Lucas Comanici

Market Update 10-23-21

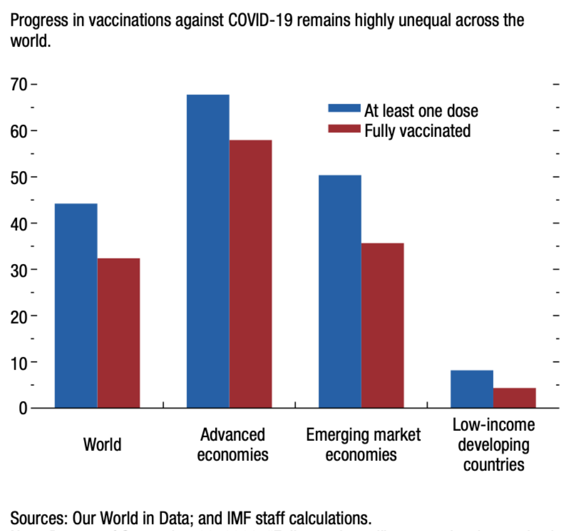
DM-EM Divergence

Thesis: In comparison to developed markets, emerging markets (excl. China) have struggled to recover from the COVID-19 pandemic and its economic impacts due to low vaccination rates and weaker government policy support. While initiatives have been set up by the WHO and G20 to provide support to EMs, the overall divergence can be expected to continue due to shortfalls in their effectiveness. To express this view on DM-EM divergence, we can long the iShares MSCI World Index ETF (URTH), which tracks equity markets in DMs, and short the iShares MSCI Emerging Markets Index excl. China ETF (EMXC), which tracks equity markets in EMs, excluding China.

Historic Relative Returns of URTH, EMXC

Vaccination Rate:

The widespread availability of vaccines in DMs and the relative efficiency of their vaccination campaigns has resulted in high vaccination rates. At the same time, many EMs and LDCs have struggled to achieve adequate numbers of vaccines and effective distribution. Due to their weaker healthcare infrastructure, the latter also happen to be the most at-risk from the effects of COVID outbreaks.



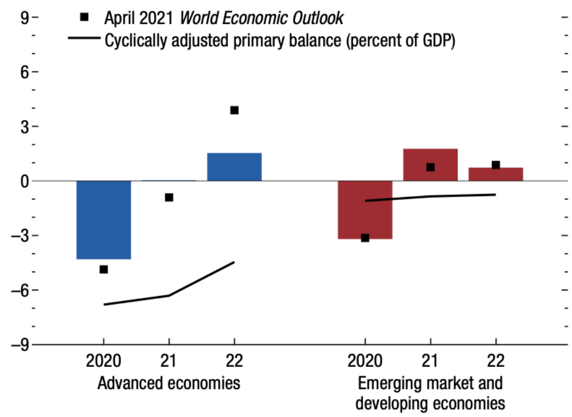
Covax is a WHO initiative aimed at distributing vaccines from DMs to lower income countries, but has not been very effective so far. Covax's key supplier is the Indian company Serum, which has been focused on producing vaccines for domestic use and only expects to begin full-size shipments at the start of 2022. Similar restrictions inhibiting both the flow and the production of vaccines continue on a global level, and the pressure for booster shot availability in DMs indicates that this divergence will persist.

Policy Support:

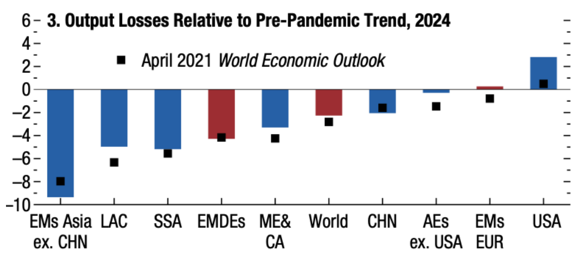
Many DMs have extended policy support in both fiscal and monetary categories via continued fiscal stimulus and unchanged central bank policy rates. Meanwhile, EMs and other developing economies have had to cut policy support in both areas due to shrinking fiscal space and larger risks of de-anchoring inflation expectations. Lower-income countries have seen tightening financing conditions and proportionally larger increases in public debt through the pandemic. EMs have also faced weaker output and labour recoveries than DMs, and contractionary measures will prolong the duration of their recovery.

Since the start of the pandemic, the G20 has set up several initiatives aimed at helping lower-income countries with financing issues, including the DSSI and the Global Framework. The scope of this support is very limited, however. The support does little to alleviate the de-anchoring inflation expectations driving tighter monetary policy in many EMs, which is a greater issue for non-LDC than extreme debt distress.

Fiscal tightening is already under way in emerging market and developing economies and will pick up in advanced economies as well in 2022.



Source: IMF staff estimates.



Source: IMF staff estimates.

Risks: The key risks to this trade come from convergence between DMs and EMs in terms of vaccine availability/distribution and policy support. Serum, for example, has rapidly ramped up its vaccine production and is committed to beginning exports in January. The distribution of these vaccines to EMs would contribute to a reduction in divergence. Effective fiscal and monetary programs by international bodies that increase EM policy support and/or reduced DM policy support if inflation in DM becomes more systemic would also reduce divergence. The emergence of extraneous economic issues isolated to DMs could counteract the divergence by relatively depressing DM economic activity.

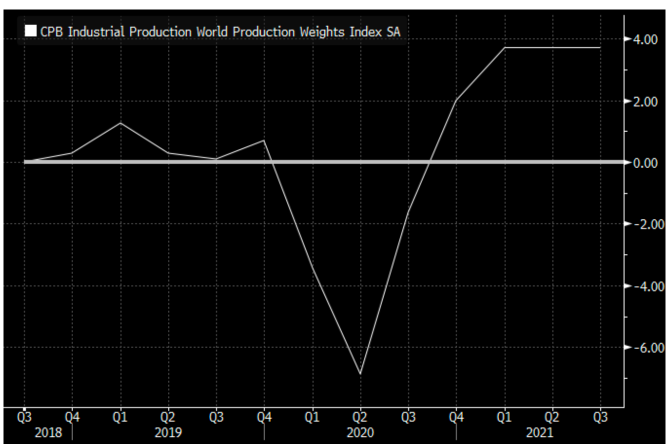
Conclusion: Global economic recovery from the COVID pandemic has been harsher in EMs than DMs due to the unavailability of effective vaccines against the virus paired with earlier reductions in policy support because of less fiscal space and de-anchoring inflation expectations. Views on this persisting divergence can be expressed through a long URTH, short EMXC trade.

Copper: Short-Term Sell, Long-Term Buy

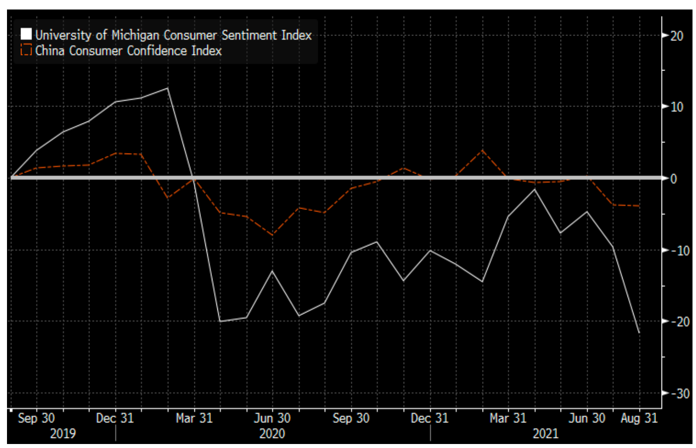
Thesis: Energy commodity shortages drove decreased metal output in China and Europe, initially resulting in a spike in copper spot prices to record-highs, extreme backwardation in the copper futures market, and near-zero LME copper reserves. However, over the past week copper spot prices and backwardation in the copper futures market slid back down after the LME imposed trading restrictions and the market repriced expectations. While the producer-side constraints that precipitated this weeks' events are expected to persist, weakening global economic growth (especially industrial production) and a shortage in complements like chips and transportation will depress demand in the short-term. In the medium- to long-term, once supply chains normalise, copper's status as an input to many decarbonisation sectors will be a major factor driving demand for copper upwards.

Global Economy Slowing Down:

A combination of demand-pull and cost-push inflation has driven global commodity price inflation higher over the past year. Energy commodities continue to spike due to the friction between surging demand and producers' uncertainty over the consistency of economic recovery hindering permanent commitments. OPEC+ committed to raising oil production by meagre 400,000 bpd per month through the rest of the year, but production issues are yielding an even lower increase in output than planned. Prices are expected to rise significantly heading into the Northern hemisphere winter. For countries with shortages, including most of the developed world and key producers such as China and India, spiking energy prices will continue to hinder industrial output growth for the foreseeable future. At the same time, weakening consumer sentiment and spending patterns in major economies like the US and China has also contributed to depressing global economic growth in Q3 and Q4.



Slowing SA Global Industrial Output Growth



Declining Consumer Confidence in US, China

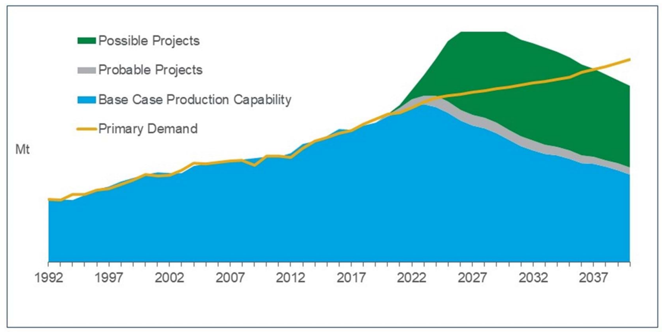
As the market realises that the depression in demand due to economic slowdowns will offset the supply shortage, the extent of backwardation in copper futures will continue to decline and the recent upward movement of copper spot prices will continue to reverse.

Chip and Transportation Shortages:

Also, due to shortages in complements like semiconductor chips, which are used alongside copper in the production of many goods, the overall demand for copper will continue to be depressed until supply chains normalise and related shortages subside. Transportation shortages, including a shortage of shipping containers, truck drivers, and freight shipping, will also place a cap on the rise of demand for copper and keep its price lower.

Decarbonisation Sectors:

Global copper production and primary demand



Source: Wood Mackenzie

Copper can be recycled over and over without a loss in function, making it a key part of a cyclical, sustainable economy. Copper is pivotal for renewable energy systems and green transportation. Renewable technologies for producing energy use over 10x more copper than conventional greenhouse-gas-producing systems. Copper is a key input to the production of a range of green technologies, including solar power, wind power, and electric vehicles. Under the backdrop of global climate commitments of carbon-neutrality around the mid-century, the growing incorporation of these technologies into the economy is projected to be the driving factor behind growing demand for copper – with consumption of the commodity projected to increase over 40% by 2035. As a consequence, the mid- to long-term demand for copper places an upward pressure on its price, which will have to be tempered by how supply is realised.

Risks:

Increasing oil and gas prices contribute to higher production and distribution costs for copper. If higher energy commodity prices through the end of the year have a greater effect on the price of copper than the decrease in demand due to complement shortages and slowing economic activity, then copper prices will move back up. Also, while copper reserves like those in the LME persist at a very low level, there is always a risk that a supply squeeze could cause prices to spike quickly. However, the LME's ability to contain erratic price movements in the past, such as with nickel in 2006 and zinc in 1992, and their quick response to the events this week lends confidence to more moderate copper price movements in the future.

Conclusion: Due in part to elevated prices for energy and also to slower overall economic growth, industrial production is expected to continue slowing down towards the end of this year. As this trend continues to be priced in, copper spot will decrease in the short-term and backwardation in copper futures will go down. However, once the global economy normalises, copper's use as an input to the production of important green technologies will push up its demand and contribute to higher copper prices in the medium- to long-term.