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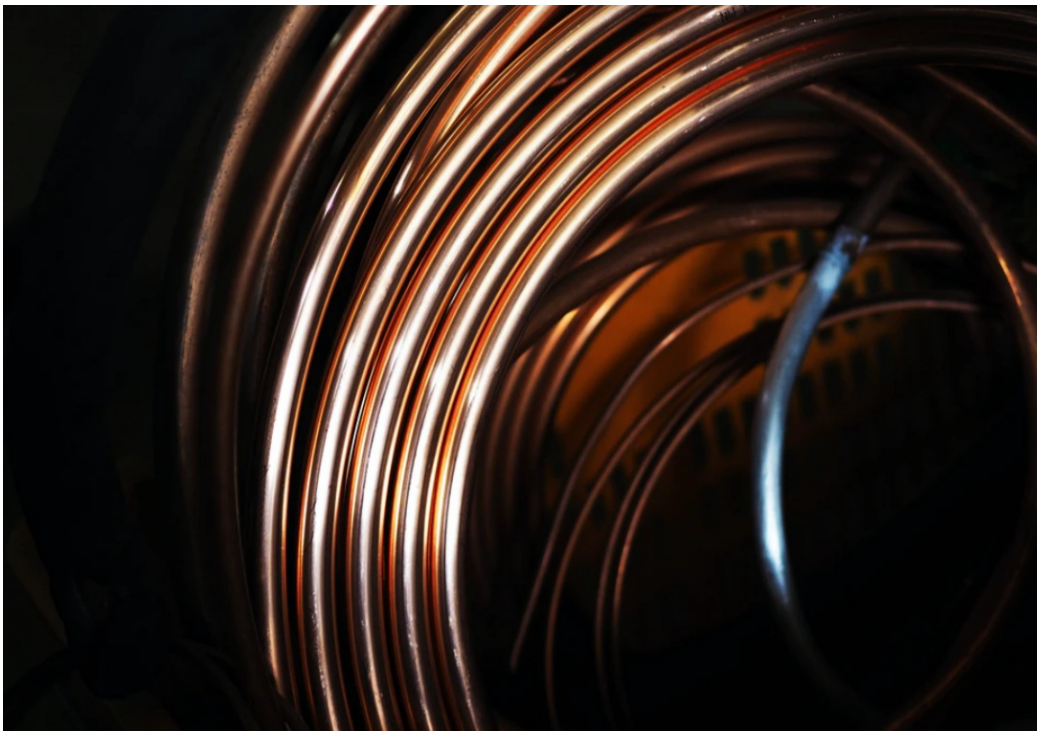
How far can commodity prices climb?



This year, inflation has been the primary topic in capital markets with investors fearing that pandemic-era fiscal stimulus could cause spiralling global inflation and compel central banks to tighten monetary policy, potentially choking off the economic recovery.

In May, US CPI came in at 5%, the Eurozone equivalent at 2%, and Chinese consumer goods CPI at 2.5%. The most notable reading in the month was China's producer price index (PPI) which increased by a red-hot 9%, the fastest on-year gain for any month since September 2008.

While transitory factors such as supply chain bottlenecks are at play, a substantial amount of the price pressure derives from surging commodity prices, fuelled by post-lockdown recoveries in demand and ample global liquidity.

To give just a few examples, in May:

- Copper hit a record high of $10,724.50/ tonne

- Zinc jumped to its highest level since 2007
- Iron ore hit a record high of more than $230 a tonne on strong demand from China and supply disruptions in Australia and Brazil.
- Brent crude flirted with $70 per barrel before touching this level on June 1st

When commodity prices rise too much, too quickly, it can adversely impact economic activity. For example, soaring lumber prices through Q1 of this year added an extra $36,000 to the average US new home price in April according to NAHB data. Quite unsurprisingly, US construction activity paused as buyers and builders approached the psychological barrier of paying too much.

Thereafter, lumber corrected, in line with the mantra that "high prices are the cure for high prices". While there were many factors at play, for instance the impact of West Coast fires on timberland and seasonal patterns (prices usually increase in Spring and peak around May), there is also a risk that ample global liquidity allows other commodities to run further for longer. This is where governments could potentially step in, as China is doing.

China is expanding more rapidly than other major regions and it is commodity thirsty. It is the world's biggest copper buyer, consuming half of all global output and the biggest consumer of seaborne iron ore, absorbing more than 70% of global production.[1]

In May, the country's National Bureau of Statistics said that much of the rise in factory gate prices (PPI), was driven by significant price increases in crude oil, iron ore and non-ferrous metals. If left unchecked, surging commodity prices could become a headache in that mid- or down- stream firms may be unable to absorb higher costs, putting significant pressure on manufacturers' margins. If companies were to begin passing on higher costs to consumers, it could potentially put the economic recovery in jeopardy.

As such, Beijing has intervened to try and cool down the market. So far, it has said it would:

- Strengthen the management of commodity supply and demand

In May, the country's Cabinet said it would strengthen its management of commodity supply and demand to curb "unreasonable" increases in prices while investigating speculative buying. To do so, it will step up adjustments on the trade and stockpiling of commodities and reinforce inspections on both the spot and futures markets. [2] Later, in June, the State-owned Assets Supervision and Administration Commission (SASAC) asked state-owned enterprises to report their futures exposures and to control risks and limit their exposure to overseas commodities markets.[3]

- Tighten its monitoring of commodity prices and strengthen market supervision

In June, the National Development and Reform Commission (NDRC) said it will issue new rules on the management of price indices for commodities and services, effective August 1st. This will

standardise how price indices, which are mainly run by private providers, are compiled and improve transparency on the release of information. [4]

- Release strategic, industrial metals from its national reserves

The National Food and Strategic Reserves Administration has said it will release copper, aluminium and zinc in batches to nonferrous processing and manufacturing firms "in the near future" via public auction. China last sold copper from its stockpiles in 2005 and released aluminium and zinc in 2010. [5]

- Offer additional support, including help for small businesses, particularly those affected by rising raw material prices

As a result of Beijing's interventions, and of a stronger dollar following the more hawkish US FOMC, commodity prices came under pressure last week. However, it is yet to be seen whether this is just temporary in a recovering global economy where demand is high. China's steps to cool commodity prices offers some respite to Chinese producers, but the move is also important globally. Relentless increases in commodity prices could reinforce the global inflation loop, further complicating the picture for central banks.

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