Threadneedle thinks

Commodities update

December 2011

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Commodity markets continued their sell off into year end, with the DJUBSTR index falling a further 3.75% in December, ending near its low for the year and finished down 13.32%. In contrast, The Threadneedle Enhanced Commodities Fund outperformed the index in December by 2.3% and for the whole of 2011, our fund outperformed by a solid 12.2%.

December was the fund's strongest month of outperformance since inception and reflects our staying with conviction positions that have been in place for much of the year. The biggest contributor to outperformance was the relative value energy position where we are strongly overweight refined products, namely gasoline, heating oil and gasoil versus a large underweight in US Natural Gas.

Within energy, gasoline was the best performer over the month, up 5%, while distillates were marginally lower.

However, US Natural Gas was down nearly 17%. Over the year, the US Natural Gas spot price has fallen by approximately 32%, and the total return which includes negative roll yield was over 44% with much of the price decline coming in the last two months of the year. The main reason for this is that the US Eastern Seaboard has so far experienced an extremely mild winter. Normally, Gas inventories are drawn down for residential heating during the winter months and then re-injected in the summer.

So far, there has been a fraction of the normal inventory drawdowns which has caused concern about capacity constraints within the lower 48 states and is causing the futures contracts related to delivery in the next few months to really plummet. Where commodity over production was a common problem in the 1980's and 1990's, over the last 10 years, it has become increasingly rare. As I have highlighted on numerous occasions over the last year, US Natural Gas is in oversupply and it will take time for this to work through.

Production is robust with the shale plays and rapidly improving technology, and there is little prospect for being able to export meaningful quantities of gas from the US for years. I believe this is an important macro driver because of the competitive advantage for the US economy, especially in a world where economic growth is increasingly constrained by resource limitations. To put it in perspective, the marginal cost of Natural Gas in Asia is over 5 times the current spot price of US Natural Gas.

Our positions in energy; overweight refined oil products and underweight US Natural Gas, generated about 120 basis points of outperformance in December. We continue to have a strong conviction in this position.

In contrast to the abundance of US Natural Gas, oil based refined products are tight and are likely to get tighter keeping prices elevated and those markets in backwardation, creating positive roll yield. Furthermore, closing of refining capacity in the Eastern US and more recently in Europe, with the credit crisis claiming Petroplus, will serve to keep the market short of products in at least the near-term.

Political instability in oil producing countries is rising with strikes in Nigeria, Europe on the verge of placing an embargo on Iranian oil, US troops being withdrawn from Iraq, and Libya struggling to steady itself translate into a larger than normal list of candidates for supply disruption. This is against a back drop of global demand of over 90m barrels per day and spare capacity of between 2 and 3 million barrels per day, which is virtually held by the Saudis. The net result is that in the short term, the oil markets remain tight.

Turning to the other commodity sectors, base metal prices fell over the month with the exception of nickel which was up 7%, and into which we had rotated our only overweight, which had been invested in lead until the end of November. Lead fell -3.55% in December. Our underweights in aluminum, copper and zinc added performance to the gain from our nickel overweight and generated strong outperformance of about 70 basis points. We remain underweight base metals as a sector.

We remained market weight in Gold and Silver ahead of the index rebalancing that took place this week, which saw significant selling of Gold futures as it had been one of the best performing commodities for the year. While we are positive long-term on Gold, in the short-term, deleveraging and US Dollar strength may keep its gains in check.

In grains, we were market weight but positioned further along the curve and continue to favor higher quality in Wheat. We underperformed slightly in grains where short covering led to slightly stronger term structures and Chicago wheat to outperform the other wheat contracts.

We were similarly successful within livestock where we continue to carry feeder cattle in place of live cattle and lean hogs.

Looking forward, the weak macroeconomic environment, facing headwinds from recession in Europe, a slowing China and anemic growth in the US, compel us to stay underweight across base metals where we see more downside risk and neutral precious metals. Meanwhile, geo-political risk continues to rise in the Middle-East and Africa, strengthening our conviction in the energy sector which we believe will be driven by tightness in the supply side and steady demand. Agricultural commodities have retraced as a result of better supplies, and are only at risk of weather issues in the spring, so we believe Emerging Market inflation driven by higher food prices should be off the agenda for 2012.

Overall, this is a moderately positive environment for commodities over the next few months, with further upside if global economic growth builds momentum through the first two quarters.

Audio link

http://mediazone.brighttalk.com/comm/Threadneedle/dd37faa2e9-28705-5029-31727

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