

Commodities 2015:

The outlook for investors



Agriculturals grant more diversification than gold

Could El Niño drive up grain prices in 2015?

Focus on CapEx cuts to deep-water production

In this issue...

03 Agricultural provide a greater diversifying effect than gold

By James Williams

05 Soybean and sugar boom in response to dollar strength

Interview with Nicole Thomas, McKeany-Flavell

09 Focus on CapEx cuts to deep-water production

Interview with Jeremy Baker, Harcourt Investment Consulting

10 Commodities outlook for 2015: The four key sectors

By James Williams

13 Could El Niño drive up grain prices in 2015?

Interview with Nitesh Shah, ETF Securities



Publisher

Editor: James Williams, james.williams@globalfundmedia.com
Managing Editor (Wealth Adviser & etfexpress): Beverly Chandler, beverly.chandler@globalfundmedia.com; **Online News Editor:** Mark Kitchen, mark.kitchen@globalfundmedia.com
Deputy Online News Editor: Leah Cunningham, leah.cunningham@globalfundmedia.com
Graphic Design: Siobhan Brownlow, siobhan.brownlow@globalfundmedia.com
Sales Managers: Simon Broch, simon.broch@globalfundmedia.com; Malcolm Dunn, malcolm.dunn@globalfundmedia.com
Marketing Administrator: Marion Fullerton, marion.fullerton@globalfundmedia.com
Head of Events: Katie Gopal, katie.gopal@globalfundmedia.com
Head of Awards Research: Mary Gopalan, mary.gopalan@globalfundmedia.com
Chief Operating Officer: Oliver Bradley, oliver.bradley@globalfundmedia.com
Chairman & Publisher: Sunil Gopalan, sunil.gopalan@globalfundmedia.com
Photographs: Stock.xchng
Published by: GFM Ltd, Floor One, Liberation Station, St Helier, Jersey JE2 3AS, Channel Islands
Tel: +44 (0)1534 719780 **Website:** www.globalfundmedia.com

©Copyright 2015 GFM Ltd. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the publisher.

Investment Warning: The information provided in this publication should not form the sole basis of any investment decision. No investment decision should be made in relation to any of the information provided other than on the advice of a professional financial advisor. Past performance is no guarantee of future results. The value and income derived from investments can go down as well as up.



Agriculturals provide a greater diversifying effect than gold

By James Williams

There are some commodities that investors rarely overlook when building their exposure to the complex: gold and energy commodities being top of the list. Agricultural commodities just aren't as popular.

This baffles people like Sal Gilbertie, president, CIO and co-founder of Teucrium Trading LLC, the only single commodity ETF provider in the US for corn, wheat, sugar and soybeans.

"People are shocked that in almost any 20-year period that you pick for the S&P 500 - sugar, soybeans, corn, wheat - are all often less correlated to the S&P 500 than gold. People tend to be under-represented on agriculturals because they don't buy them on a cyclical downturn, even though they are less correlated to the S&P 500 than gold.

"Why wouldn't someone take 20 per cent of their core gold holding and allocate that to agriculturals and wait for a mean reversion to potentially make some healthy returns? I'm still waiting for someone to write the headline, 'Sell your gold and buy some corn'. An investor could reallocate some gold to corn and with a mean reversion from the current gold to corn ratio levels they'd be able to buy back almost twice as much gold. Right now the same is also true with wheat and soybeans.

"Our message is that gold is not the only yellow commodity one should have in their portfolio," says Gilbertie.

Nitesh Shah is Associate Director, Research at ETF Securities. In his view, wheat and corn prices will see some upside

in 2015 following a strong year of production in 2014, as farmers reduce planting.

According to the International Grain Council, world corn production will see a sharp drop in 2015-16, with reduced output leading to a three-year low in inventories. It estimates that next season's world corn harvest will be 49m tonnes lower at 941m tonnes reported research firm Blackseagrain on 27 March 2015.

"Over the last couple of weeks one near-term trend that has stood out is a pick-up in demand for our long wheat ETP (WEAT). Any potential rise in wheat price will materialise before corn and soybeans, as there is more diversity in production for these commodities. As the Southern hemisphere's winter is in our summer you could see more of an uptick in corn and soybeans later in the year," says Shah.

Strong production in wheat led to prices falling from over USD7.50 per bushel last May to USD5.04 per bushel in September. The same trend was seen in corn. Then, a threat to a trade embargo with Russia in response to the situation in Ukraine led to a strong rally in Q4.

Gilbertie believes that of the USD100m of recorded inflows into Teucrium's four ETFs last year, approximately USD25m was probably in response to the Ukraine situation, given how important the Black Sea region is for grains, particularly wheat. "In general, however, investors are still under-represented in terms of how many agricultural commodities they own, and how much they think about them," says Gilbertie.

In Q4, the Teucrium Wheat Fund (WEAT) gained 24.93 per cent as prices climbed to a seven-month high.

Given the volatility in grain prices, investors should view agriculturals as more of a longer-term asset allocation and focus on buying in downward cycles on the back of a supply surplus.

"The way we construct our funds is to use three futures contracts to diminish the effects of contango and backwardation. This allows investors to buy and hold and not worry so much about the negative effects contango and backwardation could have on their portfolio," adds Gilbertie.

Corn impacts the lives of most people in the developed world on a daily basis (from



"An investor could reallocate some gold to corn and with a mean reversion from the current gold to corn ratio levels they'd be able to buy back almost twice as much gold. Right now the same is also true with wheat and soybeans."

Sal Gilbertie, Teucrium Trading

the ethanol containing in gasoline when filling the car up to the corn syrup used in soft drinks) so it is perhaps surprising that it tends to get overlooked. For example, anyone who had sold gold and bought corn in October 2014 would have made 18 per cent that month.

Agricultural commodities are no longer the purview of futures traders any more. "With ETFs like ours, anyone can trade. Hedge funds are beginning to realise that holding agricultural ETFs might actually offset some of the volatility in stock-based portfolios which could improve risk-adjusted returns," notes Gilbertie.

Last November, Estlander & Partners launched a new commodity program with a USD30m commitment from a large Nordic institution. Entitled the E&P Commodity Fund, it runs alongside the firm's existing systematic CTA programs, Alpha Trend and Freedom, and employs three investment themes, one of which is to exploit short-term trends by identifying potential supply shocks. The system combines different information on commodity inventories to generate a daily estimate, which is then used to plot a monthly average.

"Even though index-level volatility has been at all-time lows in commodities in recent years, there have still been huge moves in particular commodities, simply because demand is inelastic. If there is an event of some sort that impacts supply that has still led to large moves in prices. We've been analysing these short-term moves over the last 100 years of data.

"For short term moves we focus on markets where we believe there is an inventory shortage, which could lead

► 6

Soybean and sugar boom in response to dollar strength

Interview with Nicole Thomas

“We’re dealing with a global glut of soybeans compared to what we’ve seen in years past,” states Nicole Thomas, Commodity Analyst for McKeany-Flavell. “In the US last year we saw phenomenal yields; we’re sitting at 385m bushels.”

From a global standpoint, stock levels are expected to be high with estimates of 25 metric tonnes of additional stocks. This is a result of strong production not just in the US but, more importantly, in South America; in particular Brazil, which now exports more soybeans than its bigger neighbour.

“In the US this year we will likely see some significant acreage. I think it’ll be closer to 86m acres because if you look at the balance sheet and the potential impact of a crop that large, even with more normal yields of 45 bushels per acre in the US, you’re looking at close to 500m bushels, from a demand perspective that’s just too much,” comments Thomas.

Looking at the figures, the US stocks-to-usage ratio is currently 10.4 per cent; that’s high but still some way off the 17.5 per cent ratio in 2006/7, when soybean prices crashed to USD5.50 per bushel. Currently, they are trading at USD9.83, down from USD10.60 per bushel in early January.

This is being further fuelled by a strengthening US dollar, which has gained 7.7 per cent on the Brazilian real, prompting Brazilian farmers to export their crops and lock in profits.

“That is supportive of additional exports and is maintaining the strength of production we’ve seen this year. Soybean yields aren’t as high per acre as corn but as far as a cash crop is concerned it’s there in the best of times and the worst of times. It’s part



Nicole Thomas, Commodity Analyst for McKeany-Flavell

of the reason why prices are depressed right now and I suspect US farmers will be looking at the situation and use the opportunity to plant corn instead.

“The key takeaway for soybeans this year is one of ample supplies and weak prices,” clarifies Thomas.

With respect to sugar, the Sugar No.11 contract has fallen substantially, with Thomas also attributing much of this move to the Brazilian real where the cost of production is estimated to be between 17 and 18 cents per pound.

“For prices to be this low, for an extended period of time, is a rare feat. If you were to place the Brazilian real on a chart against Sugar No.11 they correlate highly. The London White or US No.6 markets are, to a degree, following what is happening with the Sugar No.11 contract so there is some causal relationship,” notes Thomas.

Since 2011, the Sugar No.11 contract has been in free fall. Prices have dropped from 32 cents per pound to 12.62 on the ICE futures exchange: their lowest in six years.

“A lot of what was driving demand for sugar was biofuels. There was a concern as to whether we could balance out supply and demand for these products, both from a food standpoint and a biofuel standpoint. However, there is now a broader energy mix, there’s been more investment in technologies outside of petroleum-based products such that we can handle demand for sugar,” says Thomas.

It is not unconceivable that sugar is entering a new structural paradigm, where the cost of production is 16 cents per pound on the low end and 20 cents per pound on the higher end, concludes Thomas. ■

4 ▶ to larger short-term jumps. Cocoa, for example, is an interesting opportunity right now, whereas at the other end of the spectrum crude oil has a supply glut. Cocoa inventories are very low right now. More than half of the world's supply is geographically concentrated to the Ivory Coast and Ghana and harvests are highly varied. We are looking at the potential for an upward trend in this commodity," explains Gillis Danielsen, Quantitative Portfolio Manager at Estlander & Partners.



"Cocoa, for example, is an interesting opportunity right now, whereas at the other end of the spectrum crude oil has a supply glut."

Gillis Danielsen, Estlander & Partners

Since June 2014, the price of Brent crude oil has slumped 46 per cent to a current level of USD57.79 on the back of a supply glut, thanks in large part to shale oil production in the US. WTI crude oil futures are trading at USD49.98, again way off their highs of USD98 in June. Although recent air strikes by Saudi Arabia in Yemen have caused a slight bounce upwards, the prospect of sanctions being lifted in Iran could lead to the country increasing its oil exports by 1m barrels per day. This would present a further downside risk to crude prices.

Danielsen refers to a "triple whammy" impacting oil prices right now: a strengthening US dollar, OPEC's desire to protect market share, and the shale oil boom.

"Historically, we saw a number of demand-driven slumps, the most recent following the Lehman Bros crash in 2008, but prices recovered quite considerably within a year. However, this is a supply-driven slump and we think the market will be range-bound for quite some time. A more fundamentally similar and lengthy slump occurred in 1985 in response to the North Sea and USSR supply glut," opines Danielsen.

Jeremy Baker is Head of Commodities at Harcourt Investment Consulting. In his opinion, shale oil production is a short-term solution to a long-term problem. Certainly, the geological conditions are unique to the US. Shale oil is not a model that can be easily replicated. Such has been the phenomenal success of shale oil that US output expanded to 9.14m barrels per day in December last year; the highest level since at least 1983 according to the US Energy Information Administration.

The number of rigs seeking oil in the US

dropped by 12 to 813 this week (24 March 2014) according to oil services firm Baker Hughes, but as Reuters recently pointed out this actually signals a slight decline in closures. The number of closures in the previous two weeks were 41 and 56 respectively.

Despite this, the reduction in horizontal drilling activity is not yet being seen. US oil production continues to hit 9.4m barrels per day, even higher than those recorded in December.

"There's a time delay factor involved here. The industry has gotten more efficient because of the lower price environment and shale oil drilling operations tend to be on a contract basis. The ones that cut off are probably contracts that have come to an end or are operating from a very high cost base. The strongest producers will survive and they've got better at what they are doing."

"The real test is that if prices fall to USD40 per barrel and remain there for a number of months, how will that affect drilling activity? It could have a significant impact. But if prices stay where they are, or bounce up to USD75 per barrel then those efficient producers will continue to produce and we won't see any meaningful decline."

"We generally believe that, excluding any kind of exogenous event, crude oil prices should move higher into the second half of the year," comments Baker.

Shah notes that over the last five years, shale oil has reversed more than three decades of production decline in the US.

"US rig numbers are down to a similar number to 2011 so we are seeing indications that the US wants to tighten supply. It's much easier for non-traditional shale oil wells to be switched on and switched off so the market can respond in both directions a lot quicker. Having said that there is still a time lag between shutting off rigs and seeing a

short order supply. We will see inventories come down as rigs get shut down, but there will be a time lag," says Shah.

This could therefore present an opportunity for investors to go short WTI crude before the price recovers. Both WTI and Brent crude oil futures are in contango (an upward sloping curve where the future price is higher than the spot price). By going short under these conditions one can benefit from positive roll yield on contracts.

"In the near-term, there could be some benefits to remaining short on crude oil. The bigger picture, in my view, is to consider going long on longer-dated contracts - June and July contracts onwards," suggests Shah.

Natural gas prices have also taken a pounding over the last 12 months. Bearish commentators were recently talking about Henry Hub natural gas prices reaching USD271 per million British Thermal Units. This week the front-month futures contract fell to USD2.60/MMBtu; a 42.89 per cent drop over the last 12 months. There are three reasons for this:

- Higher than expected supply from the Marcellus shale
- Natural gas production as a by-product of shale oil
- Increased drilling well efficiency.

"I've been hearing that prices could fall anywhere within the USD270 to USD250/MMBtu range," says Baker. "In the near-term we're moving out of winter into spring and the injection season will see production levels ramp up. People will be watching closely as to how those injections develop and the extent to which inventories build over the coming months. March through May will be a crucial period. If the injection level is solid then that could well push prices lower."

Some believe that natural gas prices are starting to reach a floor. From a longer-term structural perspective there are reasons to be slightly bullish on natural gas. More coal-fired power stations are switching to gas, and then of course there's liquid natural gas (LNG). If the US finds a natural market as a net exporter that could well push prices higher.

There are already a number of LNG export terminals in construction: the Sabine Pass liquefaction terminal in Louisiana, Cove Point LNG, Maryland.



"It depends whether the market, pricing wise, is ready to accept US LNG exportation. Where is it going to go? Probably to Europe, most likely Asia. It's still in the air at the moment. I would be a little more cautious on long-term LNG exports at the moment. There are some supportive elements for longer-term natural gas demand though," states Baker.

To conclude briefly on base metals - which will be covered more in the second editorial - Shah is not of the opinion that these present a short opportunity. He notes that for copper every one of the last four years the International Copper Study Group survey has said there would be a supply surplus, it has ended with a supply deficit.

"People really underestimate how tight copper supply is," says Shah.

Danielsen is not completely bearish on copper. One of the key reasons for lower base metal prices over the last year has been a strengthening dollar.

"Considering how much the oil price has fallen and the US dollar has risen, base metals have been doing reasonably well; in non-dollar terms they have actually risen YTD. Energy's role for metal prices on the supply side is sometimes overstated. In fact, the most energy-intensive of metals, Aluminium and Zinc, have only fallen about 5 per cent. On the other hand, there is a case to be made for long copper, considering the stimulative demand side effects of cheap energy in the current environment," concludes Danielsen. ■

One investment. Multiple benefits.

Commodities by Vontobel Asset Management

VONTOBEL



Jon Andersson
Portfolio Manager
Belvista Dynamic Commodity

Jeremy Baker
Senior
Commodities Strategist

Michel Salden
Portfolio Manager
Belvista Commodity

Loose central bank monetary policy has sown the seeds for inflation but also created higher correlations between commodities and other asset classes. Now, the gradual withdrawal of loose monetary policy means correlations between asset classes and within commodities have normalised to levels prior to the 2008 credit crisis.

The low correlation with other asset classes makes commodities an important tool to diversify a balanced portfolio, and they act as a powerful hedge against inflation. That is why we believe there is a lot more to commodities than only the secular growth of the Chinese and Indian economies.

In spite of the unique investment characteristics of commodities the asset class still remains undervalued. Catering towards institutional investment needs, our stable commodity team with over 40 years combined experience is at hand to guide clients through the complexities of commodity investing and provide actively managed investment solutions.

www.vontobel.com/am

Important legal information: This is a financial promotion for institutional investors only and is not intended as investment advice. The value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested. Please refer for more information on the fund to the latest prospectus, annual and semi-annual reports as well as the key investor information documents (KIID), which can be obtained in English from Vontobel Asset Management SA, London Branch, Third Floor, 22 Sackville Street, London W1S 3DN, or downloaded from our website funds.vontobel.com. For your protection your telephone calls may be monitored and recorded. This communication is for information only and does not constitute an offer of financial services, nor a recommendation or offer to purchase or sell shares in any financial instrument. Investors should contact their advisers and consider the investment objectives, risks and expenses of any investment carefully before investing. Vontobel Asset Management SA, London Branch, is authorised by the Commission de Surveillance du Secteur Financier (CSSF) and subject to limited regulation by the Financial Conduct Authority (FCA). Details about the extent of regulation by the FCA are available from Vontobel Asset Management SA, London Branch, on request.

Focus on CapEx cuts to deep-water production

Interview with Jeremy Baker

The last six months have been turbulent times for crude oil. On 17th March, WTI futures fell to USD42.63 – their lowest level since March 2009 – whilst Brent crude futures moved close to a six-year low of USD53 a barrel as the market reacted to the potential of Iran raising production on the back of sanctions being lifted.

On the fundamental side, steady supply growth has led to a glut of inventories in the US, reaching 444.4 million barrels according to the US Energy Information Administration; the highest level since 1982. Many were expecting last year that OPEC would address the production issue as shale oil production ramped up but nothing materialised. The result was a seismic drop in oil price: now some 60 per cent lower than a year ago.

Jeremy Baker is Senior Commodity Strategist at Harcourt Investment Consulting. “For me it was somewhat perplexing at the time why the market anticipated OPEC would do something. The crude oil price has just continued to grind lower, with no real support, and sooner or later we need to find a price level where there is a balance between supply and demand, as well as marginal cost of production.

“More importantly, as US shale oil has been a driver of growth over the last few years, the market is yet to determine the marginal cost of production for shale oil,” says Baker.

Some commentators and analysts are forecasting that crude oil prices could reach USD40 a barrel. Five months ago, Baker would never have entertained that possibility but admits that today anything is possible.

“The question is, how much is the price being driven on pure fundamentals and how much is being driven by the strength of the



Jeremy Baker, Senior Commodity Strategist at Harcourt Investment Consulting

US dollar? There is some linkage there. So yes, prices could reach USD40. Would they remain at that level for a long time? No, I don't think so,” comments Baker.

The Vontobel Fund – Belvista Commodity has since, the latter part of 2014, been holding longer-dated positions to trade crude oil.

“Rather than having a higher bias to a directional short position we are positioning the conviction trade by using longer-dated contracts due to the significant negative roll yield in the market, which is helping us generate relative alpha. February was a bit of a painful period because of the short-term rally in crude prices, when WTI futures rebounded to USD53/barrel but through the latter part of February, and on into March, we've recovered some of those losses as prices have again corrected lower.

“It is quite hard, when prices are volatile, to trade directionally. The portfolio manager's bias in the portfolio remains in contract selection. Initially, the portfolio manager was holding 12- to 15-month forward contracts in WTI and Brent but we've brought some of that positioning down to six months now,” explains Baker.

All the big oil production companies are cutting back on capital expenditure and that is going to impact deep-water production.

“If you cut back on CapEx your conventional oil supply is going to be hurt. That's what I mean about the market being overconfident; it's not factoring into account this point. Shale oil is less than 3 per cent of total oil production.

“We generally believe that crude oil prices should be higher than current levels by the end of the year, excluding any kind of exogenous event,” concludes Baker. ■



Commodities outlook for 2015: The four key sectors

By James Williams

Oil

According to the US Energy Information Administration (EIA) US oil production increased by 1.2m barrels per day last year to 8.7m barrels per day: the biggest annual change in US field production of crude oil in over a century. This supply glut caused crude oil prices to drop off a precipice last year, falling from USD107 per barrel in June to USD45 per barrel in March this year. Despite this, production has continued unabated.

On 25 March 2015, for example, the EIA announced that US crude production had risen to 9.42m barrels per day: the highest level since 1973.

Mike Wittner is Global Head of Oil Market Research and Head of US Commodities Research at Société Générale in New York. In his view, WTI will continue to see downward pressure for the next few weeks (although prices have climbed to USD48.35 at the time of writing) but the house forecast is that WTI prices will be USD45 per barrel for Q2 2015.

“WTI has been under severe downward pressure because of the stock builds in the US, in particular Cushing. It’s approaching capacity and getting tight. The weak point for Cushing is in the next few weeks because in April, as plant refinery maintenance starts to wind down, US refinery crude runs should increase and start to take the pressure off WTI; we would expect the pace of US stock builds to start to ease and by May, US inventories should top out for the season.

“We are expecting a 1.9m barrel per day oversupply for Q2. I think WTI will still see downward pressure for the next few weeks but then it will start to shift more to Brent crude as stock builds in Europe and Asia increase when refinery runs go down in April and May,” says Wittner, noting that their maintenance season comes after the US.

Wittner believes that WTI is getting close to a price floor. This is not to say that the market won’t set new lows for both WTI and Brent in this current cycle “but I think Q2 2015, as a whole, will be the low point. That

is because in the second half of the year two things happen: we will see a broadly balanced market and, more importantly, we think that some time in 2H15 we will finally see an impact on US crude supply as a result of the oil rig cuts," comments Wittner.

The potential for Iran to bring on stream an additional 1m barrels per day if nuclear negotiations continue to proceed and sanctions are lifted represents a downside risk but in Wittner's view this will be a late 2015 issue at best, and more likely a 2016 issue.

Since October, the number of oil rigs engaged in horizontal drilling to "frack" shale oil has dropped nearly 50 per cent to 813. Independent oil companies have cut spending this year by 35 to 40 per cent according to Wittner. That production has yet to reduce clearly indicates the time lag involved. That said, in Wittner's view the needle will start to move in April and May.

What investors and speculators are looking to get their heads around is where crude oil prices will be headed over the mid-term.

To start with, the OPEC meeting in June is not going to result in any reversal of decision by Saudi Arabia to cut production. The oil-rich kingdom has made a fundamental strategic shift in response to a fundamental supply shift, which is US shale oil. It will let the market balance itself and let price dynamics do the work.

"If you look at total non-OPEC supply growth over the last four years it has been totally dominated by US shale oil. That kept the global demand for OPEC crude flat to declining last year and the simple fact is that the consensus outlook is that shale oil will continue to grow into the middle of the next decade. There's no room for OPEC crude production to grow. It is being dominated by US shale oil production. That's precisely what the Saudis responded to last year.

"Could they have cut production in November by 1.5m barrels per day in conjunction with Kuwait and the UAE? Yes. At the time Brent was at USD80 per day. If they'd done that it would have rebalanced the markets and instead of prices dropping USD10 after the OPEC meeting they would have gone up USD10 and we would have been in a USD90 Brent market," explains Wittner.

The point is, the Saudis would have had to make another one or two big cuts this



"We think that some time in 2H15 we will finally see an impact on US crude supply as a result of the oil rig cuts."

Mike Wittner, Société Générale

year, and next year. While that might have succeeded in keeping Brent prices at USD90, the volume would have fallen and as Wittner stresses: "This is not about price or volume, it's about revenues.

The strategy of cutting production numerous times just doesn't work. It's precisely what happened in the 1980s."

The upshot? Probably that the crude oil market is entering a new structural price paradigm. In the old world, the supply balancing mechanism was the Saudis. In today's new world, that supply balance mechanism is no longer the Saudis and OPEC. It is the interplay between prices and production costs.

"That's what sets the market. I think we could end up in a USD75 Brent world. The bottom line is we had a three-year real world experiment with Brent at USD110 and the result of that experiment was too much supply and too little demand. Equally, I think if we found ourselves in a USD50 Brent world for an extended period we'd have the opposite problem. So I think we'll end up somewhere in the middle," concludes Wittner.

Soft commodities: cocoa

Fundamentally, there are some good reasons for the market to support higher cocoa prices than historical levels. Over 60 per cent of cocoa production comes out of the Ivory Coast and Ghana in West Africa. In both countries, the trees are getting older. Clearly, if anything happens in that region, it can heavily impact prices. The average age of the cocoa bean trees is 15 to 20 years old. Many are past their maximum yielding timeframe. As such futures prices, over the longer term, should be higher.

London cocoa futures rose by more than 13 per cent in 2014 on expectations that production would fall in West Africa. Currently, however, there are no obvious signs that futures should be trading as high as they have been; consistently above ► 14



Intelligent Access to Commodity Investments

Europe's most comprehensive choice of commodity exchange traded products (ETPs) including energy, precious and industrial metals, livestock, agriculture and broad commodities listed on Europe's leading exchanges.

ETF Securities provides accessible multi-asset investment solutions enabling investors to intelligently diversify their portfolios.

etfsecurities.com

Could El Niño drive up grain prices in 2015?

Interview with Nitesh Shah

The price of wheat and corn fell quite substantially last year, mainly on the back of strong planting and favourable weather. Between April and September, the price of corn futures fell from USD5 a bushel to USD3.30 a bushel. This year, as a result, US farmers have reduced their planting intentions.

“At the same time, the demand for corn, which is used in biofuels, may fall a little this year on the back of weak energy prices so there will be less need to put these biofuels into the energy mix,” comments Nitesh Shah, Research Analyst and Director at ETF Securities, a London-based ETF provider.

“For wheat we could see a 5 per cent increase in prices this year; for corn, which tends to have more growth in South America, the gains could be closer to double digits. We will probably see price gains in corn come later this year than wheat.”

Some market participants are even more bullish on corn if yields do indeed fall, flagging a potential uptick to USD4.50 a bushel; well above the USD3.88 a bushel the September futures contract was trading at on 17th March.

There’s always a risk, with grains, that weather conditions will be favourable.

According to the US National Oceanic and Atmospheric Agency, we are currently in an El Niño weather pattern, coming at a time when it will have minimal impact on crops. According to Shah, while the El Niño event is currently weak, “sea surface temperature in the equatorial Pacific Ocean is quite elevated, which means that there is a risk of the El Niño event gaining strength later on this year”.

Combine that with reduced planting and there could indeed be reasons to build



Nitesh Shah, Research Analyst and Director at ETF Securities

longer-dated positions in grains.

That said, exogenous events have the ability to disrupt commodities. In Q4 last year, this was clearly evident when the threat of an export ban in Russia led to a seven-month high in wheat prices.

Outside of grains, Shah believes that coffee could be another favourable contract. In 2014, the coffee price rose to USD2.20/lb on the back of a drought in Brazil (which produces 45% of Arabica coffee). Since October, however, prices have fallen from USD2.20/lb to USD1.35/lb, which Shah believes is largely unwarranted given the damage caused by the drought.

“Weather conditions have improved in recent weeks but it could be 2016 before we see the condition of Brazil’s coffee crops improve. While the depreciating Brazilian Real has weighed on coffee prices, the currency effect is likely to be transitory given the likely supply deficit this year. So it’s quite surprising that the coffee price has fallen so much for the front-month futures contract. Once the pessimism on the currency lifts and people look at the fundamentals I think there will be potential for an uptick in coffee prices this year as yields will simply be lower,” says Shah.

Shah thinks prices could go back up to the USD1.70/lb range this year. “It was trading at USD2.20/lb last October so there is certainly potential for some upside based on current prices.”

The overall theme for agriculturals this year is one of tightening supply, says Shah.

“I think there will be a conscious effort to reduce planting, particularly for grains. With respect to sugar, however, prices will likely remain relatively weak as we head into a fifth year of a supply surplus.” ■

11 ► USD2,900 a tonne over the last six months.

The International Cocoa Organisation (ICCO) last month revised estimates of a surplus to a global cocoa deficit of 17,000 tonnes in 2014/15. As a result, prices rallied 10.8 per cent in February although they have since fallen back to USD2,695 per tonne.

Asked whether cocoa presents a short selling opportunity over the near-term, Nicole Thomas, Commodity Analyst for McKeaney-Flavell responds: "A 17,000 tonne deficit might sound like a lot but it really isn't. As far as short selling opportunities go, in my humble opinion I would have to say it could be. It feels like futures are too high in relation to the fundamentals. To have maintained prices above USD3,000 per tonne over the last six months perplexes me because there is nothing out there that says the situation is that bad. However, I'd caution the short seller as due to the persistence of elevated futures, current levels may appeal to commercial users and add support to values.

"What would be a more reasonable level based on fundamentals would be a price of somewhere between USD2,400 and USD2,800 per tonne; similar prices to those seen in 2013."

Indeed, from a demand side chocolate consumption has dropped off in Europe. As the Wall Street Journal reported on 22 March 2015, the ICCO expects demand in Europe and the Americas to fall 2 per cent in each region, with demand in Asia potentially falling by 4 per cent.

"Where you need growth is in less mature markets like Asia where demand has primarily been for cocoa powder – and you need that demand to lean more on the side of chocolate. That would help balance the profitability for cocoa products. The bigger story right now with cocoa is the amount of speculation in that market and the need to plant fresh trees in West Africa," says Thomas. "It's hard to justify today's prices based on demand."

Precious metals

"At the start of the year our expectations were that the Federal Reserve would raise rates in June but we've recently revised that to September, which in the short-term is marginally more positive for gold," notes Suki Cooper, Precious Metals Analyst at Barclays.

This should present less downside risk



"We think silver is going to become much more interesting and will find more support but not before it tests further lows."

Suki Cooper, Barclays

for gold. A June rate hike would, in Cooper's opinion, have exposed a weak floor for gold prices but the rate hike potentially not happening until September should support seasonal buying in India.

"Gold faces a battle between a rate hike and seasonal strength; the rate hike is likely to be the more dominant of the two. 2015 is likely to see lows for the gold price and perhaps present good buying opportunities longer term.

"We forecast a Q3 price of USD1150 per ounce," confirms Cooper. The house forecast is for gold prices to average USD1183 per ounce for 2015.

At the time of writing spot gold was trading at USD1185 per ounce.

Silver prices in the near term are also expected to soften. Currently trading at USD16.71 per ounce, Cooper confirms that the house forecast is for prices to test lows below USD15 per ounce this year.

"However, silver looks to be an interesting market for the next couple of years. I think we are going to reach a turning point in terms of its fundamentals. Over the last couple of years mine supply has grown consistently to record levels since 2004. When we get nearer to 2017 we expect the market to switch to a supply deficit so although we think there's downside risk in step with gold, and that the rate hike is likely to be equally as negative, we do think the market surplus that has capped silver's price will become less of a burden.

"We think silver is going to become much more interesting and will find more support but not before it tests further lows," says Cooper.

For platinum, prices have been in steady decline since last year. Overall, it is still a market in deficit but above ground stocks have had the effect of capping upside price momentum. What has compounded the problem for platinum prices in 2015 is weak jewellery demand. Consumption out of China has been much weaker than anticipated.

"At the margin the fundamentals for

platinum are continuing to improve but having an annual deficit, on its own, isn't enough to push prices higher. Our price forecast for platinum this year is USD1,239 per ounce," confirms Cooper.

The outlook for palladium is far brighter. Indeed, out of the four precious metals it has the highest upside potential. Whilst it is currently trading at USD763 per ounce, Cooper says the price forecast for 2015 is USD805 per ounce. This is based on a sizeable supply deficit forecast for 2015 and 2016.

"It is a market that remains structurally under-supplied on an annual basis. Even though we are expecting some supply growth it's been weak this year: the South African strike has impacted supply. From a demand perspective, we are seeing growth in recycled metal and the auto story is much more favourable for palladium. We are seeing demand growth coming out of the US and China," concludes Cooper.

Base metals

"We're quite positive on copper prices this year. Although they've had a weak start to 2015 a lot of that has been down to the timing of Chinese New Year and in some cases, the fact that prices have fallen has deterred Chinese buyers in case prices fall further," comments Caroline Bain, Senior Commodities Economist at London-based Capital Economics.

LME stocks for both copper and nickel have continued to rise since the beginning of February. Copper stocks, for example, have risen 85 per cent since the start of the year.

There is a sense of optimism in the market about copper mine supply this year, which hardly grew at all last year. According to the International Copper Study Group (ICSG) in its March 2015 Copper Bulletin, world copper mine production increased by just 1.3 per cent in 2014 and had a production deficit of 475,000 tonnes.

Despite the optimism, recent price falls for copper – which have fallen from over USD3.20 per pound in July 2014 to USD2.77 per pound at the time of writing – will potentially delay bringing new mine production projects on stream.

"There's a lot of overconfidence in the market with respect to mine supply and probably too much negativity about



"We are slightly more bullish on where copper prices could finish by the end of this year."

Caroline Bain, Capital Economics

demand at the moment," says Bain. "China's economy might be slowing, but GDP growth of 7 per cent is still respectable by anyone's standards. We think the market has become a bit swept up in the China slowdown and that the price weakness has been overdone."

Based on Chinese government announcements on infrastructure spending by the state grid there should be some copper buying coming through anytime soon, says Bain.

"We are slightly more bullish on where copper prices could finish by the end of this year. As it becomes clearer that there isn't going to be a massive glut of copper then we might see speculators reduce their short positions and that could act as an additional catalyst for higher prices," says Bain.

As for other base metals, zinc stocks are falling. The market is expected to see a large number of mine closures over the next 12 months which could lead to stockpiling ahead of a tightening market. The nickel market looks like it will tighten significantly this year because Indonesia has a ban on ore exports. Once those stocks have been wound down there will be a lot of scope for nickel prices to rise.

"We think both the zinc and nickel markets will see some significant tightening this year. The signs are that demand is there but supply is a bit more difficult. MMG Limited is closing its massive Century zinc mine in Australia in Q3, for example," comments Bain.

Bain agrees that zinc has more upside potential than copper "except that copper is more highly traded and when sentiment towards copper turns more positive we might see a higher price move".

Demand is expected to be weak for lead to the extent that Bain does not expect to see a marked lift in prices this year. "The medium term outlook on demand is quite poor.

"We are also negative on both steel and iron ore prices because there are huge amounts of supply in the market," concludes Bain. ■