Jaguar Investments Limited

1 Northumberland Avenue
Trafalgar Square
London
WC2N 5BW

The Fall and Rise – JULY 2014

“They spend their time mostly looking forward to the past”
John Osborne, Look Back In Anger, 1956

Last month we wrote a report that focused mostly on the soft commodity and grain sectors and considered potential price action should a significant El Niño event later in the year. One of the conclusions of our report was that an El Niño event generally has minimal impact on the base metal, precious metal and energy sectors. So what might get the copper, gold and oil markets moving this year? As far as we can tell there are two significant risks; US equity markets FALLING and US interest rates RISING.

Part.1: FALLING US equity markets

In recent weeks, mainstream US equity markets have made successive record highs with the DJIA breaching 17,000 and the S&P500 within touching distance of 2,000. This has prompted a raft of headlines with many pundits predicting an imminent, sharp correction, if only for technical reasons. At this point it should be noted that many of these experts predicted similar corrections when the DJIA hit 15,000 and 16,000, and also when the S&P500 hit 1,700, 1,800 and 1,900!

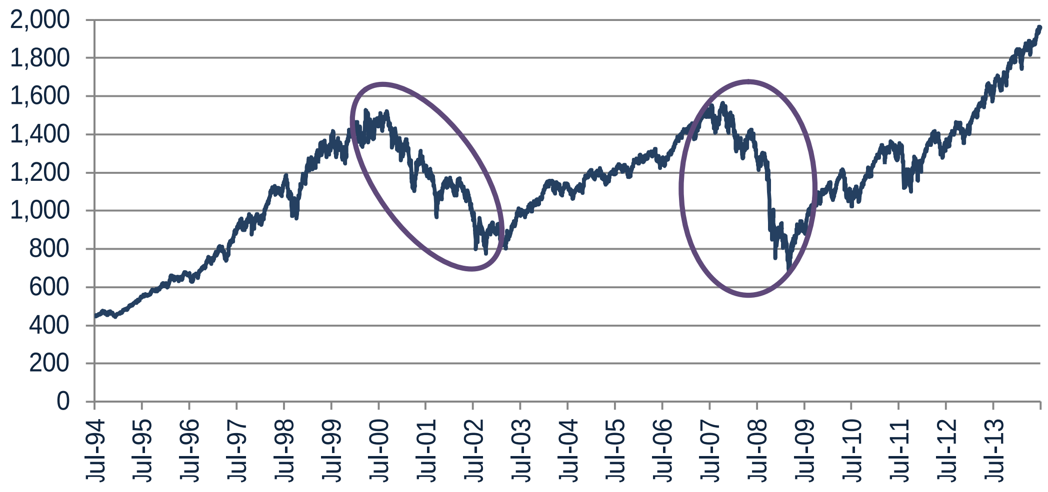

Chart.1: S&P500 Index from 1st July 1994 to 30th June 2014

Since 1994 there have clearly been two major bear market phases. We are not necessarily advocating an imminent bear market (though we would not be surprised to see one), but rather we are echoing recent sentiment by more well-renowned market participants. On 10th July, Carl Icahn noted that “it is time to be cautious”. Previously on 15th May, David Tepper had noted “I think it’s nervous time”. It should be noted that Tepper subsequently confirmed his nervousness and fears had been “alleviated”.

Perhaps more seriously;

> "...it is hard to avoid the sense of a puzzling disconnect between the markets buoyancy and underlying economic developments..."
>
> *Bank of International Settlements, 84th Annual Report, 29th June 2014*

We are more of the opinion that there could be a very sharp, short-term sell-off that sparks a mini-rout. Aside from any technical issues, we believe there is a degree of complacency in the markets that is perhaps misplaced. Chart.2 below shows the performance of the S&P500 since early 2012 set against the performance of the VIX. The VIX is widely portrayed as a "fear" index but the reality is that it reflects option demand – it is after all a measure of S&P500 volatility. In "dangerous" market conditions it more accurately reflects PUT option demand as investors look to buy downside protection for long-only portfolios.

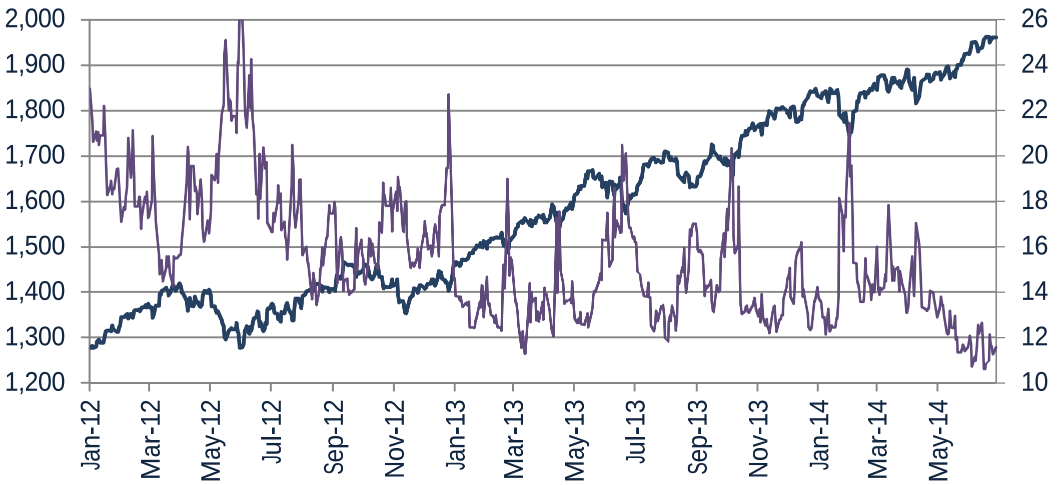

Chart.2: S&P500 Index vs. S&P VIX from 1st January 2012 to 30th June 2014

You can see that each time the S&P500 has had a sell-off, the VIX has spiked but each spike is getting shorter and shorter implying less and less concern on each sell-off. Consequently the VIX has dribbled away in recent months to the lowest levels since early 2007 (pre-financial crisis). Chart.3 below shows the VIX over the last ten years;

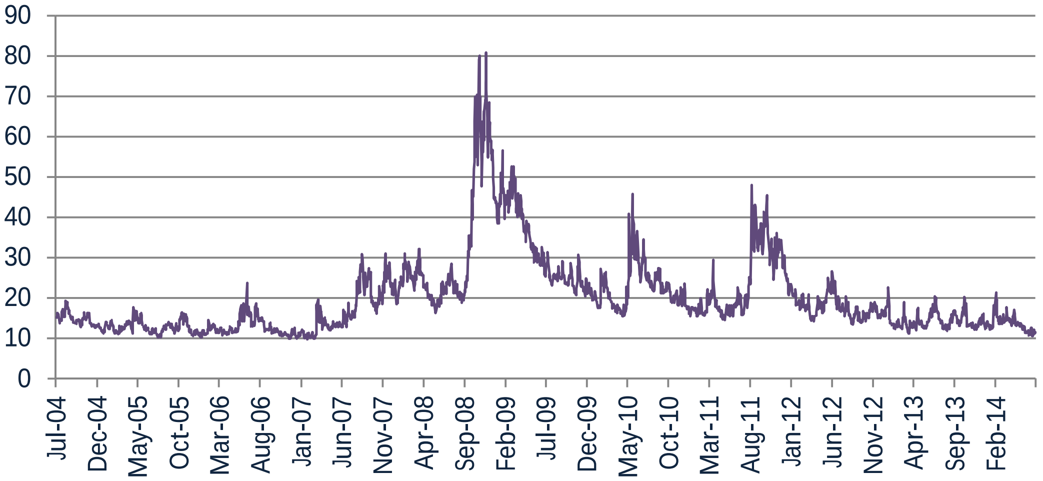

Chart3: S&P VIX from 1st July 2004 to 30th June 2014

Of the 2583 trading days since 1st July 2004, the VIX has closed below the psychological 10 level on just four occasions.

So how many times has the S&P500 had downside mini-crashes? Chart 4, below, shows the rolling 5 day percentage change over the last twenty years;

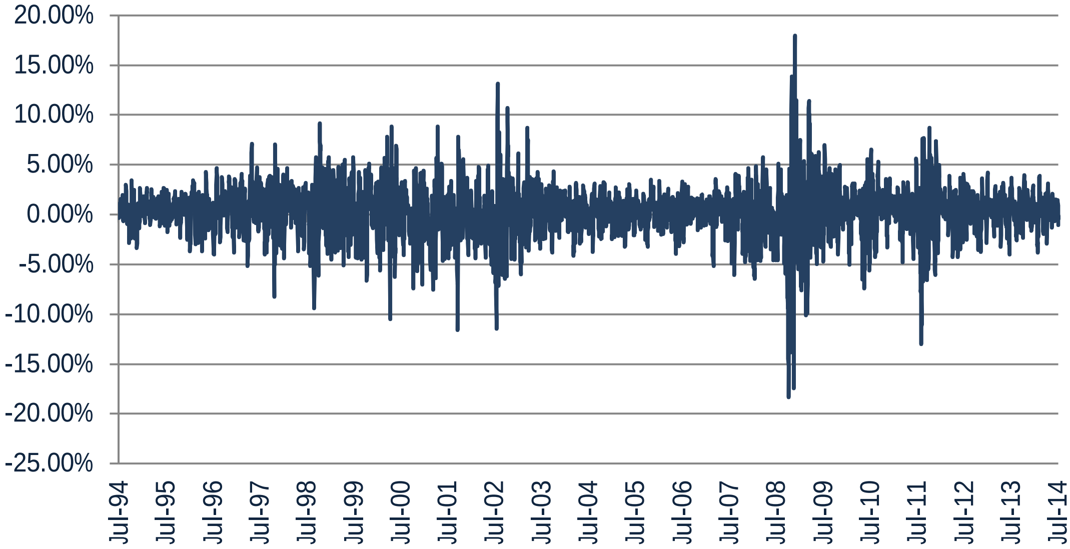

Chart4: Rolling 5day %age change in the S&P500

Aside from the slew of occasions in late 2008 / early 2009 as Lehman imploded and the financial crisis exploded, there has been just one occasion on which the S&P500 dropped more than 10%. That was back in August 2011 as the Standard & Poors ratings agency cut the US credit rating for the first time ever from AAA to AA+. The market had already started to slip ahead of the announcement; in mid-July the S&P500 had been trading around 1350 but by end of July / early August the market was trading around 1300. The downgrade was announced after hours on 5th August (a Friday) and by Mondays close the market was at 1120 – see Chart.5 below;

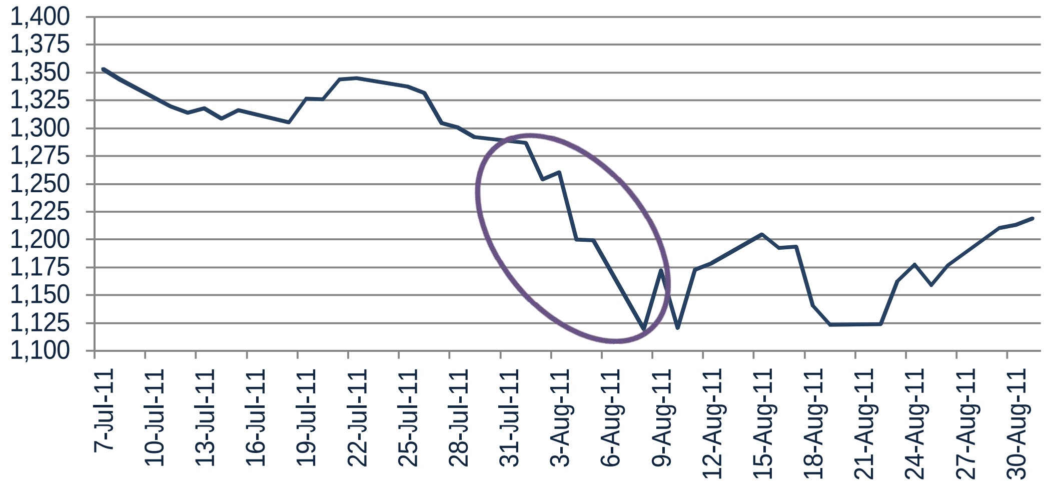

Chart5: 5 day decline of 13%, from 1287 on 1st August to 1119 on 8th August

The question is how did the copper, gold and oil markets fare in that period? Fig.1 below shows the price action of the three commodities at that time;

	Close on 1st Aug 2011	Close on 8th Aug 2011	%age change
LME Copper (3m)	9650.00	8781.00	Down 9.0%
Spot Gold (pm fix)	1623.00	1693.00	Up 4.3%
NYMEX WTI (Active)	94.89	81.31	Down 14.3%

Fig.1: Price performance of three flagship commodities

Unsurprisingly industrial commodities fell, while "safe haven" gold rallied.

Did the same pattern hold back in 2008? The worst 5 day decline in the S&P500 in that period (indeed the worst period in the last twenty years) was the 17.40% loss as shown in Chart.6 below;

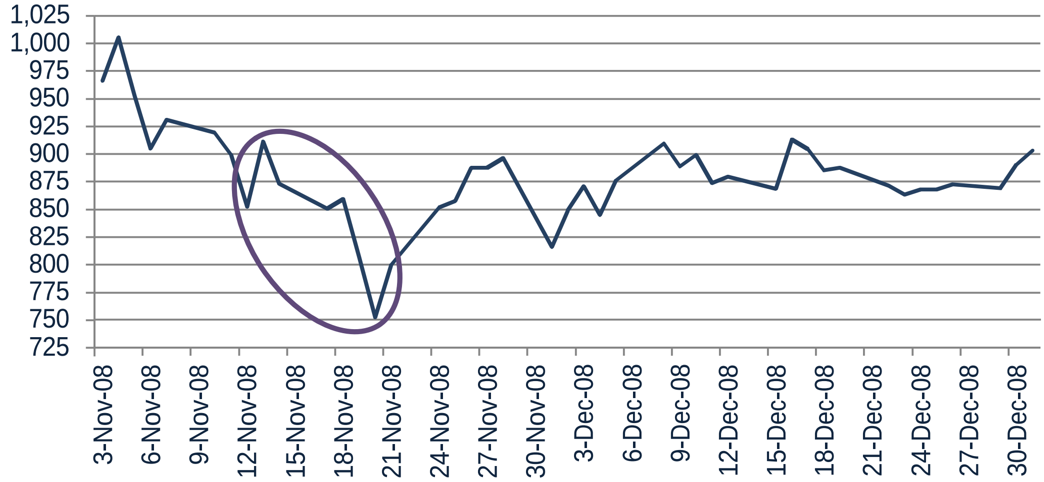

Chart6: 5 day decline of 17%, from 911 on 13th November to 752 on 20th November

Fig.2 below shows the price action of the three commodities at that time;

	Close on 13th Nov 2008	Close on 20th Nov 2008	%age change
LME Copper (3m)	3670.00	3480.00	Down 5.2%
Spot Gold (pm fix)	713.50	738.00	Up 3.4%
NYMEX WTI (Active)	58.24	49.62	Down 14.8%

Fig.2: Price performance of three flagship commodities

The same pattern holds – industrial commodities fell, while "safe haven" gold rallied.

We believe that these positive correlations will hold should US equities experience a similar (c10%) short-term correction. Our preferred trades in this instance, basis current market positioning, would be to short copper and WTI and remain neutral on gold.

"The two worst strategic mistakes to make are acting prematurely and letting an opportunity slip"

Paulo Coelho, The Manual Of the Warrior of Light, 1997

Part.2: RISING US interest rates

There seems no doubt that at some point the Federal Reserve will have to raise their Fed Funds rate from the record lows that have held since December 2008. The critical question, as in all trading of course, is when. The current market consensus is that it will happen at some point between late 2014 and early 2016. But what happens to our three commodities when rates rise? There have been three tightening cycles in the last twenty years, as shown in Chart.7 below;

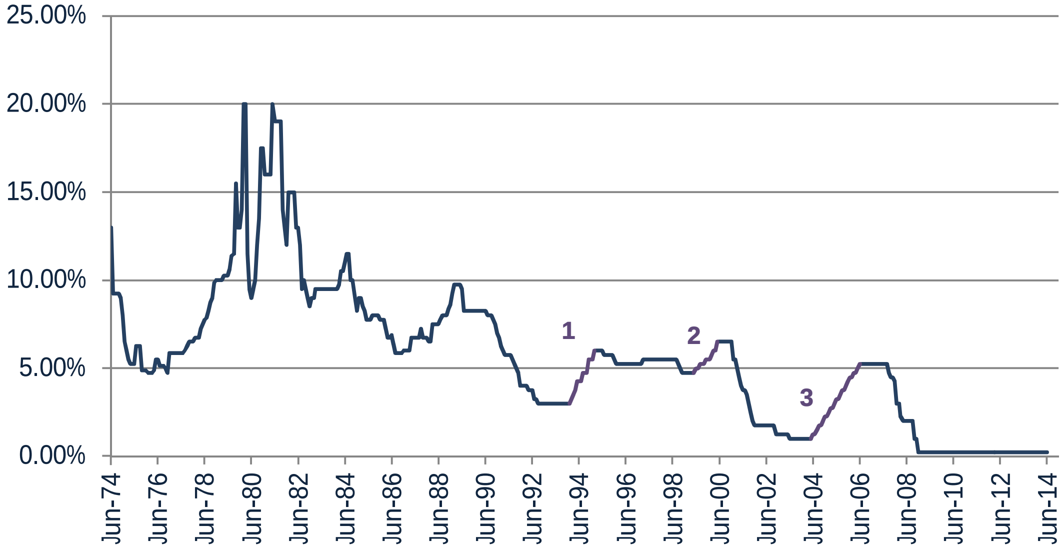

Chart.7: US Fed Funds Rate from 1974 to 2014

Cycle #1: Feb'94 rates raised from 3.00% to 3.25%. Last tightening Feb'95 at 6.00%
Cycle #2: Jun'99 rates raised from 4.75% to 5.00%. Last tightening May'00 at 6.50%
Cycle #3: Jun'04 rates raised from 1.00% to 1.25%. Last tightening Jun'06 at 5.25%

In each case, the industrial metals rose significantly as shown in Fig.3 below. Gold barely moved on the first two occasions but rose sharply on the third;

	End Jan'94 to End Feb'95	End May'99 to End May'00	End May'04 to End Jun'06
LME Copper (3m)	Up 50.2%	Up 26.1%	Up 264.6%
Spot Gold (pm fix)	Down 0.4%	Up 1.4%	Up 66.1%
NYMEX WTI (Active)	Up 21.7%	Up 72.2%	Up 78.8%

Fig.3: Percentage Price Change of three flagship commodities

We believe that these positive correlations will hold when US interest rates finally rise. Our preferred trades in this instance would be to establish medium-term length in copper and WTI.

"A pessimist sees the difficulty in every opportunity;
an optimist sees the opportunity in every difficulty"
Winston Churchill, 1921

Part.3: Conclusion and Strategy

- If US equity markets fall, we would expect the prices of copper and oil to fall.
- If US interest rates rise, we would expect the prices of copper and oil to rise.

So which comes first?

Our view is that the markets are currently pricing in a rate rise in early 2015. Indeed much of the recent strength has arguably been down to the continued dovish rhetoric from Chair Yellen. The longer rates are low, the better for the stock market and whenever there is any hint of the first rate rise coming sooner than early 2015 the markets sell off. To date this has been fairly orderly – which has led to further complacency.

At some point however, markets will truly start to believe that rates will rise (rather than simply hearing random and vague mutterings) and at that point we believe there will be a sharp correction which will lead to lower copper and oil markets.

There will then be a period of volatile, sideways price action as markets react and adapt to the new economic environment – and after a few months we will get the first rate rise. At this point we think copper and oil markets will start to rally.

One risk to the above strategy is that the Fed simply springs the first rate rise out of the blue (in much the same way that Draghi surprised the markets with the ECB rate cut last November). Given the potential downside impact of doing this, and their new-found love for "forward guidance", we suspect this won't be the case.