

S&P Dow Jones Indices

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Riding the Colossal Commodities Wave in Asia

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Last year, commodities hit their lowest level since 1999, but as of mid-year 2017, they were up nearly 15% from the bottom.¹ The S&P GSCI posted its first positive year in 2016 since 2012, which matters because positive years rarely show up alone. In fact, there have only been single years of positive returns for commodities three times since 1970. Also, inflows were the largest since 2009, when market participants took advantage of the 2008 crash that led to a three-year bull market.

While flows can influence price structure, they tend to be less important than fundamentals. The fundamental picture seems to be turning since most commodities that have been in substantial oversupply are looking healthier currently. Oil, the flagship of the commodities, has been in one of the largest surpluses ever, lasting over the past 2.5 years. The surplus seems to be balancing toward a deficit, bottoming out roughly at same level seen in 1999.

If commodity surpluses turn to deficits, the opportunity for growth can be substantial. Market participants in Asia see this and have responded with numerous product launches and pending listings to participate in this chance for growth. Since 2015, there have been 32 new listed products in Asia, plus nearly 30 more pending listings across a variety of single commodities and broad baskets, along with many 2x leveraged and inverse versions that are contributing to inflows.²

Three of the most compelling reasons to believe that the surge of inflows is sustainable are from the strong inflows to gold, the risk management available from broad baskets, and the trading opportunities in single commodities, especially in energy. Uncertainty about the stock market and global growth with rising political risks are likely to support continued flows into gold. Also, unlike in previous cycles, a critical mass of market participants now have experience with commodity risk and the benefits like diversification and inflation protection it can bring to a portfolio. With the majority of asset owners still underexposed to commodities, these inflows could reasonably continue. Lastly, the high volatility in oil and gas could persist from the developments in the market that will likely continue to provide attractive trading opportunities.

The potential trading opportunities in the midst of high volatility have also been attractive to Asian market participants, as evidenced by over twenty regional pending listings on inverse and 2x leveraged commodity indices. The most popular commodities used in these products are Brent crude, copper, corn, WTI crude oil, gold, natural gas, silver, and soybeans. While these inverse and 2x leveraged indices perform better in trending markets, if the market is choppy, then the return magnitude determines gains.

Historically, corn has trended most and has had relatively large gains to losses, making it a strong candidate for 2x leveraged and inverse strategies. Natural gas has posted the highest percentage of consecutive negative returns and has had large losses in opposite consecutive daily returns, making it a strong inverse candidate. Gold and silver may be good choices for the 2x leveraged indices, based on their high positive consecutive return rates, even though silver was more choppy than trending.

¹ Source: S&P Dow Jones Indices.

² Source: S&P Dow Jones Indices.

Gold and oil are the two most prevalent commodities in Asia. They can not only provide trading opportunities but may also offer diversification and inflation protection like broad commodity baskets.³ These two single commodities have much higher up-market capture ratios than down-market capture ratios across all major Asian stock markets. Not only are the up- and down-market capture ratios favorable in each market, but, on average, gold is positive during negative stock market months in Japan and Taiwan. Gold may provide inflation protection, though oil and copper have historically provided more inflation protection than gold. Since the launch of the S&P GSCI indices in 1991, the inflation beta of oil has been about 16.5 versus 9.2 from copper and 3.5 from gold. The excess return over inflation was also about 1.5 times greater from copper and oil than for gold, so while gold may be a solid diversifier, oil may offer more inflation protection.⁴

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³ Source: S&P Dow Jones Indices.

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