MARKET INSIGHTS

Commodities: A strategic perspective

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Foreword

The investment environment of the last decade has been the most turbulent in modern history. Two recessions, two wars, two huge market collapses, a housing bubble, an oil bubble, a spectacular global financial collapse, a deep recession and sovereign debt worries have left investors both scared and confused. Through all this volatility and confusion, commodities have performed well both in absolute terms and as a way to provide diversification benefits to investors. But will this be the case going forward?

In this paper we try to address this question from a number of different angles. How important is the growth in emerging economy demand in driving commodity prices higher? Are there genuine supply constraints or will technology and innovation allow the world to find cheaper alternatives as a way to hold down prices? Can we be sure that recent price increases will be long lasting, or are they the result of the peculiar demand and supply dynamics of commodity markets and just represent a high point in a commodity cycle?

We also look at some investment dynamics. Is it possible that the increase in commodity prices in recent years just reflects too much investor money being funneled into a small sector of the capital markets? How much of the increase in commodity prices can just be ascribed to a falling dollar? Do commodities really hedge against inflation?

Finally, we consider the different vehicles available today for commodity investing, including investments in individual commodities, exchange-traded funds (ETFs) and actively managed commodity funds. While each of these have their advantages, the volatility and complexity of commodity markets suggests a need for a strategy that is both diversified and professionally managed.

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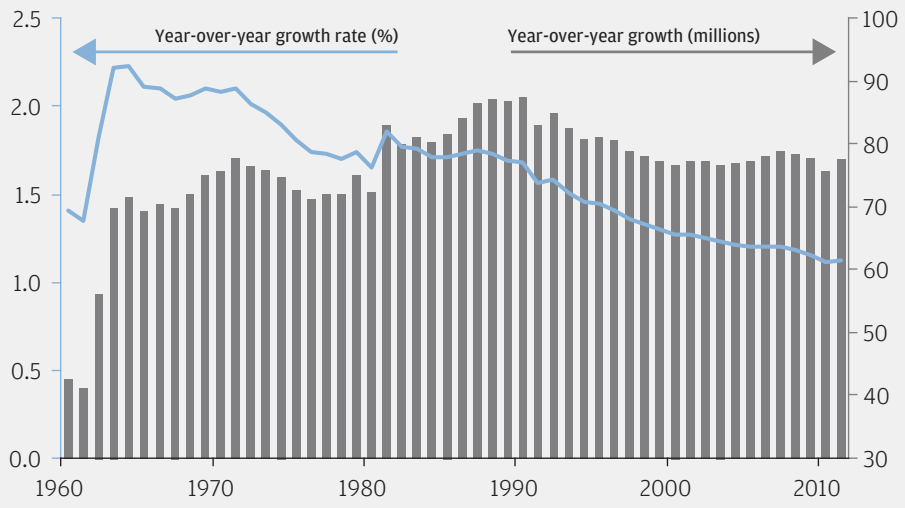
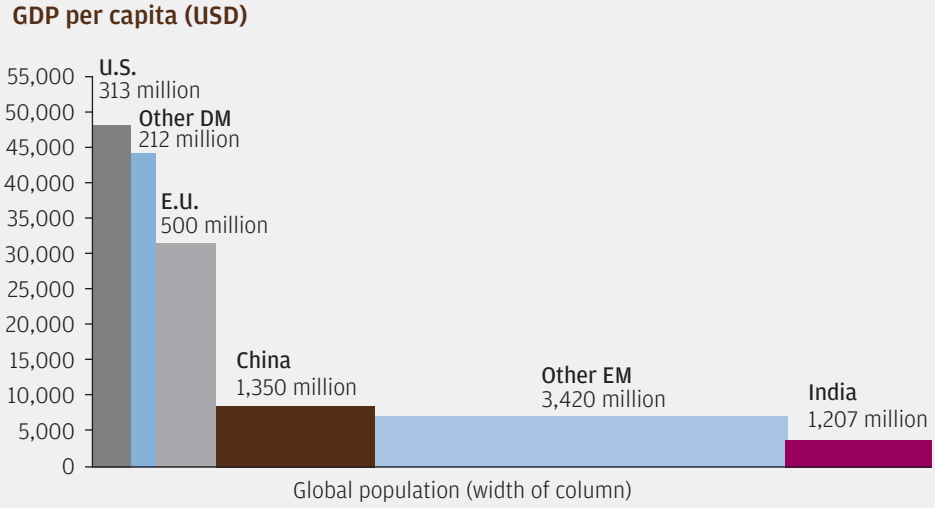
Commodities: A strategic perspective

EXHIBIT 1: The global population continues to expand despite declining growth rates



Source: U.S. Census Bureau International Database, J.P. Morgan Asset Management. Data are as of 11/30/11.

EXHIBIT 2: Most of the world's population still subsists on very low income



Source: United Nations Population Division, IMF WEO Report, J.P. Morgan Asset Management.
Data are as of 11/30/11.

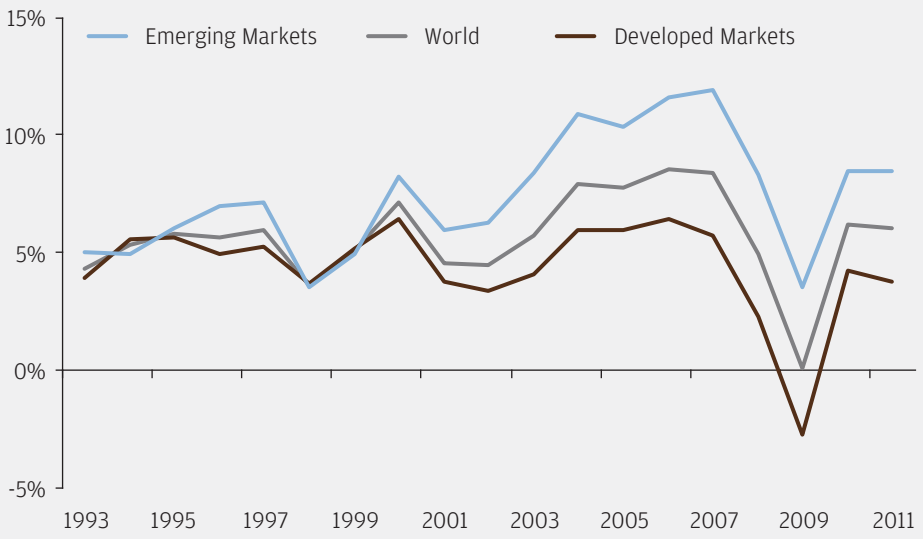
Emerging economies and commodity demand

While commodity prices are determined by a complex array of economic fundamentals and market forces, one often referenced factor has been the global growth in population and living standards. At the start of November 2011, the U.N. announced that the population of the Earth exceeded 7 billion people. Although the rate of global population growth is slowing in percentage change terms, in raw numbers, it is not. This means that at the start of each year, the planet has roughly 75 million additional people to feed, clothe, house and transport.

Population growth, in itself, does not necessarily imply a huge increase in the demand for commodities. In fact, for most of modern history, the vast majority of mankind has lived in poverty without the financial means to impact commodity demand. Even today, as shown in Exhibit 2, most of the world's population subsists on a small fraction of the income of the developed world. However, the potential for commodity demand to rise with living standards is clear.

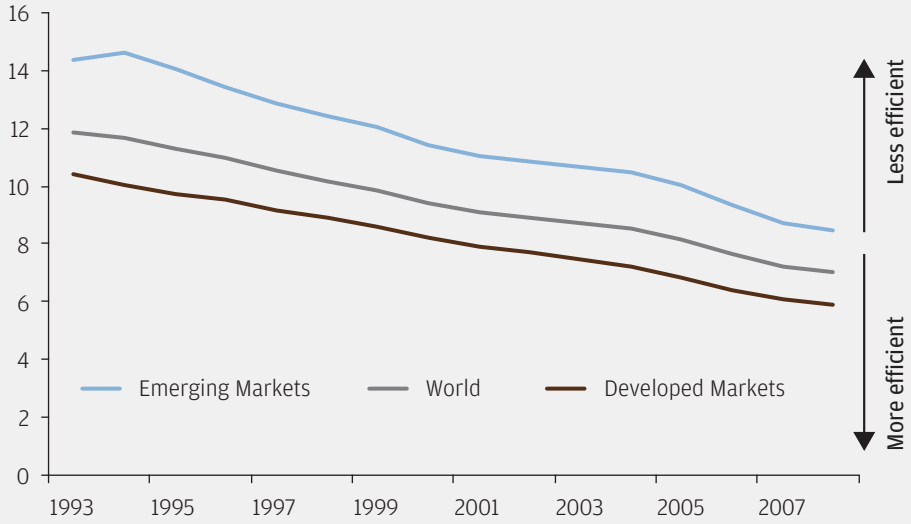
At this point, an important distinction between Developed Market (DM) and Emerging Market (EM) demand growth must be explained. The dispersion between moderate growth in the developed world and rapid growth in emerging nations has become evident over the past decade as shown in Exhibit 3. Energy intensity, or the amount of economic output an economy generates from each energy input, tends to fall over time as technology becomes more efficient, as shown in Exhibit 4. It should be noted that while both DM and EM economies have become more efficient over time, their levels of energy intensity are different, resulting in the very different paths for overall energy consumption, as shown in Exhibit 5. Historically, moderate economic growth in the developed world has been largely offset by gains in energy efficiency, resulting in only slowly rising energy demand in those areas. By contrast, in emerging market nations the pace of economic growth has overwhelmed improvements in efficiency resulting in rapidly rising overall energy demand. This illustrated example concentrates on energy use, but these dynamics are at play more broadly across the commodity spectrum.

EXHIBIT 3: Divergent economic growth rates



Source: EIA, IMF, J.P. Morgan Asset Management. Data are as of 11/30/11.

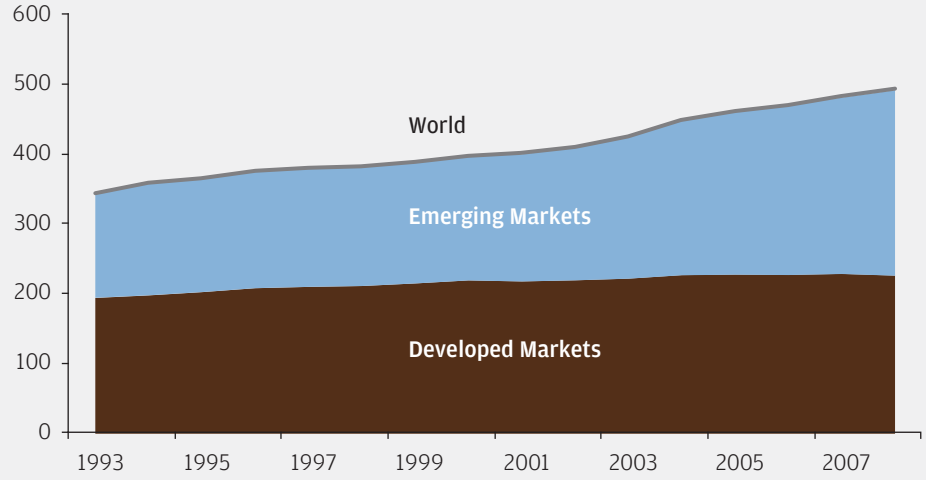
EXHIBIT 4: Despite efficiency gains, EMs use more energy per unit of output



Source: EIA, IMF, J.P. Morgan Asset Management. Data are as of 11/30/11.

EXHIBIT 5: Faster growth in EM has led to growing global energy consumption

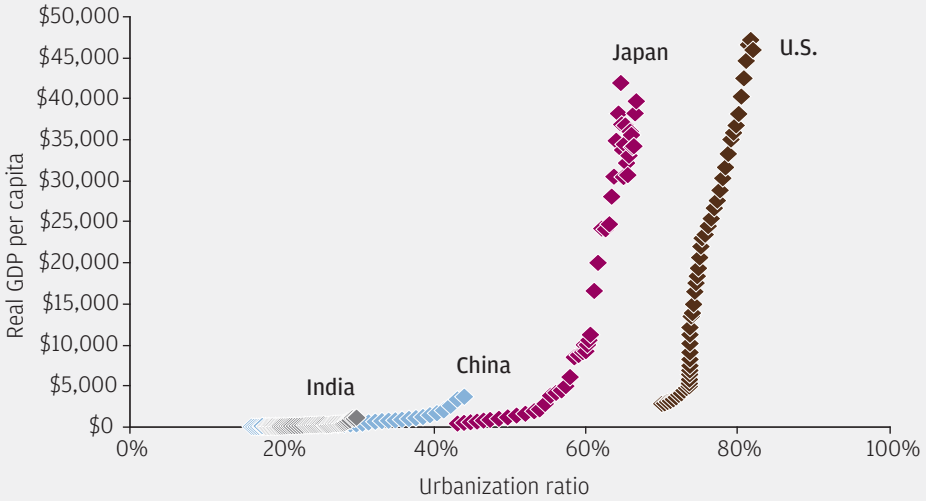
Total primary energy consumption (quadrillion BTU)



Source: EIA, IMF, J.P. Morgan Asset Management. Data are as of 11/30/11.

EXHIBIT 6: Urbanization should fuel rapid economic growth in China and India

Urbanization ratios and real GDP per capita, annual (1960 to 2009)



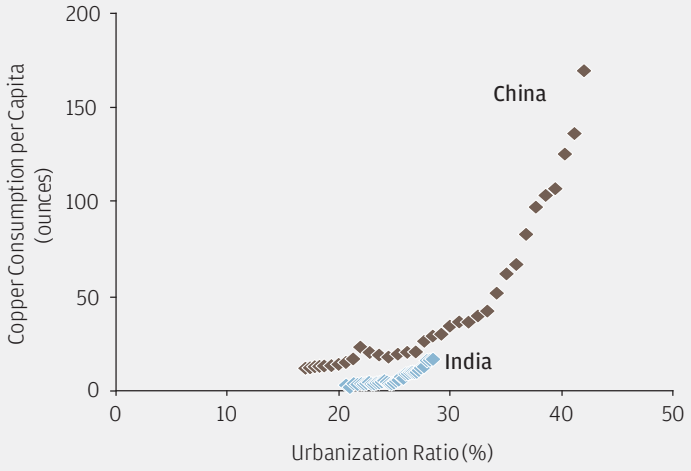
Source: World Bank, J.P. Morgan Asset Management. Data are as of 11/30/11.

Another way to look at global demand dynamics is to recognize that while population growth alone doesn't necessarily imply an increase in commodity consumption, urbanization does. As a population becomes more urbanized, wages, living standards and the end demand for goods all tend to increase in tandem. As shown in Exhibit 6, 82% of the U.S population lives in urban areas, a far cry from China's equivalent ratio of only 47%. China's relatively low urbanization rate is forecasted to grow 2.3% per year from 2010 to 2015; that equates to roughly 31 million Chinese workers migrating to cities each year. Or put another way, it is like moving half of the American population from an agrarian society to 21st-century living standards over five years. India appears set for a similar shift in the decades ahead given its population of 1.2 billion people, but with an urbanization ratio of only 28%, India's incremental impact on commodity demand probably still has a fair amount of runway before it noticeably takes off.

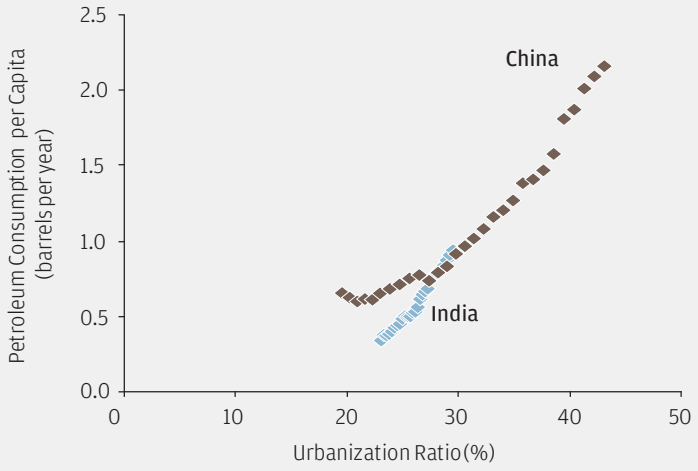
The relationship between urbanization and output per person is relatively intuitive, and given the low base in key EM countries, the trend seems clear. The charts below highlight the link between urbanization in those countries and their per capita demand for petroleum and copper. Urban populations simply require more industrial metals and energy per person, since the production of goods and services in a factory or office building tends to require substantially more energy than rural subsistence farming. Additionally, offices and apartments need to be built, machines and computers need to be manufactured and all of this, along with modern transportation, requires energy. A similar story tends to play out in agricultural commodities as improved living standards shift diets from staples, such as rice and wheat, toward higher value foods, such as pork and beef, which in turn boosts demand for both groups, since grains are used as feed for livestock.

EXHIBIT 7: The impact of urbanization is already being felt in Chinese and Indian demand for copper and petroleum

Copper demand and urbanization —annual (1976 to 2009)



Petroleum demand and urbanization —annual (1976 to 2008)



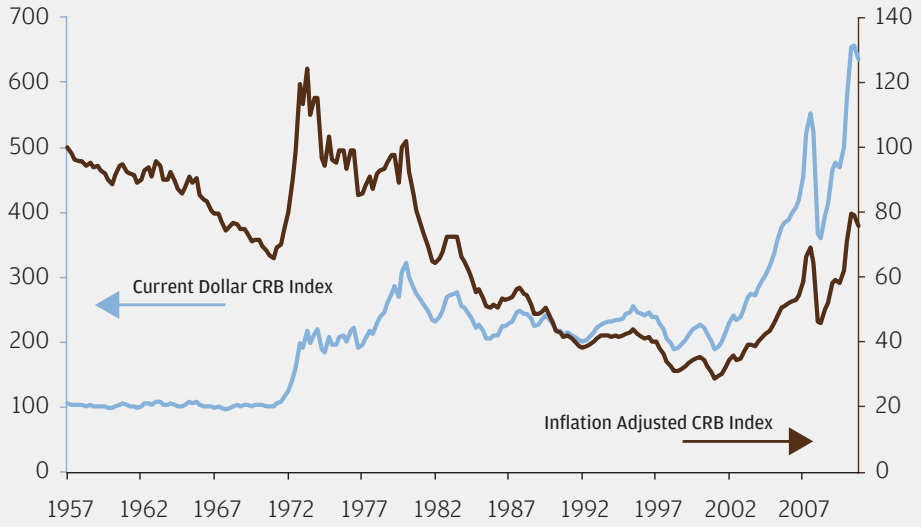
Source: World Bank, J.P. Morgan Asset Management. Data are as of 11/30/11.

Productivity gains and commodity supply

The growth in the global economy in general, and in emerging markets in particular, would seem to assure an increase in the demand for commodities in the years ahead. However, this in no way guarantees an increase in prices for those commodities. Indeed, as shown in Exhibit 8, commodity prices have generally failed to keep pace with inflation for long stretches of time.

EXHIBIT 8: Real commodity prices have generally trended lower until recently

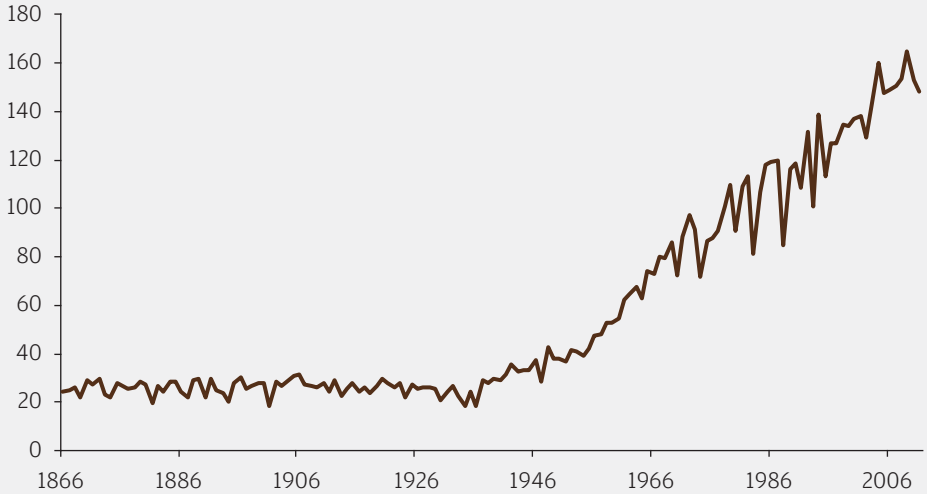
Commodity prices—current dollars and inflation adjusted



Source: BLS, CRB, FactSet, J.P. Morgan Asset Management. Data are as of 11/30/11.

EXHIBIT 9: Better farming techniques, seeds and fertilizers have increased corn output per acre over the last century

U.S. Corn yields, bushels per acre



Source: BLS, CRB, FactSet, J.P. Morgan Asset Management. Data are as of 11/30/11.

One of the perennial errors in economics has been to underestimate the ability of mankind to adapt and innovate in ways to negate supply limitations. In 1798, the Reverend Thomas Malthus wrote:

Must it not then be acknowledged by an attentive examiner of the histories of mankind, that in every age and in every State in which man has existed, or does now exist, that the increase of population is necessarily limited by the means of subsistence, that population does invariably increase when the means of subsistence increase, and, that the superior power of population is repressed, and the actual population kept equal to the means of subsistence, by misery and vice.

—Thomas Robert Malthus, *An Essay on the Principle of Population*, 1798.

Or, to put it less elegantly, in the long run, we are doomed to starve. However, time and time again this has proven to be too pessimistic. As an example of how we have avoided starvation, Exhibit 9 shows the average corn yields in the United States from the 1860s to today. Since the 1920s, corn yields have risen more than seven-fold—improved fertilizers and genetic modification mean that each acre of corn is now seven times as bountiful as 90 years ago.

Similar gains have been made throughout agriculture with bigger harvests across a variety of crops, more productive milk cows and more calorie-laden livestock. In a similar vein, ever deeper wells and horizontal drilling have increased our ability to extract oil from the world's most inaccessible oil fields. Hydraulic fracturing (fracking) technology has vastly added to exploitable U.S. natural gas supplies, while ever-advancing mining technology continues to satisfy the world's need for new metals.

It should be noted, however, that while technological innovation has enabled supply to keep pace with demand over the long run, some of these innovations can effectively exacerbate short-term supply dynamics, impacting price volatility and correlations, a subject we will delve into in more detail later in this paper.

Aside from price impacts, many of these supply successes carry a sinister environmental cost, from the fertilizer runoff into the Mississippi that kills marine life in the Gulf, to the deeper scars left by open-pit mining or the dangers inherent in over-medicated livestock and, perhaps most importantly, the ever-growing carbon emissions that are gradually heating our planet. However, given our ability to innovate in production and substitute in consumption, it remains an open question, for many commodities, whether the limits of supply are truly biting and must inevitably push prices higher.

The commodity cycle

One very important aspect of all commodity markets is that neither supply nor demand can turn on a dime, but rather respond slowly to price changes. In economics parlance, this means that both the price elasticity of supply and the price elasticity of demand are relatively low in the short run and rise over time.

Consider, for example, some shock that reduces world oil supplies. In the short run, consumers may drive less to conserve on gasoline but most can't just sell their vehicles to buy a more fuel-efficient one. However, the next time they do buy a new vehicle, they will think more carefully about miles per gallon. Oil producers, meanwhile, have only a limited ability to increase production in the short run. However, over time, new drilling projects that are profitable at new higher oil prices can increase supplies.

Thus, in the short run, oil prices will overshoot to the upside. Then, as both supply and demand can fully respond, prices fall back. This price decline causes only a small reduction in supply and increase in demand in the short run. However, over the long run, consumers start buying SUVs again while less economical drilling projects are abandoned.

Taken together, all of this sets up a commodity price cycle. It is true of the energy market, agricultural markets and metal markets, and it is for this reason that investors should be very nervous about jumping into a commodity market after a sudden spike in prices that have not yet elicited a full response from both producers and consumers.

The advantages of commodities: Returns, diversification and inflation-hedging

For investors, there are three important benefits to investing in commodities. First, the world is experiencing a steadily rising demand for commodities. While this in no way implies that commodities will always rise in value, they have a good potential to provide positive long-term appreciation at a time when investors remain cautious about their exposure to many traditional asset classes.

Second, commodities have generally provided a degree of diversification to portfolios. Many commodity prices should be impacted by issues that have little relationship to each other or broader markets. A freeze that disrupts the coffee harvest in Brazil should not impact the production of oil in Iraq or the overall trend of the S&P 500. As shown in Exhibit 10, commodities have had a correlation coefficient of less than 0.5 to major stock indices over the past decade, and any correlation coefficient below 1 implies that an asset class has the ability to diversify a portfolio.

EXHIBIT 10: DJ-UBS Commodity Index 10-yr. correlations based on monthly total returns—Nov. '01 to Oct. '11

S&P 500	Russell 2000	High Yield	MSCI EAFE	MSCI EM	EMD	Barclays Agg.	Eq. Mkt. Neutral	Hedge Funds	REITS
0.41	0.39	0.38	0.40	0.34	0.29	-0.38	0.70	0.52	0.52

Source: DJ-UBS, MSCI, Russell, Barclays Capital, Standard and Poor's, FactSet, J.P. Morgan Asset Management. Data are as of 10/31/11.

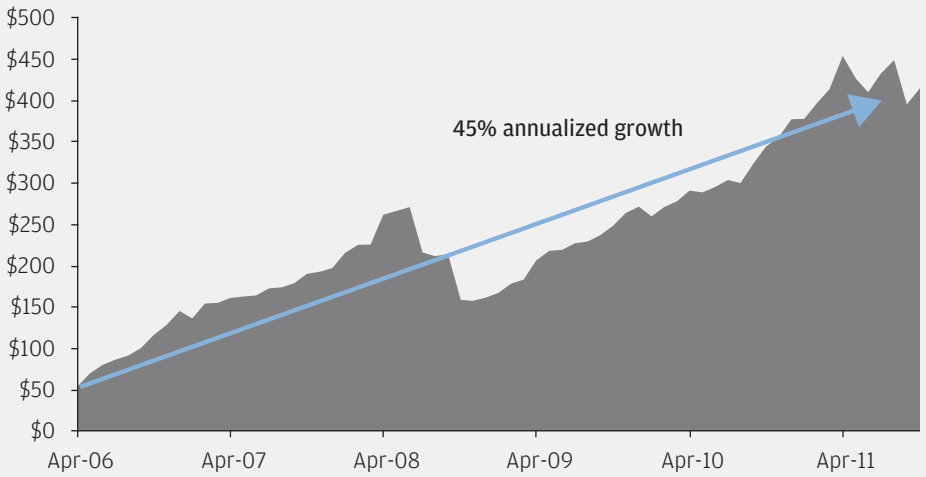
Countering this diversification benefit is the reality that some recent technological innovations have effectively linked the prices of certain commodities that would otherwise have no apparent relationship. One prime example is the recent link between crude oil and corn prices, enabled by innovation in biofuel technology. When oil prices reach a certain level, converting corn into ethanol becomes economically viable, at least temporarily, creating a link between the two prices. A less obvious but still important corollary is the link between crude oil prices and the price of steel. Deeper oil wells and horizontal drilling technologies mean more oil is ultimately accessible, but more steel tubing increases the cost of production and can create a price feedback loop until these interconnected markets come back into equilibrium. Increases in crop yield per acre has also allowed for lower levels of food stores globally and in the event of a shock to supply (weather related or otherwise) can add to price volatility in the short run.

Some of commodities' diminished power of diversification is also the inevitable result of more investor interest, one measure of which is shown in exhibit 11. According to data from Barclay's Capital, in the five and a half years ending in October 2011, investor assets in commodity funds grew from $52bn to $412bn, an average annual increase of 45%. To put this growth rate in context, if we crudely extrapolate the 45% annualized growth in AUM, by 2018, commodity investor AUM would actually be greater than that of the U.S fixed income and equity mutual funds today. This explosive growth rate is of course likely to normalize as this emerging asset class matures and flows transition from "new money inflows" to more "sentiment driven-flows," similar to what we see in other major asset classes.

Unfortunately, as more and more investors add commodities to portfolios as a diversifying investment, they will tend to undermine the diversifying quality of the asset class. In late 2008, in the midst of the global financial crisis, commodity prices fell far more sharply than would seem rational even with the prospect of a severe global recession. Part of the reason for the collapse was a general "risk-off" trade, as investors seeking to increase liquidity sold all risky assets almost indiscriminately. Since then, commodity markets, like currency markets, have seemed to become more and more hostages of this risk-on, risk-off trade. This has two unfortunate impacts. First, by treating commodities this way, investors have collectively reduced their ability to diversify a portfolio. Second, and more seriously, the more commodity prices overshoot due to financial markets, the more disruption they inflict upon the real economy, ranging from the frequently tormented gasoline buyer in the United States to the subsistence food consumer of developing nations.

EXHIBIT 11: Investor interest in commodities has grown dramatically

Commodity investment product assets under management ($ billions)

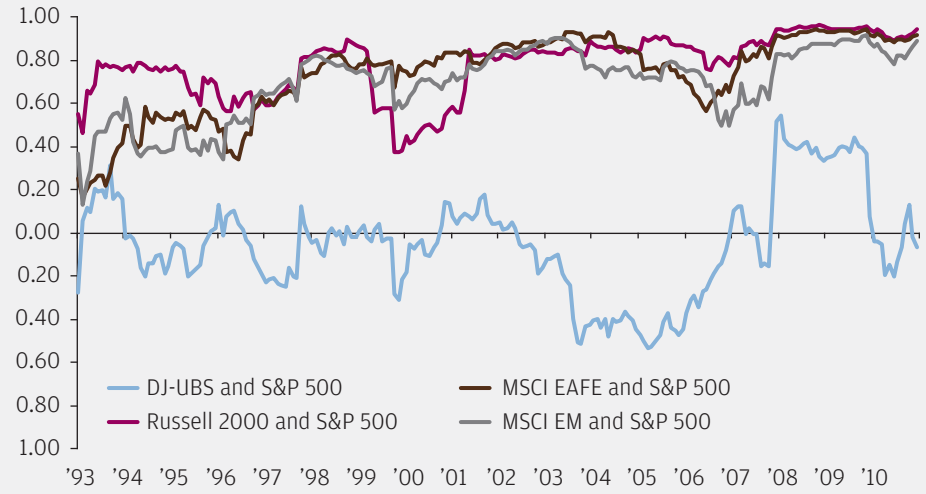


Source: Barclay's Capital, J.P. Morgan Asset Management. AUM includes commodity linked notes, index swaps and exchange traded products. Data are as of 11/30/11.

Even with the growth of the risk-on, risk-off trade, commodities have retained some diversification advantages over other "risk assets." In Exhibit 12, we show the trend in S&P 500 correlations to small cap U.S. stocks, EAFE stocks, EM stocks and commodities. Among these asset classes, commodities still clearly retain the greatest ability to diversify a portfolio relative to large cap U.S. stocks.

EXHIBIT 12: Commodities have a relatively low correlation with U.S. stocks—Nov. '93 to Oct. '11

Coefficient based on 2-yr. rolling monthly correlations, total returns

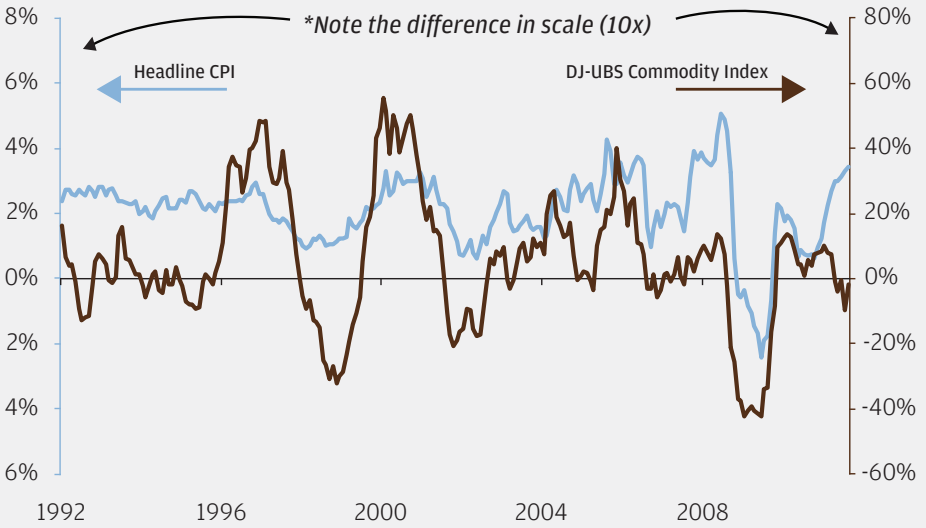


Source: DJ-UBS, Russell, MSCI, J.P. Morgan Asset Management. Data are as of 11/30/11

A third advantage of commodities is their potential to hedge against inflation. Exhibit 13 shows the relationship between the DJ-UBS index and overall consumer inflation since 1992. In general, commodity prices move in the same direction but to a greater extent than overall inflation. This shouldn't be a surprise—energy and food are both generally the most volatile components of inflation indices and the biggest components of commodity indices. This is a particularly valuable characteristic for investors who are heavily exposed to bonds, which generally fall in value when inflation rises.

EXHIBIT 13: Commodities can provide a natural hedge against inflation

Headline CPI and commodity prices, year-over-year (% change)*



Source: DJ-UBS, BLS, J.P. Morgan Asset Management. Data are as of 11/30/11.

Again, it should be noted that this positive correlation to inflation has waned somewhat in recent years as U.S. inflation has been held in check by a soft local economy while commodities have been boosted by strong global demand. Nevertheless, for those who fear that massive fiscal and monetary expansion could eventually result in higher U.S. inflation, commodities may offer a degree of inflation protection.

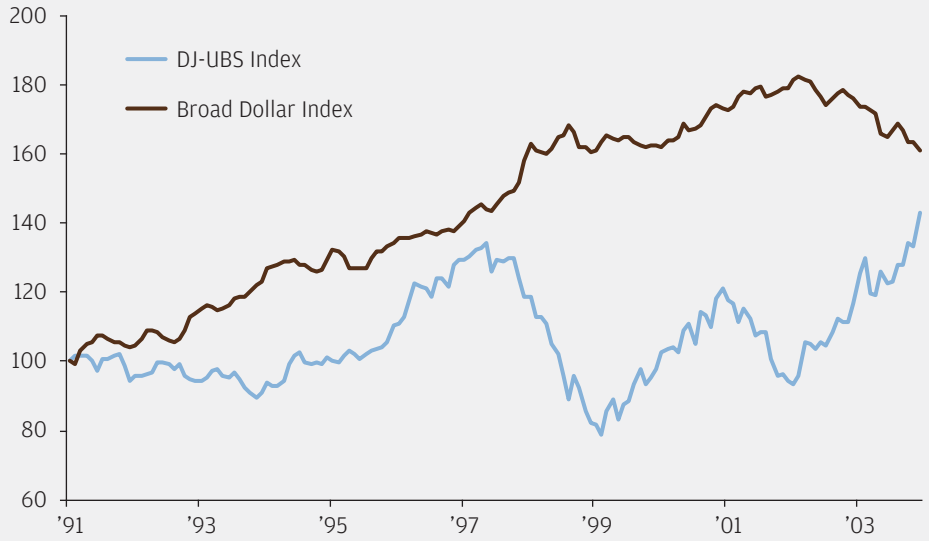
The dollar and commodities

One frequently expressed theory about movements in commodity prices is that they simply reflect movements of the dollar in the opposite direction. There is a clear logic to this—most commodities can be shipped around the world relatively inexpensively and therefore should have one global price determined by real demand and supply conditions. By convention, commodity prices are denominated in dollars. However, if the dollar falls 10% overnight against the euro, Europeans shouldn't wake up the next morning to find that the commodities they buy are 10% cheaper, while their price to Americans was unchanged. If that were the case, demand would presumably increase, pushing prices higher again. Indeed, as a matter of economic theory, if the dollar were to fall by 10% overnight, the dollar price of commodities should rise, but by less than 10%, while the euro price of commodities should fall by less than 10%.

Exhibit 14 shows monthly levels of the DJ-UBS Commodity Index and the U.S. Broad Trade-Weighted Dollar Index from January 1991 to December 2003, and this relationship is relatively clear. Regression analysis shows that, over this period, a 10% fall in the dollar was associated with a 4% rise in the dollar price of commodities. This negative relationship has sharply intensified in recent years, and Exhibit 15 shows the relationship between the commodity index and the dollar index from January 2004 through October 2011. Over this period, regression analysis shows that a 10% fall in the dollar was associated with a 20% rise in the dollar price of commodities.

EXHIBIT 14: From 1991 to 2004, a 10% fall in the dollar was associated with a 4% rise in commodity prices

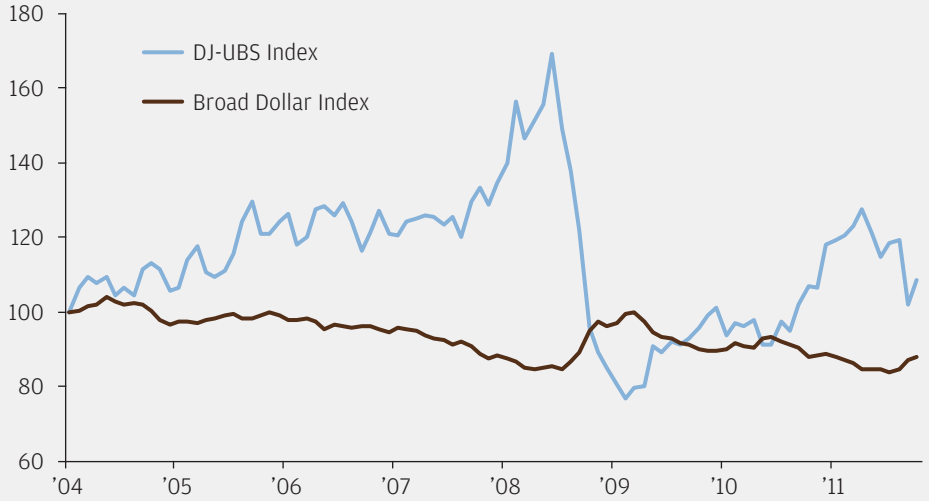
U.S. dollar and commodity prices, 1991–2004



Source: DJ-UBS, BLS, J.P. Morgan Asset Management. Data are as of 11/30/11.

EXHIBIT 15: Since 2004, a 10% fall in the dollar has been associated with a 20% rise in commodity prices

U.S. dollar and commodity prices, 2004–present



Source: DJ-UBS, BLS, J.P. Morgan Asset Management. Data are as of 11/30/11.

Why would this be the case? One possibility is a change in the nature of commodities in the economy in recent years. In the 1990s, commodity prices were mostly driven by issues impacting the actual producers and consumers of commodities and, as such, the economic logic of the impact of a dollar change prevailed. However, in recent years, commodity prices have become more of a financial asset and as such have reflected the hedging needs of investors rather than the commercial needs of consumers and producers. In this new guise, one of the key attributes of commodities has been as a "risk asset" and a supposed hedge against a dollar decline. Generally, when markets have been calmer, the dollar has tended to drift down and investors have piled into commodities as a risk asset of choice.

In this new world of commodity markets, a falling dollar still contributes to rising commodity prices for traditional and logical economic reasons. However, the fact that commodity prices overreact to dollar declines reflects the reality that commodities are being used as a risk asset and dollar hedge by investors. This probably contributes to far more volatility in commodity prices than is justified by genuine changes in supply and demand conditions and, as such, likely adds a disruptive element to the global economy.

How to invest in commodities: Knowing the pros and cons

Just as investor interest in commodities has grown over the years, so has the variety of investment vehicles available. The simplest investment is holding the physical commodity, but given the inconvenience of physical ownership, this option only really makes sense in the case of precious metals. Investors wanting exposure to a wider range of commodities can invest in futures markets. Commodity futures trading, however, is not recommended for the faint of heart. In most cases, the individual investor will be taking the opposite side of the trade with someone who is more knowledgeable about the market than the investor, and as contracts close out, investors have a limited time to make a profit on the transaction and have to rollover their investments into new contracts in order to maintain exposure.

Exchange traded products such as ETFs and ETNs based on commodities offer investors a low fee way to diversify their exposure. However, as the ETF industry has grown, ETFs themselves are frequently the victim of market movements, particularly those based on underlying futures exposures that can be forced to roll over into higher-priced contracts as expiration days approach, only to watch prices fall sharply in the immediate aftermath.

Actively managed commodity funds often use various derivatives markets to express investment views, but with the experience of a professional manager, they should have a chance to better time purchases and avoid some of the pitfalls confronting passive ETFs. However, most of these funds are long only, so an individual investor in the fund has no choice but to experience the full extent of market movements. Actively managed funds with the ability to go short as well as long can, in theory, dampen the impact of commodity price swings on investment performance, provided the managers are adept at forecasting commodity price cycles and exploiting market inefficiencies.

Finally, an investor can gain indirect exposure to commodities by investing directly in the stocks of commodity producers or a natural resources fund that buys these stocks. Again, there is a danger that these funds will experience close to the full volatility from commodity markets along with the swings associated with broader equity markets, but skilled managers may be able to amplify rises and dampen declines.

While *how* you invest in commodities clearly makes a difference, we believe that most investor portfolios would benefit from some exposure to the asset class as it can be a source of capital appreciation, diversification and a hedge against inflation. The wide range of investment vehicles available, each with pros and cons, makes the choice of commodity investment a highly personalized one and, depending on an investor's risk tolerance and time horizon, is best made with the help of a professional.

Conclusion

A well-balanced portfolio with a variety of relatively uncorrelated assets is the best approach for investors over the long run. A strategic allocation to commodities can help provide both the benefit of diversification and exposure to a number of investment themes. Emerging market economic growth, urbanization and industrialization are all important drivers of incremental demand for commodities. Rapidly rising demand has challenged producers' ability to adjust supply over the last decade, a dynamic that is at least partially responsible for rising real prices over the same period. However, it should be noted that throughout history, supply and demand eventually do come back into equilibrium, bringing prices back down and creating a typical commodity cycle. Innovations on the part of commodity producers should not be underestimated, particularly when prices are elevated, but those innovations can also link the prices of seemingly unrelated commodities, impacting price volatility and cross commodity correlations.

The cyclical nature of commodity prices combined with the importance of food and energy in common measures of inflation make commodities a natural hedge against the threat of inflation, a characteristic of particular importance for investors that are overweight fixed income and therefore at risk of inflation eating away at future fixed payments. Commodities, priced in dollars but demanded globally, tend to exhibit a negative relationship with the value of the dollar. A steady flow of investor money into the commodity space and the broad risk-on/risk-off trading environment have likely exaggerated the inverse relationship between commodity prices and the dollar in more recent years.

Along with the factors noted above, differences in commodity indices and investment vehicles make any investment in commodities a highly personalized one. Finally, commodities are not a homogonous group, particularly given the idiosyncratic supply constraints, so while a strategic allocation to commodities carries positive benefits, it is important to consider the risks and seek professional advice when considering commodity investments.

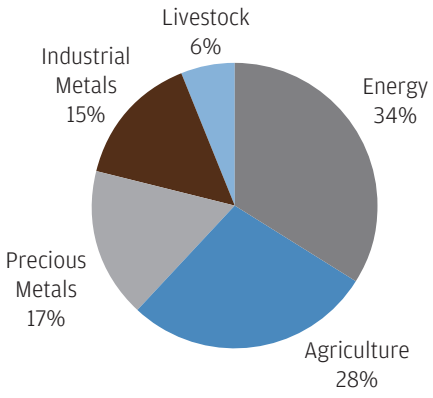
Comparison of commodity index weights

Which index?

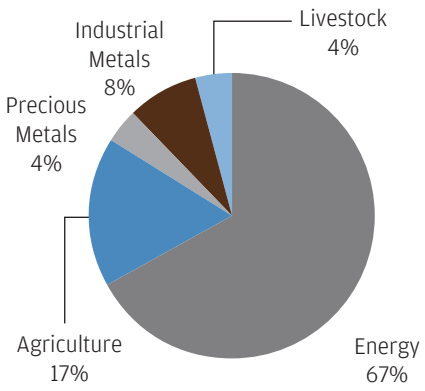
The Dow Jones-UBS Commodity Index (DJ-UBSCI), the Goldman Sachs Commodity Index (GSCI) and the Thomson Reuters-Jefferies Commodity Research Bureau Commodity Index (TRJ-CRBCI) are industry standard benchmarks for commodities investing. All three indexes are made up of unleveraged, long-only positions in futures contracts on physical commodities. Each index provider utilizes market liquidity, open interest and economic significance to determine the weight of each commodity, but as evidenced in the charts below, the weightings vary significantly.

The disparity is attributed to differences in sector constraints and rebalancing. Unlike the GSCI, which has no weight restrictions, the DJ-UBSCI and TRJ-CRBCI limit the weight that can be given to any one commodity. The impact of these restrictions is most obvious in the energy sector, which carries a much heavier share in the GSCI. Reweighting of the GSCI and DJ-UBSCI occur annually, while the TRJ-CRBCI has periodic reweighting (10 since 1957) along with monthly rebalancing. Taking all of these nuanced differences into account, the DJ-UBSCI is probably the most appropriate benchmark for investors seeking the diversification benefits of commodity investments, as it is well balanced across a wide range of commodities. Where the DJ-UBSCI falls short is in the amount, available historical data (started December 1990), so for longer-term analysis, we use either the TRJ-CRBCI or the GSCI, which have data going back to 1957 and 1970, respectively.

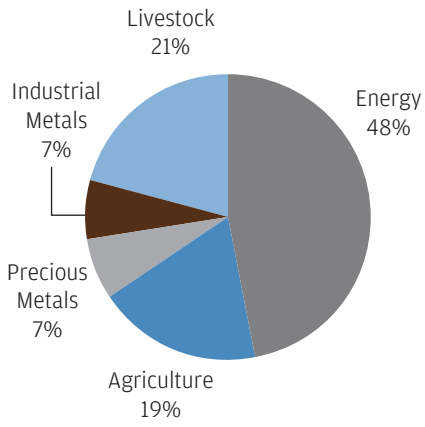
DJ-UBS
Commodity Index Weights



GS
Commodity Index Weights



TRJ-CRB
Commodity Index Weights



Source: GSCI, DJ-UBS, TRJ-CRB, J.P. Morgan Asset Management. Data are as of 11/30/11.

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Investments in commodities carry greater volatility than investments in traditional securities. The value of commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss.

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