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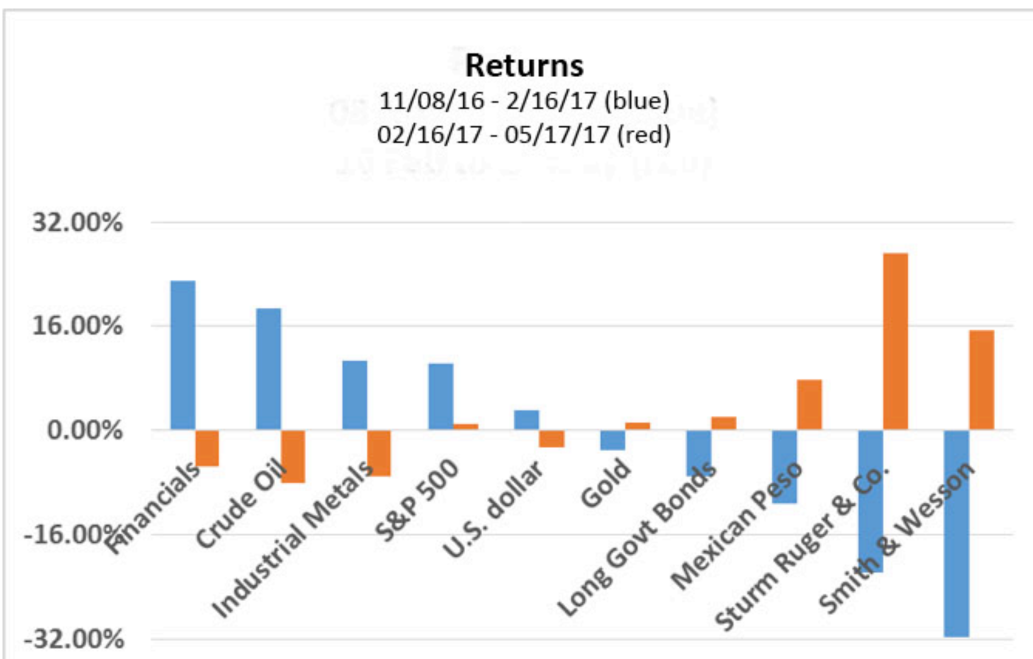
Commodities Insights – The Next 90 Days May 2017

Key Takeaways

- Key market reversals have taken place over the last 90 days.
- Commodities markets were broadly lower from mid-February through mid-May.
- Chinese and U.S. developments continue to impact commodities markets.
- U.S. shale producers eagerly await OPEC's May 25 meeting.

In February's edition of Commodities Insights, we reviewed markets over the first 100 days from the U.S. election. Meaningful reversals have subsequently occurred in most of these markets. One of the most recent examples being the rising VIX, which we'd previously noted given its surprisingly low level. The following chart highlights the un-wind of some of the post-election period's largest moves.



Source: Bloomberg

Past performance is no guarantee of future results.

Specific to commodities, enthusiasm for industrial metals has ebbed in recent weeks due to revised expectations for the timing of U.S. tax cuts and infrastructure spending and China's efforts to tighten shadow banking controls. In the roughly three months from February 16 to May 17, the BCOM Industrial Metals Index fell 7.02%. This decline coincided with the Chinese equity market falling more than 4% on weaker than expected data. Similar declines occurred in all commodity sectors with the exception of livestock. Beyond the idiosyncratic factors impacting individual commodities, shifts in sentiment will continue to influence prices.

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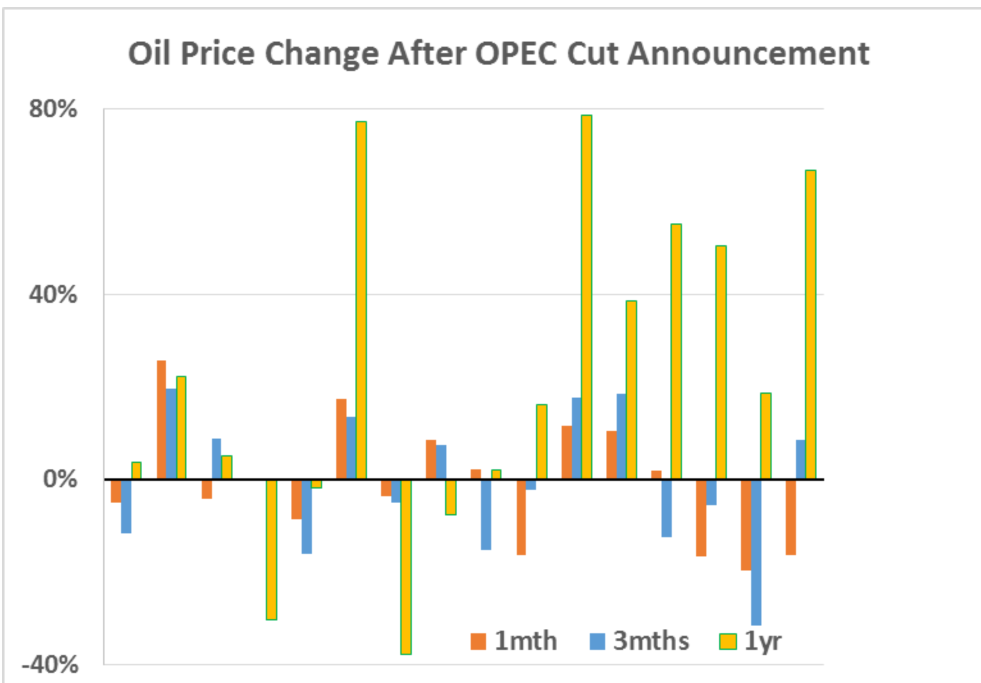
The impact of sentiment will be especially evident in energy markets over coming weeks. Specifically, the market's assessment of information around the May 25th OPEC meeting will influence energy prices. As a reminder, oil prices advanced almost 20% in the 30 days following the late November OPEC meeting with one-half of the gain occurring the day of the OPEC and non-OPEC agreement to cut production by 1.8 million bbl (barrels)/day. From a historical perspective, this contrasts with the typical price reaction to announcements. Prior to November's meeting, OPEC announced 16 production cuts over a 32 year period. We produced the chart below measuring the price change of crude oil from the trading day before the start of each OPEC meeting from which a cut was announced. The average price change one and three months later was essentially zero (-0.77% and -0.33% respectively). Whereas the price change one year later averaged 22% with three-quarters of the observations positive.



Source: OPEC, Bloomberg
As of 10/01/1984 – 10/31/2016

A likely explanation for this phenomenon is some combination of the following:

- Production cut announcements are often anticipated and thus priced into the market resulting in little initial price movement.
- Production cut announcements historically resulted in minimal actual production curtailments so short-term fundamentals remained largely unchanged.

- While minimal reductions in production may occur, announcements often coincide with members already producing near capacity (limited spare capacity from which to increase future production) and a low price environment causing global oil supply and demand shifts rebalancing the market over the ensuing 12 months.

Current dynamics include signals from major OPEC and non-OPEC players for a desire to extend the existing cut agreement until global inventories normalize, and an unusually high level of compliance in recent months. Concerning inventories, the U.S. is six weeks into the typical spring oil inventory decline as refiners increase utilization to maximize gasoline production for the upcoming summer driving season. As for producer behavior, we expect OPEC and non-OPEC adherence to agreements to be tested as producers are reluctant to yield market share as Libyan and Nigerian output comes back on-line. An even bigger dilemma for OPEC will continue to be U.S. shale production. U.S. producer cost reductions in the aftermath of the recent price collapse, and considerable increases in new well productivity have resulted in rig counts climbing from a May 2016 low of 316 to 712 rigs drilling for oil on May 12, 2017. OPEC and non-OPEC countries extending cuts beyond May 25th may initially raise the odds of a continued mid-40's to mid-50's oil price range which will offer shale producers hedging opportunities, supporting additional drilling activity. Our last piece suggested upward revisions to U.S. oil production seemed inevitable. Indeed, U.S. oil production increased almost one million bbl/day in the last 7 months – well beyond the market's initial estimates.

While it's important to note Saudi Arabia has an economic incentive to support prices (the planned 2018 IPO (Initial Public Offering) of 5% of Aramco) and one eye should be kept on security developments in Venezuela, Libya and Nigeria, we'll be keeping a suspect eye focused on OPEC and Russia's willingness to maintain unusually high levels of production cut compliance as U.S. shale producers enjoy the fruits of OPEC's labors.

Kevin Baum
Chief Investment Officer

Definitions:
VIX: A trademarked ticker symbol for the CBOE Volatility Index, a popular measure of the implied volatility of S&P 500 index options; the **VIX** is calculated by the Chicago Board Options Exchange (CBOE).

BCOM Industrial Metals Index: A financial benchmark designed to provide liquid and diversified exposure to physical industrial metals via futures contracts.

One cannot invest directly in an index.

Diversification does not eliminate the risk of experiencing investment loss.

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USO001377 Exp. 5/31/18

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