# Commodities Price Volatility: Impact on Capex and Inflation

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## Introduction

Commodities prices – most particularly energy and metals – will remain volatile. This primarily is due to persistent economic policy uncertainty and financial stress arising from policy errors by central banks, and geopolitical uncertainty. As a result, investment (capital expenditures, or capex), which is needed to increase energy supplies in the future, remains subdued. All else equal, this imparts an upside bias to headline inflation going forward.

Central bank efforts to induce labor-market slack via hiking interest rates — i.e., pushing unemployment rates higher to reduce aggregate demand — in an effort to bring down core inflation will, if successful, reduce demand for energy and metals as incomes fall.

The upshot: As interest rates rise, the cost of funding conventional and renewable capex will increase, and the final-investment-decision (FID) process will slow. Net, supply will tighten as demand is squeezed. This will resolve itself by higher volatility and price inflation.

## Uncertainty in economic policy

Prior to the latest banking crisis affecting small and regional banks in the US, markets were divided over whether the Fed would return to a more aggressive footing in the wake of a still-strong labor market and persistently high inflation. Now markets are anxiously watching to see how the Fed will navigate monetary policy against the backdrop of multiple banking crises and the increasing likelihood of persistent inflation. Against such a backdrop, economic policy uncertainty will remain elevated.

Following the latest 25bp hike in the Fed funds rate at the beginning of May to a 5.0 – 5.25% range, we expect the Fed to remain in a risk-management mode, which most likely translates into holding rates steady to the end of the year. The Fed will remain “data dependent,” and will act if it becomes apparent inflation is on the march higher or the economy suffers a sharp downturn. For now, the wait-and-see mode will be observed until the Fed is assured that latent risks on small- to mid-sized bank balance sheets resulting from monetary tightening are contained, in our view.

This doesn’t mean the Fed will lighten up its efforts to contain inflation and return core PCE inflation to its long-term target of 2% p.a. However, achieving this goal is unlikely in our view, because the role of tight commodity markets in keeping headline inflation elevated is not being addressed by current central bank policies.

The principal driver of our view on oil and base metals (especially copper), which drive headline inflation, is these markets are supply-constrained. Inventories are tight – either due to production management per OPEC+ policy in the case of oil, or persistent physical supply deficits, as is the case in copper.

In both of these markets, capex is weak, which will limit future supply growth. This results in supply-side inflation pressures, which central-bank policy is not equipped to deal with: The Fed and other CBs are trying to reduce aggregate demand via higher interest rates, which will lead to lower capex as prices weaken and tighten supply further in the future.

In short, there is an almost deus-ex-machina aspect to headline-inflation expectations. Investors are counting on persistent supply deficits in commodity markets somehow being attended to, simply because central banks are increasing borrowing costs and inducing lower incomes to increase slack in the economy. For this reason, core

inflation will remain biased to the upside, as higher wage demands persist to cover cost-of-living expenses.

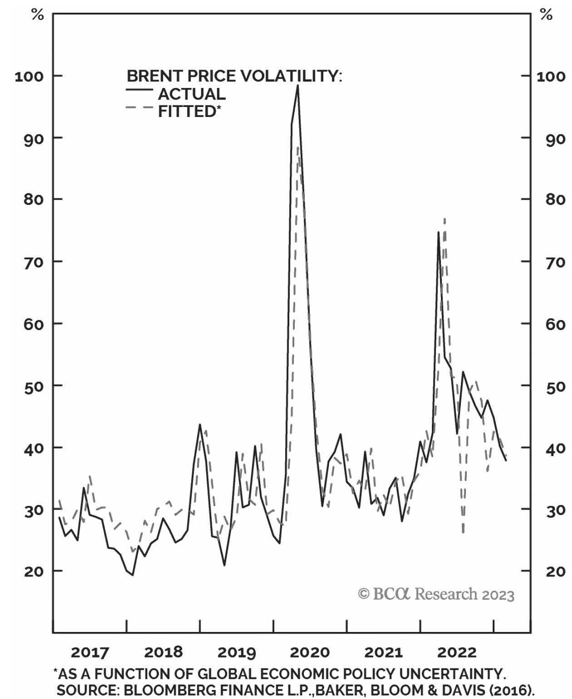
## Monetary policy will send the wrong signal

Increasing slack in the economy most likely will reduce incomes, which will push demand for scarce commodities lower. This will, all else equal, send a signal to energy and metals producers that demand for their output is falling, which will lead to lower prices in the short term. It will, over the medium-to-long term, lead to lower capex as producers rein in production in response to lower demand, all else equal.

This policy will increase economic policy uncertainty as headline inflation fails to fall, and will lead directly to higher energy-price volatility (Chart 1).

Higher energy-price volatility also directly translates into lower capex, which means the supplies needed to maintain and grow output will not be available in the future (Chart 2). This will continue to feed higher headline inflation, even as demand for commodities is falling due to falling incomes resulting from higher unemployment supply will contract.

Chart 1. Higher Uncertainty, Higher Vol




On the back of higher interest rates and tighter financial conditions, financial stress also can be expected. These effects also feed directly into higher oil-price volatility, which contribute to lower capex and lower future oil supplies (Chart 3).

Chart 2. Higher Vol, Lower Capex

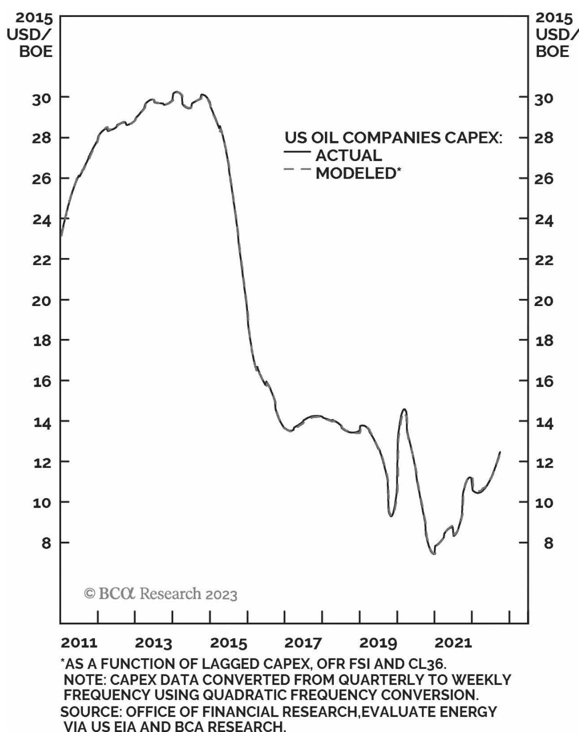
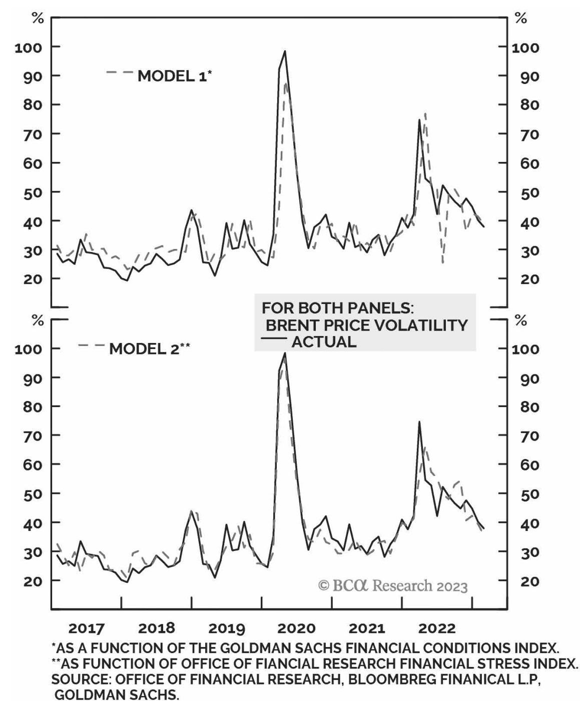
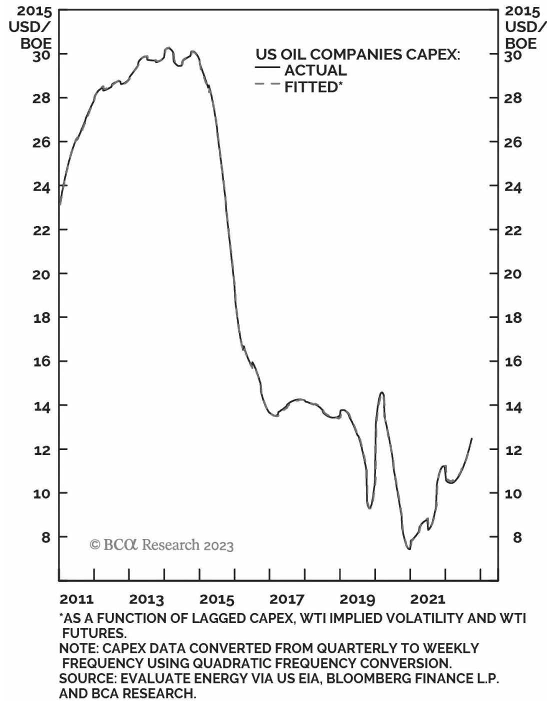



Chart 3. Tighter Financial Conditions, Financial Stress, Higher Vol



It's also important to point out that higher financial stress feeds directly into capex as well (Chart 4). As policy uncertainty rises, so does financial stress, which translates into lower capex.

Chart 4. Weak Capex Will Reduce Supply




## Unforced errors

Central banks aren't the only ones making unforced errors. Governments are doing the same in energy policy, to the detriment of capex. With governments around the world scrambling to address numerous policy failures, the results have been:

- Continuing dependence by the EU on Russia as a supplier of natural gas via pipeline and LNG shipments and, indirectly via shipments to third countries, crude oil and refined products.
- Reduced capex in traditional energy sources (oil, gas and coal) in favor of renewables, policies that neglected to encourage continued production of oil and gas necessary during the global transition to renewable energy. In addition, this neglect means fossil-fuel energy will not be available to cover the loss of renewables when the wind stops blowing and the sun's not reaching solar panels. It goes without saying that such shortsightedness left markets vulnerable to exogenous shocks like the Russian invasion of Ukraine.
- Rampant attempts to shield households (i.e., voters) from higher energy prices by subsidizing consumption, and discouraging production via "windfall profits" taxes.
- The release of some 220+ million barrels of oil from the US Strategic Petroleum Reserve, which started out as a stop-gap measure to address supply dislocations from the Russia-Ukraine war launched in February 2022. This now appears to have been aimed at suppressing gasoline prices ahead of US mid-term elections.

Combined, these errors have the effect of reducing conventional energy supplies like oil and gas, and encouraging consumption beyond levels market-based price signals would support. Most importantly, going forward they will discourage investment in future oil and gas production, which still is required to build the renewable-energy supplies needed for the transition to low-carbon electric generation.

Reduced capex within and outside OPEC 2.0 since 2014 has tightened the supply side of the market to the point where it could not keep up with the pent-up demand released following the post-COVID-19 global re-opening outside China. This will continue into the foreseeable future, barring a massive demand shock from, say, a global recession, which destroys a significant share of oil demand.

## Investment implications for commodities

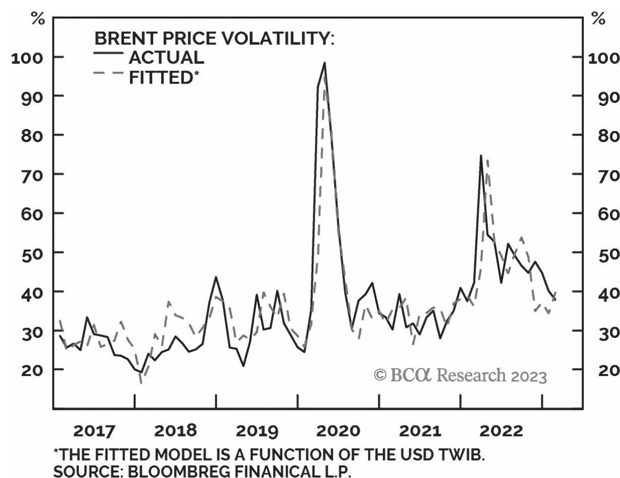
Rising policy uncertainty, tighter financial conditions and financial stress will increase oil- and metal-price volatility, which will reduce investment on the supply side of energy markets. This will contribute to persistent headline inflation, which will bleed into core inflation. We maintain exposure to the equities of energy producers — oil and gas companies, and metal mining and refining — via the XOP and XME ETFs, respectively. This is a volatile position to maintain, particularly as markets appear to be giving higher odds to a recession later this year or next year.

In terms of specific commodities …

***In energy,*** we are keeping a close eye on the broad-weighted USD as economic-policy uncertainty remains elevated. A stronger USD translates directly into more volatile oil prices, which, as the discussion above showed,

causes energy producers to scale back on capex until the uncertainty falls (Chart 5).

Chart 5




We continue to expect the USD to weaken as non-dollar oil transactions increase and Fed policy is constrained by multiple competing policy goals — i.e., financial stability vs. maintaining USD liquidity globally. A falling USD could support energy capex going forward, which would offset the inflationary impulses described above.

***In base metals,*** in March, China's National Development and Reform Commission threatened to consider measures to curb iron ore prices, following the steel-making component's rally since the beginning of this year (Chart 6). Chinese iron ore prices fell ~ 2.6% on the back of this news and plans to curb 2023 steel production. Earlier that month, Bloomberg reported that Beijing authorities urged traders to sell iron ore in port stocks, and according to sources, were considering raising port storage fees for

Chart 6

large volume cargoes in a bid to disincentivize hoarding. This adds to the short-term bearish news that China's single iron ore buying entity — created to purchase discounted iron ore for all Chinese steel makers — is expected to begin operations this year. As the state inserts itself into the iron ore market, low prices and increased volatility will reduce producers' investments, risking long-term supply security of the commodity.

***In precious metals,*** gold prices have fallen, with rising expectations of US Federal Reserve interest rate hikes and the market's increased risk-taking appetite. The FOMC decision to raise interest rates should help convince markets of the US economy's health. However, the Fed is still stuck between risking an economic meltdown as a result of aggressive rate hikes, or runaway inflation due to inaction. Under such conditions, gold prices will remain supported on the back of heightened US economic policy uncertainty and the risk of elevated headline inflation.

<Biography>

**Robert Ryan** is currently BCA Research's Chief Strategist, Commodity & Energy Strategy. Since joining BCA Research in 2014, he has served as the Managing Editor and Chief Strategist for the CES service. Prior to BCA Research, Robert was a consulting economist at Limehouse Research & Trading providing bespoke modeling services. As a research economist at the N.Y. Mercantile Exchange, he developed the crude oil options contract. He spent 18 years in commodity markets at Clarendon Ltd; Bankers Trust; Goldman Sachs's commodity unit, J. Aron; and Deutsche Bank. He also worked as an economist at the U.S. DOE. Robert is an honorably discharged veteran of the U.S. Navy, where he served as an Arabic linguist. He holds a diploma from the Defense Language Institute at Monterey, CA, and degrees from Penn State University in Journalism and Economics.