Will interest-rate cuts turbocharge oil prices?

The Economist

As policymakers prepare to ease policy, traders (and presidential candidates) hold their breath

When commodity prices move in tandem, it is usually because real-world events jolt markets. China is the world's biggest consumer of raw materials, so its economic leaps and stumbles matter. Russia's invasion of Ukraine hindered the trade of fuels and grains, causing prices to surge. But every once in a while it is news in the financial sphere that prompts traders to act. And the most common source of such news is America's Federal Reserve.

On August 23rd Jerome Powell, the central bank's chair, said that the time had probably come to lower interest rates. A first cut is expected on September 18th, when its rate-setting committee meets. The shift would call an end to a cycle of rises that has taken the Fed policy rate from close to zero in 2022 to between 5.25% and 5.5% today. Rate cuts lower the opportunity cost of owning commodities, which, unlike assets such as bonds and property, do not provide a yield. Will the Fed factor deliver the boost to prices that investors hope for and incumbent politicians (not least Kamala Harris) dread?

History provides a guide. Since 2000 the Fed has managed three rate-cut cycles: in 2001 (when the dotcom bubble burst), 2007 (as America's subprime blow-up went global) and 2019-20 (during trade wars with China and the covid-19 slump). The drivers for each were different, helping explain why the cuts varied in their speed, magnitude and, ultimately, impact on commodity markets.

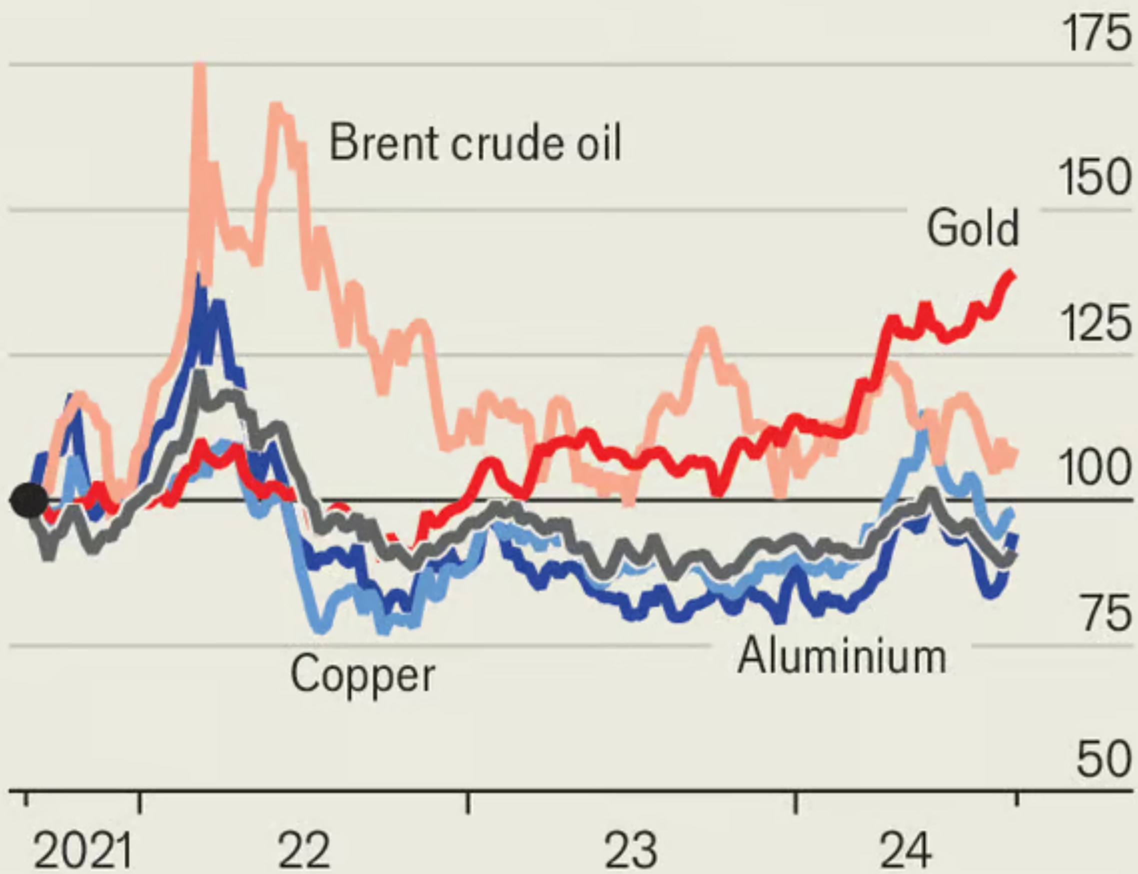

Chart: The Economist

The first lesson is that rate cuts affect some markets more than others. Lower policy rates enhance the relative appeal of commodities for investors seeking protection against inflation—namely, banks, insurers and pension funds. That has been most apparent in prices for gold, as well as those for industrial metals, such as aluminium and zinc, and crude oil. The commodities least sensitive to rates include "bulk" materials, such as coal and grains, says Tom Price of Panmure Liberum, a bank. Markets for these are ruled by producers and consumers, and obey local factors.

The second lesson is that that the Fed factor varies in length. During a "good" cutting cycle inflation comes under control and economic growth remains decent, meaning that the initial boost to commodity prices tends to last longer as demand for the underlying materials endures. "Bad" cutting cycles, when central bankers cannot prevent recession, provide a fleeting fillip to commodity markets, with the exception of gold, which does better when things turn truly pear-shaped. Oil and metals both did terribly after the global financial crisis of 2007-09 and covid-19, despite the Fed's rush to slash rates.

So what should you expect this time? Traders are certainly hoping for a boost. In the week during which Jerome Powell made his remarks, net investor positions across all commodity markets rose to a four-week high of $97bn, up by 13% against the previous week, according to JPMorgan Chase, a bank. Prices for a broad group of industrial metals had already risen by 4-10% in the run-up to Mr Powell's speech. They will probably rise again when cuts materialise, and may stay high for a while, because indicators suggest that the economic landing under way seems to be of the soft variety, with growth holding up.

Yet the most politically sensitive commodity—oil—may be less affected. Members of the Organisation for the Petroleum Exporting Countries (OPEC) are keen to unwind production cuts, which have deprived the world of 3% of the cartel's potential crude supply since late last year. Members' compliance with these cuts is weakening anyway, and oil production is rising outside the cartel. The extra supply will weigh on prices. So will weak demand: even if America's economy is slowing only gently, it is doing so when China remains beset by problems.

At the same time, commodities that do benefit from lower rates will probably benefit more than in previous cycles. Gold is going ballistic, boosted by geopolitical tensions, retail demand and central-bank appetite for bullion. MUFG, a bank, predicts that the metal will reach $3,000 an ounce by 2025, up from $2,500 today, which is already a record. Copper could also see a bigger boost than usual. In recent years the metal has become ever more popular among institutional investors owing to its role in the green transition.

Ehsan Khoman of MUFG reckons that this could be enough for commodities as a whole to outperform every other big asset class in the year following the Fed's first cut. Rather than 2001, he believes the world is back to 1995, when the Fed cut three times mid-cycle to ease the economy over a modest bump, causing commodities to soar. The prospect of low oil prices is a pleasing one for Ms Harris. Investors, for their part, will be happy with rising prices elsewhere. ■

For more expert analysis of the biggest stories in economics, finance and markets, sign up to Money Talks, our weekly subscriber-only newsletter.

Subscriber only | Money Talks

Expert analysis of the biggest stories in economics and markets

Delivered to your inbox every week