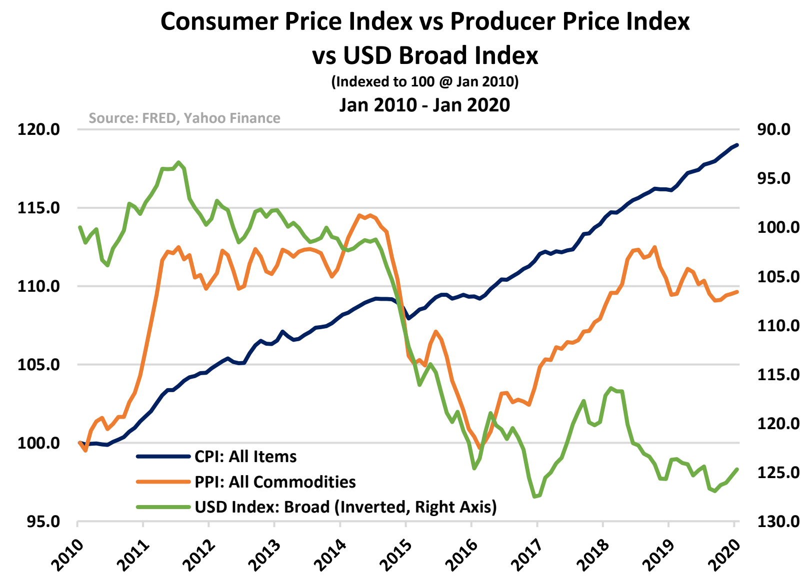
Post-Coronavirus Commodities Comeback

Market Viewpoint: February 28, 2020

Summary: Commodities have fallen fast and hard in the wake of the Coronavirus' pummeling of nearly every asset class. This is not surprising as Chinese industrial output, as well as exports of key materials have grinded to a halt over the last month. However, given the virus's deteriorating foothold in China, as well as the upcoming changing of the seasons, investors should start looking beyond the epidemic and into the recovery. MRP sees historically cheap commodities ready to explode once warehouses begin to empty out and the Dollar returns to depreciation.

From the financial crisis Lows, assets prices have had a stunning rebound: Common stocks have quadrupled; emerging markets have doubled; bonds prices have surged as interest rates have plunged and home prices have more than recovered what they lost. But the pariah at the party has been commodities. Broad indexes of commodity prices are actually lower now than at the worst point in 2009, pushed even further down by concerns around the outbreak of COVID-19 (known colloquially as Coronavirus).



Within the broad commodities asset class, there have been some divergent performances. Lumber prices surged on the housing market's recovery and US tariffs on Canadian softwood imports while increased consumption of meat across emerging markets has consistently pushed live cattle and beef prices higher. The standout has been precious metals, which had rallied as of late, before getting wiped out in late February.

That more recent performance of commodities can be attributed to the Coronavirus, which is highly contagious and is mostly spread through drops of saliva and mucus coughed up by those infected, originated in the Chinese city of Wuhan, Hubei Province. Total infections now tally over 80,000 and the concentration within China has brought the world's second largest economy to a standstill.

Through all of the doomsday forecasts, MRP has worked to keep a cool head and convey some optimism to our clients. In our viewpoint from last month, we noted that the Coronavirus, while more contagious than similar epidemics like SARS, was likely to be much less deadly, with those most affected to be the elderly or immunocompromised by a pre-existing condition. That projection has held true as *The Chinese Journal of Epidemiology* now estimates that the risk of fatality as a result of Coronavirus for those 10-39 years is just 0.2%, rising to just 1.3% for those infected aged 50-59. The most at-risk demographic cited in their study was the 80+ age group, with a likelihood of death as a result of infection at 14.8%.

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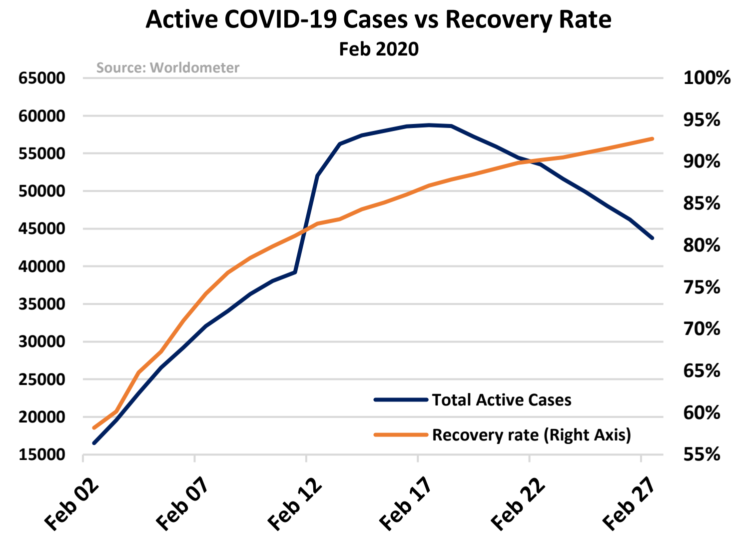
Those with cardiovascular disease, diabetes, or chronic respiratory disease also maintain higher likelihoods of Coronavirus-induced fatality.

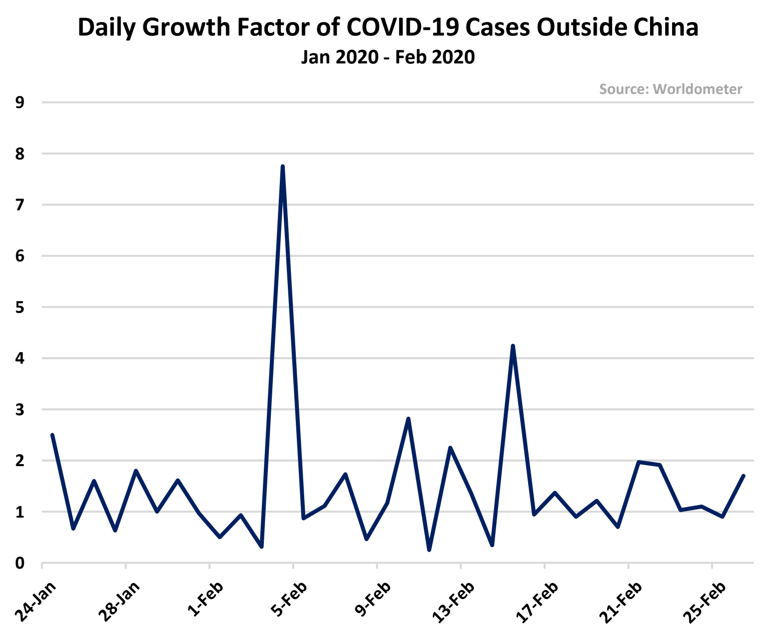


Already, the worst appears to have passed for China as new cases inside Hubei Province, where the original outbreak began, have slowed significantly over the past week. Daily new cases within China but outside of Hubei are dwindling and could be within striking distance of zero very soon.

Total active cases, as well as serious and critical cases look to have already crossed their peak as the 30,000+ recoveries now outstrip deaths by a factor of 11. Daily recoveries have oupaced daily new cases everyday since February 19.

Injecting some much-needed optimism into the market, Apple's CEO Tim Cook took to the airwaves to try and assure the world that China's supply chain has started to get back to work. Apple, a major bellwether for Chinese manufacturing, has previously warned that Coronavirus could hurt iPhone supply around the world. But Cook noted that they've already reopened factories and insited that damage to company sales targets can be managed, calling the virus a "temporary condition" and not a "long term kind of thing." According to the Baidu Migration Index, more than 60% of people have returned to their workplace areas in China's 100 biggest cities.

However, the focus of concerns around Coronavirus have shifted from China to the international stage. While cases around the world are now gaining much more attention than they had, the significance of Covid-19's weakening epicenter should not be understated. China has demonstrated that, even after being caught offguard and undersupplied, regional hospitals overflowing with the infected, the Coronavirus can still be effectively contained.



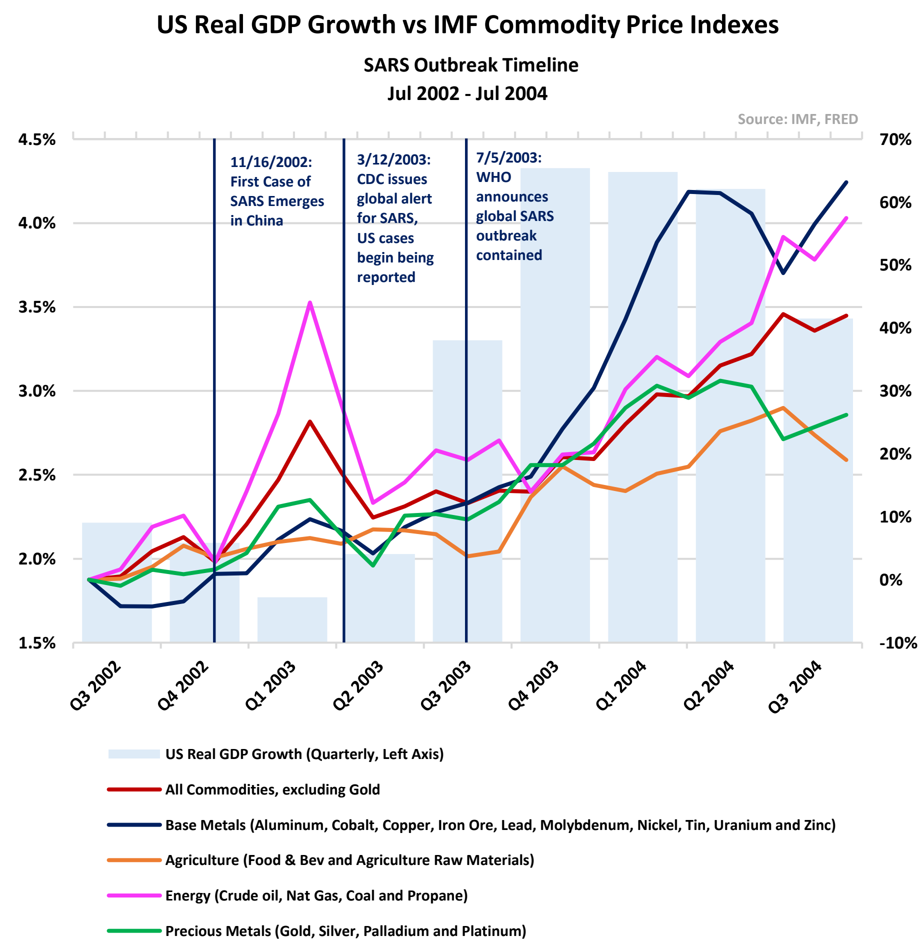
Though the uptick in international cases seems significant, the growth factor for non-China cases actually remains within the same range it has maintained since January. So, while there are indeed more cases, there has not been a notable acceleration in new international infections.

Along with improved treatment methods that have been uncovered, the extreme contagiousness of Coronavirus is expected to be hampered by the same changing of the seasons that draws flu season to a close. The occurrence of flu season is brought on by winter months of cold air and little humidity weakening human immune systems and allowing viruses to pass through the air more easily. Flu season began in

November, so Coronavirus' late arrival is a clear silver lining, as growth in new cases could mostly be halted by April or May. For context, by the time Coronavirus appeared on the scene, 15 million people had already contracted ifnluenza as part of the normal flu season. Influzenza is responsible for anywhere from 12,000 to 61,000 deaths per year since 2010, per the CDC.

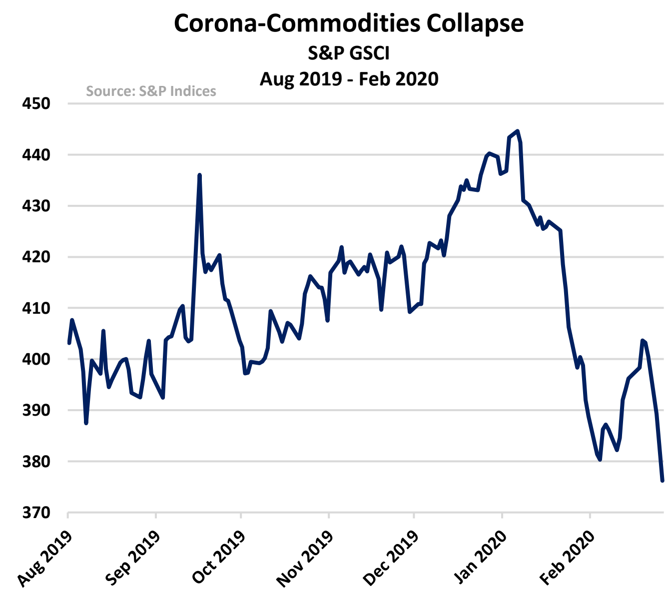
Countries where the number of cases have now grown exponentially like South Korea, Japan, Italy, and Iran are correct to respond fast and hard, but are likely not in nearly as bad of a way as China was. The potential economic impact of Coronavirus on domestic economies outside of China, for now, looks to be marginal. South Korea would be the top market facing economic disruption.

China, as well as the rest of the world, will undoubtedly see a contraction in Q1 growth as a result of the Coronavirus, but as we observe how the virus has developed, it looks more and more like the hardest hit sectors will be retail and services, and the impact will be more accute than long-lasting. Traders priced in a huge wave of risk at the end of January when the WHO and CDC were unsure of exactly how deadly the virus could be. That was followed by a sharp run-up in equities and commodities prices that even set a new record close for the S&P 500, and a subsequent, even deeper drop off of nearly 8%.



A similar phenomenon could be observed in 2002 – 2003 when the SARS epidemic originated in China's Guangdong Province. At the time, China was the 6th-largest economy on the planet. Commodities began to roll over as the crisis unfolded through the late winter months. SARS emerged even later into the flu season than Coronavirus, so the first US cases started popping up in April, leading to a strong sell-off in commodities. However, by the time Spring rolled around, it became clear that the severity of the virus was waning and industrial, manufacturing, and farming activity returned to order. Between July 2003, when the CDC officially announced that SARS had been contained and no new cases has been reported in about a month, and July 2004, nearly all classes of commodities rebounded to outperform the S&P 500.

MRP expects a similar outcome in the aftermath of Coronavirus. While this virus has no doubt been more destructive than SARS by all metrics, we believe commodity markets will continue to tighten and resume the climb they had been on through late 2019. Prior to the Coronavirus breakout, the Goldman Sachs Commodity Index (GSCI) had also been on the rise for nealy 6 months straight, gaining almost 15% from its 2019 trough to its early January peak. For now, it appears to be making a double bottom, presenting an opportunity for investors already looking beyond the Coronavirus into the rest of the year. MRP believes that when China is back in full swing and virus fears subside, weak commodity prices, driven up by trapped inventories in China, will reverse course swiftly.



Weaker Dollar Will Drive Commodities Higher

One of the most detrimental trends for most commodities, though, has been the pervasive strength of the US Dollar, following a period of rapid appreciation between 2014 and 2016. Since the Dollar serves as the exchange mechanism for most commodity prices around the world, its value versus other currencies often runs inverse to the price of commodities. An especially strong Dollar means it will take more units of another currency to purchase the commodities that are denominated in USD, oftentimes hurting demand.

The Dollar's breakout in the mid-2010s led to a significant downturn in the US Producer Price Index (PPI), a measure of the average change over time in the selling prices received by domestic producers for their output, completely decoupling it from the consumer price index (CPI). Essentially, while consumer prices continued to rise, American manufacturers and other purchasers of raw goods were handicapped by the Dollar for years.

This led to huge underperformance by commodities when compared to other asset classes in the post-financial crisis era.

The Invesco DB Commodity Index Tracking Fund (DBC) shows just how bad things have been for commodities when compared to other major sector and asset-class specific ETFs. While most other funds have now surpassed their pre-crisis levels, the DBC remains just half of what it was worth in October 2007.

A weaker dollar sent the DBC to a two and a half year high in 2018, but a resurgent Dollar prevailed and sent commodities plunging once again.

Commodities Notch Worst Post-Crisis Recovery

Sector/Asset Class ETFs (Source: Yahoo Finance)	Return Since Oct 2007
Technology SPDR Fund (XLK)	239%
Health Care SPDR Fund (XLV)	171%
Consumer Staples SPDR Fund (XLP)	122%
Industrial SPDR Fund (XLI)	87%
Utilities SPDR Fund (XLU)	69%
Materials SPDR Fund (XLB)	31%
iShares 7-10 Year Treasury Bond ETF (IEF)	38%
Financials SPDR Fund (XLF)	1%
iShares MSCI Emerging Markets (EEM)	-15%
Energy SPDR Fund (XLE)	-35%
Invesco DB Commodities Fund (DBC)	-49%

In December futures for materials, crops, and energy all looked promising as the USD experienced its worst monthly performance in 2 years, sliding 2%. Prior to its decline, the Dollar had skyrocketed more than 11% between January 2018 and August 2019.

Following that period, and MRP's publication of "The Booming Buck" which detailed a number of reasons why the surging strength of the Greenback was unsustainable, the Trade Weighted US Dollar Index for Goods and Services declined by more than 2% versus a broad basket of currencies through January.

While Coronavirus has driven a short-term surge in the Dollar, the fundamentals behind our belief in a fading Dollar through 2020, highlighted in last month's viewpoint, remain intact.

The spread between US and Eurozone real rates remain tight and many emerging markets have halted the monetary easing cycles that bolstered the Dollar through 2019. A weaker dollar also makes commodities denominated in the U.S. currency less expensive for overseas buyers, which will benefit commodity markets.

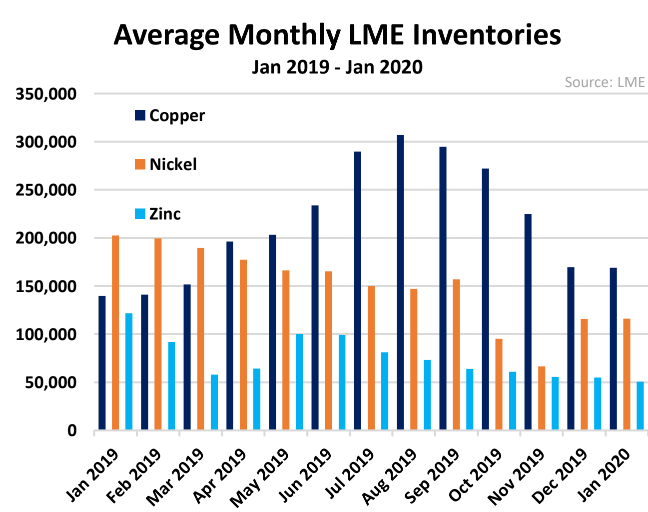
Industrial & Precious Metals

Simultaneously, copper, zinc, aluminum, steel and iron ore inventories have all risen according to statistics from S&P Global Platts. However, only a slow ramp-up in usage of stocked material was seen occurring following last week's official return to work for many Chinese facilities. These recent supply builds in China can almost wholly be attributed to transport restrictions introduced to halt the spread of the Coronavirus. Many manufacturers had voluntarily postponed the resumption of operations after the holiday period until February 10.

Major metals & mining firm BHP now expects China's growth to slow to about 6% this year and, depending on how long the virus' effects linger on, expects growth to decline even further to between 5.5% - 5.75% in 2021. However, that's not really out of line with IMF projections published in January before the Coronavirus outbreak began. The IMF pegged China's 2020 and 2021 growth at 6% and 5.8%, respectively, reflecting a Chinese slowdown that has been foreseen for some time now. So, while the Coronavirus will be a catalyst, it is not solely responsible for the Chinese slowdown.

Stimulus plans have long been laid out by China's government to boost spending on infrastructure and industrial output. In 2019, China approved 26 infrastructure projects with a total expected investment of 981.7 billion yuan (US$142 billion), a drop of 66.33% from the 1.48 trillion yuan approved investment for the 27 infrastructure projects in 2018, according to the National Development and Reform Commission (NDRC). As MRP noted in last month's Viewpoint, the timing of Coronavirus has been somewhat fortuitous for a couple of reasons.

Construction activity winds down in January and February due to severe weather, before picking up to full speed between March and June. Not only do workers traditionally receive an extended period of time off for the Lunar New Year, but extremely cold weather in many parts of the country halt operations like cement output, which must wait on warming weather to effectively mix concrete on building sites again. While January and February figures are often too weak to be reported by China's statistical agency, May output over the same period averaged about 23% above the levels just two months earlier.



The Wall Street Journal reports that February is typically the weakest month for metals output in China. Trading in iron ore, coking coal and alumina slows or stops entirely as restocking mostly occurs in the run-up to the holiday. Per the Washington Post, in the five years through 2018, daily pig iron production in March was about 7.4% higher on average than it was in January.

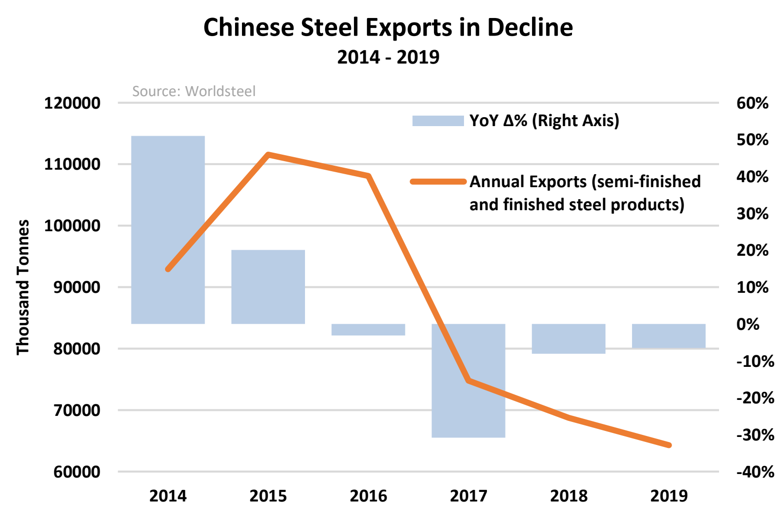
Copper inventories had been running extremely low in last month, after their warehouse stockpiles tracked

by the three international exchanges shrank by about 37% between July and January following an annual decline in production last year.
Argus Media notes that inventories of sulphuric acid, the main by-product of copper, lead and zinc smelting, are now on the rise as it cannot be delivered on time because of logistical restrictions. Smelters may be forced to reduce production capacity if sulphuric acid storage capacity is full, the association warned.

Bloomberg notes that the price of copper, a barometer for the global economy, could jump in 2020 with capital spending for new production down and stockpiles tapped out at a time when U.S.-China trade tensions are easing. Inventories at warehouses tracked by the three international exchanges, a last resort for supply, had shrunk by about 37% since July to just shy of 300,000 tons in January, equivalent to just 1.2% of global consumption. Meanwhile, mine production fell 0.4% last year from 2018.

China's finished steel exports dropped 7% year on year to 64.293 million tonnes in 2019, the lowest annual total since 2014 and a fourth consecutive annual drop. Additionally, an S&P Global Platts survey found that 35% of surveyed Chinese steel mills had already trimmed steel output or were planning to, while 23% said their operations were running normally so far. Some mills had wanted to bring forward maintenance of their steelmaking operations – which is a proxy way of reducing production – but were unable to do so due to lack of workers and equipment.

Hellenic Shipping News reported earlier this month that, although inventories continue to surge, a number of mills announced steel production cuts of 20%-30% from March, partly due to the bringing forward of maintenance.



Iron ore prices have already bounced off of an early February low, climbing for a number of reasons inside and outside of China. Concerns about supply had been circulating after Brazil's Vale posted Q4 results showing a sharp drop in output following dam ruptures and bad weather last year. Vale's fourth-quarter production fell 22.4% from the same period last year and 9.6% from the previous quarter. Supply disruptions can also be observed in Western Australia due to infrastructure damage caused by tropical cyclone Damien.

Resulting concerns around the seaborne supply of iron ore have already pushed prices to their highest level in nearly a month.

In addition to Industrial metals, precious metals had been enjoying their own run up in recent weeks. Gold broke above $1600/oz for the first time since 2013 last week and looked to keep strengthening as Commerzbank reported that inflows of gold into exchange-traded funds rose for 21 business days straight through last week and central bank purchases remained equivalent to approximately 20% of new gold production, according to Kitco. However, the yellow metal became a surprise victim of the "sell-everything" plunge this week and gave a months-worth of gains.

Since MRP transitioned our Long Gold and Gold Miners theme into a Long Silver and Silver Miners call in July 2019, the silver miners had outperformed gold miners, en route to a 6-month high in the spot price of silver.

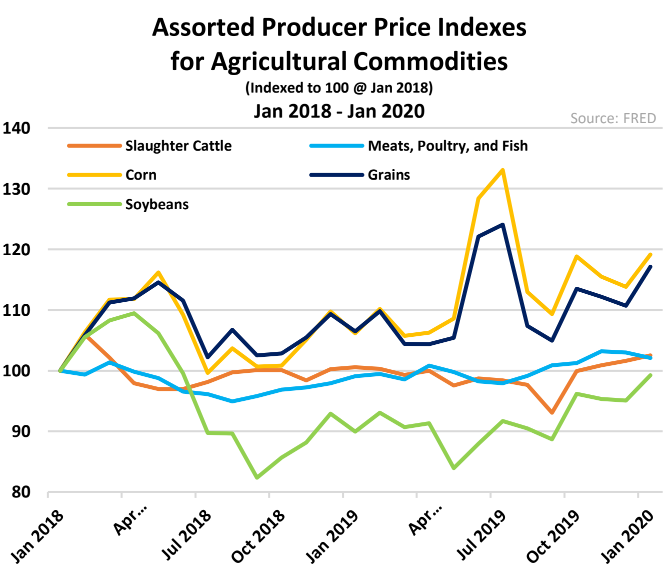
MRP also identified Palladium as a potential market-beater way back in October 2017. We pulled the theme prematurely in late 2018, after strong outperformance of the broader commodities market, but it has continued climbing since then. Overall, palladium is up by more than 430% from its 2016 low and looks to keep surging.

Crops & Animal Agriculture

When it comes to agricultural goods, a building meat shortage had been the story in China prior to the Coronavirus outbreak.

China's been increasing meat imports from the United States, Europe and Brazil as African Swine Fever (ASF) has killed up to half its pigs since August 2018. The US Department of Agriculture (USDA) is forecasting China's pork production this year will fall more than a third to 36m tonnes. This should increase the country's reliance on overseas suppliers. Chinese pork imports jumped an estimated two-thirds last year and the USDA predicts another 42% rise in 2020 to 3.7m tonnes. MRP noted the potential impact of China's diseased hog supply all the way back in May 2019, arguing stronger Chinese demand for international exports would drive up prices for livestock and meat products.

Even with the rise in imports, multiple sources including Beef Magazine and Global AgriTrends have estimated the loss in meat supplies at anywhere from 22-25 million tonnes. "The problem is that total global pork exports in 2018 were 8 million tonnes, and China is short 24 million," Rupert Claxton, of international food consultancy Girafood, told The Guardian. Therefore, the Chinese will be forced to fill the gap with a healthy mix of poultry and beef, as well as the pork that has become a staple of the Chinese diet.



Beijing has already pledged to increase purchases of US farm goods in an initial trade deal last month, raising traders' expectations for more pork shipments. As part of the deal, Beijing has pledged to buy an additional $32 billion in farm goods over the next two years and will strive for another $10 billion of purchases. Bloomberg reports that the government is in discussion over what commodities it may begin purhcasing at the end of February or early March. Demand for food is not destoryed like demand for gasoline when people are not travelling during a major holiday season, rather the demand is delayed. So, once the flow of goods resumes in China, it is unlikely that the aggregate demand for things like corn, soy, and meats will be any lower than it was before the virus.

One interesting development worth noting outside of China has been in coffee beans, one of the agricultural commodities hurt worst by the Coronavirus since it is a discretionary good and largely dependent on populated coffee shops that many in China have been avoiding. However, humongous swarms of locusts are now plaguing East Africa and causing extensive damage to coffee crops in Ethiopia and Uganda, 2 of the world's top producers. A single swarm of the insects can measure 25 miles long by 40 miles wide, according to the UN Food and Agriculture Organization (FAO). The FAO is now warning that locusts have continued to breed in the Horn of Africa, which would lead to new swarms forming in March and April. The international Coffee Organization's (ICO) composite indicator shows prices up 7% since the start of the month.

Energy Products

Energy prices have been the commodity most endangered by the Coronavirus, but crude oil has managed to remain resilient in the face of shutdowns of major airline routes through China, as well as curbs on travel within the country. After falling from $63 per barrel to below $50, OPEC and its synidcate of non-member oil producing states (often referred to as OPEC+) remain in talks, but have not yet taken action, to tighten their output further than they already have in 2019. Saudi Arabia has threatened to lead new production cuts of 700,000 bpd – with or without the agreement of Russia and others – if the demand situation deteriorates further.

Even with emergency ouput cuts, though, energy is still the wildcard among commodities, given the disproportionate effects of Coronavirus on travel stocks. Flight cancellations around the globe, which will extend into March for many airlines, will undoubtedly slam crude oil and finished oil product sales in a year that was projected to see demand rise before Coronavirus cancelled the party.

Earlier this month, the IEA noted that the coronavirus outbreak would lead to the first quarterly contraction in global oil demand in over a decade. The IEA has already slashed its 2020 oil demand growth forecast by 365,000 bpd to just 825,000 bpd—which would be the lowest oil demand growth since 2011.

MRP's Themes

MRP believes the upcoming post-Coronavirus recovery of commodity prices will be hugely beneficial for our long themes on Silver & Sliver Miners, Agricultural Commodities, and Emerging Markets.

In the intermediate, our short Coal theme will benefit from an even steeper decline than it has already experienced since we added it to our list of themes last December.

Certainly, we are not calling a bottom here, considering the past week of volatility, but MRP is always looking ahead to identify the next discontinuity in the market that will create disruptive change and generate alpha. In addition to the aforementioned themes, we will also be keeping an eye on the Invesco DB Base Metals Fund (DBB), but will hold off on declaring it a theme until the dust begins to settle.

Though the financial consequences of Coronavirus seems to be the only thing that matters in markets today, there is still plenty happening behind the scenes that will lay the foundations of the market's eventual comeback and a strong performance for commodities over the balance of 2020.

Our hearts go out all of the families whose loved ones have been effected by Coronavirus and hope that the outbreak is stemmed as soon as possible. We are also thankful for the millions of brave doctors, nurses, and other medical care workers who have labored tirelessly to treat those who have been sickened.

Joe Mac

For MRP's research disclaimer, please go to www.mcalindenresearchparters.com/disclaimer.html

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