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Reports Of Commodities Bull Market Demise May Be Greatly Exaggerated

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Oil Drilling Platform in the Santa Barbara Channel (Photo credit: mikebaird)

It has been a powerful bull market in commodities. So impressive, many refer to it as “the super-cycle.” Driven by insatiable demand from China and other developing nations, cheap money courtesy of the Fed and lack of investment in the previous cycle, commodities have been the place to be for over a decade. Oil prices are up five-fold since the late 1990s, iron ore is up seven times and most agricultural commodities have more than doubled. Gold, as attested to on AM radio and in late night TV commercials, also enjoyed a bullish ride and is up over five times its price in 2001.

Now, if you believe the commodity bears, this super-cycle is over. Their argument: China’s economy is permanently stuck in a lower growth mode and Beijing’s focus has moved from building infrastructure to stimulating its consumer economy. This will slacken demand for commodities, the argument goes, and put downward pressure on prices. The big investment banks have published unequivocal research supporting this view including Citi’s, “From Commodities Super-cycle to Unicycles,” and Deutsche Bank’s, “Trading the Commodity Underperformance Cycle.”

This thesis has gathered steam as commodity prices have fallen. Since Labor Day 2011, gold has dropped by 34%. Many other formerly hot commodities haven’t fared much better.

The bear case makes sense if you believe in the theory of reversion-to-the-mean. This is the idea that asset prices, or other price points, inevitably return to their long-term historical averages. An old adage says the cure for high commodity prices is higher commodity prices. The idea is that higher prices will destroy demand, thereby leading prices lower.

The bullish case also calls on history for its thesis. The average length of prior commodity super-cycles is 30 years, according to Professor Ocampo of Columbia University and others. If history is a reliable guide, then the current cycle is only half over and the super-cycle is just entering a less intense phase.

Bulls point out the super-cycle's death has been wrongly pronounced before, most notably by the World Bank during the 2008 financial crisis. They argue that recent steep price corrections are already creating new demand for storable commodities and have resulted in production cuts that will reduce supply. In just Australia alone, according to the Bureau for Energy and Research Economics, resource projects worth $146 billion have been cancelled or delayed over the past year.

Bulls maintain spare capacity is tight and geo-political supply risks are increasing. They say the potential effects of China's shift in policy have been overblown and global growth and inflation rates likely are bottoming. As the global economy improves, so too will commodity prices.

Our analysis considers both these theories and what it means for the world if the super-cycle is indeed over. Mining companies, oil and gas groups, and agribusinesses would all be adversely affected. There would be a negative domino effect for the companies that serve these industries including commodity exchange operators, equipment makers, portable housing manufacturers, and transportation groups. In the same vein, countries directly dependent on natural resources for their prosperity including Australia, Chile, Canada, Brazil and Saudi Arabia are fair game for reassessment. Are they doomed given the potential for a negative multiplier effect? Does Saudi Arabia tumble due to civil insurrection caused by economic depression? Does the Canadian loonie go to something like 50 cents?

In diversified economies like the U.S., the end of the super-cycle would create winners and losers. Implicit in the death of the super-cycle argument is that globalization is dead. This is important to commodity prices since they have risen in lock-step with the removal of barriers to trade over the last few decades.

The end of globalization is not impossible to imagine as it happened a century ago when the U.K. decided to go to war against its biggest trading partner, Germany. It is, however, a low probability event. Arguably for American blue chips, the super-cycle's demise would be more of a headwind than a benefit given something like 40% of the earnings of the S&P 500 Index comes from outside the US, according to Deutsche Bank.

The death thesis also must include a belief that the rise of the global middle-class is over since their aspirations cannot be achieved without the inexorable need for energy, better food, water and infrastructure to support it. We doubt that governments from Bangkok to Brasilia to Jakarta will be able to turn a deaf ear to the aspirations of their awakening and increasingly better informed populace. Recent civil unrest in the Middle East and the developing world in general underscores that people everywhere want more, not less, today. If their rulers want to hold on to power, they will have to deliver on increased expectations.

We believe globalization is alive and well and Pax Americana is not going away. We also believe people in the developing world will continue to demand a better life and their governments will continue to seek to provide them with the infrastructure needed for prosperity. In short, reports of the commodities super-cycle's death may be greatly exaggerated and we smell opportunity in the recent price declines.

We are always attracted to "misery." Our favorite exercise is scanning the new low list in search of potential bargains. Currently we note share prices of quality diversified mining firms have declined over 25% this year versus a 12% rise in the S&P 500 Index.

Gold shares have been even more of a disaster: a proxy for gold mining shares is the Market Vectors Gold Miners ETF (GDX) and that is down 50% year-to-date. Oil and gas shares have generally underperformed the stock market this year but are up slightly in price. The same is true generally for shares of most Agribusinesses except for fertilizer companies and farms, down slightly on average. Shares of some companies involved in global infrastructure are at bargain level with deep-recession valuations.

Our strategy is to be realistic, discerning and opportunistic while maintaining a margin of safety. We assume commodity prices will languish, or go even lower and stay there for a while. Nonetheless, we are excited by the long term opportunity created by these lower share prices.

We believe careful investment selection trumps random diversification and rarely has it been truer than today with respect to mining stocks. We reject owning ETFs because if prices go lower and stay there for an extended period, particularly for the junior gold miners, there will likely be many bankruptcies.

Our strategy is to own companies with stronger balance sheets, lowest costs of production and diversified businesses. There are a few companies that meet these criteria but we find Swiss-based Glencore Xstrata (GLNCY) particularly interesting due to its money-making culture and its valuation at roughly tangible book value and dividend yield of over 3.7%. Separately, in the junior mining sector, McEwen Mining (MUX) is a speculative purchase worth considering given the CEO's track record, his 25% ownership stake, and a debt-free balance sheet coupled with a 40% discount to its tangible book value of $2.97.

In the oil & gas business we also favor the big diversified companies with solid balance sheets. We like sedate old Royal Dutch Shell (RDS.A) due to its 5% dividend, high credit ratings and 7X P/E multiple. Two Agribusinesses worth considering for the long-term are Mosaic (MOS), the leading fertilizer company, and SLC Agricola (SLCJY), owner of one of the world's largest publicly traded farms located in Brazil. Clearly investing in an emerging market is risky, and the ADRs are thinly traded, so one must be careful with this name.

Finally, in global infrastructure Singapore-based Keppel Corp (KPELY) is involved in offshore oil-rig construction; environmental engineering, power generation infrastructure and property development. It pays a dividend of 4.4% and sells for 10 times earnings. GDF Suez (GDFZY) is a global leader in infrastructure with impressive power generation, waste management, water distribution and natural gas assets. The Paris-based company currently pays a dividend yield of 7%.

The author of this commentary and/or his clients owned the following positions discussed in this commentary GLNCY, MUX, RDS.a, SLCJY, MOS, KPELY and GDFZY.

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