MARKET ANALYSIS

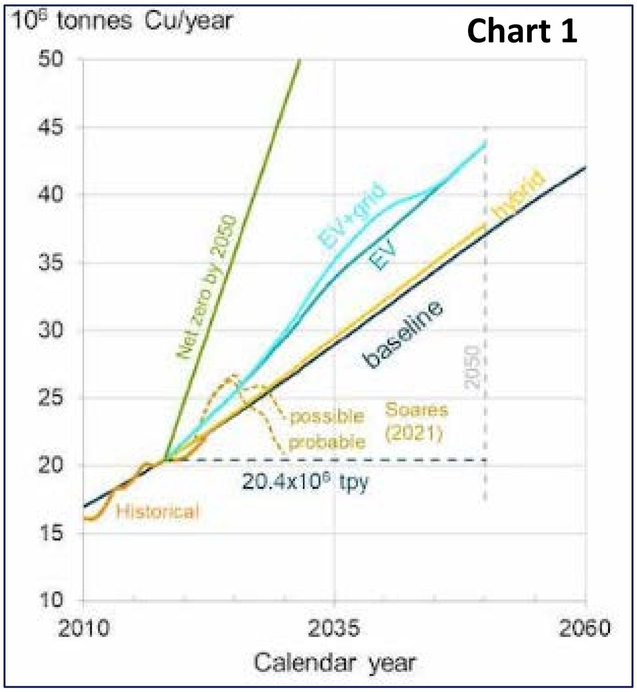
OBSERVATIONS ON EQUITY VALUATION

Philip Blancato, Chief Market Strategist, Osaic

June 2024

What are Commodities?

Commodities are basic resources that are the same across producers, like wheat, which has consistent specifications and pricing no matter where it's grown. They fall into two main categories: metals and softs. Metals include precious metals (silver, gold) and industrial metals (copper, nickel, lithium). Softs cover agricultural products (soybeans, livestock) and energy (oil, natural gas). Commodities are usually traded via futures contracts which are standardized agreements to buy or sell a specific amount of a commodity at a set date and price. These contracts help buyers and sellers lock in prices and allow financial market participants to profit by speculating on price changes.



A Secular Bull Case for Commodities

Due to uniformity among producers, charging a premium or discount for a product in a commoditized market is challenging. Consequently, market prices are often dictated by product availability. Short-term constraints, coupled with the inability to rapidly increase production, can cause commodity prices to surge. Additionally, long-term trends can disrupt the supply-demand equilibrium, leading to price fluctuations as markets adjust to new production levels.

A 2024 study by the International Energy Forum found that meeting "business as usual" copper usage trends for the next 30 years requires 115% more copper than has been mined in all of recorded history. This demand increases further with trends like global vehicle electrification (see Chart 1[1]). Given the 20-year lead time to establish a copper mine, there is potential for a medium-term supply shortage and a consequent rise in copper prices.

In the short term, other industrial metals used in battery production, like nickel, may also see a supply/demand imbalance. With reserves concentrated in just a few nations, geopolitical tensions play a significant role in the price fluctuations of this metal. Recent sanctions on the third largest producer, Russia, have resulted in a large drop in supply for Western nations. Furthermore, large-scale civil unrest across another top producer—France's New Caledonia—prompted the shutdown of the entire territory's nickel industry.[2]

Battery production and the corresponding necessity for industrial metals is not the only bullish scenario for commodities. Implementing artificial intelligence requires widespread usage of data centers to house and query astronomical quantities of data. Those data centers require enormous amounts of energy to operate. By 2026, data center electricity usage is expected to double in the U.S. and account for 9.1% of total electricity generation.[3] Energy providers are already rushing to bring new power plants online to meet energy demand. It is estimated that around 60% of data center electricity is produced using nonrenewable energy, which indicates a potential tailwind for commodities like natural gas and coal – more traditional energy sources.

The increase in natural disasters such as droughts, wildfires, and severe storms has caused at least $1 billion of damage (adjusted for inflation). These types of disasters have risen from three per year in the 1980s, to 13 per year throughout the 2010s in the U.S.[4] This has hurt agricultural production – destroying or lowering crop yields and forcing prices higher. After an unseasonable freeze in Florida, orange juice concentrate futures have risen over 56% in the past year, highlighting the volatility and unpredictability that the increasing frequency of natural disasters can have on commodity prices.[5]

How Are Commodities Used in A Portfolio

Commodities can provide a suite of benefits to investors beyond the typical, balanced 60/40 exposure, which traditionally only includes equity and fixed-income securities. First, commodities have a low correlation to traditional asset classes. This means commodities can help diversify a portfolio more broadly than standard exposures. Investors have also been revisiting the asset class because commodities are physical goods as opposed to financial assets, and, as such, are often positively correlated with inflation. In other words, when inflation rises, commodities appreciate in value, and thus, should provide a stronger hedge against inflation than other assets.

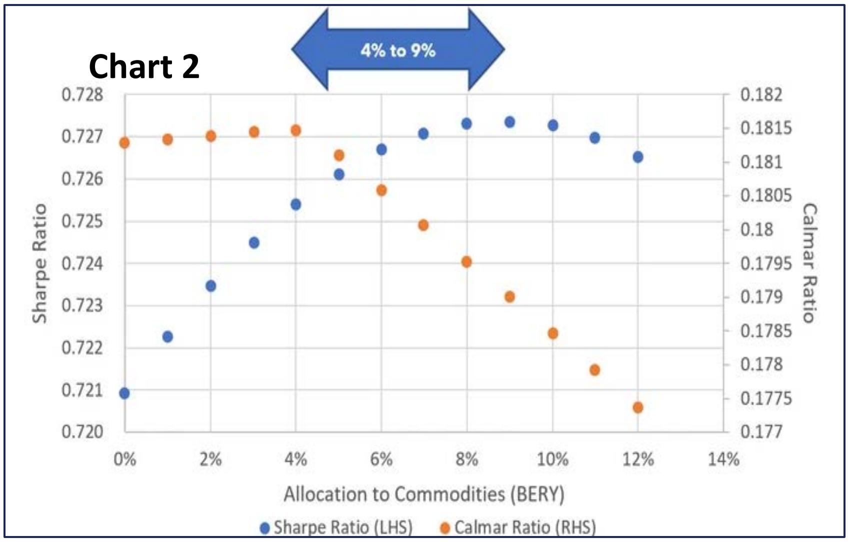


Chart 2[6] illustrates the impact of increasing commodity allocations on a traditional 60/40 portfolio using the Sharpe and Calmar ratios. The Calmar Ratio assesses a portfolio's recovery from its largest loss, while the Sharpe Ratio measures return adjusted for volatility; higher values are preferable for both. Allocating between 4% and 9% to commodities can enhance risk-adjusted returns and improve the overall portfolio.

In spite of the benefits that an allocation to commodities can provide a portfolio, many investors do not take advantage of this unique asset class. There is a long lead time on commodity production, and the cyclicality of the broad asset class can span over years in many cases. This leads to long term bull and bear markets in many commodity cycles. As we appear to be turning the corner in a long bearish cycle, many investors are under exposed to the asset class as returns have been de minimus in recent years. As this trend begins to shift, it is likely the forgotten asset class will begin to garner attention once more.

Conclusion

A culmination of shifting technological and environmental trends has set up commodity markets for a potential upsurge. When coupled with the arduous process of bringing new supplies online, it is reasonable to predict that the prices of many commodities may be poised to rise. With current allocations to commodities near 10-year lows,[6] the market seems unprepared to capitalize on a diversifying asset class that can help portfolios produce more attractive risk-adjusted returns.

Disclosures

Index performance does not reflect the deduction of any fees and expenses, and if deducted, performance would be reduced. Indexes are unmanaged and investors are not able to invest directly into any index. Past performance cannot guarantee future results.

The statements provided herein are based solely on the opinions of the Osaic Research Team and are being provided for general information purposes only. Neither the information nor any opinion expressed constitutes an offer or a solicitation to buy or sell any securities or other financial instruments. Any opinions provided herein should not be relied upon for investment decisions and may differ from those of other departments or divisions of Osaic or its affiliates. Certain information may be based on information received from sources the Osaic Research Team considers reliable; however, the accuracy and completeness of such information cannot be guaranteed. Certain statements contained herein may constitute "projections," "forecasts" and other "forward-looking statements" which do not reflect actual results and are based primarily upon applying retroactively a hypothetical set of assumptions to certain historical financial information. Any opinions, projections, forecasts and forward-looking statements presented herein reflect the judgment of the Osaic Research Team only as of the date of this document and are subject to change without notice. Osaic has no obligation to provide updates or changes to these opinions, projections, forecasts and forward-looking statements. Osaic is not soliciting or recommending any action based on any information in this document.

Securities and investment advisory services are offered through the firms: Osaic Wealth, Inc., Osaic Institutions, Inc., Osaic FA, Inc., Osaic FS, Inc., and Triad Advisors, LLC, broker-dealers, registered investment advisers, and members of FINRA and SIPC. Securities are offered through American Portfolios Financial Services, Inc., and Ladenburg Thalmann & Co., broker-dealers and member of FINRA and SIPC. Advisory services are offered through Arbor Point Advisors, LLC, American Portfolios Advisors, Inc., Ladenburg Thalmann Asset Management, Inc., and Osaic Advisory Services, LLC., registered investment advisers. Advisory programs offered by Osaic Wealth, Inc., and Triad Advisors, LLC., are sponsored by VISION2020 Wealth Management Corp., an affiliated registered investment adviser. 6743627

[1] Copper Mining and Vehicle Electrification | IEF Report
[2] Explainer: What New Caledonia riots mean for the nickel industry | Reuters
[3] AI will require even more energy than we thought | Popular Science (popsci.com)
[4] Are major natural disasters increasing? (usafacts.org)
[5] Orange Juice Is The Most Expensive It's Ever Been—Here's Why (msn.com)
[6] The power of a commodities allocation: A little goes a long way | Insights | Bloomberg Professional Services