# Rethinking the strategic case for commodities

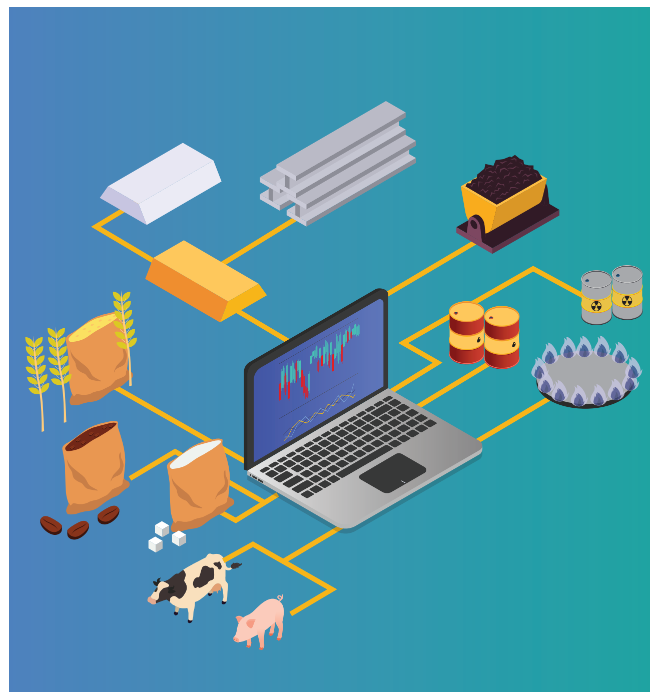


ILLUSTRATION: SHUTTERSTOCK

Institutional investors are scaling down their allocation to commodities while inflation may finally return to the scene, due to massive monetary and budgetary stimulus. What potential role is left for the asset class?

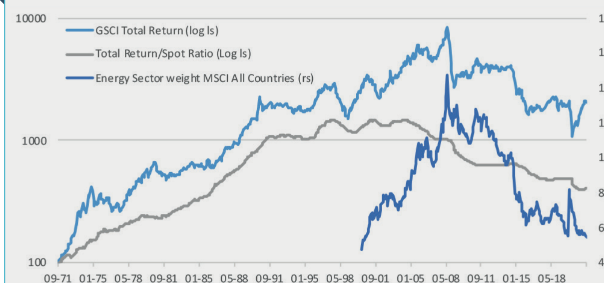
By *Gerlof de Vrij*

The jury is still out on whether the revival of inflation will be transitory or more structural, but the question of what would be a good portfolio hedge for a regime switch away from deflation, has become an important topic. Commodities have long been an asset class that should have served that purpose, but the post-2008 performance has been extremely challenging, especially during the COVID-19 shock in March 2020, when oil prices sank to subzero. Some pension funds capitulated and abandoned the volatile asset class, but others are still holding on[1]. The next exodus is on its way for ESG reasons, with additional large pension funds announcing their fossil fuel related disinvestments.

Commodities as an asset class became more widely accepted in the early 2000s. The underlying strategic investment studies were using pre-2000 return data, and especially the '70s showed the benefit of commodity investing in a stagflation regime. The oil shocks of 1973 and 1979 harmed both bonds and equities. When the investments in commodity indices took off, there had been a long period of underinvestment in capacity. Then the rise of China lifted the commodity complex from a low base, thereby generating solid returns. This commodity supercycle came to an abrupt standstill after the price of Brent peaked mid 2008 north of 145 $/b, to drop to 34 $/b late Dec 2008. Although a significant recovery followed, the return profile of the asset class never fully recovered and the diversification benefit eroded significantly.

As commodity investing is predominantly implemented through futures, the total return is the sum of three components: the cash, spot and roll return. The cash yield under the funded futures portfolio used to be high and positive, even in real terms, but the result of continuous central bank emergency rate cuts and deflation fighting is that money market rates have vanished completely, and worse. Regarding the roll return, the assumption was that this component would be positive, as for several commodities, crude being the most significant, the futures curve tends to be in backwardation in the front end, as a premium for the commitment to buy oil in the future. However, as more investors embraced commodities as an asset class, this backwardation premium quickly became thinner and turned negative (contango) in 2004. Over the period of 1980 to 2004, the return generated more than 8% annualized on top of the spot index, but from 2004 to today, it subtracted more than an average 7% per year (Figure 1). This combination of peaking spot prices, ever lower cash returns

**FIGURE 1: COMMODITY RETURN AND ENERGY SECTOR WEIGHT**




Source: Bloomberg, Capstone

and deeply negative roll yields, has been costing passive commodity investors dearly.

Regarding the diversification benefit, the story is not much different. In a commodity supply shock prices spike and shortages will dampen economic growth. This combination is very unfavorable for stocks and bonds, especially when looking at real returns. The global central bank fight against inflation, which started in the early '80s, implied a reaction function that was a fundamental driver behind the negative correlation between commodities versus stocks and bonds. The higher commodities, the higher inflation, the more hawkish the central bank and the more difficult it becomes for equities to trade at high multiples.

From 2000 onwards, this reaction function changed, as deflation fighting became the most important goal. If commodities rose, it was seen as a reflection of economic reflation, which was good for equities while bond yields were kept relatively low to ensure there would be enough escape velocity to end the deflation regime. Diversification failed when it mattered most. The first time was 2008 and the second severe overlapping loss came in March 2020.

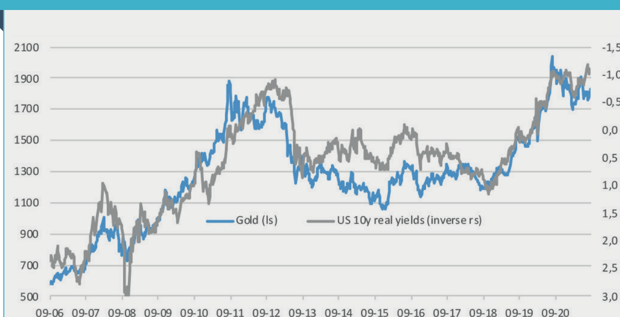
Commodities have rebounded from the low in 2020 and inflation has rebounded beyond market expectations. This has revived interest in the asset class, but there are many unknowns. Some of the return drivers might be structurally impeded. For instance, the reliance on low to negative rates has become so dominant that a return to historically 'normal' levels is unlikely. Furthermore, the backwardation premium is unlikely to structurally return as investor awareness will induce mitigating flows. The possibility of a new supercycle might be quite remote. For instance, OPEC crude production capacity is much larger than current production, which is held back by quite a remarkable discipline amongst OPEC+ members. Although this discipline might hold, it still represents a fragile balance and it is contrary to the capacity shortage during the supercycle.

The story of commodities within the equity market resembles the story of the commodity futures index. For example, the market cap weight of MSCI All Countries energy sector was 5% in 2000 and rose to a peak of 14.7% mid 2008. Since then it has fallen continuously and now only stands at 5.5% (Figure 1). Not only had the underlying fundamentals caused this, but also ESG considerations, that resulted in exclusion by large institutional investors.

Some investors see gold as a special asset class and an inflation hedge. However, the price of gold is closely linked to US real yields, as gold itself doesn't have a yield and competes with Treasuries as a safe haven (Figure 2). This implies that gold is probably very expensive as real yields are at rock-bottom levels. And a rise in gold when inflation rises, is conditional on lagging nominal yields.

So, if static long-only investing in commodities raises doubts, should one abandon the asset class altogether? This would be quite radical and would leave a sector that is economically and financially highly relevant in neglect. Commodities do offer a wide range of opportunities, for instance as in real investments/natural resources or in trend-following, where they represent an important and successful part of the universe. Furthermore, a dynamic approach to commodity investing can overcome the pitfalls of a static approach. Conditional rule-based participation, if preferred long-only, can outperform a passive approach and offer protection and returns when commodities build upward momentum. ■

**FIGURE 2: GOLD VERSUS REAL YIELDS**




Source: Bloomberg, Capstone

1 https://fd.nl/beurs/1364042/pensioenfonds-zorg-en-welzijn-na-miljardenverlies-uit-olietermijnmarkt; https://fd.nl/beurs/1409803/eerste-grote-nederlandse-pensioenfonds-stapt-uit-olie-en-gas

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## SUMMARY

Commodity investing has been a challenge.

Massive stimulus triggers renewed interest in inflation protection.

Passive exposure requires a renewed assessment of return drivers.

Alternative approaches to commodities offer a broad opportunity set.