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Policy Triumvirate Accelerates Opportunity in Global Natural Resources

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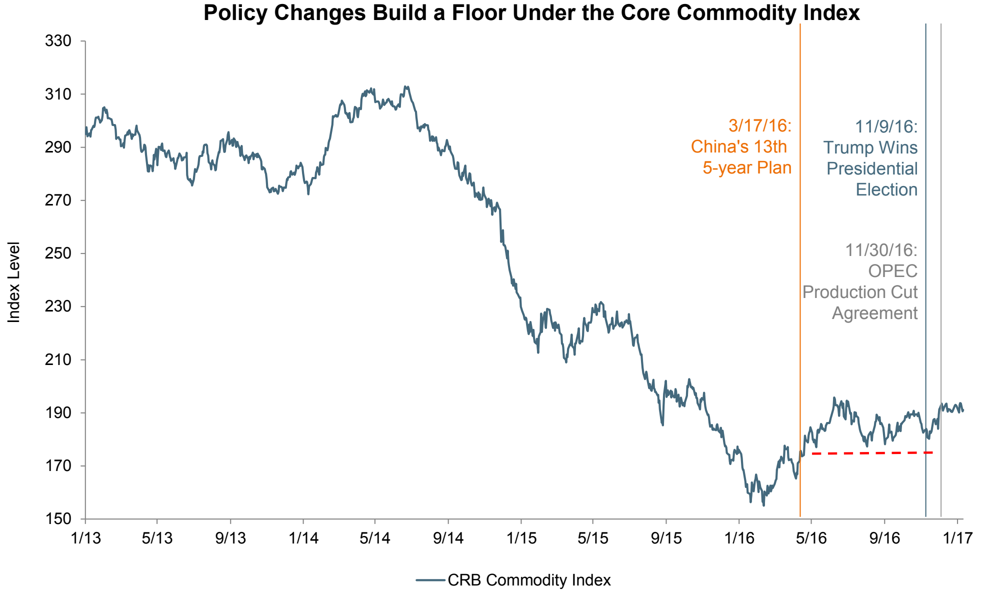
While our commodities-first approach focuses on supply/demand fundamentals, recent political events have accelerated a natural resources recovery. Full repercussions are still unknown, but coming through a fundamental trough is quicker when policy helps it along.

China's recent reforms, OPEC's promised production cuts and the election of Donald Trump have cemented the final stages of the commodity correction. Policy has likely truncated downside risk and is now enabling investors to think more constructively about the future.

Since 2009, commodities have been contending with a Chinese demand-binge hangover. Free-flowing capital fed voracious demand, which created a buildup of excesses that we are only now burning off. Balancing forces have been at play, so the commodity recovery had been sporadic.

This unlikely triumvirate has catalyzed an inflection in commodity prices that will likely continue for years to come. Reversal of deflationary pressures and a resumption of capital deployment will lead to inflationary pressures, and global natural resource equities directly benefit from gradual rises in commodity prices.

Policy Changes Build a Floor Under the Core Commodity Index



Source: Bloomberg, 1/1/13 to 1/10/17.

Chinese Reform

In March 2016, the National Development and Reform Commission (NDRC) published their thirteenth five-year plan, which emphasized supply-side structural reform to improve competitive fairness, efficiently satisfy growth, improve overall quality and enhance adaptability (cut overcapacity and reduce leverage).

Steel-Making Coal Prices Adjust on China's Policy Changes

Source: Bloomberg, 5/2/13 to 1/10/17.

The policy initially targeted coal; illegal mines were forced to close, and the NDRC restricted the number of days that legal coal mines could operate from 330 days per year to 276 days. With Chinese capacity effectively cut from 5.0 billion tons to 3.2 billion tons, a price response began globally given the country's 50% share of global annual consumption. Prices have climbed 85% higher for thermal coal and 290% higher for metallurgical coal through December 2016. China has since relaxed the 276 mining day restriction, but we estimate illegal mines producing 1 billion tons of coal remain shut, creating a structurally higher level price for coal and, consequently, finished products like steel.

Trump Effect

Information flows faster than a Twitter feed, but one thing is certain: all three branches of the government are likely to be more favorable for the industry. At this time, it is unclear what specific rules may change, but we expect leadership changes at the Environmental Protection Agency (EPA) and Federal Energy Regulatory Commission (FERC) to support energy and power market development. Congressional changes could have a wide-ranging impact on trade, tax and repatriation, not to mention fiscal stimulus. Changes in the Judicial branch could also alter the prevailing legal climate.

OPEC Agreement

On November 30, after weeks of tense speculation in the oil market, OPEC reached a firm decision to cut production by 1.2 million barrels per day (b/d). A sequential accord with some non-OPEC producers, principally Russia, to cut production by an additional 600,000 b/d added fuel to the upside surprise and took total cuts to 1.8 million b/d. This was the first time that OPEC and non-OPEC countries agreed to simultaneously cut production since 1998. Oil prices rallied by more than 15% over the course of the following three days.

Given the history of OPEC production cuts, we believe it is unrealistic to assume participants will adhere to the full 1.8 million b/d cut. If achieved cuts amount to only half of this level, the crude oil market will experience balance, and perhaps even a deficit, in the first half of 2017. OECD inventories, currently about 15% above historical averages, would experience drawdowns, which would support oil prices. More importantly, we believe OPEC action creates a psychological floor for oil prices at around $50 per barrel and prices will continue to creep upward toward $60 per barrel over 2017.

2017 Outlook

Clearly, these three policy inflections caused equities to respond, but we continue to expect strong compound returns from commodity-linked assets. We believe the entire universe has ample upside as companies are leaner, less leveraged, consolidated and now stabilizing due to increasing revenues. Even so, the path forward is more complicated.

To identify areas of outperformance in 2017, we are scrutinizing cyclical and secular trends. We expect cyclical stories to play out sooner, but for now, they remain attractive and balance out our portfolio. However, we are beginning to favor longer-term secular stories in preparation for the next phase of the cycle. As streamlined supply grows ahead of demand, additional volumes will moderate price growth, but companies with value-added bottlenecks should exhibit superior secular profitability growth. The recent severity of cyclical pressure on secular growth stories has created multi-decade value opportunities in companies leveraged to commodity volumes, not necessarily prices. The potential to generate alpha abounds, and we believe exemplary fundamental analysis is necessary to unravel the implications from policy shifts.

About the Authors

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Robin is a senior research analyst on The Boston Company's Global Research team, covering the energy sector. He is also the lead portfolio manager of The Boston Company's Global Natural Resources strategy, which takes a bottom-up macro approach to investing. In addition, he serves as a member of the Global Insight team, a group of the firm's investment leaders. He holds a B.S. from Lehigh University and an M.B.A. and an M.S.F. from the Carroll School of Management at Boston College.

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