Philequity Corner (October 10, 2016)
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Should commodities be part of one's portfolio? – Part II

Last week, we discussed how investing in commodities can offer diversification benefits to one's investment portfolio (see ***Should commodities be part of one's portfolio?***, October 3, 2016). We mentioned that a broad recovery in commodity prices may be underway and that precious metals and industrial metals have led the way this year.

In today's column, we will take a look at energy commodities. Oil prices appear to have bottomed in February after a 20-month decline that sent prices of WTI crude tumbling from $105 per barrel down to as low as $26.21 per barrel. WTI crude oil has since bounced 90 percent spurring a wider rally in the overall energy complex.

Energy commodities bottom out – biggest rally since 2008

Since bottoming out in January – March, energy commodities have rallied an average of 81.6 percent, led by natural gas and WRI crude oil which are up 94.6 percent and 90.1 percent, respectively. This is the biggest rally in energies since 2008.

Year-to-date, energy commodities are up 22 percent. Natural gas is the best performer with a gain of 22.1 percent, followed by heating oil and gasoline which retuned 18.6 percent and 16.6 percent, respectively.

Energy		Last Price	% Since Low	% YTD
Natural Gas	USD/ MMBtu	3.19	94.6%	22.1%
WTI Crude Oil	USD/ bbl	49.83	90.1%	14.9%
Brent Crude	USD/ bbl	51.93	86.3%	13.0%
Heating Oil	USD/ gal	1.58	82.4%	18.6%
Coal	USD/ st	57.05	71.4%	51.0%
Gasoline	USD/ gal	1.4818	64.8%	16.6%
		Average	81.6%	22.7%

Source: Bloomberg

Technical picture is turning bullish

Technical analysis points to a bullish picture for energies. Crude oil's weekly chart continues to form a possible 14-month inverted Head and Shoulders (H&S) bottom pattern. It would be worth watching how crude oil performs when the H&S neckline at 50 is challenged. A close above 50 would represent a buy signal.

Source: Stockcharts.com

Meanwhile, natural gas has confirmed its 20-month H&S bottom when it closed last week at 3.19.

Source: Stockcharts.com

Initially, natural gas targets 3.50 based on a 3-month H&S continuation pattern.

Source: Stockcharts.com

Investing in energy commodities thru ETFs and ETNs

As mentioned in last week's article, a convenient way to invest in commodities is to buy exchange traded funds (ETFs) or exchange traded notes (ETNs) that provide exposure. Examples of these are the United States Oil Fund (USO), the United States Natural Gas Fund (UNG) and VanEck Vectors Coal ETF (KOL). Note, however, that these funds have various levels of tracking error which can cause the returns of these funds to be different than the actual returns of the underlying commodities.

Leveraged funds

Recently, leveraged funds which promise 2x or 3x the returns of the underlying commodities have become very popular. Examples of these are the VelocityShares 3x Long Crude Oil ETN (UWTI) and the Proshares Ultra Bloomberg Crude Oil (UCO).

Despite its popularity, it is important to note that there are many risks associated with holding leveraged ETFs which may be detrimental to long-term investors. Aside from the compounded risk due to the leveraged exposure, these funds are known to lose value over time due to the "volatility decay" effect from the various derivative strategies employed.

Buying energy stocks

An alternative way to get exposure to energy commodities is by buying energy stocks. These also provide some form of leverage on the underlying commodity prices. As prices of the underlying commodity prices rise, the profitability of these energy companies is amplified.

Investors can buy oil stocks and coal mining stocks which have also performed well this year. Oil stocks are further subdivided into different industries such as the Oil Refining/Marketing, Oil and Gas Production, Oil Exploration and Oilfield Services/Equipment.

Part III of this series on commodities will be a review of the performance of agricultural commodities. We will be discussing this in a future article.

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