

Global Recession Risks Rock Commodities

As the economic landscape deteriorates industrial commodities and related equities de-rate. A well-diversified portfolio employing defensive and cyclical companies will be critical to traverse the more uncertain macro environment ahead.

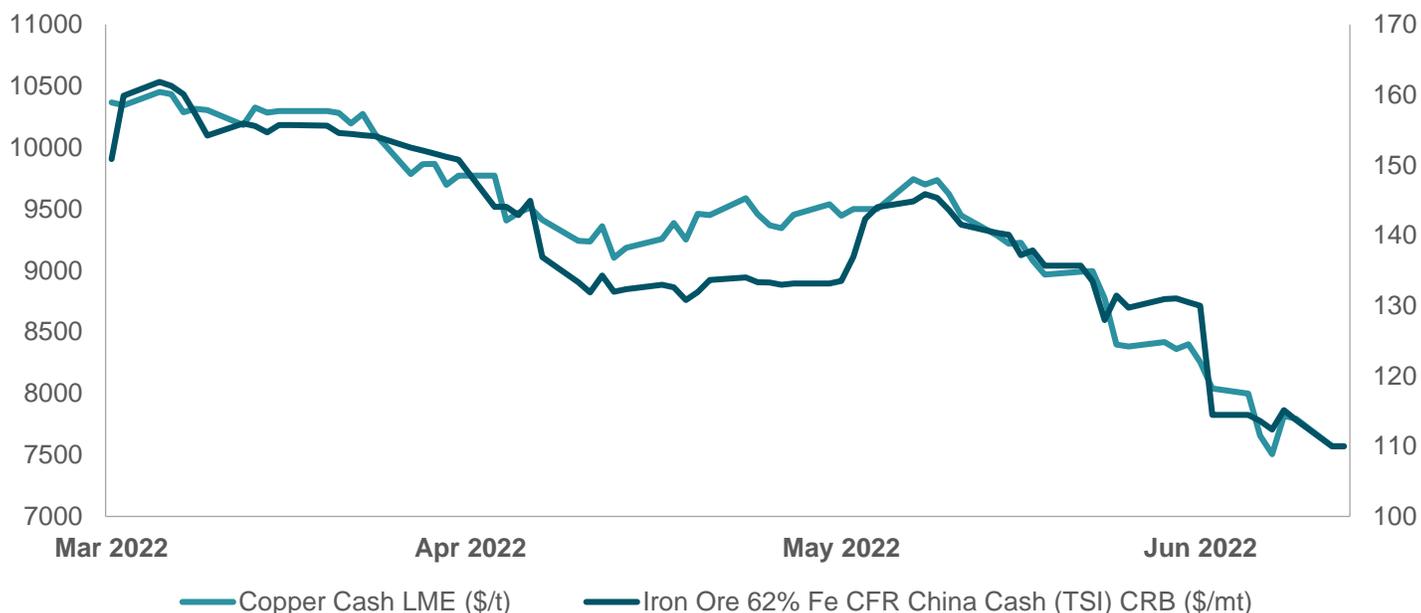


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Copper and Iron Ore Feel the Heat as Recession Risks Rise

As the risk of a global recession rises, industrial metals are facing increasing headwinds. The copper price is often seen as a bell weather for the global economy and at times referred to as “Doctor Copper” for that very reason. Since the end of March the price for copper has declined by -27% from 10368 \$/t to 7572 \$/t. Iron Ore another industrial metal and a particular bell weather for the strength of the Chinese economy has also declined -27% from 151 \$/mt to 110 \$/mt (see figure 1). Aluminium another industrial metal is down -39% since the end of March.

Figure 1: Copper & Iron Ore down -27% (since 31 March 2022)



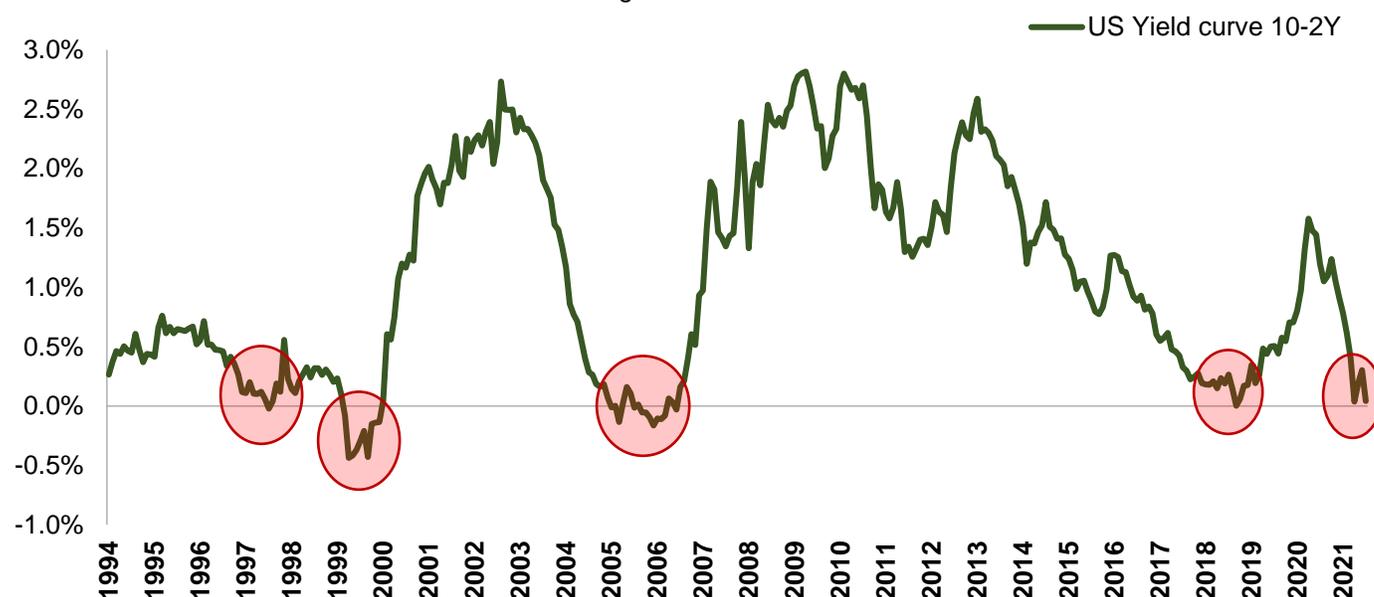
Source: State Street Global Advisors, Factset as of 12 July 2022.

Many economic and financial indicators are now pointing towards an economic slowdown and increased risk of recession. A widely watched barometer for economic growth is the US yield curve (see figure 2). The Yield curve is equal to the 10 year yield minus the 2 year yield. For example as at 30 June 2022 the 10 year yield was 2.98% and the 2 year yield was 2.93% making the difference 0.04%.

Why is the yield curve such a good indicator of the growth outlook? The 2 year yield embodies the markets assessment of monetary policy over the next 2 years and the 10 year yield curve embodies expectations for future growth and inflation in 10 years' time. Together they provide the markets assessment on the path of monetary policy and its implications for future growth. It is actively traded every day by informed market investors who incorporate new information. The yield curve has been flattening since mid-2021 and in July 2022 it turned negative.

Figure 2: Yield Curve Signalling Greater Risk of Recession

US Yield Curve as a barometer for future economic growth



Source: State Street Global Advisors, Factset as of 30 June 2022.

For many economists the negative yield curve is a marker for future recession but it need not be interpreted that directly. A broader interpretation is simply if the yield curve is trending up the market is expecting the future path of monetary policy to be pro-growth and if it is trending down the market is expecting the path of monetary policy to slow growth. The yield curve flattening has some direct implications for industrial driven commodities like copper and iron ore and for related equities.

Commodities are supply and demand driven and large changes in economic growth and aggregate demand are expected to impact the underlying commodity price. Industrial metals like copper, and iron ore are expected to be even more sensitive to changes in economic growth. Figure 3 looks at the average returns to copper, aluminium and iron ore and associated metal and mining indices. During periods of a flattening yield curve (a proxy for slowing economic growth expectations) returns to commodities are significantly lower than during periods of steepening yield curve (a proxy for improving economic growth expectations). This historical relationship has good economic rationale.

Figure 3: Yield Curve Environments and Subsequent Returns to Commodities

Yield Curve State	Copper LME (\$/t)	Aluminium LME (\$/t)	Iron Ore* 62% Fe (\$/mt)	S&P Global 1200 Global Metals & mining (USD) **	S&P ASX 300 Metals & Mining ***
Steepening	22.9%	11.0%	47.7%	18.1%	15.2%
Flattening	-4.5%	-2.7%	-18.1%	-1.9%	5.6%

Source: State Street Global Advisors, Factset. Start as at 30 June 2022. The yield curve is defined as steepening if the yield curve is above the 6month average of the yield curve, and flattening if the yield curve value is below the 6 month average yield curve. Monthly returns are averaged for either state and multiplied by 12 to provide an approximate 12 month impact. The study is based on data from December 1995 to June 30 2022. *Iron ore data only from 28-02-2013, ** Start date Jan 1988, *** start date March 2000.

Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The Bottom Line

As the risk of a global slowdown increases industrial metals are facing increasing headwinds. Historically periods of slowing growth expectations (as proxied by a flattening yield curve) has been associated with lower returns to industrial commodities like copper and iron ore and their associated equities. Having a diversified portfolio across both defensive and cyclical companies is especially important as the economic environment becomes more uncertain.

Important Disclosures

Disclosure

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