



## So What Now – JULY 2016

As you may know, we occasionally produce ad-hoc reports whenever we feel that we have something interesting to say (they are all downloadable from our website). We have always preferred to do this rather than write regular but dull features simply to satisfy some random demand for regular “research”. That’s not to guarantee that our articles are not dull – rather it means that you will only have to suffer them on a less frequent and irregular basis.

“He was dull in a new way, and that made many people think him great.”

*Dr. Samuel Johnson (of Thomas Gray), 1791*

The last one we produced was in February 2016, although to be fair this was less of a research piece and more of a blatant advertorial for our investment strategies. In recent weeks I have been asked by various quarters to produce something fresh. I suspect these requests are not necessarily looking for illumination and enlightenment – at least I hope not. More likely those requesting them have had enough of the market turbulence and just need some light-hearted read while they drown their sorrows in another coffee.

## Regime Change

But what to write? Clearly Brexit is the *soup du jour* but there have already been a million words written about that by people smarter than me – and still no-one knows what it means for the future. With no historical precedent, we can’t look at previous market scenarios and draw any conclusions so there is no real value in me trying to add my thoughts into the mix.

“It ought to be remembered that there is nothing more difficult to take in hand,  
more perilous to conduct, or more uncertain in its success, than to take the lead  
in the introduction of a new order of things”

*Niccolo Machiavelli, The Prince, 1513*

So then I thought about the upcoming Presidential election – which clearly has the potential to shake markets. At least here we have precedent. So I looked back to 1980 (covering nine elections) and analysed the effect on the two main commodity markets we trade; copper and oil. For each election I looked at the price of the commodity at the end of August (three months before the election), at the end of November (when the election took place) and then again at the end of February (three months afterwards). The results are shown in Table.1 below;

			Copper		Crude Oil	
			End Nov	End Feb	End Nov	End Feb
1980	Reagan	R	4.55%	-10.54%	-2.50%	4.71%
1984	Reagan	R	-4.67%	2.56%	-6.83%	-2.75%
1988	Bush	R	31.25%	-2.63%	0.66%	18.63%
1992	Clinton	D	-10.99%	-1.94%	-4.97%	2.69%
1996	Clinton	D	9.74%	5.93%	6.74%	-14.53%
2000	Bush	R	-5.19%	-2.90%	2.11%	-19.01%
2004	Bush	R	11.01%	4.35%	16.64%	5.33%
2008	Obama	D	-51.80%	-4.72%	-52.86%	-17.77%
2012	Obama	D	4.99%	-2.25%	-7.84%	3.53%

*Table.1 Percentage change in outright prices*

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Although it covers over thirty years, a sample size of nine elections is still ridiculously small – and it should come as no surprise that there is no clear pattern. The only pattern I could find was that in the three months leading up to the election, the copper price alternates on election cycles. I also looked at the effect of different scenarios, i.e. Democrat victory, Republican victory, first-term President etc. and the only conclusion I could draw from that was that copper tends to fall in the three months after a new (not second-term) President. Since the sample size of occurrence is five occasions in the last thirty-six years I'm not sure I'd want to risk a dollar on that trade.

*"Women will be no longer made the slaves of, or dependent upon men.  
They will be equal in education, rights, privileges and personal liberty."*

*Robert Owen, A New View of Society, 1813*

After dismissing the election as a topic, I thought about writing about the impact of the growth of female leadership around the world. The leaders of the following countries are all female; Germany, UK, Norway, Chile, South Korea, Taiwan. That obviously doesn't include Hillary Clinton (yet?). Nor does it include any monarchs, or leaders of other important institutions (Janet Yellen, Christine Lagarde). But then I figured that the subject matter was just too fraught with difficulty, that I would upset somebody (possibly everybody) and I got scared.

*"The female of the species is more deadly than the male"*

*Rudyard Kipling, The Female of the Species, 1911*

So regime change and a new world order were not going to provide me with any pearls of wisdom.

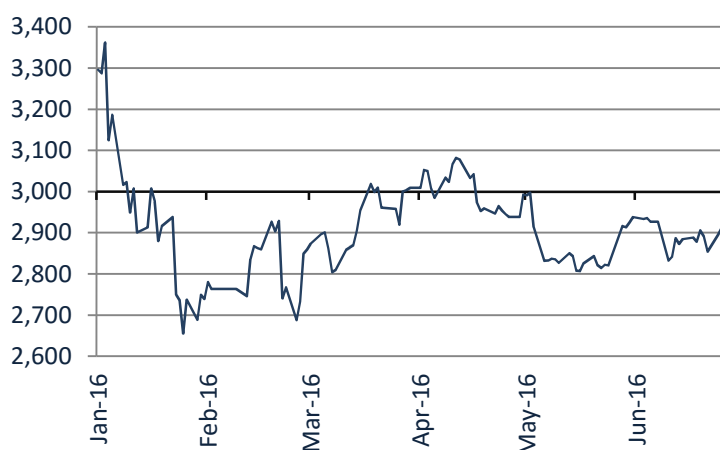
## A Bear in a China Shop

Perhaps unsurprisingly, China has featured heavily in a number of our previous reports and so like an old friend I turned once more to her for some inspiration. The much heralded GDP figure has essentially been dribbling away since the heady 10%+ days of pre-2008. Notwithstanding the "true" figure is probably much lower, the official figure for the second quarter of 2016 was 6.7% - broadly in line with expectations and not very inspiring.

*"There are three kinds of lies; lies, damned lies and statistics."*

*Benjamin Disraeli, Attributed, UK Prime Minister 1868 and 1876*

Previous reports have also looked at the Shanghai Composite as a more appropriate reflection of short-term sentiment. Graph.1 below shows that after some initial volatility in January, the SCI has traded mostly sideways within the 2800-3000 range for the last five months or so;

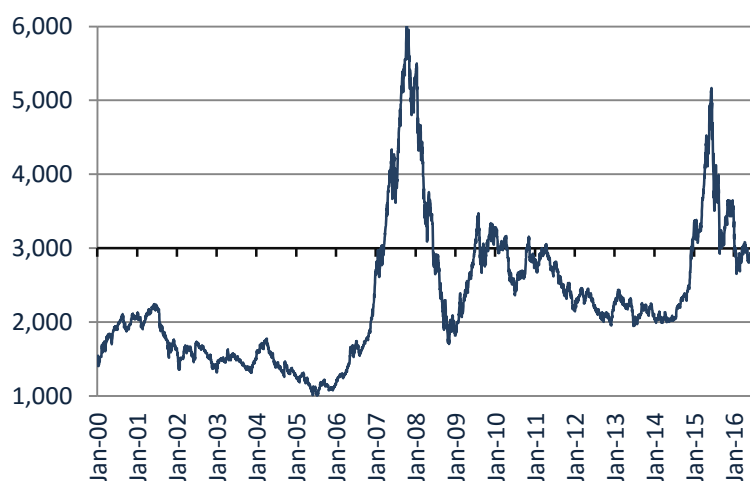


Graph.1 Shanghai Composite Index

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The recent stability has arguably been a result of the somewhat ham-fisted measures by the authorities there but either way it does not give us any clues as to potential future commodity price moves. Surely over a longer time horizon, and given that China has been/is such a key player in commodity markets, one should be able to draw some inferences from their stock market performance though?

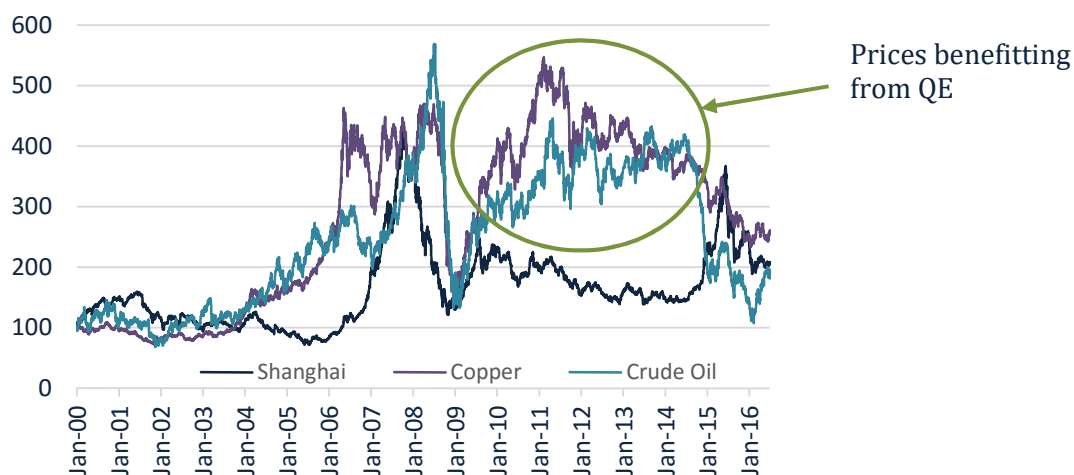
Graph.2 below shows the same SCI since January 2000;



Graph.2 Shanghai Composite Index

*“Those who cannot remember the past are condemned to repeat it”*

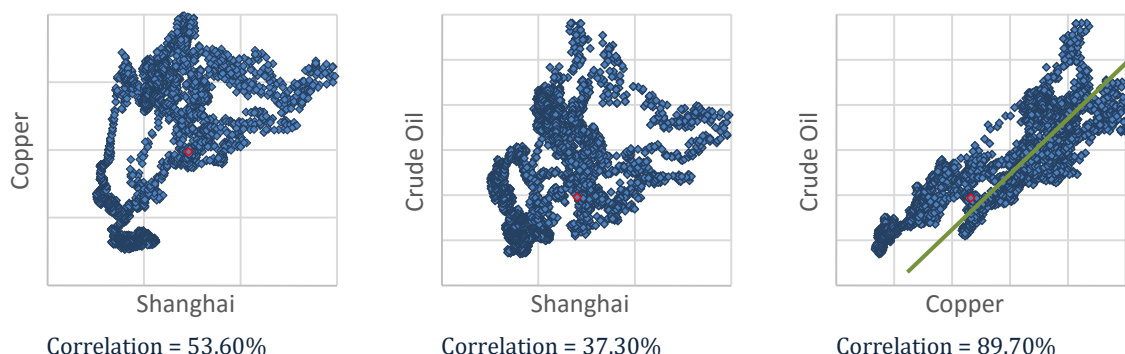
*George Santayana, The Life of Reason, 1905*



Graph.3 Shanghai Composite Index vs Copper vs Crude Oil, all rebased to 100 at Jan'2000

The significant bull-market that peaked in early 2008 certainly coincided with bull markets in both copper and crude oil over the same period (indeed as Graph.3 above shows, copper and oil were leading indicators of stock market strength). But as Graph.3 also shows, neither copper or oil have shown any real affinity for the SCI since the crash in late 2008. Interestingly the one thing the graph does show clearly is how artificially high commodity prices were kept (dollar-denominated) as a result of the extraordinary quantitative easing by global central banks from 2008 to 2015. Once the markets began to price in the end of QE (at least in the US) then prices plummeted back to where they should have been all along.

Further and clearer evidence of these low (non?) correlations can be seen in Graph.4 below;

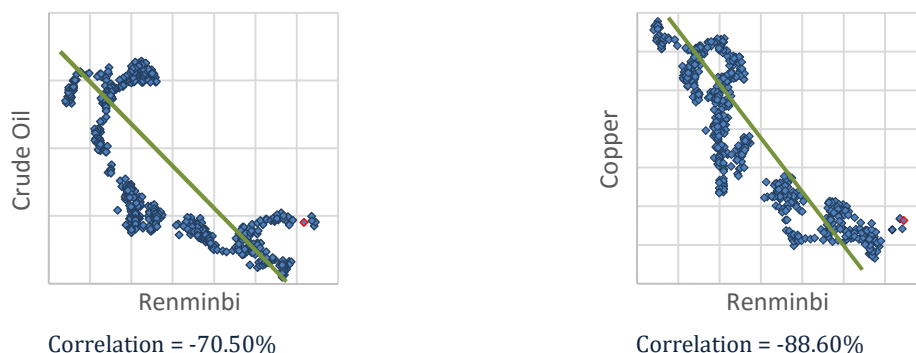


Graph.4 Scatter charts showing price correlations (data from Jan'2000 to Jun'2016) – red shows latest

So no real clue there then. But what about the currency? While the Western world has been biting its nails, gnashing its teeth and collectively wailing about Brexit and the end of the world, the renminbi has surreptitiously slipped further from around 6.50 in early May to 6.67. This means that there has been a “stealth” devaluation of 10% since the highs of 6.04 in January 2014. Graph.5 below shows the US\$/CNY rate from July 2005 (when the 8.27/8.28 peg was abandoned);



If we look at the correlations since the Renminbi highs (US\$ lows) of 6.04 on 14<sup>th</sup> January 2014 (Graph.5 below), we can see clear correlations;



Graph.5 Scatter charts showing price correlations (data from Jan'2014 to Jun'2016)

The disappointing issue with this indicator however, is that although the correlations are high from January 2014, if we take the data back to July 2010 (when the second peg was abandoned), the correlation falls to just 25% and 14% respectively – i.e. not tradeable

“If you can keep your head when all about you are losing theirs...  
...Yours is the Earth and everything that’s in it.”

*Rudyard Kipling, If, 1909*

## **Conclusion Part.I:**

Neither Brexit, nor US Presidential elections, nor female leadership, nor the Chinese economy or Chinese stock market give us any clue as to where the prices of copper and oil may go next. We can draw some comfort that over the last two years, there has been a relatively high correlation between the prices of these commodities and the Renminbi and so perhaps it would be prudent to keep an eye on that for future guidance. Although the PBOC is trying to manage currency volatility, there does not seem to be any meaningful attempt to stop the slide. Against a backdrop of expected economic weakness in the second half of 2016, the consensus seems to be that it will continue to slide through 6.70 and ultimately towards 6.90. This would imply copper and oil prices moving towards \$7000+ and \$80+ respectively. But I’ve been wrong before...

“The golden rule is that there are no golden rules.”

*George Bernard Shaw, Man and Superman, 1903*

## **Conclusion Part.II:**

Happily our two flagship investment strategies do not look to capture outright price action. Instead, these two strategies aim to capture short to medium-term spread and arbitrage opportunities.

Both have disciplined risk processes that aim to ensure relatively low volatility and contained drawdown. The two strategies have a combined AUM of \$100m+ and have both been trading live since January 2012. They both offer daily liquidity, full transparency and have low margin requirements (average 10-15%). Instruments are all exchange-traded and exchange-cleared using major exchanges in the UK and US. There is no OTC exposure, nor any exposure to commodity currencies, commodity equities or commodity ETFs.

We would be pleased to discuss our strategies with you in more detail.

## Notes

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