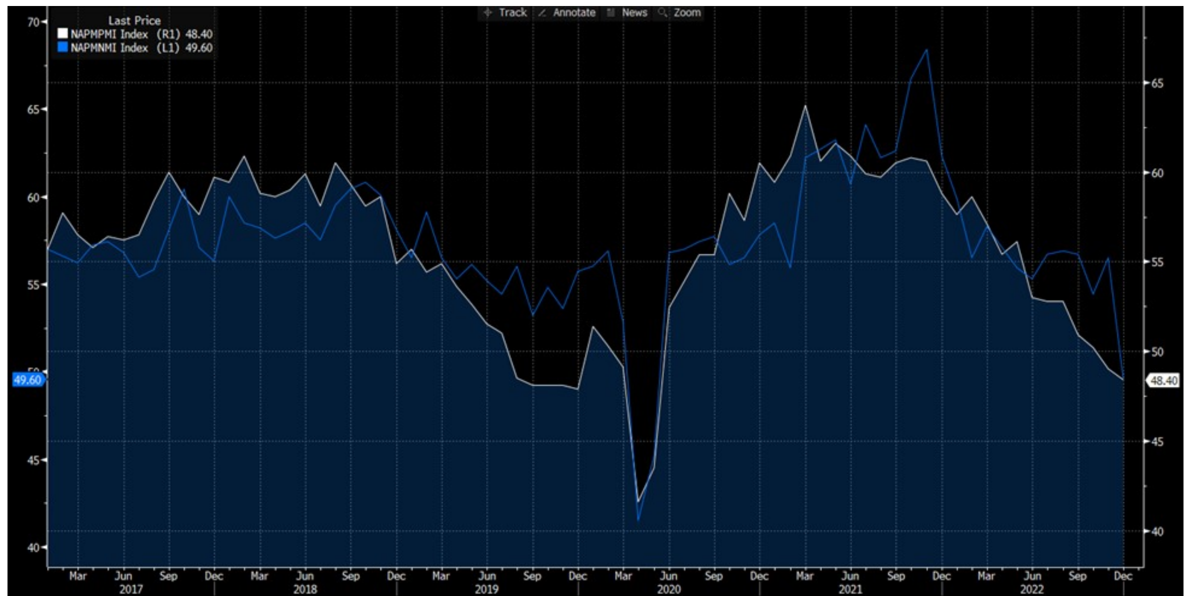
DAVIS COMMODITIES LLC

December 2022 Macro Commentary

As discussed in last month's commentary, economic activity continues to show signs of slowing even though employment remains strong on the surface. The Purchasing Managers Indexes for both manufacturing and services are showing contraction as they are both below 50.



Surprisingly, the US unemployment rate sank from 3.7% to 3.5%. While the unemployment data would seem supportive, when you start looking "under the hood," there are some cracks showing up. There are two industries that typically lead the cycle of unemployment: residential construction and temporary help services. Both of these sectors have shown declining employment since 2021. In fact, most sectors are cooling with only consumer services industries still showing advancement in hiring. The bottom line is that the US economy is cooling as the rapid increase in interest rates starts to bite.

How the slowing economy flows through into interest rates is a bit tricky. If unemployment slowly ticks higher, the Fed will likely hold steady on interest rates for the foreseeable future. However, if unemployment ramps up quickly, there will be a sharp pivot out of the Fed to reduce rates. In the former scenario, our interest rate spreads should work, albeit at a relatively slow pace. However, in the latter scenario, the spreads will move quickly toward a steeper curve.

If the latter scenario above plays out, a quick pivot to cutting should also inflate both precious and industrial metals. Weaker interest rates and a slower US economy should allow the dollar to deflate from its current lofty levels. Weaker dollar will be a further tailwind to the metals space. Beyond the economic influence of the Fed, the industrial metals story extends further into the ESG movement. With the governmental push to expand green energy, there will be an ongoing shortage of key metals like copper, aluminum, nickel, zinc, and lithium. These ongoing shortages will lead to higher prices. While the program has started to accumulate precious metals, industrials have yet to be added.

Finally, the energy sector has sold off sharply over the past few months due to the combination of better than expected flows out of Russia and the sales by the US government out of the Strategic Petroleum Reserve (SPR). Russian production has proven more resilient than our initial thinking, however, the true test will come in the spring. With the typically cold Russian winters, spring maintenance is essential for maintaining production levels. With almost every major energy producer leaving the Russian space, one has to wonder who will maintain those wells? Spare parts will be harder to acquire even if they can find the manpower to perform the work. In addition to potentially lower production in Russia, SPR sales by the US government are mostly coming to an end. There are some sales scheduled through previous legislation, but those amounts pale in comparison to the ~222 million barrels sold over the past year. Energy will be added back to the portfolio at various times throughout the year.

Sincerely,

Stephen Davis
January 10, 2023

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