Asset Class Investment Strategies

Commodities

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

We retain a 0% tactical allocation to the broad commodities index, consistent with our strategic allocation. We consider gold separately to other commodities and maintain a recommended allocation of +2%.

Partners Capital has recommended a zero allocation to commodities since 2014 as commodities were not expected to improve the risk-adjusted return of portfolios. To date, this has been a highly accretive decision. In our ENEB risk budgeting framework, commodities have underperformed their 0.5x equity risk budget by -8.6% per year over the 5-years to 31 December 2020, with the broad commodity index declining by -2.8% per annum while world equity markets have risen +11.6% per annum.

After such a protracted period of underperformance, commodity prices do appear cheap relative to equities. However, the relative valuations appear justified. The oil market is still working from a position of elevated inventory, so recovering demand on a vaccine deployment would need to moderate these inventory levels before suggesting brighter prospects for oil prices. Industrial commodity prices have risen sharply recently, supported by the prospect of higher fiscal spending in the US and strong demand growth in China. These themes are expected to support higher commodity prices in 2021, but we prefer more targeted investment alternatives which better exploit the opportunities created, rather than simply buying commodity futures, with all the esoteric risk and volatility they carry.

Commodities are typically thought of as an inflation hedge. However, empirical evidence for this relationship is weak. A study published in the Financial Analysts Journal found that of the 12 commodities traded continuously in the futures market between 1970 and 2010, only 3 had modest positive correlation to inflation at a 95% confidence level - heating oil, cattle and copper.[1] We prefer more dependable sources of inflation protection, including inflation-linked bonds, gold, real estate and certain equity sectors.

In short, we expect commodity prices to continue to move higher in 2021, driven by renewed global demand, higher global fiscal spending, an upswing in corporate capital expenditure and investment which culminates in rising inflation expectations. However, we continue to think that commodities are a blunt and volatile investment tool and favour alternative uses of capital.

Gold is the exception. We consider gold separately from commodities given its unique safety characteristics. We continue to recommend holding +2% to gold in 2021, funded from inflation-linked bonds. Investors face a wider than usual range of risks at a time when very low yields have increased the potential opportunity cost of holding bonds. Such an environment merits a more diversified mix of protection relative to the SAA benchmark, which has no gold allocation.

[1] Erb, Claude B. and Harvey, Campbell R., The Tactical and Strategic Value of Commodity Futures (revised 2010).

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Asset Class Definition

The commodities asset class covers a broad range of physical commodities including energy, agriculture and metals. Investment is typically achieved via futures contracts or exchange-traded funds (ETFs). Depending on the underlying commodity, ETFs may achieve exposure through physical ownership, futures or swaps. The total return for investors is therefore typically derived from any change in the spot price plus the roll yield (reflecting the cost/benefit of buying futures contracts relative to the spot price) and any collateral yield (typically US Treasuries which are used as collateral for the futures contracts). Ownership of the physical underlying asset is more common for long-life commodities such as precious metals, and the total return must include the ongoing cost of storage and insurance.

Role in Portfolio

The perceived role of commodities in an investment portfolio is to provide diversification and a hedge against inflation. However, broad commodities provide neither with any reliability, and investors may at times muddle correlation and causation. For example, higher oil prices may cause higher inflation, but higher inflation does not necessarily cause a higher oil price, particularly if new supply is used to meet growing demand. As such, we continue to prefer more dependable sources of inflation protection, including inflation-linked bonds, gold, real estate and certain equity sectors.

Commodities also tend to be a blunt tool for playing specific themes. For example, as of October 2020, China made up 60% of global demand for refined copper. As such, the price of copper is very sensitive to Chinese stimulus and economic conditions. Whilst we are constructive on Chinese growth prospects, we would rather obtain exposure to China through equities where we can invest via active managers to make targeted, income generating investments focused on attractive subsets of the Chinese economy, rather than take a broad bet on the overall Chinese economy via copper futures.

Active management in commodities has also proven particularly challenging. Consistently predicting the price swings of volatile commodity markets is inherently very difficult and, in our experience, very few commodity managers have been able to produce a consistent level of alpha that is high enough to merit the risks. Advances in data science and quant trading strategies may improve the scope for alpha in commodity focused funds in the future, but for now there is insufficient data to support this thesis.

Golden Rules

Our investment philosophy incorporates the following beliefs regarding commodity investments:

1. Commodities do not provide an income stream and thus there is no long-term risk premium to be harvested or fundamental anchor to valuation beyond demand and supply.
2. Both supply and demand are prone to unpredictable exogenous shocks from politics, weather, natural disasters and technological disruption. This makes fundamental research particularly difficult.
3. Commodity markets are highly efficient. Profiting from commodity price movements requires having a differentiated view from the broad market.
4. These above factors mean that it is exceptionally difficult to generate alpha from trading commodities. This is borne out by the lack of any persistent alpha from active commodities managers.
5. Too much emphasis has been placed on the role of commodities as a source of portfolio diversification. While diversification benefits appear minimal at best, the key issue is that without a long-term risk premium, there is little economic justification for a structural investment in commodities.

Market Overview

Exhibit 1

Only the energy sub-component suffered a price decline in 2020

Asset Class	2016	2017	2018	2019	2020	CAGR
S&P GSCI Total Return	11.4%	5.8%	-13.8%	17.6%	-23.7%	-1.9%
Energy	18.1%	6.4%	-17.1%	29.7%	-46.3%	-6.2%
Agriculture	-4.2%	-11.9%	-8.0%	-0.3%	14.9%	-2.3%
Industrial Metals	17.6%	29.1%	-18.0%	2.6%	14.8%	7.9%
Precious Metals	8.4%	12.0%	-3.6%	17.6%	23.0%	11.1%
MSCI ACWI	7.9%	24.0%	-9.4%	26.6%	16.3%	12.3%

Source: *Bloomberg*

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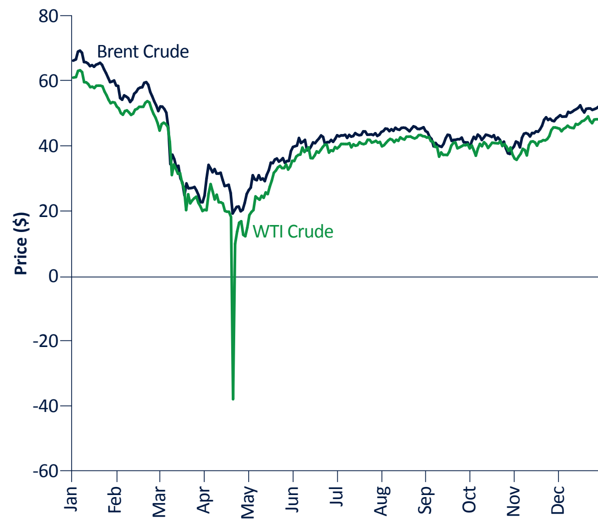
Energy: The GSCI Energy Index declined -46.3% in 2020 as the COVID-19 pandemic triggered an unprecedented drop in oil demand. In April, a price war between Saudi Arabia and Russia compounded the oversupply, and holders of large futures contracts found themselves in a scramble to exit as storage facilities stopped taking delivery. Positive vaccine news, OPEC production cuts and large fiscal stimulus packages have seen oil recover, but only as of February 2021 is oil approaching its pre-COVID levels (Exhibit 2).

Exhibit 2

The price of WTI futures dropped to negative $37 per barrel in April 2020 as storage capacity ran out.



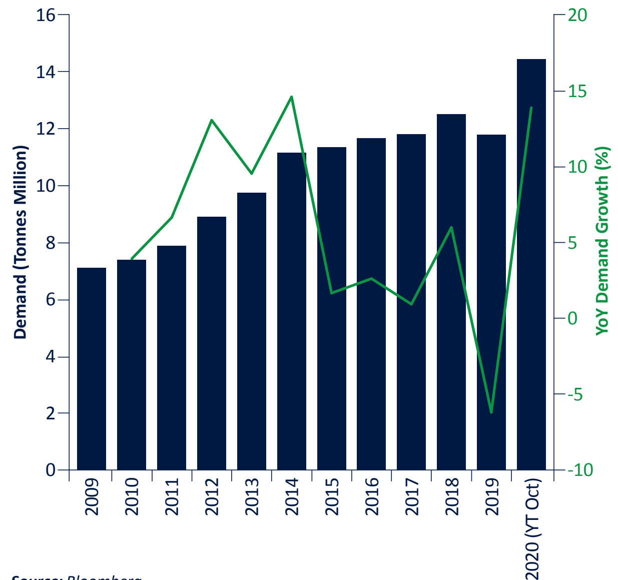
Source: *Bloomberg*

Precious Metals: The GSCI Precious Metals Index rose +23.0% in 2020 as investors sought safe-haven assets and a store of real value following unprecedented monetary and fiscal stimulus. The gold spot price rose +25.1% in 2020. Silver has more industrial uses than gold, so its price typically falls when global economic growth weakens but outperforms as stimulus drives improved growth outlooks. The price of silver fell to an 11-year low in March as industrial demand collapsed, but rebounded +144% to a recent high of $29/ounce in August, ending the year +47% higher.

Industrial Metals: The S&P GSCI Industrial Metals Index returned +14.8% in 2020. Industrial metal prices weakened in January as China, the world's largest consumer of industrial metals, went into lockdown. Renewed global fiscal stimulus and supply disruptions relating to industrial action in South American mines helped drive a rapid recovery in industrial metals prices in the second half of the year.

Exhibit 3

Despite lockdowns, China's copper demand increased by 15% year-on-year to October 2020



Source: *Bloomberg*

Agriculture: The S&P GSCI Agriculture Index returned +14.9% in 2020. Agricultural commodities are highly volatile as their supply is a function of variables such as weather and crop diseases. Corn prices fell with other assets in Q1 2020 and continued to decline until August as favourable weather conditions in the US set expectations for high crop yields. A sharp increase in demand from China triggered a 40% rally in the final five months of the year, with China's demand boosted by a recovery in the domestic hog herd (previously diminished by Asian Swine Fever) and speculation around tight inventories of Chinese grain.

Investment Strategy

Rather than speculate on the direction of commodity prices, we prefer to assess the merits of an allocation to commodities on the basis of portfolio theory. Put simply, we ask whether an allocation to commodities is more likely than not to improve the risk-adjusted return of an investment portfolio. However, we recognise that this is a weak argument for inclusion in a long-term portfolio relative to other risk assets which have a positive expected real return over time.

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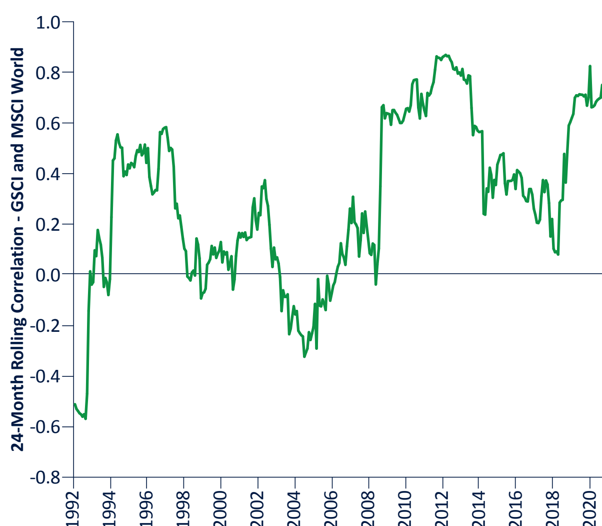
1. Diversification benefits of broad commodities as a strategic allocation are limited

During the commodities super-cycle of the late 1990s/early 2000s, equities and commodities were largely uncorrelated, making commodities an attractive diversifying asset for an investment portfolio. This no longer appears to be the case. In recent years, the correlation of commodities and equities has been elevated, particularly during periods of market stress, limiting the portfolio diversification benefits of a commodities allocation (Exhibit 4).

Exhibit 4

The correlation of commodities to global equities has risen during times of market stress



Source: *Bloomberg*

2. Futures markets have moved into backwardation, but this has been highly volatile

In an efficient market the cost of investing in commodities via futures contracts should be the same as buying the physical commodity and paying the related costs such as financing, transport, storage and insurance. However, supply and demand expectations mean that future prices may vary dramatically from these fundamentals. As shown in Exhibit 5 across the page, a number of important commodities are now in backwardation, resulting in positive roll yield.

For example, as of 31 January, the price of Brent Crude for delivery in 12-months' time was $52/barrel, below the 1-month future price of $56/barrel. Buying at a discount in the futures market is preferable, but is no guarantee of a positive return. If the market expectation is correct, the spot price will converge towards the future price and holding the future's contract will yield no return.

Exhibit 5

Roll yield is positive for Oil, Copper and Corn but negative for gold (as of 31 January 2021)

	Brent Crude	WTI	Gold	Copper	Corn
1 Month Future	$56	$52	$1,847	$7,863	$547
12 Month Future	$52	$49	$1,870	$7,797	$418
Roll Yield	6.7%	6.1%	-1.2%	0.8%	31.0%

Source: *Bloomberg*

Backwardation is also generally seen as supportive as it means traders no longer have an incentive to store oil to sell it at a later date. Backwardation should therefore prompt an inventory drawdown. As per Exhibit 6, the oil market is still working from a position of elevated inventory, so recovering demand on a vaccine deployment would need to moderate these inventory levels before suggesting brighter prospects for oil prices.

Exhibit 6

Oil storage capacity utilisation rates suggest large oil inventories were accumulated in 2020

Note: *MENA = Middle East and North Africa. Countries and regions as defined by URSA.*
Source: *URSA Space systems; and IMF staff calculations*

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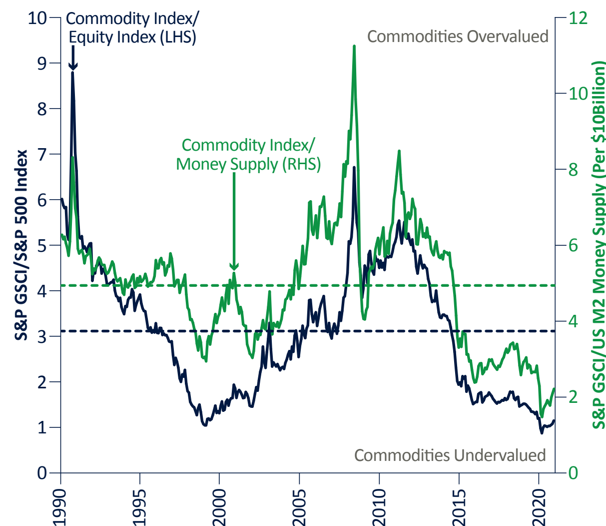
3. Relative valuations continue to look attractive, but have done so for the last 5 years

One approach to assess commodity valuations is to compare prices relative to other assets. Exhibit 7 below shows the ratio of the of the commodity index level to that of the S&P 500 index and to the level of M2 US money supply over time. Both measures have been close to record lows since 2015. Based on these relative measures, the price of the commodity index would need to increase by 2.6x for the price relative to equities to return to the long-term average, or by 2.2x for the price relative to the current US M2 money supply to return to its 30-year average.

Exhibit 7

Commodity prices are at record lows relative to equities or the US money supply



Source: *Bloomberg*

Much of this relative cheapness is justified by recent technological advances. For example, the fundamentals of the oil market have undergone a regime change as the discovery of shale oil dramatically increased supply and significantly reduced extraction costs. Hence, such relative measures are of little use from a timing standpoint.

Secular growth themes supporting long-term commodity demand

In addition to the above, we monitor secular themes that are likely to have a meaningful impact on commodity prices. One such example is the growing popularity of electric vehicles (EVs). EVs typically require three to four times more copper than internal combustion engine vehicles, and the batteries require cobalt, lithium and nickel.

By 2030, relative to 2015 levels, demand for cobalt and lithium is expected to increase by 37x and 18x respectively, driven by EV demand[2]. It is estimated that EV demand could lead to a shortage of lithium and nickel by 2025. This trend could be accelerated if, as suggested, the Biden administration subsidises EVs and starts to replace the government's fleet of cars and trucks (c. 645k vehicles) with EVs.

We do not yet have enough conviction in this investment idea, but it is an example of the type of opportunistic commodity investment that we may recommend in the near-term if the scenario analysis and modelling suggests a high probability of future return with an asymmetric return profile.

2021 Investment Strategy

We recommend clients hold an 'at weight' allocation to commodities relative to their SAA benchmark. For most clients this will mean maintaining a zero allocation to the asset class. For those clients seeking inflation protection, we continue to view a combination of inflation-linked bonds, gold, real estate and certain equity sub-sectors as a more efficient means of achieving this, with lower opportunity cost over the medium-term. For the few clients who maintain commodities in their SAA benchmark, a neutral outlook is best reflected by holding a broad diversified commodity tracker.

Gold is the exception to our agnostic stance on commodities allocations. We consider gold separately given its unique safety characteristics. We continue to recommend holding +2% to gold in 2021, funded from inflation-linked bonds. Investors face a wider than usual range of risks at a time when very low yields have increased the potential opportunity cost of holding bonds. Such an environment merits a more diversified mix of protection relative to the SAA benchmark, which has no gold allocation.

[2] The EV revolution: The road ahead for critical raw materials demand. Jones et al (December 2020)

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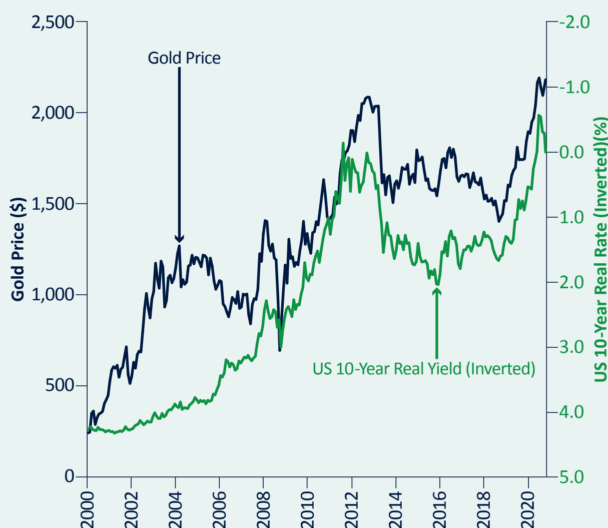
Gold as a portfolio hedging tool

Gold is materially different from other commodities and should really be considered as a separate asset class with its own unique investment characteristics. Gold is a useful asset to hedge against the risk of unexpected inflation. As shown in Exhibit 8, the gold price continues to be closely and negatively correlated to US 10-year real yields, i.e, the 10-year nominal bond yield less the 10-year inflation breakeven rate priced into US TIPS.

Exhibit 8

Gold is closely correlated to the inverse of the US 10-year real yield



Source: *Bloomberg*

Based on regression analysis, a real yield of -1.0% (for example, a nominal 10-year yield of 1.2% and breakeven rate of 2.2%, as was the case on 15 February 2021) suggests that the fair value of gold is between $1,750 and $1,830. Exhibit 9 across the page provides a sensitivity table of gold for different inputs of yields and inflation expectations. This analysis suggests that a gold price of $1,800 as of 15 February is reasonably well supported by current market expectations.

[3] These estimates of performance returns should not be construed to be indicative of actual events that will occur. Please see important disclosures at the end of this material

Exhibit 9[3]

Expected price of gold for different real yields

Breakeven Rate	10yr Treasury Yield					
	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
1.00%	1,609	1,535	1,461	1,387	1,313	1,239
1.25%	1,684	1,609	1,535	1,461	1,387	1,313
1.50%	1,758	1,684	1,609	1,535	1,461	1,387
1.75%	1,832	1,758	1,684	1,609	1,535	1,461
2.00%	1,906	1,832	1,758	1,684	1,609	1,535
2.25%	1,980	1,906	1,832	1,758	1,684	1,609
2.50%	2,054	1,980	1,906	1,832	1,758	1,684
2.75%	2,128	2,054	1,980	1,906	1,832	1,758
3.00%	2,203	2,128	2,054	1,980	1,906	1,832

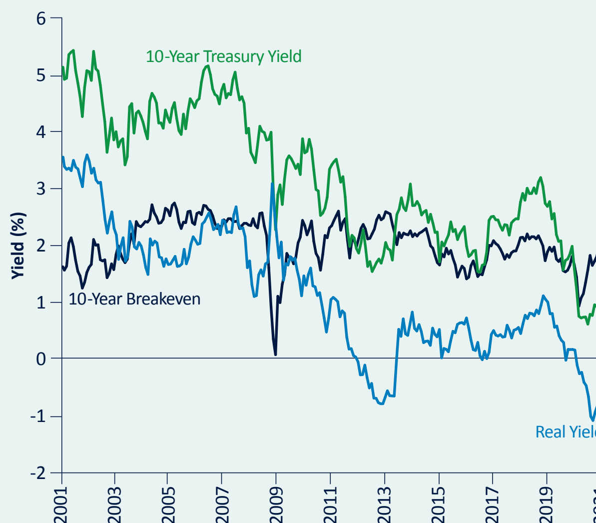
Notes: *Expected price is based on a single factor regression of gold vs. US 10-year real yield since Dec 2008. Regression has an R-squared of 72%.*

Source: *Bloomberg, Partners Capital*

For the price of gold to rise significantly from here, real yields would need would need to decrease further. The most likely scenario in which this occurs is further fiscal stimulus driving higher inflation expectations while central bank quantitative easing continues to suppress nominal bond yields. This is largely what has transpired over the last 12 months. Exhibit 10 shows that inflation expectations have risen significantly faster than nominal bond yields since March 2020, the nadir of the COVID-19 growth shock.

Exhibit 10

The recent fall in real yields has been driven by inflation expectations rising faster than nominal yields



Source: *Bloomberg*

The downside scenario for gold is likely one in which global growth stalls, possibly as a result of a new COVID-19 variant. If growth falls and inflation expectations declined by more than nominal yields, the real yield will rise and the gold price will likely fall. In such a scenario gold would underperform relative to other traditional safety assets such as government bonds. It is the dependency on the economic drivers of a downside scenario that has us favouring a well-diversified mix of safety assets in client portfolios, including gold, bonds, index-linked bonds, absolute return managers and certain unhedged currency exposures.

2021 Investment Strategy

Gold is a recommended allocation in client portfolios primarily as a hedge against a scenario of higher-than-expected inflation resulting from a policy mistake and/or monetary debasement. Gold should be held as part of a diversified mix of safety assets, but should not be sized at larger than c. 3% of total portfolio value. Gold is sensitive to real yields which are close to all-time lows, so there is reason to be cautious. Over the last 30 years gold has realised a standard deviation of c. 15%, similar to that of equities, and twice suffered a peak-to-trough decline of nearly 40% over that period. While gold is a diversifying safety asset and a good store of real value, it is not without its risks and should therefore be sized accordingly.

Exhibit 11

Commodities Total Return Expectations by Scenario

Scenario	Summary Analysis	2021 Calendar Year Total Expected Return	Weighted Return	Long-term Return Forecast	Recommended Deviation from Benchmark for 2021
Upside Scenario: “Warp speed to normal growth” (20% probability)	Larger than expected US fiscal stimulus and better than expected growth in EM leads to a further price gains. An increase of 0.5x the standard deviation is assumed in the upside scenario.	10%	1.8%	3.0%	0.0%
Base Case: “The herd slowly immunises” (60% probability)	A strong global recovery helps absorb some of the excess supply still prevalent in oil markets. Supply and Demand growth is largely in line with consensus estimates and accurately reflected in forward rate pricing, resulting in modest spot price appreciation.	3%			
Downside Scenario: “Ongoing waves” (20% probability)	Global growth stalls, leading to weaker than expected demand. We expect a 0.5x standard deviation event to the downside vs. our baseline scenario returns.	-10%			
TAA Implications of short-term returns vs. long-term expectations	While it is particularly difficult to predict changes in commodity prices, we expect commodity supply and demand growth to broadly match consensus expectations. These expectations are already priced into futures contracts. It follows that prices should broadly track inflation and global growth both in the near-term and over the next ten-years.				

Notes: *Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance. Please see important disclaimers at the end of this material.*

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