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Business Cycle Risk: Diversifying With Commodities

Commodities not only protect against inflation – they also hedge business cycle risk in late stage expansions and early stage contractions.

Throughout historical economic business cycles – acceleration, peaks, deceleration and troughs – financial assets have exhibited varying return, volatility and correlation characteristics. While stocks and bonds possess values that are tied to expectations of capital appreciation or of changes in future cash flows, the main drivers of commodity futures prices consist of changes in expectations for the global supply of and demand for raw materials. As a result of these differences, the risk and return characteristics of commodities may be different from those of financial assets. While investors believe that the goal of building a diversified portfolio is to find the right balance of risk and return, another reason to have a diversified portfolio is to hedge against shifts in the business cycle. If an investor strongly believes that the economy is to continually expand year after year, then that investor may intentionally be under-diversified and own mostly stocks in anticipation of corporate profits growing year after year. However, as the economy progresses from an early to late expansionary cycle and eventually a contractionary phase, forward cash flow projections for equities are likely to be revised lower while current demand for commodities may be strong. As a result, commodities as an asset class may serve as a portfolio diversifier against late stage expansionary and early stage contractionary business cycle risk.

The National Bureau of Economic Research (NBER) declares the end of expansions and contractions, often more than a year after the specified end date. Therefore, it is not always obvious that a particular stage of the business cycle is complete, even months after it ends. The current upswing in the US economy, which the NBER believes started in June 2009, is rather unique. While it can only be determined that the current expansionary phase has concluded with the benefit of hindsight, if we assume that it will end in mid-2019, it would then be the longest cycle on record relative to other historical expansionary phases. One of the biggest contributors to the current expansion has been loose monetary policy, which led to all-time low interest rates and the resultant availability of inexpensive credit. This cycle has been protracted as the US central bank attempts to make tweaks and shifts to policy after assessing economic data – equivalent to tapping on the brakes (raising interest rates) if it believes the economy can potentially accelerate too rapidly or stepping on the gas (lowering rates) when it senses the economy is slowing. This back and forth in central bank policy has likely accounted for the modest acceleration and deceleration in the US economy over the last 10 years. As we progress through 3Q 2019 in this current expansionary phase, investors should consider commodities as an asset class to help mitigate upcoming business cycle risk.

In examining the phases of the US business cycle, it can be observed that in each stage a different asset class may outperform others (see Exhibit 1). Based on our analysis from 1969 through 2009 for US Equities, Non-US Equities, the US Dollar and Commodities, the following elements were observed:

- On average, expansionary periods lasted for over five years, whereas contractionary periods lasted for only one year.
- US and non-US equity returns were always positive during early stage expansions and almost always positive in late stage expansions.
- US and non-US equity returns were always negative in early stage contractions.
- US equities were mostly positive in Stage 4 or late stage contractions.
- Commodity returns were positive and typically outperform equities during late stage expansions (Stage 2) and early stage contractions (Stage 3).

Exhibit 1: Comparing Equity Markets Returns vs. Commodities During Various Stages of the US Business Cycles (12/31/1969 – 6/30/2009)[1]

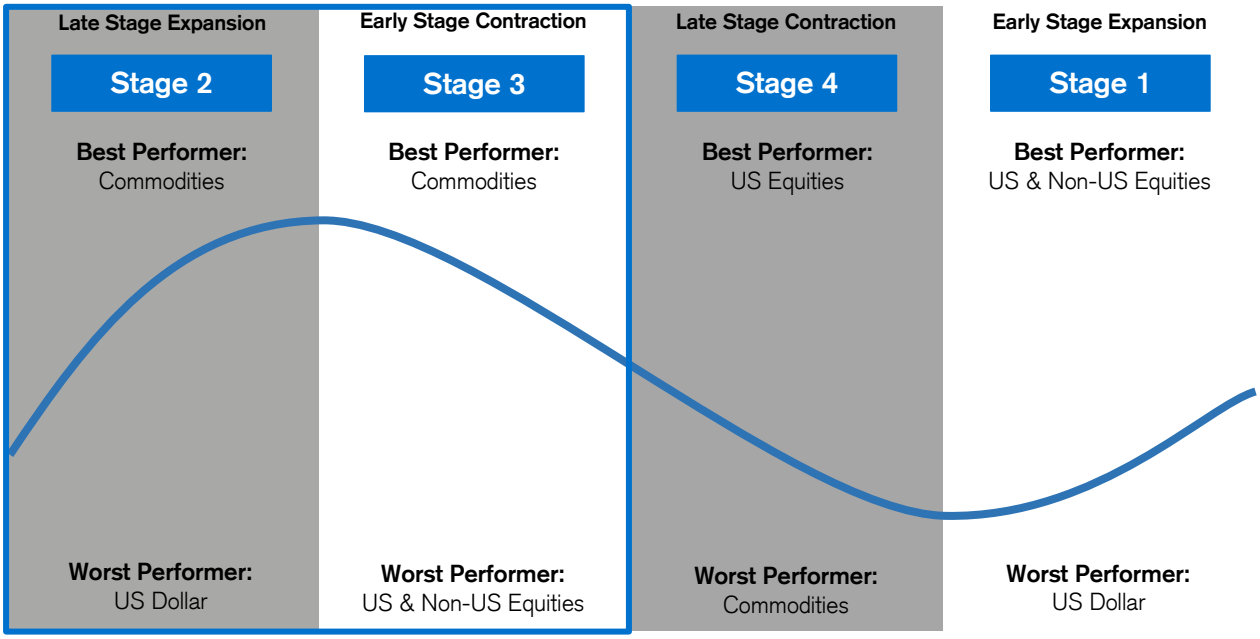

Exhibit 2: Analysis of Average Monthly Returns in Each Business Cycle (12/31/1969 – 06/30/2009)[2]

Business Cycle Stage	Commodities (Excess Return)[3]	US Dollar	US Equities (Excess Return)[3]	International Equities (Excess Return)[3]
1 - Early Stage Expansion	0.30%	-0.20%	0.70%	1.05%
2 - Late Stage Expansion	1.04%	0.00%	0.46%	0.37%
3 - Early Stage Contraction	0.71%	0.11%	-2.37%	-2.80%
4 - Late Stage Contraction	-1.71%	0.21%	1.03%	0.09%
1+2 – Early Stage Expansion and Late Stage Expansion	0.67%	-0.10%	0.58%	0.71%

Exhibit 3: Correlation of Monthly Returns of Commodities versus US Dollar, US Equities and International Equities in Each Business Cycle (12/31/1969 – 06/30/2009)[2]

Business Cycle Stage	US Dollar	US Equities (Excess Return)[3]	International Equities (Excess Return)[3]
1 - Early Stage Expansion	-0.11	-0.07	0.15
2 - Late Stage Expansion	-0.16	0.03	0.08
3 - Early Stage Contraction	-0.12	-0.04	-0.06
4 - Late Stage Contraction	-0.30	0.31	0.28

Thus far, the peak in the current US expansion that started in June 2009 has yet to be defined. **Given that the current economic expansion is already the longest in history, it is unlikely that we are still in the "early stage" part of the expansion. Historically, Commodities has been the best performing asset class in "late stage" expansion and "early stage" contraction cycles, one of which is likely the current phase.** Beginning in 2009, central banks globally began implementing comparable easing measures to those of the US. Many of these economies have also responded positively as indicated by their key economic indicators. To date, central banks continue to maintain accommodative policies with the goal of targeting higher growth and higher inflation. The US central bank may even allow inflation to run hotter than normal as it considers moving towards targeting an "average" level of inflation, as realized inflation has come in below targeted levels over the last several years. All of these policy adjustments may lead to the intended effects of a global economic acceleration, higher commodity demand and inflation risk. Otherwise, global economic growth may continue to progress at a moderate pace, sometimes helped along or pulled back by continued monetary policy decisions, which may likely benefit other parts of one's portfolio. Hence, a well-diversified investment strategy may help to reduce overall portfolio volatility during a business cycle shift following a lengthy and unprecedented expansion.

Notes:

1. Sources: NBER, Bloomberg LP, Ibbotson, Credit Suisse Asset Management, LLC. NBER official periods for contractions and expansions were split in half to represent the four stages of the business cycle. The first half of each expansion and contraction period represents the early stage expansion (Stage 1) and early stage contraction (Stage 3) phases, respectively. The second half of each expansion and contraction period represents the late stage expansion (Stage 2) and late stage contraction (Stage 4) phases, respectively. **Past performance is no guarantee or indicator of future results.**
2. Sources: Credit Suisse Asset Management, LLC, NBER, Bloomberg LP, and Ibbotson. Commodities measured by: S&P GSCI Excess Return Index. US Dollar: US Dollar Index. US Equities: S&P 500 Excess Return Index. International Equities: MSCI Daily TR Net EAFE Index. NBER official periods for contractions and expansions were split in half to represent the four stages of the business cycle. The first half of each expansion and contraction period represents the early stage expansion (Stage 1) and early stage contraction (Stage 3) phases, respectively. The second half of each expansion and contraction period represents the late stage expansion (Stage 2) and late stage contraction (Stage 4) phases, respectively. **Past performance is no guarantee or indicator of future results.**
3. The excess return includes the return of the index (including dividends if applicable) minus the risk free rate.

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