TD Asset Management

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Anticipating a new commodities super-cycle

Observing early signs of a bull market in commodities

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At a glance

- Investors are motivated to invest in commodities for three primary reasons: inflation protection, portfolio diversification and expected returns
- Heightened inflation uncertainty and compressed yields are prompting discussions around the inclusion of commodities during portfolio construction
- Supply and demand balances for many commodities have started to reflect years of reduced capital expenditures and underinvestment
- TD Asset Management Inc. (TDAM) feels that commodity prices are likely in the early stages of a structural bull market

After spending the better part of a decade in a bear market, we feel that commodity prices are likely in the early stages of a structural bull market. Many commodities are trading at near record highs in nominal terms, however, when adjusting for inflation, prices in "real" terms are below levels observed at the peak of the last super-cycle, and more possibly aptly, even further away from the highs observed in the 1970s.

A consideration for many portfolios

Heightened inflation uncertainty and compressed yields are prompting discussions around the inclusion of commodities in portfolio construction. We believe their inclusion at this juncture is very timely.

Although this article is more structural in focus (the role that commodities serve in a portfolio) we also provide some context as to where we are in the commodity cycle and explain why we anticipate higher commodity prices, and returns, in the coming decade.

> Commodities can serve an important role in portfolio construction and we believe their inclusion now is very timely.

Years of underinvestment

Supply and demand balances for many commodities have started to reflect years of reduced capital expenditure and underinvestment. Demand, on the other hand, despite efficiency gains and substitution, continues to grow. A necessary focus on Environmental, Social, and Governance (ESG), climate-change and the energy transition might prove to make this cycle unique.

Demand for certain commodities, particularly those needed to foster the energy transition (the inputs in electric vehicle battery production for example) will find support, while supply of others (primarily commodities that contribute to increased greenhouse gases) becomes restricted. It is this landscape that forms our view that we are in the early stages of a period that should see higher commodity prices and returns. Although prices are elevated in nominal terms, when adjusted for inflation, prices are still not considered expensive.

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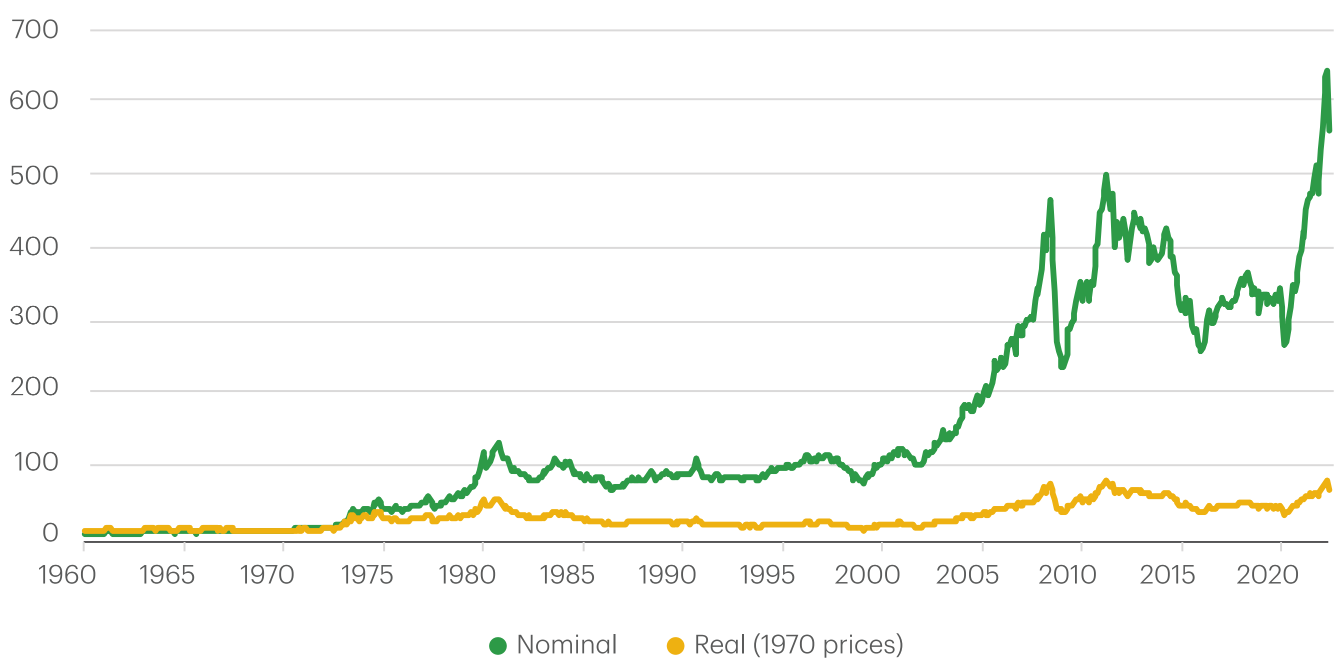
Commodity prices trading at nominal highs, but cheap in real terms



Source: Bloomberg Commodity Index Spot (BCOM), Bloomberg Finance L.P. Data as of June 30, 2022

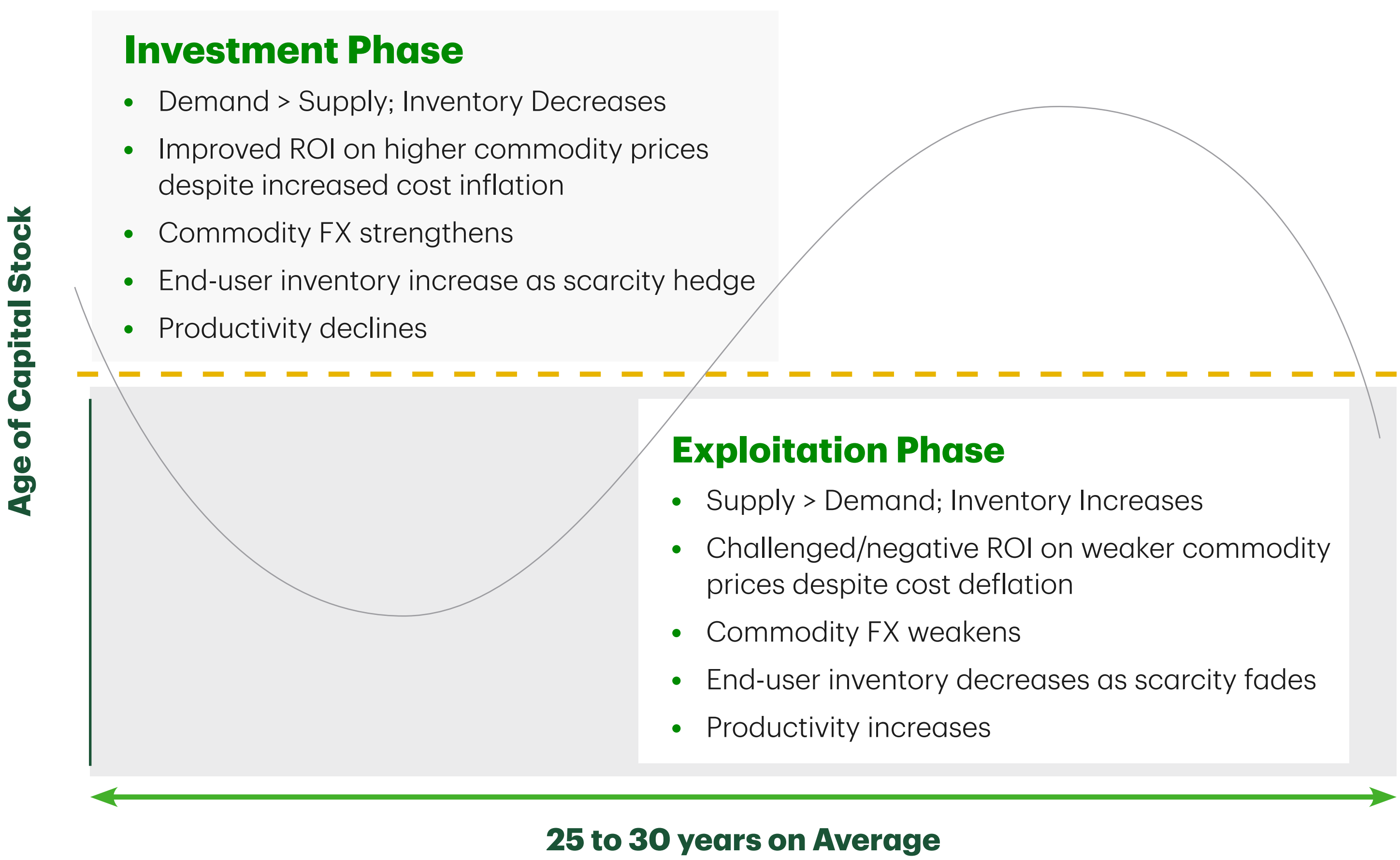
The commodity cycle and expected returns

The commodity cycle is different from the business cycle. Commodity cycles are longer in nature, in total lasting 25-30 years and can be broken down into two phases – the investment phase and the exploitation phase. The last decade was characterized with weaker prices, reflecting the exploitation of investments made through the commodity super-cycle that started in 2002.

The inelasticity of supply, or the duration of time that passes before higher (lower) commodity prices lead to higher (lower) commodity production, plays a material role in driving this commodity cycle.

> Investors are typically motivated to invest in commodities for three primary reasons: inflation protection, portfolio diversification and expected return.

The Commodity Cycle



For illustrative purposes only.

After peaking in 2008, commodity prices spent more than a decade in the doldrums, discouraging investment in commodity supply. Prices have started to move higher reflecting tightening inventories – driven by robust demand and challenged supply.

With the outlook for supply challenged, we believe we are at the onset of another investment phase. The last investment phase started in the late 1990s, gaining momentum in the early 2000s, as growing emerging market demand, particularly from China, resulted in deficit balances. Higher commodity prices attracted investment and ultimately additional supply to satiate this demand, but not before commodity prices went through a super-cycle, with prices for many commodities reaching record highs in 2008.

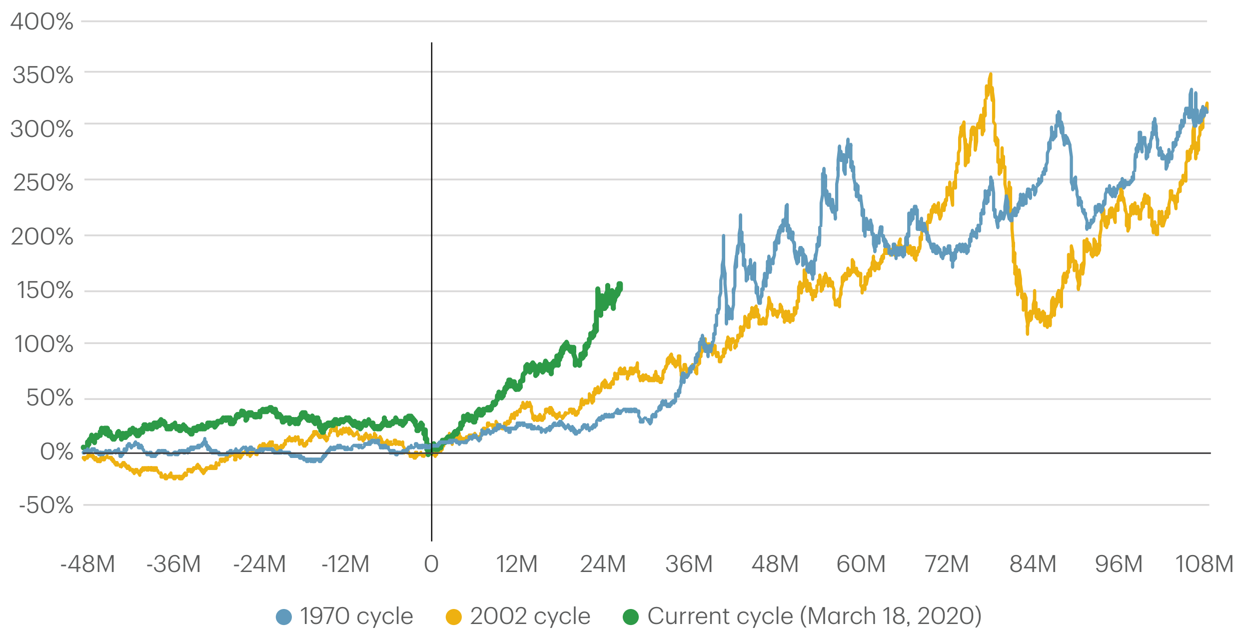
> With the outlook for supply remaining challenged, we believe we are at the onset of another investment phase.

This time feels different

The investment phase that we are embarking on now is likely to be unique, as we navigate the challenges of reducing our global carbon footprint to meet climate objectives. The transition from carbon fuels to renewable fuels will hinder the supply of commodities like oil and gas, while boosting demand for others used in electric vehicles and power generation/distribution like copper and nickel.

Importantly, the challenges associated with growing production through the last super-cycle, including resource nationalism, as well as resource depletion and declines, have not gone away and the energy transition is likely to make finding equilibrium more of a challenge.

Commodity super-cycle: start to peak
Bloomberg Commodity Price Return Index



Source: Bloomberg Finance LP as of June 15, 2022

Diversification and inflation protection

Unlike stocks and bonds which are anticipatory financial assets, commodities are more concurrent assets whose prices tend to be driven more by spot developments — the here and now.

As an example, central bank rate hikes are quickly reflected in fixed income and equity valuations. The impact of rate hikes disproportionately impacts growth vs. value stocks as we have seen this year. Their impact on commodities is mixed as they are unlikely, particularly in the short-term, to have a meaningful effect on the supply and demand of commodities and resources like corn, copper and oil (among others). This difference between commodities and other assets, contributes to their low correlation with other asset classes and explains why their addition to most portfolios results in an improved portfolio risk-adjusted return.

> The addition of commodities may help boost the potential risk-adjusted returns of a portfolio.

Commodities low correlation with other asset classes

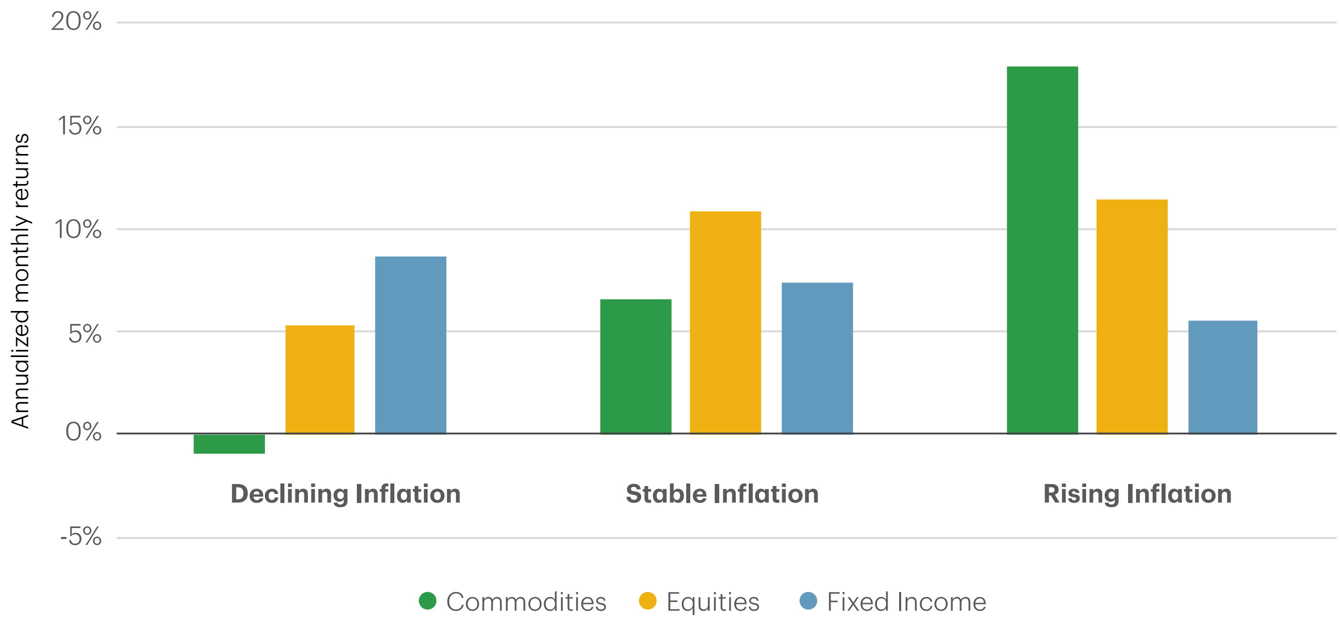
	Commodity	US Equity	US Bonds	Global Equity	Global Bonds	TIPS	Real Estate	Infra
Commodity	1.00							
US Equity	0.34	1.00						
US Bonds	-0.18	-0.36	1.00					
Global Equity	0.47	0.95	-0.39	1.00				
Global Bonds	0.13	-0.08	0.64	0.00	1.00			
TIPS	0.40	-0.22	0.68	-0.17	0.61	1.00		
Real Estate	0.34	0.21	-0.17	0.23	-0.05	0.04	1.00	
Infrastructure	0.32	0.27	-0.24	0.30	-0.06	0.01	0.53	1.00
CPI	0.76	0.19	-0.28	0.24	-0.08	0.28	0.46	0.33

Source: Bloomberg Finance L.P. Correlation based on quarterly annualized returns. Data from March 1998 to March 2022. Real asset data from March 1998 to September 2021

Incidentally, it is also in periods of higher inflation that stocks and bonds tend to exhibit higher correlations. Because inflation was muted for the last 30 years, the traditional 60/40 portfolio benefited from the negative, or low correlation, exhibited by stocks and bonds. With inflation now elevated, the negative correlation between stocks and bonds may suffer as it did during the higher inflationary period from 1973-99.

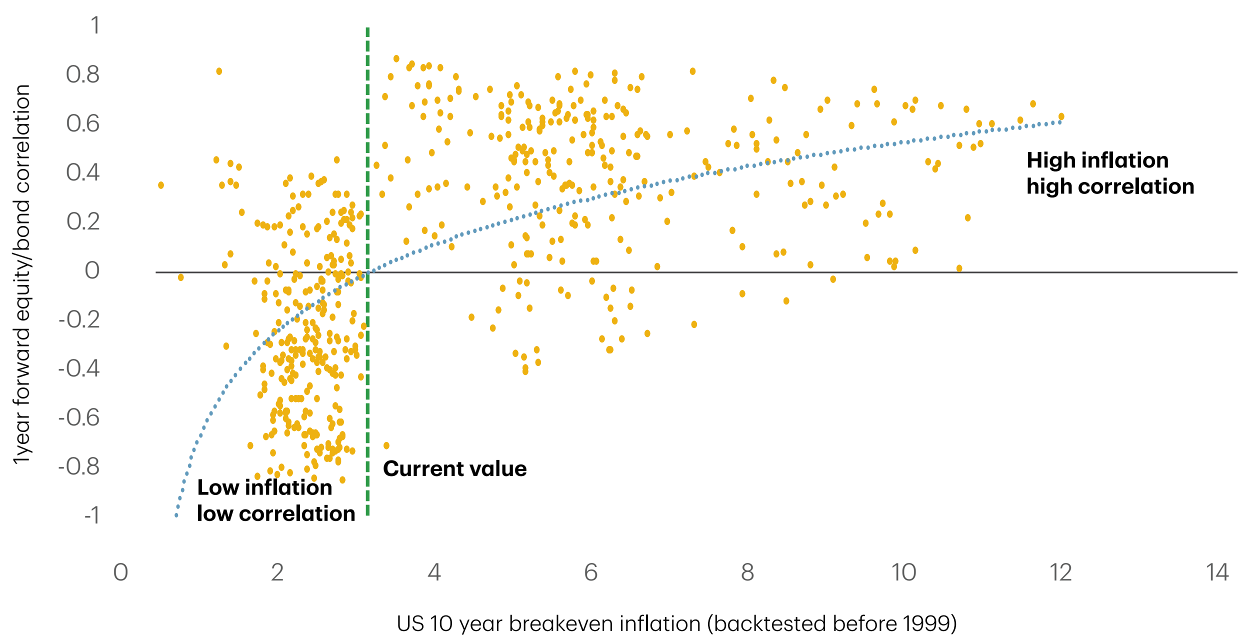
> In periods of low/contained inflation, equities and bonds are negatively correlated which makes for good portfolio construction. However, in periods of elevated inflation, the correlation between bonds and equities is positive – as such, the addition of bonds to a portfolio adds risk (less diversification).

Commodities exhibit their best performance in periods of rising or high inflation



Source: Bloomberg Finance L.P, FRED, TDAM. Data period from January 1977 to April 2022. Commodities are represented by the GSCITR Index, equities are represented by the S&P 500 Index and Fixed income is represented by the Bloomberg Global Aggregate Index.

Higher inflation lends to postitive equity/bond correlations



Source: Bloomberg Finance L.P, Federal Reserve Bank of New York. Data from Jan 1973 to April 2022

In summary

We see the addition of commodities as an essential consideration in portfolio construction due to their low correlation with fixed income and equities. We also see the addition of commodities as timely given their performance, both relative and absolute, in periods of increased inflation and inflation uncertainty. In terms of return expectations, we see commodities as entering a period of reduced supply, which should support both commodity prices and returns.

Portfolio

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