SEPTEMBER 2015

NAVIGATING COMMODITY BOOM-BUST CYCLES

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Main Points

- Commodity prices tend to move in boom and bust cycles, sparked first by temporary demand factors that encourage a surge in production, followed by sharply falling prices as demand conditions return to normal.
- Oil, natural gas, gold and iron ore have all fallen recently, some by as much as 70%, due to a variety of supply and demand dynamics.
- SCS has reduced its exposure to public commodity markets and sees better potential in private real estate and distressed or special situations within private energy.

Overview: Commodity prices tend to move in boom and bust cycles. These cycles are typically sparked first by temporary demand factors that encourage a surge in production, followed by sharply falling commodity prices as demand conditions return to normal. Extra production facilities often stay on-line during this period, even if operating at a loss, either in the belief that lower prices will prove to be temporary or in order to meet the sunk costs incurred in building these facilities. Oil and natural gas prices have recently seen a variant of this theme, with rapid advances in technology (horizontal drilling and hydraulic fracturing, or "fracking,") resulting in surging US production which drove prices lower. Global oil and gas production has not yet fallen, leaving prices under continued pressure. Supply increased. Demand didn't. Prices fell. Some of the reasons for the continued high level of production are discussed below. In addition, we briefly look at several different sectors of the commodity markets and forces that may have shaped recent price movements. Finally we share some of our views on the investment implications for SCS portfolios and why we see better potential within private real estate and distressed or special situations in private energy.

Energy—Oil and Natural Gas: Global oil prices declined significantly in 2014 and made a low of $37.75/bbl this summer. High to low, West Texas Intermediate (WTI) crude oil prices declined by 65%. Natural gas prices fell by 69% between 2008 and 2012 and have generally been in a range around $4/BBtu since then. Much of this decline in prices appears to be directly the result of increased US production that has not been met by cuts from other producers. US oil production rose from roughly 5.5 million barrels per day in 2011 to a high of 9.6 million barrels per day this year. This is the highest level of US oil production since its peak at around 10 million barrels per day in the early 1970s. Yet in response, oil producers globally have just kept pumping. OPEC and Saudi Arabia in particular have stated that they are willing to suffer sustained periods of price declines and accompanying revenue shortfalls in order to force oil production to decline in the US. So far their approach hasn't worked. Until just recently, US oil production continued to rise even as the number of operating oil rigs in the US has plunged[1]. (See chart on following page showing US oil production in white plotted against price, in yellow).

Two fundamental reasons are behind the continued global glut of oil. In terms of the US, the main reason for still high production has been a surprising surge in productivity. Estimates are that by the end of 2015 "every dollar spent on unconventional oil will be 65% more efficient than in 2014,"[2] according to top energy expert Daniel Yergin, Vice

U.S. Crude Oil Production vs. WTI Price
September 8, 2010 - September 8, 2015

Source: Doubleline, Bloomberg. DOETCRUD Index = DCE Crude Oil Total Production data tracks weekly barrels of petroleum status released by the Energu Information Administration. CL1 Comdy = generic crude oil futures current contract. You cannot invest directly in an index.

Chairman of HIS Cambridge Energy Research Associates. Unconventional (shale and horizontal) oil producers have become surprisingly more efficient at cutting costs in order to keep wells on-line when facing pressures, Yergin writes. There is a limit, obviously, to what can be achieved through increasing efficiencies, and the recent rollover in production suggests that US producers may have reached their productivity limits. In addition, a lot of production was successfully hedged, but as these hedges roll off, production may begin to fall. The lack of any oil production cuts is the other major reason for the continued oil glut. Many producing countries, such as Russia and Saudi Arabia, have grown accustomed to spending oil revenues on domestic social programs, to support their otherwise weak economies or even to suppress social unrest. The Saudis are running a budget deficit and have actually begun large-scale borrowing in the global debt markets to make up for their revenue shortfall. They could cut production, but then they would be giving up market share, something they remain unwilling to do. Other producers find themselves forced to increase production as prices fall, in order to maintain cash flows to pay fixed expenses. Finally, with sanctions against Iran being lifted, there will be a likely increase of between 400,000 and 600,000 barrels per day of additional supply coming onto the market. Thus, prices remain depressed, in the $45/bbl range today.

Over the long run, however, we expect that energy prices will stabilize and then move higher as energy demands continue to grow. Global demand for energy is widely expected to continue growing at the rate of about 1.5% per year for the next 30 years. The majority of this demand is expected to come from developing market economies which continue to see more rapid population and economic growth than is forecast for developed market countries. Fossil fuels are expected to continue to supply close to 80% of global energy use through 2040, according to the US Energy Information Administration (EIA). Oil demand is expected to rise from 86.8 million barrels per day in 2010 to 119.4 million barrels per day by 2040, a 37% increase. Demand for electricity is expected to grow at a rate of 2.6% for the next couple of decades.

Gold and Silver: Gold has suffered a 44% decline from its high price of $1,920/oz in September of 2011 to a low of $1,072/oz in August. This represents a full 50% retreat of the rally from the lows of 2001 of just over $250/oz. Three main reasons for this decline include (1) Falling inflation expectations: The high in gold prices in September 2011 corresponded almost exactly with the post-crisis high in US consumer prices of +3.9% that month. And, while the picture is choppy, this year's July low in gold prices roughly corresponded to the low in US consumer price inflation over the same period, which bottomed at -0.2% in April; (2) General political stability exists in the developed world while oil producing countries remain largely unaffected by violence and the continuing refugee crisis. No Middle Eastern oil producing nations are accepting any refugees. Recall that in 2011, there was a multi-country European debt crisis which, at the time, was considered a threat to the existence of the euro itself. All of the major issues concerning the sovereign bonds of the EU have since been resolved. There is currently little risk that the EU will break apart. Thus the EU "crisis insurance premium" that had been built into gold's price has disappeared. (3) Finally, the US dollar has rallied since 2011, this year reaching its highest value in over a decade. Also remember that there had been concerns back in the budget crisis of 2011 that political disagreements might result in the US defaulting on its debts. S&P even downgraded the US from AAA to AA+ as a result of budget battles in August 2011. Those fears turned out to be unfounded, which again reduced a "fear premium" that had been built into the price of gold. While other globally important currencies, particularly the euro and the yen, have declined sharply since 2011, these declines did not occur because of crisis conditions in these nations. Instead, these currency declines were encouraged by their own central banks in order to boost exports and generate economic growth. The currencies of these countries didn't collapse as a result of rank mismanagement or policy mistakes as many had feared. Economic growth has been generally positive in Europe and Japan, bond markets are stable with positive equity market returns, while threats to sovereign solvency have abated. All of this has helped to reduce the demand for gold.

Industrial Metals: Over the past several years, industrial metal prices have suffered from the classic boom-bust cycle. Chinese demand first surged as infrastructure spending rose. Stockpiling of raw materials expanded in China in anticipation of even more construction, driving prices higher. New investment in mines increased. Then China shifted its policy focus from an infrastructure build-out to a focus on developing a services-based economy. Suppliers had geared up to meet what was expected to be ever increasing Chinese demand. Instead, demand was hit doubly hard as China's domestic policies changed and suppliers were left with already large but now unneeded stockpiles along with increased production capacity that had come on-line. As a result, iron ore prices collapsed from $179/dry metric ton in 2011 to $52 per ton this summer, a decline of 71%. Prices of copper, aluminum and other industrial metals have also seen significant price declines since 2011.

REITs: Real Estate Investment Trusts (REITs) are not equivalent to traditional commodities, but we've included them here because most REITs have a real asset component. REITs are hybrid instruments that perform either like bonds (if they are mortgage-backed REITs) or like equities (if they own their underlying real estate assets), which is most of the market. While REITs tend to perform like equities, they also tend to have higher volatility because of their relatively higher sensitivity to interest rates. REITs outperformed the S&P 500 between the low in equities in March 2009 and today by about 600 basis points per year (based on the returns of the Dow Jones REIT Index). However, REITs tend to underperform during periods of rising interest rates. For instance, during the taper tantrum of 2013 when 30-year Treasury yields rose from 2.80% to 3.97%, the Dow Jones REIT Index underperformed the S&P 500 by 981 basis points. This sensitivity to interest rates exists because REITs have both an interest rate component (they pay out rents which make them more like a fixed income asset) as well an inflation component (i.e., the changing values of their underlying real estate). Rising rates, therefore, will tend to make REITs less attractive compared to bonds. REITs also face risks from rising financing costs and are at risk from deflationary conditions due to potentially falling real estate prices. REITs have underperformed the S&P 500 this year by about 330 basis points on expectations of rising rates – in spite of low vacancy rates in both commercial and residential REITs, rising rents and rising real estate prices. We expect that REITs will continue to underperform as interest rates normalize in the US, and we prefer to invest in less liquid private real assets that can be purchased at market discounts.

Conclusion: Investments in traditional commodity markets (oil, coal, gold, industrial metals) tend to be subject to boom and bust cycles caused by changing supply and demand dynamics and price swings following excessive investment in production capabilities. SCS has reduced exposures to public commodity markets in stages beginning with very timely reductions in commodity-based mutual funds and limited partnerships in 2013. We followed this move with cuts in REITs and Master Limited Partnerships (MLPs) in late 2014, and finally with reductions to gold in March. As of this writing, all of these commodity investments have moved lower in value since our sales. Although our current tactical views are pretty much neutral, commodities will continue to be an important investment in periods when increases in inflation stay above market expectations. We do not, however, see such a scenario developing within the next year. Since commodities do not pay a dividend and are vulnerable to large downside volatility from supply shocks, our public commodity exposure is likely to remain limited during periods of benign inflation. While we may be approaching the bottoming phase for commodity prices, we feel that we are still in a period of back and forth price movements that don't yet warrant an allocation.

Given our view that interest rates will methodically normalize over the next several years and will, therefore, provide a headwind to public REITs, we don't currently recommend an allocation. We see better opportunities in private real estate investments in markets that are less efficient. These investments have cheaper valuations and present opportunities to buy properties that can be greatly improved upon in various ways by private fund managers to boost yields and generate capital gains. We also see better ways to play the energy space than large, public diversified producers and refiners. The best current opportunities appear to be in special situations and distressed areas in the private energy space, utilizing top specialist managers who can get access to acreage in the best areas representing the lowest cost extraction of oil and gas, at deeply discounted valuations.

Finally, we are keeping a close eye on MLPs, which are likely to be the first area in the public markets where we may re-enter with an allocation. Midstream oil and gas plays in a tax-advantaged vehicle such as an MLP, which answer the need to provide logistical services to transport energy from downstream to upstream players, is probably the best current opportunity in the public markets. Prices are off 20% to 30%, on average, although investments still face headwinds. It is important for the industry to work through the groups that are best positioned going forward in terms of financing needs, contractual issues and credit risks. Time is needed to work through these issues before a more general uptrend is likely to resume. We feel that there is plenty of time to evaluate the best opportunities and patiently wait for a better time to re-establish an investment.

REFERENCES

[1] The Baker Hughes count of oil rigs operating in the United States plunged from a high of over 1600 in October of 2014 to just 662 as of early September. Other rig counts differ significantly, but tell the same story of a significant pullback in operational rigs since Q4 of 2014.

[2] "Oil Expert Daniel Yergin: 'hard times' ahead for producers", by Brian O'Keefe, Fortune Magazine, August 25, 2015; Daniel Yergin is Vice Chairman of HIS Cambridge Energy Research Associates.

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