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PROGRESS.**

Illuminating Wealth,  
Accelerating Investments

July 27, 2015

## **Commodities are dead. Long Live Commodities!**

*Broad commodity indices have fallen over 50% since the 2008 “super spike” in prices. Crude oil fell over \$100 per barrel from its peak in July of 2008 to the low reached in March of this year. Gold has dropped over \$700 since 2011 and it isn’t that far away from breaking below \$1,000 per ounce given the pace of its descent. By some people’s calculations, silver is trading below its production costs. Copper has fallen over 40% since its high in 2011. Wheat has fallen over 50% since 2008. Last month, Molycorp, the “can’t lose” rare-earth mining company investment declared bankruptcy. Some investment strategists that specialize in asset allocation have declared that commodities are not now, nor ever were, an asset class and have disassociated themselves from any prior comments to the contrary. Many institutional investors have been liquidating commodity trading related investments for quite some time now. The mere mention of investing in commodities can result in the same social ostracism that the mention of the NASDAQ would have caused post tech-bust in 2000-2002. With all this, we feel one is justified in declaring commodities dead at this point, but as with monarchies, we now need to look forward to the time when commodities will once again be king, even if the coronation is still a bit in the future.*

### **Commodities: Why should we care?**

Commodities are a lot like your heartbeat, respiration and blood tests. When they are exhibiting price behavior that is beyond “normal” expectations, you should pay attention because they are trying to tell you something. So even if you don’t invest in commodities, you should have some sense as to why they are doing what they are doing because they are impacted by factors that may also ultimately impact the performance of more mainstream investments like fixed income, equity, direct business ownership and real estate.

### **Are commodities an asset class?**

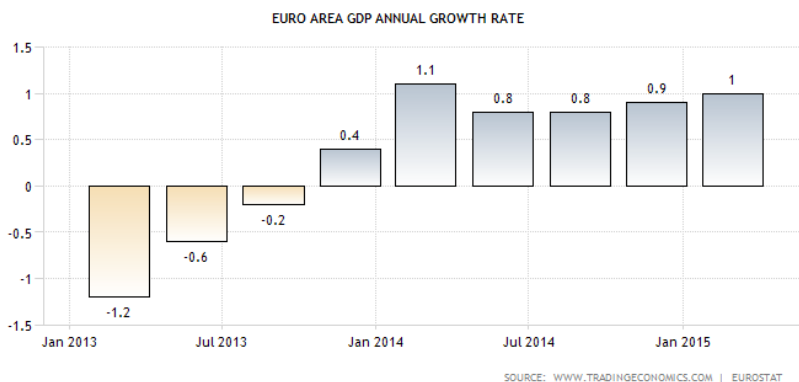
If you asked that question 5-7 years ago, many, if not most would have said “yes”, but now they have underperformed for so long, by so much, that many will say “no” or just refuse to answer. Our answer is “yes”, but with an important caveat. We would describe commodities as a “semi-cycle” asset class much in the same way we view the VIX volatility index. Both can provide attractive diversification benefits, but the right conditions must exist in order to be confident that their benefits have the potential to outweigh their risks. When the global economy is in the later stages of “synchronizing” (which is where we think we are now in the cycle), the

potential benefits begin to increase. Pursuing a commodity allocation for the purposes of diversification is very different than declaring “from this point forward, commodity prices will rise!”

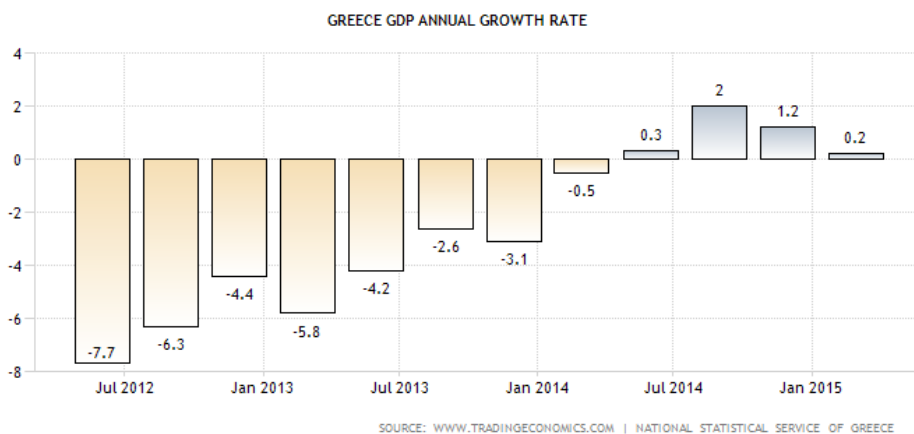
**Is there evidence of a positive global economic synchronization? We believe so.**

**Greek Debt Crisis** – Despite all the media attention paid to the Greek Debt Crisis, there are a couple of important questions that remain to be asked: “Why now?” and “Why?”

*Why now?* The European Union is growing again and has been for over a year (in fact, on a quarter-on-quarter basis it grew faster in the first quarter of this year than the U.S.):



It should also be noted that despite the “failure of austerity” rhetoric, that Greece had also recently begun to grow again. If the Greek Prime Minister Tsipras, and his political party Syriza, had been cooperative enough to have averted the closing of the Greek Banking system, their country’s progress might have been continued uninterrupted, but some “re-healing” will be needed to repair the economic damage done by the failed negotiating tactics used:

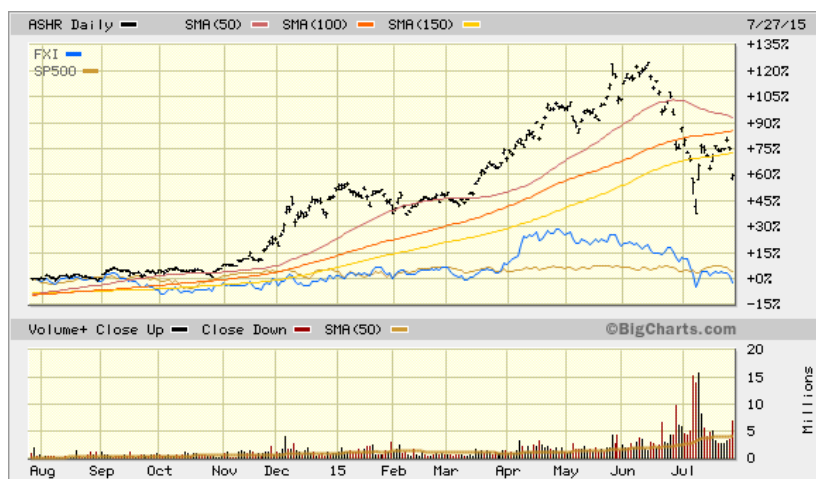


The ECB’s “quantitative easing” program is now in place and many of the European banks have made significant progress in fixing their balance sheets, though perhaps not to the same degree as U.S. banks. The timing of Greece’s debt payments is an obvious factor as to why this situation rose to a boil in recent months, but that is not the reason why the EU and ECB took such a hardline in the negotiations and risked a Euro exit by Greece. They were very firm in laying out Greece’s options because they had the confidence that the broader economic

and financial system could withstand the ramifications that a Greece exit posed. In this respect, the recent debt crisis was a sign of EU strength, not weakness as many tried to declare.

*Why?* This is really an important question because it lays out a future for most of Europe that is very different than most tend to expect. Many Americans tend to think of Europeans as unbridled socialists who dislike free markets, spend excessively on entitlements and support overly protective labor markets. Yet, if you look at what the EU and ECB demanded of Greece, and all of its members, it was and is: better fiscal management, a reduction in entitlements, freer labor markets, more privatization and a commitment to meet its financial obligations to the other EU members and organizations. The “rules of the road” for remaining a member of the EU are well documented and detailed and are more in keeping with capitalist orientation than an old style socialist approach.

**China’s Stock Market Crash** – The China stock market bubble/crash was a liquidity driven event that was largely limited to the domestic stock exchanges in Shanghai and Shenzhen or the “A” share markets. The China A-Shares ETF (ticker: ASHR) is a good proxy for observing this phenomenon as it rose just over 120% in less than a year, then gave back more than half of those gains, and as of today’s close is approximately 60% higher than it was a year ago as you can see the following chart:



The blue line in the above chart is the China Large-Cap ETF (ticker: FXI). It invests in “H” shares which are traded on the Hong Kong exchange. The FXI rose to a peak less than 30% above its starting point a year ago (90% less than the “A” share ETF) before pulling back to a 12-month price change of negative 2-3%. If these moves were more fundamentally driven, as opposed to liquidity driven, the “A” and “H” price performance would likely have been much more similar in both directions.

Despite the stock market volatility, we believe we are approaching an inflection point where the deceleration in the growth of China’s economy abates, and a new, lower rate of more sustainable growth is established. Many doubt the accuracy of China’s economic data. Yet, even without looking at the actual numerical values you can see that the Chinese economy is growing much slower than it did just a few years ago, but that slower rate of growth is starting to stabilize much more than it has at any point in the past decade:

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**The Shrinking Supply of U.S. Economic Recovery Doubters** – Many said the U.S. Federal Reserve’s actions would lead to hyper-inflation. That has not happened and now gold is coming under heavy selling pressure, breaking through the \$1,100/ounce level after having already fallen almost 40%:



Many said last year that the Federal Reserve would not end “Quantitative Easing”, but they did. Many have said that the Federal Reserve will not raise interest rates this year, but it is looking more likely that they will as we approach the end of summer. Many said that the rate of employment would not fall back to pre-crisis levels, but it has largely already done so:



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U.S. GDP is now growing close to 3% which is about the same rate that the U.S. economy grew on average from 1990-1997:



**OK, Europe is growing despite Greece, China might be stabilizing, and the U.S. is growing despite the skeptics. So are we at the start of a new commodity bull market?**

While there are certainly many other important economic regions (like Japan), and billions of people living in those other regions (like India), Europe, China and the U.S. are a very large sampling of the global economy. All three are growing now and their increased consumption of commodities will eventually follow. The precipitous fall in commodity prices over the past several years is causing high cost commodity producers to decrease supply at the same time that the foundation for increased commodity consumption is beginning to build. We are not at the inflection point where the excess supply has been diminished sufficiently to begin to push commodity prices higher on a broad basis. There are several events that may unfold in the coming year that will provide greater clarity as to when the next commodity bull market is ready to begin:

- 1) The full extent of the increased oil production from Iran needs to be better quantified.
- 2) The resolve of Saudi Arabia to maintain market share rather than try and support prices needs to be tested further if Iranian oil supplies rise sharply.
- 3) The potential effects of the current, and potentially historic, El Nino weather pattern needs to be better understood.
- 4) The remaining risk premium in gold and other precious metals needs to be “priced out” as the remaining “hyper-inflation/economic collapse” scenario-focused bears complete their final capitulation.
- 5) Confidence needs to increase with regards to whether China’s economic growth is truly stabilizing or if there is another significant down leg to come.

**If there are so many things that might need to happen before the next commodity bull market begins, and those developments may take a year or more to come into reality, why write about them now?**

One or more of these developments could happen much quicker than most everyone thinks they could happen, and for those who aren’t already thinking about this possibility, it could catch them unprepared.

We will continue to look for signs of stabilization in the broader commodity markets, and keep you informed as we continue to look for the next royal heir’s approach towards the commodity throne and the next commodity bull market begins anew. Until then:

**“Look to the Future, be Optimistic...but Hedge.”**

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