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MACRO MORNING BRIEFING

May 29, 2024

No Commodity Bulls In China's Shops

Commodity prices now driving broader asset allocation

- Supply constraints not a marginal driver, but China demand isn't either
- Neither 'new' nor 'old' economy running down commodity inventory
- China's domestic and external growth dynamics remain disinflationary

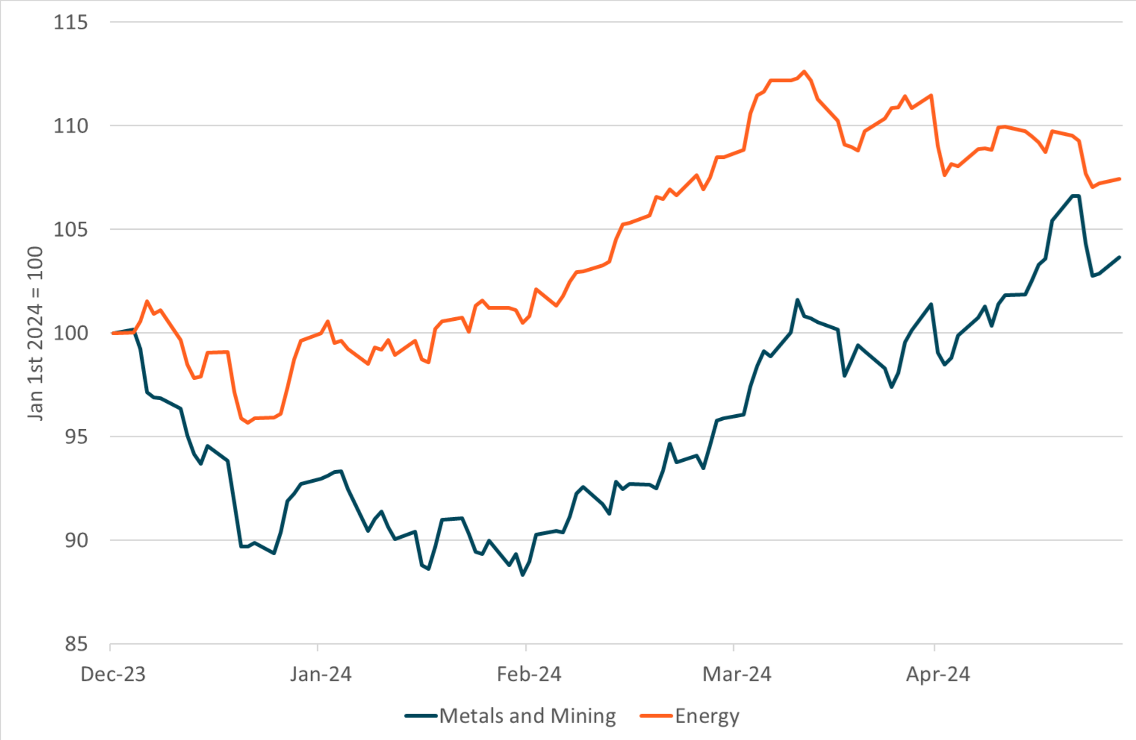
Input prices highly inconsistent with growth fundamentals

Throughout May, the US equity market’s tech prowess has led the recovery in risk appetite globally. Hardly news, we know. On a marginal basis, however, one of the core themes we have identified heading into potential month-end rebalancing flows is the strong performance of equity markets with heavy commodity exposures. Due to improved performance (based on total return benchmark indices) of the UK and South African markets, on top of strong buying of their currencies as per our iFlow data, we expect some selling to emerge in either equities or through hedging out currency risk. On an idiosyncratic basis, both countries have elections over the next month which could result in significant fiscal uncertainty, so some reduction in exposures would also be consistent with fundamentals.

Taking a step back, however, it is striking just how strong a role commodity prices are now playing in asset allocation – this while many questions linger over how much fundamental support can justify the gains. Metals and mining feature heavily for the UK and South Africa, and Norway’s stock market – evidently high levels of energy-related exposure – also rebounded strongly. If we consider the sustained gains in gold and other supposed interest in ‘real-terms value protection’, then it would be easy to simply infer that the shift in expectations for the Federal Reserve has generated reflation pricing across global markets. However, there is notable sector outperformance for Metals and Mining globally versus Energy (exhibit #1), and this is where the macro discrepancies begin.

Ultimately, notwithstanding the subjective supply dynamics in the energy market, the lack of strong momentum in prices and weaker returns in related companies point to a soft global growth environment. Purchasing Managers' Indexes in the Eurozone and the Fed's assessment of the current direction for the US economy support this view.

Exhibit #1: Mining vs. Energy Sector Divergence



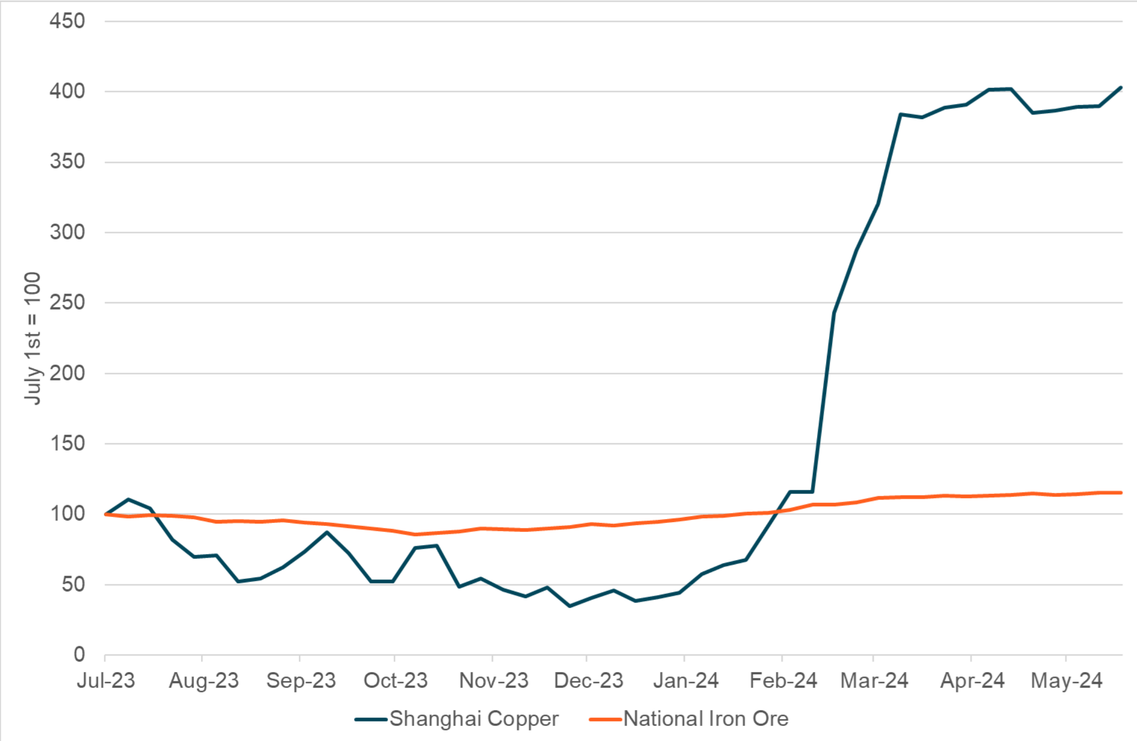
Source: Bloomberg, BNY Mellon

Crucially, Energy underperforming points to a lack of marginal demand from Asia. However, the strong gains in Metals and Mining indicate the opposite, as gains in the underlying commodities and corresponding producers should point to reflation led by China. Furthermore, for the first time this year there are clear policy details on the table, led by the re-lending programme announced by the PBoC this month. More seem almost certain to follow. If higher commodity prices often reflect a turn in financial conditions emanating from the Fed, then there should be a similar reaction to PBoC initiatives. The difference, however, is that China stimulus at present continues to struggle generating the underlying demand impulse that is often seen in reactions to similar stimuli in developed markets.

Exhibit #2 shows that inventory levels of iron ore and copper – two of the most relevant indications of China industrial demand – are not showing any clear signs of drawdowns. The iron ore demand story remains highly correlated with China's real estate market, and markets have largely reached the consensus that the economy has entered a period of secular decline in demand. It is merely a question of ensuring that the adjustment process does not affect household and financial sector balance sheets – and therefore price expectations – further to the downside. China's exports of steel products have been running at high levels, indicating that any demand is not based domestically.

Copper's role in the global Green transition is far greater (we have highlighted this before). Even with China's clear lead in many related technologies and subsidies for domestic upgrades, there is no sign of a strong inventory drawdown either, which would indicate high levels of production to satisfy domestic or global demand. The latter already faces ever-rising barriers to trade amongst the economies most able to afford the relevant products, in particular electric vehicles – the US's recent imposition of tariffs of over 100% on Chinese vehicles could be replicated by the EU, though most likely not on the same scale.

Exhibit #2: China Commodity Inventory



Source: Bloomberg, BNY Mellon

For commodities and the sector to continue its recent performance, inflation expectations should also begin to rise. In the absence of additional shocks as seen between 2020 and 2023, it would have to be a more regular cyclical process of demand outpacing supply. Household cashflow is now entering an acute phase in developed markets, where it is difficult to see the combination of higher nominal or real wage growth, supplemented by stronger interest income, continuing to strengthen disposable income as rates remain at elevated levels. The European Central Bank's latest Consumer Expectations Survey (published yesterday) points to ongoing stability in short- and medium-term inflation expectations. The Fed is also comfortable with the direction of travel for US households.

In China – which will lead the Asia price cycle – the concern remains one of averting deflation expectations becoming entrenched. Even on a nominal basis, there is very little sign of a strong marginal pickup in activity. Official data is relatively subdued, whereas the higher-frequency activity index (aka the Li Keqiang index, after the late Premier who detailed his own methods of assessing growth with these components), which corresponds to changes in hard activity data such as power generation and freight volumes, is running at a higher level compared to nominal GDP. Even so, it has not shown any strong sign of trend change in the past few years, and it is hard to argue for a pickup in growth expectations considering that 2022 was still a year of very high social stringency.

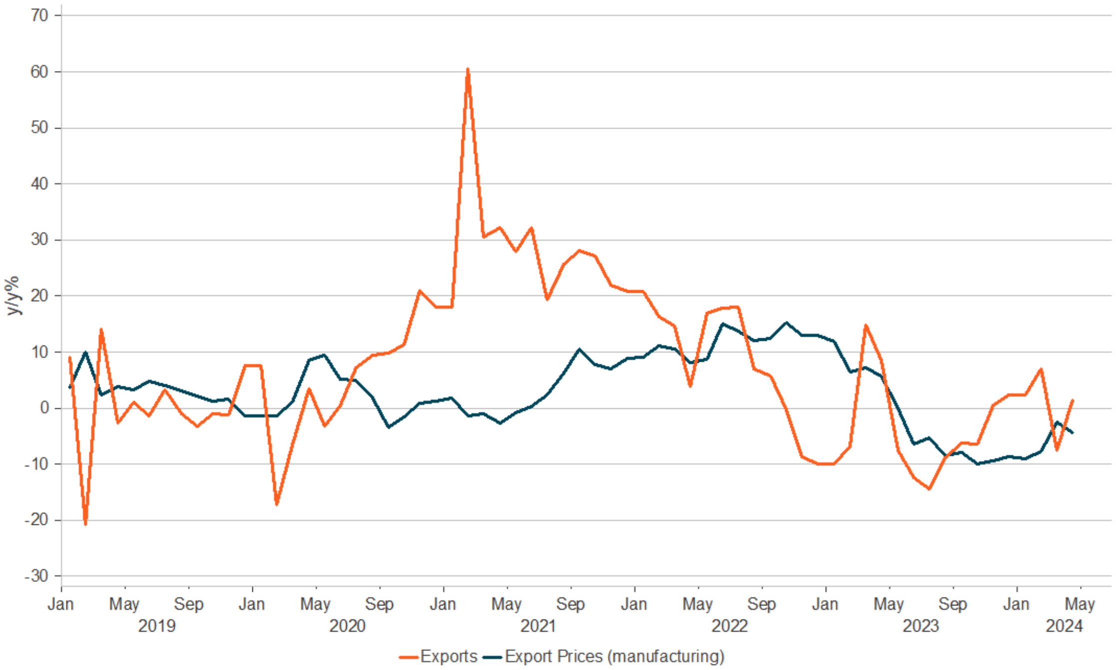
Exhibit #3: Li Keqiang Index vs. Nominal GDP

Source: Macrobond, BNY Mellon

There is a case for higher input prices via commodity prices being exported by China and Asian manufacturers overseas across the value-added supply chain. After all, Asia-Pacific currencies have been under pressure throughout the past few years, and it would be apt to pass on some of these potential losses to protect margins. However, this will only be successful if global demand is resilient. Yet, outside of very advanced manufactured products, the case is still relatively weak. Exhibit #4 shows that China's export prices and nominal export values have continued to struggle; the former has not managed positive prints in over a year, though momentum suggests that a positive turn could arise soon. Given the current state of trade relations, raising export prices can help undercut any 'dumping' accusations in disputes. More importantly, better margins can feed into income gains across the entire labour and goods supply chain and lift domestic sentiment as well.

The seasonal window is closing fast for meaningful change. Without that, outperformance of commodity prices and commodity-related equity sectors seems unlikely to extend.

Exhibit #4: China Export Prices & Nominal Values



Source: Macrobond, BNY Mellon

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