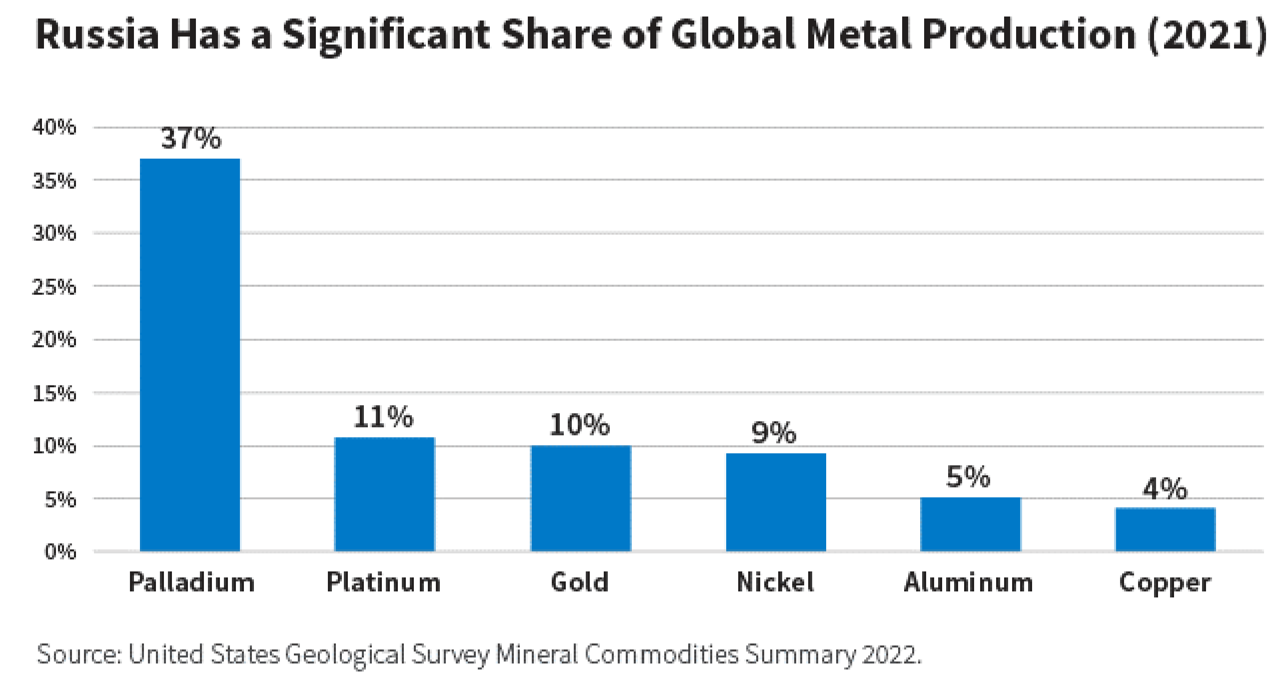
Russia-Ukraine Conflict Hits Commodity Markets

April 13, 2022

The sanctions imposed on the Russian government and companies, along with countermeasures by Russian authorities, have caused further disruption to commodity markets and contributed to rising prices. Despite the conflict, however, we believe emerging markets should fare well this year.

Demand (and thus prices) for many commodities—particularly copper, aluminium, nickel, cobalt, and lithium, which we call the commodities of the future—has already skyrocketed, thanks to the supply-chain constraints stemming from COVID-19 and the rise of electric vehicles.

Sanctions against Russia, along with countermeasures by Russian authorities and self-sanctioning by buyers, have led to severe supply disruption in not just metals, but also energy and grain markets, and the prices of a wide range of commodities have reached record levels.



The desire to shift to alternative sources of metals—namely, the United States and Europe—will likely be associated with structural shifts in trade patterns, in our opinion. In the short term, this could benefit established metal exporters such as South Africa (a major PGM producer) and Zambia in Africa; Brazil, Chile, and Peru in Latin America; and Indonesia and the Philippines in Asia. We believe this may further spur exploration and production activity in nations with the potential to grow output.

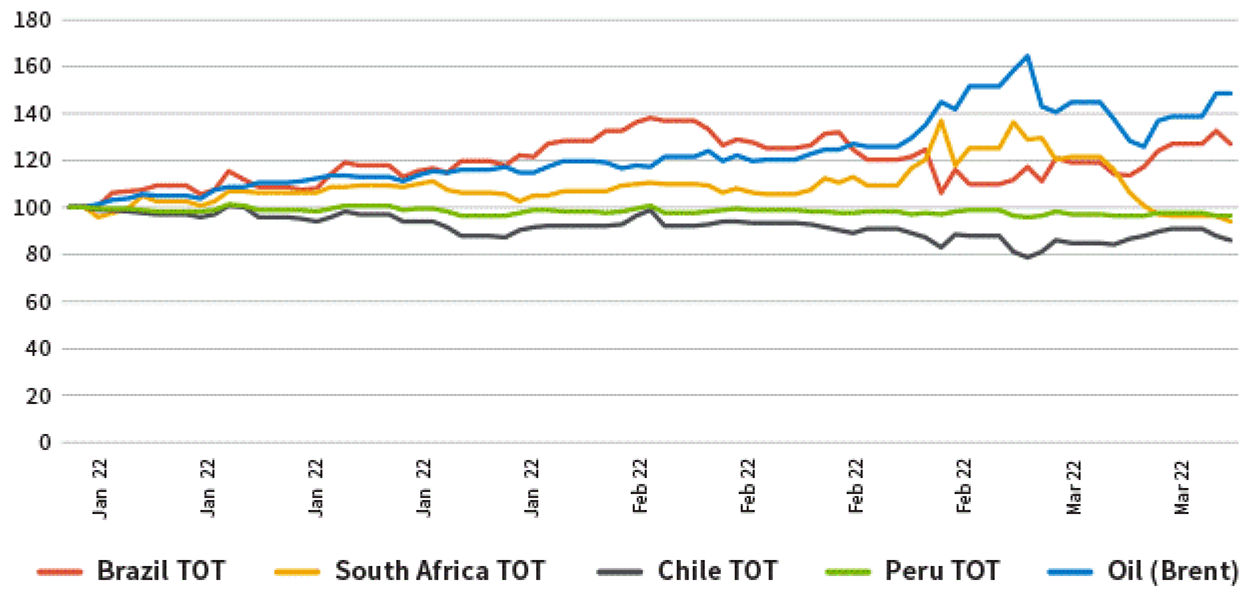
Disruptions in the supply of Russian energy have also caused natural gas and oil prices to soar, but we believe the effect on emerging markets is unlikely to be uniform. Net energy importers are clearly experiencing a deterioration in terms of trade and current account balances. However, the opposite is true for net energy exporters.

We classify 40% of the JP Morgan Emerging Markets Bond Index (EMBI) Global Diversified as oil exporters and thus potential net beneficiaries of the rise in prices, both from an external sector and public finance perspective. Specifically, we consider the following countries oil exporters: Angola, Azerbaijan, Bahrain, Cameroon, Colombia, Ecuador, Gabon, Ghana, Iraq, Kazakhstan, Kuwait, Malaysia, Mexico, Nigeria, Oman, Qatar, Russia, Saudi Arabia, Trinidad & Tobago, and the United Arab Emirates. (Malaysia and Mexico are included because a large share of their index weight comes from national oil companies.)

Because of these dynamics, the sharp rise in oil prices that ensued after Russia’s invasion of Ukraine has offset the impact of higher metal prices. As a result, significant metal exporters such as Chile (where metals make up 62% of total exports), Peru (63%), and South Africa (24%) have not seen a meaningful improvement in terms of trade year-to-date.

As the chart below shows, for example, Peru's terms of trade have improved only marginally since the start of the year. In Chile's case, the rise in copper prices was partly offset by increasing oil prices. And in South Africa, the deterioration in terms of trade as oil prices moved higher and peaked on March 8, 2022 (reflected by the line moving higher), is even more striking, highlighting the country's reliance on imported energy. The more recent rise in oil prices, however, has been more than offset by increasing export prices.

Terms of Trade Resilient Amid Fluctuating Oil Prices



Sources: Bloomberg, Citi, and William Blair, as of April 2022. January 2022 = 100. TOT refers to terms of trade.

Despite the conflict in Ukraine and sanctions against Russia, we believe emerging markets debt should fare well this year, thanks to compelling valuations and sizable improvements in countries' terms of trade—but that doesn't mean we can expect smooth sailing. In the short term, hard-currency bonds could remain volatile given the challenging global macroeconomic backdrop.

We do, however, see pockets of opportunities. In particular, metal exporters in the frontier markets space are underappreciated in our opinion. That's because regulation and consumer preferences are creating demand for clean transportation, and we believe this demand will drive strong growth in the commodities of the future. This could bolster the outlook for copper exporters, and could also improve the prospects for markets with burgeoning mining investments.

In fact, many of the countries we mention above (including China, Chile, Russia, and Indonesia) are categorized in our investment process as low-beta countries, which generally have strong macroeconomic fundamentals and present potential investment-grade opportunities. We see interesting longer-term investment opportunities in these markets.

Yvette Babb is a hard and local currency portfolio manager on William Blair's emerging markets debt (EMD) team.

Disclosure:

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Information and opinions expressed are those of the authors and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC, or affiliates. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information is current as of the date appearing in this material only and subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material may include estimates, outlooks, projections, and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. The securities of smaller companies may be more volatile and less liquid than securities of larger companies. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Different investment styles may shift in and out of favor depending on market conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Derivatives may involve certain risks such as counterparty, liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Currency transactions are affected by fluctuations in exchange rates; currency exchange rates may fluctuate significantly over short periods of time. Diversification does not ensure against loss.

There can be no assurance that investment objectives will be met. Any investment or strategy mentioned herein may not be appropriate for every investor. References to specific companies are for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. Past performance is not indicative of future returns.