April 23, 2016

High Conviction Macro Trades: Commodity & EM Opportunities

The Reflation Trade: As clients know, BWR's commodity forecasting methodology examines where a commodity's spot price trades with respect to its long-term average ratio to gold. This has allowed us to make some very powerful forecasts in the past, including real estate, cotton, coffee and oil.

The following is the Bretton Woods Research commodity matrix table which offers price targets for nearly 30 commodities assuming a gold price of $1225/oz.

We currently see the early stages of an improving environment for commodities with strong upsides for energy, specifically, natural gas, oil, and unleaded gasoline. We also see modest upsides ahead for grains, meats, metals and soft commodities. The only commodities that currently exhibit the potential for weakness in the medium-term are iron ore, cocoa and bananas.

Bretton Woods Research's Commodity Matrix Assuming $1225 Gold Price

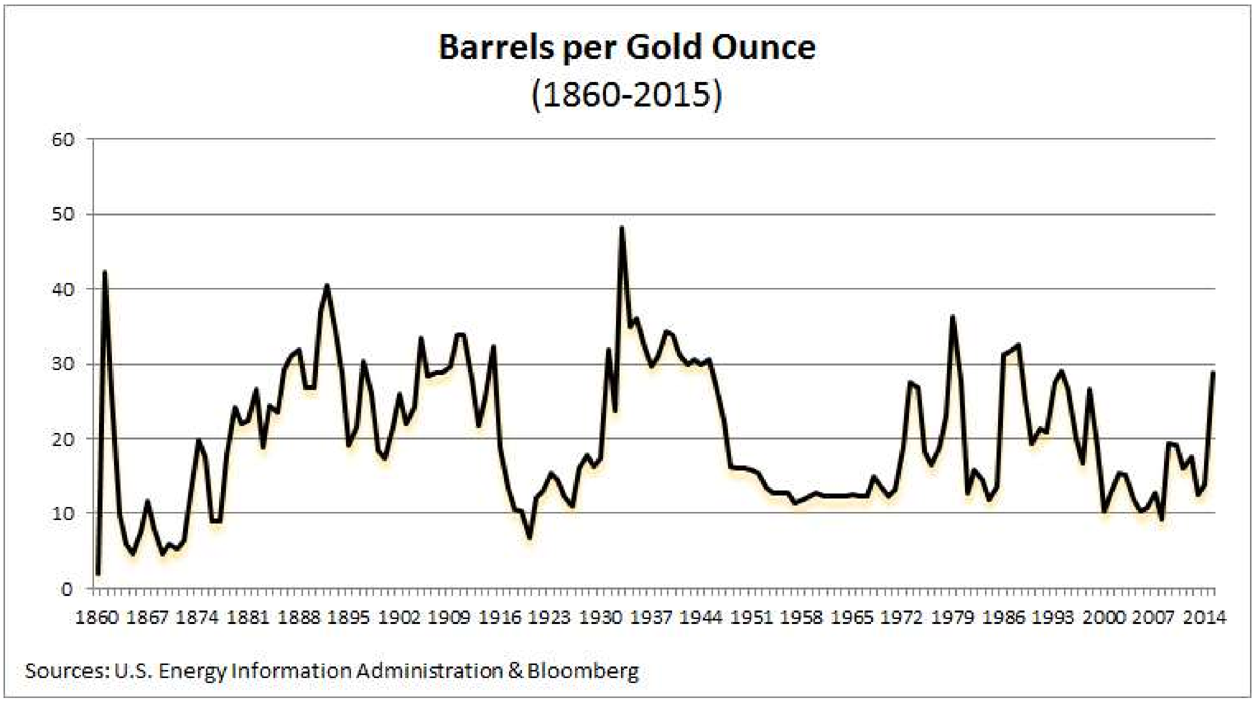
Category	Commodity	Recent Price (Spot/Index)	BWR'S Long-range Price Target	Change Since Year-End 2015	Potential Upside/Downside
Energy	Natural Gas (Henry Hub)	1.94	3.96	-16.15%	104.46%
Energy	Oil (West Texas Intermediate)	42.82	82.00	15.60%	91.50%
Energy	Unleaded Gasoline (US Retail)	2.14	3.53	-4.77%	65.01%
Energy	Coal (NYMex Spec Month 1)	46.20	64.25	8.07%	39.07%
Grains	Rough Rice (JP Morgan)	10.93	14.71	-7.69%	34.69%
Grains	Wheat (S&P GSCI)	341.65	448.83	7.13%	31.37%
Grains	Corn (S&P GSCI)	321.77	409.23	8.64%	27.18%
Grains	Soy (S&P GSCI)	407.94	481.73	18.89%	18.09%
Meats	Lamb (New Zealand)*	95.54	154.42	0.00%	61.62%
Meats	Chicken (FOB Georgia Docks)	141.50	222.18	-5.35%	57.01%
Meats	Live Cattle (S&P GSCI)	398.98	487.43	-14.55%	22.17%
Meats	Lean Hogs (S&P GSCI)	116.62	135.87	32.98%	16.51%
Metal	Nickel (LME)	9,068.50	18,905.39	3.29%	108.47%
Metal	Uranium 308 (Evolution Mkts)	26.75	45.35	-22.46%	69.53%
Metal	Copper (LME)	5,014.25	6,983.75	6.56%	39.28%
Metal	Platinum	1,028.49	1,428.21	17.97%	38.86%
Metal	Aluminum (LME)	1,626.25	2,256.79	8.40%	38.77%
Metal	Palladium	604.63	783.96	10.91%	29.66%
Metal	Zinc (LME)	1,904.50	2,307.66	19.57%	21.17%
Metal	Lead (LME)	1,779.75	2,088.90	-0.96%	17.37%
Metal	Silver	17.17	19.92	23.64%	16.01%
Metal	Tin (LME)	17,200.00	19,474.79	17.88%	13.23%
Metal	Iron Ore (China 62% Ferrous)*	58.40	52.16	34.56%	-10.69%
Softs	Cotton (S&P GSCI)	91.08	121.90	1.15%	33.84%
Softs	Coffee (JPMorgan)	1,575.81	2,044.64	1.61%	29.75%
Softs	Orange Juice (JPMorgan)	128.75	154.89	-10.99%	20.30%
Softs	Lumber	279.90	326.22	9.38%	16.55%
Softs	Sugar (S&P GSCI)	166.21	189.14	3.61%	13.80%
Softs	Cocoa (S&P GSCI)	122.04	115.51	-3.24%	-5.34%
Softs	Bananas (US Gulf Delivery)*	1,052.35	986.08	12.75%	-6.30%

*Sources: IMF, Bloomberg includes S&P Indices, JP Morgan Indices, and Dominant Spot Prices (*Most recent value from IMF Series)*

Long Case for Oil Still Strong

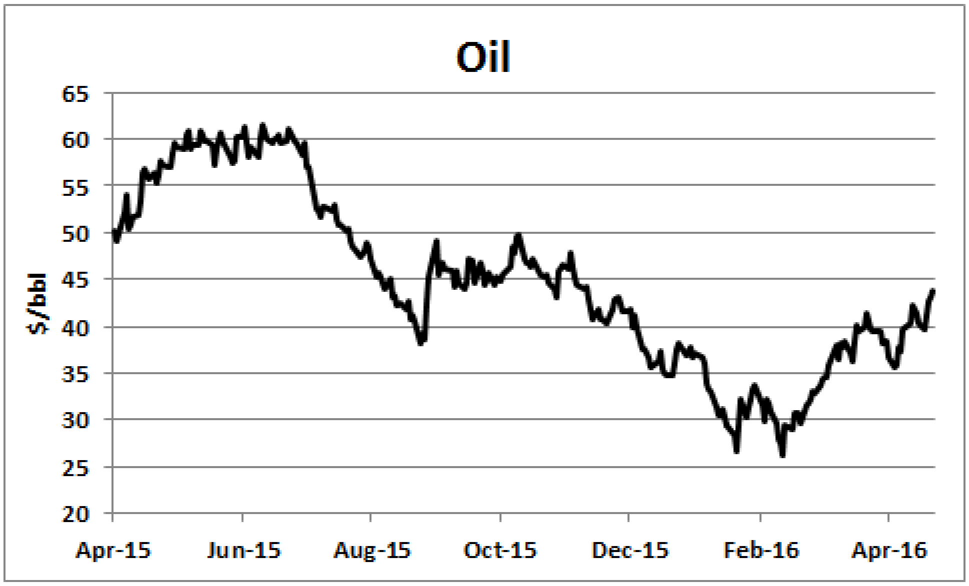
Oil is a prime example of gold-centric forecasting prowess. During the last 40 years, oil has tended to trade between 12 and 15 barrels per ounce of gold, i.e. that is a level to which this ratio mean reverts. When oil has traded at extremes significantly above or below that range, we have argued that oil has been respectively cheap/attractive (e.g. 25 barrels per ounce of gold in January 2009) and expensive/unattractive (e.g. 6 barrels per ounce of gold in June 2008).

As one can see in the following graph, which plots the oil/gold ratio going back more than 150 years, oil/gold generally ranged between 15-20 barrels per ounce.



In our 2016 Outlook on January 5, when oil traded around $36, we predicted a 35+% appreciation for oil by year-end given that the ratio of about 28 barrels per ounce was abnormally high, and we specifically forecast an oil bottom of $25.85/bbl.

Our forecast for the oil bottom came strikingly close. On February 11, when the oil/gold ratio reached a historic high of 48.2 barrels per ounce, oil closed at $26.21/bbl. That was the bottom. The commodity has since rallied 65+% to nearly $44/bbl.



On March 29, we raised our oil forecast to $62.50/bbl by year-end. FOMC Chair Janet Yellen's speech that same day was critical to us as she reaffirmed the 'Fed Put' by making clear three important 'data points' that would warrant future caution on rates: 1) a stronger dollar; 2) falling oil prices; and 3) any increase in global growth uncertainty, e.g. China's steep slowdown at the time. These considerations are still likely to keep hawks such as Fed Vice-Chair Stanley Fischer at bay for most of the year.

Today, our base case is that the Fed will not raise the funds rate until after the November elections. This is consistent with the formulation spelled out by permanent voting FOMC member Lael Brainard: "the Fed's main duty is to preserve and protect all the economic progress" since the dark days of 2008. On this basis, we believe gold will trade between $1200 and $1250 by year-end.

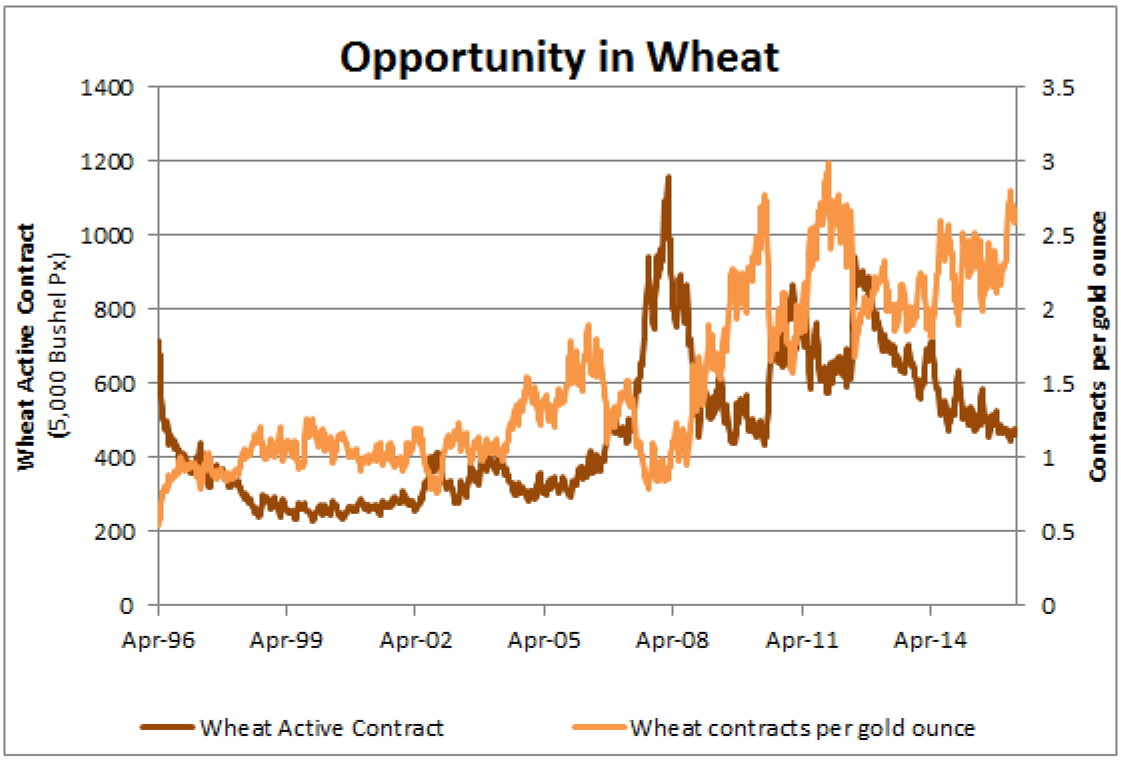
This boosts our belief that the oil/gold ratio will head toward 20 barrels per ounce by the end of 2016.

Although in technical terms oil may be a bit 'overbought' in the near-term, we would certainly use any near-term pullbacks, say into the high $30s, to take advantage of an expected recovery to $62.50 and use an exchange-traded fund such as Proshares Ultra Oil & Gas (Ticker: DIG) to play such a scenario.

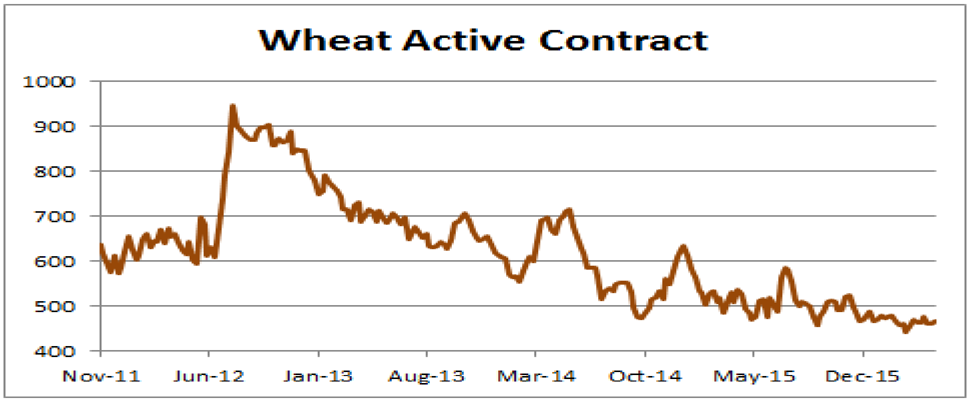
One of our long-time clients and oil experts, former IPAA Chairman George Yates has informed us that despite the drop in prices from mid-2014 to earlier this year, excess capacity has not increased. Additionally, with a half-trillion or more dollars in capital expenditures and investment deals that have been scotched as a result of the recent oil crash, investment, employment and output are likely to lag any price recovery. In other words, supply could lag global demand for several years. Oil could be in the early stages of a multi-year bull market.

Long Wheat (WEAT): The dollar's reflation from $1052 to nearly $1250 has certainly been welcome for agriculture. Similar to oil, where historical parities with gold have elevated potential appreciation, we now see gains ahead for grains such as rice, corn and specifically wheat.

The exchange-traded fund Teucrium Wheat (Ticker: WEAT) which seeks to keep track of wheat futures prices on the Chicago Board of Trade, enjoys a 96% correlation with the CBOT active wheat future contract.



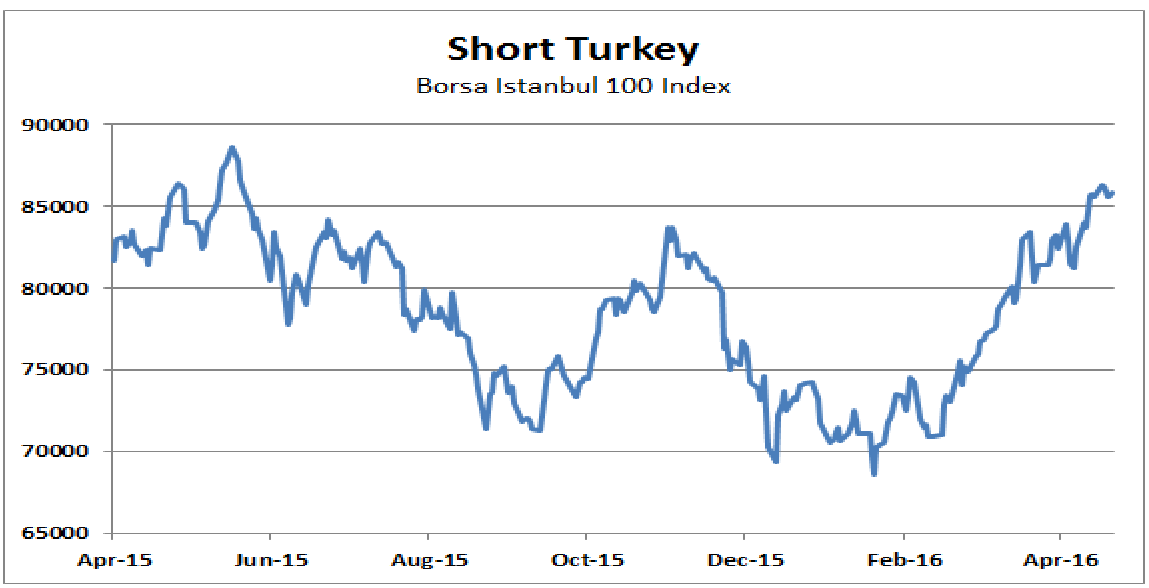
Between1980 and 2007, the average ratio of the CBOT wheat contracts per gold ounce was 1.12. Since 2008, however, that ratio has been 2.04 contracts per gold ounce. And the three-year moving average is 2.21 contracts per ounce. On Friday, the active wheat contract closed at $467/5,000 bushels, pushing the wheat to gold ratio to 2.67. This is extreme cheapness for wheat, as the chart above illustrates.



Not including the potential for undershooting, if the wheat/gold ratio reverted just to its three-year average of 2.21 contracts per ounce (and holding the gold price $1250), this would mean wheat prices would climb to $555. This would correlate to WEAT rising to $11.25/share; a 24+% appreciation.

Bottom line: We recommend going long the exchange-traded fund, Teucrium Wheat (WEAT). WEAT closed at $8.88 pm on Friday. Our target price is $11.25/share for an approximate gain of 27%. Our stop/loss threshold is $8.25.

Short Turkey (TUR): The Borsa Istanbul 100 Index is up nearly 21% since mid-February. We see Turkish equities as having benefited from the general wave of risk-on sentiment during the last two months consistent with the dollar's reflation and the recovery in oil and other commodities.



Turkey has also benefitted from: 1) movement toward normalizing relations with Russia including sanctions imposed since the downing of a Russian jet on November 24 near the Syrian border, recently, Moscow lifted the flight ban to Antalya, Turkey's Riviera; 2) a more dovish central bank chief in Murat Cetinkaya, following Erdogan's vocal insistence that the central bank avoid contractionary rate policy in dealing with Turkey's inflation problem; and 3) a tentative deal with the EU that offers Turkey financial aid (close to $6.8 billion) in return for assisting with the Syrian refugee crisis.

The big problem we see ahead for Turkey, however, remains Syria.

First, we believe U.S. warnings during the last month of imminent terrorist attacks on tourist sites are likely to be a significant drag on Turkey's tourism, which accounts for 11% of Turkey's GDP.

Additionally, it is clear that so long as U.S.-backed Kurds gain ground against ISIS in Syria, Erdogan will look to pound Kurdish territories inside Turkey. This sets up for a more deadly response from Kurdish nationalists inside the country. Meanwhile, Business Insider notes that Ankara has no strategy to deal with the militants who return to Turkey after fighting with ISIS in Syria and becoming radicalized. This could be one significant thorn that gets in the way of the EU giving Turkish citizens visa-free travel throughout the EU by June.

The Syrian cease-fire and peace deal appears to be breaking down during the near-term. On Monday, the main Syrian opposition group quit peace talk negotiations in response to an unraveling ceasefire (that has roughly held since February). The United States is blaming Bashar al-Assad's regime, the Russians and Assad are blaming factions of Al Qaeda, and hostilities are gearing up. We believe Turkey is headed for a period of geopolitical turbulence that will negatively impact its equity market.

Finally, despite Janet Yellen's reaffirmation of the Fed Put in late March, it is clear that when equities get too 'frothy' i.e., the S&P 500 rises close to 2,100, reflexive Phillips Curvers at the Fed will come out of the woodwork to jawbone rate expectations higher. Such rhetoric will tend to chill risk appetites, hurting emerging markets in the process. Turkey will likely not be spared in such a scenario.

Bottom line: We recommend going short the exchange-traded fund, the iShares MSCI Turkey (TUR). TUR closed $45.19 on Friday. Our target price is $35.25/share for an approximate gain of 22%. Our stop/loss threshold is $49.70.

Bretton Woods Research