December 2016
Investment Publications Highlights

Conquering Misconceptions about Commodity Futures Investing

Claude B. Erb and Campbell R. Harvey, *Financial Analysts Journal*, vol 72, no 4 (July/August 2016): 26–35

The authors review three common misconceptions many investors hold about long-only commodity futures. Overcoming these misconceptions—namely that commodities are a play on commodity prices, commodities provide an inflation hedge, and commodity markets can absorb abundant capital—may help investors make better decisions.

Regarding the first misconception, the authors analyze correlations between rolling ten-year spot price returns, income returns (the collateral and roll return), and total returns of the S&P GSCI™, as well as the inflation rate from January 1970 to June 2015. They find that spot price returns have a weak or negative relationship with total returns (-0.07) and income returns (-0.73), and income returns have a positive relationship with total returns (0.73). To emphasize the dominating effect of income returns on total returns, the authors review the impact of knowing the ten-year spot price or income returns in advance. Regression results show that perfect forecasts of spot price and income returns explain 0% and 54% of total return variability, respectively, suggesting that commodities are not a play on commodity prices.

Using the same analysis, the authors look for evidence that commodities hedge inflation. Their results show that S&P GSCI™ price returns (-0.26) are negatively correlated with realized inflation and that both income returns (0.55) and total returns (0.55) are positively correlated with realized inflation. Many investors expect commodity price returns to be the driver of a positive correlation between commodity total returns and inflation, but the muted link between price returns and inflation suggests otherwise. The authors note, though, that inflation measures are flawed and may not capture the true covariation of commodity returns with inflation.

Finally, although many investors consider commodities as a way to diversify portfolios, the authors argue it would be difficult for all investors to have a meaningful allocation. They emphasize that commodities account for only 0.22% (approximately $240 billion) of the total value of global stocks, bonds, and commodity investments as of October 2015, according to the Bloomberg Barclays Multiverse Index. Thus, if investors collectively want to allocate 5% or 10% to commodities, it may not be possible.

Inflation-Protecting Asset Allocation: A Downside Risk Analysis

Tim Koniarski and Steffen Sebastian, *The Journal of Portfolio Management*, vol 41, no 2 (Winter 2015): 57–70

Following years of expansionary monetary policies, the danger of high inflation exists. To help investors preserve the real value of investments, the authors analyze the inflation protection properties of cash, bonds, equities, and real estate, finding that real estate is the best hedge over medium- and long-term horizons.

The authors examine correlations of the four assets—proxied by the 90-day Treasury bill rate, the Ibbotson US Long-Term Government Bond Index, the S&P 500 Index, and the NCREIF Property Index—to inflation, relying on data from 1978 through 2010. The analysis reveals that although cash has the highest correlation with inflation over all time horizons, the loss protection of asset classes varies substantially over time. In the short run of zero to five years, cash is the best inflation hedge. But over the medium and long term, real estate outperforms the other asset options. When focused just on bonds and equities, bonds are a better inflation protector in the medium term, and equities are better in the long run.

Correlation alone can be misleading; an asset could be highly correlated with inflation but consistently return less than the inflation rate. To complement the correlation analysis, the authors measure the risk of returns for these assets falling below the inflation rate. For the probability of shortfall, cash is the worst inflation hedge when looking at periods longer than one year. For investment periods of ten years or longer, real estate provides the best downside inflation protection.

Finally, the authors look at the best portfolio of assets to hedge against inflation risks. For one- and two-year horizons, the portfolio least likely to fall below the inflation rate is cash. For five-year horizons, the optimal inflation-protecting portfolio holds 95% cash, 3% real estate, and 2% bonds. When looking at longer periods for investors requiring returns above the inflation rate, riskier assets tend to outperform. Once the horizon increases to ten years, the asset allocation to real estate jumps to 47%, with 28% in cash, 15% in equities, and 10% in bonds.

Reflation Overcomes Initial Market Concerns Post Election

Peter Oppenheimer et al., Goldman Sachs Portfolio Strategy Research, November 9, 2016

The authors believe the initial market reaction to the US election results suggests reflationary pressures will continue to strengthen in the near term.

Looking back, the bond market sell-off in July may have been the first signal of reflationary repricing. The sell-off was joined by a rotation from defensive to cyclical sectors and from growth to value strategies, further supporting reflationary pressures in the market. In addition, October global manufacturing data hinted at a pickup in global growth prior to the election.

Although the initial market reaction to the US election results was negative, investors later poured back into risk assets, and by intraday they had generally recovered. The initial sell-off was likely due to the unexpected outcome and the uncertainty surrounding many of President-elect Donald Trump's economic policies. But the subsequent rebound highlights the positive market sentiment linked to the single-party control of the executive and legislative

branches. This reality may increase the likelihood that inflationary legislative initiatives are passed.

In terms of fiscal policy, a US fiscal stimulus (in the form of lower taxes and/or spending on infrastructure, for example) would likely provide a boost to growth in 2017. The election results also had implications for monetary policy. The probability of a Fed rate hike in December remained high post-election, and speculation about a more hawkish Fed chairman replacing Yellen once her term ends in February 2018 has already begun to surface. The immediate impact of the election results on reflation repricing flowed through to bond markets. Yields continued their initial July rise following the election, especially on the long end of the spectrum. The authors expect the sell-off in bonds has more room to run, as the markets absorb details of the administration's fiscal policies.

Overall, near-term policies are likely to reinforce reflationary trends that began in July. Clearly, the uncertainty surrounding trade policy is a potential risk to this expectation. But, the authors believe the incoming government's policies have the potential to strengthen some of the reflationary rotations that began during the summer, at least for the near term. ■

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