodity consumption. So, the reflation effort does help the commodity price outlook.

The risk, of course, is you get to an inflationary outcome where you support demand to the economy's productive capacity, you start to see overheating. And that actually tends to support commodity prices for the same reason. Right? Commodity demand is supported, commodity demand starts to hit its productive capacity, and you start to see a commodity appreciation. So, from that respect, commodity, as a real good being consumed and stimulated through reflation policies, is a good inflation hedge.

Now, often people associate, instead, commodity as a good inflation hedge for an input shock. Think oil shocks of the 1970s. Right? Through that, in the short run, commodities are at that point good inflation hedge since they're the source of inflation. But those environments are very short lived, right? The appreciation commodity prices forces [UNINTEL] other goods lower. And quickly it's a recession and deflation.

What we're arguing for here is different. It's the ability of commodity to heading inflationary pressures. Not a one-off shot, but really, growing pressures as demand gets supported through reflation policies. And that's why, ultimately, we think that this structural bull market in commodities, you know, is important for investors to consider in their portfolio allocation as a hedge against an inflationary risk going forward.

Liz Bowyer: Thanks Damien.

Damien Courvalin: Thank you, Liz, very much.