Investment Commentary **January 2017**

Commodities: Why Recoveries Typically Persist

In our May 2016 Investment Commentary, we stated our opinion that the price action of all three major commodity sectors (energy, metals, and agriculture) was signaling a trend reversal in commodities, and that it was a good time to reexamine commodity allocations. Crude oil, in particular, had just made a dramatic move from the lows in late January and early February, and was up over 75% from that point. That sizable a move in what is arguably the world's largest "market cap" physical asset was, we concluded, indicative of a cyclical change in direction, sentiment, and likely subsequent performance expectations for the commodities asset class as a whole. Now that we have seen a full calendar year of positive price action (+13.35% in 2016, and +1.34% YTD**), an even stronger case can be made that we have entered a period of commodity price recoveries, and there are a number of reasons to support the contention that the rally in 2016 is not a temporary phenomenon.

The most compelling evidence is simply the historical cycle of commodity prices. Commodity prices move up and down primarily due to the very normal process of supply (production) and demand (consumption) price equilibration. Over a full cycle, increasing demand leads to higher prices, which is then met with higher and more profitable production as a response. The combination of increased production and higher prices leads to a corresponding decline in demand, and possible over-production, which is eventually followed by a decline in prices. Lower prices, in turn, lead to production destruction at the same time that demand may again be building, and the cycle begins again. Although the economic environment is certainly also a driver, this cyclical movement of commodity prices over time can be thought of as mean reverting, many times independent of economic influences (2016's commodity performance is an example of this, having occurred without the benefit of significant positive revisions to GDP or CPI).

For this reason, when commodity investments experience a protracted price decline, eventually *this has always been followed by a period of protracted price increases.* This would seem to be a normal characteristic of any investment class, that low prices are followed by high prices, and vice versa. But, the obvious fact that price trends in investments always eventually change directions is really not what matters. What we're really interested in is the *persistence* of this, since we're typically investing after the directional change has occurred. In the case of commodities, positive performance following a trend reversal has been *predominantly multi-year in duration.* This has been so consistent that for the period from 1970 to 2016 (the longest available published major benchmark data*), there was only *one year* in which a previous period of commodity benchmark price decline was not followed by *multiple years* of increasing prices. While that lone year (1992) was followed by a decline in 1993, it also preceded a significant rally in the years from 1994-1996. So, it is

historically anomalous for commodities to exhibit a single year of positive price performance and then suddenly stop.

When an asset class returns to outperformance following multiple years of underperformance, there may be a natural tendency for some investors to either be wary of a possible false rally or think that it’s too late to reallocate because they’ve missed a genuine rally with limited further momentum. Investors should gain confidence from the fact that diversified commodities investments have almost never behaved this way.

John Reese
Chief Executive Officer

**Commodities data represented by the S&P GSCI Total Return from January 1970 to July 1998 and the Bloomberg Commodity Index Total Return from August 1998 through December 31, 2016 **Rogers International Commodity Index® data through January 14, 2017*