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INVESTMENT MANAGERS

Investment viewpoint

Looking beyond commodity prices: A carry opportunity

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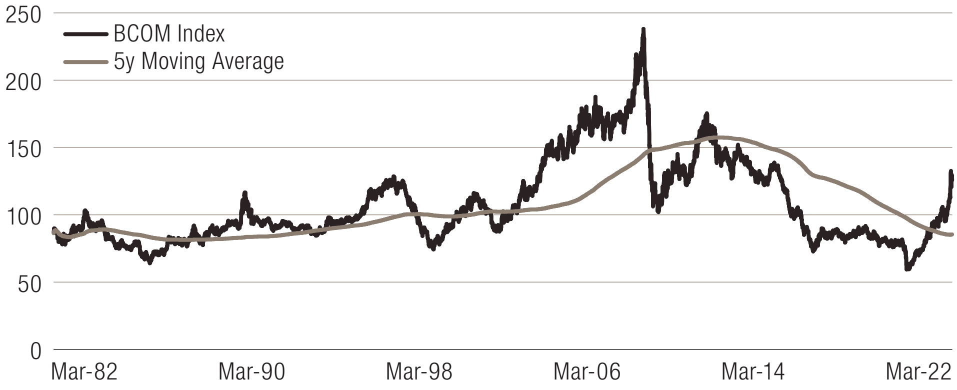
Commodity prices are breaking from long term trends

After a prolonged period of underperformance (2008-2020) commodity prices are on the rise and breaking from a decade long bear market.

FIG. 1: COMMODITY PRICES BREAKING ABOVE THE 5-YEAR MOVING AVERAGE



Source: LOIM, Bloomberg.

While commodity prices have broken above their five-year moving average, they remain below their 40-year high of 2008. The recent rally is nonetheless impressive not only because of its strength but also since the price increase is broad-based across all sectors.

Our conviction is that planned infrastructure spending and investment into technologies to transition away from carbon will continue to provide long term support for commodity prices, notably industrial metals.

Recent exogenous events such as Covid-linked supply chain disruptions and the war in Ukraine acted as catalysts to trigger the transformation towards more self-reliance and less dependence on fossil fuel imports. Such policies will require raw materials to be effectively implemented. This can potentially exacerbate shortage and support commodity prices.

Moreover, as investors across the globe are worried about the resurgence of inflation, they look at commodities for hedging purposes, which is an additional source of tension in an already stretched complex.

How long can the bull market last?

While we do not have a definitive answer to that question, we acknowledge that commodity markets might currently be difficult to read but we believe that the transition to a greener energy mix and reducing reliance on imports will remain supportive for the complex.

In addition, we believe that commodities currently present a very interesting pattern for investors: they offer positive carry.

Most commodities are in a bullish term structure called *backwardation*. This holds some interesting properties that will be the focus of this note and should incentivise investors to hold commodities.

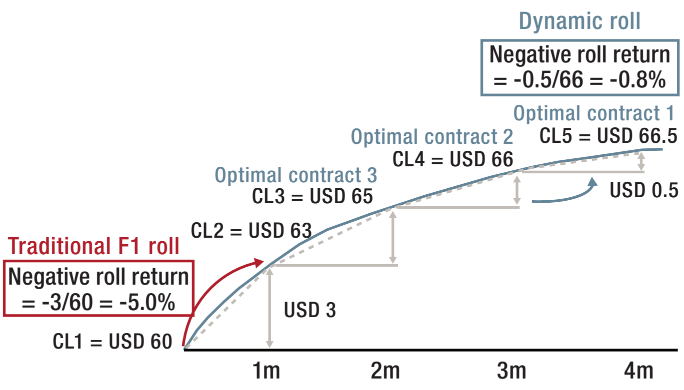
We aim to look at this asset class beyond price and through the prism of carry and term structure. The first section will detail the particularities linked to the term structure of commodity futures. The second part will look at the carry of commodities in comparison to the yield of other asset classes and the final section will focus on LOIM's commodity solution.

The term structure of commodity futures

Commodity futures have unique characteristics not usually found in other asset classes. Commodity futures oblige the buyer to purchase (sell) some underlying commodity at a predetermined future price and date. They have an expiry date and positions must be rolled in order to keep an exposure over time. Commodity futures have a term structure, which is represented by the price gap between different maturities of future contracts.

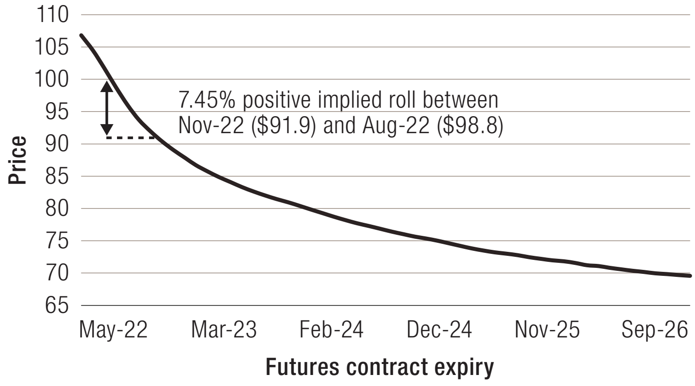
The prevailing term structure configuration for commodity futures is contango. This means that investors are willing to pay more for a commodity in the future (Figure 1). The premium above the current spot price is usually associated with the cost of carry, or negative roll yield. This can include any charges the investor would need to pay to hold the asset over a period of time (i.e. storage costs, insurance, spoilage, etc…). As such, a commodity in *contango* will see gradual decreases in the price to meet the spot price at expiration.

FIG. 2 TERM STRUCTURE IN CONTANGO: HIGHLIGHTING A NEGATIVE ROLL YIELD ON F1 CONTRACT VERSUS A DEFERRED MATURITY (F4)



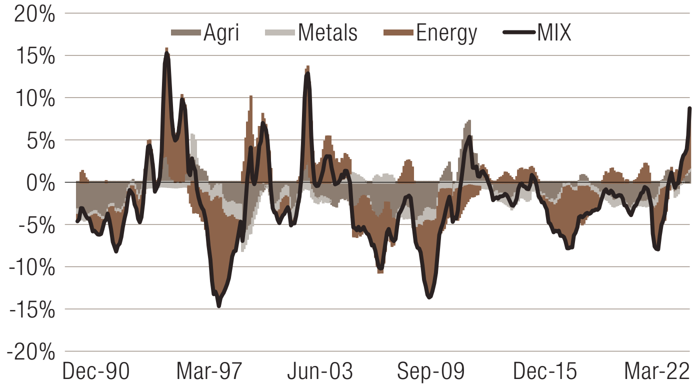
Source: LOIM. For illustrative purposes.

FIG. 3 WTI FUTURES CURVE IN BACKWARDATION AS AT MARCH 28TH



Source: Bloomberg, LOIM.

FIG. 4 ANNUALISED CARRY – GLOBAL COMMODITY



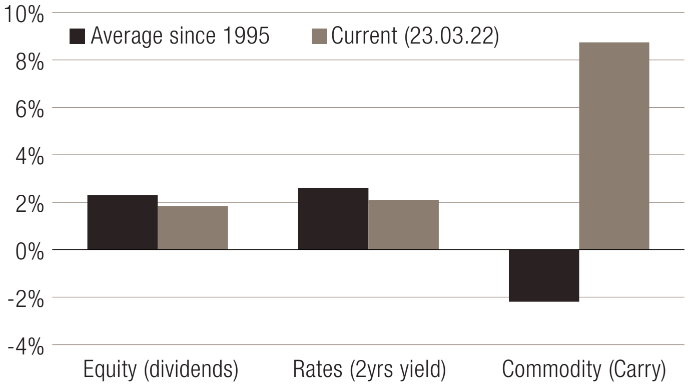
Source: LOIM, Bloomberg. Figure 4 uses an equal allocation with and within the three main sectors (Agriculture, Energy, Metals). Calculation uses the front end of the curve carry monthly differences, and smoothed using a six month median. Some future prices were estimated in this calculation.

On certain occasions, the term structure can be in backwardation (Figure 3) – when the current price of an underlying commodity is higher than prices trading in the futures market. This is not the prevailing term structure configuration. It can occur as a result of a higher demand for an asset currently than the contracts maturing in the coming months through the futures market. A shortage in the commodity in the spot market can typically result in backwardation. In this case, since the futures contract price is below the current spot price, investors who are net long on the commodity benefit from the increase in future prices over time. As the futures price and spot price converge, the roll yield becomes positive.

Commodities carry at the highest point in a decade

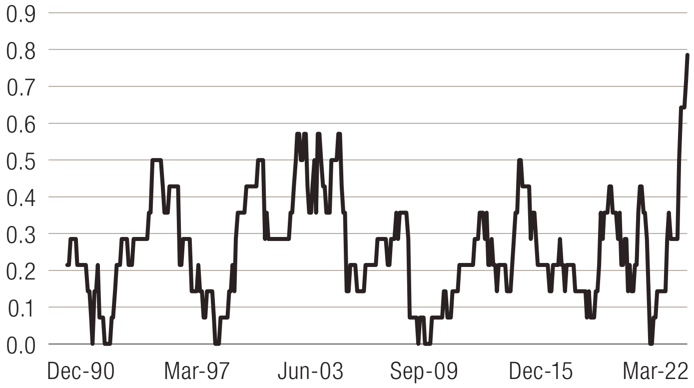
As shown on Figure 4, global commodities such as metals, agriculture and energy are experiencing the steepest backwardation in more than 20 years, confirming how strong the fundamentals are for the asset. Global carry is currently close to +10% per year,

FIG. 5 CURRENTLY COMMODITIES OFFER THE HIGHEST "YIELD" VERSUS EQUITY AND FIXED INCOME



Source: LOIM, Bloomberg. Equity: MSCI World in USD, Rates: US 2yrs yields, Commodity: see above Figure 4.

FIG. 6 ALMOST 80% OF THE SELECTED COMMODITY UNIVERSE IS IN BACKWARDATION



Source: LOIM as at March 25th 2022.

which means that in the hypothetical case commodity prices remain the same, there will still be a mechanical positive performance coming from the current carry (or positive roll yield) of the instruments.

This unique premium reinforces the case for commodity investment, as it currently offers the best income versus the other traditional asset classes such as equities or fixed income, as shown on Figure 5.

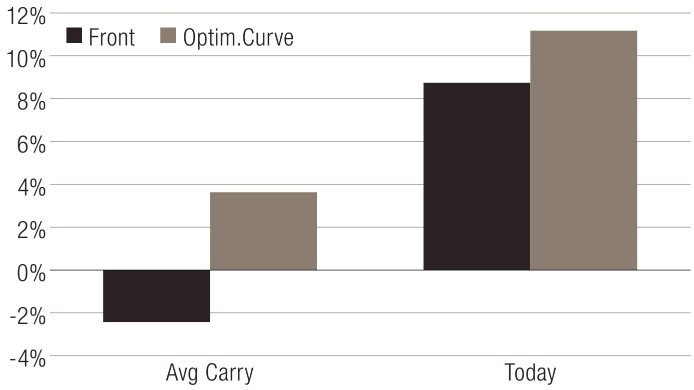
In addition, what is interesting to point out, is that it is one of the first times in history that there are so many commodities at the same time in this situation, increasing the scale and importance of this disruption. Figure 6 is showing the percentage of commodities in backwardation.

LOF Commodity Risk Premia focus

Negative roll yield can be very corrosive to performance. This is precisely why our LOF Commodity Risk Premia strategy aims at maximising positive roll yield and minimising negative roll yield by choosing the contract maturity of a commodity best suited to its current term structure.

In simple terms, it means that the strategy will always pick the maturity with the cheapest expected roll cost when curves are in contango or with the highest expected positive roll when curves are in backwardation. Figure 7 illustrates the benefits of optimising the contract maturity and shows that over a long period of time it can turn the negative cost of rolling the front future into a positive carry.

FIG. 7 THE LONG-TERM BENEFITS OF OPTIMISING MATURITY SELECTION VERSUS ROLLING THE FRONT FUTURES



Source: LOIM as at March 25th 2022.

Conclusion

In our opinion, commodity prices will continue to be supported by long term fundamentals even if some relief is possible in the short term. Irrespective of the price momentum, commodities curves currently offer some return opportunities thanks to their steep backwardation term structure. This technical situation should incentivise investors to hold commodities and potentially achieve a positive yield, even if prices remain at their current level.

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