CIO thinks investors should return to the oil market as larger inventory draws become more visible in the months ahead. (UBS)

Fundamentals still favor higher commodity prices

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Broad commodity indexes have come under pressure amid disappointing macroeconomic news, with the UBS Constant Maturity Commodity Index (CMCI) hitting the lowest level since September 2022. The pullback in prices, except for gold and soft commodities, has also come with a reduction in investor positioning.

However, we retain a positive view on the asset class and see attractive expected returns over the next 12 months, as bottom-up factors still favor higher prices in the second half of this year.

Market balances for crude oil are likely to tighten meaningfully. We expect oil production to fall back toward 100 million barrels per day (mbpd) in 2Q23 from around 101mbpd in the first quarter this year, due to voluntary production cuts by OPEC+ countries and declining output due to wildfires in Canada. At the same time, demand is likely to approach 102mbpd in June, fueled by the driving season in the US and more oil being used to generate power to cool down buildings in the Middle East. Against this undersupplied backdrop, we think investors should return to the oil market as larger inventory draws become more visible in the months ahead.

Supply constraints should support industrial metal prices. While we have revised down our demand estimates this year to reflect recent disappointments on the manufacturing side, we still see higher prices ahead, with copper, aluminum, and zinc all having a deficit this year. We believe the market is overlooking supply constraints, especially for copper and aluminum. Copper has been struggling with mine supply growth in recent years, while refined aluminum faces smelter capacity cuts in Europe and hydropower electricity challenges in China.

Near-term consolidation in gold should reverse on solid demand. Gold fell below USD 1,950/oz last week amid progress on the US debt ceiling deal and a repricing of US rate hike expectations. But gold's role as an effective long-term hedge makes the yellow metal valuable in a portfolio context, in our view. With solid central bank demand, renewed US dollar weakness, and rising US recession risks, we continue to believe that gold is on track to break its all-time high later this year and hit USD 2,250/oz by June 2024.

So, we still forecast over 20% total returns for broad commodities by June 2024, and advise investors to hold on to their long positions. We like longer-dated oil contracts and recommend selling volatility in Brent crude oil. We also advocate gold's portfolio diversification, liquidity, and wealth preservation benefits, and see opportunity in yield pickup strategies in copper.

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Content is a product of the Chief Investment Office (CIO).

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