Insights & Strategies

PRIVATE CLIENT SOLUTIONS

September 3, 2020

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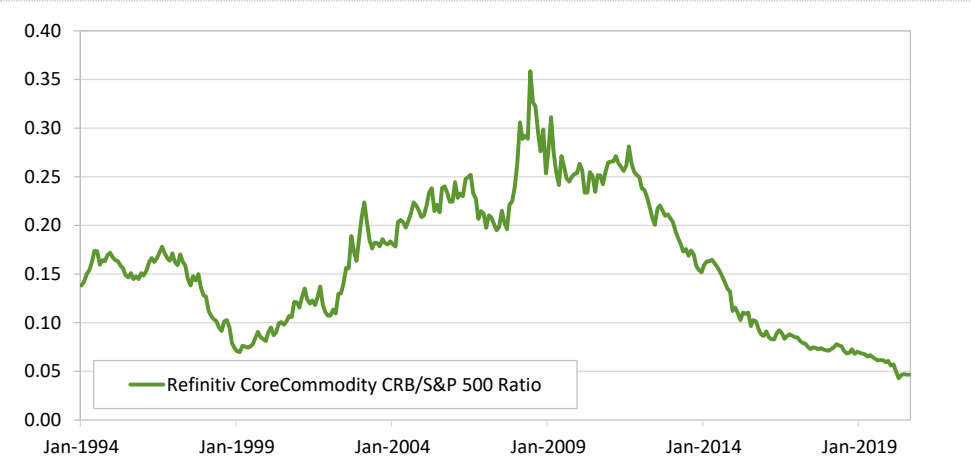
Commodities: Road to Redemption?

US equity markets have pushed into record territory driven by a handful of mega-caps. The Canadian market, however, remains 7% below its peak achieved in February. The composition of the Canadian market has a lot to do with our relative underperformance given the S&P/TSX heavy weighting of financials, energy and materials, whereas the US tilt towards technology has been a benefit. One concern about the current bull market has been the lack of participation; to sustain further gains we would anticipate a broadening in participation, which may in fact look like a rotation from the leaders (technology) to laggards. This is not only limited to North America - it's a global phenomenon where many markets have lagged the US advance. There are plenty of names that have been left behind, but one area in particular that has struggled for some time is commodity-related sectors, which has weighed on the overall Canadian market. Commodity producers have been dealing with weaker prices from oil to copper since 2010. The commodity bear market appears closely tied to the slowing in China's GDP growth over the past decade as the country transitions from an investment-based to consumption-based economy, negatively affecting a variety of materials across the commodity complex. However, when looking at broad commodity indices one must realize they are typically dominated by energy. The Refinitive/CoreCommodity CRB Index, for example, is composed of 19 commodities, but heavily weighted toward energy-related ones. As such, weakness in energy markets can mask some of the underlying trends, such as the rally experienced in gold and industrial metals.

Commodities: Hitting Rock Bottom, A Long Road to Redemption



Source: FactSet, Raymond James Ltd.

Please read domestic and foreign disclosure/risk information beginning on page 9.

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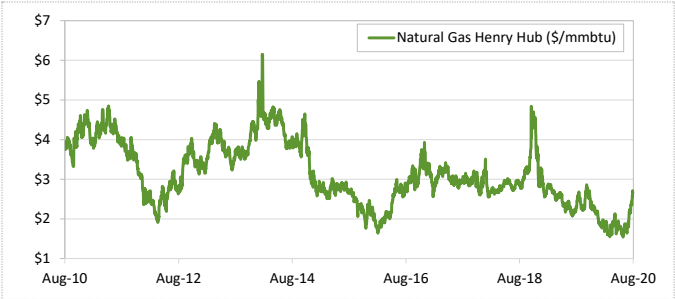
But things may be about to change. The significant actions taken by governments and central banks to support the global economy was in part intended to arrest deflationary impulses. As economic conditions improve, these measures have the potential to lead to higher inflation. In fact, the US Federal Reserve fully intends to allow inflation to run "hot" as they have changed their policy from inflation targeting to inflation averaging. Following years of undershooting the Fed's inflation target, the central bank now intends to allow inflation to run above 2% to make up for the prior years. We can see that the ingredients for higher inflation are present once the economy is on a firmer footing. Higher inflation can provide a tailwind for the commodity complex as prices typically rise when inflation is accelerating. Given the inflationary backdrop, the significant long-term underperformance of commodities and the potential for an equity sector rotation there appears to be an opportunity within the commodity complex. As such, we take a closer look at some of the underlying trends.

Energy: A Gas Turnaround?

Oil often dominates the energy conversation, and it certainly made headlines earlier this year when the commodity traded in negative territory due to the collapse in demand and swelling inventory levels. Perhaps overlooked has been the big jump in natural gas prices. After hitting a 25-year low this summer, natural gas advanced ~60% since June driven in part by improved demand by gas-powered utility and its customers' cooling demands.

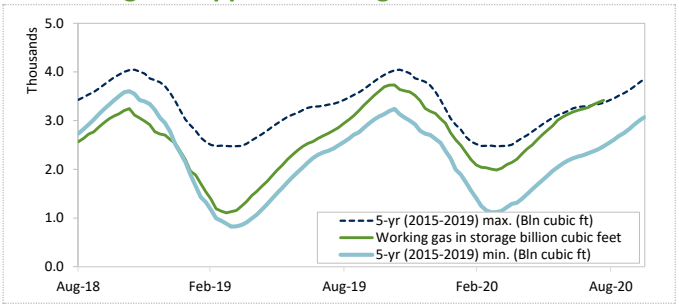
Henry Hub Bounce



Source: FactSet, Raymond James Ltd.

The natural gas market also received a vote of confidence this summer from **Berkshire Hathaway**'s (BRK.A-US, BRK.B-US) recent acquisition of **Dominion Energy**'s (D-US) midstream natural gas assets. Further, natural gas may also be reflecting a potential Biden win in November as the Democrats would look to change regulations to restrict the production of natural gas, which may serve to increase prices as supply is constrained. Given the significant jump in natural gas prices and inventory levels near the upper end of the 5-year average, a period of consolidation seems to be a reasonable assumption, but clearly there are some renewed signs of life in a market that has struggled for many years. A new bull market is too early to call simply looking at the price action where natural gas has made lower highs and lower lows over the past decade.

Gas Storage At Upper 5 Yr Range

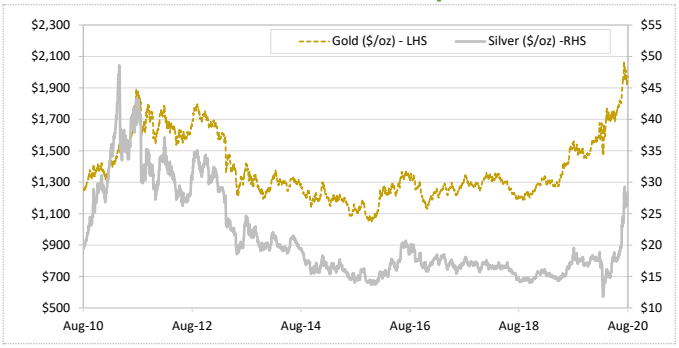


Source: FactSet, Raymond James Ltd.

Precious Metals: It's Time to Shine

Gold and silver have moved into new bull markets after spending years consolidating. The break higher coincided with real interest rates moving steeply into negative territory as most central banks slashed their benchmark lending rates to effectively zero (real rates are calculated by subtracting inflation from nominal interest rates. For example, if annual inflation is 2% and the government 10-year bond yield is 0.5%, the real rate is -1.5%). While negative real rates is one reason to be bullish on precious metals, there are plenty of other reasons investors are attracted to the commodity, which we covered in our May *Insights & Strategies: The Midas Touch*. That said, our primary bullish thesis on precious metals is that central banks will maintain rates lower for longer while also allowing inflationary pressures to build. This combination should maintain real rates in negative territory for a considerable length of time; an environment where precious metals shine.

Gold & Silver Breakout After Multi-year Consolidation

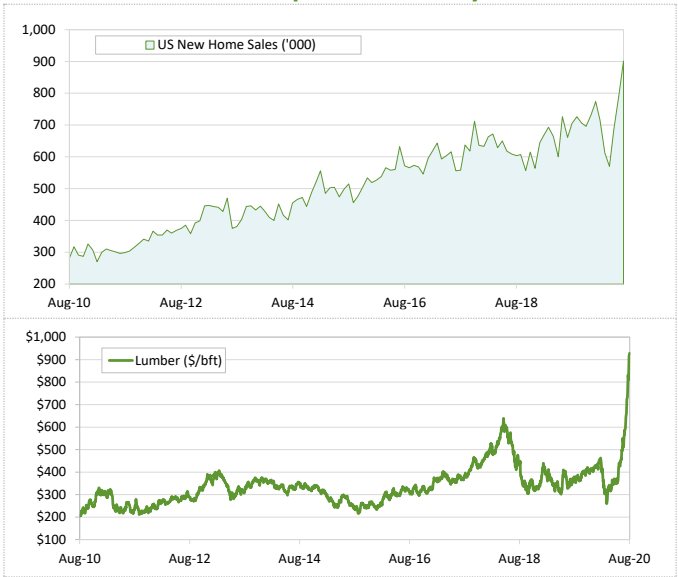


Source: FactSet, Raymond James Ltd.

Lumber: Raising the Roof

Despite muted economic news, housing data on both sides of the border have remained resilient. Housing demand has been supported by ultra-low mortgage rates, as well as the desire to relocate due to the pandemic. According to a Pew Research Center survey, around 22% say they either changed their residence due to the pandemic or know someone who did, a rather significant figure compared to historical norms. One of the hangovers from the financial crisis has been a lack of investment in suburban/rural single-family residences. The surge in demand this year has served to support housing prices and to meet rising demand, homebuilders have ramped up production as evident by new home sales. However, over the longer term, it is hard to imagine how housing sales could continue to advance without a significant rebound in employment, so this will be a factor to watch to support further gains. Nonetheless, the strong demand for housing, as well as renovations and DIY projects has pushed lumber prices through the roof. Adding to this pricing pressure from the supply side has been production disruptions owing to beetle infestations in several producing regions. As one can see in the lumber price chart, lumber has gone parabolic. Typically moves such as these experience a period of consolidation and/or partial retracement of the move.

News Homes Sales Jump & Lumber Skyrockets



Source: FactSet, Raymond James Ltd.

Base Metals: Dr. Copper

Copper prices are heading for their highest close since mid-2018 on the back of positive economic data, particularly in China, which reinforces that the country's economic recovery is on track. China's official purchasing managers' index (PMI) for August remained in expansion territory following a July print that was also above 50. The economic expansion has increased copper consumption, thus helping to support prices, but growing signs of tightening supply is also feeding into the commodity's price advance. Most notable is the decreased production in copper-rich regions, such as Latin America and Africa that continue to deal with negative effects of the pandemic. The outlook for copper appears bright as major economies continue their monetary and fiscal stimulus, with significant fiscal spending earmarked for infrastructure, supporting base metals demand. The copper chart suggests prices may consolidate for a period in the $2.00-$3.00/lbs range, unless there is a significant move above $3.25/lbs.

Copper Bounce

Source: FactSet, Raymond James Ltd.

Broader commodity indices can mask some of the underlying trends occurring within the commodities complex. Besides precious metals, the remaining commodity complex is highly cyclical in nature and more dependent on economic expansions. While global economic activity remains muted, it is moving in the right direction and the significant actions taken by governments and central banks points to a continuation in the recovery. The strength in the commodities space is certainly one indication that investors believe economic conditions are on the mend. As growth continues to strengthen, this will place greater demand on most commodities putting upward pressure on prices. Higher commodity prices will improve the prospects for many producers, which in turn may attract greater attention and investment thus broadening the market's participation. An improvement in market breadth is one factor we are looking for to help sustain the market advance. Notwithstanding, a supportive outlook for commodities would also favour the S&P/TSX given the index weighting and our economy's reliance on the commodities complex. Considering Canada's relative valuation advantage, our market may be poised to outperform once global economic conditions firm.

Jason Castelli, CFA
VP, Head of Investment Strategy

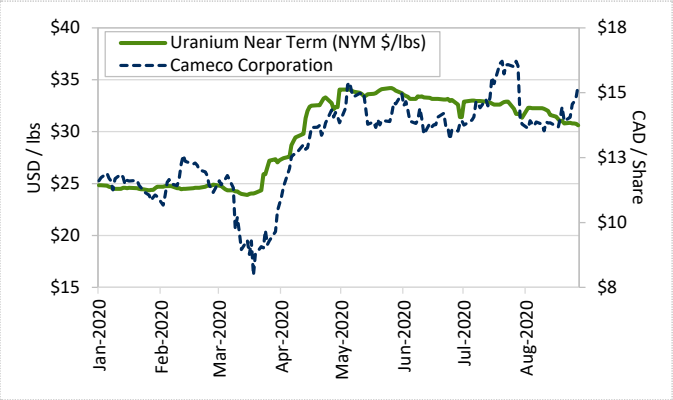
Commodity Plays

While commodity producers can provide a hedge against inflation and may benefit from the anticipated sector rotation, it's important to note energy and non-energy producing companies have certain characteristics that make them unique in comparison to other businesses. Companies involved in the exploration and production of raw materials are price takers, meaning they must accept the prevailing market prices for their products, making their business highly cyclical in nature and more volatile than most other businesses. However, investors with moderate risk tolerance looking to gain exposure to commodity producers can do so by sticking with mature producers that have solid balance sheets, fundamentals (good management team and a focus on profitability) and have experienced the ups-and-downs of a full cycle.

The Warm Glow of Uranium

The Raymond James mining team is positive on the uranium market given solid price performance (commodity up ~20% year-to-date, YTD) along with an improving supply/demand backdrop. **Cameco (CCO-T)** is Raymond James' favoured name in the space, rated Outperform with a $17 target price, presenting 12% upside from current levels. The company is a dominant player in the uranium markets, having contributed to 9% of global uranium production in 2019. CCO offers investors with a long term time horizon and positive view on uranium markets a lower risk form of gaining exposure to the commodity given a geographically diversified asset base along with a solid balance sheet with close to $900 mln in cash and a $1 bln undrawn line of credit. The uranium producer and refiner is also the best performer in the energy sector, up +30% YTD driven by increased uranium prices.

Cameco and Uranium: Strong Positive Relationship



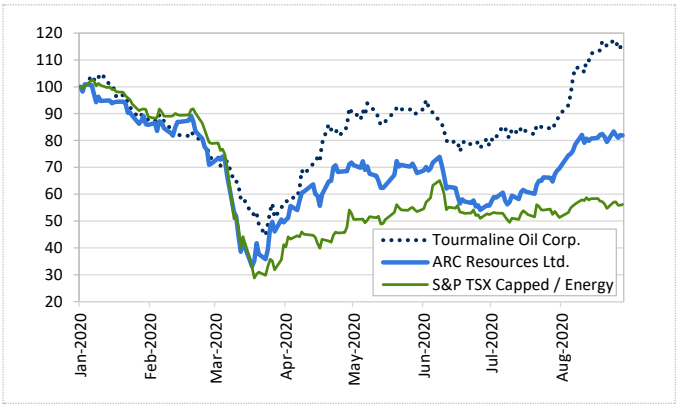
Source: FactSet, Raymond James Ltd.

The stock is positively correlated to the commodity with multi-period (5, 10, 15 and 20-year) monthly correlations ranging between 0.33 and 0.45 (a correlation between 0 and 1 indicates both securities move in the same direction with a value of 1 meaning a strong linear relationship, or perfect positive correlation). As such, further improvement in uranium prices should bode well for CCO's stock price.

Oil & Gas

As for energy, we believe as sentiment in the sector begins to improve, investors will return, searching for quality companies that have strong balance sheets and are focusing on improving profitability. Despite its quality characteristics, **ARC Resources' (ARX-T)** price performance has been depressed compared to similar gas-weighted peers. In fact, while **Tourmaline Oil (TOU-T)** is up 8% YTD, ARX is down ~19% despite similar asset positioning in the Montney region of British Columbia.

ARC Resources and Tourmaline: Nice Bounce Back



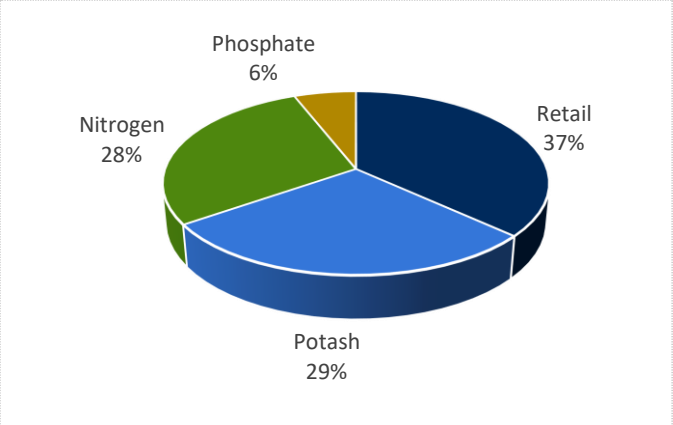
Source: FactSet, Raymond James Ltd.

The oil & gas exploration and production company has a solid balance sheet, showcasing one of the lowest leverage profiles in the sector at 1.2x 2021 D/CF (similar to TOU) and over $1 bln in available liquidity to sustain its business. The company also boasts a low cost structure, which can deliver strong profits once commodity prices stabilize.

Nutrients

Within the world of crop nutrients, **Nutrien (NTR-T)** is a name worth highlighting. The stock is Strong Buy-rated at Raymond James with a US$48 target price, indicating over 30% upside from current levels. While not a pure-play fertilizer company, NTR contributes over a fifth of global potash capacity and derives two-thirds of its EBITDA from potash, nitrogen and phosphate.

Nutrien EBITDA Breakdown



Source: FactSet, Raymond James Ltd.

The company also has exposure to retail distribution of crop nutrient/seeds/merchandise, making it more resilient during periods of commodity price volatility. The stock is made even more attractive when considering its healthy balance sheet, free cash flow yield (~12%) and dividend yield (~5.0%).

Larbi Moumni, CFA
Senior Equity Specialist

Canadian Energy Debt Dynamics

There is no escaping the importance of oil and gas on the health of the Canadian economy. According to the Government of Canada, as of 2018 the energy sector's share of total employment (direct and indirect) was 4.5%. More importantly, the sector accounts for 10.6% of overall GDP. With this in mind, there was cause for concern when demand destruction arose for crude oil, spurred by government-mandated shutdowns to combat the spread of COVID-19. Though the perception of time has been distorted as daily routines have been drastically altered, many forget that only four months ago the price of a barrel of West Texas Intermediate crude oil (WTI) traded in negative territory. As many countries in Asia and Europe have steadily come back online, so too has sentiment on the pricing of this commodity. In fact, despite a tumultuous few months global crude oil benchmarks are nearing pre-COVID levels. Many energy-related companies are capital intensive, and thus these corporations need to raise funds. Issuing bonds is often a straight-forward way to secure capital at reasonable rates and with uncertainty looming many companies have already tapped bond markets this year to bolster their cash positions. In this article, we will examine how the Canadian bond market has weathered the storm by analyzing the bonds of energy companies.

In examining the debt of Canadian energy firms, we focused on the outstanding debt of companies throughout the life cycle of crude oil. This includes the exploration and production (E&P) companies that derive oil from the ground (upstream), pipeline companies and rail companies that transport oil to and from key locations, as well as integrated companies that perform both upstream and downstream (refining and processing of oil). To help streamline our analysis and ensure we are getting as close to an 'apples to apples' comparison as possible we used the below screening criteria to create a basket of bonds for each category:

- Seniority: Senior unsecured
- Credit Rating: Investment grade (i.e. at least BBB-low by DBRS)
- Years to Maturity: Placed into one of three buckets; 0-5 years; 5-10 years; 10+ years
- Issuance Date: Issued prior to December 31, 2019
- Issue Size: At least $100M
- Currency: Canadian dollar
- Number of Issues: At least two bonds outstanding per firm that meet the above criteria

Canadian Energy Debt Dynamics

Firm Type	Credit Rating	Average OAS (basis points)			Correlation with WTI		OAS Volatility	
		Current (Aug 21)	March 31 Peak pandemic	Feb 28 Pre-pandemic	March 9 to May 16	May 20 to August 21	March 9 to May 16	May 20 to August 21
Oil-Integrated	A	248	430	203	-0.35	-0.41	10.2%	3.2%
	BBB	228	586	144	-0.38	-0.48	10.5%	2.7%
Oil-E&P	BBB	296	568	239	-0.39	-0.51	10.3%	2.3%
Pipelines	A	252	375	239	-0.23	-0.37	8.1%	2.8%
	BBB	268	436	242	-0.29	-0.37	7.8%	2.3%
Transport-Rail	A	156	227	154	-0.34	-0.38	7.4%	5.4%

Source: Raymond James Ltd., FactSet
Average OAS calculated by equal weighting each Firm Type's respective OAS for each maturity bucket

One of the main statistics used by corporate fixed income investors is option-adjusted spread (OAS). OAS is used instead of the yield to maturity (YTM) due to many bonds having embedded options in their structure. These features must be considered so that any potential changes in cash flow as a result of the option are reflected in the analysis. Callable optionality is the most common example of an embedded option in a bond, where the issuer can redeem the security on a date prior to maturity.

After performing some rudimentary analysis of OAS for our selected bonds we can make a few general observations:

- **Quick Recovery** – The recovery in credit spreads of energy-related companies only slightly lagged the recovery in crude oil prices. This signals to us that fixed income investors are comfortable with the notion that crude oil prices have stabilized. If crude prices were predicted to materially weaken again, we would instead expect spreads to remain wide to reflect the perceived future credit risk. Bond pricing is often forward-looking in this respect.
- **Does Business Model Matter?** – Integrated and E&P companies are generally more exposed to spot prices of crude whereas pipelines and the rail companies that transport crude oil operate on longer-term contracts and are thus less exposed to spot pricing. However, during the oil selloff we witnessed some convergence among the correlations of the OAS for different types of businesses and crude oil. We did, however see that those with business models more exposed to spot prices saw greater volatility in their credit spreads.
- **Credit Spread Correlations With Crude Oil Has Strengthened** – For the time being, crude oil prices have seemed to find a floor but the outlook for pricing is somewhat muddied given that the staggered re-opening of global economies. Fixed income traders are keeping a close eye on the outlook for crude to help support cash flow models of energy companies. As such, fixed income investors evaluating bonds from energy-related companies should be more acutely aware of expectations for crude oil pricing.
- **Volatility Subsided** – Volatility has been subdued as investors are largely past the phase of re-positioning their fixed income portfolios to reflect their updated outlook. From our trading desk's perspective, buying and selling activity with respect to energy company bonds is now focused on finding short-term value opportunities.

Conclusion

As the economic repercussions from the pandemic continue to evolve, so too will investor sentiment on the debt instruments of energy-related companies. We remain confident that the worst of the sell-off in these names is behind us; but their long-term visibility is clouded by how life may change post-pandemic and the increased shift towards renewable energy. In the near term, these concerns at the margin will negatively impact energy consumption, but long term they pose a greater threat. The Canadian energy patch and its fixed income instruments can selectively offer value but those looking to invest long term must weigh the potential future risks before investing in a company's long-term debt.

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Charlotte Jakubowicz
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Under the Hood of Commodity ETFs

In the May edition of the *Insights and Strategies*, we discussed several ways to gain exposure to physical gold through exchange-traded products. In this edition, we turn to commodity exposure in general, with an emphasis on the importance of how commodities trade in an ETF. The managed money space can provide a great opportunity to invest in commodity markets that have long been accessible only to the largest institutional investors. ETFs now provide exposure to not only precious metals, but physical commodities such crude oil, natural gas, and uranium. After making the decision to invest in a commodity, it is crucial to understand how an ETF gains its exposure.

Most commodity ETFs are passive and must follow a set of rules to track a benchmark. In certain cases, the ETF will own the physical commodity and include the storage cost as a part of its management expense ratio (MER). This works when storage of the commodity is simple and cost effective, for example storing gold or silver bullion in a vault at the mint or bank. On the other hand, storing commodities such as barrels of crude oil can be costly and logistically complex. Instead, many commodity ETFs use futures contracts to get exposure to the spot price of the underlying commodity. Depending on what rules the ETF employs when purchasing futures contracts, the return profile for investors can vary significantly from the commodity itself.

Futures 101

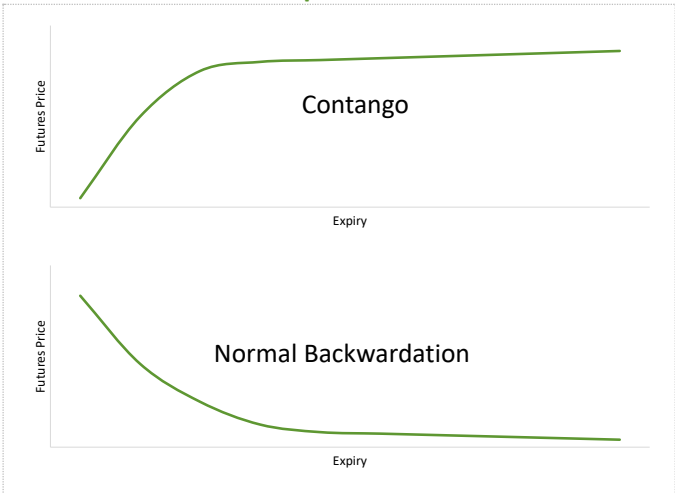
A futures contract is an obligation to buy or sell an asset in the future with the quantity, price and delivery date all specified. A textbook example is as follows; a wheat farmer will be selling bushels of wheat at harvest, but the farmer wants to know what price they will receive today. To do this, the farmer sells futures contracts for their wheat, locking in a price. As an investor, you might want to speculate of the future price of wheat. You buy the farmer's future supply of wheat taking on the price risk. It could go up or down. Holding a futures contract to its expiration date would trigger an obligation to take delivery of the underlying asset at the given price. To avoid the logistical nightmare, most investors sell their contract prior to expiration using the proceeds to buy another contract that expires further down the road. This is known as "rolling" and can be positive or negative depending on whether the contracts being purchased are more expensive (contango) or less expensive (backwardation) than the contracts being sold.

Contango and Backwardation – What Does It Mean?

The chart below shows a futures curve, a series of futures contracts with price on the y-axis and maturity on the x-axis. If the prices of the commodity were more expensive in the future than it is today, we would say the market is in contango. Contango is a natural state for markets given storage costs, delivery, and insurance associated with the commodity. Markets can also be in a state of backwardation. This is where it is cheaper to buy something in the future than today. Typically, this occurs when the current supply of a good is limited and people will pay more today than they would in the future. For example, the scarcity of N95 masks in March 2020 drove up their price versus what someone would be willing to pay to receive the mask in two years time.

ETFs tracking commodities need to roll into the next set of contracts to avoid physical delivery of the assets. If the commodity is in contango, you need to pay more each time the contact rolls to maintain the same exposure to the commodity. Persistent negative roll yield will eat away at your principle investment over time. On the flip side, if your chosen commodity remains in backwardation, you get paid a premium every time the contract rolls to maintain the same exposure.

Futures Curves Take Shape



Source: Raymond James Ltd.

Curves Matter

Determining the shape of the futures curve can be complex but there are some simple rules investors can follow. First, contango has a negative effect and backwardation a positive one when it comes to these ETFs. Second, know how often (and when) the underlying contracts for the commodity rolls into the new ones. Is it daily, weekly or every few months? The more frequently you expose your investment to contango, the

Oil ETFs

Name	Ticker	MER	Roll Frequency	Roll Strategy	Correlation with Spot WTI			
					1 Year	6 Month	3 Month	30 Day
United States Oil Fund ETF	USO-US	0.79%	Monthly	Predominantly near month; now have the ability to roll into further out contracts	0.44	0.44	0.82	0.96
Invesco DB Oil Fund ETF	DBO-US	0.78%	Monthly	Rules based approach to identify the most attractive contract between 1 &13 months	0.32	0.32	0.64	0.93
Horizons Crude Oil ETF	HUC-TO	0.88%	Annually	Only December contracts, rolled in June	0.35	0.36	0.66	0.86

Source: Raymond James Ltd., FactSet; Data as of August 31, 2020
All trade in $USD; HUC-TO is hedged to $CAD

more costly it will be to maintain your exposure. If your ETF rolls its contracts daily, this can compound into significant losses over time regardless of what the commodity does.

Products with a daily roll are not suitable for long-term investors; rather, they are suitable for speculating on intra-day market moves.

Looking At Existing ETF Structures

Many will remember when oil traded into negative territory early this year. While there were many factors at work, in part it was due to the largest oil ETF in the world and the rules it had to follow. **United States Oil Fund ETF (USO-US)** rolled over its future contacts to the nearest month's futures contract. For example, toward the end of May the fund would sell its May-expiry futures contracts and purchase June expiration contracts, and so on. This became problematic this spring when a precipitous sell-off in oil markets caused the near-month futures contracts for WTI crude oil to go negative (a topic deserving of its own publication). The fund rewrote its own rulebook following negative oil prices to allow it to roll some contracts into further months out (i.e. they do not need to be forced buyers in a negative marketplace). Other commodity ETFs employ different structures in an attempt to reduce negative roll. **Invesco DB Oil Fund ETF (DBO-US)** uses a rules-based approach to roll its expiring contracts into the most attractive contract that expires within the next 13 months. Canadian-based **Horizons Crude Oil ETF (HUC-TO)** takes a different approach by exclusively gaining exposure to crude oil futures contracts that expire in December as these are often the most liquid contracts while rolling its contracts only once a year in June. HUC therefore could be a more appropriate, longer-term holding versus its aforementioned peers.

Putting It All Together

Investors have never had more choices when it comes to gaining exposure to commodities than they do today. Adding commodities to your portfolio can be a great tactical decision for investors, but we implore those seeking this exposure to be mindful of the structural choices that may cause their investment to deviate from spot prices. As with any investment, understanding how it fits into your overall and long-term plan is critical. Any commodity ETFs that roll their exposure on a daily basis, for example, are simply are not suitable for long-term asset allocators, but rather are trading tools. As with any investment decision, it is prudent to review the prospectus documentation to gain a more thorough understanding of how the fund should behave relative to spot prices.

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