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FQ INSIGHT:

Balanced Risk Commodities (BRC): 2013 Year-End Review

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In 2013, commodities demonstrated their global nature. Around the world, economic growth was mixed: the US economy continued to recover, the European economy was still largely stagnant, and emerging economies slowed. Although equity markets in these three regions were the most obvious reflection of the economic divergence, commodity markets were also affected. Industrial metals suffered due to the transitioning Chinese economy, whereas energies were relatively supported by the second half demand recovery in the US. The largest move of the year, though, was precious metals, which tumultuously broke their decade long up-trend as gold suffered the largest annual loss in over 30 years.

The most important driver for precious metals returns this year was the US Federal Reserve, specifically their telegraphing of plans for bringing Quantitative Easing (QE) to a close. For most of the year, investors played a guessing game of how each economic data release for the US would affect the timing of the tapering of asset purchases. An impending reduction of QE quelled fears of extreme currency devaluation, one potential economic motivation for holding gold. Continually low readings of inflation further reduced the appeal. The reaction of gold prices was strongest in the spring when tapering plans were first mentioned by Fed officials and pundits, sparking a few large sell offs. There was almost certainly a behavioral element to those moves as well, since the unceasing rise of gold prices in the previous years likely left many investors fearing the onset of a secular reversal. Gold-backed ETFs and ETPs had record outflows during the year, indicating that many investors did decide to head to the exit.

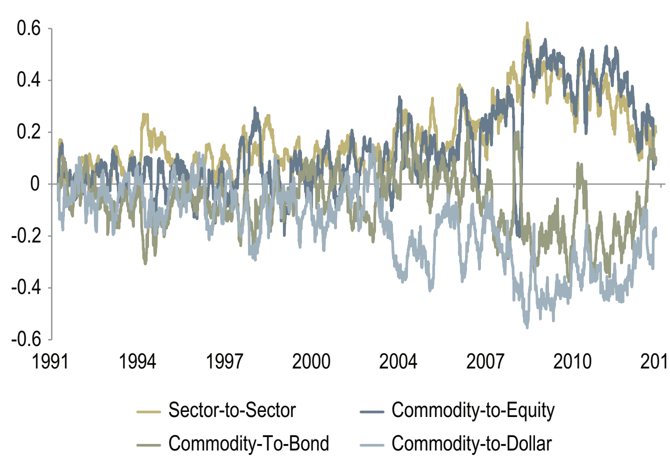
Of course, there are other drivers of gold prices besides private sector investments. One component of gold demand is from central banks around the world to diversify their reserve holdings. Another source of demand is retail consumers. In fact, Bhartia and Seto (2012) conjecture that consumer demand from emerging markets has driven much of the increase in gold prices over the last decade. However, it did not seem that either of these elements played a role in this year's decline, based on data through Q3 provided by the industry group the World Gold Council. Demand from central banks was only slightly smaller than last year, still showing a net increase in gold holdings on the year. Consumer demand for gold actually increased in 2013, likely spurred by the continually falling prices. The only segment of demand that showed a measurable decline was in ETFs, which further highlights the significance of tapering expectations and the related investor flight on the year's price move.

At the time of this writing, we have the benefit of hindsight to understand the returns of precious metals. However, even earlier in the year while watching gold and silver break dramatically to the downside, we reasoned that unique forces were at work. To manage this risk, BRC implemented a separate higher risk regime, resulting in a reduced weight for the sector for a few months. That weight reduction and the subsequent expansion of the sector mid-year to include platinum and palladium, which were supported this year by industrial demand, helped to mitigate the losses from exposure to gold's terrible year.

Turning back to the wider commodity universe, 2013 was also a year that the asset class finally stopped being dominated by post-crisis macroeconomic considerations as each sector exhibited more independent behavior in reaction to changing fundamentals. Grains markets were mixed with a recovery in corn stocks that drove corn prices down, while renewed export demand supported soybeans and soybean meal. In softs, ongoing multi-year surpluses continued to depress coffee and sugar prices, though a poor harvest in Africa led cocoa prices higher. In livestock, demand erosion early in the year was followed by declining supplies late in the year causing prices to finish broadly flat.

The reconnection of commodities to fundamental supply and demand themes closes a frustrating chapter for commodity investors. One of the reasons for investing in commodities is the diversification they can provide to other investments. The plot below shows correlations over time between commodities and equities, bonds, and the US Dollar as well as the average correlation between commodity sectors with each other. Over most of the history, commodities have been an impressively consistent diversifier to equity and bond markets, have offered a unique exposure not strongly related to the US Dollar, and have also consistently diversified each other. Through the global financial crisis period, however, correlations between commodities and other asset classes grew as macroeconomic considerations dominated virtually all assets. This hurt potential diversification benefits. These elevated correlations occurred not just between commodities and other asset classes, but between different sectors within commodity markets as well. Finally, in 2013, those crisis-driven correlations started a meaningful reversion to their normal low levels.

ROLLING CORRELATIONS BETWEEN COMMODITY SECTORS AND COMMODITIES WITH OTHER ASSET CLASSES



Sources: Bloomberg, CRB, Federal Reserve Economic Data

Looking forward to 2014, we believe that a few major themes will continue to play out. The US economy will continue to lead developed market growth, but Europe will start catching back up. It is clear that ECB support is resolute and that individual European economies, most importantly Germany, have stabilized and are showing early signs of growth. Continued US and European growth should be positive influences on commodities. The transition of emerging markets to more sustainable growth models will continue as well. While 2013 was a particularly challenging year in emerging markets, it was also a year that should instill tentative confidence that those governments, most importantly China, are up to the task of managing the economic transitions. Their success or failure will impact commodities, making this a key theme to watch going forward. Last, the decrease in correlations, both within commodity markets and between commodities and other asset classes, will continue. Crisis drives correlation, and without any major new or renewed global economic issues, commodity markets will continue to be driven by their own differentiated fundamentals. Particularly for a balanced risk commodity portfolio that seeks to maintain genuine diversification amongst different commodity sectors, we expect that these falling correlations should set up BRC for an effective and successful new year.

COMPOSITE INFORMATION

For more information regarding the **Balanced Risk Commodities Strategy – Composite Information and Disclosures**, please contact Marketing Services at 626 683 4223 or email us at info@firstquadrant.com.

This material is for your private information. The views expressed are the views of First Quadrant, L.P. only through this period and are subject to change based on market and other conditions. All material has been obtained from sources believed to be reliable, but its accuracy is not guaranteed.

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