

Supply shortage, soaring demand drive up commodity prices, Shankar Sharma explains backwardation in lumber and tin

Unless you have been living under a rock, it's been pretty evident that commodity prices are surging across the globe. Oil, steel, copper, lumber, corn—anything and everything in the commodity land is up massively.

But, what is increasing the allure of commodities? The “roll yield” or “backwardation”. It refers to a situation where the current price of an underlying commodity is higher than prices trading in the futures market (example: 1M Futures > 1Y Futures Price).

The premium for commodities that can be delivered now versus later into the future is the highest it has been since at least 2007, signalling just how strong is the demand for raw materials and how tight supplies are.

The World Needs More Commodities

Shortage of commodities has pushed backwardation to nearly 15-year high

Commodity backwardation rate



Source: Bloomberg, CME, ICE, LME

Note: Chart uses current BCOM constituents and weightings. Calculation uses current spot futures price versus the forward 1 year futures price. Some futures prices were estimated in this calculation.

The above chart plots the percentage difference between the spot futures price and the one-year forward futures price for the constituents of the Bloomberg Commodities Index (BCOM).

Over 12 months, this process—also known as positive carry—currently returns 7-8 percent in oil, 22 percent in corn, 16 percent in soybean and 1 percent in copper, thus offering a healthy return even before any further price increases.

This backwardation has only exacerbated over the last month and year-to-date (see table below). With yields from many of the more conventional asset classes depressed, this is something to be noted.

Commodity Indices Performance		
Commodity Indices Performance	April	YTD
Bloomberg Commodities Index (BCOM)	8.3%	15.8%
BCOM Energy	7.1%	25.6%
BCOM Precious Metal	3.6%	-6.0%
BCOM Industrial Metals	8.8%	17.0%
BCOM Agriculture	14.0%	21.8%
BCOM Livestock	-1.5%	8.8%

1 Year Spread % of First Contract				
Commodity	April	1M Chg	YTD Chg	%ile 20M
Soybean Oil	26.1%	11.4%	15.2%	100%
Corn	22.8%	9.8%	13.8%	100%
Natural Gas	13.1%	6.7%	28.8%	100%
Sugar	9.4%	6.5%	1.5%	89%
Wheat	2.0%	4.0%	2.3%	94%
HRW Wheat	-2.3%	3.8%	0.7%	94%
Soybean	16.4%	2.1%	0.8%	94%
Aluminum	-0.4%	1.6%	1.3%	100%
Crude Oil	7.9%	0.9%	5.5%	89%
Nickel	-0.4%	0.4%	0.9%	94%
Zinc	-1.0%	0.2%	0.7%	78%
Silver	-0.6%	0.2%	0.7%	100%
Brent Crude	6.9%	0.0%	4.2%	89%
Copper (LME)	1.0%	0.0%	0.8%	89%
Gold	-0.6%	0.0%	0.4%	94%
Platinum	-0.9%	0.0%	0.1%	83%
Lean Hogs	20.4%	-0.4%	18.7%	94%
Palladium	0.2%	-0.5%	-0.2%	33%

Note: percentile 20M refers to the current 1Y spread as a percentile of the 1Y spreads seen in the last 20 months. 1M and YTD Chg refer to Change in 1Y spreads during the mentioned period. A positive number indicates backwardation while a negative number indicates contango. Data as of 30th April 2021. Source: Bloomberg.

Lumber: The hottest commodity of the year

There is no better poster boy than lumber to display the outrageous impact of supply shortages, soaring demand, and years of underinvestment on spot commodity prices than lumber.

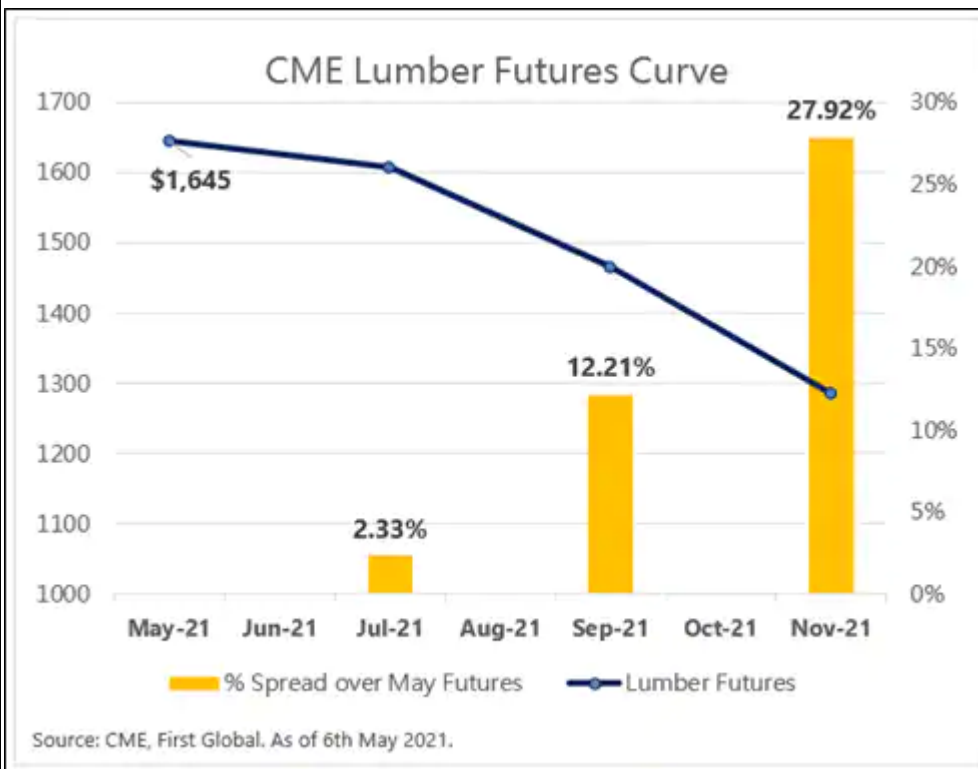
To put things in perspective, lumber is up 57 percent in the last month alone and 88 percent YTD. Since January 2020, prices have skyrocketed 282 percent (see log price chart below for data since 1973).



Lumber industry's talk on the demand-supply dynamics

"The fact is that we are in the midst of a global supply shortage for all forest products, and pure panic is accelerating the pace of demand. Additional supply cannot and will not be added fast enough to allow for sustained price deceleration in the coming year," says Kyle Little, COO of Sherwood Lumber.

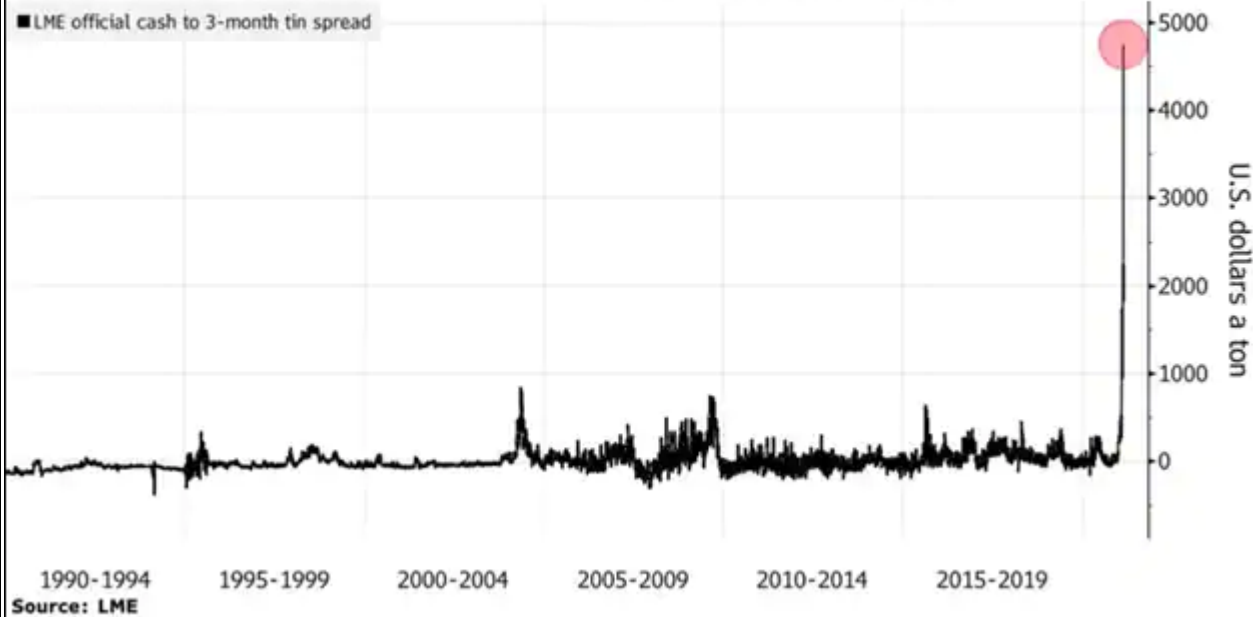
The backwardation in the lumber futures curve is hard to ignore:



Finally to leave you with the strongest backwardation of all in the metals market: tin.

Biggest Backwardation

Spot tin spiked to trade at the largest premium to futures in decades



Based on data from the London Metal Exchange (LME), as of May 6, 2021, tin is exhibiting extreme levels of backwardation with three-month LME Tin futures trading \$4,227 below cash prices, ie implying an annualised yield of close to 60 percent.

We have had reasonable exposure to industrial commodities, since the middle of last year in our Global funds, and that trade has now come to fruition and is playing out well. So far, that is.

That the world is short of commodities, is something that people do not realize but that is what the tape is telling us. Loud and clear.

(Shankar Sharma Devina Mehra and Harsh Shivlani, are part of the fund management team at First Global, a global quantitative Asset Management Company)

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