Investment Insights
Commodity Optimism Rises with Reflation

January 24th, 2018

Summary

- Global manufacturing may push commodity demand higher.
- Investors yet to regain previous positions in commodity funds.
- Commodities tend to outperform in high growth and inflation periods.

Growth and manufacturing activity points to higher commodity demand

The global economy is in full throttle with synchronized growth among both developed and emerging economies. Global gross domestic product (GDP) is expected to rise to 3.9% this year according to the International Monetary Fund. Further signs of economic reflation stem from the expansionary levels in global manufacturing and industrial activity. Recent global manufacturing Purchasing Managers’ Index (PMI) levels are at a four year high while US manufacturing PMI ending 2017 at 59.7 after hitting a 13 year high in September 2017. Increased manufacturing activity may further support commodities as demand for raw materials and trade persists against higher industrial and economic activity.

Exhibit 1: Manufacturing indicators on the rise.

Inflation is also on the rise as evidenced by increasing inflation expectations, fiscal spending, a tighter labor market, and weaker US dollar. Commodities historically hedge against inflation and may further rise as inflationary pressures continue to build.

Investor flows may kick commodities into high gear

On January 20th, 2016 the Bloomberg Commodity Index (BCOM) hit an all-time low falling 48% since December 31st, 2012. Over this period commodity funds experienced $24.5 billion in net outflows.

Exhibit 2: Investors remain underweight commodities

As commodity fundamentals improved from a global glut, the BCOM Index rebounded 24% from all time low. Investor flows, however, recouped only half of their previous holdings with net inflows of $14 billion since January 21st, 2016. As the commodity outlook improves, a return of investor interest may further support commodity prices as inflows rise to rebuild portfolio positions.

Conducive backdrop for outperformance

Periods of rising growth and high inflation have historically benefited commodities over stocks, bonds, and cash (See Exhibit 3). This outperformance is indicative of rising commodity demand at late stages of the economic cycle. The current backdrop of synchronized growth and rising inflationary pressures mirrors this cyclical stage and may see commodity returns outperform further.

Exhibit 3: Rising growth and extreme inflationary periods have historically boded well for commodities.

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<th>Slowing Growth</th>
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Source: Bloomberg, ETF Securities. Data from 01/01/76 to 12/31/17. Commodities = S&P GSCI TR Index, Global equities = MSCI World TR Index, Bonds= Barclays US Aggregate TR Index, Cash = 3 month US Treasury bill. High/low inflation = top/bottom 20% of months. Slowing/rising growth = top/bottom 20% of months in US PMI.
Important Risks

The statements and opinions expressed are those of the author and are as of the date of this report. All information is historical and not indicative of future results and subject to change. Reader should not assume that an investment in any securities and/or precious metals mentioned was or would be profitable in the future. This information is not a recommendation to buy or sell. Past performance does not guarantee future results.

The Bloomberg Commodity Index (BCOM) is a broadly diversified commodity price index distributed by Bloomberg Indexes. The S&P GSCI Index provides investors with a reliable and publicly available benchmark for investment performance in the commodity markets. The ISM Purchasing Manufacturing PMI Index (PMI) is an indicator of the economic health of the manufacturing sector. The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services; headline includes all categories while core excludes food and energy. The MSCI World Index is a free-float weighted equity index developed to track developed world markets, and does not include emerging markets. The Barclays US Aggregate Bond Index (Barclays Agg) is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Gross Domestic Product (GDP) is the total value of goods produced and services provided in a country during one year. The International Monetary Fund is an international organization that aims to promote global economic growth and financial stability, to encourage international trade, and to reduce poverty. Reflation is a fiscal or monetary policy, designed to expand a country’s output and curb the effects of deflation, which usually occurs after a period of economic uncertainty or a recession. ICI Commodity Long-Term Mutual Fund & ETFs index tracks the net flows of commodity funds (both registered and not registered under the Investment Company Act of 1940) that invest primarily in commodities, currencies, and futures. Headline inflation is the raw inflation figure as reported through the Consumer Price Index (CPI) that is released monthly by the Bureau of Labor Statistics.

Diversification does not eliminate the risk of experiencing investment losses.

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