Rocaton

INSIGHTS

End of the "Super Cycle"? The Outlook for Commodities

August 2013

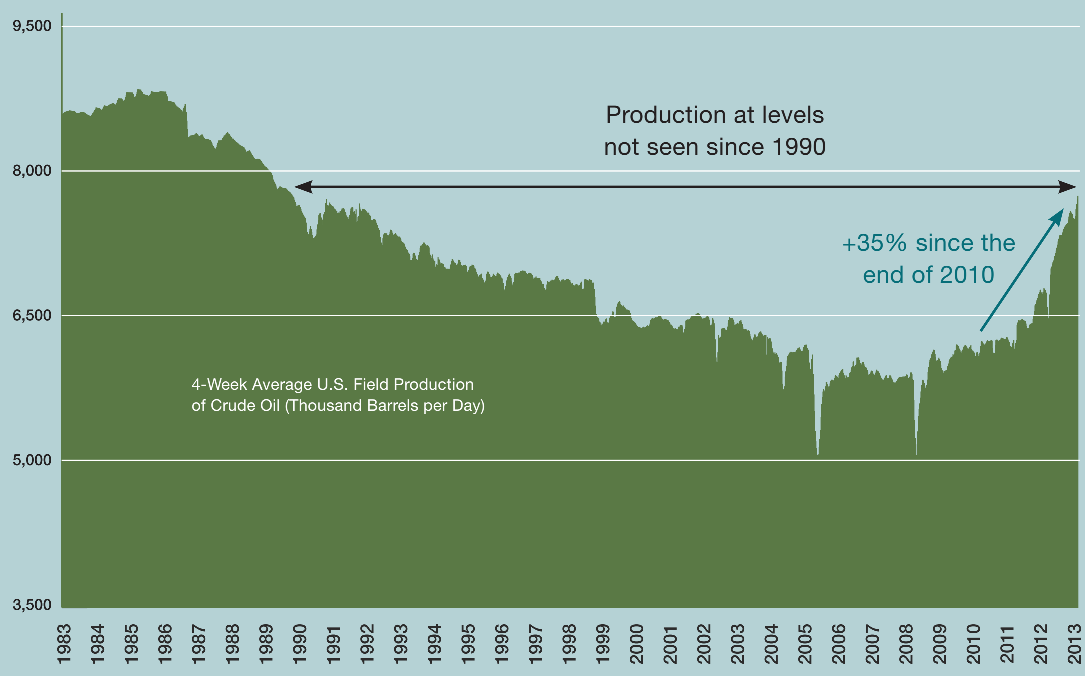
203.621.1700 | **rocaton.com**

Investors allocating to commodities have often cited diversification benefits and inflation hedging properties as two of the primary attributes which make the asset class compelling. While Rocaton still believes a portfolio of commodities can provide these benefits, we are concerned about the prospects for returns in the near- and medium-term. Increased supply in energy and some metals markets and concerns about global growth, particularly from resources intensive emerging market economies, are the basis for our concerns.

Market Overview

Talks of "peak oil" (the expectation that global crude oil production has peaked and will begin an inevitable slide) seem like a distant memory as crude oil production, and energy production in general, has increased meaningfully in the past several years. Significant new finds of oil in the last couple of years and greater use of new technologies has increased supplies faster than anticipated and has changed expectations about the future energy demand/supply balance. Oil production in the U.S. in August 2013 reached levels not seen since the early 1990's (see Chart 1). Part of the increase is attributable to new technologies, including horizontal drilling and hydraulic fracturing ("fracking") of underground rock formations. Global demand for crude oil is expected to be flat or only slightly positive over the next several years and could put additional downward pressure on prices. Demand forecasts are based on the assumption that although economic growth will lead to higher demand for oil, alternative energy (i.e. solar, electric, etc.) and improved energy efficiency (i.e. higher mileage standards for cars in the U.S.) will offset any increased demand for oil. In the natural gas sector, U.S. production levels remain high relative to the middle of the last decade, but a lack of export infrastructure continues to hinder any further advances in production.

Chart 1:
U.S. Field Production of Crude Oil since 1983

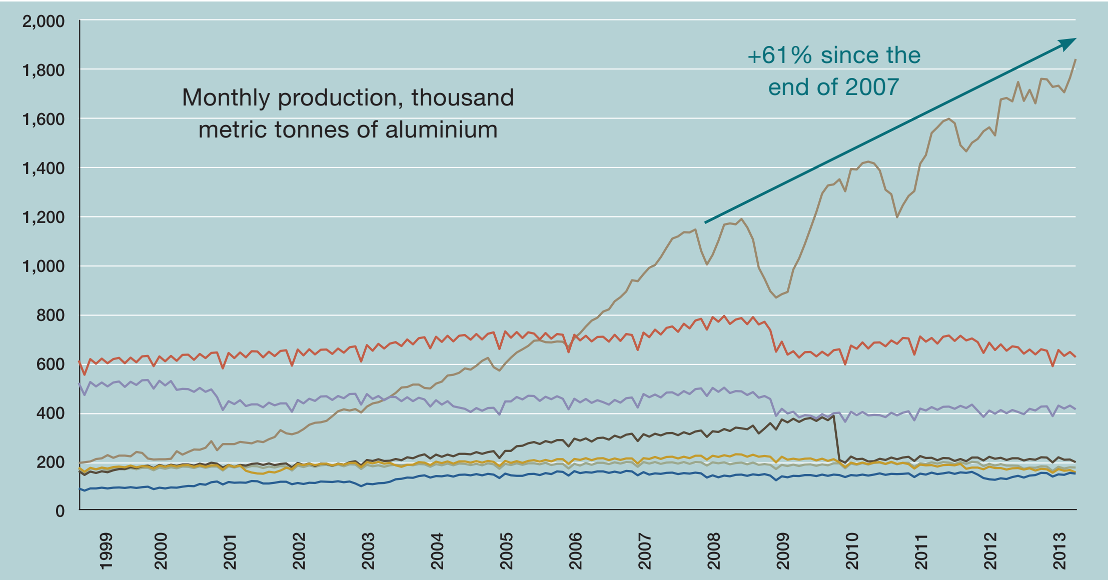


Source: Energy Information Association. Based on weekly data through August 2, 2013.

Long-term supply deficits for industrial metals, such as copper, have now reversed, leading to a surplus of supply at the same time that questions are being raised about copper demand, particularly from China. New copper mines are expected to come online in South America, Africa, and Mongolia in the second half of 2013, further expanding supply. Aluminum production is also at an all-time high, driven almost entirely by surging production in China's northern and western regions (see Chart 2). Prices in the aluminum market already reflect the growth in supply with spot prices down 45% from peak levels in 2008. In the precious metals markets, gold has fallen significantly in recent months after a nearly uninterrupted climb to a record high nominal price of $1,900/t oz. in 2011. Through August 8th, the yellow metal is down 22% year-to-date and is currently trading around $1,300 an ounce. A number of factors have contributed to this decline including a change in sentiment regarding U.S. growth prospects, rising real rates, a strengthening U.S. dollar and expectations of weaker demand for the metal, particularly in the emerging markets. As a result, gold has seen record investor outflows, observable in the form of exchange traded products (ETPs) tracking the price of gold. In the second quarter alone, outflows from gold ETPs were approximately $18.5 billion, by far the largest quarterly outflow on record. To put this number in perspective, GLD and IAU (the 2 largest gold exchange traded funds) currently have approximately $46 billion in AUM compared to $84 billion as of December 31, 2012.

Chart 2:
Monthly World Aluminium Production by Region since 1999

Legend:
China
Europe
North America
Asia (excluding China)
South America
Oceania
Africa



Source: International Aluminum Institute. Based on monthly data through June 30, 2013.

The agriculture sector is an area where the long-term outlook for prices seems more uncertain. As we have seen in recent years, year-over-year changes in price can be driven by "shock" events such as droughts, floods or natural disasters. For example, the severe drought in the Midwestern portion of the U.S. during the summer of 2012 sent grains prices soaring towards all-time highs. While agriculture commodity prices remain elevated relative to the beginning of the prior decade, market pundits seem divided on the future direction of prices. Some experts are calling for a long-term secular rise in price given population increases and growing demand from emerging market economies. Others believe increased production, both in the U.S. and abroad, will lead to declines from current "peak" prices.

Outlook

Rocaton has long held modest expectations for commodity returns and current supply/demand dynamics appear to justify these expectations. Our equilibrium return (30+ years) expectation for commodities is equal to that of cash (3.3%). This expectation is based on our belief that there is insufficient evidence to support a case for a long-term rise in spot prices (and as we have presented there is a case for a long-term decline in the spot prices of certain commodities). We also feel that long-term roll returns, which are driven by the shape of individual futures curves, are nearly impossible to predict. As such, our entire return forecast is driven by the return we expect from cash collateral. It is also worth noting that our volatility expectation for commodities is similar to that of developed equity markets.

Should Investors Allocate to Commodities and How?

We believe that clients with current allocations to commodity futures should consider eliminating this allocation or replacing it with alternative diversifying investment strategies which are more tied to the business of supplying commodities to consumers and less directly exposed to commodity spot prices. Potential strategies include Master Limited Partnerships (MLPs) and private oil and gas partnerships. It should be noted that these alternatives, like any investment, have their own unique set of challenges (i.e. illiquidity). We recognize that commodities prices are notoriously difficult to predict and prices could rise. However, we are concerned that the global demand/supply picture underpinning commodity prices is less optimistic than we have seen for a number of years. We continue to believe that commodities have diversification benefits (including acting as a hedge against geopolitical risks such as an oil supply shock driven by political instability) and potentially offer inflation-hedging benefits. However, absent major conflict in oil producing regions and significant cost-push inflation pressures, we find it difficult to make a compelling baseline case for robust commodity returns over the next 3 to 5 years.

