Commodities Update

threadneedle investments

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Monthly Summary

To begin, we would like to discuss the outlook for the commodity markets. There are two reasons for this; first, it is clear that there is a great deal of interest following this period of commodity underperformance, and second, we believe what's happening at the macroeconomic level right now is profoundly important for commodity prices over the next few years.

The most powerful force affecting commodity prices right now is the shift in "real growth" leadership from China and other emerging market countries back to the US. While this is neutral for commodities in the short term, it is bullish for commodities in both the medium and long term. Across the specific sectors, oil based energy is bullish short and medium term while agriculture, softs and base metals are neutral short term and bullish medium term. We believe all sectors will recover and be supported over the long term. The scenario of improving global growth begins with the US recovery which was first fuelled by the development of cheap and abundant energy. Initially it was natural gas and now, more importantly, it is additionally crude oil and liquids. This has driven an industrial renaissance in the US, the likes of which we have not seen for 30 years, and is being augmented by a strong housing recovery and widespread "onshoring" of business activity of all sorts. We have repeatedly stressed that the global significance of the declining US dependence on oil imported from outside of North America, and its abundant cheap energy is a pre condition for economic recovery.

One of the consequences of the US economy having abundant cheap domestically produced energy and leading the recovery in global economic growth is that it is creating a shortage of US dollars in many parts of the emerging market world. As a strong US dollar has for so long been associated with lower commodity prices, there is a tendency to make the sweeping generalisation that this is bearish for commodities. While initially, it has been, this is likely to prove to be transitory. What I expect to follow is improving economic conditions across developed markets, and as this coalesces, it will pull emerging market economies that are geared to the US and to other domestic markets. Adding to this the fact that in 2013, grain producers globally will by the end of this autumn, finally be able to replenish global inventories after several years of trying with extreme weather interruption. For many emerging market countries food shortages and price rationing should be over and food prices should fall significantly, over time this will be hugely supportive of bottom up economic growth across a wide range of these countries. We see the food supply as a key driver for emerging markets over the next 2 years.

Obviously, there are many risks to this scenario of improving global growth, such as geopolitical events or sovereign debt crises, but if this plays reasonably near to the fairway, then "real growth" will create the increased demand for commodities and importantly, the ability to afford them at higher price levels over time.

Returning to the performance of the fund for July, commodity prices rebounded 1.4%, paced by oil based energy and gold, which were the strongest sectors. Throughout the month gasoline increased 11% and gold rebounded 7.1%. Grains were the weakest with the sector declining 4.2% as weather across the Northern hemisphere has been good for growing grains and oilseeds. In this context the Threadneedle (Lux) Enhanced Commodities Fund was up 2.2% and outperformed the Dow Jones UBS index by 78 basis points.

Starting with energy, both our curve position and underweight in US natural gas combined to be the strongest contributor to performance, adding 29 bps as the benign weather that has been helping the corn crop also stretched across to the east coast in sharp contrast to last summers' extreme heat and drought. Production of natural gas has continued to be strong and is likely to increase into year end. Gasoline was strong and at the very front of the curve, where we are positioned, has outperformed. We expect continued refining issues to keep this market tight and backwardated. WTI strengthened against

brent, which dragged on performance by about 10bps. With speculative longs in WTI at record levels, there is scope for the arbitrage to widen back out against brent and WTI to return to a normal contangoed market. In total, oil based energy added 28 basis points to outperformance.

In precious metals, we were market weight and with no curve positions. These markets have become very irregular through this transition period, and we have seen a lot of fast money speculative selling creating sharp price breaks that are being absorbed by the slower moving buying of physical metal by long term investors. In base metals, we continue to be underweight in the sector but have added to that underweight, while also adding to the lead position relative to the other metals. We think base metals will be the last to turn as the influence of the Chinese slowdown and the abundant inventories of a number of base metals, especially aluminium and zinc, will overshadow these markets for some months. Largely because of the relative value performance of lead, we added 8bps of outperformance from base metals. In grains we are largely market-weight and positioned at the front of the curve, except in wheat. The roll down to lower new crop prices was helpful, but it didn't roll down as much as we expected, consequently, new crop grain prices have been trending lower with the ideal weather. The markets will need to find the right price levels that will reflect the relative abundance of grains which we have not experienced for several years. Grains were a marginal detractor at -4bps against benchmark largely because of our positioning in wheat which was a little bit further back on the curve.

Soft commodities were mixed with small outperformance gained from the weakness in coffee being offset by the recent short term tightening of the sugar curve.

Livestock has begun to revert to pricing differentials that we would expect as high margins in hog production has spurred production which is just beginning to weigh on prices. We still think there is quite a way to go for hogs on the downside. Additionally, our long suffering position in feeder cattle is just beginning to perform as the lower grain prices and greening pasture land is increasing demand for young cattle. Livestock added 19 basis points to outperformance.

Looking ahead, we expect the next couple of months to be variable; we expect the global economic recovery will begin to take hold in Q4 and into 2014. This will be led by North America and will spread across Europe and into many emerging market countries. Oil will continue to be the strongest sector and will lead commodity prices higher as increased economic activity and income will create the demand that will, in time, tighten commodity balances.

Audio link:-

http://mediazone.brighttalk.com/comm/Threadneedle/e53eae38a7-37369-5029-42861

*Source: Morningstar. All data as at 31 July 2013. Gross performance based on Global Close prices in US$, unadjusted income reinvested, adjusted by the TER (Total Expense Ratio).

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