

## QUICK MARKET UPDATE

# Commodities Update

*Justin Lenarcic, CAIA, Alternative Strategies Research Analyst*  
*Chris Haverland, CFA®, Senior Investment Research Analyst*

May 25, 2011

May, thus far, has certainly proven to be a wild month for commodities markets. It began with a sudden and steep sell-off on May 5 and 6 that appeared to catch many investors off guard. In the trading days since, commodity market volatility has stabilized to a degree, albeit with another significant reversal on May 11. This week, investors seem to be facing another bout of elevated volatility, with commodities fluctuating amid a variety of geopolitical concerns. Crude oil has traded lower most likely over concerns that the European debt crisis may curb fuel demand. A slowdown in manufacturing activity in China has pushed copper futures down, while the inauguration of President Ouattara in the Ivory Coast has likely put pressure on cocoa futures. Finally, a stronger U.S. Dollar this month, coupled with an ease in supply concerns, also has resulted in lower prices for many agricultural commodities, such as wheat, corn, and soybeans lower.

### S&P GSCI Commodity Index



Source: Factset, May 24, 2011

As is the case with "corrections," investors quickly attempt to: first understand the cause of the event, then gauge the event's impact on their portfolio and, finally, determine how the event will shape future trading and allocations. Several elements have played a critical role in the

price collapse investors are experiencing: weaker than expected economic data releases, the impact of tightening monetary policy on commodity demand in emerging economies, and a positive reversal in the U.S. Dollar (commodities prices have historically had an inverse relationship with the dollar). Additional factors include various hedge fund managers unwinding positions in concert, and the surprisingly overlooked approaching expiration of 30 major commodity contracts, which entered or were close to entering delivery periods.

### Commodities Began Correcting Months Ago

It's important for investors to realize that the events of May 5 and 6<sup>th</sup> and even this week should not be viewed as the beginning of the commodity correction—in fact, several of the largest commodity markets have been trading lower for several months now. For example, heading into May, the spot price of sugar had declined nearly 35 percent since February 2, while cotton had lost nearly 17 percent since the intra-day high reached on March 7.

Analysis of Commitments of Traders (COT) data suggests that large speculators were already in the process of reducing net-long commodity and net-short U.S. Dollar exposure between the week of April 26 and May 3. Net futures positions as a percentage of total open interest decreased in the large agricultural markets (soybeans, corn and wheat), metals (gold, silver and copper) as well as energy (crude oil and gasoline). Short positions in natural gas and the U.S. Dollar Index also were being covered heading into May.

More recent data suggests that throughout the commodity correction, large speculators continued to decrease net-long exposure to commodities within the agricultural, metals and energy markets, and also further covered natural gas and U.S. Dollar Index positions. Meanwhile, money managers reduced their net-long positions in U.S. commodity futures and options by 11 percent in the week ended May 17 to the lowest level since July 2010.<sup>1</sup>

	April 26 Notional Exposure	Weekly Large Speculator Exposure Δ	May 3 Notional Exposure	Weekly Large Speculator Exposure Δ	May 10 Notional Exposure	Large Spec Positioning as of May 10 <sup>th</sup>
<b>Soybeans</b>	\$9.5B	↓	\$9.0B	↓	\$7.9B	Neutral
<b>Corn</b>	\$18.1B	↓	\$16.1B	↓	\$14.9B	Crowded Long
<b>Wheat</b>	\$0.9B	↓	\$0.5B	↓	\$0.4B	Neutral
<b>Gold</b>	\$30.3B	↓	\$29.7B	↓	\$26.7B	Neutral
<b>Silver</b>	\$5.6B	↓	\$5.0B	↓	\$4.5B	Neutral
<b>Copper</b>	\$2.6B	↓	\$2.2B	↓	\$1.2B	Neutral
<b>Platinum</b>	\$2.3B	↑	\$2.5B	↓	\$2.1B	Crowded Long
<b>Palladium</b>	\$0.9B	–	\$0.9B	↓	\$0.7B	Neutral
<b>Crude Oil</b>	\$29.0B	↓	\$27.1B	↓	\$22.0B	Crowded Long
<b>Natural Gas</b>	\$8.9B (short)	↑	\$8.8B(short)	↑	\$8.6B(short)	Crowded Short
<b>Heating Oil</b>	\$3.6B	↑	\$3.9B	↓	\$2.9B	Neutral
<b>Gasoline</b>	\$8.6B	↓	\$8.5B	--	\$8.5B	Neutral
<b>US \$ Index</b>	\$0.6B (short)	↑	\$0.5B (short)	↑	\$0.3B (short)	Neutral
<b>Euro</b>	\$10.0B	↑	\$14.8B	↓	\$8.9B	Neutral

Source: CFTC Data

<sup>1</sup> Bloomberg, May 24, 2011.

## What Are Investors To Do?

We believe a major price driver for commodities in the near-to-intermediate term will most likely be a “war for acreage” in agricultural markets, as high prices across the grain and other soft complexes force farmers to examine margins and planting strategies. Additionally, weather-related issues, such as the flooding in the U.S. and Australia, could continue to pressure agricultural commodity supplies. Finally, the fact remains that despite a moderate tightening policy, China is expected to increase commodity demand in the coming years and engage in a large-scale commodity-purchase program over the next few months. This will likely have a positive impact on the metals complex, specifically copper, platinum, and palladium.

The recent slowdown in global economic growth, particularly from emerging markets, and the rebound in the U.S. Dollar may be temporary headwinds for commodity prices. Nonetheless, the long-term forecasts for rising demand (especially in emerging markets), supply shortages and U.S. Dollar weakness are supportive of higher prices. The recent correction has moved commodity prices more in line with fundamentals and may provide a buying opportunity, given the favorable long-term outlook.

Given the level of volatility experienced this month—which is not unusual for this asset class—and the potential for continued volatility on an interim basis, investors likely are wondering what is the appropriate allocation to commodities within a diversified portfolio. Our approach is to employ a strategic allocation to real assets for diversification and inflation-hedging purposes, with a portion of that allocated to a diversified basket of commodities. Within the commodities space, we prefer exposure to sectors that most likely will fuel global economic growth, particularly agricultural, industrial metals and energy. Going forward, we anticipate continued GDP growth in emerging markets and further stabilization in developed markets GDP, and believe a well-diversified commodities allocation should remain an important component of an overall portfolio.

*All data in this QMU sourced from Bloomberg unless otherwise noted.*

## Disclosures

Wells Fargo Wealth Management provides products and services through Wells Fargo Bank, N.A. and its various affiliates and subsidiaries.

The information and opinions in this report were prepared by the investment management division within Wells Fargo Wealth Management. Information and opinions have been obtained or derived from sources we consider reliable, but we cannot guarantee their accuracy or completeness. Opinions represent Wells Fargo Wealth Management’s opinion as of the date of this report and are for general information purposes only. Wells Fargo Wealth Management does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

Past performance does not indicate future results. The value or income associated with a security may fluctuate. There is always the potential for loss as well as gain. Investments discussed in this presentation are not insured by the Federal Deposit Insurance Corporation and may be unsuitable for some investors depending on their specific investment objectives and financial position.

This report is not an offer to buy or sell, or a solicitation of an offer to buy or sell the securities or strategies mentioned. The investments discussed or recommended in the presentation may be unsuitable for some investors depending on their specific investment objectives and financial position.

Some complementary strategies may be available to pre-qualified investors only.

Asset allocation does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

The S&P GSCI™ Commodity Index is a composite of commodity sector returns, representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. Individual components qualify for inclusion in the Index on the basis of liquidity and are weighted by their respective world production quantities. You cannot invest directly in an index.

Wells Fargo Advisors is the trade name used by two separate registered broker-dealers: Wells Fargo Advisors, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, non-bank affiliates of Wells Fargo & Company.

© 2011 Wells Fargo Bank, N.A. All rights reserved.

**Investment Products: ► NOT FDIC Insured ► NO Bank Guarantee ► MAY Lose Value**

Securities offered through H.D. Vest Investment Services<sup>SM</sup>, Member SIPC  
Advisory services offered through H.D. Vest Advisory Services<sup>SM</sup>,  
Non-bank subsidiaries of Wells Fargo & Company  
6333 N. State Hwy. 161, Suite 400, Irving, TX 75038  
(972) 870-6000.

The views and opinions presented in this article are those of Justin Lenarcic and Chris Haverland at Wells Fargo and not of H.D. Vest Financial Services<sup>®</sup> or its subsidiaries.