# Resources & Commodities – Is it now time to re-think!

**Dr Stephen Bartrop**
Breakaway Investment Group

2014 and 2015 to the end of September has been plagued by weak commodity demand on the back of softening world growth, particularly in China, and a lack of meaningful production cuts which has led to building inventories.

Bulk commodities, particularly iron ore, dominate the earnings of the major miners and stoic statements by iron ore miners like Rio Tinto that China with produce 1 billion tonnes of steel by 2030 are met with undermining by Chinese predictions of lower production rates and market disbelief. However, is this really market disbelief or is it that the market doesn't really care now what the demand is in 2030 but rather sees a short to medium term outlook of increasing production into potentially stagnant demand?

While thermal coal supply has been weaker in response to the softening demand, the metallurgical coal market still remains well over supplied and waits for US supply cuts which may never occur.

So what has changed? In base metal markets Glencore surprised the market with both copper production cuts (400ktpa) and zinc production cuts (500ktpa) – the zinc cuts announced only on the 9th October and before London Metals Exchange Week. Commodity prices rallied on the back of the announced cuts but importantly it potentially pushes both the copper and the zinc market into deficit next years.
Indeed while the volatility in the Glencore share price reflecting its debt position may have stimulated Glencore into this action, it nevertheless provides an important catalyst to these commodities markets – in the very least it now makes it high risk for hedge funds to short these markets.

*Breakaway* is of the view that while the bulks may go nowhere for some time, it is the base metals (and in the short term, gold) that may signal the start to an upswing to a steady recovery without the exuberance of the 2003 to 2007 cycle. In traditional commodity upcycles, there is a pattern for commodities to move in sequence: initially gold followed by base metals and then bulks. Oil often moves with gold to reflect inflationary movements potentially occurring at that time. Minor metals are more complicated and follow individual supply/demand fundamentals – in some cases a function of new technology and also supply dynamics from China where China dominates supply.

In terms of sequencing of commodity price movements in normal cycles, this time there are variations:

- **The very low interest rate environment and the likelihood that the US will raise rates during the remainder of 2015**
- **New sources of oil from shale oil and gas, particularly in the US and its impact on energy supplies**
- **Increasing investor negativity towards thermal coal production, particularly from University funds**

**Throw into the mix the relentless increases in iron ore production by the majors and you have a commodity cycle that may be slower and more selective in its participants.**

**So what about world growth projections…**

The International Monetary Fund has recently published *The World Economic Outlook* with a subtitle, *Adjusting to Lower Commodity Price.*
This is an important report as it sets a base line for investors to contemplate what resource movements might occur over the next two years and while this view is subject to frequent revision, investment risk has moved to one of timing rather than a risk of further commodity price and resource market falls – *in certain commodities!*

Our first analysis is the composition of world growth which itself defines where the commodity demand may occur.

| | | Projections | |
|---|---|---|---|
| | **2014** | **2015** | **2016** |
| World Output | **3.4** | **3.1** | **3.6** |
| | | | |
| Advanced Economies | **1.8** | **2.0** | **2.2** |
| *Including* | | | |
| US | 2.4 | 2.6 | 2.8 |
| Euro | 0.9 | 1.5 | 1.6 |
| Japan | -0.1 | 0.6 | 1.0 |
| UK | 3.0 | 2.5 | 2.2 |
| | | | |
| Emerging Market and Developing Economies | **4.6** | **4.0** | **4.5** |
| *Including* | | | |
| Russia | 0.6 | -3.8 | -0.6 |
| China | 7.3 | 6.8 | 6.3 |
| India | 7.3 | 7.3 | 7.5 |
| Brazil | 0.1 | -3.0 | -1.0 |

*Source: World Economic Outlook October 2015*

The forecasts are encouraging as the clearly highlight an improvement in 2016 from what is a considered a low point in 2015. However the drivers of this growth differ between the Advanced Economies and the Emerging Economies as summarised from the IMF as follows.

**Advanced Economies**

The IMF forecasts growth in advanced economies to increase modestly in 2015 and 2016. The IM highlight that 2015's developments reflect primarily a strengthening of the modest recovery in the euro area and a return to positive growth in Japan, supported by declining oil prices, accommodative monetary policy, and in some cases, currency depreciation. The pickup in advanced economies is tempered by lower growth in commodity exporters—particularly Canada and Norway—and in Asia outside of Japan (in particular, Korea and Taiwan Province of China). Unemployment is declining, but underlying productivity growth remains weak, including in the United States, where the recovery is more entrenched. This heightens concern about the medium-term outlook. Some pickup in growth is expected in 2016 (especially in North America), but medium-term prospects remain subdued, reflecting a combination of lower investment, unfavourable demographics, and weak productivity growth.
The recent further decline in oil prices, as well as in prices of other commodities, should support demand in the majority of advanced economies that are net commodity importers,
but the slowdown in emerging markets

**Emerging Economies**

The IMF reports that growth prospects in emerging markets are very different across countries and regions, but the outlook is generally weakening, with growth projected to decline for the fifth year in a row. This reflects a combination of factors:

- weaker growth in oil exporters;
- a slowdown in China with less reliance on import-intensive investment;
- adjustment in the aftermath of credit and investment booms;
- and a weaker outlook for exporters of other commodities, including in Latin America, following declines in other commodity prices,
- geopolitical tensions and domestic strife in a number of countries.

What encourages Breakaway is that the outlook factors in declining rates of growth in China. However when we look at the areas that are actually forecast to drive the growth they come from economies like the US and Euro zone where there is tangible evidence that this is occurring. There what are the potential surprises?

We think they are:

- Advanced economies do not meet growth expectations – we think this is unlikely  but if it does occur it is more likely to push out growth forecasts rather than generate sentiment towards a recession
- Chinese growth may surprise on the upside.
  We believe that while the Chinese economy is slowing, the Government is actively taking measures to boost growth while at the same time ensuring that data released at least meets market expectations.

We believe this combination of risks tends to be skewed more to the upside than downside.
There is no doubt short term volatility will continue and which is expected at this point in the cycle when economic data is variable. It is also being enhanced by the expectation that US Fed will raise rates by the end of 2015 and many believe it should have occurred already.

From an investment perspective now is the time to dabble in a few shares although the better approach is to acquire advanced mining assets as most companies are still feeling the pain of low commodity prices while the market is already anticipating a modest recovery in 2016.

**Dr Stephen Bartrop**
Executive Director
**Breakaway Investment Group**
Suite 505, 35 Lime Street
Sydney NSW 2000
Australia
t: +61 9392 8010