FORTEM CAPITAL

FRIDAY NIGHT 'LIGHTS

AU… have you thought about investing in commodities?

21st April 2017

In recent weeks, FNL has considered the growing concerns of potentially toppy equity markets and clients' desire for diversified assets. We aren't calling for "tin foil hats" just yet, but as diversification becomes increasingly important, we've thought it necessary to reference the increasing levels of correlation in various asset classes and consider why this is making "alternative assets" both more necessary, but also harder to come by. This week we turn our focus to commodities, their equity market beta and the increasing potential of "backwardation" in the commodity futures markets. In their Q2 2017 outlook for commodities, many research desks have suggested that the oil futures curve may well move into backwardation. For those that need a little refresh on futures, please see **this previous FNL** on the shapes of these curves and why it is so important.

To take a step back before getting into the nitty gritty, investors in commodities point to three highlights of the asset class – (1) overall low correlation to traditional equities and bonds; (2) equity like returns and (3) a positive correlation with inflation. Over the last 50+ years the beta of commodities to developed market equities has been close to zero, but this statistic doesn't tell the whole story – beta has in fact ranged from as low as -0.39 to as high as +0.76. The current correlation over a 20year period of the Bloomberg Commodities index (*observed monthly*) to the MSCI World is roughly 0.40% – a diversifier for sure, but more correlated than one might have thought.

The Midas Touch…

A famous study entitled *Facts and Fantasies about Commodity Futures* by Yale University took data from July 1959 to December 2004 (*since updated to include recent data*) on an equally weighted index of the most frequently traded commodities and analysed average returns. They found that a portfolio of fully collateralized commodity futures offered very similar returns (for a near identical Sharpe ratio) to that of US equities, while maintaining low degrees of correlation over the longer term. For the geekier amongst you it is a fascinating study, if a little dense, and makes a well-reasoned argument for commodity investing as part of a broader portfolio. Moreover, following a strong 2016 (+11%), numerous institutions have come out in favour of commodities for 2017.

Product	Participation
Citigroup 6yr Gold USD Supertracker, EIS	125%

Rates (bps)	Current	Week Chge
GBP 1yr	50.40	0.00
GBP 3yr	60.50	0.20
GBP 5yr	74.70	0.90

Equity Indices (%)		
FTSE 100	7116.17	-2.89%
S&P 500	2,345.96	0.73%
Nikkei 225	18620.75	1.05%
Eurostoxx 50	3422.38	-0.75%

Currencies (%)		
GBPUSD	1.2804	2.41%

5yr Credit Spreads (bps)		
Citigroup	62.31	-0.12
Credit Suisse	104.77	-0.72
Deutsche	129.47	-1.43
GS	76.75	-2.10
HSBC	64.30	-1.19
JPM	53.15	-0.20
MS	73.07	-2.56

Commodities (%)		
Gold	1281.43	-0.50%
Oil (CLA)	50.69	-5.43%

3m Implied (vol pts)		
FTSE 100	13.10%	0.76%
S&P 500	11.35%	-0.35%
Nikkei 225	17.35%	-1.18%
Eurostoxx 50	19.23%	0.08%

5yr Implied (vol pts)		
FTSE 100	18.02%	0.01%
S&P 500	19.54%	-0.20%
Nikkei 225	18.03%	-0.55%
Eurostoxx 50	19.25%	-0.11%

Source Bloomberg / Partner Banks
Data as at 21st April, 10.30am

Upcoming events	
23rd to 27th April	French Presidential Election 2017 – First Round
27th April	Bank of Japan Policy Statement
27th April	Draghi comments on Eurozone Interest Rate announcement
28th April	UK and US GDP % y/y

Contact:

General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2905 E sales@fortemcapital.com
Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2904 E research@fortemcapital.com

"Our culture runs on coffee and gasoline, the first often tasting like the second" – *Edward Abbey*

The research team at one of partnered banks assessed the impact of inflows into the Goldman Sachs commodity index (GSCI) or Bloomberg commodity index (BCOM) on the back of oil becoming **backwardated** (this is where front month futures cost less than back month futures). The "rising tide" of oil backwardation should drive new index flows, which in turn should "lift all boats" and elevate the price of smaller commodities such as copper, and more importantly, move some into backwardation. Specifically, they were interested in determining, in the event of significant inflows into commodity indexes, how much inflow would be required to pull other commodities into backwardation. They assumed a 10% increase in total index AUM from the flows into the BCOM, and estimated that this would result in approximately 7,600 contracts being bought in COMEX copper. Over a 12- week period, this would elevate front month copper prices, but also prices along the curve. They believe that the contango between 1month copper futures and 6month copper futures would disappear within three weeks, and after 12 weeks there would be significant backwardation. Logic dictates that the same is likely of other commodities, though the nuances of each market would obviously determine the precise price impact and how the curve might change.

Suffice to say, using copper as an example, a move into backwardation in oil, analysts strongly believe would create a change in sentiment, initiate renewed interest in the commodity complex, and generate inflows that would elevate commodity prices. This could, in many instances, lift commodities from a state of contango into backwardation. This structural change to the commodities curve improves pricing in longer dated participation structures as naturally, if the forward is less expensive an investor is able to purchase more upside than if it were at a higher price. Fortem and our partner banks will remain vigilant and be sure to make our clients aware if this does occur. Currently longer term futures are still quite expensive, and as such favourable pricing is harder to find (though there are exceptions). The below structure provides geared participation to Gold for example with a strong level of capital protection.

Gold	
Product	[Product Factsheet]
Participation	**125%**

However, there are other ways to play the commodity theme… Given the research detailed above, what about an investment with near zero equity beta, that benefits from inflows to the traditional commodity indices? Citigroup and Fortem have together developed a capital protected structure on a "smart index" launched by Citigroup's commodities team. The basic premise is that the major commodity indices have fixed schedules for rolling their futures, so by rolling prior to this, an investor is able to take advantage of the structural market inefficiencies that result from forced buyers and sellers. The average return of this index is 3.96% p.a. since inception in 2012, while simulated 10year return performance returns 5.51% p.a. (with a Sharpe ratio of 1.50). The simulated returns of the index have been as high as 16.5% in a single year, while also managing to return consistent positive results year on year to date. As result of the low volatility target (3%), call options on the index are very cheap; so cheap in fact that we can deliver a capital protected product on it with 2x leverage. Please see a brief summary of terms below with BBG ticker. Due to the unique nature of the product, this merits a more in depth discussion.

Smart Commodities	
Product Type	Citigroup 5 Year USD Capital Protected Participation on Commodity Index (CVICSA14) EIS
Participation	**200%**

For more details on any of the studies referenced in this week's FNL, or to find out more about the products described above, do please get in touch via the usual means.

Contact:

General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2905 E sales@fortemcapital.com
Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2904 E research@fortemcapital.com

Disclaimer

This factsheet has been issued and approved as a financial promotion by Fortem Capital Limited for the purpose of section 21 of the Financial Services and Markets Acts 2000. Fortem Capital Limited registration number 10042702 is authorised and regulated by the Financial Conduct Authority under firm reference number 755370. This factsheet is intended for Professional Investors and Institutional Clients and advisors and should not be communicated to any other person. The information has been prepared solely for information purposes only and is not an offer or solicitation of an offer to buy or sell the product. All information, including prices, analytical data and opinions contained within this factsheet are believed to be correct, accurate and derived from reliable sources as at the date of the factsheet. However, no representation or warranty, expressed or implied is made as to the correctness, accuracy or validity of such information. Fortem Capital Limited assumes no responsibility or liability for any errors, omissions or inaccuracy with respect to the information contained within this factsheet. All price and analytical data included in this factsheet is intended for indicative purposes only and is as at the date of the factsheet. The value of investments and the income from them can go down as well as up and the investor may not get back the amount originally invested. Past performance is not necessarily a guide for the future. The information within this document does not take into account the specific investment objective or financial situation of any person. Investors should refer to the final documentation and any prospectus to ascertain all of the risks and terms associated with these securities and seek independent advice, where necessary, before making any decision to buy or sell. The product may not be offered, sold, transferred or delivered directly or indirectly in the United States to, or for the account or benefit of, any U.S. Person.

Contact:

General: T 020 8050 2900 E enquiries@fortemcapital.com
Sales: T 020 8050 2905 E sales@fortemcapital.com
Trading: T 020 8050 2901 E trading@fortemcapital.com
Research: T 020 8050 2904 E research@fortemcapital.com