Index Volatility: Reviewing the Options

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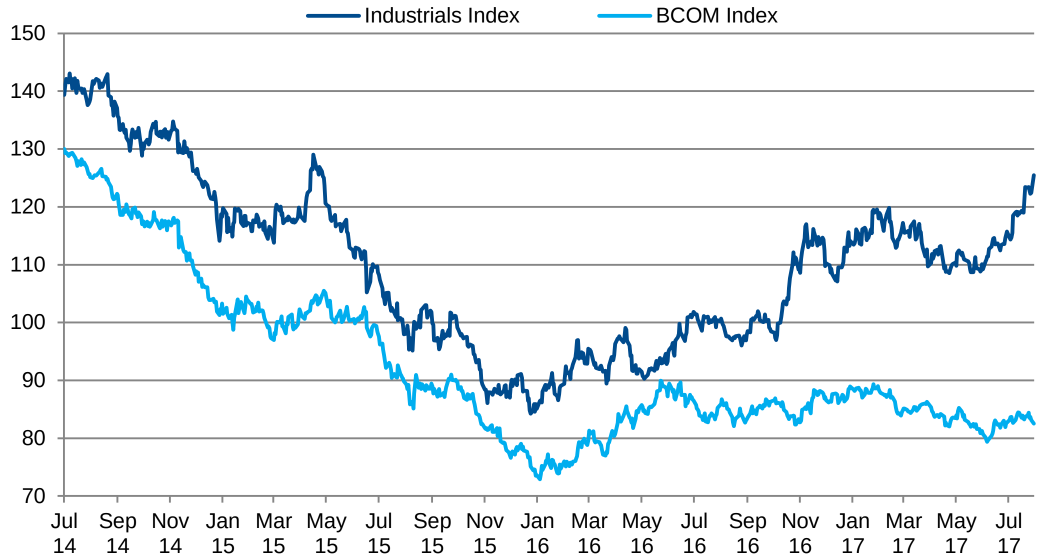
Summary

- Bloomberg commodity (BCOM) indices were under severe pressure in the first half of the year but since mid-June volatility has picked up prompting the indices to take back some of those losses.
- The industrial metals index leads the way posting strong gains of 15% year-to-date in contrast the energy sub-index is the worst performer with a year-to-date loss of 18.7%.
- Recent commodity gains have been underpinned by dollar weakness with the dollar index falling to its lowest level in a year at 92.548 before recovering to 94.
- Agricultural products volatility has increased in recent months on fears of drought in the US, we anticipate agri-products to remain more volatile due to weather risk during growing and harvest season and a strengthening BRL.

Bloomberg Commodity Index vs Industrials Index: BCOM Index remains subdued despite the *strong start to the second half of the year from industrials.*



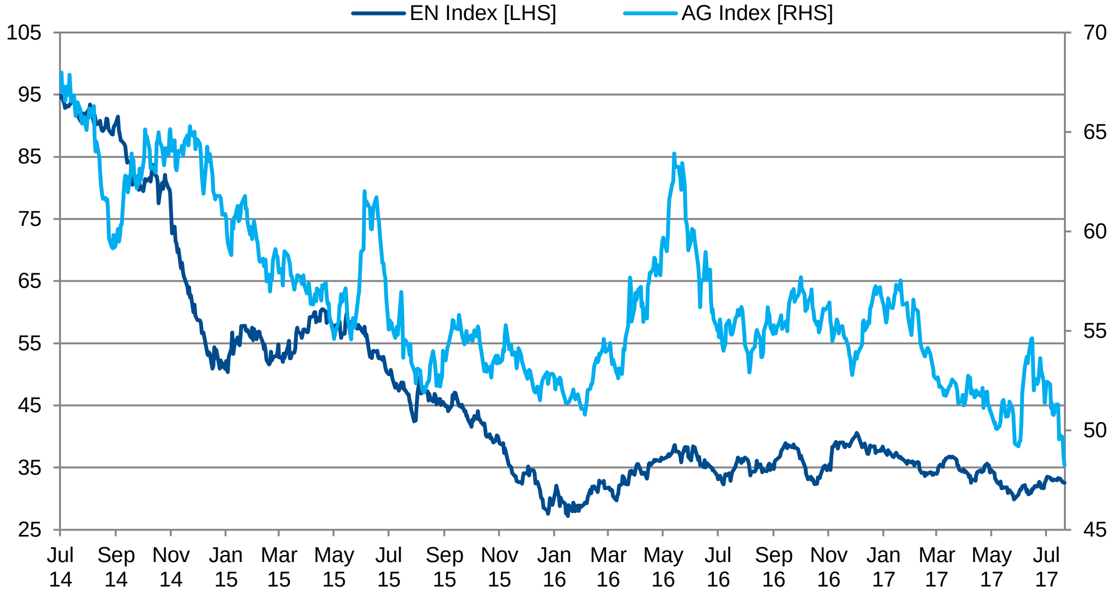
Source: Bloomberg

Commodities as an asset class were under considerable pressure in the first half of 2017 with the Bloomberg commodity index (BCOM) falling -3.8% year-to-date from 86 to 82.75. The index was down 7.8% to mid-June, however strong performance in the last six weeks, helped by the poor performance of the US dollar, has seen the index take back some those year to date losses as it recovers towards 84.

The industrial metals sub-index has gained 12.8% year-to-date (as of the 11th of August) as the recent rally in the base metals complex buoys the outlook. As one of the best performing sectors last year, adding 20% and closely trailing solid gains in precious metals the decoupling between the base metals complex as individual supply and demand drivers take the fore, set the stage for a promising tail end to the year.

The index started the year strongly reaching 121 having opened at 108.9 but then tumbled back to 108, down 0.89% on the year in early May. Since early June, bullish sentiment has returned with the index up 11.36% from 108 to 122.9 from the 6th of June to the week ending 11th of August. We attribute 3.5% of this move to the recent move in copper as a result the unrest in Freeport's Grasberg mine and thus if the unrest can be mediated appropriately we would anticipate a retracement back towards 115 as some of the impulsiveness fades.

BCOM Energy Index vs BCOM Ag Index: ***The agriculture and energy index remain under pressure.***



Source: Bloomberg

Performance for the energy and agriculture sub-indices has dragged the Bloomberg commodity (BCOM) index down this year. The energy sub-index has declined 16% year-to-date. OPEC production cuts agreed last year failed to materially affect the supply overhang, prompting an extension to the deal.

"The supply of oil increased by 520,000 pdb in July compared to the month previous…"

In July, OPEC including Libya, Nigeria and Equatorial Guinea, produced 33m bpd suggesting a low compliance rate. The supply of oil increased by 520,000 pdb in July compared to the month previous, whilst production outside the cartel is anticipated to expand by 700,000 pdb in 2017. After the recent OPEC meeting, the cartel remain adamant that countries are committed to the recent production cut despite the month of July producing the most this year.

The EIA 12-month average ratio of crude oil world demand vs supply reached 0.999 in June, the highest level since January 2014 when it hit 0.997, suggesting demand is increasing against supply. OPEC expects global oil demand to grow 1.27m bpd in 2017 to average 96.4m bpd, with the organisation projecting a further growth in 2018 of 1.26bpd to average of 97.6m bpd.

"…fear of drought in the US sent underlying prices for corn, soybeans and wheat into overdrive…"

The agricultural index had a bad start to the year, down 9.2% year-to-date from 54 to 49 to June 26th, when the fear of drought in the US sent underlying prices for corn, soybeans and wheat into overdrive prompting the sub-index to take back all the year's losses and touch a high of 54.8. The weather in the US has returned to more normal condition thus causing the index to sell off once more, now down 10.39% year-to-date.

Volatility subdued despite rise in ETF flows

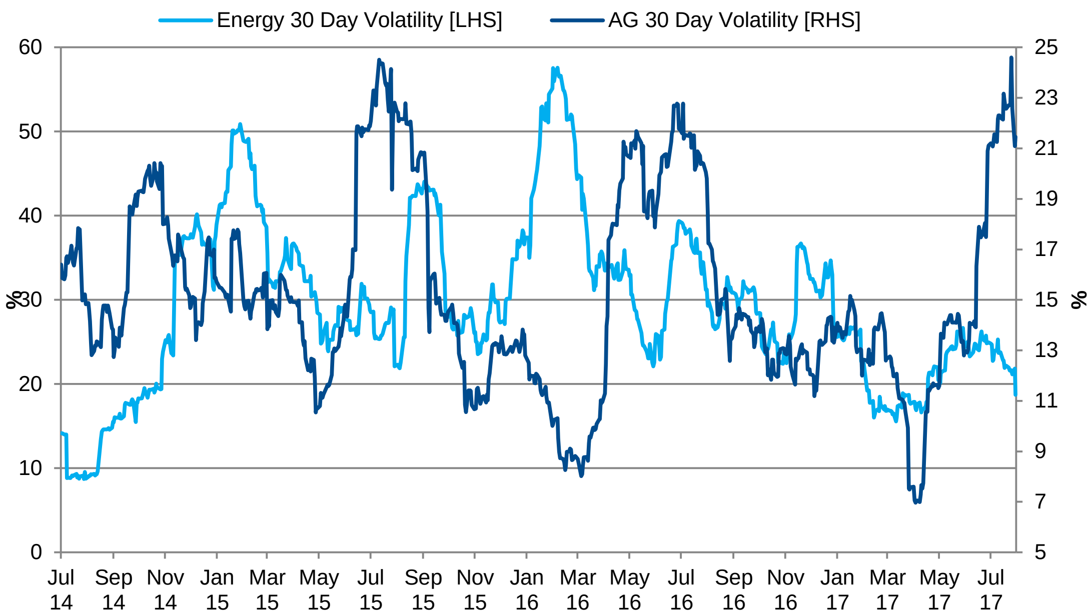
The 30 day volatility for the BCOM index has been subdued; this is attributed to prices remaining under pressure The 30 day volatility peaked in January at 15.56, what followed was months of falling volatility as prices tracked lower. Since April volatility has increased in the commodities space and the 30 day rolling volatility stands at 9.8 as of the week ending 18th of August, low in comparison to previous years, the 5 year average is 12.20.

Typically, volatility for the agriculture sub-index increases during the summer months as prices become increasingly sensitive to weather risk. Crops have different production cycles around the world but volatility increases during the growing season as production estimates can be impacted due to adverse weather and deteriorating growing conditions. The recent surge in volatility has prompted the highest level since summer 2015 when volatility peaked at 24.50, as of the 7th of August the 30 day rate was fractionally below last summer's peak of 22.77 at 22.60.

"…we may see further spikes higher as weather risk affects conditions and crop quality."

Fears of drought in the US prompted the surge in volatility as corn, wheat and soybeans prices took off causing speculators to bet on declining crop quality and higher prices. Whilst the growing and harvest seasons continue, we may see further spikes higher as weather risk affects conditions and crop quality. However, as we move through the harvest towards year end we anticipate volatility to retreat back towards the 5yr average of 14.83.

BCOM Energy 30 Day Volatility vs BCOM Ag 30 Day Volatility: *Weather risk keeps volatility for agriculture elevated.*



Source: Bloomberg

The excess supply in the oil market has caused volatility in the sector to fall sharply. The end of March saw volatility hit the lowest point since Q4 2014 at 15.48. Since then we have seen the index continue to weaken, however the 30 day rolling volatility has mean reverted back towards the 5 year average of 24.40. We believe low volatility will continue if compliance with the production cut remains low.

The agreed OPEC production cut tasked with re-balancing the market is expected to come to close at the end of Q1 2018. The disconnect between OPEC and Non-OPEC members cannot be misconstrued and continued production growth in Non-OPEC and exempt countries is expected to moderate the speed of inventory draws in 2017. Libyan production rose to an average of 1m bpd, 600,000bpd short of what they produced pre-civil war.

"…biggest fall in stocks this quarter with crude and other liquids projected to fall an average of 430,000bpd."

The EIA forecasts the biggest fall in stocks this quarter with crude and other liquids projected to fall an average of 430,000bpd. In Q2 global inventories fell by 500,000 barrels a day to just over 3bn barrels. Drawdowns outside of the seasonal norm, assuming cooperation with the production cut, may prompt volatility to surpass the 5 year average and head towards 30, acting as a tailwind for prices towards the top end of the recent consolidation channel.

Volatility for the industrial metals has declined since reaching a high last year of 24.62. The index pulled back to reaffirm support at 108 before surging higher to test 120 with 30 day volatility hitting a low for the year at 9.76 on the 25th of July well below the yearly average of 16.14. As copper and nickel took off, responding to supply side factors, volatility bounced back to 15. Supply unrest in Freeport's Grasberg mine prompted copper to spike higher to $6,400/tonne; if unrest continues we expect a more volatile environment.

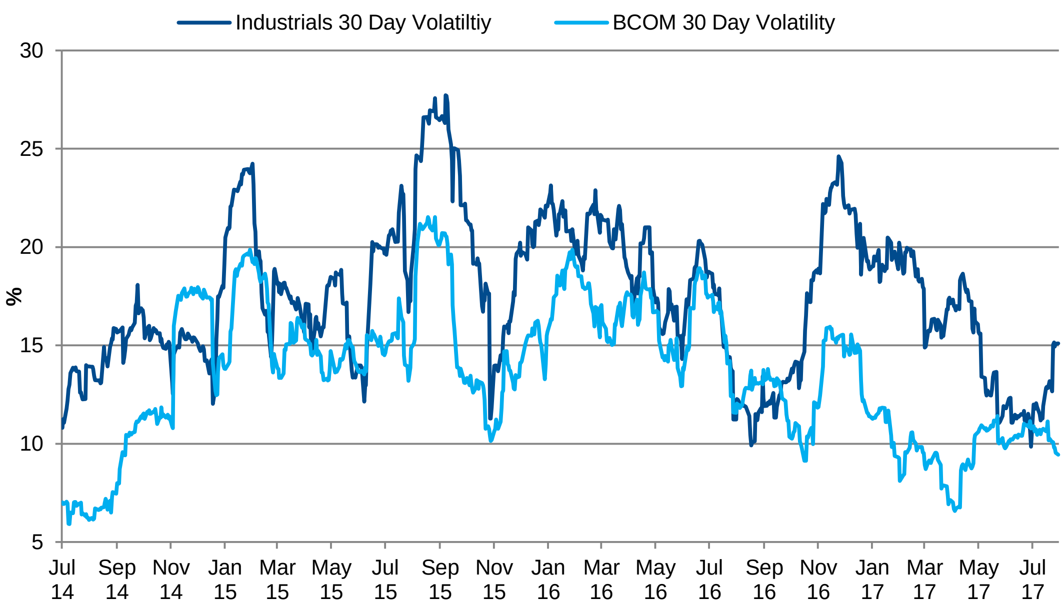
"...**China are considering banning imports of certain grades of copper scrap prompted the impulsive rally, adding over 8%...**"

Recent developments in the copper market have prompted a fresh rally in prices with three month LME copper prices spiking towards $6,500/tonne. Aside from the ongoing industrial action, which we believe the market has already factored in, the announcement at the end of July that China are considering banning imports of certain grades of copper scrap prompted the impulsive rally, adding over 8%, adding $500/tonne since the 24th of July.

The correlation between the industrial metals index and Bloomberg's energy sub-index peaked at 0.37on the 15th of August, suggesting a moderately positive relationship. The relationship has since weakened to 0.22 as of the 18th of August. Accordingly, gains in the energy sector could help support prices for industrials through the second half of the year. We would need the correlation to be > +0.5, implying a strong positive relationship to add more clarity.

2017 promised to be a tough year for precious metals with the US Federal Reserve pledging 3 rate hikes as they tighten monetary policy. Thus far, two of these hikes have been achieved acting as strong headwinds to precious metals. However, the precious metals index is up 8.6% year-to-date at 172 with a year-to-date high of 178.82 achieved in April on heightened event risk.

BCOM Industrial Metals 30 Day Volatility vs BCOM 30 Day Volatility: Industrial metals *volatility is subdued despite strength in underlying prices.*



Source: Bloomberg

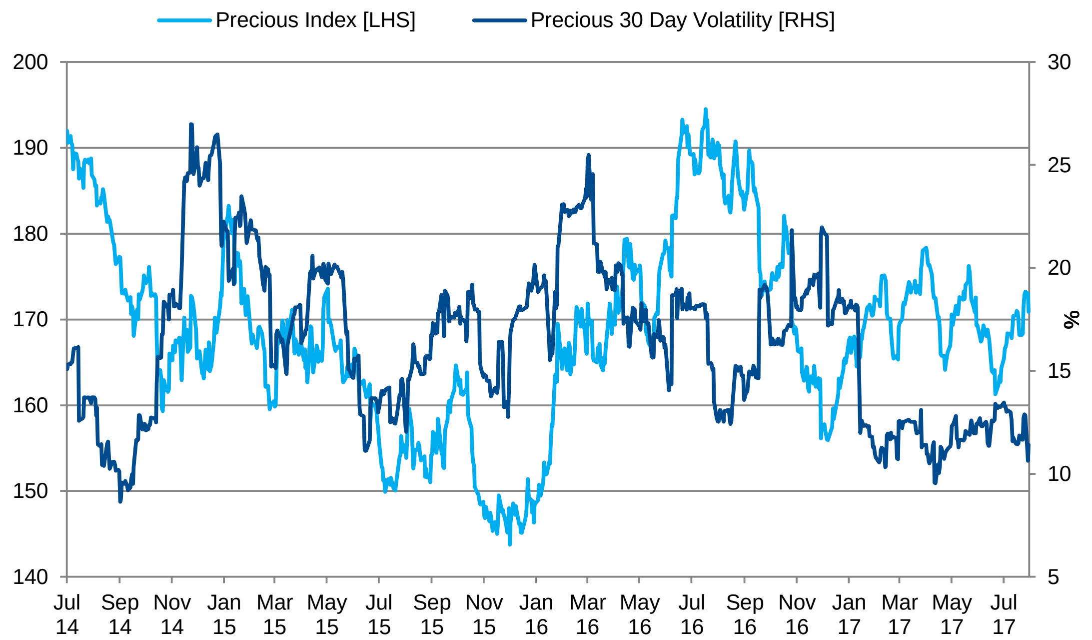
We view waning election risk in Europe, and dissipating geopolitical risks, lessening inflationary pressure and a broader based cyclical global economic recovery as stronger

"Reduced appetite for safe havens may prompt the index to pull back towards 165…"

headwinds for gold prices throughout the remainder of H2. Reduced appetite for safe havens may prompt the index to pull back towards 165, however, as recent events between North Korea and the US have proven, spot prices could be exposed to exaggerated spikes in the near term although we do not expect these impulsive moves to persist in the long run. World Gold Council data shows H1 2017 gold demand falling 14% to 2,003 tonnes compared to the same period last year. ETFs and similar products fell to 56 tonnes in Q2 2017 from 237.4 tonnes the year before.

Volatility for precious metals has been subdued in 2017 with the year to date average of 12.79 below last year's average of 18.07. The 30 day volatility picked up in recent weeks to 13.47but has since fallen back to 11.70. As expected Janet Yellen did not increase interest rates during the July meeting however the Federal Reserve did mention they are prepared to pare back its balance sheet as soon as September. We anticipate notable headwinds for precious metals in the coming months as the global economy looks to broaden its recovery and the FED continue on their tightening path causing prices to drift back to $1,200/oz.

BCOM Precious Metals Index vs Precious Metals 30 Day Volatility: ***An improving macroeconomic outlook has weakened haven demand, despite geo-political spikes.***



Source: Bloomberg

Dollar weakness has helped support commodities in recent weeks but prior to this, the BCOM and DXY indices were moving in tandem. Flows into the greenback throughout the past 3-4 years have been significant but as the economic outlook for Europe improves we could see more flows into the EU. Further disappointment from President Trump in regards to his legislative promises could prompt more weakness from the dollar and help support commodities. Volatility for the dollar index has been on a downward spiral since the beginning of the year falling from 8.62 in January to a low of 4.96 in June.

"Industrial metal's year to date flow is up 15.8% which equates to a net fund flow of $294.3…"

ETF flows for the commodity sectors analysed above have been strong this year, unsurprisingly precious metals leads the way with year to date net flow of $4.8bbn. As a sector, agriculture has seen an increase of 10% in flows year to date which amounts to total net flow of $252.3m, compared to the 1 year net flow of $186.4m. Industrial metal's year to date flow is up 15.8% which equates to a net fund flow of $294.3 compared to the one year net flow of $359.6M.

The commodity sector as a whole has seen net flow up $7.02bn on the previous year which corresponds to +3.8% asset flows, indicating that investor confidence in commodities is slowly returning.

Year-to-date fund flows into commodity ETFs have improved to $40.64bn

Commodity Sector	1 week net flow ($)	YTD net flow ($)	1 year net flow ($)
Commodities as a whole	274,641,729.20	7,025,893,659.16	-2,910,953,870.79
Precious Metals	503,143,255.20	5,052,081,106.10	-686,145,768.00
Industrial Metals	44,153,897	294,322,868.10	359,635,249
Agriculture	-4,026,377	251,260,646.30	165,944,540
Energy	-281,427,956	1,135,405,099.56	-2,863,902,480.99

Source: Bloomberg

Strategic outlook

Looking ahead at the remaining months of the year the heightened volatility in the base metals space in particular could present investors with some dynamic trading opportunities. Speculation that Chinese authorities may ban the import of scrap copper that fails to meet a certain standard propelled the LME price towards $6,500/tonne since the tail end of July.

Prices have pared some of these heady gains on profit taking with three month LME prices looking to settle back between $6,300-350/tonne at the time of writing. Near term caution should be exercised as the recent rally will likely prompt an influx of scrap into the market and after a period of consolidation, with participants testing appetite for prices back towards $6,100 and possibly $6,000/tonne we expect the bullish run to continue on the back of solid macroeconomic indicators.

"…we expect the bullish run to continue on the back of solid macroeconomic indicators."

Chinese economic data has impressed in recent months as GDP growth in the second quarter came in at 6.9% y/y and industrial production, manufacturing PMI data and crucially fixed asset investment growth continue to beat estimates. Accordingly we project a positive outlook for copper prices for the rest of 2017, albeit after a period of near term profit taking.

Fund positioning on the LME has hit levels seen during the February spike towards $6,200/tonne with 72,563 net long contracts. COMEX managed money net positions bolster the current bullish outlook with net speculative length surpassing the February peak and rising to the highest level on record at 104,000 net longs.

"…significant long exposure among the fund community does leave three month prices prone to heightened volatility…"

The significant long exposure among the fund community does leave three month prices prone to heightened volatility and as money manager reduce exposure it could leave copper prices exposed to significant downside risks in the short term. However, any short term aggressive moves lower could provide an attractive entry point to re-establish long positions.

Fundamentally, the demand outlook remains robust if not exciting, but a tightening market on supply constraints owing to industrial action and a greater than anticipated shortfall in concentrates production will provide a consistent tailwind throughout the rest of Q3 and into Q4.

Indeed, the base metals complex decoupling as fundamentals continue to expend greater influence on market prices and aside from copper, which we have singled out as one metal that will likely offer up substantial volatility throughout the remainder of H2 2017, we see aluminium market dynamics presenting similar trading opportunities.

Chinese authorities continue to reinforce the promise to shut smelting capacity that does not conform to stricter environmental standards. The latest developments at the start of the month from the Ministry of Industry and Information Technology in China have sought to curtail alumina and aluminium capacity in Shandong, looking to move capacity away from coastal regions in a bid to curb pollution. The news was enough to see three month LME aluminium prices breakout of the sideways range that has dominated activity since the start of the year, rising impulsively above $2,000/tonne and attempted to test $2,050/tonne.

While the news of capacity closures is broadly seen as a positive step in addressing supply/demand story bringing the market closer to balance, looking at the capacity pipeline investors should be wary of any reversion towards the year-to-date average, sitting just under $1,900/tonne. The Chinese authorities are taking away illegal and unauthorised capacity that doesn't meet environmental standards with one hand, but are still pushing ahead with significant integrated capacity expansions with the other.

…we anticipate aluminium prices will remain volatile for the remainder of the year…

Owing to this, we anticipate aluminium prices will remain volatile for the remainder of the year as supply concerns remain a present threat. The demand outlook for aluminium, predominantly from the automotive, power generation and consumer goods sectors, sets the light metal apart as one among the base metals complex that has a promising near term outlook. However, concerns over China's commitment to shutter capacity which have in the past been largely empty rhetoric could see a sea change among the fund community.

Indeed in recent weeks we have seen the net spec length among money managers pull back, with net longs declining 8% since the 25th of July to 133,452contracts as participants are cautious to the recent spike. To put this in some wider context, money managers were net long approximately 204,000 contracts in April where the bullish mood for the year peaked after prices failed to push past $1,970/tonne.

For the remainder of H2 2017 we expect prices to pull back in a similar fashion to copper, on short term profit taking and as short positions build momentum. Uncertainty surrounding Chinese capacity cutbacks will provide the backdrop of heightened volatility but on the whole an encouraging demand outlook will present sustained upward momentum.

Turning to gold, recent flaring geopolitical tensions have seen spot prices extend gains back towards $1,290/oz, a level last reaching in early June. While tensions between the US and North Korea has risen in recent weeks, spurring a rally from $1,250/oz as the precious metal gained 2.7% in three days, we believe cooler heads will eventually prevail. We view the double top at $1,296.15/oz as a significant technical obstacle to any further price appreciation which could trigger a sharp reversal, provided the nuclear threat from Pyongyang does not escalate further.

Risk assets have come under increased pressure in recent sessions and while this has supported safe haven assets, we feel attention has switched away from the expectation of rising interest rates and improving global macroeconomic indicators. Accordingly, we believe these recent moves higher are transitory in nature and expect prices to turn lower on any positive outcome, averaging $1,250/oz for the final quarter of the year.

Softs on the back foot

"The large net short position could trigger price spikes especially if crops are downgraded "

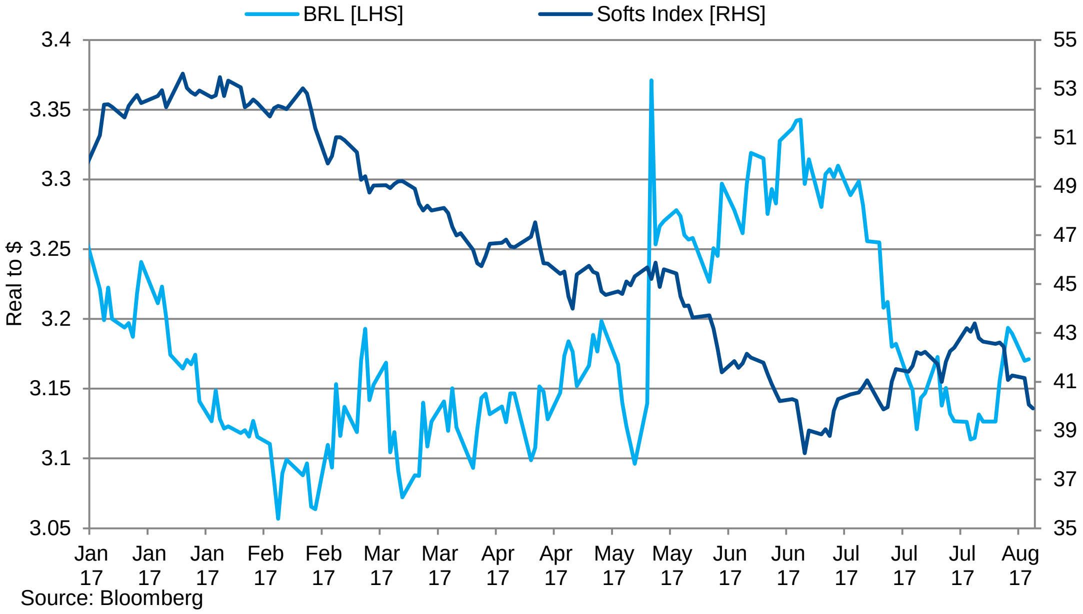
Whist not ignoring the soft commodity basket, we believe the outlook is less attractive for these assets. The net short position across sugar, coffee and cocoa could provide some upside pressure to these commodities. The large net short position may trigger exaggerated price spikes especially if crops are downgraded.

The lack of bullish fundamental news has seen the total net short for non-index funds and speculators was 121,826 as of the close last Tuesday. The Indian Government recently increased their import tariff to 50% in an attempt to keep domestic prices elevated. Another tight fundamental situation could put further pressure on the government to import sugar but government remain adamant on no 0% tariff imports. Ultimately, stocks will be the determining factor.

"The early crush was spurred by dry weather however this could have implications to cane yields further down the line."

Unica reported that strong sugar output in CS Brazil, responsible for 90% of Brazilian production at 3.41m tonnes in the second half of July up 9.5% year on year which could keep a cap on prices. The early crush was spurred by dry weather however this could have implications to cane yields further down the line.

Brazilian Real vs BCOM Softs Index: ***The negative correlation has weakened in recent months.***



Source: Bloomberg

"…the ICCO accordingly forecast 1.7m tonnes for this crop year which is a year on year change of +27.3%. "

The cocoa market has consolidated after hitting the multi-year low at $1,769/tonne. Net spec short positions stood at -37,738 contracts to the week ending 18th August. The asset fails to build any sort of momentum on the upside. Due to stronger than expected crop yields in the Ivory Coast and Ghana we anticipate high year ending stock levels, the ICCO accordingly forecast 1.7m tonnes for this crop year which is a year on year change of +27.3%.

We remain sceptical over next year's crop as low prices may prompt farmers to switch to more profitable crops. Grindings have improved in recent months, signalling a response to the weak price activity. European grindings were up year on year in Q2 to 331,850 tonnes while Asia continued to post strong gains with year-on-year growth of 9.92% to 160,878 tonnes in the same period.

This signals a response to the strong combined cocoa ratio which will help organisations exploit the widened margin however demand improvements is unlikely to offset the supply side growth. A tighter supply outlook in the coming year could see cocoa prices for the New York contract push back towards $2,300/tonne.

Coffee performed well to the week ending the 11th of August as the 2nd month contracts bounced higher to test resistance at 147USd/lb. The coffee market has moved according to currency fluctuations, the dollar weakness underpinned the move towards 150USd/lb however as the Real has weakened against the dollar in recent weeks, coffee has pulled back from the recent high of 147.25USd/lb.

The recent short covering undertaken by investors has seen the CFTC commitment of traders for the week ending 11th of August net spec length at -4,560 lots for ICE coffee with the commercial position at -30,478 lots. Fundamentally, the outlook for the 2017/18 season suggests that production will remain flat around 159m bags with consumption improving to a record 157.6m bags, according to the USDA.

There are threats to the outlook as heavy weather in Vietnam causes issue and contributes to feelings of tight a Robusta crop. These concerns are heightened due to already low stock levels and which could keep the London contract supported towards $2,200/tonne.

In-conjunction with these fears in Vietnam, the outbreak of borer beetle could put severe pressure on Brazilian coffee production thus tightening the fundamental outlook for next year. The outlook has already been clouded by the prospects of lower quality coffee with reports of beans being rejected by buyers.

Farmers are holding back coffee in anticipation of more competitive prices which caused the lowest volume of coffee exports from Brazil in a decade last month at 1.6m bags. Through the first 9months of this coffee year exports have reached 87.4m bags, 4.9m bags higher than last year.

"…that exports on the year have been raised by 2m bags to 110.7m bags…"

The USDA suggest that exports on the year have been raised by 2m bags to 110.7m bags, with Vietnam drawing on inventories to export 25m bags, last month they exported 106,000 tonnes. Recent reports suggest that Vietnamese growers are 96% sold on their 2016/17 crop meaning that most of Vietnam's stocks are held by companies.

"…coffee forward curve is steepest 12months out with next September 2018 at 145USd/lb +10.50% on the current price. "

The coffee forward curve is steepest 12months out with next September 2018 at 145USd/lb +10.50% on the current price. Accordingly, it is our opinion that there is some upside to prices in the coming months if the lower quality beans in Brazil due to the infestation of borer beetles along with early rains in the regions of Parana and Sau Paulo with a risk of these rains moving north causing premature flowering. Owing to this and foreign exchange fluctuations, a deferred position further down the curve may be preferential.

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