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Investing in a low growth environment.

The Investment Report.

Global Resources

It's a cycle but we are getting closer to the bottom....

Global resources equities and commodity prices are cyclical in nature. For the first decade of this century high prices provided both the incentive and funding for new projects and expansions. In some sectors, the timing of this new supply coincided with a slowing rate of growth in demand from China. Commodity prices were pushed lower, weighing upon investor sentiment.

The following five years have seen commodity prices decline to a level where a significant proportion of the industry is struggling to generate free cash flow. Producers are being forced to respond aggressively; cutting costs, jobs and high cost production. Later cycle, consumer-oriented commodities such as base metals, precious metals, diamonds and oil have the best potential for price recovery in the medium term, in our view. Bulk commodities like iron ore, coal and steel are likely to remain in over-supply for longer, despite recent supply discipline.

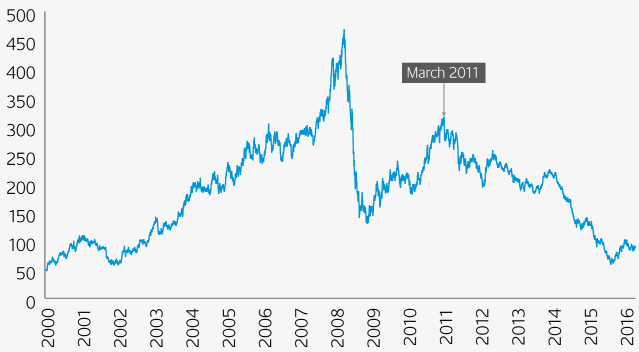
History suggests global resources equity turning points are often sharp and sudden, as evidenced by strong share price moves this year. Unfortunately few can predict when this will occur.

To reduce risk, we invest in quality companies that we believe can survive the cycle. We look for robust margins, strong balance sheets and rich geological endowments. These elements should provide the flexibility for a company to adapt to changing conditions, allowing it to weather an extended downturn and prosper when conditions improve.

Commodity prices have rallied

Global resources equity and commodity markets have rebounded from multi-year lows that were experienced at the beginning of 2016. The Bloomberg Commodity Index (Chart 1) is up by over 5% this year (to 31 August 2016 in USD terms), but is coming from a low base. The recovery has occurred across a broad range of equities, with precious metals seeing the greatest gains.

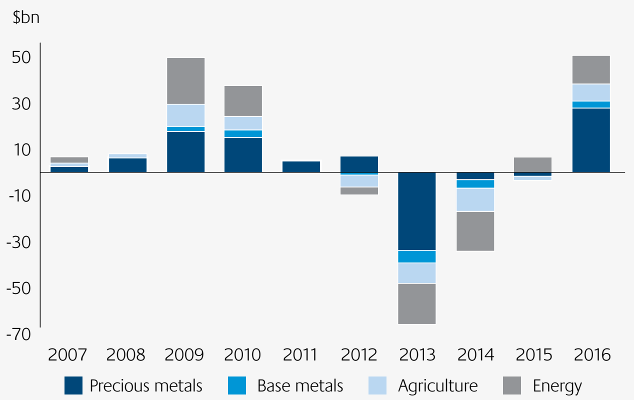
Chart 1: Bloomberg TR Commodity Index 2000 – 2016 YTD



Source: Bloomberg, in USD as at 26 September 2016. Past performance is not indicative of future performance.

There has also been a jump in investment flows, indicating increased investors optimism. According to Barclays, commodities saw investment inflows of US$54 billion (bn) between January and August, an all-time high for the first eight months of the year (see Chart 2). If the current trend continues, 2016 will mark the first year of net inflows into commodities for the first time in four years.

Chart 2: Commodity investment inflows by sector



Source: Bloomberg, ETP issuer data, Barclays Research.

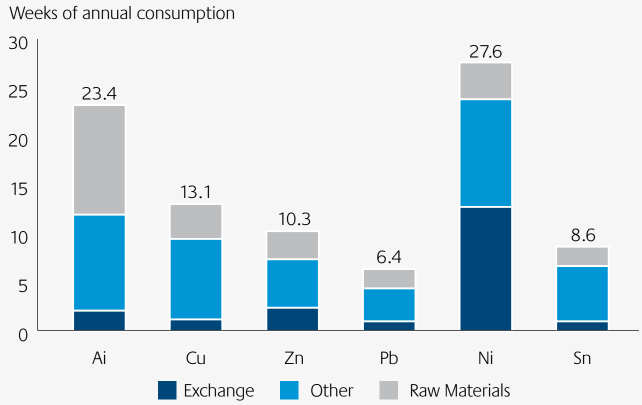
Previous periods of commodity price rises and increased investment flows were accompanied by strong global demand growth and supply constraints. However, neither of these are a feature of current market conditions. While demand has improved following credit stimulus in China, most commodity markets remain oversupplied, which suggests prices could move lower in the short-term. Ultimately, the cure for low prices, is low prices.

The outlook for global resources in the coming months

While some commodities are experiencing a rebalancing of supply and demand, given the recent run up in prices we are cautious on the outlook for most metals and bulk materials if global industrial output remains subdued. Precious metals are more difficult to forecast. Gold, in particular, is quite different to the other commodities because very little of it is consumed, and as a result, investor sentiment will always be the main driver of the price.

In our view, miners have made significant progress adapting to this lower growth and often oversupplied raw materials environment, scaling back or closing high cost operations to help reduce costs. Despite this improvement, inventory overhang still exists across several base metals. Ultimately, the supply response is going to be critical for the direction of commodity and equity prices in the short-to-medium term.

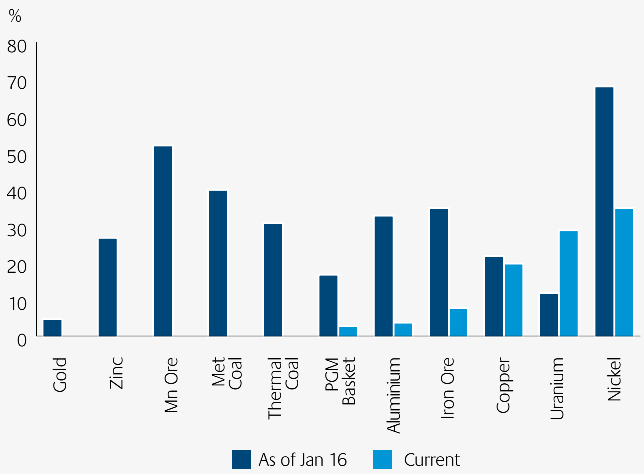
Chart 3: Estimated total stocks for base metals to end-August 2016



Source: CRU, IAI, Worldsteel, Macquarie Research, September 2016.

Whilst supply can be 'sticky' for a number of reasons, a cash negative operation cannot persist indefinitely. As shown in Chart 4, the proportion of commodity producers losing cash has declined in recent months. This has been driven not just by higher commodity prices, but by closures and cost control.

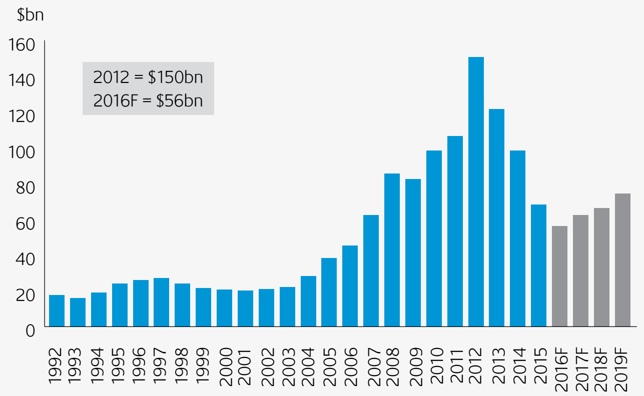
Chart 4: Proportion of supply losing money – cash basis



Source: Wood Mackenzie, CRU, HIS, Government data, Macquarie Research, September 2016.

The majority of major mining companies have aggressively reduced operating costs and capital investment. Companies with high debt levels have been selling assets and raising capital to repair their balance sheets. We expect to see miners continuing to adjust their operating and financial practices to ensure survival in a lower price environment.

Chart 5: Global mining expansion capex



Source: Company data, Wood Mackenzie, Macquarie Research, September 2016.

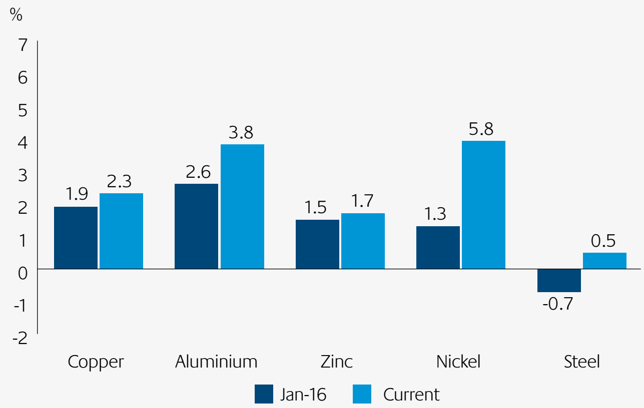
At this juncture in the cycle, we would normally expect merger and acquisition activity to increase, the weakest producers to shut down production and supply-demand fundamentals to boost commodity prices.

Whilst we have seen the first leg of the long-awaited supply cuts announced, the recent uptrend in commodity prices and the downtrend in costs, aided by weaker producer currencies and lower energy prices, has provided enough breathing room for some marginal producers to survive. In the steel sector, we are starting to see some idled capacity restart as a result of improving margins. However, we believe a number of commodities are still in oversupply. Therefore, at some point, commodity prices will need to move lower to result in the supply cuts required for balanced markets.

Current demand, and hence prices, for most metals and bulk commodities are being supported by Chinese stimulus measures. Coal and steel are also receiving support from Chinese government policy targeting overcapacity in the local industry, forcing a reduction in domestic supply. In our view, if this support is withdrawn, the price for many commodities will weaken, especially steel and thermal coal. Under that scenario, 2017 may see further cuts in production, capital spending and dividends, as well as balance sheet restructurings and asset sales. For pricing tension to return, more needs to be done to address oversupply.

Demand for commodities has moderately improved, despite global economic activity being lacklustre. Commodity demand has been supported by China's manufacturing and property sectors. Even further downstream, sectors such as China's automobile industry are also seeing financial conditions improve. If the benefits of government stimulus continue and we see further investment by the private sector in the property sector in particular, this will be supportive for commodity prices.

Chart 6: 2016 demand growth expectations



Source: LME, Platts, CRU, Bloomberg, Macquarie Research, September 2016.

Increased US unconventional oil and gas production, combined with the removal of sanctions on Iran has resulted in additional oil supply, reducing price tension. In the absence of any major geopolitical disruption in the Middle East or Russia causing concern over security of supply, we think energy prices are likely to remain around current levels for several years.

Our current portfolio positioning

Despite a mixed outlook for commodity prices, there are still attractive investment opportunities in the metals and mining sector because we expect to see a wide dispersion in returns among industries and companies. We maintain a well-diversified portfolio representing as many commodities as possible, where we can find good quality companies or exciting growth opportunities.

At this point in the cyclical recovery, large cap miners and energy companies need to continue to demonstrate capital discipline and to maximise free cash flow. Amongst the mid-cap and intermediate producers, high asset quality, low costs and balance sheet strength are qualities that we emphasise. Smaller companies are inherently higher risk, and small positions can make a meaningful impact upon the portfolio. Catalysts such as exploration success, permitting and development, as well as operational turnarounds, are considered amongst the acorns in the portfolio.

A sustained low interest rate environment has been supportive for precious metals over base metals and bulks. Future actions by the US Federal Reserve will be key to investment demand for precious metals. Platinum and palladium are also benefiting from this, with growing support from a rise in global automobile demand.

Despite closure of some high cost domestic iron ore production in China and the curtailment of global swing production entering the export markets, the world remains structurally oversupplied as a result of new, relatively low cost supply coming from Australia and Brazil. In thermal coal export markets, any gap between Chinese domestic supply and production will have major ramifications for price. After years of loss making by its domestic producers, it would appear that the Chinese government policy is directed towards greater pricing stability. The aim is to underpin margins for efficient producers, whilst not encouraging new capital investment.

Amongst the base metals, the medium-term outlook for zinc and nickel appear more favourable. Closure of the large scale Century zinc mine in Australia and smaller operations in Ireland indicate a potential deficit for this metal. Political developments in both Indonesia and the Philippines to restrict the environmentally damaging export of nickel laterite ore to China will help to reduce the relatively large inventory of the metal.

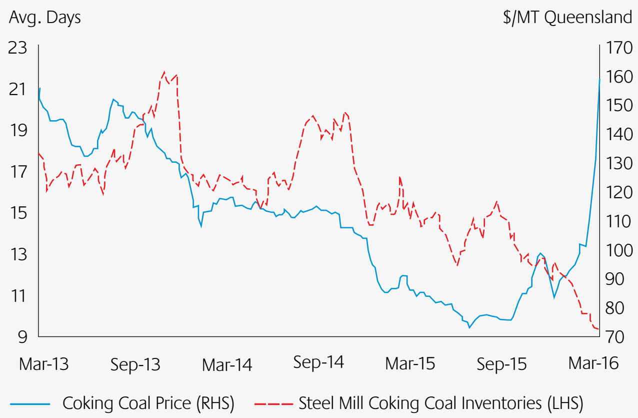
The energy sector offers a wide range of choices from major integrated players, regionally focused exploration and production companies as well as service providers. The latter sector has borne the brunt of the fall in energy prices. Exploration spending is the easiest thing to cut when cash flows are less than planned. The dramatic fall in demand for drill rigs and pressure pumpers over the last few years has devastated this industry. As the industry begins to readjust its business to the ‘new norm’ of oil prices closer to US$50 a barrel than US$100 a barrel, only the strongest and best will survive. We expect to see the negativity towards this sector reduce as a result of this rationalisation.

What could surprise on the upside?

China remains by far the largest consumer of mined commodities and the second largest consumer of oil and gas. In general, demand has remained robust, growing in absolute terms. However, the rate of growth has declined.

Market sentiment towards China turned very negative in 2015. In response, the government boosted demand through policy support to the industrial sectors of the economy. While we would have expected Chinese stimulus measures to have faded by now, it looks increasingly likely that demand will hold up until year end or even into early next year. China’s manufacturing and property sectors are leading the charge.

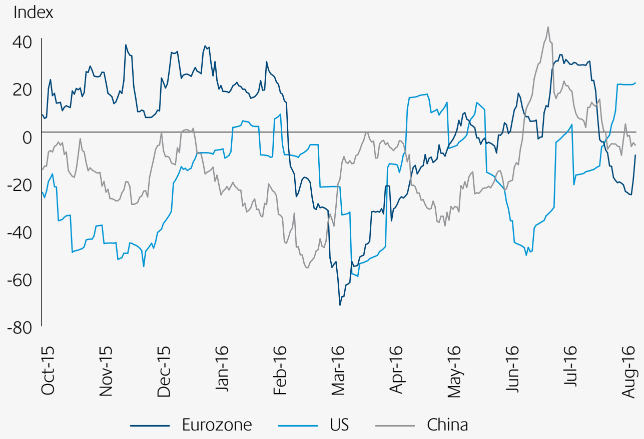
Chart 7: Coking coal prices rebound sharply in response to supply constraints



Source: Clarksons Platou Research August 2016.

Better-than-expected economic data releases and resilient demand this year have somewhat eased concerns around the potential for a ‘hard landing’ in China. The situation in the country remains uncertain, but if China continues to improve then this would likely see the mining sector surprise on the upside. A sustainable economic recovery in the US and Europe would lend further support for commodity prices.

Chart 8: Economic surprise indices turn



Source: Citi, Macrobond, Macquarie Research, September 2016.

The biggest risk to our view

The bounce-back in commodity prices and mining equities occurred very quickly and unexpectedly. Most generalist investors were caught off-guard as the Chinese boosted stimulus. In response, investors and speculators quickly reduced their short positions and slowly began to increase their exposure to commodities. Our concern is whether this momentum continues amid continued excess supply. While we are already seeing signs of the market re-balancing it is going to take time before we see more sizable supply rationalisation.

Seasonality is also a concern for us. We have passed the typical commodity peak in trade flows, production rates and deployment. Metal processors usually commence de-stocking in the September quarter, prior to the northern hemisphere winter when construction rates usually slow. A pullback in bulk commodity prices is likely with steel and steelmaking raw materials like iron ore and coking coal most vulnerable, given their somewhat elevated levels.

A stronger US dollar (USD) has historically been a headwind for base and precious metals prices. Should the USD strengthen due to rising US interest rates, this would likely have a negative impact on the USD-denominated commodity prices. However, it is important to note that should the USD strengthen due to increased safe haven buying, this would continue to be a supportive environment for precious metals.

In a low inflation and low global growth environment, should investors consider a global mining strategy?

We have all heard economists using the phrases “new normal”, “lower for longer” and “secular stagnation” to describe the current low growth and deflationary economic environment. This could equally apply to the mining sector as it rebalances in response to falling prices and oversupply.

As stock pickers, we are always looking for opportunities to invest in quality mining companies that have a better than average opportunity set to create value for their shareholders. Our oak trees and acorns approach, with a portfolio of high quality majors combined with high growth stocks can deliver better than average returns with less risk throughout the cycle.

Whilst inflation is expected to remain low for now, investing in mining and energy equities may provide a hedge against inflation and deflation.

Worries about global economic growth and negative interest rates has increased demand for gold, as has the desire of investors to benefit from volatility in individual commodities. Gold has been by far the single most popular commodity investment in 2016, with flows into physically backed exchange traded products climbing to a net US$27bn according to Barclays.

Commodities have historically had a negative correlation with the USD, providing currency diversification as well. When the USD is rising, commodities tend to underperform, but when it is falling, commodities can do well.

Mining equity performance historically has run counter to overall equity performance in the last five years, so the sector can be a hedge against weak secular performance in overall global equities, providing portfolio diversification. It is prudent to have some allocation to resources through the entire cycle because of the diversification benefits the sector provides.

The long-term underweight position in metals and mining equities that investors have held for a number of years has been gradually decreased over the course of this year, providing positive momentum. We expect investors to continue to seek alternative assets, such as natural resources, as they continue to hunt for ‘hard assets’ and yield in an era of historically low interest rates.