Speculators Drive Commodity Gains

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9:00AM Thursday, 28 July 2016

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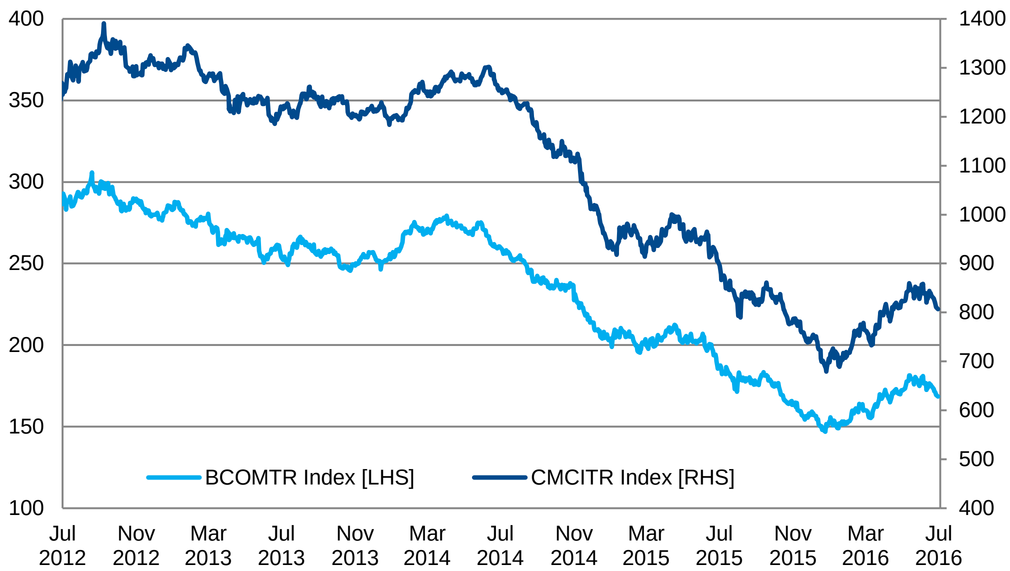
July 2016

Bloomberg Commodity Index vs. UBS CMCI Commodity Index: *After years of lacklustre performance, commodity markets picked up significantly in H1 2016.*



Source: Bloomberg

The commodity market has long been seen as a hedge against inflation; offering portfolios exposed to the asset class some safety against rapid price appreciation. The only problem is there hasn't been much inflation in this post-financial crisis world, largely a result of ineffective monetary policy pushed by the central banks and QE which failed to influence the market as intended. With the current generation of central bankers committed to this outlook the prospect of higher inflation in developed markets seems to be a long way off.

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This in itself raises an important question, as the traditional importance of the commodities space fades will we see the market dominated more and more by speculative activity? This month we're taking a look at the relative performance of commodity indices and ask ourselves whether the market trends we have seen dominate the first half of the year will become the new norm.

Rewind 6 months and investors were dealing with Trafigura winding down their prized metals hedge fund, citing a fundamental alteration in investor appetite for commodities as an asset class. The CFTC also stated that they would cease publishing commodity index information due to a 'low level of interest'.

Fast forward to now and with concerns of a Chinese devaluation abating and the dust settling post-Brexit vote, appetite for commodities has improved substantially. In a sign of the enhanced appetite for commodities, investment managers PIMCO are in a position that was thought of as a distant prospect at the start of the year and according to company reports have already closed the door to new investors after assets in their three year old commodities hedge fund unit exceeded $1bn.

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An interesting point to note has been the breakdown of the historic search for yield in traditional asset classes. It makes little sense for investors to hold overvalued bonds in a negative interest rate environment; instead investors are looking at hard assets which don't offer any yield but the potential upside from price appreciation.

But in the years following on from the financial crisis where central banks have adopted zero interest rate policies and in some cases negative interest rate policies, this relationship has become heavily distorted and investors frantically searching for anything resembling a decent yield have driven up the valuation of not only stocks and bonds but almost every other asset class as well.

The commodity space hasn't been ignored by investors on the hunt for alpha and the steady unwind in prices throughout the past few years may have presented an attractive entry point for opportunistic speculators.

Market conditions aren't expected to return to anything resembling "normal" for some time, accordingly investors have settled for the lacklustre returns that the safe havens provide; historically low and in some cases negative bond yields, and the often meagre dividend yields provided by defensive stocks.

But interest in commodity markets has picked up substantially since the beginning of the year, fuelling rapid price appreciation according to Bloomberg data, notably in iron ore which is up 23.27% half way through the year, nickel which is up 23.46% so far this year and soybeans which were up as much as 30% year-to-date, but has seen some cooling of gains as a result of a favourable US harvest.

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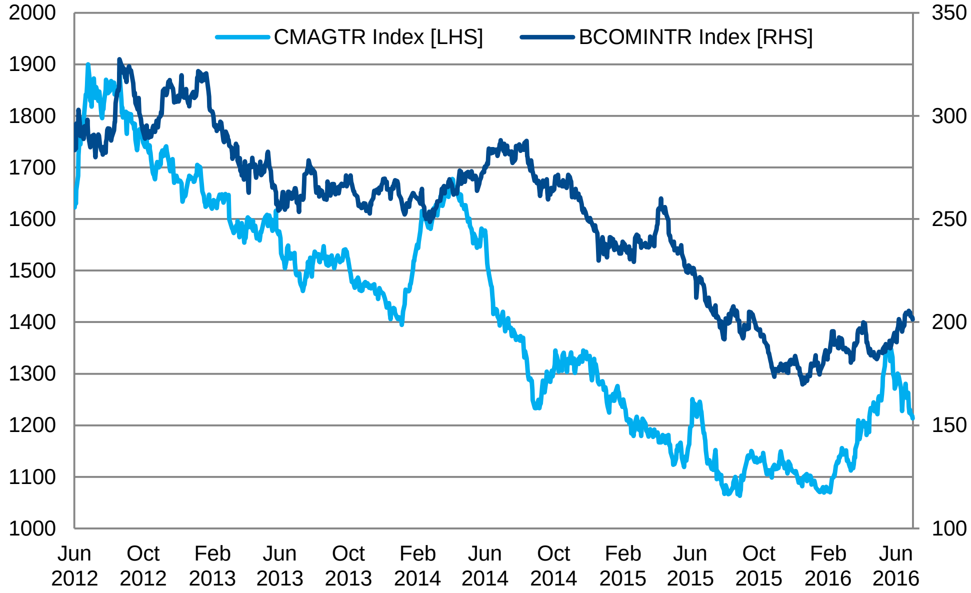
In addition the volume of futures reported by the CFTC suggests appetite from hedge funds is increasing. In June across the 13 agricultural markets, net long positions rose 25% to more than 850,000 lots. This included new record bets on sugar, currently up 30.39% year-to-date.

After years of lacklustre performance, commodity investors can breathe a collective sigh of relief this year as the markets for energy, agricultural goods and base metals stage a strong rebound after underperforming the wider market.

…investors should be grateful for the returns the commodities space is offering a diversified portfolio.

Bloomberg's Commodity total return index and the UBS CMCI Composite Index have both returned over 10% as of the end of June. For what is turning out to be one of the most volatile years since the financial crisis investors should be grateful for the returns the commodities space is offering a diversified portfolio.

UBS Agriculture Index vs. Bloomberg Industrial Metals Index: *Both base metals and agricultural markets have outperformed in 2016 on a total return basis.*



Source: Bloomberg

…base metals and agriculture sectors in particular have proven to be the engines driving gains during the first half of the year…

The base metals and agriculture sectors in particular have proven to be the engines driving gains during the first half of the year as Chinese stimulus measures boosted the demand outlook for the former while adverse weather conditions in key growing regions crimped the supply outlook for the latter.

Returns during the first half of the year were additionally buoyed by a rebound in crude oil prices, with the global Brent benchmark almost doubling from its January slump to $52.80/bbl in June as cost inflation presented itself once again.

While crude prices staged a dramatic recovery, freight costs were less responsive during the first half of the year as an oversupply of bulk carriers ensured the benchmark Baltic Dry Index hit a historic low towards 429 at the start of the year. To put this figure into context the BDI touched an all-time high of 9,589 in June 2008 and has fallen a staggering 92% since then. However, the market looks to have bottomed out earlier this year with activity so far in July hinting at some tightness in the market with the BDI gaining almost 13% so far this month.

These factors combined offered up a very attractive climate for brave speculators hoping to achieve double digit returns and with spot commodity prices tracking the futures market higher, traders could still be well positioned to benefit over the second half of the year.

Naturally long producers struggled to find a suitable institution to hedge with and take on that counterparty risk…

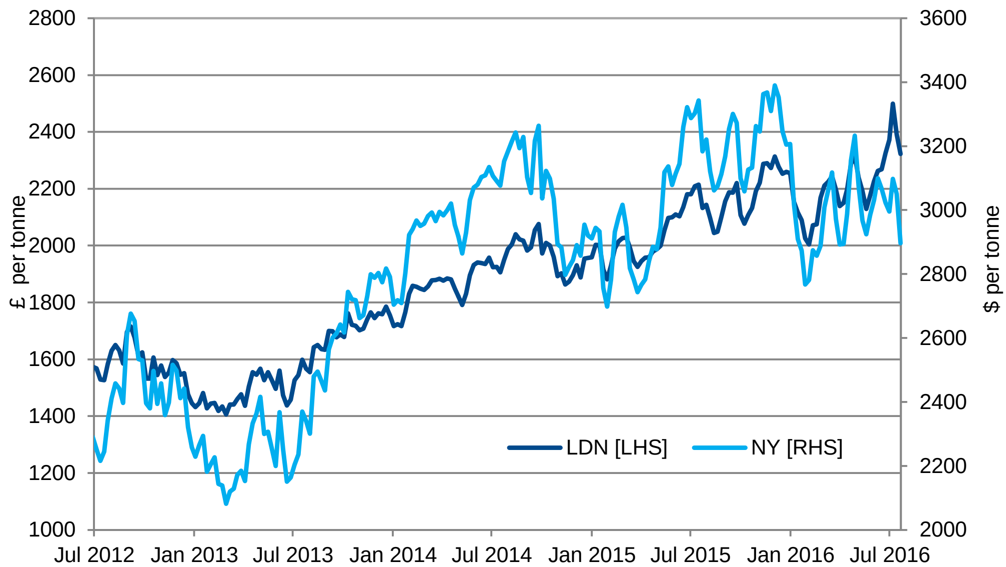
Since the financial crisis, the retreat by banks which had historically been the liquidity providers in the commodities space triggered a disproportionate decline in what was considered healthy speculative activity. Naturally long producers struggled to find a suitable institution to hedge with and take on that counterparty risk and accordingly the funds who relied on this deep liquid pool struggled to operate.

However, a steady stream of quantitative easing which has boosted liquidity across the board and the search for yield has seen an encouraging pick up in the commodities space as investors look to register quick gains. A textbook example of this was earlier this year in March when iron ore prices jumped by 19% amid speculation of stimulus from the Chinese government.

…we do not believe the steady march by the funds back into the commodity space will slow given the current economic climate.

Of course, regulators have been quick to react to such sharp price movements as the Chinese regulators hastily warned investors about excessive speculation in the commodity space to the point where three exchanges imposed restrictive measures in the hopes of curbing excessive speculation. Still, we do not believe the steady march by the funds back into the commodity space will slow given the current economic climate.

London Cocoa vs New York Cocoa: *2nd month London cocoa futures benefited from a weaker pound since the referendum, adding as much as 8% immediately after the vote.*



Source: Bloomberg

…dollar denominated buyers of London cocoa and natural gas will benefit due to the contracts being priced in pound sterling.

For goods denominated in dollars, a weak American currency helped support the markets of oil, gold and silver…

Recent volatility in the market has created many opportunities for investors not just in the commodity space but also in currencies. This currency volatility is magnified in the commodity space as European trade houses reporting in EUR, GBP and CHF face a battle on two fronts.

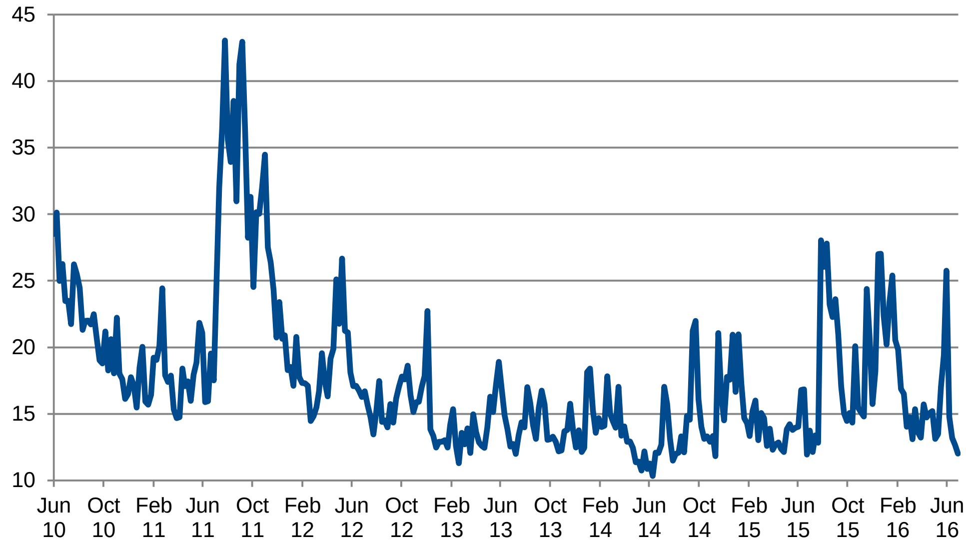
With the recent weakening of the pound throughout the last month, dollar denominated buyers of London cocoa and natural gas will benefit due to the contracts being priced in pound sterling. The weakening of sterling led to firm support for London cocoa as prices soared 11.17% to record highs of £2518 per futures contract (10 metric tons), according to Bloomberg.

As currency volatility has subsided and sterling has stabilised, so has cocoa, which has now fallen back to £2290 as of the 26th of July. This offers a recent and clear example of commodities as an asset class becoming increasingly driven by currency volatility which in turn is based on heightened global macroeconomic uncertainty.

With the dollar denominating the majority of the commodity industry, it's no surprise that as the currency has strengthened commodity prices across the board have retreated. Even though each commodity has its own distinctive characteristics, the value of the dollar has a direct influence on the price of commodities.

For goods denominated in dollars, a weak American currency helped support the markets of oil, gold and silver throughout the beginning of the year. Looking into the second half of the year and beyond, if recent market volatility continues, what does this mean for commodities?

CBOE VIX: *Exaggerated spikes in volatility have dominated risk assets since the second half of last year; it seems this magnified event risk is here to stay.*



Source: Bloomberg

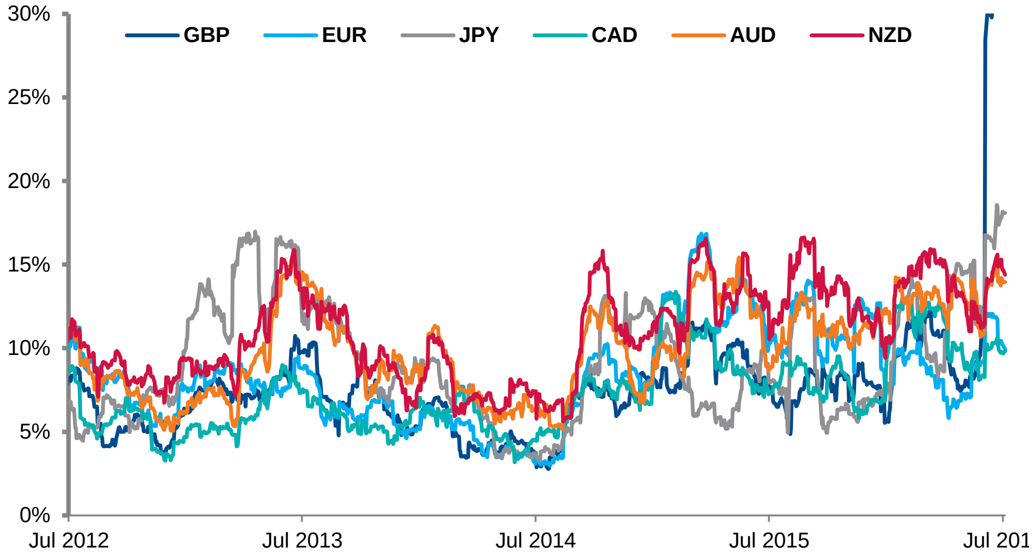
…the outlook for a stronger greenback could add headwinds to commodity prices in general…

With the Fed the only central bank on the path to higher interest rates, albeit a long and drawn out path, the outlook for a stronger greenback could add headwinds to commodity prices in general while individual supply and demand drivers prompt diversion within the asset class, further convoluting the market dynamics and presenting additional opportunities for savvy speculators. Uncertainty from the Brexit cloud is still lurking overhead and market participants remain on edge, with volatility spiking in recent months. Deutsche Bank's currency volatility index hit a four year high in June, reaching 12.58, a stark contrast from 2014 where the index hit 5.26.

Continued global uncertainty…will likely see growing participation in commodity assets…

Such extreme swings are increasingly becoming business as usual and the second half of 2016 will likely see more volatility on the horizon as central banks around the world try and kick start growth amid fears of secular stagnation. Continued global uncertainty and a loss of confidence in central banks' ability stimulate growth coupled with increasingly high valuations across stock and bond markets will likely see growing participation in commodity assets with fund flows expected to be the driving force behind this.

Foreign Exchange Volatility: *30 day historical rolling volatility indicates investor sensitivity to market gyrations has increased.*



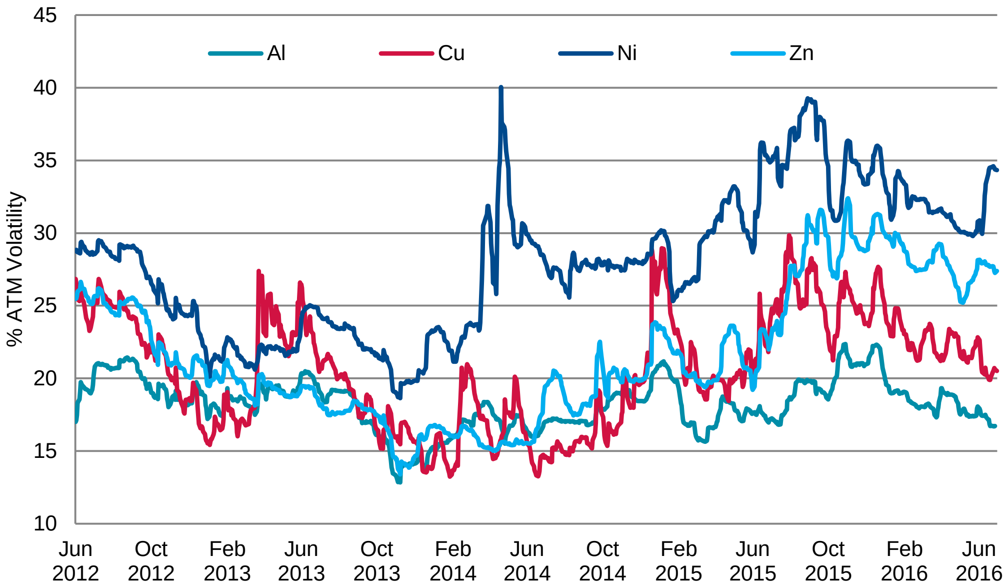
Source: Sucden Financial

Fed Chair, Janet Yellen has stood firm on her cautious stance this year, with the central bank remaining dovish throughout 2016 as global macro concerns saw rate setters hold off from increase the target rate in June. Expectations for a second rate rise this year now stand at 45%, up from 7.7% immediately after the UK's decision to leave the EU, according to Bloomberg.

This outlook of higher interest rates in the US could provide some tailwinds for commodity markets…

This outlook of higher interest rates in the US could provide some tailwinds for commodity markets, and will exacerbate the divergence between monetary policy in the US and the rest of the world, which judging by recent comments from BOJ, ECB and BOE officials continues to be on a path of easing.

ATM Implied Volatility: *Heightened currency risks and macro concerns are portraying themselves in commodity markets with base metals seeing a sharp increase in implied volatility.*



Source: Bloomberg

…the backdrop of a volatile and uncertain macroeconomic climate will prompt investors to focus their attention towards the commodity space…

To summarise, the twin heads of currency volatility and increasingly overpriced stocks and bonds against the backdrop of a volatile and uncertain macroeconomic climate will prompt investors to focus their attention towards the commodity space, which for many years has been undervalued. With low and negative bonds very much at the foreground in today's global economic picture, we could see increasing inflows into the commodity space as investors seek returns. The second half of the year could well see increased currency volatility play out in the commodity market, prompting broad swings across the base metals, softs, grains and energy markets in particular.

It is important to note that commodities are likely to need a strong fundamental outlook in conjunction with currency volatility, as the latter may not be enough to support the asset alone. A strengthening dollar is likely to add headwinds to the market as commodities become more expensive around the globe. As an asset class commodities look attractive to investors and although they will need a steely resolve and deep pockets if they hope to avoid getting stung, if the first half of the year is anything to go by fortunes could be made and lost in the blink of an eye.

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