Commodities Outlook 2014: What can investors expect?

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Over the past 12 months the S&P 500 index has gained nearly 24 per cent. With the US economic recovery building momentum, the UK enjoying its fastest period of growth since 2007 and the Eurozone returning to some sort of normalcy, many commentators are expecting the influence on commodity prices to shift from East to West.

“I agree with this to some extent but it will be commodity-specific,” says Jeremy Baker, Head of Commodities at Harcourt Investment Consulting. “A lot of industrial metals are still geared towards Asia and China. China for example is 50 per cent of the copper market.”

Certainly there are risks to some Emerging Markets who are not commodity producers and whose currency declines against the greenback have led to significant outflows. As Bloomberg reported this month, investors have withdrawn USD29.7bn in the first two months of 2014: equaling total net outflows (USD29.2bn) for the whole of 2013.

But one should not throw a blanket over all emerging markets. The argument is more nuanced than that.

“Chile, Turkey, Peru, South Africa; these countries are all commodity producers. A weakening currency is a benefit to their mining industry. Domestic costs can be anything from 15 to 40 per cent of the total cost basis. It won’t necessarily improve production, but a weaker currency will help reduce the marginal costs of production and that’s important,” says Baker. In his view, China will not tighten its monetary policy because of currency weakness but more in response to restrain domestic credit.

“I think China is insulated from the wider emerging markets crisis. The issues there are more credit related.”

For anyone who has invested in
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commodities over the last three years returns have been disappointing. Over the last two years the Dow Jones-UBS Commodity Index has fallen -10.49 per cent. In 2013, returns were close to -9 per cent. The belief is that as the West starts to build through the economic gears, the supercycle that was rudely interrupted in 2008 will recover; that is, a lot of the negative market sentiment has been priced in to commodities. Already in 2014, DJ-UBS Commodity Index is up 6.6 per cent.

It is very early days, of course. The risk of WTI and Brent falling below USD90 and USD100 (12 months forward) is about 50 per cent according to the commodity price outlook and risks report published by the IMF on 12 November 2013. Tail risks causing crude prices to climb above USD120 or USD130 are estimated to be 8 per cent only.

“We are overweight precious metals right now, not because we are bearish but more because the price of precious metals is going to be challenged by the relative strength of the US dollar as a store of value. I agree we are seeing a strong OECD economic recovery. We’ve been on that theme for the last three years, which is being driven by the US and the massive increase in hydrocarbon production,” says David Donora, who co-manages the Enhanced Commodities Strategy at Threadneedle, adding: “In terms of oil-based energy we have high conviction and are significantly overweight. It’s a sector where both fundamentals and structure are very clear.”

The point Donora makes on commodities having been challenging for investors in recent years is that the very reason the global economy has been able to recover is thanks to lower priced adequate supplies of commodities.

“One of the reasons investors have enjoyed solid returns on their equity portfolios is precisely because commodities have not been the headlines for the last three years,” says Donora.

“Any prerequisite to sustain higher commodity prices is an increase in incomes of end consumers. I think that will be a theme for 2014: the share of corporate profits will be to some extent rebalanced and distributed towards employees and consumers. That will be the first step in the underpinning of higher commodity prices over the next few years.

“We are becoming more bullish on commodity prices because we have meaningful global economic growth.”

Harcourt’s Baker says that within energy he would recommend being long Brent Crude and short WTI. “In the US, economic growth could go someway towards reducing the inventories of Cushing. That could flatten the curve for WTI, which we have seen recently. But the overarching story for us is one of being slightly more bearish WTI than Brent.”

One contract that Harcourt has made meaningful returns in its Belavista fund this year is Henry Hub natural gas. This again plays into the energy revolution taking place in the US where natural gas prices for front-month futures have surged 79 per cent over the last 12 months to USD5.87/mn Btu. Towards the end of 2013 this was very much a demand story as the US was gripped by a polar vortex.

“We have changed our trading style a little bit and become more tactical in trading natural gas. That’s played out very well for us in the first quarter of 2014,” says Baker who thinks that over the next few months natural gas will become more of a storage-related story.

“If you look at natural gas storage levels there’s been significant depletion of inventories especially against the five-year average. Come April, those inventories will need to be re-injected through to October. The key question will be: how much can production increase? Will higher prices lead to some form of demand destruction? Potentially,” says Baker. A hot dry summer in the US would also lead to greater demand and deplete resources.

“We expect summer contract prices to trade higher and the curve to be flatter. There’s still some reasonable upside in the summer contract price relative to longer dated contracts. In March you could see prices pull back as weather anomalies subside. Prices could fall more for March and April contracts relative to July/August contracts,” explains Baker.

Donora, who confirms that the fund’s highest conviction is in oil-based products, thinks that soft commodities is a market that is bottoming and has some upside potential.
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As the US economy continues to show signs of recovery and Europe begins to stabilise there is growing sentiment that developed markets will have more of an influence on global commodity prices this year.

This is how David Donora, co-portfolio manager of the Threadneedle Enhanced Commodities Strategy is positioning the portfolio, with oil and oil-based products – in particular gasoline – forming the highest conviction sectors.

As Donora explains, a growing US economy will lead to increased demand for gasoline. This has already been borne out by the IEA, which said US oil demand rose by 390,000 barrels a day last year, or 2 percent.

“We are overweight products such as gasoline and distillates. This was our highest conviction play for 2013 and we expect it to remain so for 2014 as we expect the US to pick up momentum (economically),” says Donora.

The strategy employs strong bottom-up analysis with fundamental research to identify investment opportunities across energy, metals and agricultural commodities. Expanding on how the strategy is positioning itself with the energy complex, Donora notes that Henry Hub natural gas prices could fall by year-end, as others are forecasting, but it would depend on a number of factors:

“The challenge for the natural gas market in the US this year is going to be replenishing inventories. We need to prove that for the first time in several years, production as well as the infrastructure is capable of rebuilding inventories from a very low level. We would only make that call (on prices falling) if we have benign weather between now and the end of the year and infrastructure in the US is up to the task. That’s an awful lot of qualifications to meet so right now I would say it’s too complex to call.”

Rather, Donora is more bullish on Brent Crude, WTI, gasoline and heating oil whose forward curves are in backwardation; this is where the spot price is higher than prices for future delivery so the curve is inverted.

“We want to capture that backwardation because it gives us the positive roll return. We position ourselves accordingly in the portfolio to capture both aspects: one is the strong flat price and the other is the roll down.”

Donora believes that the economic recovery underway within OECD countries will result in a cascade effect within broad commodities with oil-based energy the first sector to likely experience positive price momentum.

“Next would be soft commodities. Prices have been too low, to the point where they are cutting into the marginal costs of production. That would in turn cause producers of these commodities, who are largely based in emerging market countries, to cut back on husbandry as well as fertiliser usage. We therefore expect to see a dropping off of production in coffee, sugar,” says Donora.

The third commodity complex to move will likely be grains, followed by base metals and precious metals, says Donora, who elaborates on why precious metals by commenting:

“Investors who were sitting on gold as a safe haven asset are re-evaluating their position and looking to redeploy assets. Usually this is expressed by investing in dollar-based economic activity: US bonds, equities, and infrastructure projects.

“This is a tactical investment shift that we’ve seen happening over the last 12 months and will continue as we believe the US dollar will strengthen for the next few years.”
“We’ve brought our underweight position on soft commodities back up to neutral. We will look more constructively towards soft commodities during the year and position the portfolio accordingly,” says Donora.

One contract that has worked particularly well for Donora is coffee, largely as a result of dry weather in Brazil and concerns over the size of the Arabica crop. Prices have risen 55 per cent year-to-date.

“To put things into perspective, the price was over USD3/lb a few years ago and nearly fell to USD1/lb towards the end of 2013. Having a bounce from that level is not earth shattering but does give some indication to us that coffee prices at this level do not support increasing production.”

Baker confirms that the main conviction in the fund at the moment is short grains. “This is a position we also held last year in the old and new crop contracts of corn. That was quite a strong contributor last year. This year we remain short corn and soybeans and long wheat.”

A recent research note by Capital Economics suggested that both corn and wheat prices could fall below their current level by year-end. But Donora says that whilst that might be possible there are a number of concerns he has:

“Firstly southern hemisphere producers (Brazil, Argentina, Uruguay) would have to flawlessly execute the harvesting and delivery of crops to market. Given the political instability in Argentina right now, I think there are serious question marks on this being achievable. Secondly, you would need to see perfect weather conditions in the northern hemisphere. If such conditions were to be satisfied then fine, but we don’t have any great expectations that will happen so we are not bearish on grains.”

In soybeans and soymeal there is tightness in the market with the soybean forward price for year-end already around 15 per cent below the current spot price. “The curve is in backwardation right now and is a market in which we as commodity investors will enjoy the roll return in both soybeans and soymeal,” adds Donora.

As the influence from developed markets on commodity prices begins to take hold the industrial metal complex could be slower to react than energy and soft commodities.

Many of the industrial metals used in infrastructure development such as copper, aluminium, steel are being consumed, as one would expect, by emerging market countries, of which China is the dominant player. It is predicted that China’s urban population could reach one billion people within the next 15 years and as Baker points out, the shift towards a domestic-based economy in China will support higher commodity prices: “Currently, we remain short on copper but it is an area where we might have higher conviction in the second half of 2014. Per capita consumption for commodities, globally, will continue to grow. However, it is going to be more directed at certain commodities where there are real market inefficiencies like copper, platinum and palladium and to a lesser extent lead and zinc.

“The excess capacity in metals such as aluminium and steel means it’ll be a long time before we see a structural bull market.”

Donora notes that copper production will increase through the first half of 2014 and keep the market supplied and thinks that slower emerging market growth means “we wouldn’t be surprised to see further downside in copper”.

“In the short-term, we think this is more about western economic growth and that it will take a while for base metal prices to recover, even though the US has some infrastructure rebuilding. For most of 2014 it wouldn’t surprise me if we hold a large underweight position in base metals. The slowing of China’s economy and the infrastructure story over there means that the demand driver, whilst still robust, is not increasing as fast as people had been expecting.”

By people Donora means the main base metal producing companies. They cut capital expenditure last year and this is continuing in 2014. However, projects that are delivering more metal into the markets still have momentum and are going to carry through for the first half of 2014.

“We need time for growth in demand to overtake supply and for markets to tighten up. We think that’s very much an end-2014 story. Currently, we have a positive view on zinc and lead and a negative view on copper, aluminium and nickel,” concludes Donora.
China growth continues to support commodity prices

Interview with Jeremy Baker

To countenance the idea that any form of economic slowdown in China could lead to an extended period of depressed commodity prices is misguided. Admittedly, commodity prices over the least three years have been poor. But in the view of Jeremy Baker, Head of Commodities at Harcourt, the events of 08 and ‘09, which led to a structural bear market were more of an “interruption” to the commodity supercycle than anything long-term.

Simply put, the case for investing in commodities remains high says Baker, particularly when placing China at the centre of the argument; something that Baker has written about in detail in a research paper entitled China and commodities – the next stage.

“China was driven by an export-model to the rest of the world. When that model collapsed because of the financial crisis they had to compensate through fixed asset investment into infrastructure and has created the issues we see today. If you consider where China was, where it is today and where it’s going, then I still think there’s significant upside to various commodities - not all. This will relate to ongoing infrastructure development and China’s consumer market as, which I think continues to be underestimated by many external observers.

“The consumer model is going to drive China’s economy going forward as living standards and per capita income levels rise,” says Baker.

That expansion on a long-term basis should provide impetus for consumer demand-related commodities such as grains, meat, and certain industrial metals like copper for high-end infrastructure as well as energy: all have significant growth potential.

It is estimated that China’s urban population will reach a staggering one billion within 15 years. As its economy shifts from the external export-driven model to an inward domestic-driven model, demand for commodities will remain significant.

“The reason I focus on China is because of the combination of industrialisation and manufacturing and the increasing expansion of per capita income," states Baker.

If one were to extrapolate data based on Japan and Korea’s economic growth and apply it to China it suggests there is plenty of room for industrial metal consumption. Copper for example, is around 6.21kg per capita consumption. In Korea it is 18kg.

“Does China go from a model where it is consuming 50% of copper production to 70%? Probably not, but it could go from 50% to 60% consumption. There is that potential for it to increase and I think that’s something that still gets misconstrued.

“People have been focusing on production supply growth in 2014, 2015, suggesting that copper prices should be lower but things are more opaque. I think there are significant supply constraints in copper, zinc (because of the lack of infrastructure development), lead and nickel to some degree.

“If you look at steel, whose core component is iron ore, then no I don’t see a supply issue there. I would say steel is a long-term sell, aluminium also a long-term sell. However, things like copper are still interesting,” opines Baker.

As the Wall Street Journal reported, copper prices in February rose to their highest level in three weeks ($3.286/lb) on the back of encouraging Chinese economic data.

“There is a strong trend for increasing commodity consumption going forward. However, it will be more directed at commodities where there are real inefficiencies in the market: copper, platinum and palladium and to a lesser extent lead and zinc,” concludes Baker.
For many investors, ETFs are fast becoming an effective way to engage in tactical trading. And when it comes to investment tactics, commodities represent one of the most challenging arenas in which to participate. Last year, the Dow Jones-UBS Commodity Index was down nearly -9 per cent. This was reflected in outflows from Exchange Traded Commodities (ETCs).

Already, though, things appear to be picking up. The DJUBS CI is now up over 6 per cent YTD and economic growth in OECD countries is helping commodities slowly move out of a three-year down cycle.

“If you look over the last 10 years, including the underperformance of the last three years, commodities as an asset class have actually outperformed developed market equities on a risk-adjusted level,” states Nicholas Brooks, Head of Research and Investment Strategy at ETF Securities.

“The volatility of the broad commodity complex is slightly less than the S&P 500 index so on an absolute and risk-adjusted basis commodities have been one of the best performing asset classes.”

Much of the reason for recent poor performance, according to Brooks, has been the slowdown in Chinese economic growth from 10 to 12 per cent previously to 7 or 8 per cent more recently.

“The other factor was a supply response to the higher prices over a number of years. We saw an increase in supply across a number of key commodities but we think that outperformance cycle is over.

“That’s why we are slightly more bullish on commodities in 2014. We don’t expect to see performance that will shoot the lights out but we forecast solid high single digit returns as long as we see continued economic growth in developed markets,” says Brooks.

In terms of outflows last year, Brooks notes that gold ETPs were the main casualty but with respect to industrial metals a spike of interest was noted in long copper ETPs (ETFS ticker: COPA) towards the end of 2013. The largest inflows, however, were in US energy infrastructure ETFs prove popular with investors

By James Williams
the ETFS long coffee product (COFF), which tracks the Arabica coffee price.

“Arabica prices fell to seven-year lows last year and that attracted investors. Towards the end of 2013 we saw a large spike in the coffee price and that has continued into 2014. We’re starting to see investors taking some profits on that trade but certainly last year we saw significant inflows into our COFF product,” confirms Brooks.

Another trade that worked particularly well for investors was taking a long position in Henry Hub natural gas. Prices towards the end of the year climbed to USD4.41/MMBtu and have continued to rise in 2014 – reaching USD5.551/MMBtu on 24 February – as the brutal winter in America depletes gas supply inventories.

“We are now starting to see tentative inflows into our short natural gas product, SNGA right now,” adds Brooks. “We think the natural gas price rose too high on the back of the cold weather in the US. We’ve had the short position on now for a while. The price has fallen to $4.90/MMBtu but we think it can go down a lot further as we move into spring.”

The rotation out of precious metals such as gold and silver into more industrial-driven metals such as platinum and palladium indicates that investors are starting to gear up their investments to tap into the economic recovery taking place in the west.

MJ Lytle is chief development officer at Source. Lytle observes that whilst gold sustained substantial outflows in 2013, the fact that the gold price has stabilised in 2014 (it has risen from USD1,195 in December to USD1,334 at the timing of writing) shows that there is still value in gold.

“In Q3 we saw meaningful buying of gold for jewelry consumption in India. When the gold price dropped people bought more of it during the wedding season than they would otherwise have bought. China has also been a meaningful buyer of gold and this has emboldened investors to a degree. There remains, however, a big question mark over where the gold price will go. It’s still range-bound. Investors have lost their conviction that we will see large, sustained moves in the price of gold.

“We’ve seen a change in investors’ gold holdings from 4 per cent to around 2 per cent,” says Lytle.

One area of consensus among ETF providers is that crude oil is proving to be a difficult commodity to call. "I don’t see conviction in the oil price. I think the net consensus is slightly higher but I don’t see anyone calling for big price movements,” says Lytle. The spot price for WTI crude oil has been largely range-bound at around USD100/bbl since last year. Prices spiked at USD110/bbl at the end of August 2013 but have since mean-reverted. The same is true of Brent crude oil, currently trading at USD110.64/bbl.

“We don’t see any major directional change in crude oil in 2014. There’s nothing we can see that will support a breakout. However, one area that is potentially profitable is the closing of the gap between Brent and WTI. With WTI currently trading above USD100 (USD102.82/bbl at the time of writing) the trade would be to long WTI and short Brent,” suggests Brooks.

The energy revolution taking place in the US is obviously an attractive proposition for investors. As already mentioned, natural gas has been a strong performer of late. But commodities are inherently complex. There is no straight-line relationship between the US energy boom and buying ETCs to gain exposure to commodity spot prices. Unless investors are exceptional, trading ETCs tactically to anticipate changes in spot price and volatility is nigh-on impossible.

One alternative to play the energy story is to invest in ETFs that provide exposure to commodity producers rather than the physical commodities. This is something that New York-based firm Global X Funds provides in its range of 11 commodity producer ETFs.

“Miners are perceived as a leveraged play on commodities. Generally if a commodity goes up the mining company goes up more, and vice versa. You saw that earlier this year with the gold price increasing in January while the stock price of gold miners increased significantly more. This was equally true last year when gold producers fell further than gold metal prices,” comments Bruno del Ama, CEO of Global X Funds.

Source’s Lytle says that investors are starting to show interest in the firm’s US energy infrastructure ETP (MLPS LN), an equity ETF that tracks the Morningstar MLP...
ETF Securities has established itself as one of the true pioneers in the commodity ETP arena. Commodities dominate the firm's product suite of 278 ETPs with 100 individual ETCs available to investors.

As to where investors should be focusing their attention in commodities, Nicholas Brooks, Head of Research and Investment Strategy at ETF Securities notes that despite investors' increased appetite for riskier assets - in particular US equities - a straight-line economic growth trajectory is not necessarily guaranteed.

"On the one hand cyclical commodities like industrial metals and platinum and palladium are attracting strong interest because most investors haven't given up on a bullish global macro scenario."

"On the other hand, while everyone was talking at the end of 2013 about gold being a great short, since the beginning of 2014 gold has in fact outperformed most other assets, and we have seen a noticeable change in investor sentiment. True to its nature as a diversifier, so far this year gold has been one of the better performers as equities have dropped. So it appears we are now seeing a more constructive view towards gold," says Brooks.

As a general theme for 2014, Brooks advises investors to remain long cyclical commodities but maintain a position in gold to hedge against any further setbacks to the consensus strong US global growth recovery scenario.

What investors need to grapple with, when looking at commodities, is how much further upside there will be in the US (S&P index gained around 24 per cent in 2013) and Europe versus further downside in emerging markets.

"In our view China will likely sustain healthy GDP growth of 7 to 8% this year despite continued efforts by the government to clamp down on the shadow banking sector," says Brooks. "Commodity prices have had to adjust to the slowdown in China GDP growth from the 10%-12% range and increases in the supply of a number of key commodities over the past three years. However, if recovery in the West continues and China sustains its current growth momentum, we expect demand to drive commodity prices higher.

"The two metals we feel most bullish on are platinum and palladium, both of which are facing large supply deficits. We think those deficits will get larger, eventually forcing prices higher."

"Platinum is often viewed as a strong play on European automobile demand, which appears to have hit the floor. Couple the potential increase in demand with supply issues in South Africa where 70% of supply is produced and platinum could enjoy some upward price momentum according to Brooks."

Then there's gold. Within emerging markets, China still has huge demand for this safe haven asset. This can partially be explained by China's crackdown on its banking system, which is pushing investors into gold. As China liberalises its markets and opens up to the West, import quotas are likely to be relaxed.

"On the base case scenario that the global economic recovery continues in 2014 we think platinum, palladium and copper have good upside potential.

"To hedge against the risk that this consensus view is wrong, we think gold is an attractive choice. The gold price has dropped 30 per cent and is trading below its marginal cost of production so we are at the lower end of the gold price range. For medium to longer term investors, it's worthwhile looking at gold again," concludes Brooks.
“Using commodity prices simply as a way to harness a story [in this case the US energy boom] can often bring the wrong level of correlation. With something like an MLP, which is a company with consistent cash flows, then as long as people are investing in energy infrastructure on the premise that the energy revolution will continue, it will make money and draw off significant cashflows. This is a more direct correlation,” says Lytle.

Indeed, investing in the US energy infrastructure story is a trend that del Ama is also observing. The firm, like Source, offers an MLP and Junior MLP ETF, which invest in US energy infrastructure companies.

“The amount of natural gas and shale gas exploration that’s taking place in the US is incredible. How, though, do you participate in that revolution without getting burned? Clearly, investing in spot or futures-based natural gas prices is risky. It’s going to be a very volatile trade for a while yet.

“In our opinion, a better option is to invest in the infrastructure being built around it, primarily pipeline to storage of natural gas. That type of investment is not driven much by the price of the commodity at all. It’s very much a growth business model and we think that’s a compelling market,” says del Ama.

Aside from offering investors exposure to commodity producers, Global X Funds specialises in highly niche commodities including metals such as lithium and uranium.

“If investors want to make a call as to what the best producers might be within a specific sector like uranium, for example, our products allow investors and managers to make those tactical calls,” says del Ama, who believes that uranium, as a long-term supply/demand story, offers compelling investment opportunities to investors right now.

“We are not massively constructive on industrial metals. The exception to that is uranium. The price displacement that took place following Fukushima went a little too overboard.

“It is clear that we are running at a deficit where the supply of new uranium being extracted is less than demand. It’s a question of when (not if) that price adjustment happens. Even though the industry dynamics are long term the price adjustments have historically been very quick. We are now starting to see uranium prices move upwards and we think it’s a very good time for investors to gain exposure,” explains del Ama.

Year-to-date the fund has attracted USD30mn in net inflows; a decent level considering the fund is less than USD200mn in AuM. The supply constraint is due to various mining projects being put on hold, even though demand remains supportive with China continuing to build nuclear reactors.

It’s an interesting area of the commodity space, and a useful diversifier for investors who want to avoid both direct exposure to spot prices and to more ubiquitous industrial metals such as steel and aluminium.

One metal that Brooks says ETF Securities still favours is copper, citing an overestimation by analysts on the amount of supply coming into production in 2014.

“Analysts have extrapolated supply figures based on historical data but we think there could be some supply issues in 2014. We also think demand will remain strong both in China and the US. Copper inventories in Shanghai Futures Exchange (SHFE), London Metal Exchange and COMEX have been declining steadily which suggests that there is more demand than supply in the market.”

Brooks says that if the glut of aluminium in the market starts to reduce it could be worth paying attention to but warns against trying to catch a falling knife; that is, if aluminium prices were to improve initially they could very easily reverse. There are no signs of price improvement yet, however, with oversupply actually forcing firms like Alcoa to close its Point Henry smelter in Australia. At USD1,765/tonne, aluminium prices for three-month delivery on the LME are 43 per cent lower than in 2008.

Although still not high on investors’ minds, there are interesting ways to gain exposure to commodities via ETFS. US energy infrastructure could well be a story for investors to pay close attention to going forward.