Reappraising the case for commodities

We think now is a good moment to consider a strategic allocation to commodities. Despite a bounce in performance in 2016, sentiment has rarely been worse. Previous poor performance means they remain one of the few asset classes that look genuinely cheap. They provide an inflation hedge few other asset classes can match, while offering significant diversification benefits. Indeed, we argue they can improve risk-adjusted returns even on a pedestrian outlook. In fact, given relatively inefficient markets, skilled managers should be able to extract high excess returns.¹

Commodities have been on a rollercoaster ride. For a number of years since 2000, returns exceeded expectations as insatiable demand from emerging markets and China in particular spurred a "supercycle" in prices (Figure 1).

Figure 1: The rise and fall of commodities

![Cumulative total return](image)

Source: Bloomberg, Datastream and MSCI, data to 30 June 2016.

But more recent performance has been disappointing. Even after this year’s upturn, the Bloomberg Commodity Index (BCOM) has fallen around 50% from its 2011 peak, while the S&P GSCI index is down around 60%². Investors are not surprisingly shunning commodities. Yet it is often when sentiment is close to rock bottom that investors should reassess a potential investment. For commodities, there are at least three key reasons for a rethink:

Reason 1: Inflation hedging

Commodities have generally been positively correlated with inflation. Thus returns have tended to pick up when inflation has been rising and decline when inflation has been falling, making them potentially a better hedge than US Treasuries and equities (Figure 2, left-hand chart). Other asset classes typically considered inflation hedges include real estate and inflation-linked bonds, but both now look expensive.

¹ This article is a summary of our longer paper, “Reappraising the case for commodities”, published in August 2016 and available at www.schroders.com.

² BCOM was established in 1991 and is more diversified by commodity than the longer-standing S&P GSCI index (GSCI), which has an allocation of over 70% to the energy sector, although it also has a much longer track record, having been established in 1970.
Figure 2: Commodities are positively correlated with inflation, unlike equities and bonds

Given that commodities are literally the raw material for much economic growth, it is hardly surprising they perform well when high inflation results from overheating growth. However, they are also a key component of inflation indices, so it is axiomatic that commodity prices will be positively related. To delve a bit deeper, we segmented history into four different inflation environments and assessed the real performance of equities, commodities and US Treasury bonds in each. Our first division was between periods when inflation was high (defined as 3% or more) and low (defined as 1.5% or less). Then we further divided each period into times when inflation was rising and times when it was falling (Figure 2, right-hand chart).

This analysis showed that real returns from commodities tend to be positive when inflation is rising and negative when inflation is falling. Returns are particularly strong when inflation is both high and rising.

In contrast, equities, bonds and cash have all historically generated real losses at such times. There is a cause and effect issue here as, more often than not, the cause of a spike in inflation is a spike in commodity prices. Thus, if an investor is worried about periods of high and rising inflation and a likely cause of such an outcome is rising commodity prices, then they should benefit from an allocation to commodities.

The correlation between commodities and inflation was persistently positive throughout the late 1980s, 1990s and 2000s, despite inflation being relatively restrained in these periods. However, it is fair to say that the other clear conclusion is that real commodity returns are negative when inflation is falling, with performance being particularly poor when inflation is both low and falling. This helps explain why commodities have been poor performers since 2008, a period when inflation has been low.

Despite the low level of inflation in recent years, there are signs that pressures are building. The 12-month change in the US core Consumer Price Index, which excludes commodity prices, has been steadily moving upwards (Figure 3, left-hand chart, overleaf). In addition, the US unemployment rate has fallen below the Congressional Budget Office’s estimate of the Non-Accelerating Inflation Rate of Unemployment (Figure 3, right-hand chart). This is an estimate of the “equilibrium” rate below which inflation is expected to pick up. At the same time, consensus expectations for longer-term inflation remain above 2%.

Dollar deliverance

Historically, there has been a strong inverse relationship between commodity price indices and the dollar. Most commodity prices are denominated in dollars, so they become more expensive for non-dollar investors when the dollar strengthens, which has a negative impact on demand. Prices have therefore generally declined during periods of dollar strength. Similarly, demand from non-dollar investors picks up when the dollar is weaker, which puts upward pressure on prices. Unheded non-US investors who are concerned about the impact that a weaker dollar could have on their other investments may find this characteristic attractive.
Figure 3: US core inflation has been rising...


...while a tight labour market also presages inflation


So, while there continue to be deflationary pressures outside the US, it would be complacent to ignore the dangers of inflation. All the more so given the sums that have been pumped into the financial system and the policy bias towards generating inflation. After all, a bit of inflation would help governments reduce the real value of public debt burdens. Against this background, an allocation to commodities starts to make a lot more sense.

Reason 2: Commodities diversify equity risk... but that doesn’t make them a tail risk hedge

Despite their diversifying attributes, it would be unrealistic to expect commodities to offer protection against so-called tail risks, such as the financial crisis of 2008–09. In reality, the relationship between commodities and equities varies considerably. At times a negative correlation exists, but on average they show a low but positive correlation (Figure 4, left-hand chart). The relationship weakens as the length of the holding period increases. For example, the correlation between equities and commodities on both a quarterly and an annual basis is around zero. This suggests that there may be significant diversification benefits from adding commodities to an equity-heavy portfolio. In contrast the relationship with Treasuries has been more persistently negative (Figure 4, right-hand chart).

Figure 4: Commodities offer significant diversification benefits


We would argue it is not necessary for commodities to be negatively correlated with equities for them to add value. Combining two asset classes with a correlation of less than one can lead to a reduction in the overall risk of an investment portfolio.
For example, assuming a 0.2 correlation between equities and commodities (a reasonable assumption based on experience), then adding a 10% commodity allocation to an equity portfolio could result in a 7.5% reduction in volatility from 17% to 15.7%. It is true that correlations can be highly unstable, but it is not necessary for them to be negative for commodities to reduce risk, even on reasonably conservative correlation assumptions.

Moreover, returns do not have to be that good for commodities to merit a place in a portfolio. Our calculations suggest that, assuming a commodity-equity correlation of 0.2, commodities only have to generate returns of 2% a year or more to improve risk-adjusted returns compared with the equity-only portfolio. Even on the more conservative assumption that the correlation is 0.5, commodities only have to generate returns of around 4% to improve risk-adjusted returns.

**Reason 3: Potential for attractive risk-adjusted returns**

Given what we have found so far, we would argue that there is a case for commodities’ inclusion in a portfolio even if returns are relatively muted. In fact, however, current conditions suggest that they could actually be much better than that.

While the past looks uninspiring, future returns should reflect the current low level of commodities prices. Certainly prices look cheap compared with their history, particularly against equities. Indeed, the prices of some commodities are also low relative to their production costs. Aluminium, nickel and copper prices, together representing over 80% of the industrial metals complex, currently trade below the marginal cost of producing them. Oil is changing hands for less than the industry’s average cost of production. Furthermore, return on capital among the major oil companies that together represent 30% of global production recently fell to an all-time low.

So, we would argue, there has rarely been a better time to buy commodities. Moreover, commodities markets offer plenty of potential for active managers. For instance, they can profit from passive funds buying and selling in predetermined ways each month. Then the fact that different commodity sectors perform better or worse at different stages of the economic cycle allows managers to add value through sector selection. And, as noted above, it should be possible to add value by focusing on those markets which have downward sloping futures curves. With many commodities being poorly-researched, active managers should be able to add value.

### Conclusions

We believe there is a particularly interesting opportunity in commodities. They look genuinely cheap, both with respect to their own history and their costs of production. For investors concerned about inflation, they provide protection that few other asset classes have been able to demonstrate. Moreover, they offer beneficial diversification to a portfolio. The result is that, even without making heroic assumptions about their prospects, commodities should be able to improve expected risk-adjusted returns in a multi-asset portfolio. And the inefficiencies of the asset class mean there should be a rich vein of opportunities for active managers to exploit.

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