Key Questions

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What Are the Implications for Commodity Markets From the Russia-Ukraine Conflict?

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In the modern world, everything is connected. It has also become a much more complicated place.

Russia's invasion of Ukraine and the West's unprecedented, unified response of devastating economic sanctions have combined to send the prices of numerous commodities skyrocketing. We have no edge when it comes to the global geopolitical *realpolitik* and the outcome of the war, and we abhor the humanitarian tragedy that continues to unfold. However, we can objectively assess the implications for commodity markets from the ongoing conflict: Things are not good over the near term and are likely to get worse before they get better. The good news is that the long-term situation will get better as the world adapts and rebalances supply and demand.

Russia's Influence in Commodity Markets

In the modern world, everything is connected. Russia has a relatively small economy but exerts outsized influence because of its ability to intensify global energy, food and metal price inflation. The country is the world's largest exporter of natural gas and is the second-largest exporter of crude oil and petroleum products. It supplies more than one-third of Europe's energy.

Russia is also a major producer of fertilizer, wheat, nickel, aluminum, palladium, platinum, titanium, coal and uranium. Shortages of these commodity products have the potential to inflict damage on other economies during a time when central banks have few tools to tame inflation other than to aggressively raise policy rates, risking economic contraction.

Energy Markets

We are most connected to the energy markets. Less than half of Russian exports can be replaced by a combination of incremental US shale production, Iranian barrels released post resumption of a potential nuclear deal, and spare capacity from OPEC+. Unfortunately, there are no other oil spigots to be turned on as the world has been underspending for years on oil and gas capital expenditures because of low energy prices before 2021 and environmental, social and governance pressures.

We expect that more Russian oil will flow to China at a significantly discounted price, allowing oil markets potentially to stabilize at a higher level.

In a scenario where Russian flows are re-routed away from Europe and the US but no major structural deficits emerge globally, we see an average West Texas Intermediate (WTI) crude oil price in 2022 of $105 per barrel. If sanctions remove Russian supplies completely from the market, we see WTI averaging $125 per barrel.

If additional supplies are ostracized from the market because of commingling with Russian oil, then equilibrium prices could be even higher.

Supply chains also will reorient with refined products such as gasoline and Russian crude types used in various regions will see substitution by other compatible types that have higher transportation costs. The systems will eventually function and gasoline/diesel will be produced, but the process will be less efficient, again arguing for stability at a higher price level.

The US natural gas market should remain relatively insulated from global turmoil, as it is primarily focused on production for domestic consumption. As with crude oil, near-term risks are skewed to the upside.

Outlook for Global Food Markets

We are most concerned about the global food commodity markets. The impact has the potential to divide the world between rich nations able to feed themselves and poor nations that cannot.

Together, Russia and Ukraine account for 25% of global wheat export sales so wheat prices are near record highs. The two countries also account for 18% of global exports of corn. With tanks rolling across Ukrainian soil instead of tractors and Russian exports under sanction, key customers in both the Middle East and sub-Saharan Africa are at risk for civil unrest. Russia pursued a policy of food sovereignty after the annexation of Crimea in 2014; its people may miss their McDonald's Big Macs, but they will not go hungry. The same can't be said elsewhere.

Compounding the difficulties, Russia's Minister of Industry and Trade recently announced his nation is suspending fertilizer exports. Russia accounts for 13% of the world's fertilizers, according to Reuters. Potash, phosphate and nitrogen-containing fertilizers are now subject to shortages. Most importantly, lack of fertilizer could hit Brazil, Africa, the Middle East and South Asia the hardest, further affecting the ability to feed much of the world. As food prices rise, American farmers will respond to market price signals, planting what they think can be grown for the greatest return.

This means the US could modestly increase both its production and export volumes but the removal of Russian and Ukrainian production and lack of fertilizer availability combine to create a perfect storm. The result of which could be insufficient food for hundreds of millions of people.

The situation is alarming, and we have not even discussed impact further down the food supply chain, where feed grains are converted into protein via livestock. Protein prices are likely headed much higher as well.

Mined Raw Materials

Finally, Russia is an important producer of mined raw materials, including aluminum, nickel, platinum and palladium. Outright sanctions on the mined commodities have not been imposed, but there still is concern that trade restrictions through payments could have a meaningful impact on global markets. Russia accounts for about 20% of the Class 1 refined nickel market. China may ultimately take most of Russia's production, but it will take time to re-route materials, so the amount of market disruption depends on how quickly the conflict is settled. Russia is also a major palladium supplier. The West will keep using Russian ounces, but as contracts expire, we expect that it will try to shift toward South African supply. A switch will take time, so prices could spike, providing additional incentive to shift from palladium into platinum in auto catalysts, the major end market.

Key Takeaways for Investors

Much depends on how quickly the conflict is brought to resolution and the manner of that resolution. Most commodities are elastic in nature and markets will find new equilibriums over the long term because of supply response, substitution effects, and demand destruction. The mix between those three variables is what is to be determined.

However, a few general points have come starkly into view:

1. We see the long-term interests of four of the world's great cultures – China, Russia, India, and Iran (as the successor to Persia) – aligned, and not with the West. This could result in a weaker US dollar.
2. We see increased consumption of commodities continuing and believe that the nascent "super cycle" of the 2020s now has its raison d'etre.
3. We see inflation likely running higher than expected for longer than expected, impacting wages and productivity.
4. We see the West pursuing policies that reorient its energy producing infrastructure.
5. We see more spending on alternative/clean energy, including nuclear, but this will not happen quickly.
6. We see friction between the developed markets and emerging/frontier markets resulting from food security issues.

The world has changed since the fall of the Berlin Wall, and market participants and policymakers will need to adapt to a much more uncertain landscape going forward. Investors should continue to evaluate tools designed to increase their exposure to real assets within their portfolios. This may include exposure to commodity- and energy-linked equities, emphasizing exposure to low-cost producing assets in politically secure jurisdictions, instead of owning commodity futures outright and de-emphasizing companies susceptible to margin pressures.

We also recommend long-term investors maintain exposure to equities, despite both near-term uncertainties, that will spur continued volatility and potentially higher risk premiums. Historically, it has proven wrong to bet against the West and we currently do not think it will be different this time, even though the world has become a much more complicated place.

For more information, please contact your advisor.

About the Author

Stephen Hoedt is responsible for the oversight of our proprietary equity strategies, individual equity due diligence, equity trading, and both taxable and municipal fixed income due diligence with an emphasis on credit research. Within the Equity Research team he is responsible for coverage of Energy, Financials, Industrials, and Materials.

Prior to joining Key, Steve was the Industrials and Materials Analyst for the National City corporation's Private Client Group. He began his investment career in 1993 as an equity research analyst with responsibilities for the computer hardware and software industries.

Steve has been quoted in several publications including Barron's and The Wall Street Journal, and has also appeared on CNBC and Bloomberg TV.