COMMODITY OUTLOOK

"A combination of a strong U.S. dollar, higher interest rates and relatively subdued growth should keep commodity prices in check in 2015. With OPEC giving up on its mission of 'ensuring the stabilization of oil markets' and allowing the market to 'balance itself,' the cartel has entered a new era – and we believe oil will see higher volatility and lower prices in 2015. In addition, base metals, particularly aluminum and zinc, could perform relatively well on falling inventories. So investors need to tune out the background noise and look closely at each commodity and see how supply and demand are balanced."

– Francisco Blanch, Head of Global Commodities and Derivatives Research

Our view

Commodities face continued headwinds from a strong U.S. dollar: In 2014, we expected the combination of a strong U.S. dollar, higher interest rates and relatively subdued growth to create downward commodity price pressures. The outlook for 2015 does not look much different, in our view. We expect growth in advanced economies to accelerate on the margin, while emerging economies generally look relatively soft. China's economy seems stretched as domestic housing prices fall and key currencies such as the Japanese Yen continue to depreciate, painting a bleak outlook for battered bulk commodities in 2015. The one key difference is that most commodity prices have fallen sharply compared to last year and that lower oil prices should support global GDP growth accelerating from 3.2% this year to 3.7% in 2015.

Greater volatility and lower prices for oil in 2015: The first consequence of OPEC's decision to shift away from moderating prices should be a big structural increase in oil price volatility. After volatility reached the lowest point in history this summer, price swings of $50+ per barrel could become more frequent. Greater volatility could benefit low-cost producers with strong balance sheets such as Saudi Arabia. While excess production can move into storage for a while, we believe supply and demand ultimately need to adjust via lower prices. With oil demand taking on average six months before it really starts respond to lower prices, we believe the impact likely should be seen in the second half of 2015.

Stronger growth could bring slightly higher metals prices: Base metals could perform relatively well on falling inventories, particularly aluminum and zinc, although copper is less certain. The rapid narrowing of U.S. current account, coupled with expansive monetary policy in Europe and Japan, creates risks for emerging markets next year; gold prices potentially could fall to $1,100 per ounce as the U.S. dollar strengthens and U.S. rates move higher with the approaching end of quantitative easing by the Federal Reserve.

Dynamic carry, spot mean reversion are favored strategies: Heading into 2015, we see some near-term upside to commodity prices on the back of a modest cyclical upturn ahead and OPEC's oil production shift, so commodities as an asset class should deliver positive total returns over the next three months. The outlook over 12 months is less certain, in our view, since prices are likely to remain capped by abundant supply, subpar economic growth and a strong dollar. With a cautious outlook on commodity beta, systematic strategies such as dynamic carry, contrarian positioning or spot price mean reversion are likely to deliver strong, uncorrelated returns for investors next year.

Key calls

- WTI could drop to $50/bbl in 1H15 before it recovers to $81/bbl in 2016
- A strong U.S. dollar is a big headwind to commodity prices
- Rising U.S. interest rates: Sell gold in the short-run
- Play cyclical beta upside: Buy industrial metals
- Spot mean reversion, dynamic carry yield uncorrelated returns