Research @ Citi Podcast, Episode 10: What's Next for Oil, Gold and Copper?

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Guest: Max Layton, Head of Commodities Research, Citi

Transcript:

Lucy Baldwin (00:02)

Welcome to the Research @ Citi Podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe. Now, let me hand you over to our host today.

Elise Badoy (00:22)

Welcome to Episode 10 of our Research @ Citi podcast series. I'm Elise Badoy, and I head up Equity Research for Europe, UK, the Middle East and Africa. It's my real pleasure today to be joined by Max Layton, who heads up commodity research globally at Citi. The topic for today is very exciting: it's the Commodity Big Three, or Commodity Trinity — oil, gold, and copper. Essentially, it's really great timing. The Commodities Team at Citi has some very high conviction calls, so I can't wait to hear from Max on these. Obviously, if I'm not mistaken, Max, you're very bearish on oil, bullish on gold and silver, and you see copper doing well in the next global upcycle?

May Layton (01:01)

Yes, I do. I do very much. Thanks, Elise. Thanks for having me on. We think it's a pretty exciting time for commodities now. I get to look across 25 or so commodity markets and pick out the standout opportunities for you, our listeners, and the opportunities over the next 6–12 months are pretty exciting. We see around 20% downside in the oil price, potentially more, over the next 6–12 months and we see at least 20% upside in gold and silver in our base case over that period. So, we particularly like— across the entire complex, we particularly like oil lower relative to precious higher, not just the individual outright calls.

Elise Badoy (01:42)

And so Max, obviously, before we get into your calls and your conviction calls on the Big Three, I think it's very interesting for our listeners to learn a little bit more about your team, how you approach commodities research and price forecasting, and the methodology that you're using to basically approach that.

May Layton (01:59)

We've got a great team of research analysts here, a little over ten people across the world, across all the main regions globally. We are looking across as I mentioned 25 different commodity markets. What I've tried to encourage the team to do is combine a macro approach — demand, really focusing on demand expectations on marginal costs — with a micro approach, which is the real S&D [supply and demand], detailed investigative reporting side of the equation. And we think this is going to help maximize the likelihood of us getting the price forecast correct. We've got a real focus on catching the big moves — commodity markets, if you look at any individual commodity market, particularly in the industrial metals and oil and energy complex, you tend to have really big moves roughly every three years or so, whether it's a big bull market or a big bear market. You want to focus on catching a good chunk of each of those moves. And obviously, as well, the cherry on top will be calling turning points where we can. We place a lot of weight on developing commodity price frameworks that stand the test of time, and we really look to just start with the framework and then build and develop them over time. I'm trying to encourage the team and remind myself to be quiet when conviction is low. We don't want to be loud all the time. We really try to signal to our listeners and our clients. You know we really will focus on signaling when we see the base case and the risk skew as being heavily one way or relatively high probability of occurring. And that's when you'll see us publishing a lot, you know, some catchy headlines, things like that. Right now, as I mentioned before, the big calls we have are oil lower, gold and silver higher across the entire complex.

Elise Badoy (03:50)

That's great. That's obviously a great intro into the outlook for oil. Now we want to hear about that. Obviously oil is super important. It's a $3 trillion physical commodity market. Often, we tend to say that oil is the mechanism of transmission sometimes for geopolitical crisis into the economy. It does drive global volatility in inflation. It impacts the relative economic performance of nations, and it drives changes in the dollar, bond market, equity market, all alike. Obviously, the team sees prices falling sharply over the next 6–12 months. What are the key drivers of that view, Max?

Max Layton (04:24)

Overall oil is really quite highly leveraged to a slowing in global growth. We think that's because of its specific supply/demand balance and capacity issues. It's really overall because oil in the next twelve to eight— 6 to 12–18 month period, it's broad based across various different countries, low-cost supply growth. It's got high levels of OPEC+ spare capacity. One big problem that the oil market has is it's negatively exposed to China's accelerating energy transition. What do I mean by China's accelerating energy transition? I'm referring to — and why it's accelerating — I'm referring to in particular for oil, electric vehicles and how penetration rates are booming in China. They've increased from 30%–35% of the market, electric vehicle sales in China, to over 50% over the past 12 months. They're running about 53% at the moment. China's created new hybrids and extended-range electric vehicles, got new battery tech that overcomes range, charging, weather, price-related anxiety — all the anxieties we talk about outside of China in North America and Europe, China's solving these issues, or solved them, or the next generation of cars will solve them. The market in EVs was almost getting saturated in China in the small car market where the batteries were big enough to work really well, and they're having issues with range and all these anxieties we talk about outside of China with the bigger cars, SUVs and trucks. And they've essentially been solving those issues, and they're going to continue to improve the problems that people have had there. And that's what's driving this big increase in penetration rate. That's not driving oil demand negative, in our view, in China, but it is significantly dampening growth and slowing down growth in oil demand in China. I wouldn't say everything that could possibly be going wrong in oil structurally and cyclically is going wrong. Maybe that's a bit extreme because there's clearly conflicts in the Middle East, conflicts, Russia–Ukraine, which can affect oil supply if they escalate, and there's issues in shipping, and U.S. supply growth's been slowing down a bit, and Libya's having issues with production. So there are some things on the bullish side that are happening, but overall the outlook looks really tough over the next 6–12 months.

Elise Badoy (06:58)

So understandably, I guess OPEC+ wants to bring back some of this spare capacity, absent any perhaps geopolitical tension as we've discussed it, starting as early as December 2024, and the plan is to increase production by 2.2 basically by December 2025. So how do you think that could pan out?

Max Layton (07:19)

Elise, I think the simple answer is it won't pan out very well. I mean, we just— our modeling suggests that this market just can't handle one extra barrel from OPEC+ for at least the next 12 months. For that to happen, we're talking about the market— if OPEC brings back those 2 million barrels, that would be going on top of what we see as an underlying surplus over the period of over a million. In other words, you're talking about a 3 million barrel surplus in that world and $50 oil or even potentially lower. So the market just cannot handle that increase. So our base case is that OPEC+, they will continue to push out their restarting, their desire to restart spare capacity all the way through the middle of next year, essentially in the hope that there is some significant supply disruptions or a pick-up in global demand growth, but that ultimately even in that scenario, we're modeling that million barrel surplus. Another way to put it is, in our view, in the base case, it has to cut another million barrels plus to keep prices at current levels. So the bull case is flat prices for us, broadly flat prices. The base case significantly lower and the bear case is $50 or so.

Elise Badoy (08:38)

Those are— this is sort of what the industry is doing, but obviously the big elephant in the room is the U.S. election, the upcoming U.S. election. Can we talk about this now? And how does that impact your oil view specifically?

Max Layton (08:53)

Yeah. Thanks. That's a great question. I think if Kamala wins, our conviction in the bearishness is unchanged. And this base case, bear case, bull case scenarios that I present is likely largely unchanged. If Trump wins, it really depends on what he does. So if Trump wins, we would still be bearish and we would still see $60 in the base case. But the risks around the bullish and bear case change. Conviction is probably slightly lower. And I'll just quickly explain why. Either way, there's large spare capacity which can offset an Iranian supply disruption under Trump, leaving the market surplus unchanged. But the thing is, Trump presidency may be really harsh on Iran and may not do tariffs on China. And in that world, you lose all the supply and OPEC wouldn't have to cut to balance the market, potentially. There's another scenario where Trump does the tariff Section 301, for example, in February next year on China, and it significantly increases the tariffs, it hurts global growth, hurts oil demand, hurts Chinese demand, and he does a deal in the Middle East, which involves a de-escalation, and it's possible that either that happens or the strict measures on Iran don't work very well and it doesn't impact oil production significantly. In that world, a Trump presidency would be even more bearish than our base-case scenario. Kind of really depends how tough you think Trump will be on Iran, how effective that will be, how tough you think Trump will be in terms of trade war with China. So becomes a little bit more tricky, but overall the equilibrium under both parties would be roughly $60 for next year.

Elise Badoy (10:47)

So listen, that’s a pretty bearish setup, but obviously our listeners may want to go into something a little bit more positive. So, per that usually with a bearish oil outlook, obviously, given where the growth is globally, et cetera, as an equity analyst, I'm perhaps not so surprised that you should be bullish on gold and silver, but I want to hear all about that. So what's underpinning your views there?

May Layton (11:11)

Big underlying driver of our bullish view on gold and silver, or the delta, where do we think the upside is going to come from from gold and silver over the next 6–12 months? It's really coming from the materialization of the Fed cutting cycle. When it actually happens, real rates go down, not just financial real rates, but real rates in the real economy go down, and we think over that period, also, things, people's concerns about other asset classes will increase, and therefore they'll want to hold more gold. So we do see gold and silver ETF demand increasing quite substantially over the next 6–12 months in line with other Fed cutting cycles — in particular, the one in second half 2007 is an interesting comparison. Gold and Silver did very well when the Fed cut from 5 to 2 percent during the second half of 2007, early 2008, and we're looking for the same kind of thing over the next 6–12 months. I mean, there's also the scenario if the falling oil price call is correct, we could see the Fed cuts being larger than currently priced and than even our pretty dovish house view on the Fed is going into early next year. Our gold and silver bullish view is much, much more than just the Fed.

Elise Badoy (12:26)

That’s very, very clear. Can we switch to the technical ways that you look into commodities? You have released — and I want our listeners to really know about this — a fairly unique and innovative new framework for gold. It seeks to explain how gold pricing has worked over the past 55 years. Can you tell us about that, Max? Because I think that's very interesting and also perhaps what motivated you to develop this framework?

Max Layton (12:52)

In my career, I've overseen and been involved with a number of different models that have tried to explain historical gold prices. Unfortunately, these models — whether they're real rates models or currency models, which they invariably have tended to be — they break down. Most recently, the last two to two-and-a-half years, we've seen a major breakdown in the gold versus real rates relationship. So a lot of clients are asking about that. The motivation was, can we explain the last couple of years, what happened? The breakdown and essentially real rates went up a lot and gold went up a lot, which was a big breakdown in relationship. Can we explain that? And then can we not just explain the last couple of years, but come up with something that explains the last 50 years? And we believe that this framework that we put out a couple of months ago now does exactly that. The core of the framework is that gold is driven by investment demand fluctuations. The reason why the relationship— well, one of the reasons why the relationship between real rates and gold didn't really work the last few years is that real rates isn't the only driver of investment demand for gold. Obviously, there's multiple reasons why countries or individuals or institutions will buy gold, and it’s not just about the U.S. real rate. That's what's happened in the last few years, investment demand has been driven by other factors unrelated to U.S. real rates that have dominated the U.S. real rates investment. Over the past two years since Russia–Ukraine, private investment in gold’s come from China, had government investment from all over the world. And obviously neither of these anything really to do with U.S. rates. I mean, this explains some of the breakdown over the last few years.

Elise Badoy (14:43)

Do you want to take a minute just to tell us how it works? I mean looking at some of the specifics?

Max Layton (14:50)

Yeah, exactly. So the idea about the framework is that it recognizes that over time physical investment's the core driver of gold pricing. What I mean by that is that more specifically, we look at physical investment as a share of mine supply, and we do it both on an annual basis and a quarterly basis, and it works really well using either. As physical investment as a share of mine supply rises, the idea is that the market needs to price out jewelry demand and encourage jewelry scrap. And if that's not enough, the market needs to encourage existing gold stockholders to sell their gold. Really this dynamic is what's been happening very recently. So over the last couple of years, you've had central banks, Chinese retail, basically buying lots of physical gold, driving up the investment share of mine supply to nearly 100%, to the 90%–100% of mine supply. I mean, that's up from about 70%. And so you've got to price out the jewelry, so you can't use that mine supply to make jewelry if you're using it for investment. The jewelry tends to be quite responsive. Essentially, if the gold price goes up 10%, usually you buy 10% less jewelry volume and still spend the same amount on the gift or present or item for yourself. Yeah, this is really what's been happening now, but it's also what happened during the 2000s. The nice thing about this framework is you can go through every bull and bear market and see which parts of investment demand are driving the bull market or bear market, and you can understand all the different various things that can lead to big gold sell-offs or big gold rallies.

Elise Badoy (16:37)

And no doubt that's led to some amazing conversations with investors as you look for those key turning points. Now on to the last commodity within our trilogy: So copper. Copper always strikes me— I tend to get a lot of questions from investors on copper, it's usually seen as a real symptom of growth or not growth. But really, the one part that I find striking is the energy transition, which has come up as a bearish factor for oil previously, but also a bullish factor for silver. Now, wasn't the energy transition supposed to be super bullish for copper because what really happened to that?

Max Layton (17:13)

Yeah. So we certainly had a really strong copper bull market earlier this year, but that's almost completely unwound in the last few months. I think I guess when you look back on it, the energy transition alone just isn't enough to drive a sustained copper bull market. You really need an upswing or solid global growth alongside that energy transition demand. Over 80% of copper demand, around 80% of copper demand is still coming from non-decarbonization or non–energy transition sectors — cyclical sectors, you might call them. Those are in the doldrums. Those are really struggling this year. There was some hope and when the PMIs picked up in March–April that we were starting to see a restocking cycle, for example, in the U.S. manufacturing sector, and that helped alongside AI and the broader positioning that was happening across the equity market rally in risk assets, that all will help to contribute to that copper bull market, but it's unwound for the most part. You just look at it, I think you look at the energy transition demand in copper, and what it's done is it's enabled copper to have higher highs and higher lows in pricing over the last couple of years, over the last 2–3 years. It hasn't meant that we can get away from copper being a cyclical asset. It's going to have cycles around those higher highs and higher lows. And look, just on that note, while we're talking about the energy transition, I really wanted to touch on China's bifurcated economy and how this fits into our oil, our gold and silver, and our copper views. We really think China's bifurcated economic performance will continue for some time. And what do I mean by bifurcated? On the one hand, China, it's got this— it's allowing a lot of investment into the energy transition. So it's got an energy transition led FAI growth economy model these days, like the old infrastructure on China. On the other side of the bifurcated economy, you've got a super weak household sector, low confidence, weak housing market. And so the energy transition is bearish oil, bullish copper demand, super bullish silver demand through the use of silver panels, electric vehicles, and electronics. And on the weak part, the household part — the falling house prices, low confidence, that part — Chinese households are buying a lot of gold and just recently in the last few months, for the first time that we can see in the data history for the last five, six years, is it looks like China retail is importing silver bullion and starting to buy silver presumably as a store of value. All of these dynamics, we think, are going to remain in play for some time. And if anything, if a trade war happens again, China is likely to double down on its energy transition, reducing oil demand growth further. Households are likely to be even more concerned about growth, buying more gold and more silver. These dynamics of the bifurcated Chinese economy, energy transition, trade war, they kind of— they can build upon themselves and they really help solidify our confidence in our views. In any case, back to copper, final word is we don't think we're going to get a big rally in copper again, maybe until people start to think that the Fed's cut enough to lead to an upswing in global growth. So sometime through the first half of next year, we think we'll have another copper bull market. It's not imminent.

Elise Badoy (20:43)

Perhaps summarizing what we've been discussing, Max, is there any commodity that you'd like to talk about that we have omitted that you think investors ask you a lot of questions that our listeners would want to hear about?

Max Layton (20:58)

I'd say lately we're getting a lot of interest in a commodity that's fallen 80%–90%. There's a lot of talk about lithium. This market's under huge pressure. Prices are trading around the 50th to 60th percentile of the cost curve. Mines are starting to shut, refineries are starting to shut, and we don't think we're there yet. But at some point over the next 6–9 months, we do think lithium will put in a bottom and off the lows, let's call it around in the $8,000–$10,000 range, we think we can get back up to $15,000, which is some pretty impressive percentage upside, say by the end of 2025.

Elise Badoy (21:32)

Well, Max, thanks very much for joining us. And obviously, if you have any questions and— you're listening to this podcast and have any questions, feel free to check the Citi website or get in touch with your contacts. This was a real pleasure to have you and this concludes Episode 10 of Research @ Citi podcast series.

Lucy Baldwin (21:51)

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[Disclaimer] (22:16)