Investment Commentary **April 2019**

Commodities- The Outlook for 2019

Highlights:

- **4th Quarter decline in commodities and equities was sharp but brief**
- **Commodity decline was idiosyncratic, and confined to energy**
- **Prices are up significantly in 2019, recovering 2018's decline**
- **Commodities remain historically cheap**

Bull markets seldom demonstrate a straight-line appreciation, and big rallies in commodities have been interrupted before. This was no truer than in the 4th quarter of 2018. Beginning in early October, a perfect storm of trade uncertainty, questions about the health of the global economy, a shift in central bank policy focus, Middle East geopolitical concerns, and even some adverse position unwinding combined to drive the world's largest tradable commodity, crude oil, dramatically lower. While commodity investors normally benefit from crisis *alpha* capture, with typically positive price responses to global risk events, occasionally the news can conspire to temporarily have the opposite effect. Broad commodity indices like the RICI®, up +7.28% by early October, finished the year at -9.17%, and the benchmark indices fared even worse.* From the beginning of the commodity bull market in early 2016, the unusually steep 4th quarter decline meant that many commodity strategies had given back a fair portion of their prior gains. Investors can be forgiven if this was alarming, especially given the fact that global equity markets were also behaving in a similar fashion. From late September through late December, the S&P 500 declined by *over 19%,* but recovered enough to finish down -4.38% for the year, its first annual negative performance since 2008.* Meanwhile, fixed income assets, which had been on a steady rate-driven decline, unexpectedly finished flat for the year.

Performance so far in 2019 has demonstrated that the prior quarter's decline was an overreaction to a series of idiosyncratic, short-term events, or more accurately, a premature and incorrect interpretation of those events. With both equity and commodity markets resuming their bullish posture, broad commodity indices are up significantly (the RICI® is up over 12% YTD**), having already erased the prior year's losses. We believe that the 4th quarter price decline did not signal a new vulnerability in the commodity bull case, and it does not alter our opinion that the direction of commodity prices generally will remain persistently positive.

Each of the seemingly adverse events which drove markets lower in late 2018 have either been resolved or likely soon will be:

The U.S.-China trade war is already fully priced into the commodity markets, but it is highly doubtful that this stays unresolved for the duration of 2019, and negotiations between the two countries will resume in the late Spring. The effect of an agreement that reduces or eliminates the current penalty-level tariffs would be positive, particularly on agricultural and industrial metals prices.

Uncertainty around crude oil export levels was clarified when OPEC+ countries agreed in December, and Saudi Arabia again in April, to significantly reduce supplies through at least the Summer. Potential fallout from Saudi extralegal activities, which might have resulted in an *increase* in exports, lowering crude prices in an effort to repair relationships with the West, appears to have subsided. Additionally, the potential for the elimination of waivers for the purchase of Iranian crude, which could impact supply, remains on the horizon.

The Federal Reserve policy shift to a more dovish stance in response to softening economic data has, in fact, baked in a flat yield curve at levels that are still higher than the rest of the developed world. As a reminder, commodity strategies typically invest a high proportion of investible funds in short-term obligations, which represents the income portion of commodities investing, and commodity prices are well correlated to the Fed Funds rate. The risk-free rate on UST-Bills is currently approximately 2.40%, which exceeds the S&P average dividend rate by 65 basis points.

A highly-leveraged long crude oil/short natural gas position was common among commodity and other hedge funds through much of 2018. During October and November, natural gas prices spiked by almost 40% while crude oil prices declined, forcing the unwinding of those positions, which temporarily exacerbated both the direction and volatility in those markets.

The most important rationale for the bull case is that commodity prices are still relatively low. Even after the rally that commenced in early 2016, most commodities prices are still below their 5 year mean average and are hovering around 50% below their former peak. Supply and demand equilibration is the reason commodities tend to exhibit predictable mean reversion. After years of production destruction, especially in the areas of energy and mining, supply will again take a full cycle to fully meet the renewed demand in a stronger economy. This implies that meaningful upside potential for commodities remains, especially in comparison to equity and fixed income markets, which are at or near record valuations.

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* Source: Bloomberg LP historical price data in USD

**RICI® YTD through April 10, 2019 (this writing); source: Bloomberg LP

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