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FUND COMMENTARY – Q3 2023

Threadneedle (Lux) Enhanced Commodities

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Since: 01/08/2022

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Since: 01/08/2022

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Since:

Fund Information

You are investing in a fund that is actively managed in reference to the benchmark below. Please refer to the Prospectus and KIID for the Fund objective.

Fund Benchmark: Bloomberg Commodity Index

Inception Date: 29/06/2010

Fund Currency: USD

Fund Domicile: Luxembourg

Summary

- The Bloomberg Commodity index returned 4.7% in US dollars for the quarter.
- Gross of fees, the fund returned 5.2%, beating its benchmark.
- Agriculture exposures were the biggest contributor to relative returns, followed by precious metals. Base metals and energy exposures detracted.

Market Background

Commodities registered gains in the third quarter (Q3) of 2023, aided by strong rises in oil-based energy amid output cuts. The asset class posted all of the quarter's gains in July, with small losses in August and September still leaving the Bloomberg Commodity index up 4.7% in Q3. Commodities bucked the general downward trend in financial markets over the period, with many asset classes falling or delivering only marginal gains. Aside from supply/demand dynamics, the outlook for monetary policy and economic growth in the US and China were key market drivers for the complex.

Initially, commodities were supported by renewed hopes of a 'soft landing' for the world economy, as ongoing resilient US economic data and falling inflation spurred hopes that central banks may not have to raise rates much further. However, as the quarter progressed, risk sentiment weakened amid concerns around China's faltering economic recovery and the troubles of the country's indebted property sector – despite Beijing's announcement of stimulus measures. And while headline inflation continued to ease in major economies, core inflation (which excludes volatile components such as food and energy prices) remained elevated and labour markets remained tight. This stoked fears that central banks may not lower interest rates as quickly as previously anticipated. Later in the quarter, a strike by US United Auto Workers union members at Ford, General Motors and Stellantis weighed on risk assets and safe havens alike, given the inflationary implications of higher wage demands. While strength in crude oil prices supported the complex, they also helped push US Treasury yields higher, as did the prospect of a US government shutdown in September. The yield on 10-year Treasuries hit a 15-year high during September and closed the quarter at 4.57%, weighing on equities and commodity sectors, particularly metals, as this increases the cost of financing physical metal holdings. US dollar strength was a further headwind in Q3; the US dollar index also rose to a 10-month high towards the end of the quarter.

US economic data, while increasingly mixed over the quarter, remained relatively resilient. Inflation continued to broadly ease, and there were some signs of a loosening in the tight labour market: the l report released by the Bureau of Labour Statistics in September showed that 187,000 new jobs were added to the economy in August, while July's new jobs number was revised up to 236,000 and June's was revised sharply down to 105,000 jobs. All three monthly reported figures remain below the 12-month average. The unemployment rate rose slightly. According to the Bureau of Economic Analysis, the US economy grew more than expected in Q2, at an annual rate of 2.4%. However, measures of manufacturing and services activity weakened. September's S&P flash composite purchasing managers' index (PMI) only narrowly remained in expansionary territory as manufacturing activity continued to contract and service sector growth fell to its lowest level in eight months. Having slowed in the preceding two months, consumer price inflation surprised on the upside and accelerated in August and September, but core inflation edged lower due to declines in energy prices. Annualised consumer spending for Q2 was revised sharply lower to its weakest reading since Q1 2022.

After pausing increases in June, the Federal Reserve hiked interest rates by 25 basis points (bps) in July, bringing them to their highest level in 22 years. However, commentary from Fed Chairman Jerome Powell at the Jackson Hole summit in August was hawkish, emphasising that policy would remain "restrictive" until inflation trended down towards the 2% target. While the central bank held rates as expected in September amid increasingly mixed economic data, its closely watched 'dot-plot' projections showed one further hike this year to bring the federal funds rate to between 5.5% and 5.75%. In addition, interest rates were projected to remain high for an extended period, with gradual rate cuts not expected until 2024, and the central bank's median forecast showed that the benchmark rate would remain at 5%-5.25% next year.

Performance

12M Rolling Period Return in (USD) - as at 30 September 2023

	09/22-09/23	09/21-09/22	09/20-09/21	09/19-09/20	09/18-09/19	09/17-09/18	09/16-09/17	09/15-09/16	09/14-09/15	09/13-09/14
Fund (Gross) %	1.05	11.95	40.24	-4.66	-6.53	1.27	0.64	-0.28	-26.96	-8.26
Index (Gross) %	-1.30	11.80	42.29	-8.20	-6.57	2.59	-0.29	-2.58	-25.99	-6.58

Source: Columbia Threadneedle Investments as at 30/09/2023. Gross of fee fund returns are time-weighted rates of return net of commissions transactions costs and non-reclaimable taxes on dividends interest and capital gains using pricing of investments which is either the last traded price or a bid basis. Cash flows are factored as of the end of the day and exclude entry and exit charges. Index returns include capital gains and assume reinvestment of any income. The index does not include fees or charges and you cannot invest directly in it. The return of your investment may change as a result of currency fluctuations if your investment is made in a currency other than that used in the past performance calculation.
Past performance does not predict future returns and future returns are not guaranteed.

For detailed information on Fund Changes please see Significant Events - Threadneedle (Lux) Funds PDF available on www.columbiathreadneedle.com/en/changes

Market Background continued

Data from China showed economic weakness, while turmoil in the property sector persisted. However, economic data towards the end of the period actually showed some improvement, with industrial production and retail sales stronger than expected. The manufacturing PMI returned to expansionary territory in August for the first time since March. Less optimistically, the Caixin manufacturing PMI survey (which captures smaller and more export-oriented firms) was much weaker than expected, illustrating a lack of domestic demand, external uncertainties and job market pressures. In response to the soft macro environment, the People’s Bank of China cut the reserve requirement ratio in September for the second time this year. Property developer Evergrande filed for Chapter 15 bankruptcy protection in New York in August, and investors also speculated that Country Garden, another heavily indebted property company, could default on its bonds, though the company allayed short-term fears after it met a key payment deadline.

Against this backdrop, energy was the strongest sector over the quarter. Base metals rose modestly, while agriculture fell on the quarter.

Performance

In gross terms, the fund returned 5.2%, outpacing the benchmark Bloomberg Commodity index by 50 bps.

Portfolio positioning within agriculture was the main driver of the outperformance, though positioning in precious metals was also favourable. However, positioning in base metals and energy was detrimental for relative returns.

Energy

The energy allocation detracted from relative performance in Q3, mainly reflecting unfavourable positioning in crude oil, though positioning in gasoline was also unhelpful. However, the impact was largely offset by beneficial positioning elsewhere in the sector, particularly in natural gas (where we held an average underweight) and heating oil (where we were overweight).

Energy prices strengthened significantly over the quarter, led by oil-based energy. Output cuts and expectations of strong seasonal demand supported crude oil, with West Texas Intermediate (WTI) gaining 30.0% and Brent posting 22.9%.

Oil prices posted their largest monthly gain in over a year in July, buoyed by news of a 500,000 barrels per day (bpd) cut in crude export output by Russia and as Saudi Arabia’s extended its 1 million bpd supply cut into August. Prices were also supported by a larger-than-expected US oil inventory draw and speculation that Saudi Arabia would further extend its cuts into September. The extension duly followed, and oil prices initially extended their gains in early August, further helped by record global demand due to strong summer air travel, power generation and higher-than-expected demand from China, as well as expectations for further demand in the second half of 2023. However, later in August WTI crude dipped under $80 per barrel on weaker-than-expected economic data from China and a pullback in equity markets. Oil prices were also hurt by news of increased crude supply from Venezuela, Iran and Iraq, along with reports that 2023 US crude production had hit record levels, running at 12.76 million bpd.

September saw oil prices resume their upward trajectory amid further OPEC+ cuts, a Russian ban on diesel exports and a critical fall in US crude stockpiles at the key Cushing storage hub in Oklahoma due to strong refining and export demand. This gave rise to concerns about the quality of the remaining oil and the potential for stocks to drop below minimum operating levels. In response to tight inventory levels, WTI crude front-month backwardation (when the current price of an underlying asset is higher than prices trading in the futures market) reached its highest level since July 2022.

The Energy Information Agency (EIA) projected that Brent crude oil prices would average $93 per barrel in Q4 2023 and $88 in 2024, given the likelihood of increasing inventories starting next year. A slowdown in oil-demand growth, non-OPEC production growth and the end of Saudi Arabia's voluntary output cuts also contributed to the EIA’s 2024 forecast. The agency also lowered its US gasoline consumption forecast for 2024 by 0.2 million bpd versus August’s projection, driven by the Census Bureau’s reduced estimate of people of working age.

Meanwhile, natural gas fell 10.4%, as inventory levels remained well above long-term seasonal averages. This weighed on prices and offset the positive impact of higher cooling demand due to record summer temperatures. In Europe, prices fell as high storage levels were compounded by improved supply from Norway after previous production outages came to an end. In late August, the US natural gas market was supported by worries about impacts to production in the Gulf of Mexico due to Hurricane Idalia. However, the hurricane was also expected to cause power outages for over a million households, temporarily decreasing electricity demand and natural gas use and offsetting impacts on production. European natural gas prices were volatile in August, partly as a result of labour disputes at the Chevron and Woodside natural gas facilities in Australia, which threatened expected to impact supplies to Europe and Asia.

In September, the EIA projected US natural gas consumption would average 80.5 billion cubic feet per day (bcf/d), up 5% year on year and a record for September. High summer temperatures and reduced coal-based generation contributed to a significant jump in gas-fired electricity production.

Metals

The metals exposure contributed moderately to relative returns, as gains from positioning in precious metals outweighed a detraction from base metals exposures. In the former, the below-benchmark stance in gold was advantageous, while in the latter, our underweight in aluminium and above-benchmark stance in lead were a drag on returns.

Base metals were mixed in Q3 but ended the period up 2.1%. The stronger US dollar, higher interest rates and 'higher for longer' Fed messaging were headwinds for base metals over the quarter, but sentiment was also driven by fluctuating inventory levels and the flow of economic data and government stimulus announcements from China. In July, the subsector registered gains as Beijing promised stronger support for the Chinese economy and the country's distressed property sector. This was particularly supportive, as home building has historically been a significant source of Chinese metal demand. Increased optimism regarding China came as factory activity beat estimates but still marked a fourth straight month of contraction in activity. However, industrial metals fell sharply in August amid weaker-than-expected economic data (and disappointing stimulus measures) in China, as well as a stronger dollar and higher interest rates. The negative tone of global equity markets also weighed on expectations for economic growth for much of the month. September was a more mixed month for industrial metals, as sentiment regarding China's economy improved somewhat amid new stimulus measures from the Chinese government aimed at boosting the property market, including lower mortgage rates and reduced down payment rules. New home sales in Beijing jumped in early September, but data across the country was down. US economic releases were less encouraging, with housing starts and vehicle sales both down month on month, though building permits rose.

Zinc was the strongest performer in Q3, returning 10.8%. Prices were supported by a fall in stockpiles in September and a notable resumption of imports of refined zinc by China following a hiatus since 2022. Falling inventories and improving sentiment towards China's economy boosted aluminium prices in September, bringing quarterly returns for the metal to 7.8%. Meanwhile, lead registered a modest gain, posting 3.5%.

At the other end, copper prices fell slightly on the quarter (-1.4%), despite posting its strongest month of the year in July as Chile's Codelco – the world's biggest copper miner – scaled back its annual production forecast. Nickel returned -10.2% on rising inventories and news that Chinese nickel sulphate producers were converting excess material to nickel metal, adding to supplies. Nevertheless, the growing use of nickel in the clean-energy and electric vehicle sector may provide support in the future.

Precious metals retreated in Q3, with gold returning -5.2% and touching its lowest level since March during the quarter. After rallying in July on hopes that the Fed may have reached the end of its hiking cycle, the sector was impacted thereafter by the strengthening of the US dollar, hawkish Fed commentary and interest rates that moved higher still. Falls in equity markets also proved insufficient to generate strong safe-haven buying. Silver held up slightly better, posting -3.9%, supported by expectations of tight supply amid growing industrial demand at the start of the quarter.

Agriculture

Agriculture exposures were the biggest contributor to relative returns. Within this, grains added significant value, softs were moderately beneficial and the livestock sub-sector had a broadly neutral impact.

In grains, the biggest contributors were the underweights in corn and soybeans, together with the aggregate underweight in wheat.

In softs, the underweight in coffee added value.

Within livestock, our positiong in lean hogs was unhelpful but the impact was almost completely offset by favourable positioning in live cattle.

Agriculture returned -4.5% in Q3, dragged lower by sharp falls in wheat.

After rallying in July, wheat prices plunged in August as concerns about drought eased due to higher-than-expected rainfall in key areas. Wheat was also impacted by record global production and the potential for increasing supplies from Russia, despite the UN-brokered safe corridor shipping agreement lapsing in July. Ukraine's 2023/2024 wheat exports were expected to fall from 16.8 million tons to 10.5 million, while corn exports were expected to drop to 19.5 million tons from 28 million. Wheat prices continued to be impacted by worries about better-than-expected supplies in September, despite the US Department of Agriculture (USDA) lowering its 2023/24 global production forecast from last year's record, implying a drop in global production for the first since 2018/19. Kansas Wheat returned -18.3% in Q3, while Chicago Wheat posted -20.0%.

The USDA also projected the lowest levels of global wheat stocks since 2015/16, given large drops for China, the EU, Pakistan and elsewhere, while wheat consumption was forecast to hit a record in 2023/24 and to exceed global production. Strong export competition from Russia contributed to pressure on prices, even as ending stocks at the top 10 wheat exporters fell to 11-year lows. Ukrainian grain exports fell 51% year on year in September due to Russia's blockade of Black Sea ports and attacks on Ukraine's Danube River ports.

Corn prices fell more moderately (-5.0%) as export prices were supported by low water levels on the Mississippi River System which impacted freight costs. For the 2022/23 season, the USDA forecast global corn production would remain near record highs, supported by increased production in Brazil, Ecuador and Mexico. Exports were also forecast to rise from Argentina, Brazil, Canada and Russia.

Soybeans returned -5.1%, despite being supported by tighter supply. In September, the USDA reported a fall in global exports, with lower US exports partly offset by higher shipments from Brazil and Ukraine.

In softs, sugar was the standout, rising 15.1% for the quarter. In July, the commodity was supported by adverse weather (as were cotton and cocoa) and as production in Mexico, the world's eighth-largest sugar producer, was forecast to hit a 10-year low due to several regions experiencing drought during the October-April growing season. Supply concerns were later exacerbated, as India – the world's second-largest sugar producer after Brazil – suffered severe drought. In late August, media companies reported that India was expected to announce a ban on sugar exports for the next season starting in October. Sugar prices were later boosted by strong oil-price gains in September, which added support for ethanol production to mix with gasoline.

Cotton registered 8.4% in Q3. In July, prices were buoyed by reports from the USDA of a projected 1% fall in global cotton production for 2023/24, driven mostly by lower production in China. China's 2022/23 cotton imports hit at a five-year low, at less than half the volume seen two years prior. According to the USDA, factors weighing on import demand included the highest domestic output in nine years, lower domestic prices versus external, and less demand for government reserves. In August, the USDA reported that Bangladesh's growing apparel exports were set to boost consumption in 2023/24. However, in September, the agency raised the cotton production forecast for 2022/23, due to record production in Brazil.

Cocoa also returned 8.4%. Prices reached a 12-year high on the New York exchange in July amid supply concerns for the current season as well for the 2023/24 crop year. Heavy rains in West Africa impacted production for the 2022/23 season from leading producers Ghana and Ivory Coast. Cocoa pared quarterly gains in September but remained up almost 30% for the year to date at the end of the period.

Coffee posted -7.9%. In September, The International Coffee Organization stated that world coffee production decreased by 1.4% year on year in coffee year 2021/22 but forecast a 1.7% rebound in production in coffee year 2022/23. A lower rate of growth was attributed to increased fertiliser costs and bad weather conditions; these were expected to offset the positive impact of biennial production from Brazil. Meanwhile, world coffee consumption increased by 4.2% during the 2021/22 season and was projected to increase by 1.7% to 178.5 million bags in 2022/23. This would leave the global coffee market in deficit by around 7.3 million bags in 2022/23.

In livestock, live cattle posted a modest rise (1.9%) while lean hog prices fell (-0.7%).

In September, the USDA forecast Q3 pork production to be down 1.8% year on year and reduced its forecast for 2023 commercial beef production by 40 million pounds versus August’s forecast, given reduced output in the second half of the year. US beef exports in July were 15% below the five-year average due to weaker demand in parts of Asia and increased competition from Australia.

Outlook

Going forward, we expect some consolidation in the asset class over the short term, as we come out of peak demand season for oil ahead of the winter months. In the medium to long term, we remain constructive on commodities; we expect production-growth bottlenecks to continue, and a lack of investment to drive commodity prices.

Key Risks

Key Risks

The value of investments can fall as well as rise and investors might not get back the sum originally invested.

Where investments are in assets that are denominated in multiple currencies, or currencies other than your own, changes in exchange rates may affect the value of the investments.

The fund may enter into financial transactions with selected counterparties. Any financial difficulties arising at these counterparties could significantly affect the availability and the value of fund assets.

The fund invests in markets where economic and regulatory risk can be significant. These factors can affect liquidity, settlement and asset values. Any such event can have a negative effect on the value of your investment.

The fund’s assets may sometimes be difficult to value objectively and the actual value may not be recognised until assets are sold.

Short selling intends to make a profit from falling prices. However, if the value of the underlying investment increases, the value of the short position will decrease. The potential losses are unlimited as the prices of the underlying investments can increase very significantly in a short space of time.

The investment policy of the fund allows it to invest materially in derivatives.

Leverage amplifies the effect that a change in the price of an investment has on the fund’s value. As such, leverage can enhance returns to investors but can also increase losses, including losses in excess of the amount invested.

The fund may exhibit significant price volatility.

The fund invests in derivatives rather than physical securities. Therefore, there is a risk that that the price of the instrument does not accurately reflect the price of the underlying security/commodity.

As the fund gains exposure to commodities, it is exposed to factors affecting a particular industry or commodity, for example, weather, embargoes, tariffs and international economic, political and regulatory developments and trading activities in commodities and related contracts.

All the risks currently identified as being applicable to the fund are set out in the “Risk Factors” section of the Prospectus. Please read the Key Investor Information Document and the Fund Prospectus if considering investing.

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5444090 (01/2023)