FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

25 November 2022
Volume 1163

Seeking the truth behind commodity drivers

Author: Chantelle Baptiste, Senior Equity Analyst, Fairtree

Human emotion can be an overriding factor when making an investment decision. The elation of being right on a stock call can create confidence and greed. Likewise, the pain and shame experienced when your call goes against you, breed fear and resentment. We often experience the latter in the cyclical part of the market, most pronounced in resources or commodities.

Let's revisit the basics. A commodity is a physical good that is traded – traded, not held into perpetuity. In fact, the value of any good is only realised when it is exchanged for an amount the market is willing to pay for it. If you want to generate alpha in resources, it's imperative to be active to trade them. In economics, a commodity is an economic good, usually a resource, that has full or substantial fungibility: that is, the market treats instances of the good as equivalent or nearly so, with no regard for who produced them.

I believe there is much opportunity and much alpha generation potential in the resource part of the market, and here are three key basic concepts to consider when investing in these cyclical sectors:

- **Different commodities are less correlated than what investors may think.**
- **Long-term commodity forecasting is pointless.**
- **Resources are politically agnostic.**

Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider
Glacier Management Company (RF) (Pty) Ltd is a registered and approved Manager in Collective Investment Schemes

This document is intended for use by intermediaries. The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be dependable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness, or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients.

1. Sub-sectors of resources have low correlations.

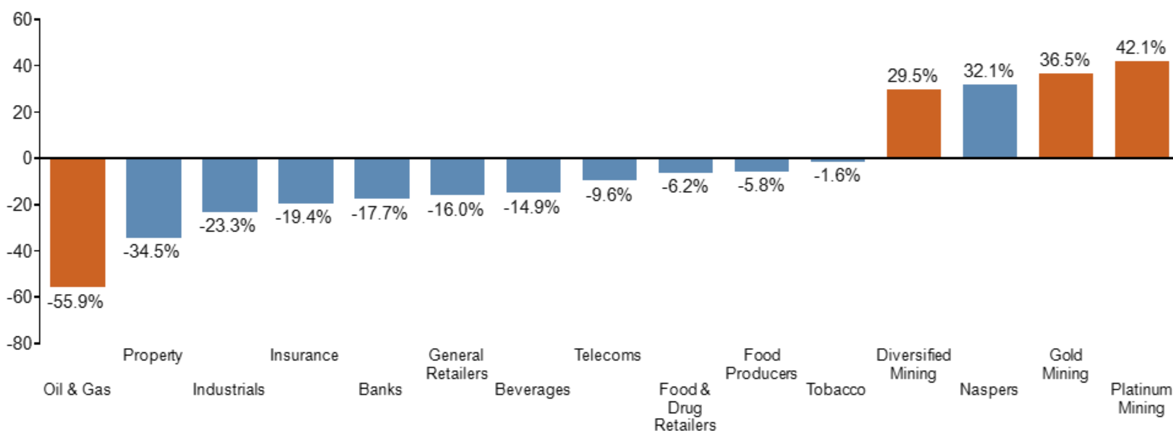
Investors generally group resource companies or commodities together based on their cyclical nature when analysing stocks. This broad-brush stroke approach results in the perception that all resource companies are correlated and move in tandem. If the global environment is slowing or even signalling a recession, then you should not have any resource exposure, given the correlation between global growth and commodity prices. Yet this is not the case, as illustrated in Figure 1 and Figure 2 below.

I use two examples of when recessionary fears were elevated: in 2020 during pandemic fears and in 2022 during heightened inflation, tight monetary policy, and very weak growth in China.

In the graphs below, I highlight a few key resources counters in orange and want to demonstrate that although they all fall within the same grouping (resources), they have performed in polar-opposite directions.

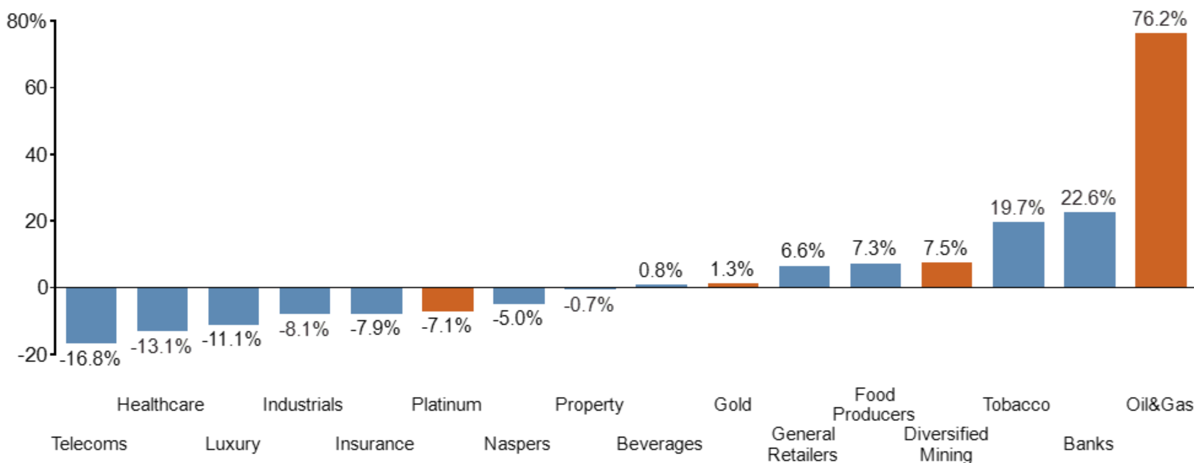
During 2020, an investor could have had their entire resource exposure made up of energy and completely underperformed the market. During 2022, an investor could have had their entire resource exposure in platinum group metals (PGMs) and still underperformed the market.

Figure 1: 2020 FY Total Return by JSE Index



Source: Fairtree, Bloomberg

Figure 2: 2022 YTD Total Return by JSE Index



Source: Fairtree, Bloomberg

The key reason for uncorrelated performance is that different commodities have different drivers. When investing in commodities, you need to take the time and effort to understand what is driving the spot price of each commodity, and you need to keep abreast of changing global trends.

To best explain this, let's take two commodities, oil and copper, and unpack their underlying drivers. Foreign exchange considerations have been ignored in this example.

Oil

This year, energy has been high across the board, and even with oil retreating below $90, it remains robust. The price of oil is underpinned by global demand for energy, which one could argue, should be weak given that global growth is slowing – traditionally, this would create a headwind for the price of oil. Then there is the supply side of oil which is supportive for two reasons: decarbonisation and supply control.

The reality is that the world has not been investing in fossil fuel production for over a decade, given that it is a demonised energy source due to its high carbon footprint and the market presumed that we would be driving pure electric vehicles by now. For these reasons, the oil refining industry has been grandfathered. Additionally, the war in Ukraine broke out this year and created a shock to energy supply, and energy prices skyrocketed. Finally, the iron-fisted supply-side response from OPEC+ is, of course, political in nature and a direct response to President Biden's depletion of the US's Strategic Petroleum Reserve inventory. This political cat-and-mouse could continue for some time and is an added complexity to consider when determining the drivers of oil.

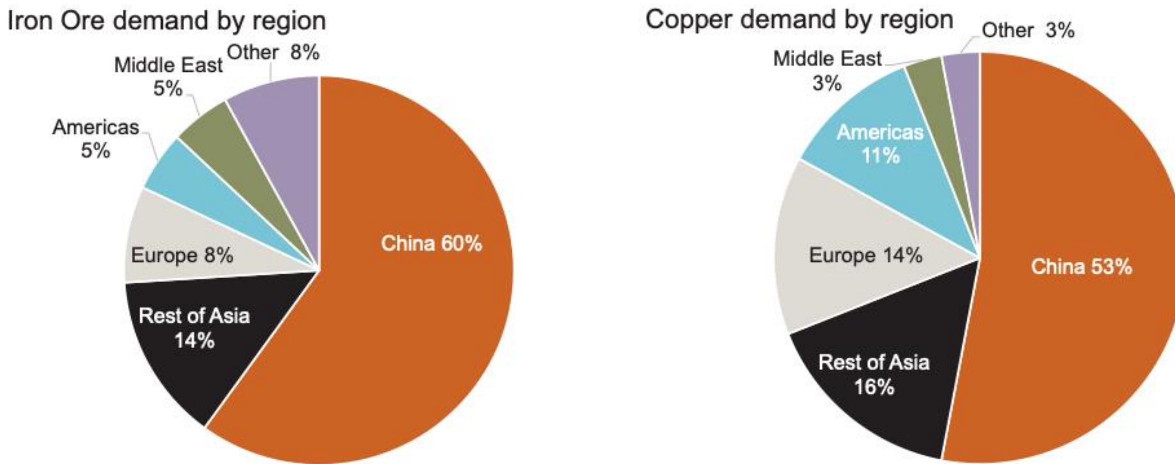
Copper

Copper is used in electrical equipment such as wiring and motors as it is a good conductor of both heat and electricity. It also has uses in construction, e.g., roofing and plumbing, and industrial machinery, such as heat exchangers. As with oil, the price of copper is determined by supply and demand dynamics.

Copper forms part of the base metal grouping. These are metals used for industrial purposes and should not be confused with precious metals, normally held as a store of value or investment hedge. Applying theory again, one would argue that if we are currently entering a global recession (most pronounced in the developed world), manufacturing and construction should wane and demand for copper would be destroyed.

It is a well-known fact that the greatest base and bulk commodities' consumer has been and continues to be China (as illustrated in Figure 3 below). The underpin has been due to the Chinese industrial boom over the last two decades, making China the single largest consumer of base and bulk commodities globally. However, China's growth has been weak over the last 18 months, and Xi Jinping has single-handedly decimated his property market through common prosperity goals, which could explain why copper has softened during the year, but why does it remain elevated when historically it has not? For two reasons: decarbonisation and supply tightness.

Figure 3: Iron Ore and Copper - demand by region

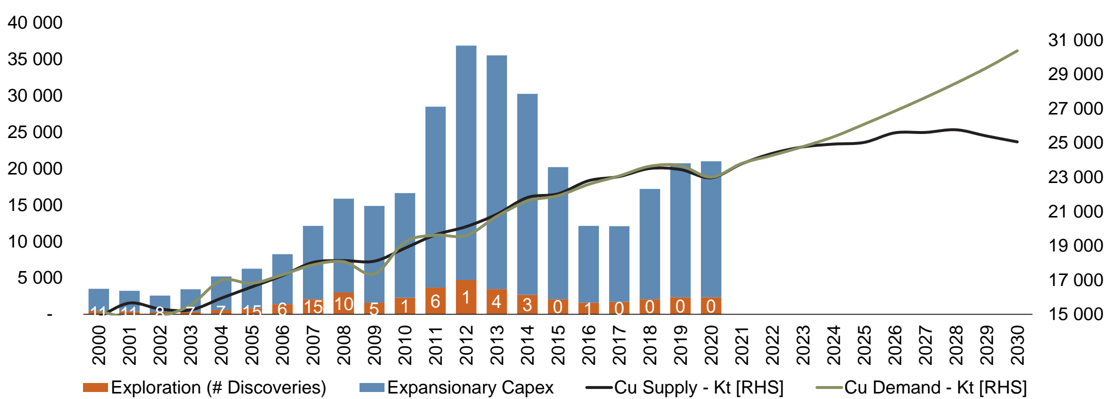


Source: JP Morgan, Fairtree, Bloomberg

Since copper is a highly efficient conduit, it is used in renewable energy systems to generate power from solar, hydro, thermal and wind energy worldwide. There is 12 times more copper in many renewable energy systems than in traditional systems. For example, a gasoline internal combustion engine uses c.20kgs of copper, whereas a pure electric vehicle requires c.80kgs.

Copper is one of the few materials that can be recycled over and over again without a loss in performance. That said, even though the metal is 100% recyclable, recycling alone will not be enough to meet demand and ensure a stable supply of copper. Continued mining for new copper will be needed, which leads to my second point on spot price robustness. Globally, we have not found new copper discoveries for some time; and the ones we have found are in challenging jurisdictions where merely obtaining a mining license has proven impossible. Therefore, even taking into account copper recycling, demand for the metal will outstrip supply, as illustrated in the Figure 4 below, based on very conservative assumptions.

Figure 4: Global Copper Mining - Growth Expenditure ($mn) vs Production (kt) & Major (500kt) Discoveries



Source: Wood Mackenzie; S&P Global, Fairtree

2. Long-term commodity forecasting is pointless.

I know this heading will strike a nerve with the academics and economists, who love to forecast commodities into perpetuity, but the bottom line is that you will be 100% right at select points in time but horribly wrong most of the time. By no means am I dismissing the importance of unpacking and understanding the drivers of commodity prices. As I have stressed above, it is complicated, dynamic and takes time. But trying to forecast what the price

of gold will be in 2040 and using a discounted cash flow model ("DCF") to arrive at an appropriate valuation today, is pointless.

Instead, our approach would be to keep it simple: Take the commodity spot price today, plug that into your DCF equity model and understand what the equities are pricing in; a lower or higher spot price? If the equities are pricing in much lower spot prices, then there is value, and it could be a buying opportunity. However, that depends on what is driving the short-term spot prices.

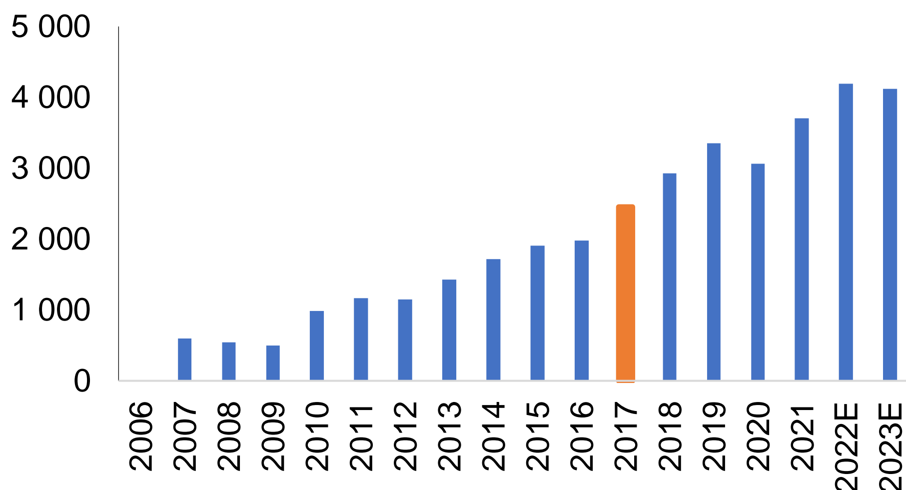
Take the time and effort to understand global dynamics and trends, and know that when you invest in resources, do not try to apply long-term averages as the spot price will rarely be at the average level – do not fight spot. Commodity prices will go much higher than you can imagine, and they can plummet in the blink of an eye, which is why it is important to trade them during the various mini-cycles.

3. Resources always find a home and are politically agnostic.

As mentioned at the outset, a commodity is an economic good that has full or substantial fungibility - the market treats instances of the good as equivalent or nearly so with no regard to who produced them.

Therefore, over time, resources tend to be politically agnostic and will find a home if demand is robust, even in the face of sanctions. An example was in 2017, when the US banned Chinese aluminium, there was almost zero impact on Chinese aluminium exports, as shown in Figure 5 below.

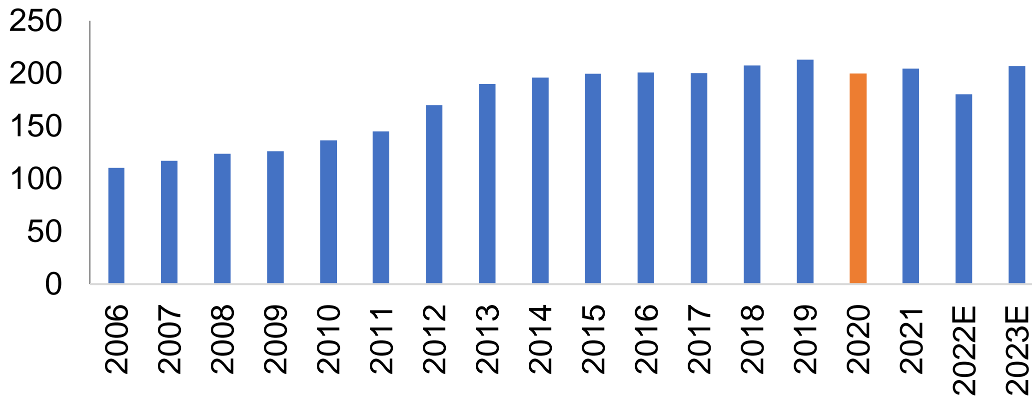
Figure 5: China aluminium net exports (kt)



Source: Standard Bank, Company Reports, Bloomberg, Fairtree

Of course, in some instances, it takes time (a minimum of a year) for trade flows to recalibrate. An example of this would be in 2020 when China banned Australian thermal and coking coal. In Figure 6 below, we can see the normalisation of Australian exports. Coal exports out of Australia have largely found new homes (outside of China), and it is highly probable that some volumes still will find their way to China via Singapore.

Figure 6: Australian thermal coal export (Mt)

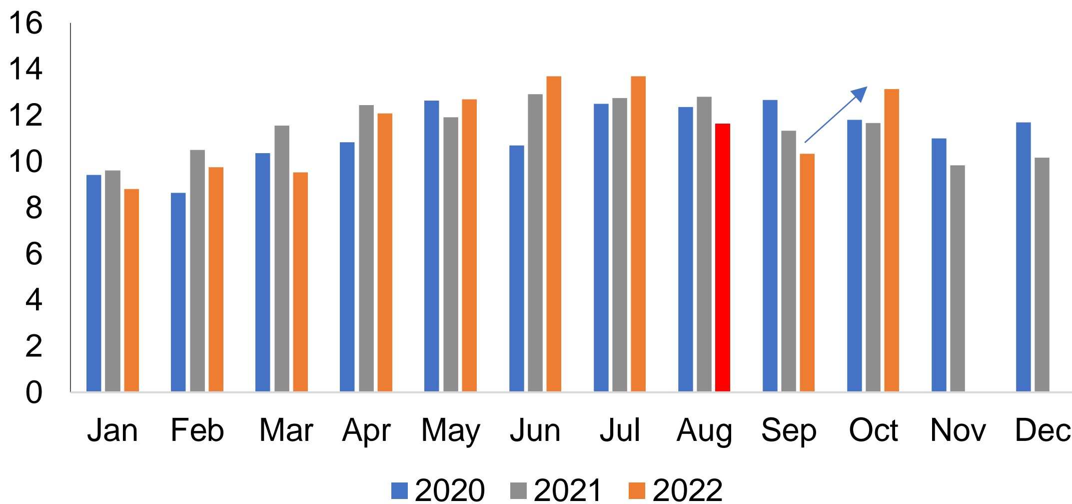


Source: Standard Bank, Company Reports, Bloomberg, Fairtree

The most recent political headwind in the commodity space has been the sanctions against certain Russian goods. If we use Russian coal exports as an example, sanctioned from August 2022, we can already see a clear rebound, meaning the resource is finding a home. (see Figure 7 below)

Russian refined copper is still flowing into Europe in the face of European companies' self-sanctioning. Eventually, all Russian commodities will find a home, with the exception perhaps of bulk commodities where rail constraints are still an issue – the latter not being a political issue but rather an infrastructure issue, due to the lack of Russian railroad capacity.

Figure 7: Russian Federation monthly coal exports (Mt)



Source: Standard Bank, CRU, Company Reports, Bloomberg, Fairtree

Note: Ban on Russia energy commodities by Belgium was implemented on 10 August 2022

Conclusion

There are many moving parts to investing in commodities, and given their cyclical nature, there is downside risk. However, as equity investors, we are designed to continuously weigh up risk vs reward and seek opportunity for alpha generation.

There is much opportunity in the resources sector. Decarbonisation is providing secular support for some metals (e.g., copper) and has created scarcity support for others (energy). It is paramount when investing in resources to look at them individually, as they do not have the same drivers. It takes top-down, and bottom-up analysis and the information is ever-changing.

Do not fight spot prices. If demand is robust, the commodity will always find a home.

Glacier Research would like to thank Chantelle Baptiste for her contribution to this week's *Funds on Friday*

Chantelle Baptiste

Senior Equity Analyst

Fairtree

Chantelle Baptiste is a senior equity analyst at Fairtree Asset Management and portfolio manager on the Select BCI Equity Fund. Chantelle achieved her Honours degree in Management Accounting at Stellenbosch University. After graduating, she joined Deloitte in Johannesburg where she completed her articles. During this period, she completed her studies through CIMA, being awarded a Chartered Global Management Accountant (CGMA®) designation.

She joined Barclays Africa and worked in finance for 4 years, and then moved internally into the Barclays Africa Equity Research team where she joined the Financials team. She was a sell side analyst for 5 years covering South African Banks and General Financials, and in 2016 was rated #2 by the Financial Mail Ranking the analyst in General Financials and #6 in SA banks. She joined Fairtree on 1 January 2017.

When Chantelle is not at her computer looking at the markets she is outdoors running or cycling and is a spinning instructor in her spare time.