Primary Concerns

4th May 2018

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Material Witness - *insights from the Manager*

Rigorous process: flexible implementation

- Solid returns to the paper portfolio with the promise of added benefits in real-world practice

Thierry Ralet, CEO & Founder

Mark to Market - *observations from the front line*

Not backward in coming forward

- commodities are smartly outperforming more traditional asset classes

Sean Corrigan, Chief Investment Strategist

Material Witness - *insights from the Manager*

Rigorous process: flexible implementation

The paper portfolio we are running at present on a month-to-month basis, solely for illustrative purposes, showed a positive return of +2.5% in April, mainly due to large gains in the energy complex and in livestock.

We would emphasize that our models sent different signals on some commodities, this month; i.e., with regard to Unleaded Gas (long in one, short in the other); Copper and Live Cattle (short & flat, respectively).

These structural anomalies are the principal reason why we choose to split our positions between the two main benchmarks: it helps to have a better diversification and to reduce the volatility when signals and fundamentals are not fully and consistently aligned.

We would again point out that the model's returns do not reflect the full benefit of our unique methodology because they do not incorporate the effects of the intra-month rebalancing we will regularly be carrying out. The better to illustrate the advantages of our approach, we also report results on an excess return basis—i.e., without the additional earnings to be made on the underlying collateral. Indeed, if investors were to follow our suggestion of designating some part of their existing bond holdings to this purpose—for which commodities are a natural, negatively-correlated hedge—the impact on the portfolio could be even more favourable.

In this instance, several curves changed their shape during the month and so would have invited remedial action. Aluminium was a notable example, with the sanctions-inspired change from short to long taking place around the 12th of the month. Similarly, Cotton started out flat but would have changed to long, while Cocoa would have seen a full reversal from short to long. We estimate that the rebalancings we could have undertaken due to such factors could have brought 50bp additional performance.

Moving into May, the WTI curve has flattened somewhat, leading to a weakening of the associated signal (indeed, to the point of calling for no position whatsoever in one of the models), though that for Brent is stronger. Grains show less momentum on the short side and some have already moved to a long bias.

It is not usual for the model to take position in Precious Metals, as was the case this month as the negative roll yield widened with the lessening of political tensions (mainly in North Korea) and the partly dollar-occasioned weakness of Gold and Silver. Once again, when the portfolio is in full operation, such changes will be effected as they arise intra-month and will not have to wait until the period's end.

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Mark to Market - *observations from the front line*

Not backward in coming forward

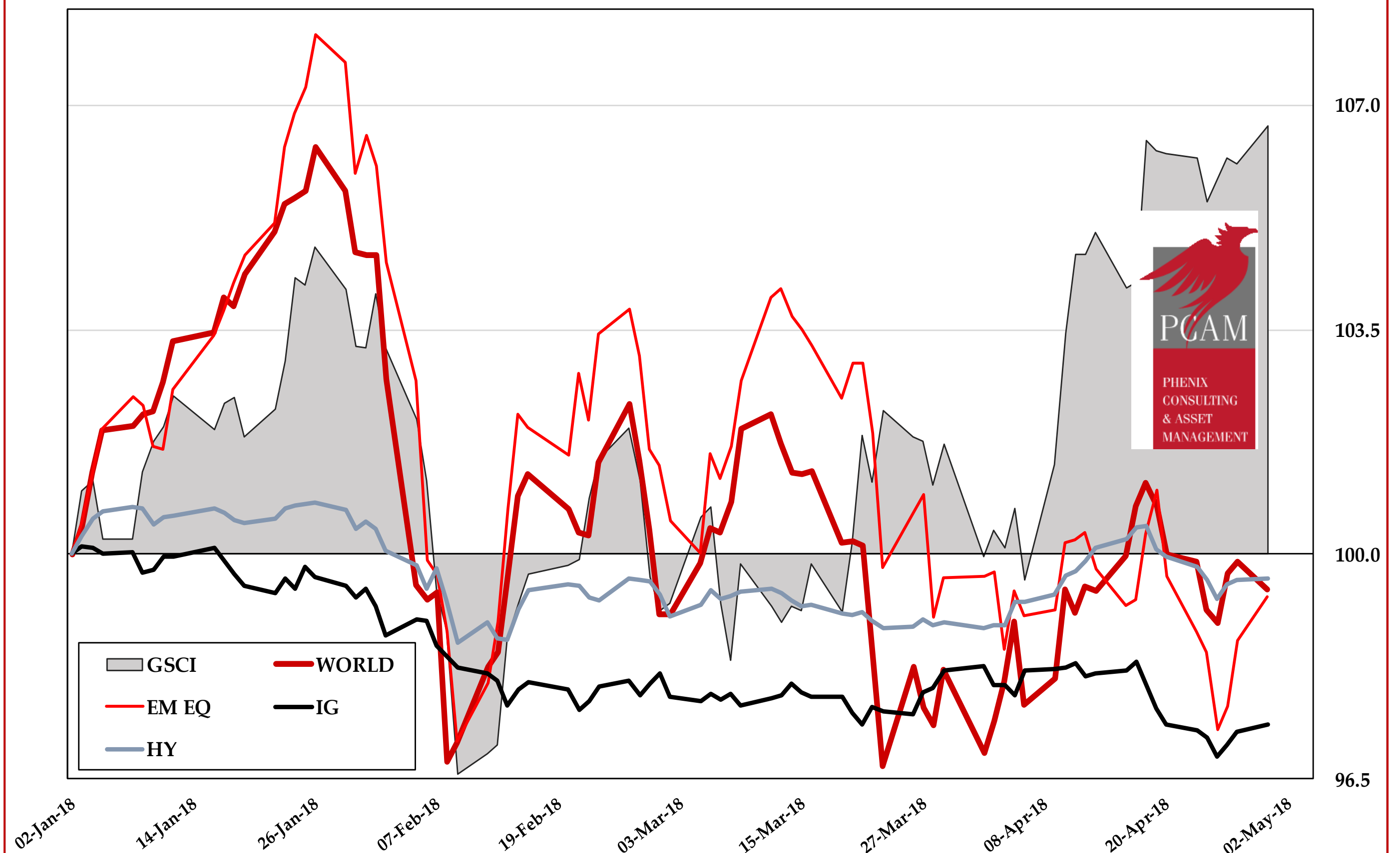
So far this year, the commodity investor has enjoyed both relative and absolute returns of a kind not seen since the shale oil bust of late 2014 ushered in what we have often since referred to as the 'hidden recession' in the US.

Given the steep rise in all manner of interest rates—particularly evident at the shorter end of the curve—it should be no surprise that bonds have languished, with investment-grade US corporate bonds off around 3% on a total return basis and junk joining them in the negative column. Perhaps more surprising is that equities, too, have belied a promising start to the year to slip into the red themselves at the end of April. While long experience has taught us that early February is often a time for a sea-change in market behaviour, some may be nonplussed at the inability of stocks to respond to what—in the US, at least—has proven to be a particularly solid quarter for earnings reports; one in which a decidedly above-par quotient of companies has beaten the Street's elevated expectations for gains in the mid-20s of percent to be posted over the like period last year.

Post hoc rationalizations are everywhere to be found, whether in citing the heightened political tensions in the Levant or with respect to Russia; or in the increasingly acrimonious trade dispute being prosecuted with China. Paradoxically, the successful passage of Trump's corporate tax reforms has left would-be buyers with an 'after the Lord Mayor's show' feeling- i.e., the sense that all the good news is 'in' and that all that is left now is to fret about what the programme might imply longer term for the budget deficit and hence for bond yields.

A simpler explanation is, of course, that in making their 27% gains to the January highs (35% to the March ones if we instead consider the Nasdaq 100), equities had already far outrun whatever passes for 'fundamentals' in an age of massive central bank intervention, automated pattern-following trading, and mass participation in blanket ETF vehicles.

YTD Returns: Equities & Fixed Income (TR) v Commodities (ER): *Source - S&P, MSCI, BoAML*



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Commodity returns have arisen from a number of factors. The general intuition that 'inflation' might be about to make an appearance. The problems posed by sagging bonds and stagnant equity prices. And, of course, idiosyncrasies of their own.

Poor growing conditions in South America, coupled with the long, harsh winter on the northern plains, have so far offset any malign impact of the tit-for-tat tariffs imposed on US grain exports to China. A victim of protectionism much closer to home, lumber—now spared more intense price competition from producers above the 49th parallel—has gone super-exponential, almost tripling in price in 2 1/2 years, to the horror of homebuilders everywhere. Metals have split broadly into two camps—those dependent for their demand on an evidently decelerating China—zinc and lead, as well as iron ore, are the ones suffering here—and those whose supply is adversely impacted by US policy—witness the chaos unleashed in the aluminium market by the latest round of Russian sanctions, as well as the increased anxiety concerning what the attack on Rusal chief, Oleg Deripaska, might imply for Norilsk's supply of nickel and palladium, as well as a range of lesser, but nevertheless 'strategic' metals.

Then, of course, there is oil. The possibility that the US—which is now a net importer of no more energy than it was before the first oil shock, over forty years ago—will shortly find some pretext to renege on the nuclear accord stuck with the Iranians, has given renewed impetus to front-month pricing, while back months are being kept in check by committed hedging flows emanating from those responsible for record domestic production (now firmly registering above 10Mbpd). This 'backwardation' has brought its own windfall. For example, buyers of the September oil contract at $66.40/bbl would—if all else remained unchanged—earn an annualized carry in excess of 6.5% over the next few months if it were to roll up the curve to expire where June is currently priced, viz., $67.50.

Let us all make hay while that constellation of rising, front-end led prices continues to shine on us, but let us also be aware that the trend requires a steady stream of eager new, speculative buyers to help the guys in the oil-patch lock in their profits and re-assure their lenders. If the war-drums ever start to beat a little less insistently along the Shatt al-Arab, rigorous risk management, combined with decisive and timely intervention will be needed to retain as many of those gains as possible.

This is very much the sort of thing that we intend to practice.

Sean Corrigan

Chief Investment Strategist

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