Asset allocation update

13 January 2016

Raise commodity position to neutral after oil prices mark new lows

Summary

- We are adding exposure to an oversold asset class
- Our confidence regarding oil prices has increased with a growing number of companies unable to cover production costs at current levels
- Combination of resilient oil demand and extremely pessimistic investor sentiment provides attractive risk/reward in our view
- However, steep oil forward curve prevents a move to overweight stance

The Investment Committee has decided to increase the commodity allocation to 5 percent, which is in line with a neutral position in our model portfolios.

There are several reasons for the decision. Regarding oil, we think the current low prices are not sustainable in the longer run. Most producers outside the Organization of the Petroleum Exporting Countries (OPEC) are currently operating at a price level that does not even cover their costs (see chart 1). Although several companies are still capable of trimming their expenditures even further, many currently have no choice but to cut production or even suspend it completely. This will eventually improve the demand/supply picture. Therefore, after the current period of heavy oversupply, we think global markets should start to anticipate a more balanced situation of demand and supply. While there is still the risk that Iran and Saudi Arabia will pump more oil than expected, global demand growth should absorb this over time. Under our overall positive main economic scenario, we expect oil demand to grow at a robust daily rate of more than 1 million barrels in 2016. Behavioural indicators also support our more confident view: energy markets are highly oversold, many investors hold short positions, sentiment is deeply pessimistic and outflows in the asset class accelerate.

Chart 1: Many companies’ cost of production exceeds oil prices by far

Source: Bank of America, Thomson Reuters Datastream, Vontobel Asset Management
Within the commodity space, the price of oil is most likely to hit a floor, in our opinion. We also think that the recent correction in agriculture and metal prices has gone far enough. After a steady three-year decline, grain prices now are at levels near the cash costs of producers, which should limit the downside risk. At the same time, adverse weather could result in an upward move in prices.

For metals, most major producers face the same situation. Due to the current economic slowdown in China, which takes in nearly half of the global exports of copper, aluminium, zinc and nickel, prices likely won’t move significantly higher. However, the high amount of short positions in the metal market should prevent a sharp price drop. To take a more positive view on base metals, we would need to see more significant production cuts.

The main reason why we move to a neutral rather than an overweight position is the steep forward curve for many commodities. Especially in the energy space, an investor loses at the moment around 20 percent per year roll return due to high contango (see chart 2). To compensate this, commodity prices need to rise significantly. This scenario is unlikely in our opinion. However, if we see additional signals for a turnaround in commodity prices, we would consider further investments in commodity-related stocks, emerging-market assets and currencies as well as equities of commodity-producing countries.

Chart 2: Oil market continues to see steep futures curves

Changes to our model portfolios

USD portfolio: Increase our position in commodities from 3.5 to 5 percent, out of cash.
EUR portfolio: Increase our position in commodities from 3.5 to 5 percent, out of cash.
CHF portfolio: Increase our position in commodities from 3.5 to 5 percent, out of cash.
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