Investment Strategy Group

August 2015

Commodities, Despite Weakness, May Still Have an Important Role in Portfolios

Commodities have endured another tough year so far in 2015, creating ripples across many other asset classes, such as high yield bonds and emerging market equities. We believe that dollar strength, declining demand from countries such as China and a spike in supply are mainly to blame for recent commodity price action. Despite the Asset Allocation Committee's tactical underweight to the asset class and near-term risks of further weakness, we continue to believe that commodities may buffer against inflation and warrant a place in a long-term strategic allocation.

Broad Impact from Commodity Weakness

Year-to-date (as of August 25, 2015), commodities, as measured by the Bloomberg Commodity Index, have delivered a return of -17.3% for investors, strongly underperforming stocks and bonds. While headlines have largely focused on energy markets, we have seen weakness across the commodity complex. As measured by the Bloomberg commodity sub-indices, energy, industrial metals and agriculture have returned -24.1%, -21.3% and -15.8%, respectively, year-to-date.

The drastic decline in commodity prices marks a continuation of a trend that started in the middle of last year and has affected many other asset classes. Assets ranging from U.S. high yield bonds, emerging market equities and debt, and master limited partnerships (MLPs) have all seen weak returns this year, in large part due to the "knock-on" effects of commodity prices. In addition, lackluster corporate earnings from commodity-related sectors such as energy and materials have also dragged on S&P 500 returns, as investors remain cautious about narrowing margins and slower profit growth in these sectors.

The Investment Strategy Group provides guidance on asset allocation and portfolio strategy in support of Neuberger Berman's clients and investment professionals.

Matthew Rubin
Director of Investment Strategy

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Changing Macroeconomic Regime

We believe there are a few primary forces affecting commodities markets in the near term. First, investors are seeing changes in the drivers of the global economy. Slower-than-expected growth in emerging markets, led by China, and, more importantly, a shift in the composition of Chinese growth away from being infrastructure-led, have resulted in weaker-than-expected demand across the commodity complex, most acutely within energy and industrial metals. The changing supply landscape is also to blame as large

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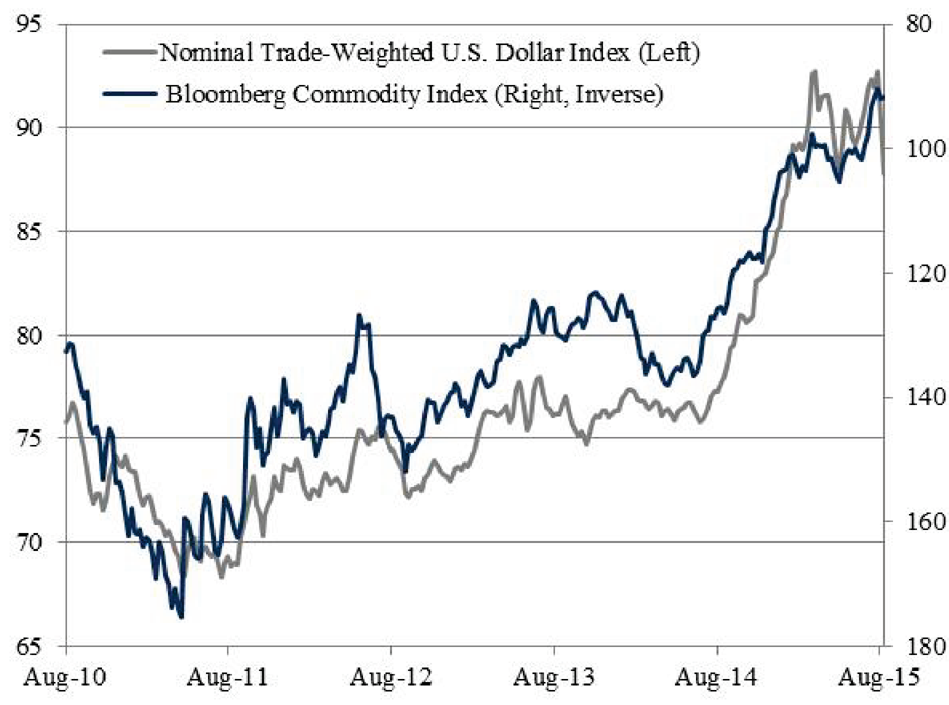
scale investments, technological changes and geopolitical shifts have raised production levels materially. Particularly within energy, rising productivity from U.S. shale producers and the recent prospect of a truce with Iran have further raised concerns about already elevated oil inventory levels.

In addition, dynamics in the currency markets, spawned by divergent growth and monetary policy responses across countries, have been a large factor. Given that most commodities are priced in U.S. dollars, the strong surge in the dollar over the past year has made commodities more expensive in many countries, and the expectation is that reduced consumption will dampen prices. Finally, we believe the shape of the commodity curve has also detracted from returns as the differential between more expensive long-term futures and lower spot prices have resulted in a so-called negative "roll yield" for the index.

Near-Term Outlook

We continue to have a cautious outlook on commodities in the near term. As seen in recent years, the performance of commodities is closely tied to the strength of the trade-weighted U.S. dollar (see display) and we believe there are a few events over the next few months that bear watching. More specifically, an earlier-than-expected rate hike by the Fed, hawkish guidance on the pace of future rate hikes and further devaluation of the Chinese yuan could potentially send the dollar higher. In addition, we think supply/demand imbalances could continue to dog markets until we see clear signs of a rebound in global growth (particularly in China) which can lead to higher demand.

DOLLAR STRENGTH IS OFTEN INVERSELY CORRELATED TO COMMODITY PRICES



Source: FactSet, ISG; trailing five-year data ending August 21, 2015.

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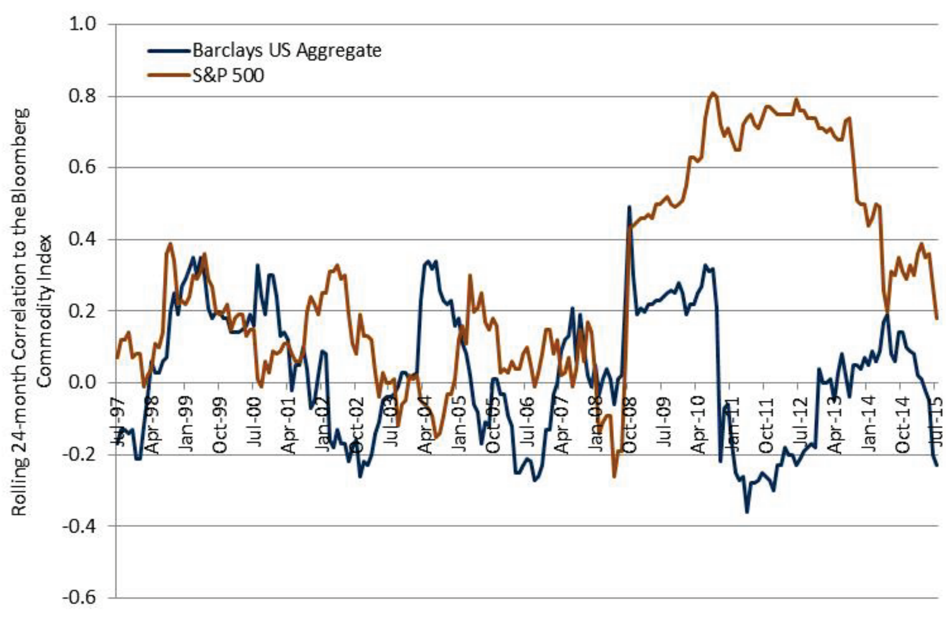
Despite the cautious outlook on commodities, we think the recent volatility has created opportunities across other asset classes that we believe have indiscriminately been sold off. Specifically, we think that MLPs, which currently yield around 7.4% (as measured by the Alerian MLP Index) and trade at a wider-than-historical-average spread of around 530 basis points to 10-year Treasuries, look attractive—particularly as we believe dividend yields will keep growing. In addition, emerging market hard currency debt, which is trading at yields of around 6.2%, also look attractive to us, particularly as the majority of bonds within the JP Morgan EMBI Global Index are investment grade.

Commodities in a Strategic Allocation

The weakness in commodity returns over the past four years has called into question whether investors should own commodities at all. Despite our tactical bearish outlook, we believe that commodities continue to have a special and important role in a strategic allocation. For one, we believe that commodities can help diversify a portfolio, particularly as their correlation with stocks and bonds appears to have declined in recent years (see display). Over the longer term, we have found that adding commodities often improves the risk-adjusted returns of a portfolio.

In addition, we believe that commodities still provide a good hedge against high inflation, in the event it reemerges. Although inflation has been low for a long time, for many investors, elevated inflation remains a significant risk to their portfolios. We acknowledge that commodity prices can fluctuate in cycles, but the arguments that made them popular over the past decade—such as rising demand from a growing global population and the potential for higher levels of inflation going forward as a result of excess central bank liquidity—still stand. As such, we continue to believe that commodities are an important component of a thoughtful strategic allocation.

CORRELATIONS BETWEEN COMMODITY PRICE MOVEMENTS WITH STOCKS AND BONDS HAVE DECLINED IN RECENT YEARS



Source: FactSet, ISG; data ending July 30, 2015.