As commodity investing gains momentum, industrial metals may offer better opportunity

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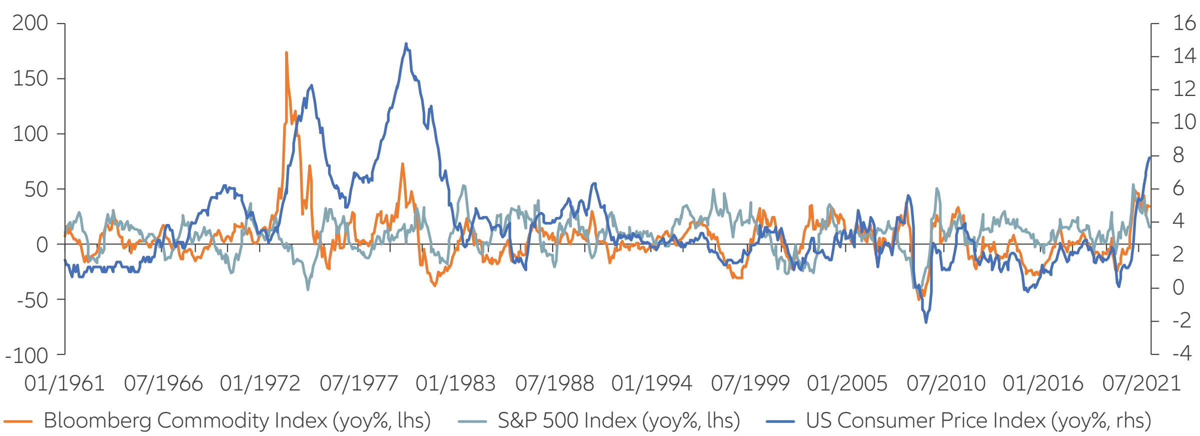
Russia's invasion of Ukraine has shone a light on investing in commodities. Due to potential disruptions to Russia's significant supplies of energy-related raw materials, the asset class – which had previously been languishing for a protracted period in the doldrums – has regained favor among investors, with most of the attention focused on oil and gas. In fact, many experts predict crude oil prices could even top $200 a barrel[1] in 2022 amid tight supply.

While we do not consider the attention to energy to be misplaced, we believe that some investors may be overlooking another important aspect of the current commodity cycle: Industrial metals such as nickel, palladium, and aluminum – which are also plentiful in Russia and might face similar disruptions as oil and gas – could offer a potentially better investment opportunity today.

In addition to supply disturbances, we see two other key factors bolstering the asset class in general – and industrial metals in particular – over the long run; a) industrial metals are crucial in the manufacturing of key components of the clean-energy transition (i.e., electric-vehicle batteries), and, b) commodities have historically been an effective hedge against inflation in investors' portfolios, a particularly effective trait when price increases in many developed economies have hit decades-high levels. Additionally, low correlations with equities and bonds mean that commodities can also potentially smooth returns during periods of intense volatility, such as the present (**Exhibit1**).

Exhibit 1: Commodities have fared well when inflation is high, can smooth returns

Year-over-year, percentage change



As of March 31, 2022
Source: Bloomberg, Allianz Global Investors

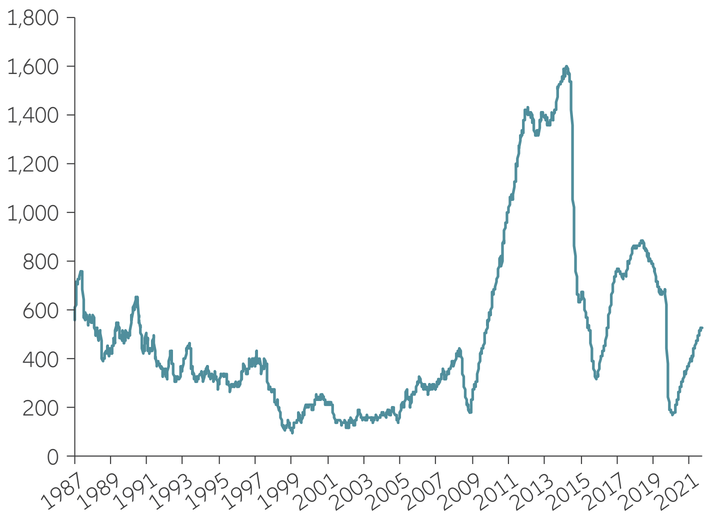
[1] *Top oil traders warn prices could breach $200 a barrel*, Financial Times, March 24, 2022

Value. Shared.

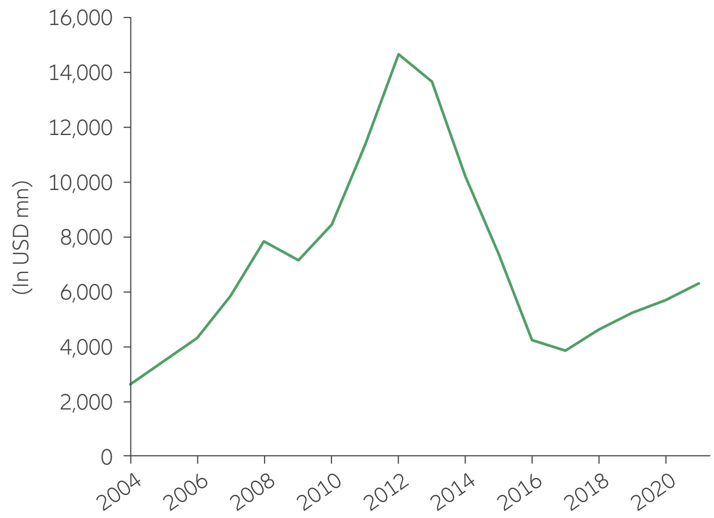
Allianz Global Investors

Exhibit 2: Weak capital expenditures have restrained commodity supply

Oil rig numbers slowly rising but remain low



Big 4 mining capex remains tight



Note: Graph on left shows Baker Hughes US Crude Oil Rig Count, a leading indicator of demand for products used in drilling, completing, producing and processing hydrocarbons. In right-hand graph, Big Four refers to the world's four largest diversified miners – Rio Tinto, BHP, Anglo American and Glencore – collectively considered a proxy for the industry more broadly.
As of March 31, 2022
Source: Baker Hughes, Bloomberg, Allianz Global Investors

Supply-demand dynamics provide significant tailwind

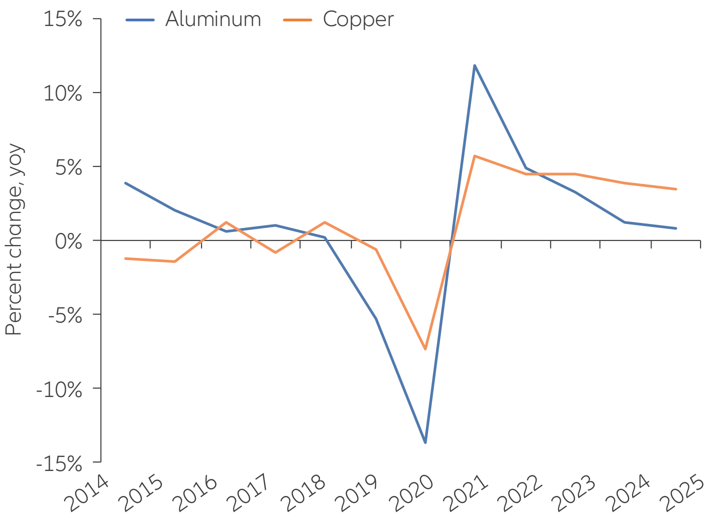
Supply-demand dynamics, both short- and long-term, offer a significant tailwind for commodities, in our view. In the short term, the global economy is still only in the early stages of emerging from the economic slowdown caused by the COVID-19 pandemic, boosting demand for commodities. At the same time, Russia's invasion of Ukraine coupled with supply-chain disruptions are hampering the supply of everything from oil to industrial metals.

For many years, the supply side has been starved of capital investment in everything from oil exploration to mining (Exhibit 2) as capital discipline has prevailed in the energy and mining sectors. With new projects such as new oil rigs, shale drilling or metal mines taking years to get from initial investment to production, we see the risk of a significant increase in supply as low.

New supply is also being restricted by factors that open companies up to environmental, social and governance (ESG) risks. For example, new and existing mines are producing falling ore grades. Producing metals from lower-grade ores adds technical complexity to extraction, while processing requires larger equipment and the use of more chemicals. As mining becomes potentially "dirtier", protests against new mines have grown, amplified by social media.

On the demand side of the equation, commodities – and industrial metals in particular – appear to have a rosy outlook, not least because demand should increase as the energy transition gathers pace. Indeed, many countries in Europe, most notably Germany, have said they want to accelerate their switch to more renewables as part of an urgent strategy to reduce their dependence on Russian gas. Significant planned spending on infrastructure backing the US renewable energy transition also buoys demand. As shown in Exhibit 3 (see next page), demand is forecasted to be strong for such metals as copper and aluminum in the coming years (current inventories of both these metals are low).

Exhibit 3: Forecasted demand for copper and aluminum is high



As of March 31, 2022
Source: CRU Group, Wood Mackenzie, J.P Morgan Commodities Research

Net-Zero transition favors industrial metals

At the 2021 Glasgow Climate Pact, governments globally agreed to accelerate efforts to keep temperatures from rising more than 1.5 degrees Celsius by 2050, admitting that actual progress toward earlier commitments had fallen short of promises. As governments globally redouble their efforts on renewable energy, the road to Net Zero should favor industrial metals.

The shift from combustion-engine cars to electric vehicles (EVs) is copper-, nickel-, lithium- and aluminum-intense. A battery-powered EV, for example uses 75 kilograms (165 pounds) of copper vs. 20 kilograms (44 pounds) in a traditional car. Solar power, wind power and battery power storage are also tailwinds for metal demand. Photovoltaic cell technology uses metals such as silver, aluminum, copper, zinc, and steel, while the deep-sea cables used to bring offshore wind energy back to land require copper, aluminum, and steel.

The International Energy Agency estimates demand for lithium used in the batteries that power EVs could expand by a factor of 30 by 2030.[2] Demand for aluminum for solar panels was roughly 2.4 million tons in 2020. It is now forecast by the industry magazine mining.com to rise to 4.6 million tons by 2040.

Russia is an industrial metal powerhouse that produces nickel (used in batteries), palladium (a key component of catalytic converters), aluminum (used in such things as battery casings, wind turbine nacelles and blades, hydrogen fuel cells and for framing solar panels), platinum (used in auto catalysts), steel (used in construction and car manufacturing) and copper (used for making cables and for wiring in EVs, solar panels and wind turbines). The country accounts for almost 14% of global mineral extraction and produces more than 10% of the world's nickel, according to Thomson Reuters.

As investors consider exposure to the asset class, however, they should be mindful of potential risks associated with passive strategies. The S&P GSCI Index – the most popular benchmark among passive commodity strategies – is heavily tilted towards energy, with a modest weighting of about 10% to industrial metals. By contrast, the industrial metals weighting in the Bloomberg Commodity ex Agriculture/Livestock Index is about twice as large, leaving it better placed to benefit from the energy transition. Finally, given the environmental, social and governance risks that are inherent in the industrial metals sector, an active approach can help identify and mitigate such risks.

For investors without commodities in their strategic asset allocation, we believe that industrial metals may offer an opportunity to profit from the structural trend in commodities or hedge part of their inflation risk. For those who already have an allocation that may be overweighted towards energy, now is the time to consider taking an active approach with the goal of enhancing diversification – and potential returns – while investing in this asset class.

[2] International Energy Agency, *Clean energy demand for critical minerals set to soar as the world pursues net zero goals*, May 2021

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