MORNING BRIEFING
March 9, 2022

Commodities Go Limit Up

Check out the accompanying chart collection.

Executive Summary: Is China's President Xi able to stop Putin's War? With high stakes for both China's economy and its reputation on the world stage, he has every reason to try. The Dragon must restrain the Bear. … The CRB raw industrials spot price index typically peaks and troughs in lockstep with business cycles. This time is different: The CRB's vertical ascent reflects not booming global demand as usual but looming supply crunches. … And: Blocking Russian exports from global markets will mean painful supply constraints for the rest of the world, not only of oil and gas but also of metals and agricultural products.

Geopolitics: Will the Dragon Restrain the Bear? The March 8 *New York Post* reported, "The United Nations has advised its communications staffers against using the terms 'war' or 'invasion' to describe Russia's attack on Ukraine, according to a report out Tuesday." Moscow describes its actions in Ukraine as a "special operation" to disarm its neighbor and unseat leaders it calls "neo-Nazis." Ukraine and its Western allies call this a baseless pretext for an invasion to conquer a country of 44 million people.

It's certainly Putin's War, which started as an invasion of the Ukraine by Russia. Almost everyone on the planet except for Putin believes it should end immediately to stop all the deaths and destruction in Ukraine. There is also a widespread consensus that only China's President Xi Jinping has the power to stop Putin.

Last month, just before the Winter Olympics started in China, Putin and Xi met in Beijing. Their joint statement declared a new world order, with Moscow and Beijing working together to undermine American power. The new BFFs vowed that their countries' friendship had "no limits." The Chinese leader also declared that there would be "no wavering" in their partnership, and he added his weight to Putin's accusations of western betrayal in Europe.

Seems like Xi is starting to waver. On Tuesday, China's president called for "maximum restraint" in Ukraine and said China is "pained to see the flames of war reignited in Europe," state media reported, in his strongest statement to date on the conflict.

The war is bad for China's business. The sanctions imposed by the West are sending Russia's economy into a depression. Supply-chain disruptions and soaring oil and gas prices are likely to push Europe into a recession. In other words, the war is depressing global economic activity, which is bad for China's exporters. Soaring commodity prices are bound to raise China's inflation rate.

Agreeing to a partnership with Russia on the eve of Russia's invasion was a major foreign policy blunder for Xi. He put China on the wrong side of history, as evidenced by the historic UN General Assembly vote denouncing Russia on March 2. The resolution was supported by 141 of the assembly's 193 members.

The Ukraine crisis has led NATO nations to work together more closely and to increase their defense spending. China now fears that a similar defensive alliance led by the US will coalesce in its neighborhood. China has partnered with the world's most hated pariah nation and risks becoming a pariah itself if it invades Taiwan. But if China can broker a peace agreement between Russia and Ukraine, it will be among the biggest winners of this conflict. To do so, the Dragon must restrain the Bear.

Commodities I: Wartime Markets. In the past, the CRB raw industrials spot price index has tended to peak at about the same time as the peak of business cycles and to trough near the end of recessions. This time has been different in some ways, both as a result of the pandemic and now Russia's invasion of Ukraine. The index peaked during 2018; Trump's trade wars depressed global economic activity during 2018 and 2019. The two-month lockdown recession began in early 2020; the index bottomed on April 21, 2020, correctly anticipating a short recession and a V-shaped recovery. As of Monday, March 7, the index was up 63% from its bottom. It has been in record-high territory since mid-October 2021.

The index is one of our favorite high-frequency indicators of global economic activity. Debbie and I like it because it excludes energy, wood, and agricultural commodities. By excluding them, the index tends to be more sensitive to the booms and busts of the business cycle, especially in the US (*Fig. 1*). The index is available daily and includes the spot prices of the following commodities: copper scrap, lead scrap, steel scrap, tin, zinc, burlap, cotton, print cloth, wool tops, hides, rosin, rubber, and tallow.

Most of the rebound in the index since the end of the last recession was attributable to the V-shaped recovery in the economy resulting from extremely stimulative fiscal and monetary policies around the world, especially in the US (*Fig. 2*). However, the Russian invasion of Ukraine, which started on February 24, has sent commodity prices flying across the board, including industrial, metal, energy, and agricultural commodities. That's because of mounting concerns that the war will disrupt the supplies of all these commodities.

The CRB all commodities price index has been rising in a vertical fashion since the start of Putin's War (*Fig. 3*). The metals component of the CRB raw industrial spot price index has been doing the same (*Fig. 4*). And the same can be said about the S&P GSCI all commodities index, which gives a heavy weight to energy commodities (*Fig. 5* and *Fig. 6*).

This time is different because of the war. The boom in commodity prices doesn't reflect booming global demand but rather looming reductions in available supplies of many key commodities. The risk is that soaring commodity prices, especially for energy and food, will not only cause higher inflation but also depress growth. A recession seems increasingly likely in Europe, where consumers and businesses are facing even higher prices because they've become more dependent on Russian oil and gas.

Commodities II: Putin's War Hits the Pits. The threat that Russia's oil might be cut off from the global oil supply is driving up crude and petroleum product prices. Other commodity prices are going up as a result of the war too. Russia is the world's largest exporter of natural gas and nickel, the world's second-largest exporter of oil and steel, and the third-largest exporter of coal and aluminum, according to geopolitical strategist Peter Zeihan. He recently *tweeted* that he doesn't see much discussion of "what happens when you sanction the world's largest exporter of wheat." That's a great question. But one thing is certain: More supply-chain disruptions are coming, and commodity prices will continue to rise or remain elevated for many critically important commodities, including food.

Let's mine recent developments in specific global commodity markets for insights:

(1) *Oil.* Could the price of oil soar to $200 per barrel? Bank of America analysts think so, *according* to oilprice.com. If so, that would be a major shock for consumers and businesses relying on oil.

The price of Brent crude oil futures rose from its 2020 low of $19.33 per barrel to $77.78 at year-end 2021 as the economy rebounded from Covid-19's impact. The outbreak of war in Ukraine and the related sanctions on Russia sent the price of oil higher still, to $123.21 as of Monday (*Fig. 7*). On Saturday, Ukraine President Volodymyr Zelensky called for western governments to ban the import of Russian oil. Oil futures prices briefly rose above $130 on Sunday, on the news that the US and European partners were in talks to do just that. The US did so on Tuesday as the EU promised to significantly reduce its dependence on Russian oil by the end of the year. The price of crude again *flirted* with $130 a barrel, but settled a bit lower by the end of Tuesday's trading session.

Russia accounted for about 8% of 2021 US oil imports, including crude oil and petroleum products. The US recently has been importing around 700,000 barrels per day of Russian crude oil and petroleum products, according to Energy Information Administration (EIA) *data*. Europe is a much bigger importer of Russian oil, however. According to Eurostat data, the region imports about 4 million barrels per day (mbd) of Russian crude and refined products. Russia typically supplies around 40% of Europe's gas imports, *according* to the *WSJ*.

On CNN's State of the Union on Sunday, European Commission President Ursula von der Leyen noted the difficulty in reducing Europe's dependence on Russian crude over the short term. On Tuesday, the EU announced its plan, called "REPowerEU," that could result in the EU's gas demand falling by volumes equivalent to two-thirds of Russia's 2021 gas imports, according to a March 8 *document* published by the EU. The plan focuses on diversifying the EU's gas supply sources from non-Russian sources and boosting the use of renewables.

Spurred by prodding from Congress and higher profits, US producers likely could pump up production in short order. They are currently pumping about 1.0 mbd of crude oil less than in 2019 (*Fig. 8*). The EIA *said* in its last Short-Term Energy Outlook that US crude oil production could hit a record high of 12.6 mbd on average next year. That was before Putin's War, but the point is that there is capacity.

The International Energy Agency announced the release of 60 million barrels from strategic reserves (half from the US and half from Europe and Asia) to send a "strong message to global oil markets that there will be no shortfall" because of Russia's invasion of Ukraine. But that release wasn't enough to cool markets, as CNN *discussed*, because the reserves are finite and will eventually need to be replenished.

The US is also looking to other major oil producers, including Saudi Arabia and Venezuela, to produce more to help make up for the potential shortfall in Russian oil imports, *according* to oilprice.com. Another option comes from Canada: Alberta's Premier Jason Kenney *tweeted* on Sunday that Canada's oil-producing province could export nearly 1.0 mbd "from the USA's closest friend and ally! All it would take is his approval for Keystone XL. Easy." That won't happen, the White House responded, as other means are available to replenish supply, *reported* the *NYP.*

How much will the severely reduced demand for Russian oil from the US and Europe hurt

Russia? Quite a lot, financially speaking. Russia's most important oil importer is China, which takes in nearly 35% of Russia's exports, as this 2020 statista *chart* shows. But counting all the imports from EU countries and the US, a stop on Russian oil deliveries could remove from Russia's economy over 40% of the trade value it gets from oil exports.

It's unclear whether Beijing could buy up whatever crude Russia can't sell elsewhere, Zeihan said in a note yesterday. But the pipelines that "carry oil to Russia's Pacific loading terminal, and directly into China itself, source their crude from eastern fields. Russia's western exports are sourced from western fields. There's precious little in the way of connecting infrastructure between the two—meaning if Russia can't load tankers in the Baltic and Black seas, there's little reason to pump it at all," he explained.

(2) *Metals.* Prices are also soaring in the metals markets. On Tuesday, the London Metal Exchange suspended the trading of nickel after prices more than doubled, surpassing $100,000 per metric ton. The exchange said it was evident that the Russian and Ukrainian situation had affected the nickel market, *reported* CNBC.

The CRB metals spot price index reached a new record high on March 7, with copper prices near their recent highs and palladium prices (not in the CRB metals index) 35% higher ytd (*Fig. 9* and *Fig. 10*). Russia is a key exporter of palladium, *accounting* for around 40% of the global supply during 2021. Palladium is used primarily in the automobile industry for catalytic converters; it also helps to control the flow of electric current to various parts of a circuit by storing and releasing charge as required.

Rising prices of nickel, lithium, and other materials also threaten to slow the long-term trend of falling costs of batteries, the most expensive part of electric vehicles (EVs), *reported* Reuters. That could set back EV manufacturers' dreams of producing much cheaper EVs. The average price of lithium-ion battery cells could rise y/y for the first time ever, said an expert quoted in the story.

Nornickel, Russia's largest miner, produces around 20% of the world's supplies of high-purity class 1 nickel, which is used in EV batteries, according to Benchmark Mineral Intelligence. Russia is also a large provider of aluminum, used in batteries not just for cars but also aircraft, household appliances, and packaging.

(By the way, Zeihan *thinks* EVs are not just set back but dead in a deglobalized world. He says that "EVs need aluminum and chromium and rare earths and lithium and lead and silver and gold. You are replacing one problematic supply chain with 13 more and you still need Russia to make it work.")

(3) *Agriculture.* The war has exacerbated the upward pressure that food prices already were under from supply-chain challenges and drought conditions in the US and Latin America. Food prices are higher the world over than even during the pandemic. The price of wheat futures is at a record high, having risen 65% ytd, and corn and soybean futures are also close to recent highs (*Fig. 11*, *Fig. 12*, and *Fig. 13*).

Amid this food markets turmoil, the world's largest exporter of wheat has invaded the fifth-largest exporter, Zeihan has pointed out. "Ukraine will not plant crops this spring or summer. The world has lost one of its largest and most reliable sources of wheat, sunflower, safflower and barley," he wrote in a recent note.

"The war in Ukraine will deliver a shock to the global supply and cost of food, the boss of one of the world's biggest fertilizer companies [Yara International] has said," *according* to BBC News. Russia produces key fertilizer ingredients, like potash and phosphate. Yara International, which operates in more than 60 countries, buys considerable amounts of essential raw materials from Russia. And natural gas—which Yara's European plants rely on from Russia—is needed to produce ammonia, the key ingredient in nitrogen fertilizer. Moreover, about a quarter of the key nutrients used in European food production come from Russia, pointed out the head of Yara's business.

Calendars

US: Wed: Job Openings 19.925m; MBA Mortgage Applications; WASDE Report; Crude Oil Inventories. **Thurs:** Headline & Core CPI 0.8%m/m/7.9%y/y & 0.5%m/m/5.9%y/y; Initial & Continuous Jobless Claims 216k/1.475m; Federal Budget Balance; Natural Gas Storage. (Bloomberg estimates)

Global: Wed: Italy Industrial Production 3.2% y/y; Japan Machine Tool Orders; Debelle. **Thurs:** EBC Interest Rate Decision; EU Leaders Summit; Japan Household Spending -3.0%m/m/3.6%y/y. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index has tumbled 17.7% ytd through Monday's close, well behind the 5.4% decline for the S&P 500 Value index. Growth is now in a deep correction, with an 18.8% decline from its December 27 record high. Value is down just 6.7% from its January 12 record. Growth's price index relative to Value's peaked at a record high on November 30. Since then, Value's price index has risen 1.1% while Growth's has tumbled 15.7%. Since the Pure Growth price index peaked relative to Pure Value on November 18, Pure Growth has plummeted 24.5% since then into a bear market while Pure Value has risen 2.0%. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) than Value over the next 12 months, but Value is expected to have higher earnings growth (STEG). Growth has forecasted STRG of 10.0%, but its STEG is lower at 7.3%. Value has forecasted STRG and STEG of 6.9% and 9.9%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021, and has since tumbled 26% to a 22-month low of 22.4. Value's forward P/E is down just 10% since then to 15.9 from 17.6. Regarding NERI, Growth's edged down to 9.4% in February from 10.1% in January, but was positive for a 19th straight month. Value's NERI was also positive for a 19th month in February, but dropped to 4.0% from 7.0%. Growth's forward profit margin of 19.1% is at a record high and is 2.4ppts above its prior pre-Covid record high of 16.7% during September 2018, while Value's 11.0% has dropped 0.4ppt from its record high of 11.4% in December.

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Inflation continues to be a problem on Main Street, leading more owners to raise selling prices again in February," said NFIB Chief Economist Bill Dunkelberg. "Supply chain disruptions and labor shortages also remain problems, leading to lower earnings and sales for many." February's Small Business Optimism Index (SBOI) fell for the second month, to a 13-month low of 95.7 (the second consecutive month below the 48-year average of 98.0), after climbing slightly the prior two months from 98.2 during October to 98.9 by the end of the year. Once again, only one of the 10 components of the SBOI improved last month, while six declined, and three—earnings trends (-17%), expected credit conditions (-4), and current inventory (7)—were unchanged. Current job openings (to 48% from 47%) was the lone positive contributor to February's SBOI—down from its record high of 51% posted in September. The biggest negative contributor by far was hirings (19 from 26)—sliding 7ppts—while the remaining components were down from 1ppt to 3ppts: sales expectations (-6 from -3), expect the economy to improve (-35 from -33), plans to make capital outlays (27 from 29), now is a good time to expand (8 from 9), and plans to increase inventories (2 from 3). Meanwhile, inflation (26) surpassed quality of labor (22) as small-business owners' biggest problem. The former is up a whopping 24ppts from last February's 2%, while the latter is down from November's record high of 29%. The report highlights that the net percent of owners raising average selling prices increased 7ppts to a 68% in February—a 48-year record-high reading.

Merchandise Trade (*link*): The real merchandise trade deficit widened to yet another new record high in January, as real exports tumbled from December's record high, suggesting trade will be a big drag on Q1 GDP. The monthly deficit climbed to a record $118.1 billion from $111.7 billion in December—widening for the third month from October's $96.6 billion. January's $118.1 billion deficit is considerably above the average monthly deficit of $106.1 billion recorded during Q4. Real exports sank 3.9% at the start of this year after climbing 9.9% during the three months through December. January's decline was widespread, with only real capital goods exports excluding autos (+1.7%) posting a gain. Real consumer goods nonfood exports ex autos (-14.2) posted the largest monthly decline, followed by auto vehicles, parts & engines (-5.3), industrial supplies & materials (-4.0), and foods, feeds & beverages (-3.4); real exports of other goods dropped 5.9%. Meanwhile, real imports barely budged, ticking up 0.1% to a new record high, after jumping 6.4% the last two months of 2021. Real imports in January were a mixed bag, with real imports of auto vehicles, parts, and engines (+5.0), foods, feeds & beverages (+4.6), capital goods ex autos (+0.8), and consumer nonfood goods ex autos (+0.4) all in the plus column, while real imports of other goods plummeted 15.0% and those of industrial supplies & materials lost 1.7%.

Global Economic Indicators

Germany Industrial Production (*link*): Germany's industrial output advanced more than expected in January, suggesting the manufacturing sector may be gaining momentum. German headline production, which includes construction, jumped 2.7% in January—more than five times the expected gain, and more than double December's 1.1% increase—as construction output rebounded 10.1% after a two-month decline of 4.3%. Excluding construction, industrial production climbed 1.3%, following a 2.1% gain in December. Production including construction is 3.0% below its pre-pandemic level, while the measure excluding construction is 4.1% below. All four of the main industrial groupings are showing signs of a pickup in growth, led by capital goods. Capital goods production expanded for the third time in four months, by 1.2% in January and 13.4% over the period, while production of consumer nondurable goods soared 5.2% at the start of the year to within a fraction of its pre-Covid level. Intermediate goods output moved higher for the fourth successive month, climbing 2.7% over the period, while consumer durable goods output is on a volatile uptrend, slipping 1.6% in January but up 3.1% during the four months through January.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.