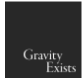


Manager Outlook Q1 2022: War, Inflation, Pandemic & Policy

March 10th, 2022

Manager — **SummerHaven Investment Management**

Asset Class/Category — Commodities/Diversified

Funds Under Management — United States Commodity Index Fund (**USCI**), United States Copper Index Fund (**CPER**), USCF Gold Strategy Plus Income Fund (**GLDX**), SummerHaven Commodity Fund (**Private**), SummerHaven Absolute Return (**Private**)

The following is an edited transcript of our call with SummerHaven Investment Management. Supplemental charts are included on the final pages.

Andrew Barber, Gravity Exists
Hello everyone. Thank you so much for joining us this afternoon. My name is Andrew Barber, and I am with Gravity Exists. This afternoon, we are going to be receiving some insight into action in the commodity markets globally from the folks at SummerHaven Investment Management. We have members of the research department and the portfolio management team at SummerHaven joining us. They're going to be walking through how recent geopolitical turmoil has impacted specific commodity markets. We're going to be touching on oil specifically and energy markets, generally. We're going to be talking about wheat specifically and agricultural markets, generally. We will be talking about other segments of commodity markets, for instance Gold, but first we're going to start off with a discussion of nickel. We do have investors on the call who have a lot of questions regarding actions in the nickel market as a result of the LME's suspension of trading and some confusion about when trading will begin opening again and at what level that opening price will be set. And I believe that Kurt Nelson the CEO of SummerHaven is going to kick off with a discussion of how SummerHaven sees the situation forming up and is also going to give us a little bit of insight into the latest information from the London metals exchange on the nickel market. Kurt. Are you able to hear me?

Kurt Nelson, SummerHaven
I can hear you great. Are you able to hear me, Andrew?

Andrew Barber
I am. Thank you so much for joining today. I'm going to let you take it away.

Kurt Nelson
I appreciate you helping to set this up, Andrew, and the opportunity for me and my colleagues at SummerHaven to briefly share some thoughts on rapidly changing dynamics in the commodity markets. nickel is sort of personal for us. It's a metal that we've traded for more than a decade.
It features in our portfolios. Not just in private portfolios for institutions but in our public ETF. The portfolio that we have in the ETF space looks to equally weight across roughly fourteen commodities each month. It's a rotating fundamental weighted index. But nickel itself is in our portfolio, and because of the rapid price rally, it's more than ten percent of our portfolio, which is sitting in a market which as of now is frozen.

So a few thoughts about nickel. First of all, it's a major industrial metal; it's critical as a catalyst. But even more important, it's used heavily in more advanced, high-tech electric vehicles. There are other ways to store electricity in a battery. Iron phosphate batteries don't use any nickel. But for the most efficient performance or very large electric vehicles, nickel is pretty critical as a battery component. In fact, the highest-end Tesla vehicles in my understanding have a battery that is almost ninety percent nickel. And when you're using an electric power source for a very large vehicle like a pickup truck they tend – because of weight concerns and other things – to rely on nickel. So, it's really important.

We saw demand for nickel going up over the last two-year cycle as more and more electric vehicles were coming on. They were about two percent of sales two years ago. In '21, electric vehicles were nine percent of global vehicle sales, and that's going to continue to grow.

But over the last two weeks with all of that set up for somewhat constrained supply and increasing fundamental demand for nickel, we had the Russian invasion of Ukraine. Nickel features there significantly because Russia produces more than ten percent of the world's nickel. So, in a relatively tight market [to have] somewhere in the order of magnitude of ten to thirteen percent of world supply potentially be cut off for some period of time is quite a significant supply shock while demand is still robust.

The other thing that happened was the freezing of the market as of Monday night into Tuesday morning in the overnight session in Asia by the London Metals Exchange. Our best understanding of why that happened is that the world's largest corporate producer of nickel happens to be a Chinese company, a state-owned enterprise called Tsingshan. As a huge commodity producer – the same as oil companies,

farmers, etc. – when you're producing a ton of a commodity, you often sell futures, whether it be on the CME or on the London metals exchange or elsewhere. You sell your production forward to lock in a price. The scale of the short positions that this Chinese entity had, along with the rapid price increase in nickel led to what's estimated to be around $8 billion of losses on their short position. Now the Chinese company, as opposed to a speculator or a hedge fund, had pig nickel and other low-grade nickel in very large quantities, but it wasn't the grade that it could be delivered to the London Metals Exchange.

There was also a delay in them meeting their margin call, and so as the price had rallied significantly up to $48,000 by the close of Monday, it rallied to between $80,000 - $100,000 in the overnight session. So, a one hundred percent increase just overnight. It would be the equivalent of oil closing at $110 tonight and in the nighttime session trading over $200. It was just a huge price shock, somewhat driven by this margin concern and the short positions and short squeeze of this large hedger in China. So, what the London Exchange did is they closed the market in the early morning on Tuesday, but then they canceled all of the trades that took place on Tuesday morning's session and fixed the price at the Monday close, which is about $48,000 per metric ton. We are waiting to see and hear when that market will reopen. The latest missive from the LME themselves today was that it's possible, but not very likely, that the market will reopen tomorrow, on Friday [March 11]. More likely than not, the London Metals Market will open sometime between Monday and Wednesday next week.

My understanding, as well, is that there was strong pressure to try and net off some of the longs and shorts and kind of clear that the books, clear the trades. And the huge short that exists is this holding from this Chinese enterprise. What we understand as well is that this Chinese enterprise has no interest in closing out their shorts. They've met their margin call between financing from Western banks and money from the Chinese government. They've posted the margin as required, and they don't have any interest in closing out their positions. So, I think the elephant in the room is first of all, when is nickel going to start trading again? Critically important to us and to investors. But second of all, where's it going to trade? What can we expect? I believe that the margin requirements for nickel haven't adjusted, but probably more dramatic is that the LME for the first time in their 145-year history has imposed daily price limits on the movement of nickel, and I believe it will be about a ten percent increase or decrease on the day. So, I think if I was to say what's going to happen to the price of nickel, I think I can anticipate it will be very volatile when it starts trading – if that's next week. That volatility will be muted to some degree by the fact that once we move ten percent up or ten percent down, that external price limit will cease trading.

But that's what's going on in the nickel market. Certainly, a shock. Not really led specifically by Russia but more due to the hedging and trading dynamics of this large producer in China.

Andrew Barber
Kurt, thank you. Thank you very much for walking us through that. I believe that your colleague Geetesh is going to be joining us now to talk about the setup for the energy markets and agricultural commodities.

Geetesh Bhardwaj, SummerHaven
Hey Andrew, this is Geetesh. Thanks for having us here. The most important agricultural commodity is wheat resulting from this conflict. Twenty percent of global wheat is produced in Ukraine and Russia, and what we have seen is heightened volatility in the wheat market. Prices have rallied. Yesterday and today, they have sold off a little bit, but there's a lot of uncertainty for the wheat market, and it's going to take some time to figure out how a twenty percent supply source is going to be… [how] the uncertainty with the twenty percent supply source is going to settle. It's purely a supply shock when it comes to wheat. Unlike energy, which we can discuss next, there is OPEC supply that can come online for oil. It is very hard for wheat supplies to be restored in a quick fashion.

And, for energy, there you have two different scenarios. One is crude oil and the other one is natural gas. When it comes to crude oil, Russia is a major supplier – is the second largest producer of crude oil – but as I said, if oil rallies a lot, there is plenty of supply in the world that can come online, Canadian sands can start producing. They are very profitable at the current price level of $100-plus dollars, and OPEC can increase its production. The last one that is very important is natural gas. Natural gas is interesting because Europe depends on Russian natural gas for its heating requirement. There is a lot of natural gas but transporting that is a problem. The US has a lot of natural gas; however, the transport of natural gas happens usually on a pipeline. Putting it on a ship, liquefying it, and de-liquefying at the destination is very expensive.

There are zero supply issues when it comes to natural gas. The good part is winter has ended, or is coming to an end, and we have time for the natural gas market to adjust. However, we have seen extreme volatility in the natural gas market, which we expect to continue.

Andrew Barber
Okay, Geetesh, if I can ask you a quick question as a follow-up. In the discussion of oil, when you were talking about the opportunity for non-Russian suppliers to make up the shortfall, is the backwardation in the futures curve representative of that? And do you want to walk us through what you're seeing in the backwardation? I know we discussed it earlier today, and you showed me a chart showing that we're at a fairly extreme backwardation in the WTI crude oil curve.

Geetesh Bhardwaj
Sure, so for the benefit of everybody, we like to use these terms “backwardation” and “contango.” “Backwardation” is a situation when the front oil that is for immediate delivery – or the spot market oil – is trading at a premium to the farther out oil. So, if you look at the price right now, you can buy oil for delivery next month at around $100, but if you want to buy oil ten months out, you only have to pay $85.
That is what is happening, and if you think of it, the only reason for that to happen is that there is a supply shortage right now. People want it, and they know six months down the line, they'll be able to find it, but right now there is massive uncertainty where supplies are going to come from, and that backwardation – that is, the premium of immediate delivery – has gone up significantly. In January, it was around $5 – the difference between twelve months out and the front price.

You had to pay a premium. There was still a supply shock and the supply chain was still constrained, so you had to pay a little bit of a premium to immediately get oil. But it has exploded from $5 to $15, and that reflects the fact that there is a supply shortage.

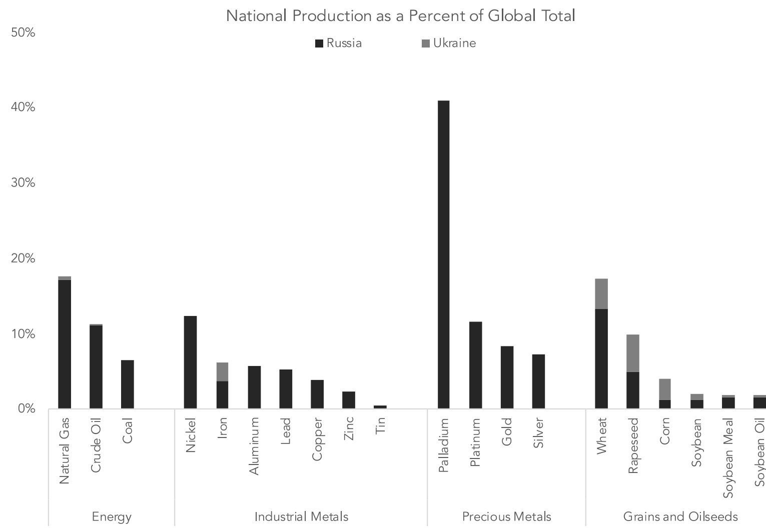
Andrew Barber
And, does that also suggest that distortion is being discounted by commercial buyers? In other words, that there is an immediate rush to purchase oil in the front end of the curve speculatively, but larger commercial traders are less concerned?

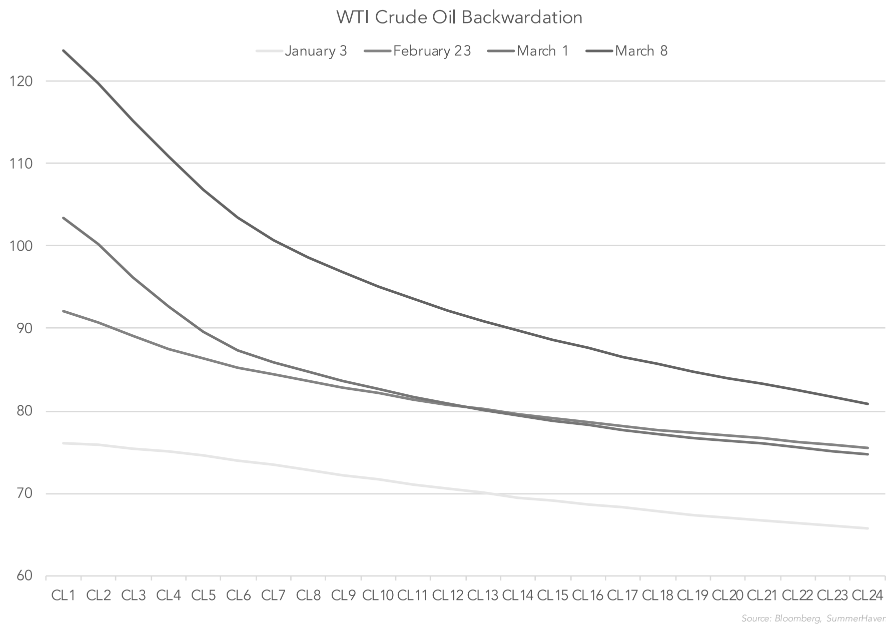
Geetesh Bhardwaj
Most speculators actually trade in the front. So, there is obviously some money that has moved in, but the fact that the price has gone up as much as it has is more reflective of what commercials are facing at the grounds. We just took out one major supplier for the world, and that affects how much product is available and the uncertainties that come with it. If somebody buys Russian oil, is it going to be available, or is it not going to be available? Is it going to make it? So, all of those uncertainties come into play. So, yes, the speculators are in the front, but this is really a price discovery and there is a shortage that is showing up.

Andrew Barber
Okay, Geetesh. Thank you so much. I know we're coming up on fifteen minutes. I have one more question I want to ask, because it's something that several people have asked me to ask you. Certainly, most of the people on this call are US-centric investors. Should we anticipate that the current bottleneck for natural gas supplies in Western Europe will lead to an increase in liquid natural gas exports from the US market? Should we see increased LNG exports as a percentage of total produced gas in the US?

Geetesh Bhardwaj
I think that's a long-term trend that has been happening for some time. A few years back, we did not export any given the price differential between Asian, European, and US markets. It is extremely profitable to do that if you're only restricted by our capacity, and I absolutely expect more and more LNG shipping to happen from the US natural gas

Andrew Barber
Okay. Geetesh, Kurt, thank you so much for taking the time. Everyone, thank you for joining us. We'll be sending out a transcript of this at some point tomorrow morning. In addition, if you have any further questions for myself or the folks at SummerHaven, please reach out. We'll be happy to answer any that you may have. Thank you so much for taking time out of your afternoon.


National Production as a Percent of Global Total
Russia
Ukraine
50%
40%
30%
20%
10%
0%
Natural Gas
Crude Oil
Coal
Nickel
Iron
Aluminum
Lead
Copper
Zinc
Tin
Palladium
Platinum
Gold
Silver
Wheat
Rapeseed
Corn
Soybean
Soybean Meal
Soybean Oil
Energy
Industrial Metals
Precious Metals
Grains and Oilseeds
Source: Bloomberg, SummerHaven


WTI Crude Oil Backwardation
January 3
February 23
March 1
March 8
120
110
100
90
80
70
60
CL1 CL2 CL3 CL4 CL5 CL6 CL7 CL8 CL9 CL10 CL11 CL12 CL13 CL14 CL15 CL16 CL17 CL18 CL19 CL20 CL21 CL22 CL23 CL24
Source: Bloomberg, SummerHaven