RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

COMMENTARY ON COLLAPSE IN COMMODITIES

August 2015

This special market commentary is intended to address the current weakness in commodity prices that began in the latter half of 2014 and has continued throughout this year. While the collapse in oil prices has drawn significant media attention recently, other commodities like natural gas, gold and copper have also suffered a similar fate. Investors in commodities and commodity-based equities have seen significant price depreciation over this time period, despite the ongoing economic recovery in the U.S. and solid corporate earnings growth in most non-commodity sensitive industries. Below are our current thoughts on the recent weakness in oil, gas and other commodity markets.

Oil and Gas

After a short-term bounce higher in the first half of 2015, crude oil fell approximately 20% in the past month and now is near its lowest levels of the year. As we have discussed in prior market commentaries over the past year, the sudden and unexpected collapse in oil and natural gas prices at the end of 2014 and continuing weakness of oil prices in 2015 is due to several factors:

1. Demand for oil and gas has weakened due to economic struggles in Europe, China and Japan. Traders are also pricing into the futures market continued weak demand due to ongoing concerns with these international economies.
2. Thanks to the Fed's expected interest rate hike and opposing monetary accommodation overseas, the dollar has strengthened significantly against foreign currencies in 2015. Oil priced in U.S. dollars has thus becomes more expensive for international consumers, further lowering demand.
3. Global oil and gas production has flourished thanks in part to the significant technological advances made in the United States by shale oil producers – this has led to crude oil inventories growing to an 80 year high.
4. The recent nuclear arms deal with Iran could result in Iran flooding the oil market with additional supply over the next 12 – 18 months, if not sooner.
5. Last, and perhaps most important, OPEC has announced that it will not cut production to support global oil prices, as it seeks to force the hand of U.S. producers to cut production first. OPEC is primarily concerned with maintaining its global market share, as prior OPEC production cuts have allowed other producers to keep pumping oil while benefiting from high prices.

We believe that the current ~ $40-50 per barrel price for WTI crude oil is not sustainable over the long term, and that eventually prices will settle around $70-$80 per barrel - near the low-end of the pre-collapse crude trading range. Whether this bounce occurs rapidly or slowly, and whether it reaches these levels by the end of 2015 or later, is extremely hard to predict and depends on a number of variables, including political stability in the Middle East and an economic rebound in Europe.

While we cannot predict the specific timing of the recovery in oil prices, we can say with confidence that the oversupply condition that currently exists will not last forever and likely will not last more than a couple of years.

Ultimately, the staring contest between OPEC and U.S. producers will cause one side to blink and cut production such that prices become more sustainable for producers with costs of production and sovereign balance sheet requirements higher than the current trading range. Further, non-U.S., non-OPEC producers will continue to cut production in the face of declining prices, as has already begun. Finally, we question how soon oil from Iran will come on the international market, as there are still significant doubts about whether the nuclear arms deal will pass through Congress, whether Iran will comply with the terms of the deal if it is approved, and whether foreign investors will be willing to make the significant investments necessary to increase Iranian oil production.

Other Commodities

The correction in oil and gas stocks has also spread to other commodity-sensitive sectors. The primary causes of weakness in these other commodity sectors in 2015 are again the strong dollar and global economic weakness, most notably in China. Gold and copper markets have been particularly impacted. Gold is heavily influenced by movements in the U.S. dollar, as it is traded in U.S. dollars and considered a safe haven investment during times of economic weakness. When the U.S. economy strengthens and the Fed becomes more hawkish, as has been the case in 2015, the dollar will strengthen and gold will tend to decline. Further, gold is often viewed as a hedge against inflation in the U.S., due to its denomination in U.S. dollars. However, since inflation has remained subdued and the dollar has strengthened, gold has been pressured by inflation dynamics as well as stock market volatility. With the S&P 500 at or near all-time highs, the demand for gold as a market hedge has declined. As a result, gold has seen a significant decline from the peak of ~ $1,900 in 2011 to ~ $1,100 today.

Additionally, a major factor in commodity weakness is economic deceleration in China. China is a significant player in copper and gold markets. During the economic expansion in China over the past 25 years, Chinese manufacturing and real estate skyrocketed, causing China to contribute significantly to global demand for copper, a key industrial component, and gold, a luxury item demanded by the Chinese consumer. In fact, China is the largest consumer and producer of copper in the world. Similarly, China is also the largest global consumer of gold, accounting for nearly 30% of global demand for gold jewelry. However, Chinese growth rates have declined from the low double digits to about 7% in recent quarters. This slowing economic growth has disproportionately impacted gold and copper markets.

While the market has understood for some time that the rapid pace of Chinese economic growth could not continue indefinitely, the recent Chinese stock market volatility has exacerbated concerns that China is on the brink of a bigger decline. In the first half of 2015, Chinese stocks skyrocketed, returning over 100%, before plummeting more than 30% recently. Relaxation of margin lending standards and the subsequent proliferation of individual unsophisticated Chinese stock investors are the primary causes of this volatility. The Chinese stock market has very little direct impact on the U.S. stock market, and few foreign investors even own the Chinese “A” shares that have been the most volatile. Nevertheless there is fear that the stock market volatility is a sign of weakness in the Chinese financial system that ultimately will spill over to rest of the economy, and thus further reduce the Chinese demand for commodities.

We view the Chinese stock market volatility as a relatively minor event for U.S. markets. The Chinese stock market is a small part of the Chinese economy and is viewed by the Chinese as short-term gambling rather than a means for long-term investing. We do not foresee the stock market volatility sparking a bigger decline in the Chinese economy. The Chinese government also is very concerned about losing the reverence of the Chinese people and the potential for public unrest that could subsequently follow. Thus, we believe the Chinese

government will stop at nothing to support its economy and markets by taking measures that no first world government would take, such as flat out prohibiting selling in shares of certain companies and trading moratoriums on others. When the fear surrounding the Chinese stock market subsides, we believe that decelerating Chinese growth on its own will be less of a headwind for commodities.

Conclusion

In short, we do not want to minimize the negative impact of slowing growth and over-supply on the commodity sector, but we ultimately view the sell-off in commodities as influenced primarily by transient, cyclical factors. Further, we believe that the dramatic extent of the sell-off already has put the sector in oversold territory. As contrarian investors, we therefore have increased exposure to select high quality, commodity-sensitive equities that we believe to be very attractively priced currently. Going forward, we will continue to monitor developments in commodity markets, in particular as they impact the performance of commodity-sensitive investments in client portfolios, and may adjust our clients' exposure as market conditions dictate.

As usual, all comments are welcome.