

## ALTERNATIVE SUBSTANCES

Natural resources are the lifeblood of the economy. They are at the heart of conflicts, innovation, and myths. They hold a special allure for investors. Yet, investments in commodities are complex and challenging.

“The Stone Age did not end for lack of stone, and the Oil Age will end long before the world runs out of oil.” In the 1970s, amid discussions of oil shortages and price hikes, Sheikh Ahmed Zaki Yamani, who served as the Saudi Arabian Minister of Petroleum and Mineral Resources, made this famous remark. His statement stands in opposition to fears of an imminent depletion of natural resources as represented, for example, in a paper commissioned by the Club of Rome, “The Limits to Growth”, published in 1972 and echoed many times since. Supplying the economy with natural resources is always vital, but in times of energy supply transition and an increasing weaponisation of commodities in conflicts, it acquires even greater significance.

Extracting natural resources requires high capital expenditure – exploration is difficult, machines and equipment are expensive, the risks are high. This is why suppliers on the commodity markets generally cannot react quickly to rising demand. On the other hand, consumption structures and the mechanisms for processing natural

resources cannot be altered from one day to the next if the supply suddenly lags or even dries up. This is why the short-term flexibility, also known as elasticity, of supply and demand in many commodity markets is limited, so that even very minor changes can provoke significant volatility in prices.

The past few years have provided plenty of real-life lessons on the precarious conditions in commodity markets: supply shortages (due to Covid-19), demand shocks (due to reopening), and disruptions in supply (such as the war in Ukraine) have occurred rapidly, unsettling markets for oil, gas, or wheat. Additionally, there are significant challenges in the energy supply sector and in decarbonisation efforts. Unfortunately, the arguably best solution to this problem, namely carbon pricing, is still in its infancy.

### **Innovation as a constant**

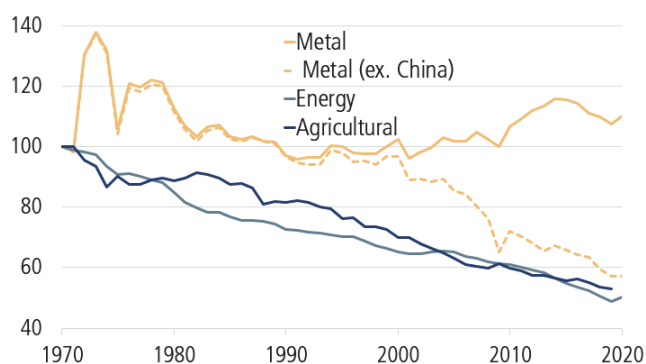
For millennia, human history has been shaped by resource shortages, price surges, and supply crises – the Bible itself contains stories of famines in Israel and Egypt. Less obvious, however, is humanity's remarkable spirit of invention, which runs like a thread through history. Initially, coal, and later oil and gas, made the Industrial Revolution possible. And contrary to all predictions – most famously that of Robert Malthus in 1798 – food has not run out despite the tremendous increase in the world's population. When resources became scarce, new technologies, deposits, or



substitutes were found: deep-sea drilling and fracking, synthetic materials to replace rubber or cotton, new fertiliser and farming methods for food production are just a few examples of the remarkable innovation in the resources sector. Certain harmful substances such as lead have been almost completely replaced or eliminated over time. Even today, in the era of decarbonisation and electrification, human research and innovation are running at full throttle. Reports of the use of artificial intelligence in the search for alternatives to the use of lithium in batteries are just one indication of this.

consumed energy and agricultural commodities per unit of GDP has decreased by nearly 50% since 1970 (see chart). Similar trends apply to industrial metals, albeit excluding the special case of China – here, significantly more metals per unit of GDP were consumed due to extensive growth. Overall, however, the relative importance of resources in our service-dominated economy has declined. The share of agriculture and resource sectors in gross domestic product and employment has now fallen to a low single-digit percentage in most industrialised countries. Yet, more than half of our grandparents' generation was employed in agriculture and forestry.

RESOURCE CONSUMPTION PER UNIT OF GDP GLOBALLY SINCE  
MORE EFFICIENT OVER TIME



Source: World Bank (2022), Commodity Markets – Evolution, Challenges, and Policies, Baffes, J. und Nagle, P. ed.), p. 131. Index 1970=100. Energy: oil, coal, and gas; metals: aluminium, copper, lead, nickel, tin, and zinc; agricultural commodities: includes wheat and corn.

In absolute terms, global consumption of many resources has increased enormously, and in some cases exponentially, due to industrialisation and rapid population growth. However, this has not led to the depletion of reserves: according to the Energy Institute in London, the currently known reserves for oil, gas, and coal are sufficient to cover current consumption for at least several decades, placing them at a similar (or even higher) level than they were 40 years ago.

While absolute consumption is rising significantly, most resources are simultaneously being used more efficiently. According to a World Bank study from 2022, the amount of globally

## A special allure

Investing in commodities poses challenges for investors. It starts with the fact that most commodities can hardly be physically acquired and stored in the basement; instead, complex futures contracts must be utilised. Additionally, there are risks associated with environmental issues as well as the susceptibility to significant price fluctuations, often triggered by political events. Natural resources are often extracted in unstable or autocratically governed countries, which, not least due to risks of corruption or human rights violations, are difficult even for insiders to predict. Furthermore, commodity markets are more complex than they seem. In the case of crude oil alone, there are dozens of different types – from the Sahara Blend produced in Algeria to Tia Juana Light from Venezuela; similar diversity exists for other commodities. Commodity traders must be highly specialised, focusing on the short term and the availability of goods. In contrast, investors tend to focus more on the long term – aiming for at least preservation of value and seeking to achieve the highest possible return with the least possible risk.

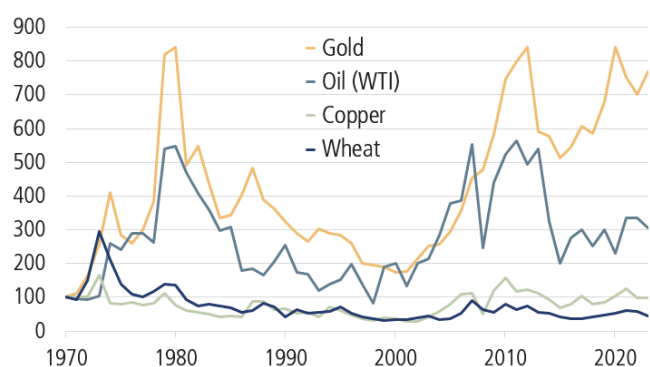
Nevertheless, investments in commodities hold a special allure. It is assumed that they protect well against inflation as real assets and are needed even in hard times. Additionally, there is a presumption that they are becoming scarcer, and prices must rise solely for that reason. In the



turbulent inflationary year of 2022, many were vindicated as commodities were nearly the only asset class with positive returns. Subsequently, Credit Suisse dedicated a noteworthy chapter to commodities in their Global Investment Returns Yearbook 2023. In it, authors Dimson, Marsh, and Staunton initially conclude that over the very long term between 1900 and 2022, only a few commodities actually generated positive real returns (in US dollars) – such as gold or oil. Gold yielded +0.8% p.a., only slightly better than US dollar bills (or cash) with +0.4% p.a. In fact, US Treasury bonds (+1.7% p.a.) and especially stocks (+6.4% p.a.) yielded better returns.

PRICE DEVELOPMENT AFTER INFLATION IN USD SINCE 1970

### PRESERVATION OF VALUE?



Source: Bloomberg. Time series for oil: Federal Reserve Bank of St. Louis (FRED); time series for copper: Macrotrends.net. Index 1970=100, all figures adjusted in USD for inflation in the USA.

In our chart, we have narrowed the analysis down to four representative commodities and the period after 1970, especially since the gold standard for the US dollar ended in 1971. The results resemble those of the long-term study by Credit Suisse, although the real returns for oil and especially gold are considerably higher over the shorter period. At the same time, it is notable that gold is subject to strong fluctuations and, especially between 1980 and 2000, exhibits strongly negative real returns (at least in US dollars). It seems that gold shines brightest in times of greater uncertainty.

### Diversification and insurance

Gold as insurance in uncertain times – for years, this has been the main reason for us to hold the precious metal where alternative assets are desired or indicated. Diversification, physical storage, easy transport, and good tradability speak for the precious metal, which has proven itself as a medium of exchange and storage for centuries. Despite its obvious weaknesses such as greater price fluctuations or lack of productivity (gold does not yield dividends or interest), it has often excelled as a safe haven in crises. And in times of high government debt and rampant money creation by central banks, it makes sense to have an asset without counterparty risk in the portfolio.

Bitcoin also has no counterparty risk if stored in one's own wallet. While the most flamboyant cryptocurrency is not a traditional commodity, it is often hailed as the gold of the future. Since there are some parallels, this could be conceivable – but for now, Bitcoin is primarily a bet on artificial scarcity generated by a computer, and on the program not being hacked. The track record is too short, the price fluctuations too high, and Bitcoin has not been a safe haven, especially in the turbulent investment year of 2022. It may have a place as a speculative and experimental asset in large portfolios, but for now, it offers little more.

Other commodity investments can also have a place in large, diversified portfolios – but we parted ways with them some time ago. For us, the risks and price fluctuations are not compensated with adequate returns in the long run, especially considering the bumpy transition of energy supply and the pitfalls of geopolitics. Above all, we prefer to consider the companies we invest in as the real drivers of innovation, substitution, and renewal – regardless of how long the Age of Oil lasts and what ultimately replaces it.

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IA, 31.03.2024



## STOP AND GO

Amidst a dearth of relevant news – wars drag on without notable breakthroughs, potentates are re-elected in unsurprising landslides, the outcome of the US presidential election is a complete enigma – two monetary policy decisions burst onto the scene in a fashion that seems somehow exotic. First, the Bank of Japan (BoJ) announced in mid-March that it was ending its negative interest regime and returning to positive interest rates. Then, almost simultaneously, the Swiss National Bank (SNB) gave notice that it was cutting rates. Stop and go – within the space of one week.

In both cases, observers found themselves rubbing their eyes. Japan has been fending off deflation for years. Given the rapid aging of Japanese society, the domestic economy is suffering from weak demand. Low interest rates were intended to keep the yen weak so that foreign trade, at least, would not be threatened; higher import prices were accepted as inevitable or even welcomed as a tool against inflation. This is now supposed to be over. Well...

Central bank interest rates appear to have little or long-delayed effect around the zero bound. Then it hardly matters how high interest rates actually are.

In contrast, the SNB had until quite recently been issuing warnings about flare-ups of inflationary forces, allowing the public to expect a continuation of its rather restrictive monetary policy. April Fool! And that in mid-March. “All clear.” Although imported commodity prices and domestically generated rents suggest otherwise.

What could the actual reasons be? In the case of Japan, one could argue that with a disproportionate population of pensioners in the economy, a policy of ultra-low or even negative interest

rates does not support the objective of returning to a more stable consumption pattern. This is because the effect of interest rates on the expectations of the most important consumer group, that is the seniors, is more negative than positive. They implicitly recognise the link between interest rates and their own pensions. Ultra-low interest rates raise fears, and fears stifle whatever consumer demand remains. Perhaps the BoJ hopes that the increase in interest rates, however slight it was, will give a boost to motivation. We shall see.

As for the SNB, a cynical interpretation comes to mind: outgoing SNB President Thomas Jordan aims to secure a positive financial result for “his” National Bank in this way. After all, lower interest rates here than abroad would tend to weaken the Swiss franc, which is quite high at present. The SNB’s immensely high investments are denominated in foreign currencies. This will result in balance sheet gains, and the Confederation and cantons can look forward to generous dividends. Perhaps this could even plug the financial hole in the Defence Department and the 13<sup>th</sup> AHV pension. Jordan as the white knight coming to save the stressed federal budget?

A less malicious interpretation in both cases would involve a theoretically sound explanatory approach. The Leipzig economics professor Gunter Schnabl pointed out in various articles how “sticky”, meaning essentially ineffective or only effective with great delay, central bank interest rates around the zero bound appear to be. He refers to this phenomenon as “hysteresis” and deserves a Nobel Prize for this insight. With it, he has single-handedly invalidated the entire monetary policy of central banks over the last 10 to 15 years.

For us laymen, we could formulate it thus: around the zero bound it hardly matters how high interest rates are. Or in other words: thanks to hysteresis, we can avoid hysteria.

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KH, 31.03.2024

