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COMMODITY OUTLOOK

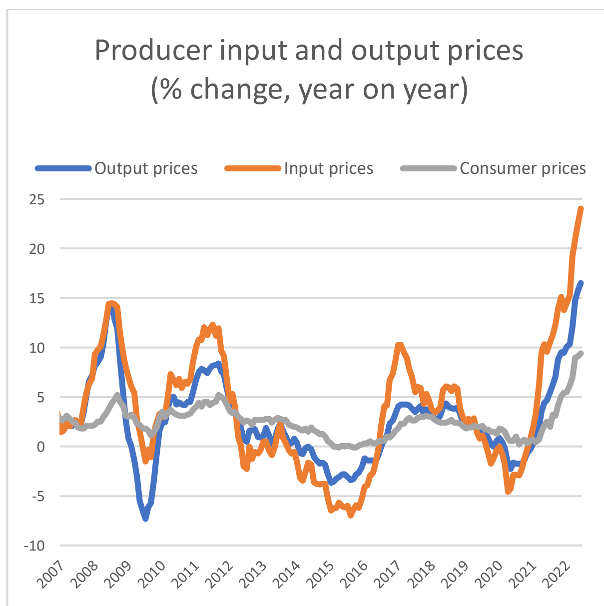
JULY 2022

Commodity prices diverge as demand doubts grow

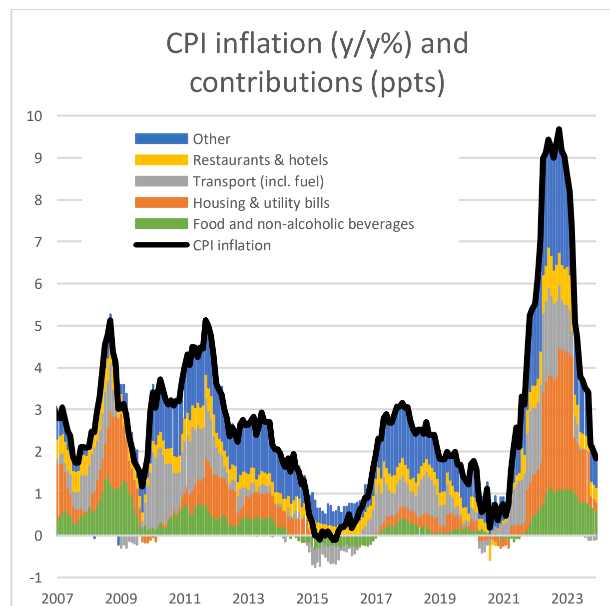
Falling prices for some commodities in the past couple of months suggest that some of the upstream cost pressures facing businesses could begin to ease soon, though partly because global economic growth is also softening. The impact of past price increases will continue to feed through to input and output prices in the coming months, and we do not expect any easing in consumer price inflation until early 2023. Meanwhile, the prospect of a renewed surge in energy prices later in 2022 remains a significant concern for the economic outlook in Europe in particular, with potential to depress growth and push up inflation further. This piece summarises recent trends and the outlook for key energy and non-energy commodity prices.

Global commodity prices have diverged in the last couple of months. Non-energy commodity prices have generally fallen back since early June, as rising interest rates, a stronger dollar and concerns about a slowdown in the global economy have weighed on sentiment. Prices for a range of industrial metals, which spiked following Russia's invasion of Ukraine, have generally fallen back below their pre-war levels. Food prices have softened too, though they remain high by historical terms.

Meanwhile, energy prices have been more volatile. Despite the prospect of a global economic slowdown over the year ahead—and hence weaker energy demand—concerns over supply constraints and the risk of further disruption are dominating markets, suggesting prices are likely to remain historically high in the near-term. In particular, natural gas prices in the UK and continental Europe have risen sharply as Russia has scaled back pipeline gas deliveries, raising the spectre of energy rationing on the Continent over the winter.



Source: ONS.



Sources: ONS; CBI forecast.

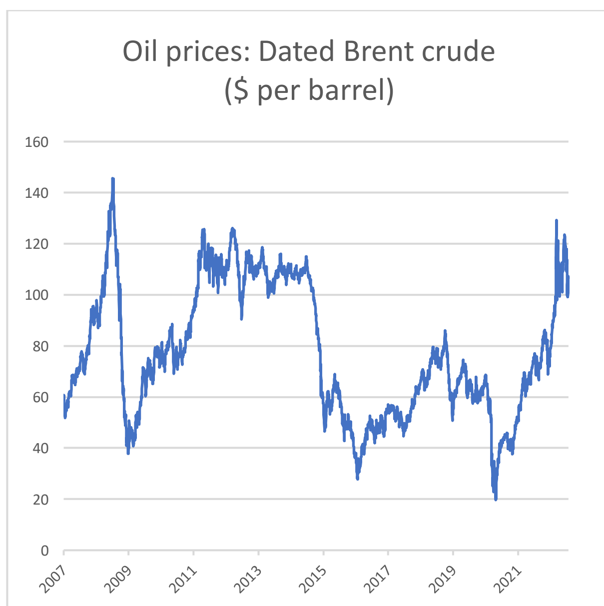
Energy

Oil

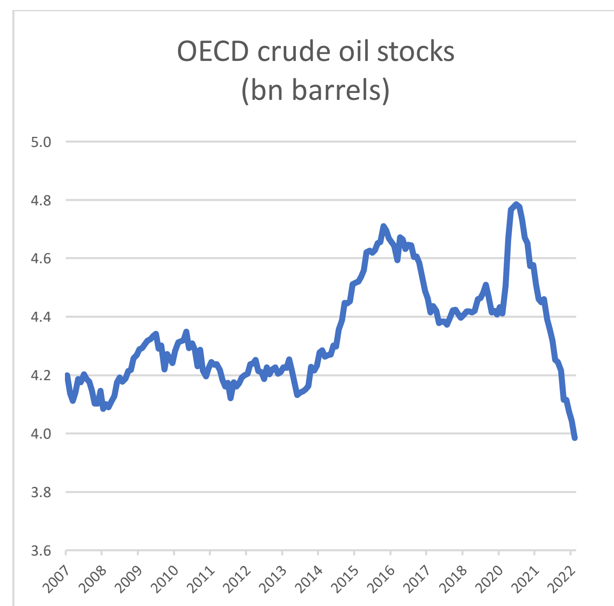
Crude oil prices have whipsawed in recent months, driven in large part by shifting expectations for the supply of oil from Russia. Having traded in the $100-110 per barrel range through much of April and May, the price of Brent crude surged back above $120pb in June after the EU (which takes around half Russia's oil exports), announced its sixth package of sanctions in response to Russia's invasion of Ukraine. These included a ban on seaborne imports of Russian crude oil from December 2022 and a ban on the provision by EU companies of insurance or finance-related services to ships carrying Russian oil to third countries. With the UK government announcing similar measures targeted at shipping, the moves are expected to make a material dent in Russia's oil exports, given that Russia exports most of its crude oil by sea.

Meanwhile, the capacity of other oil exporters to take up the slack is limited. Despite high prices, US production has not yet risen significantly, in part reflecting tighter financial conditions facing shale producers. Although output from OPEC+ countries has risen steadily over the past year, producers have consistently fallen short of the quotas they agreed in July 2021. Further increases in output have been agreed for July and August, with the aim of unwinding Covid-era cuts, but output levels from September have yet to be agreed. Quotas may be scrapped altogether, but analysts have raised doubts about whether key countries such as Saudi Arabia and the UAE even have the capacity to raise production significantly further. With global oil inventories low by historical standards, global oil supply will therefore remain tight.

Until recently, these concerns had outweighed worries about an economic downturn. However, oil prices fell sharply in early July, briefly dipping below US$100pb, as global investor sentiment turned more bearish, before recovering to $105 by the middle of the month. Looking ahead, the global economy is still expected to grow over the next year, with demand for oil buoyed by ongoing post-COVID recoveries in more energy intensive economies (such as China) in particular, as well as by the recovery of international travel. Given supply constraints, Brent crude prices are widely forecast to remain above $100pb through to the year-end (with Q3 forecasts ranging from $105pb to as high as $140pb, and Q4 forecasts ranging from $100 to $130). This is above the level implied by current futures prices ($95 pb by December), which assume further modest falls through 2023 (to $85 by the end of the year).



Source: Macrobond.



Source: Macrobond.

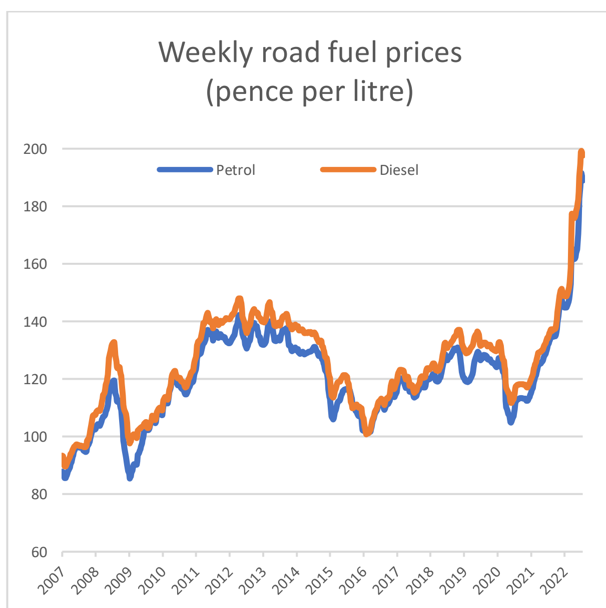
Fuels

In line with higher crude oil prices, fuel prices have risen sharply over the past year. Despite dipping a little in early July, UK petrol pump prices were still up by 42% over the year to mid-July, with diesel prices up by 45% over the same period. Prices of kerosene (aviation fuel) were 75% higher than a year ago.

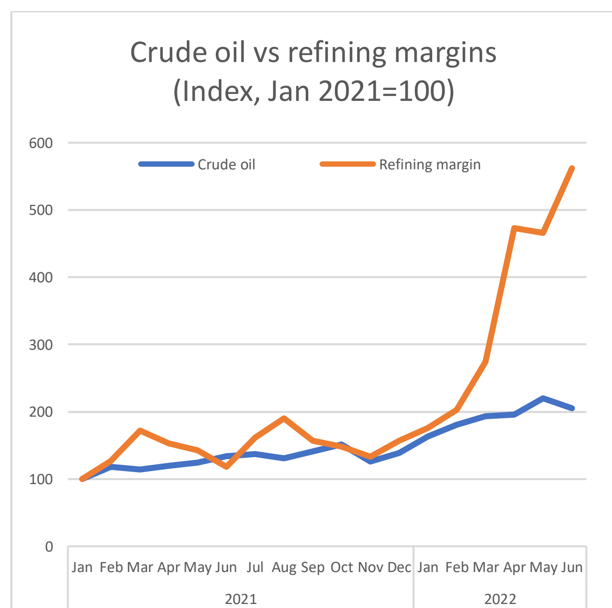
A review of road fuel prices by the Competition and Markets Authority found that higher crude oil prices accounted for around one third of the increase in pump prices over the year to June. However, the main factor driving prices higher was a growing “refining spread”—the difference between crude oil prices and wholesale fuel prices), which has more than tripled over the past year, accounting for more than 40% of the growth in road fuel prices. By contrast, the CMA found that the “retailer spread”—the difference between the wholesale price and the price charged to motorists—has been volatile but was little changed over the year as a whole.

The increase in refining spreads reflects a lack of capacity across many parts of the world. Refineries in Europe and the US are reported to be operating close to their maximum capacity, reflecting a combination of stronger demand following the pandemic and a self-imposed reduction of supplies from Russia, as well as a structural shift away from fossil fuels that has curtailed investment in new facilities. Meanwhile, China has steadily been reducing petroleum product export quotas to reduce demand for its older, more polluting refineries as part of its decarbonisation strategy, effectively removing capacity from the global market.

While a downward drift in crude oil prices over the year ahead should begin to feed through to lower fuel prices (with a lag), refining spreads are predicted to remain historically high, which is likely to keep fuel prices above the levels of recent years.



Source: BEIS.



Source: Bruegel.

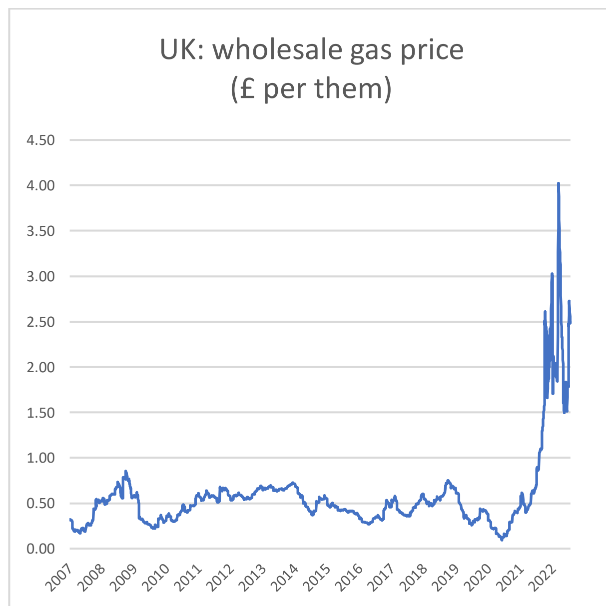
Natural gas

Wholesale natural gas prices rose sharply across Europe in early July, as Russia further curtailed pipeline deliveries to the Continent. By early July, Russian pipeline exports to Europe were almost 70% lower compared with the year earlier, with deliveries via Poland completely halted, transit via Ukraine limited and transit to Germany via the Nordstream 1 pipeline falling by 60% in the space of a month. Gas flows were reduced again in the second half of July when the Nordstream pipeline was shut for planned maintenance, and while partial flows resumed when this work was completed in late July, many analysts now expect flows to continue at around 40% of capacity, or below, through the coming months.

This points to a growing prospect of gas shortages during the winter for the countries most reliant on Russian gas, particularly Germany, Italy, and some smaller central European economies. This would weigh

heavily on European growth—with a risk of recessions in Germany and Italy in particular—and push up inflation further by a few percentage points.

Reflecting these concerns, benchmark European and UK wholesale spot prices rose by over 50% in the space of a week at the beginning of July, with UK spot prices climbing back above 270p per therm, a level not seen since the start of April. Futures curves have also risen sharply: the price of December 2022 contracts spiked to a record level above 450p per therm—nine times higher than two years earlier, with a benchmark European futures contract (Dutch TTF) increasing tenfold over the same period. Prices have since softened a little but remained close to these highs as of mid-July.



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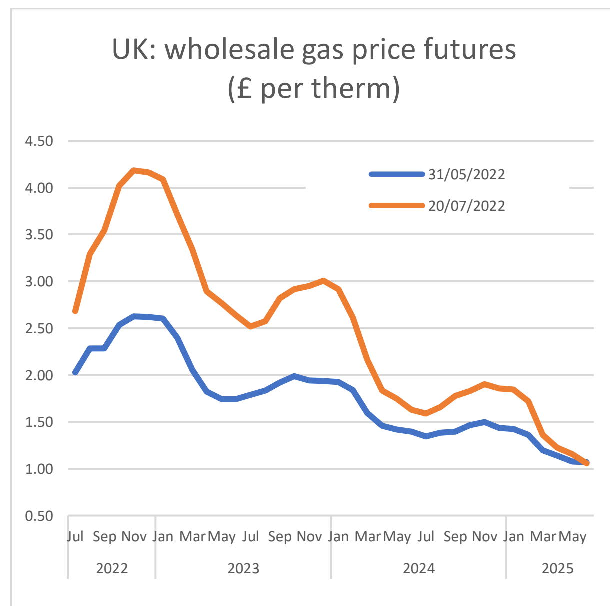


Sources: Macrobond.

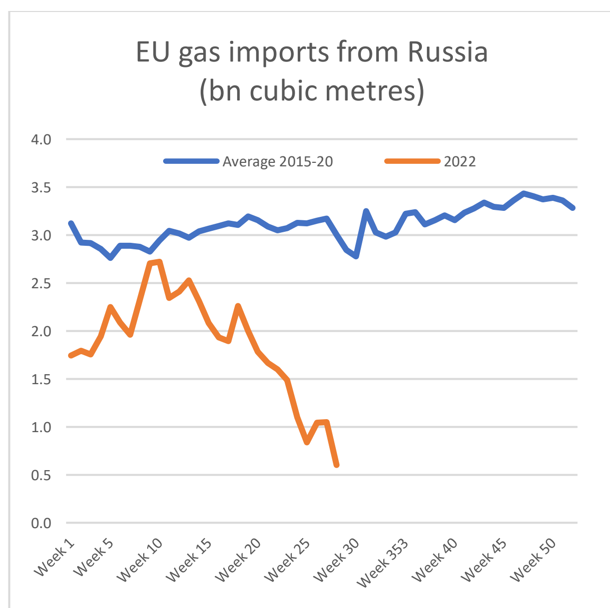
Several factors will influence the evolution of prices during the coming months. On the demand-side, global weather patterns clearly remain a major factor (but one that is impossible to predict), along with the strength of the global economy. One notable upside risk is a stronger Chinese recovery, which could increase demand for liquid natural gas (LNG), raising competition for shipments to Europe and pushing up prices. On the supply side, the main risk is that the EU's attempts to wean itself of Russian gas creates a shortfall during the peak demand this winter. A number of EU member states have already taken steps to bring more coal/oil fired generation on stream to aid the transition away. Gas deliveries to the Continent from Norway have also risen by around 15% this year and the EU is importing record amounts of LNG, though infrastructure bottlenecks limit the pace at which the EU can substitute LNG for Russian gas.

EU member states have also been successful in building up gas storage levels, which have risen sharply in recent months and were 64% full by mid-July. However, analysts are now warning that unless Russian gas flows recover above recent levels from late summer, the EU will be unable to fully plug the gap and meet its target for gas storage facilities to be 80% full by November, the start of peak demand season. It was against this backdrop that on July 20th the European Commission called for measures to ensure a 15% reduction in gas use across all member states between August and March next year. A number of EU member states have already been debating steps to reduce the demand for gas, with the burden widely expected to fall on the industrial sector, rather than on households.

For the UK, the risk of outright shortages is limited by the low direct reliance on Russia for its gas supplies (around 4%, compared with 40% in the EU, though the UK also imports around 15% of its gas from the Continent, via interconnectors from Belgium and the Netherlands). However, UK households and businesses would be exposed to further, sharp increases in gas and electricity prices in the months ahead. For households, for example, energy consultancy Cornwall Insight has forecast a further increase in the annual tariff combined cap for electricity and gas to £3,244 in October and £3,363 in the first quarter of 2023. This compares with £1,042 at the start of 2021, an increase of over 200% in two years.

Meanwhile, UK businesses, which do not benefit from the price cap, have seen their energy prices increase similarly. Based on the historical relationship between wholesale prices and the prices paid by the industrial sector, we estimate that the recent surge in wholesale energy prices implies further increases over Q4 2022 and Q1 2023 of 10% per quarter for electricity and around 20% per quarter for gas. This would represent an increase in prices of over 50% for electricity and over 200% for gas respectively since the start of 2021. These figures represent industry averages, but individual firms may be exposed to even sharper increases as past fixed price contracts expire. And for energy intensive industries—such as steel, glass, chemicals and fertilisers—such a significant spike in prices risks rendering some operations uneconomic, implying production shut-downs where this is viable or severe financial strains where it is not.

In such a scenario, UK firms may also experience further disruption to their European supply chains. For example, in Germany, which is most exposed to the risk of lower Nordstream gas flows, the sector most at risk of energy rationing would be the energy-intensive chemical and petrochemical sectors, according to analysts at Goldman Sachs. This could potentially disrupt the production of numerous compounds used in a diverse range of products, including food additives, soaps & detergents, construction materials, plastics, fibres, adhesives, paints & coatings, etc. Other energy-intensive sectors potentially at risk of disruption include paper production, food & beverages, metals and machinery & equipment.



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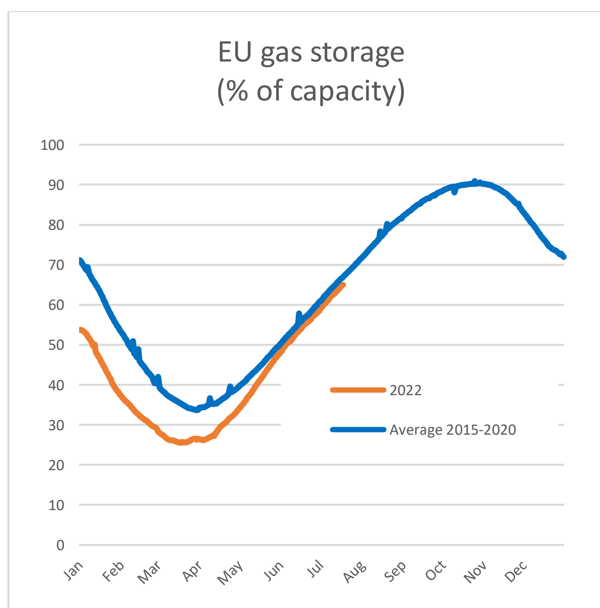


Sources: AGSI; CBI.

Agricultural

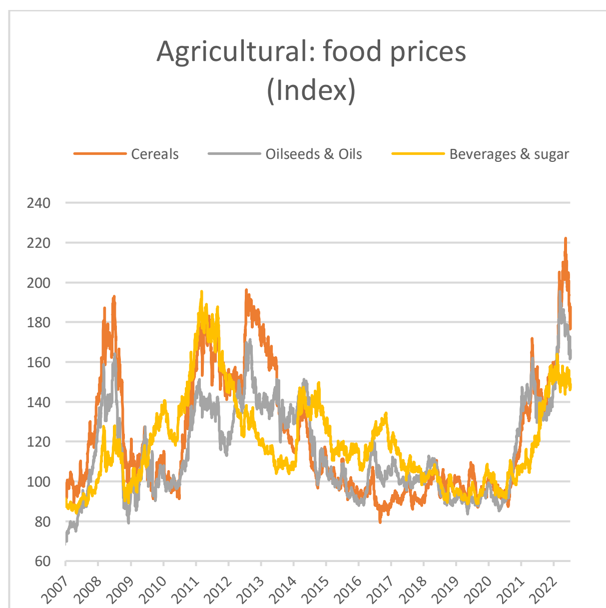
Global prices for agricultural commodities have generally softened in recent months, reflecting a deterioration in investor sentiment, a strengthening dollar, as well as improving supply conditions for key commodities. Food prices in particular had surged following Russia's invasion of Ukraine in February, which choked off Black Sea export routes from both Russia and Ukraine (both leading global exporters of grains and edible oils), adding to existing supply constraints caused by pandemic-related disruption and adverse weather over the previous year. Incoming harvest data from other major global producers, combined with a more "risk-off" attitude among investors, has tipped markets into retreat for now. However, supply concerns are likely to keep prices historically high.

According to an index produced by the Hamburg Institute of International Economics (HWWI), global food commodity prices have fallen by around 10% from their peaks in mid-May (though they remain 26% higher over the year). Prices for wheat, which spiked following Russia's invasion of Ukraine, have fallen back by steadily since in the last two months as initial concerns over disruption to Russia's exports have diminished, with upward revisions to harvest data for other major producers (such as Australia and the US) also a factor.

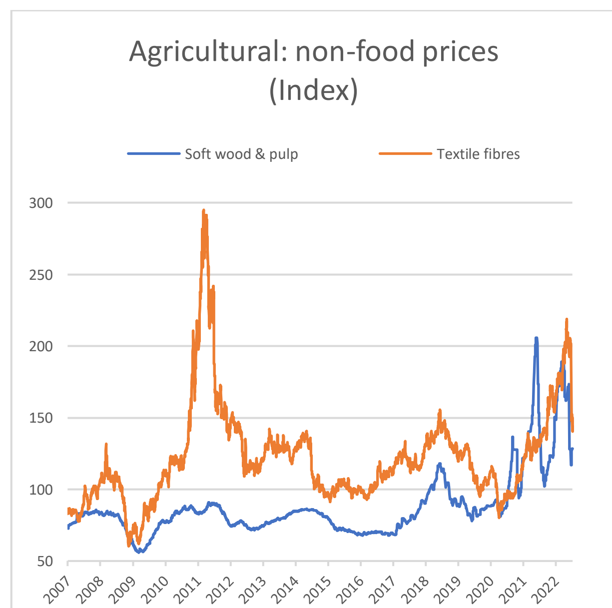
Talks to allow Ukraine to resume exports appear to have made progress, which could put further downward pressure on wheat prices in the coming months (assuming shipments proceed).

However, food prices are volatile by nature and there is little consensus among market analysts over the near-term outlook for major crops, with pressures in both directions. Further downward pressure on prices could result from a stronger supply response to high prices by other major producers, combined with an easing of shipping disruption that has hindered exports from some markets (such as Australia), as well as the potential for export restrictions to be removed by some producer countries. By contrast, upward pressure will come from tight global supply conditions, thanks in part to high agricultural input costs (especially fuels and fertilisers), which will leave prices sensitive to weaker than expected harvests. Ongoing droughts in the US, Europe, India and Argentina represent key sources of upside risk. Overall, crop prices are widely expected to remain high from a historical perspective through 2023.

Food prices are therefore expected to remain a key driver of consumer price inflation through much of 2023. Recent falls in agricultural commodity prices should begin to feed through to manufacturers' costs during the second half of this year. However, given the steep rise in input costs beyond the wholesale prices of agricultural goods—including for energy, transport, packaging and wages—lower commodity prices will feed through only slowly to manufacturing output prices. CBI surveys suggest that food & drink manufacturers have seen their margins significantly squeezed over the past year, and the process of cost recovery may still have some way to run, though this process may become even more difficult in an environment where commodity prices are falling, with retailers under significant pressure to contain prices. Having climbed above 8% in May, we expect food price inflation in the UK to remain above this level right through to the first quarter of 2023, before falling back to around 5% by the end of 2023, still high by historical standards.



Sources: HWWI; Macrobond.



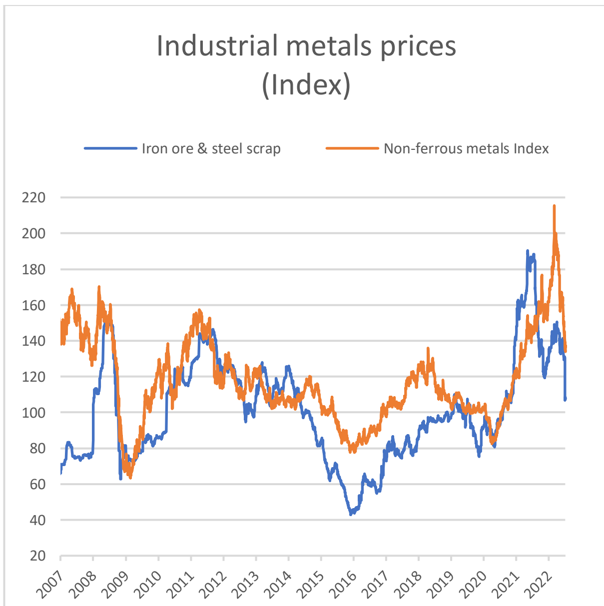
Sources: HWWI; Macrobond.

Metals

Concerns about a slowdown in the global economy have weighed on industrial metal prices over the past month or so. In the wake of Russia's invasion of Ukraine, the prices for a range of metals set new records on concerns about disruptions to supply (given the two countries' significant role in global exports of metals such as aluminium, titanium, steel, palladium and platinum). However, in many cases prices have now fallen back below pre-invasion levels.

The outlook for industrial metals is particularly uncertain currently given recent the volatility in energy markets, with the prospect of energy rationing in Europe likely to hit both the supply of metals from European smelters, but also demand for metals from manufacturing (whose production may also be disrupted) and from households (whose real incomes will be hit by higher energy price inflation). For example, aluminium

prices may receive support from a net reduction in supply, given the high energy intensity of aluminium production. By contrast some other metals, such as copper, could soften as supply is less reliant on countries at risk of gas shortages, with demand suffering a hit from reduced consumer spending on appliances and lower construction activity. Meanwhile, the outlook of industrial metals used in construction – such as steel – will depend heavily on the evolution of the ongoing Chinese property downturn.



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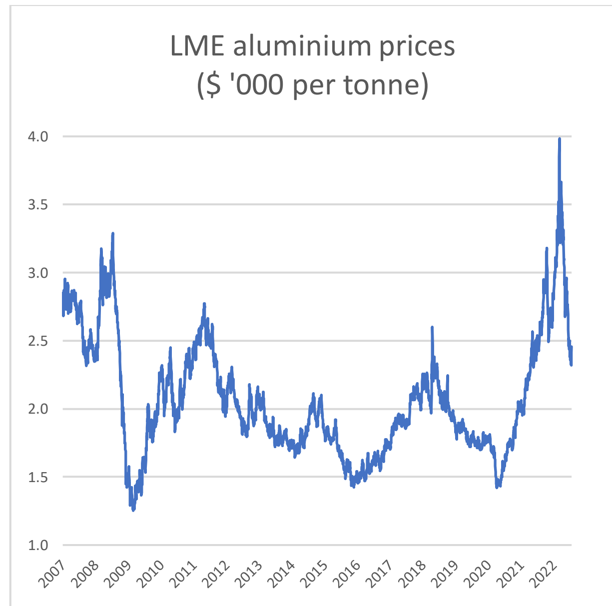

Sources: Macrobond.

For any queries relating to this note please email us at the address below. We would also welcome your feedback and thoughts on the impact of rising costs on your business. Please contact:

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