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Conference call highlights

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David Donora
Head of Commodities

COMMODITIES – MAY 2011

Causes and effects of higher commodity prices
From the middle of 2010 to the end of April 2011, there was a dramatic increase in a wide range of commodity prices. This was initially sparked by the weather effects that impacted agricultural prices and subsequently exacerbated by supply constraints in commodities such as oil following the political unrest in the Middle East and North Africa. This increase in raw materials prices has had a significant impact on inflation, particularly in emerging market countries. As a result, monetary authorities in a number of markets have begun to raise interest rates.

Correlated with inflation
Over the long term, commodity prices have displayed a significant correlation with inflation. This is perhaps not surprising, as recent experience shows how commodity price rises can be a key cause of inflation. As a result of this correlation, owning commodities can provide a useful hedge against increases in the cost of living, especially in the early phase of inflationary concerns, when expectations of rising interest rates push bond yields higher and prices lower. Meanwhile, commodities have historically displayed limited correlation with equities and bonds, making them an effective asset for portfolio diversification purposes.

Similar returns but a different distribution
Commodities have produced similar long-term returns to equities but with a subtly different distribution. The "tail risk" in commodities, i.e. the most unusual discrete period performances, tend to be more skewed towards the upside while tail risk in equities is relatively skewed towards the downside. This makes sense given the tendency of commodity markets to be affected by price spikes as a result of geopolitical or supply-side shocks, while equities are susceptible to significant sell-offs on the back of increased risk aversion.

Recent correction in context
Following the big gains of 2010 and the first quarter of 2011, commodity prices have corrected in recent weeks. There are a number of factors behind these moves, including de-stocking by governments and profit taking by investors. However, we believe that the recent correction should be viewed as a consolidation in an ongoing bull market. To take the oil market (which equates to 70% of traded commodities globally) as an example, on current economic forecasts global demand and available supply will be in balance by the end of 2011, with no incremental additional capacity available to meet further demand growth.

Production response limited
Historical experience shows that, with the exception of Kuwait in the early 1990s, geopolitical disruption to oil supplies tends to have a long-term impact on production. Iran has still not achieved the production levels witnessed before the revolution in 1979; Iraq shows little sign of getting back to pre-invasion production levels and even in Venezuela, where recent interruptions have been driven by industrial action, production is proving hard to rebuild. Meanwhile, new discoveries tend to be in more difficult locations that will take longer to bring on stream. With the supply response to heightened demand so constrained, this leaves price as the only rationing agent to balance the market.

Agricultural prices supported by weather effects
All the agricultural commodities are also running very tight in terms of supply and demand and it is incumbent upon this year's production supply response to be able

to bring those markets back into surplus. However, with the very dry weather that is currently occurring across Europe and into Russia, as well as in the South West plains area of the US where wheat crops are currently being harvested, yields are in danger of not achieving the levels expected. The US is also struggling to get control over three and a half million acres in the Mississippi Delta that have been badly affected by the floods. This could impact cotton and rice harvests. As a result, the outlook for agricultural commodity prices also appears well underpinned.

Dollar weakness to continue

Meanwhile, the US continues to grapple with unsustainable levels of debt and the authorities are likely to continue to pursue a policy of benign currency depreciation as a way of mitigating this problem. As most global commodities are denominated in US dollars, this will provide an additional tailwind for commodity prices over the medium term.

Fund performance update

The Threadneedle (Lux) Enhanced Commodities Fund was launched in mid-2010 and is one of very few actively managed products available in the regulated space. The fund seeks to generate alpha from two principal sources: allocating between commodities and positioning on the futures curve. It has generated strong performance since launch, posting a gain of 49.1% versus the benchmark return of 39.7%. The fund has attracted the attention of investors looking to establish a weighting in actively managed commodities. We expect this interest to continue in the coming months.

Conclusion

Commodity prices have been supported over the past year by robust demand coupled with constrained supply. We believe that these conditions are likely to continue, with ongoing dollar weakness providing a further tailwind. Meanwhile, as commodities provide an effective hedge against inflation and, indeed, are the biggest current driver of inflation, we expect the asset class to attract ongoing attention. We are confident that the Threadneedle (Lux) Enhanced Commodities Fund can help investors who wish to increase their exposure.