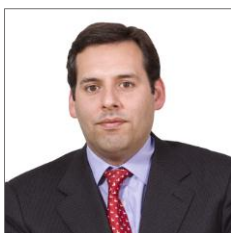


The outlook for commodities - July 2013



Nicolas Robin
Fund Manager

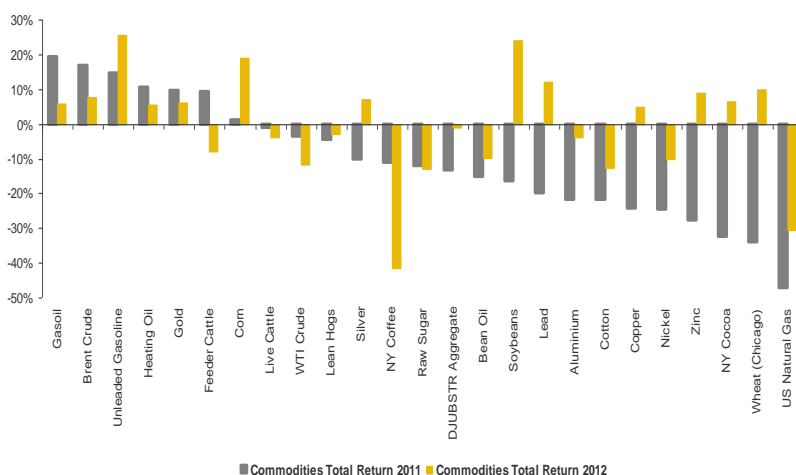
Sovereign risk, QE and geopolitical tensions the key drivers of markets

One of the key features in commodity markets over the last three years has been sovereign risk in the wake of the credit crisis and, as a corollary, quantitative easing (QE) – the colossal stimulus programme designed to boost global economic recovery. We launched our long-only commodities strategy in the wake of the first Greek crisis and markets saw considerable support in the second half of 2010, on the back of QE. Since then, markets have tended to be fairly volatile and have gyrated in both directions.

Probably the most notable market feature since 2011 has been the resurgence of geopolitical risk, starting with unrest in Tunisia and spreading to Egypt, Libya, and the Middle East. More recently, investors have become accustomed to a background level of geopolitical tension, a familiarity that has diminished the risk premium for investing in certain markets. However, we believe geopolitical tension is an on-going theme that will provide support for energy markets over the long term.

Back in 2007 and 2008, correlation between individual commodities had reached very high levels. Of late, however, we have seen significant de-correlation between individual commodities, leading to polarised returns. For example, in the year to 31 May 2013, the DJUBS Commodity index returns for corn exceeded 33% while natural gas rose by over 20%. At the same time, wheat increased by just over 1%, aluminium fell by more than 10% and silver declined by more than 20%.

Chart 1: Low correlation between individual commodities



Source: Bloomberg, DJ UBS, Threadneedle. Note: Performance for Total Return indices

Commodity decoupling has created opportunities for relative value trades within the portfolio and we have been able to successfully exploit this strategy in metals, energy and grains. This was particularly the case in grains with positions between corn and wheat, and in energy between Brent and WTI Crude Oil or US Gasoline and US Natural Gas.

So what has been driving this decoupling? We believe investors initially bought into the commodity supercycle theory, both as a way of tapping into the China story and as a hedge against inflation. The supercycle theory was based on the premise that the industrialisation of China would result in a prolonged period of sustained economic growth and increased demand for commodities, thus driving up prices for all commodities.

However, in recent months a growing consensus has developed that China's growth is likely to decelerate and undergo a shift in emphasis from investment in fixed assets and infrastructure towards domestic consumption. This is likely to have a significant impact, particularly on metals and bulk commodities. As a result, some investors have declared the supercycle dead and are focusing instead on specific factors within each commodity class, such as different supply and demand dynamics within individual markets.

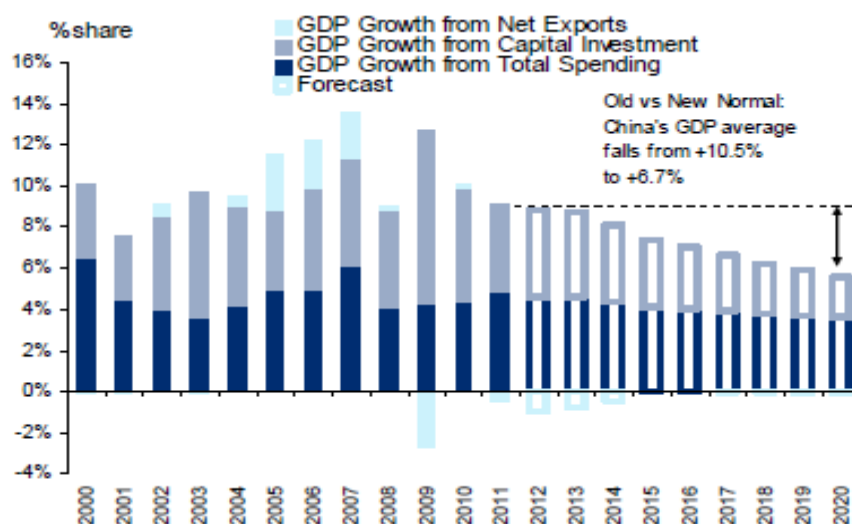
A further significant issue has been the extent to which the macroeconomic environment in the US is improving. A US economic recovery is something of a two-edged sword for commodities, as it has two opposing effects. On the one hand, a stronger US economy should lead to increased demand for commodities. However, it also tends to result in a strengthening dollar and, over time, there is quite a high correlation between dollar strength and commodity price weakness, since commodities are priced in dollars.

Our positioning

We are positive on the energy sector in general, and oil-based energy in particular, as structural demand continues to grow, particularly from emerging markets. Moreover, oil markets are less affected by a deceleration in Chinese growth or a change in the country's growth strategy. We also believe the impact of an improving US economic environment is positive for oil markets, as the US remains the largest consumer in the world and higher employment should have a positive impact on demand for oil and gasoline. A strengthening US dollar is of less relevance in this sector, as energy tends to be less correlated to the dollar than is the case with metals.

We have been underweight base metals for some time. The shift away from fixed-asset investment to consumer-led growth in China is bound to have an impact on those metals, such as copper, where China has been biggest source of demand over the past few years. The potential strength in the dollar is also likely to be negative for metals due to their strong correlation to the greenback. In addition, the investment we have seen from hedge funds has been driven by a bearish view on the dollar and, as the dollar has strengthened, we should see some liquidation of these trades.

Chart 2: Sources of Chinese growth and forecasts to 2020



Source: Citigroup, February 2013.

Outlook

We believe recent volatility in the commodities sector creates exciting opportunities to position our commodity portfolios advantageously in the second half of 2013. We remain bullish on the oil sector, especially oil products. Geopolitical risk in Syria and the Middle East in general is clearly a key issue. This risk has been underplayed lately because investors are paying more attention to China and the US – as we progress through the year, the market may be jolted by bad news. In the metals sector, we remain slightly bearish, as the outlook hinges on the changing nature of Chinese growth.

We remain firm believers in the benefits of active versus passive investment when accessing opportunities across commodity markets. We combine not only the use of curve strategies, which is a very popular way of investing in the commodities market, but also the above-mentioned relative value trades, enabling us to raise and lower risk, as appropriate. As intra-asset correlation comes down, our relative value strategies should continue to provide good opportunities.

Important information

For Investment Professionals use only, not to be relied upon by private investors. Past performance is not a guide to the future. The value of investments and any income from them can go down as well as up. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Asset Management Limited. Registered in England and Wales, No. 573204. Registered Office: 60 St Mary Axe, London EC3A 8JQ. Authorised and regulated in the UK by the Financial Conduct Authority. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited ("TPSHKL"). Registered Office: Unit 3004, Two Exchange Square, 8 Connaught Place, Central, Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Please note that TPSHKL can only deal with professional investors in Hong Kong within the meaning of the Securities and Futures Ordinance. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. Issued in Singapore by Threadneedle Investments Singapore (Pte) Limited, 07-07 Winsland House 1, 3 Killiney Road, Singapore 239519. Any Fund mentioned in this document is a restricted scheme in Singapore, and is available only to residents of Singapore who are Institutional Investors under Section 304 of the SFA, relevant persons pursuant to Section 305(1), or any person pursuant to Section 305(2) in accordance with the conditions of, any other applicable provision of the SFA. Threadneedle funds are not authorised or recognised by the Monetary Authority of Singapore (the "MAS") and Shares are not allowed to be offered to the retail public. This document is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.

This material includes forward looking statements, including projections of future economic and financial conditions. None of Threadneedle, its directors, officers or employees make any representation, warranty, guaranty, or other assurance that any of these forward looking statements will prove to be accurate.

Issued in the US by Threadneedle International Limited ("TINTL"), a UK.-based investment management firm provides financial services to individual and institutional investors. TINTL is registered as an investment adviser with the U.S. Securities and Exchange Commission and is authorised and regulated in the conduct of its investment business in the UK by the UK Financial Conduct Authority.