October 2015 Investment Publications Highlights

A Commodity Conundrum

James W. Paulsen, *Economic and Market Perspective*, Wells Fargo Asset Management, August 25, 2015

A Leadership Change?

James W. Paulsen, *Economic and Market Perspective*, Wells Fargo Asset Management, September 17, 2015

Fears of an impending global recession have increased due in part to a collapse in commodity prices. But recent history suggests that economic growth tends to accelerate once a sell-off in commodity prices ends. The author believes that commodity prices are close to finding a bottom and will likely soon embark on a multi-year advance, continuing the global recovery.

In the last 40 years, commodity prices declined during three of the last four economic recoveries (i.e., late 1970s, 1980s, and 1990s recoveries), and in each case, economic growth continued well after the trough in commodity prices. For example, the S&P GSCI™ Spot Commodity Price Index bottomed in July 1977, but the economy continued to grow until January 1980. Even though global financial markets face several vulnerabilities, the author believes a relatively healthy US economy, combined with stimulative central bank policies around the globe, should help economic growth bounce back once commodity prices bottom.

The author suggests that when commodity prices begin to rebound the economy could experience a shift in pricing power from consumers to producers. A pricing power shift typically occurs when commodity prices rise or fall and is often associated with a change in the relative performance of domestic versus international stock market returns. The author notes that international markets tend to outperform US markets during periods of strong producer prices, as the relatively large number of consumers in the United States becomes price-takers. If commodity prices begin to accelerate and pricing power shifts from consumer- to producer-oriented companies, then investors may want to consider increasing industrial sector and foreign market allocations. In any event, the author believes that once commodity markets finally bottom, US economic growth will be supportive of markets.

After the Super-Cycle

Kevin Norrish, *Commodity Markets Outlook*, Barclays, September 22, 2015

The commodity price decline in the third quarter has fueled debate over when the commodity super-cycle will end. The author believes its end may have already passed, arguing that prices of key commodities are unlikely to fall significantly further, though sluggish global demand growth is likely to cap any price advances.

The author suggests the commodity super-cycle ended in late August 2015, after the broad-based Bloomberg Commodity Excess Return Index closed below a level not reached since before the super-cycle began. The level reached in August, a

17-year low, followed a multi-year drawdown in the index that was due in large part to China's growth slowing, global supplies of commodities increasing, and unfavorable currency changes. Prices are likely to remain low into at least second quarter 2016 due to listless demand growth and a fight for market share among producers of certain commodities.

Looking closely at oil, the author believes the market needs several more quarters at current price levels to winnow out suppliers. While prices aren't likely to rise much in the next months, they're also not likely to fall much. Suppliers currently are not incented to increase production substantially, and although demand growth could deteriorate, causing prices to fall, the risk of such an event seems limited. While unlikely, if prices were to fall by $15–$20/barrel, suppliers would be forced to cut capital expenditures even further, reducing supply and pushing prices back up.

Unlike oil, the outlook for copper is far more dependent on China, as it consumes nearly half of the world's supply. Concerns about China's growth rate drove copper to its lowest price in six years in August; however, producers have not flooded the market with excess supply in an effort to maintain market share. In fact, multiple global producers have looked to close copper mines or sell them to domestic entities in recent months. Going forward, the author believes oil and copper prices could be important indicators for evaluating global growth.

The Case for Long-Short Commodity Investing

Joëlle Miffre and Adrian Fernandez-Perez, *Journal of Alternative Investments*, vol. 18, no. 1, (Summer 2015): 92–104

The authors compare the benefits that accrue to a traditional investor from an investment in a long-short (LS) commodity portfolio relative to a long-only (LO) commodity portfolio. Based on performance, volatility, and correlation metrics, they find that LS commodity strategies are superior to LO in times of both market calm and market stress.

To test the claim that LS commodity strategies are superior, the authors developed multiple LS portfolios based on different time horizons and momentum, term structure, and market net long/short indicators. The various LS portfolios were compared against an equally weighted LO commodity portfolio and the S&P GSCI™. The authors found that all of the individual LS portfolios had better risk-adjusted returns than their LO benchmarks, even after accounting for transaction costs.

In addition to better performance metrics, LS portfolios generally have a lower conditional volatility than that of LO, suggesting LS strategies may be able to reduce the risk in an overall portfolio. During times of equity market turmoil, the volatilities of LO portfolios were not just a little larger than LS portfolios—they increased seven times more than LS. As the authors note, the shorts in LS strategies helped dampen volatility during periods of turmoil.

Equally important to the reduction in volatility, according to the authors, is the difference in conditional correlations between the commodity strategies and broad equity markets. LS portfolios have a substantially lower correlation to the S&P 500 Index than LO portfolios, meaning LS strategies may be better positioned to diversify investor portfolios. Even after the Lehman Brothers debacle in 2008—which saw the average correlation of LO commodity strategies and the S&P 500 Index increase—correlations between LS strategies and equity markets remained low and close to historical averages.

The authors believe that because their LS portfolios had better risk-adjusted returns, lower volatilities, and were less correlated to equity markets than their LO portfolios, managers that can exploit LS commodity strategies are likely to be superior to their LO peers. ■

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