

# Commodities and their main drivers

EXPECT HIGHER PRICES TO BE THE NEW NORMAL IN A GROWING CONSUMER WORLD SAYS **JEAN-FRANÇOIS LAMBERT**, MANAGING DIRECTOR AND GLOBAL HEAD OF **HSBC'S** COMMODITY AND STRUCTURED TRADE FINANCE DEPARTMENT

Commodity markets have entered uncharted territories, but they have not done so in an isolated fashion. As the world economy slows down, most markets from securities, to bonds, to real estate, are learning how to cope with a new reality – the end of an era of unlimited liquidity and ‘forever growth’.

Despite this, commodity prices are still more expensive than 10 years ago. The question we have to ask is whether this is a short-term phenomenon, or whether commodity prices look set to hold their value over the longer term?

A lot has been said about the influence of financial speculation and development of the commodity market as a new ‘asset class’. Some hold the view that such speculation is driving up prices and that over the long term the value of commodities will fall. Commodity trade finance practitioners take a different view.

In stark contrast with other asset classes, commodity prices are built around the moving and delivering of physical assets. Financial commodity market instruments are key tools for suppliers, merchants and large buyers to protect their prices on future deliveries, and lock in key strategic supplies. At maturity, each ‘financial trade’ gives rise to the delivery and the off-take of a commodity cargo somewhere in the world.

Does this mean that the speculation of some financial players has failed to exert any influence on commodity prices? Of course it has. We have seen a greater volatility of commodity prices over recent years and undoubtedly some of this influence is due to speculation.

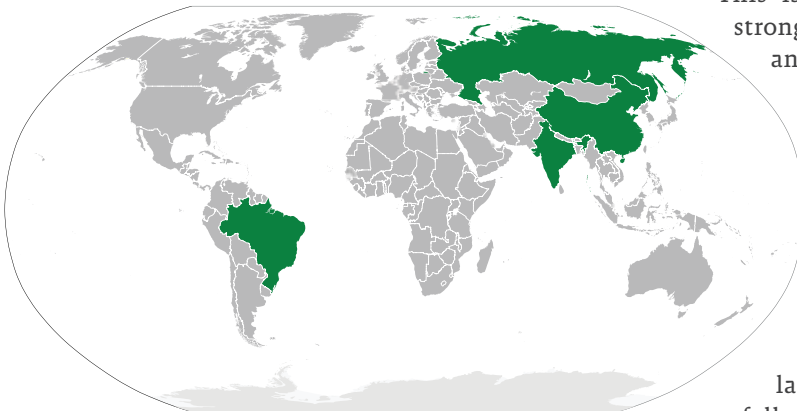
However, nobody has put it better than Professor Philippe Chalmin, a major commodity market specialist, when he compared financial speculation to the ‘foam over the wave of the fundamentals’.

This is because commodities are driven by strong fundamental trends – that of supply and demand.

These fundamentals will prevail over the longer term, because world growth remains the main driver of commodity prices: in short, people will continue to want, and need, energy and food.

Yes, we have seen a slowdown in the world’s economy, chiefly driven by a drop in China’s GDP growth in the last few months from over 10% growth, a fall we predicted to stabilise at around 8%.

However, today, China still represents over 40%



*BRIC economies*



The city of Shanghai has become a symbol of China's rapid economic expansion since the 1990s

of all commodity market requirements, and, even at 8% growth, will *de facto* be the engine of commodity growth.

So, even if current market conditions are uncertain in the short term, epitomised by the fact that spot commodity prices are showing some volatility triggered by fundamental or speculative views, by and large future prices remain unaffected and broadly neutral.

With the growth of the world population – it is estimated the planet will be home to eight billion people by 2025 – and the emergence of new heavily populated economic powers such as China, India and Brazil, securing supply of soft commodities such as wheat, soybean and sugar, energy products such as oil and gas, and base metals, will remain at the very top of the agenda for most economic and political leaders for many years to come.

It is interesting to note that whilst commodity prices have come off recently, most if not all commodities are still much more expensive than they

were a decade ago when the commodity ‘super cycle’ began. While some argue that this cycle is a mere catching-up after the 1980-90 decade when prices were abnormally low, one thing is certain – there is still a long way to go before we can say the super cycle is over.

Perhaps the best way to understand how commodity markets are driven nowadays is to imagine a corridor capped at one end by anticipation of world growth and floored at the other by the resilience of China. Indeed, HSBC contends that China has enough fire power, by way of policy intervention, to re-energise its economy if and when needed.

If this proves to be the case, then commodity prices should not significantly decline and are well supported in the medium term. In fact, our view is that prices will likely remain as much as 30-60% higher in real terms than during the latter decades of the 20th century.

If this is the case, then we should expect the new normal to be more ‘super’ and ‘less’ cycle. ■

“ China still represents over 40% of all commodity market requirements, and, even at 8% growth, will *de facto* be the engine of commodity growth

”