Middle East Strategy

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Commodities in Focus: Tracking Trends in Oil, Gold and Copper

- **Recent geopolitical tensions, particularly between Israel and Iran, have put the spotlight on the inherent risks to global energy supplies.** However, while these events underscore a less secure environment, the actual impact on global markets and economies may be less negative than initially feared.

- **Oil prices continue to teeter near two-month lows as markets' focus oscillates between geopolitical tensions and inventory reports**. Recent Energy Information Administration (EIA) data shows a temporary draw in US crude inventories suggesting a mild recovery. However, overall demand remains weak, and manageable geopolitical uncertainty in the Middle East continue to pressure prices downwards. The market's focus turns to OPEC+'s response to these evolving dynamics as major determinants of future oil price trends.

- **The differing natures of gold and copper.** While their prices have increased recently (more below), gold and copper have historically served different functions, the former being an inflation/depreciation hedge and the latter being essential for economic activity. We see a possibility where, if China succeeds in stimulating its markets, gold loses some of its momentum as Chinese consumers regain the confidence to enter the equity market, while copper grows in value due to the increased commercial activity a rejuvenated economy would likely encourage. This is not, however, our base case, as both commodities have long-term trends underpinning their own growth stories.

- **Gold's performance should be attributed to flow, not geopolitics.** Weakness in China's economy has spurred Chinese demand, while central banks globally ramp up gold purchases, driven partly by emerging economies seeking to find an alternative to the dollar. Investors wary of current levels should keep in mind that the current "bull run" has more legs to stand on than just geopolitics.

- **Market drives copper high in anticipation of growing demand.** Copper is up nearly 15% year-to-date. As copper usage grows – electric vehicles require enormous amounts – amid the electrification of infrastructure and transportation, markets grow fearful of what will happen if the rate of supply does not keep pace with demand.

Oil Markets: Balancing Inventory Trends and Geopolitical Shifts

Recent geopolitical tensions, particularly between Israel and Iran, have spotlighted the inherent risks to global energy supplies. However, while these events underscore a less secure environment, the actual impact on global markets and economies may be less negative than initially feared.

The concept of 'Economic Security,' as outlined in the Wealth Outlook 2024, suggests preparing for uncertainties by diversifying into areas like redundant energy supplies, cyber-security defenses, and robust tech supply chains. These sectors offer long-term growth opportunities, even amid their usual market volatilities.

Historical data and recent market behaviors indicate that global supply shocks, while possible, are rare. The market's reaction to the April 13 attack, where Iran fired over 300 missiles and drones at Israel, was measured, with initial volatility in oil prices but no long-term change in futures prices. This aligns with past observations where geopolitical incidents have caused initial market overshoots followed by stabilisation.

Despite the immediate concerns, the long-term impact of regional conflicts on global economic trends tends to be limited. Markets quickly recalibrate risks, and significant directional shifts in the world economy due to these events are uncommon. As noted in recent discussions, the likelihood of an inflationary recession similar to the 1973/1974 OPEC embargo is considerably reduced, given the diversified control over global petroleum supplies.

While geopolitical surprises call for vigilance, a structured and diversified investment approach can mitigate potential negative impacts. By focusing on economic security, strategic asset allocation, and maintaining a perspective on long-term growth amid short-term volatility, investors can navigate through periods of geopolitical uncertainty with confidence.

Oil Prices Fall to Two-Month Lows

Oil markets continue to teeter near two-month lows, oscillating between hopes of a peaceful resolution to the Middle East conflict and concerns over oil inventories in the United States. The stock market's attention is primarily fixed on the ongoing negotiations between Israel and Hamas, mediated by Egypt. Despite facilitation, these discussions have reached a stalemate, with both sides showing signs of renewed conflict. Israel has voiced dissatisfaction, stating that the proposed terms fail to meet its security needs, complicating the peace process.

Brent prices dipped below $83 a barrel this week, after briefly trading above $90 in early April, while West Texas Intermediate declined towards $77 per barrel. Prices are down over 8% since early April, however, year-to-date, prices are still some 9.5% higher (**FIGURE 1**). Supply and demand for crude oil point to a market that is finely balanced (**FIGURE 2**).

Adding to the downward pressure on oil prices, statements from Russian Deputy Prime Minister Novak have contributed to bearish sentiment. He mentioned that the OPEC+ alliance, of which Russia is a member, is considering several options to adjust their oil production strategies, including the possibility of increasing output. This news coincides with the latest EIA weekly inventory reports which showed a headline draw, suggesting a recovery in oil prices. However, the trajectory may still be bearish as the market shifts its focus to OPEC. Although US crude inventories fell by 1.36 million barrels per day, in line with expectations, after a slow build over the past weeks, the draw isn't necessarily bullish given the weak four-week average gasoline demand, still recovering from 2020 lows.

Moreover, front-end WTI and Brent contracts retraced losses and traded flat on the day, amid increasing OPEC+ noise which is expected to keep prices jittery leading up to the June 1st OPEC Joint Ministerial Monitoring Committee (JMMC). The price of oil rallied temporarily after headlines of loosening production cuts were denied on 7 May. Citi Research expects unchanged production cuts throughout H2, provided prices don't return to the $90-100 range.

Last week, oil prices registered their largest weekly decline since February. Despite this, prices have generally trended higher year on year, largely due to OPEC+ production cuts that have tightened the market. From supply levels and OPEC+ strategies to geopolitical tensions and economic indicators, this complex array of factors continues to play a critical role in shaping the global oil market's trajectory.

FIGURE 1: Oil prices off their April highs

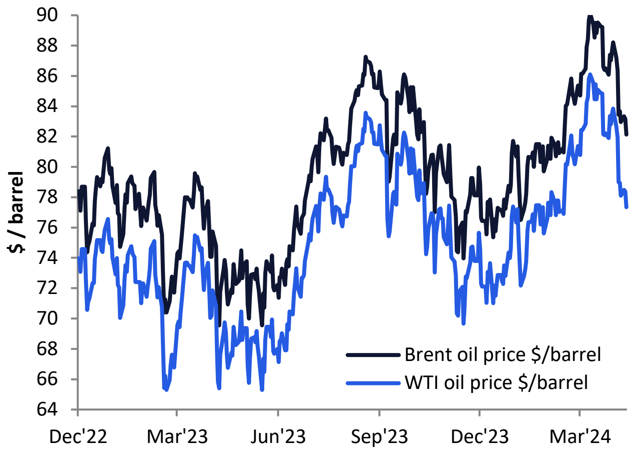
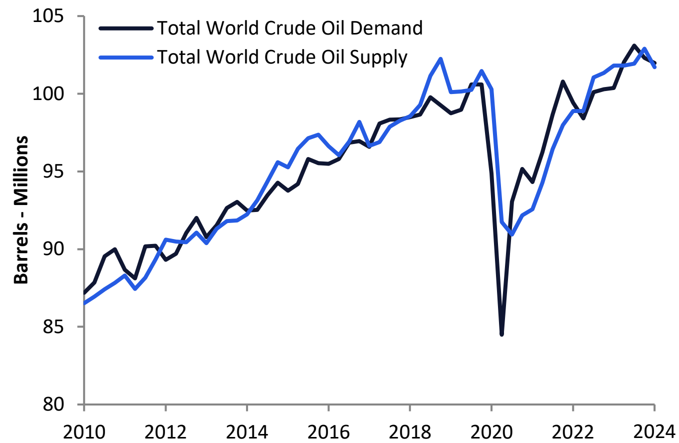


FIGURE 2: Global crude demand and supply



Source: Bloomberg as of May 8, 2024.

The Dance of Commodities in a Reviving Economy

In the realm of commodities, gold and copper stand out for their distinct roles and reactions to global economic shifts. Copper, with its ability to predict economic trends, is a pro-cyclical business input. Its demand increases during economic booms, driven by its widespread use in important sectors such as construction, electronics and manufacturing. As these industries expand with the economy, the need for copper escalates, making its demand a strong indicator of economic health.

Conversely, gold serves as a counter-cyclical asset, sought after primarily during economic downturns. It is viewed as a safe-haven investment, offering stability in uncertain financial times. Gold's value typically rises while other investments falter, reflecting its role as a hedge against economic distress.

The potential resurgence of Chinese economic growth presents a compelling case study in the dynamic between these two commodities. As China's economy recovers and expands, the demand for copper could surge, driven by increased activities in construction and technology sectors. This shift might tilt the balance away from gold, whose appeal often diminishes during periods of robust economic growth. Hence, a thriving Chinese economy could significantly bolster copper demand, illustrating the cyclical nature of these commodities in response to global economic conditions.

The Golden Marathon

Gold has had a magnificent run in 2024 (**FIGURE 3**), with spot prices starting the year at $2,063/oz, hitting a 2-month low of $1,993/oz in February, and then rising rapidly to an all-time high of nearly $2,400/oz in April. While Gold has given back some of its gains, having fallen to a little over $2,300/oz, it is still up nearly 12% YTD, exceeding the returns of the S&P 500 and even the Nasdaq 100, which are up 8.8% and 7.5%, respectively.

Many have attributed this rapid rise to geopolitical instability, with tensions in the Middle East escalating in the wake of the Israel-Hamas conflict. We concede that geopolitical events can often impact the prices of commodities (especially gold and oil). However, those impacts tend to be short-lived and limited in nature, given that the fundamentals driving commodity prices tend to remain unaffected. Despite the increase in gold post-October 7, we would argue that the driver for the increase in gold has more to do with underlying change in fundamentals (which has nothing to do with geopolitics). Namely, an increase in flow driven by increased central bank purchases and Chinese demand. This is further evidenced by the fact that the steepest increase has not been in the period following October 7 but rather the bull run that started in February 2024.

Weakness in China's economy has spurred Chinese demand. As Chinese real estate, equities, fixed income, and other investment options continue to appear risky, Chinese investors have rushed to invest in gold as a reliable hedge against inflation (and CNY currency depreciation). According to Citi Research, gold inflows to China increased by 34% YY in Q1-24, a dramatic increase from the already-high numbers observed in Q1-23 that represents close to 60% of annualized world gold mine production.

Central Banks have been ramping up purchases, a trend that started in the early 2000s. Gold purchases by central banks have increased in recent years, shifting from being net sellers to net buyers, as emerging market economies look for an alternative to the dollar (**FIGURE 4**). It is worth noting that central bank demand in each quarter of the past two years has exceeded the historical average, pointing to the possibility of a persistent shift.

It is possible that the increased demand following economic weakness and de-dollarization will continue to push gold prices upward, even as the Fed's communication points to the possibility of high interest rates for longer, which historically have undermined the strength of commodities, as the Fed struggles to tame inflation. With long-term global trends underpinning an increase in gold purchases, what started as a bull run may end up the first leg of a golden marathon.

FIGURE 3: Gold prices have risen since February

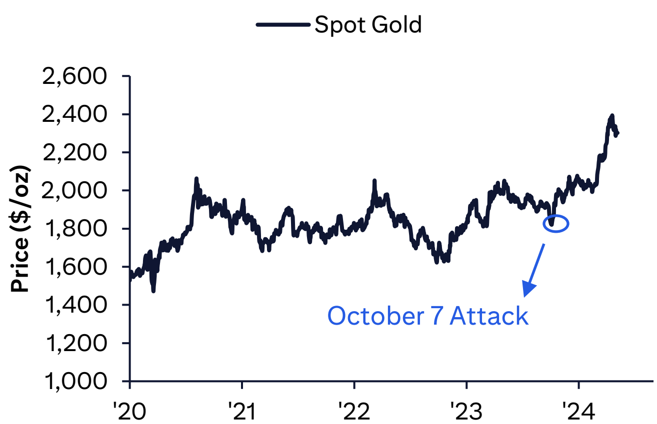
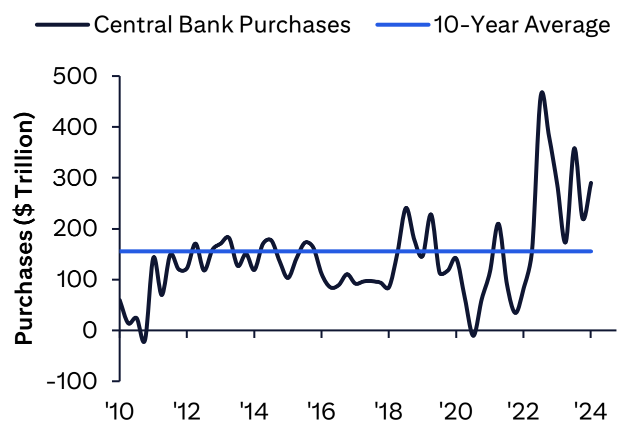


FIGURE 4: Central banks have been buying gold in record amounts



Source: FactSet, World Gold Council, and Citi Global Wealth Investments, as of May 6, 2024.

Copper: Juice Left in the Battery?

Somewhat overlooked, copper is experiencing an even stronger year than gold, up about 15% YTD (**FIGURE 5)** and managing to hold on to the gains made in the bull run that started alongside gold in February 2024. That is not where the similarities end, however; just like gold, the run driving copper prices higher (with seemingly no end in sight) owes its strength to long-term trends. In this case, an "Unstoppable Trend:" **Greening the World.**

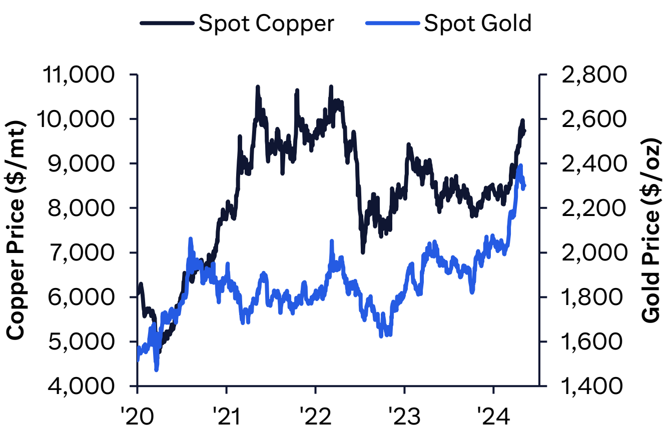
Over a hundred countries have committed to achieving net-zero carbon emissions. According to S&P Global, meeting those targets would likely entail a doubling of annual copper demand by 2035. Initiatives by governments and businesses alike to increase investments in decarbonization are promising to create difficulties for mining companies, who will likely struggle to increase supply at a rate matching demand. Much of this is caused by the increased costs of copper extraction, not to mention increased regulation and scrutiny regarding the environmental impact of current mining practices. Moreover, it takes several years to start a new mine, making acquisitions more attractive than new operations, as evidenced by BHP's attempt to purchase rival copper miner Anglo American (which was subsequently rejected, pending a new offer).

As much as access to oil has been a focus of geopolitics for the past century, competition is hotting up to access copper, as governments jostle to secure limited future supplies. In our 2024 Outlook, we projected high returns for copper over the coming years, owing largely to its necessity in the energy transition as a key component of electric vehicle (EV) batteries. Not only is copper widely used, it is also *heavily* used. As much as 80 kilos of copper go into every EV, with total copper usage in EV production expected to nearly triple from current levels to 3.8 million metric tons by 2030.

It is worth noting, however, that EV manufacturers are also working on the copper problem, aiming to reduce reliance on the key metal by promoting innovation in battery technology. Speaking to investors in May 2023, the founder of the largest EV manufacturer in the world commented that by moving from a 12-volt battery to a 48-volt battery, future EVs may require only a quarter of the copper they currently need. While estimates for future copper usage take battery innovation into account, expectations vary among analysts. Investors looking to enter the market should consider their views regarding the pace of battery innovation, particularly as the market propels prices higher in anticipation of growing demand clashing with existing technology and supply.

Given the restrained supply and the lack of comparable substitutions, the electrification of infrastructure and transportation should continue to drive copper prices higher in the long-term. Adding to our confidence, we note that while current levels (spot trades at $9,737/mt) may seem elevated, they are still well below the all-time high of $10,730/mt reached in March 2022, setting it apart from gold which set an all-time high in April.

FIGURE 5: Copper has outperformed gold YTD, though it has yet to hit an all-time high



Source: FactSet, as of May 7, 2024.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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