The New Administration and the Coming Resurgence in Commodities

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Introduction

Commodities are hard assets. Raw material production occurs in specific areas of the world. Crude oil and natural gas are present in the crust of the earth, but the economics of extracting the energy commodities differs by region. Metals and minerals are only present in certain areas around the globe. Crops require fertile soil and some agricultural commodities depend on certain climates. Commodity output is a highly localized affair, but consumption is ubiquitous.

Forecasting commodity prices is like a jigsaw puzzle: there are so many pieces to consider. Supply and demand factors are at the forefront when it comes to the path of least resistance of price for individual raw materials, but herd behavior in markets can also move the price of a raw material asset. Commodity prices tend to be highly volatile; the asset class tends to have a higher variance than stocks, bonds and currencies. Meanwhile, exogenous events like weather and political developments around the world can influence commodity prices. As we move forward this year, it is likely to be the political change sweeping across the western world that will impact availability and demand for many commodities.

Surprises in 2016

On the political front, 2016 was a year of surprises, and a year that marks the hallmark of a change from the status quo. The Brexit vote in the United Kingdom will lead to a British divorce from the European Union in the months ahead. The Italian referendum in early December was another example of a rejection of globalism; and elections in France, Germany and the Netherlands in 2017 could further debilitate an already weakened E.U.

Meanwhile, perhaps the most significant change in the world order occurred with the election of Donald J. Trump as the forty-fifth President of the United States on November 8. The U.S. election was perhaps the most contentious affair in history. A victory in the Electoral College despite a loss in the popular vote has vaulted the businessman and media star to the highest office in the richest nation on earth. On January 20, President Trump pledged to make many changes that will impact not only the United States but the world at large.

A New Approach to Business

President Trump will be the first leader of the U.S. since Herbert Hoover who comes from a business background and the first since Ronald Reagan who has been a star in his former career. On the campaign trail Mr. Trump promised to make America great again by renegotiating trade agreements, putting the nation's citizens and businesses first to create and save jobs and spur economic growth. In the days following the election, the (then) President-elect cut a deal with an air-conditioning manufacturer preparing to export U.S. jobs to Mexico. The new leader of the United States won the election on a promise to be the dealmaker-in-chief.

Energy Independence

One of the hallmarks of the new administration will be to create a regulatory environment that promotes energy independence. The United States has massive reserves of oil and natural gas. The nation is among the top three oil producers in the world alongside Russia and Saudi Arabia. The election of the new leader could be one of the reasons that the international oil cartel, OPEC, agreed to cut production and abandon a strategy of flooding the market with crude to make North American shale output uneconomic.

The new administration will eliminate certain regulations that had increased compliance, drilling and exploration costs for shale oil. Fewer regulations will result in a reduction of the production cost for all energy commodities including oil, gas and coal. The lower cost of goods sold for energy together with fewer regulations will result in more energy output for the U.S., which will likely increase the number of jobs in the energy industry. When it comes to price, it will depend on whether OPEC sticks to their production cuts and the overall health of the global economy.

Reworking Dodd-Frank

On the campaign trail, the new President said that for every new regulation his administration would get rid of two existing regulations. When it comes to commodity and financial markets, the Dodd-Frank Act is likely to change dramatically. There are many issues facing Congress and the regulatory agencies when it comes to the legislation passed in 2010. One of the most important issues for the futures markets will be position limits. There have been discussions in Washington about limiting any market participant from taking a position that is greater than 25% of the open interest in a futures contract. The agencies have focused on available supply but supply is often a function of price. It is likely that position limits will revert to the Exchanges, which will only put limits on the spot and perhaps active month contracts.

If the intention of the administration is to achieve energy independence, commodity producers in the U.S. will need the opportunity to use the futures and swap markets to hedge future production when price opportunities present themselves. With the price of crude oil around the $50 per barrel level any rallies will likely see an increase in hedging activity from shale producers. Additionally, after watching natural gas fall to lows of $1.6110 in March of 2016, it is likely that gas producers will look to hedge with prices much higher in late 2016. The new President and his appointees will change the regulatory framework in Washington to allow regulators to work for and support businesses rather than the opposite, which has been the trend since the enactment of Dodd-Frank.

Infrastructure Building and National Security

One of the other major initiatives of the Republican President, with support from both Houses of Congress, will be the biggest infrastructure building project in the United States since the Eisenhower Administration in the 1950s. Roads, bridges, tunnels and airports across the nation have aged and are in need of updating. Additionally, the construction of a security wall along the southern border of the United States will be a major infrastructure undertaking. Commodities, including metals, minerals and energy, are the basic building blocks of infrastructure. Therefore, it is likely that the demand for industrial commodities will increase. At the same time, the U.S. central bank has warned that monetary policy alone will not spur economic growth. The Fed has stated, on many occasions, that fiscal stimulus goes hand in hand with the tools used by the central bank since the 2008 financial crisis. If the U.S. economy begins to grow at a faster pace, we may see other governments around the world follow the fiscal stimulus example. Just like Europe followed the U.S. by employing quantitative easing to stabilize the economy over recent years, they are likely to follow the U.S. on a path towards fiscal stimulus if they see positive results in America.

Finally, the new President has called for a return of businesses to the United States. Over past years, commodity merchant businesses have left the shores of the U.S. for jurisdictions with lower taxes and fewer regulations. As the new government also intends to lower taxes, some commodity merchant business may return to the U.S. and other new businesses are likely to open to support the infrastructure building and take advantage of a friendlier business environment.

Moreover, the flow of commodities around the world has always been a strategic imperative when it comes to national security. Agencies like the CIA include data about commodities when modeling economic conditions existing in other countries such as Russia and China. The departure of many commodity businesses from the U.S. over the years has decreased the transparency for these agencies and attracting commodity business back to the nation will only improve the availability of data.

The commodities business will undergo a renaissance in the United States, given the policy goals of the new administration. For producers of raw materials, an exciting period could be just around the corner. For consumers, understanding the fundamentals of commodities they require on a daily basis will become of paramount importance.

Endnote

The opinions expressed in the *GCARD* are those of the individual authors.

Author Biography

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Mr. Hecht spent nearly thirty-five years on Wall Street, including two decades at the trading desk of Philipp Brothers (which became Salomon Brothers and which later, in turn, became part of Citigroup before ultimately being spun off to Occidental

Petroleum.) Mr. Hecht has unique insights into the commodity markets that are a result of his rich and varied Wall Street experience: he's booked vessels, armored cars and trains to transport and store a wide range of commodities as well as having worked directly with the United Nations.