Futures perfect

In the past few years global long-term investor interest in commodity futures indexes has exploded. This is not surprising since their performance has been stellar for several years, but their widespread backing by investors, including UK pension funds, is more than just a fad – there are compelling and durable reasons for their interest.

In this case, how should one react to the slightly negative returns in the two most popular indexes, the Goldman Sachs Commodity Index and the Dow Jones-AIG Commodity Index, over the past two quarters – a period when equities have performed well? The decline might be – with the caveat explored below – an example of the desirable cyclical diversification that commodity futures bring to a portfolio. Potential new investors might feel safer waiting a little longer before switching a portion of their portfolio into commodity futures. But this would probably not be wise: the macroeconomic scenario that financial markets have recently been working on may be misguided. If it is, returns on commodity futures may outpace those on equities in the next few quarters.

POSITIVE RETURNS The fundamental reasons for including commodity futures in a portfolio are straightforward and compelling. An index of fully collateralised commodity futures would historically have offered a return and Sharpe ratio similar to that offered by equities (one widely held explanation for this is that commodity futures offer a risk premium to investors essentially the same as that available in equities). But returns on commodity futures have been negatively correlated with returns on equities and bonds, partly because of different behaviour over the business cycle, and partly because returns to commodity futures are positively correlated with inflation, unexpected inflation, and changes in expected inflation.

Thus, "Commodity futures perform well in the early stages of a recession, a time when stock returns generally disappoint. In later stages of recessions, commodity returns fall off, but this is generally a very good time for equities… The diversification effect is not limited to the early stages of recessions. Whenever stock and bond returns are below their overall average, in the late expansion and early recession phases [defined by the US National Bureau of Economic Research], commodity returns are positive and commodity futures outperform both stocks and bonds."[1]

Moreover, "it seems that the diversification benefits of commodity futures work well when they are needed most"[2]. During the 5% of months with the worst equity market performance between 1959 and 2004, when stocks fell on average by 8.98% a month, commodity futures returned a positive 1.03%.

Many long-term investors have realised in recent years that the right question is not how to justify including a commodity futures index in their portfolio, but how to justify not including one.

The very recent outperformance of equities could be seen as showing the diversification benefit of commodity futures. But suppose that, as Rouwenhorst and Gorton argue, commodity futures offered a risk premium which, over the 1959–2004 period they studied, was similar to that on equities. The equity risk premium can change. In the spring of 2000, for instance, the risk premium – notably in technology stocks – seemed virtually to disappear and stock prices were heavily overvalued. Could the risk premium in commodity futures similarly have vanished by late last year, leaving commodity futures indexes heavily overvalued?

There is certainly a question to be answered here. The recent slightly negative returns on traded indexes do not seem to represent normal cyclical behaviour in which commodities returns outperform equities returns in the late expansion phase (which almost everyone thinks that the US, at least, is in) – might they then be a correction from a faddish level? Some also argue that the recent move of several important commodities, notably oil, from market backwardation (when a futures price is lower in the distant delivery months than in the near delivery months) to contango (vice versa) indicates that the hypothesised risk premium in commodity futures has been exhausted.

If these conjectures were accurate, it would make sense to hold off investing in commodity futures indexes until they had fallen far enough to restore the historic risk premium, as happened with

BERNARD CONNOLLY EXPLAINS WHY COMMODITY FUTURES ARE ESSENTIAL TO ANY PORTFOLIO.

Executive summary

- Commodity futures work best when they are needed most – when the equity market struggles.
- Optimism about the prospects for the global economy look likely to be misplaced.
- Long period benefits offer a balance to the abnormal state of the global economy.

equities after 2000 (although few, if any, longer-term investors switched to a zero allocation to equities after spring 2000, even though the insurance industry regulator in Britain was doing its best to encourage them to – at the bottom of the market).

But the conjectures are, in fact, unlikely to be accurate. First, the risk premium hypothesis does not suggest that commodities will be in market backwardation but that the futures price is less than the (unobservable) expected future spot price. A market in contango will still deliver the risk premium to investors if the futures price moves up as the contract moves towards expiry.

But why have returns to commodity futures not been positive in the past two quarters? The underlying reason is not connected to market expectations about commodity prices in isolation, but to expectations about asset markets and the economic cycle in general. The 'normal' late expansion relationship between returns to commodity futures, stocks and bonds has not been apparent in the past couple of quarters because the current global economic cycle, and notably the US cycle, has not been normal. For one thing, it is not normal for stock returns to have been positive when returns on bonds have been negative – but this has also recently been the case.

MISPLACED OPTIMISM Underlying everything else has been the low level of real long yields in the world – something that has concerned central bankers and market participants as well as corporate treasurers. The most plausible explanation is that markets believed, until recently, that the global economy would be too fragile to withstand a return to normal yields (as an approximation, normal real long yields would be close to the trend real growth rate of the economy – say, 3.25% to 3.5% for the US, 2.5% to 2.75% for Britain, 1.75% to 2% for the euro economies).

But recently there has been a marked increase in optimism about the global economy and with it an increased market belief in the possibility of yield normalisation. That has naturally hit bonds, but, by increasing the holding cost of commodities and perhaps encouraging producers to bring production forward, has also meant that commodity prices have undershot what had previously been expected. This has overwhelmed whatever risk premium was available in commodity futures indexes. As for equities, the greater market optimism about economic prospects – and future corporate profits – has apparently more than offset the negative impact of rising (though still low) long real yields.

But it is in fact very likely that the previous market caution will be nearer the mark than recent optimism. In the US, even if the housing market merely slows (and it could do much worse), a key support to consumption growth will vanish: significantly below-trend output growth is likely next year unless real yields reverse their recent climb. In Britain, a structural economic deterioration seems to be under way. And in the euro area, any normalisation of yields would crash the economies of the extremely uncompetitive southern countries, which are almost totally dependent on housing market gains for their growth. As the market comes to realise these unpleasant truths, bond prices are likely to rise again.

Initially, this might not be enough to offset the impact on equities of a negative turn in expectations of corporate profits, and stocks could decline. It is possible that if actual growth dipped, demand for commodities could disappoint, initially causing spot prices to further undershoot previously expected levels and producing negative returns to commodity futures. But gloomier growth expectations could push down expected future spot prices, while the reversal of the move up in yields that has been to blame for recent negative returns would support actual future spot prices. This combination would add to, rather than detract from, any risk premium in commodity futures, suggesting a real possibility of substantially positive returns at a time when equity returns were going negative.

"Might" and "could" appeared frequently in the previous paragraph. Returns on any asset class cannot be confidently predicted over any short future period. But relative returns do depend heavily on the macroeconomic scenario. With real yields below normal, all asset classes have been overvalued. But if one believes yields can normalise, then equities will probably outperform bonds and commodity futures in the near future. If one does not (and there are strong reasons not to), the reverse will probably be true. But while the abnormal situation of the world economy in the past few years may have changed the precise pattern of the diversification benefits from adding commodity futures to a portfolio, those benefits still accrue. And given that, the long-period properties of commodity futures – which have offered returns and risks similar to equities – provide a strong argument for inclusion in a portfolio. And if one thinks that inflation is going to surprise on the upside…

FOOTNOTES:

1. *K Geert Rouwenhorst and Gary B Gorton,* Facts and Fantasies about Commodity Futures*, in* Yale ICF Working Paper No. 04-20*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=560042.*
2. *Ibid.*

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