Outlook on Commodities 2023

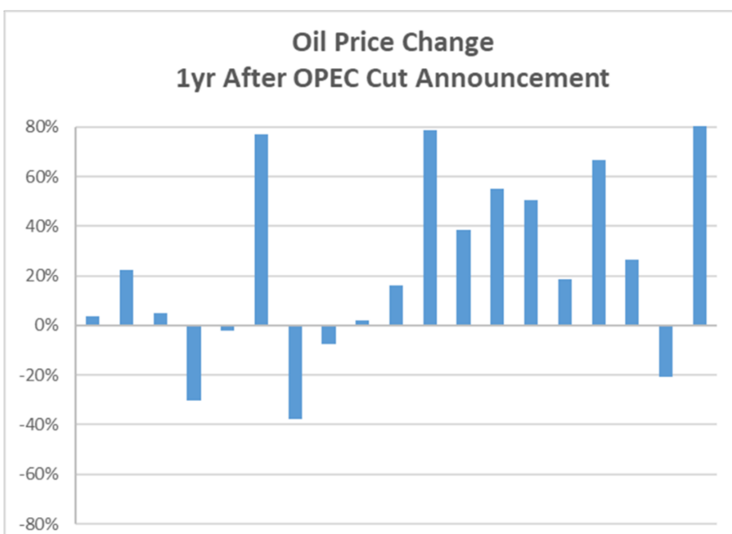
When History Rhymes **December 2022**

Inflation was a word some believed had been lost to history. Like in-laws arriving for the holidays, getting reacquainted isn't always pleasant.

Inflation has put pressure on businesses and households alike, with the subsequent Fed tightening cycle weighing heavily on financial assets. The asset class providing a ballast in the financial storm is once again commodities.

As Mark Twain stated, "History doesn't repeat itself, but it often rhymes". The recent environment reminds many investors of the 1970s which also saw commodity supply shocks, a Fed reluctant to apply the brakes, and inflation becoming unmoored. The decade of the '70s witnessed commodities, as measured by the S&P GSCI TR, generating annualized returns in excess of 20%. History doesn't necessarily repeat but let's explore the commodity dynamics setting up for 2023.

Demand rebounded from Covid much more quickly than supply, causing commodity inventories to draw down. This strong fundamental environment served as the foundation for the 2022 commodity rally. The supply side has improved through 2022 but it's worth noting OPEC has just implemented a fresh round of oil production cuts. This has typically been bullish for oil. The following chart shows the one-year percentage change in oil prices each time OPEC historically announced a production cut.



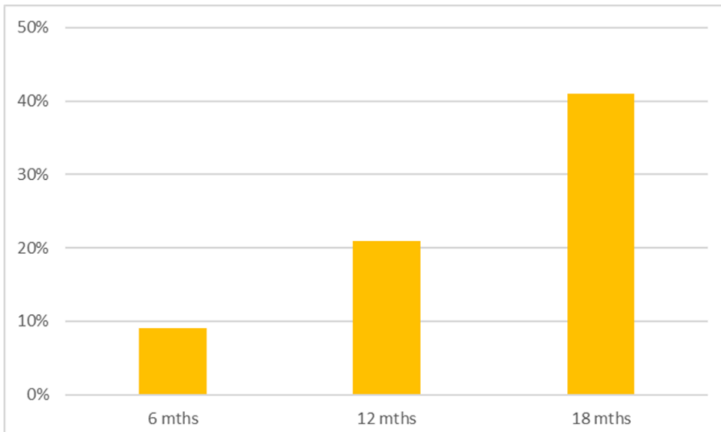
Source: Bloomberg, USCF
As of 11/30/2022

While we don't anticipate a 60% or 80% rally in oil prices for 2023, it's noteworthy that OPEC is looking to proactively manage supplies. We expect this will at least reduce downside price risks.

China is the second potentially supportive feature for commodities in 2023. China has been a massive part of the commodity landscape this century given the country's industrial revolution, urbanization, and expanding consumer class. More recently, the Chinese consumer has been constrained by the government's zero covid policy. We've seen first-hand how the U.S. consumer reacted upon coming out of covid lockdowns. It's certainly possible the Chinese government could loosen restrictions only to clamp down again should a significant covid wave occur; however, our base case expectation is for continued relaxation of certain restrictions and lockdowns. It's difficult to forecast the magnitude of the resulting China 'reopening' trade, but we expect a boost to commodity demand after three years of these lockdowns.

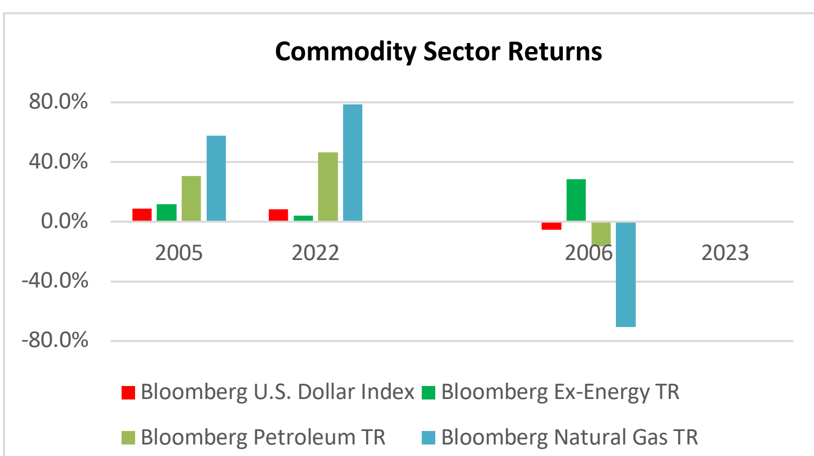
Among geopolitical factors relevant to commodities such as Iran, Venezuela, etc., Russia's aggression against Ukraine clearly takes center stage. The death and suffering resulting from this war makes a discussion of commodity markets feel inappropriate; however, we can't preview 2023 without acknowledging the impact of curtailed Russian energy supplies to global markets and the reduction of key agricultural production and exports from Ukraine. Russia is a top three global producer of many energy, metals, and agricultural commodities, while Ukraine historically provided 10% to 15% of global wheat, corn and barley exports. This horrible conflict will continue to restrict global supplies of these critical commodities for as long as it last. With the market expecting Putin to continue prosecuting this war for the foreseeable future, Russia standing down represents the outlier scenario that would surprise markets and pressure commodity prices. This is not our base case but it's nonetheless something to consider. Another risk to the commodity bull market would of course be economic activity slowing faster and harder than expected. A mild recession is anticipated in 2023 but a deep downturn caused by the Fed overtightening would dent commodity demand and pressure prices. For historical perspective, the following chart shows the returns to commodities, six, twelve, and eighteen months into Fed tightening cycles.

Returns to Commodities After Fed Tightening



Source: U.S. Federal Reserve, Bloomberg, USCF
Median SPGSCITR returns 6, 12, and 18 months from the start of Fed Tightening cycles 1971-2021.

Within the asset class, we anticipate a rotation in leadership among commodities. A meaningful shift in market penetration for electric vehicles (EVs) finally took hold in 2022, reaching 10% of global car sales. As this trend continues, demand for copper and especially metals such as lithium and cobalt which are used predominantly in batteries and electrification, will strain producers' ability to supply these markets. Rotations in sector performance within commodities is common given the lack of homogeneity of supply and demand drivers across commodities and sectors. For this reason, commodity index performance exhibits much greater dispersion from one index to another than found across indexes of other asset classes. To illustrate this point, and to revisit the theme of history rhyming, look at the similarities between 2005 and 2022 (year-to-date through November 30, 2022).



Source: Bloomberg, USCF
As of 11/30/2022

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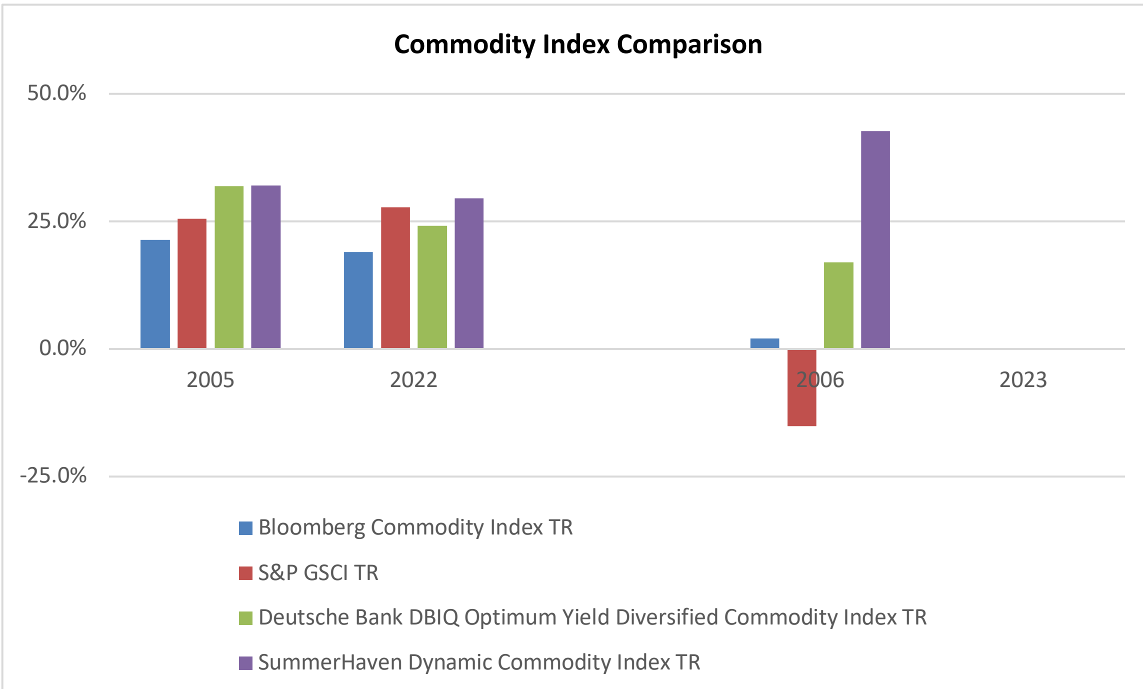

Source: Bloomberg, USCF
As of 11/30/2022

The similarities are startling. In particular, 2005 and 2022 shared inflationary economic backdrops that were met with Fed tightening cycles. Inflation rose from 1.7% to 4.7% during the eighteen-month period ending in September 2005 and from 2.6% to 8.2% over the eighteen-month period ending in September 2022. While 2022 commodity sector and index comparisons rhymed remarkably with 2005, time will tell if 2023 resembles 2006. Regardless, the point is that as individual commodity and sector fundamentals begin to diverge, the ability of an index to dynamically adjust becomes increasingly valuable.

The SummerHaven Dynamic Commodity Index (SDCITR) rotates each month into the fourteen commodities exhibiting the strongest fundamentals as reflected by the shape of their forward curves. This approach resulted in asset class leading index returns in the similar years of 2005 and year-to-date 2022 (through November 30). The SDCITR's ability to adjust as commodity market leadership rotated in 2006 resulted in dramatic outperformance relative to other commodity indexes.

Will 2023 rhyme? Stay tuned.

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Kevin Baum is a Registered Representative of ALPS Distributors, Inc.

One cannot invest directly in an index.

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