Market and Volatility Commentary

Commodity Supercycle and Related Equity Flows

Quantitative and Derivatives Strategy

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It is generally agreed that over the past 100 years, there were 4 Commodity supercycles and that the last one started in 1996 (see here). We believe that the last supercycle peaked in 2008 (after 12 years of expansion), bottomed in 2020 (after a 12-year contraction) and that we likely entered an upswing phase of a new commodity supercycle (e.g. we increased commodity allocation in our GAA report here, and see notes here and here from our Oil & Gas analysts). What drove the last supercycle? On the upswing, the most important driver was the economic rise of China (and EMs more broadly). USD was weakening and asset managers increasingly added commodity exposure to diversify portfolios (e.g. Yale model of diversification via alternatives). The 2008 global recession and further slowdown in Europe (2011) and China (2015) sent commodities lower. Figure 1 shows the last supercycle for Oil with various specific drivers that drove the 12-year up cycle and 12-year down cycle. The last leg of the oil down cycle was marked by trade wars and the ensuing global manufacturing recession, and the disastrous pandemic that sent oil prices into negative territory for the first time ever. We believe that the new commodity upswing, and in particular Oil up cycle, has started and list its likely drivers in Figure 2. Mostly it will be the story of a post-pandemic recovery ('roaring 20s'), ultra-loose monetary and fiscal policies, weak USD, stronger inflation, and unintended consequences of environmental policies and their friction with physical constraints related to energy consumption and production.

Over the past several years, financial flows are having an increasing role in asset pricing (e.g. vs. fundamentals). This is a consequence of the electronification of liquidity provision, increased use of leverage, and rise of systematic trading strategies and related flows (e.g. see here). During the last downturn, this exacerbated the size and velocity of price moves both in commodities and related equities. We believe that these financial flows can have a similar impact on prices in the up cycle, and below we qualitatively and quantitatively (where possible) discuss the financial flows that will impact commodity and related equity prices.

See page 4 for analyst certification and important disclosures, including non-US analyst disclosures.

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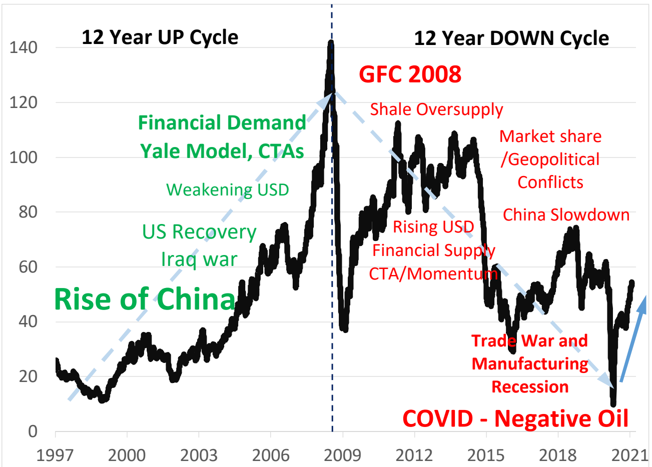
Figure 1: The last Oil supercycle and its drivers



Source: J.P. Morgan Quantitative and Derivatives Strategy

Figure 2: Potential drivers of the new commodity supercycle

End of pandemic and reopening of economies
Uptick in global economic growth (Roaring '20s)
End of trade war and manufacturing recession
Ultra loose monetary policies across the world
Increased and tolerated Inflation
Weakening USD
Fiscal measures, infrastructure
Financial inflows to hedge inflation and bond/equity correlation
Financial inflows to follow asset momentum
ESG - metals for new infrastructure/EVs/Batteries
ESG - erosion of capital/production capaicty for oil
ESG - inefficiencies/instabilities of wind/solar

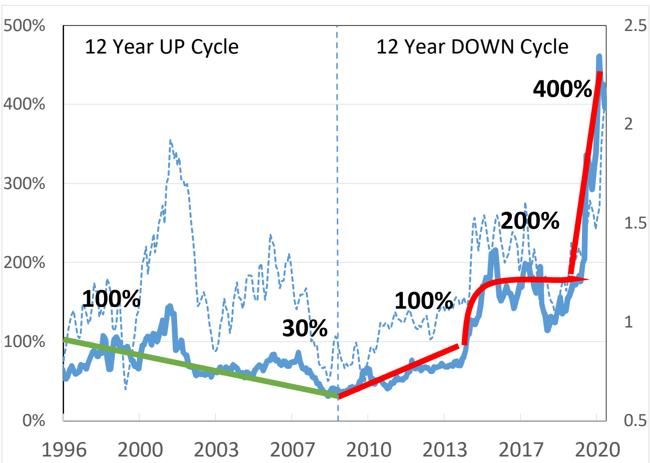
Source: J.P. Morgan Quantitative and Derivatives Strategy

Inflation hedging: The past decade was marked by low growth and low inflation. Bonds, bond proxies and secular growth stocks were in a bull market, while commodities, value and cyclical stocks performed poorly. We believe that the tide on yields and inflation is turning, which will pose a major risk to multi-asset portfolios. In fact, at our quant conference last month, investors ranked inflation as one of the top risks for their portfolios (e.g. alongside COVID resurgence). When asked what the best way to hedge inflation risk was, 42% of participants answered by including commodities, 32% by increasing equities, and only 26% see a solution in interest rate products. We expect these multi-asset portfolios to add commodity and commodity equity exposure to hedge inflation.

Bond-equity correlation hedging: Bond-equity correlation is a critical input into portfolio construction (selection of assets, weights, leverage). We have researched this correlation extensively in the past (e.g. see here) and explained its drivers. Bond-equity correlation shifted regimes when the last supercycle started in 1997 and when central bank actions started intervening in bond markets to backstop equity risk. Coincidentally, with the end of the commodity supercycle, short-term rates have dropped globally to zero, and the ability of CBs to reinforce the bond-equity relationship without driving inflation has diminished. In studying bond-equity correlation, one can notice that there are 2 drivers of it: volatility and inflation. Lower volatility and higher inflation generally weaken the bond-equity correlation. This is precisely what may happen during the monetary and fiscal engineered recovery from COVID-19 – volatility is likely to decline and inflation to increase, delivering a 1-2 punch to bond-equity correlation. Energy equities could present a good hedge for bond-equity correlation – they often deliver a yield (like bonds) but also hedge the inflation and bond-equity correlation risk.

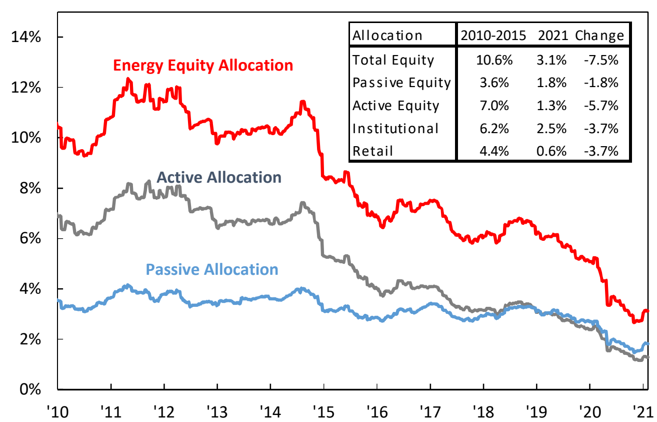
Quants and Momentum Investing: CTAs played significant role in the 2014 oil price downturn. Recently, CTA funds have been adding Energy exposure. The reason is that 12-month momentum turned positive on Oil, and going forward signals will remain solidly positive. A further decline in volatility will likely result in larger and more stable cross-asset quant allocations. A larger momentum impact may affect Energy equities, which is the only sector that still has a strongly negative momentum signal and is hence heavily shorted in the context of factor investing. That will however change in mid-March, when the momentum signal for energy equities turns positive. Equity quants are very concentrated in the 12M (or 12-1M) momentum signal and non-sector normalized models have gained in prominence in the context of risk premia and alternative beta products. Our model momentum factor will need to rebalance in March by closing ~20% of its allocation to Energy equity shorts, and adding ~2% to energy longs, for a ~22% net buying in Energy. Similarly, a 3-factor model (e.g. momentum, value, low volatility) would need to close ~5% of shorts in Energy equities and add ~1% longs for ~6% net buying. What is the significance of these flows? If one roughly assumes that there is about ~$1Tr in equity long-short quant funds and assumes that half of these funds are not sector neutralized, the flows could be quite significant, roughly $20-$30bn. In fact one can see in Figure 3 that the ratio of energy shares shorted vs all other S&P 500 shares shorted, closely followed the commodity supercycle. Most recently the number of shares shorted for energy was 4 times the S&P 500 average (note that given the decline of the sector's weight, energy share prices declined, and the effective $ amount shorted was only 2 times larger).

Figure 3: The ratio of Energy sector/S&P 500 member shorts (left axis in shares/solid line, right axis in $/dashed line)



Source: J.P. Morgan Quantitative and Derivatives Strategy

Figure 4: Fund allocations to Energy have steadily declined in recent years



Source: J.P. Morgan Quantitative and Derivatives Strategy, EPFR

Rotation by discretionary funds and retail: In the period from 2010 to 2015, the Energy sector had a 10.6% allocation in equity portfolios. This has steadily declined to a 3.1% weight currently (Figure 4). The largest decline was in active allocations, which declined from 7% to 1.5% (while passive allocations decreased from 3.6% to 1.8%). Any retracement of this decline, on a US equity fund asset base of ~$14T would result in significant inflows and re-pricing. As economies reopen, inflation moves higher, and yield curves steepen, active funds are expected to first close cyclical shorts, and then rotate from long secular growth towards value and cyclicals. Given that equity assets significantly increased over the last 10 years, and the energy sector significantly decreased, even a small rotation could produce an outsized move. **Retail** investors also reduced energy equity allocation from 4.4% to only 0.6% currently. Given the increased retail activity and interest in stocks that are volatile, have high short interest, are smaller in size and have thematic news/social media coverage (see here), the sector will likely also be of interest to retail investors.

We recently held a conference call discussing our bullish view on the Energy super-cycle with our equity research colleagues, and a podcast of the call is available here. Additionally, our latest Commodity Strategy views and price targets for Energy are available here.

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