J O Hambro
Capital Management Group

News

Emerging Markets Spotlight

James Syme takes a look at recent commodity price moves and describes how the portfolio is positioned to benefit.

James Syme

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Emerging Markets Spotlight

One of the defining features of the period of economic re-opening in 2021 has been both higher commodity prices and more volatile commodity prices. Whilst 2020 saw some, comparing 2021 to 2019 shows the structural shift in markets. For example, in 2019 the CME's lumber future ranged between USD 300 and USD 440, with an average of USD 370; in 2021, the 2021 range has been USD 454 to USD 1,690, with an average of USD 880. In 2019 Brent crude oil spot prices ranged between USD 52.82 and USD 73.89, with an average of USD 63.99; in 2021 the range has been USD 50.02 to USD 85.70 with an average of USD 70.39. In 2019 the LME's copper future ranged between USD 5,610 and USD 6,550, averaging USD 6,022; in 2021 the range has been USD 7,750 to USD 10,560, averaging USD 9,280. Prices are generally higher and more volatile.

These moves have had many industry-specific drivers, but the broad cause has been stop-start recoveries in both producers and consumers, with gluts and shortages around a broad trend of tighter supply/demand balance and higher prices.

The effects of this have been seen in inflation figures around the world, and also in both commodity-producing companies and countries. In particular, the complicated and overlapping moves in energy commodity prices create, we believe, substantial opportunity in selected emerging market companies and countries. And the heart of this is European energy markets.

Energy markets are complicated, in that regional markets are linked to varying degrees, but those

linkages are always subject to the limits of infrastructure and transport capacity. Similarly, energy commodities are substitutable to varying degrees, although some of those substitutions require significant price dislocations.

European energy and electricity markets have been substantially restructured in recent years, with large roll-outs of renewable and gas-fired electric generation capacity and reductions in coal-fired and nuclear installed capacity. At the same time, the role of natural gas in the European residential heating and industrial energy supply has steadily strengthened. Some of the gas is brought in by sea in LNG form (including from Algeria and the Middle East), but the bulk comes in from Norway and, especially Russia, in pipeline form. Aggressive de-commissioning of nuclear-powered generation capacity during the Covid-19 economic slowdown has accompanied a period of colder winters and warmer summers to create conditions where Western Europe has high dependency on imported natural gas, but low natural gas reserves in storage. With economic recovery, Asian and Russian natural gas demand has increased, leading to real fears of shortages in Western Europe. These fears have not come about because of a shortfall in supply: Russian natural gas linchpin Gazprom had, by mid-December, produced 14.2% more gas than the same period in 2020 and had exported 4.8% more gas to Western Europe.

The effects of this have been dramatic. The European natural gas one-month TTF benchmark price, which averaged USD 14.58 in 2019, averaged USD 47.27 in 2021, touched USD 180 in December, and is USD 87 at the time of writing. As discussed above, moves like this spread out through markets. With some European electricity utilities burning fuel oil, Mediterranean basin refining crack spreads jumped during the fourth quarter of 2021; similarly, other utilities burning coal have driven European coal prices to levels not seen since 2008. Meanwhile, with geographical arbitrage, global LNG shipments have been substantially switched to Europe, causing Asian LNG import prices to double compared to a year earlier.

Futures markets further ahead have also reacted. The TTF price for winter 2022/23 has risen from USD 6 a year ago to USD 26 at the time of writing. The market shift is likely to endure, although the serious economic impact in Europe will restrain demand growth to some degree. Germany shut three of its last six nuclear power stations at the end of 2021, while Belgium is committed to phase out all of its nuclear power by 2025.

With these changes, as well as others that have similar effects, such as reductions in refining capacity in China, or the pressure on Western oil majors to not increase hydrocarbon production, the stage is set for an extended period of high demand and prices for companies and countries able to meet this demand. We have resultantly increased our exposure both to oil and gas production in the portfolio, adding to Petrobras in Brazil and initiating a position in Gazprom in Russia. In addition, we have increased our exposure to the broader Russian economy. Our positive view on the impact of higher commodity prices on the economies of major exporters, which has shaped our positive views on markets such as Brazil and South Africa, also extends to Russia. Russian real GDP growth is forecast to be 2.6% in 2022, led by exports and investment, and despite an expected tightening of fiscal policy. The country should run a small fiscal surplus, and a large current account surplus, in the year, which is likely to also see strong earnings growth from both commodity export companies and domestically-focused companies.

Political risk does, of course remain elevated for Russia, particularly with tensions around Ukraine and with the recent unrest in Kazakhstan. In terms of the change in key drivers, though, we see a significant improvement in macro-economic conditions and a minor deterioration in political conditions. We believe that post-Covid re-opening and environmental policy shifts together create powerful drivers for many commodity industries, have positioned the portfolio accordingly.

An overview of the fund can be found here.

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