

7Twelve Analysis: Commodities

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It is always nice to “sail with the wind at your back”, a feeling current commodity investors are now experiencing. A confluence of forces; economic, demographic and political are driving up prices of items we need and use every day. Since this trend is anticipated to persist for many years to come, and because there is a low correlation between commodities and other investment classes, they should be strongly considered for inclusion in a well diversified portfolio.

Commodities are tangible, hard assets that we can usually see, touch and feel. Precious metals such as gold and silver, industrial materials including copper and rubber as well as agricultural products represented by corn, cocoa and wheat are all commonly traded commodities. Natural resources such as crude oil, natural gas, water and timber are also popular among commodity trades. Globally, there are 96 different commodities traded on 48 worldwide markets.

The entire commodity sector did well in 2010 but several performed exceptionally well. Cotton led the list with a scorching 85% return, followed closely by silver with a return of 83%. Coffee gained 67% and sugar returned a very respectable 53%.

There are numerous factors influencing the current surge in the commodities sector. Globally, the swelling populations in China and India as well as other emerging economies are demanding an improved living standard which is driving an increase in manufactured products of all types. In addition, governments including the U.S., Canada, and many in the EU are responding to the economic downturn and are investing in their infrastructure by building roads, increasing their power generation capabilities and expanding water and transportation systems.

The Organization for Economic Cooperation and Development, projects that governments will spend \$40 trillion over the next 20 years on improving infrastructure. Historically, the only precedent for this type of spending was immediately following a world war. Because the U.S. was at the helm of the economic resurgence, we were able to rise to a position of economic dominance at the conclusion of WW II. How governments chose to manage their countries wealth will help determine the balance of power going forward, especially in the emerging market economies.

Energy needs and reliance will have an increasing effect on commodity prices. The Brazilian government, for example, has mandated a 25% ethanol/75% gasoline blend for all their vehicles. Sugar cane, potatoes and corn are all plentiful in Brazil and are all crops utilized in the production of ethanol. As a result Brazil can expect their market prices to be positively influenced.

The fact that commodities are priced in U.S. dollars can have a major impact on their price during currency value fluctuation. For example, when the Federal Reserve engages in Quantitative Easing, more

U.S. dollars are allowed to circulate and because this money is chasing a fixed quantity of goods, it results in higher prices.

Because commodities have very low or even negative correlations, portfolio volatility is reduced and returns are enhanced when incorporated into a portfolio. Using commodities is a key component of the 7Twelve philosophy. With current global economic trends as they are, we fully intend to continue to invest in this pivotal and influential sector.