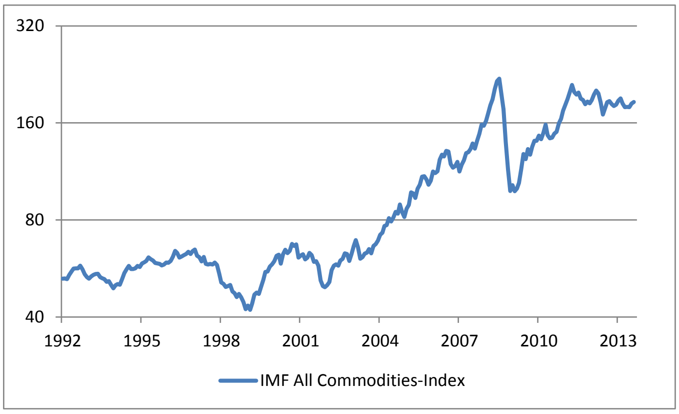
With a Steady Hand

Essays on Long-Term Investing

Number 8

Will the supercycle end in tears?

By Karl-Heinz Thielmann



Source: IMF

Speed Read:

- The strong cyclical upturn in commodities prices in the last decade has been achieved through a combination of extraordinary factors, which are fading out.
- Demand from emerging economies will continue to support commodity prices, but it will be less buoyant than before.
- There are two potential dangers building up for this sector: Overinvestment in production capacities and the flow of funds of institutional investors.
- For a few years, companies in the basic resources sector have been increasing their investments in extraction sites. These new facilities will start production in the next years, therefore, supply may grow faster then demand.
- Many institutional investors have allocated parts of their capital to commodity investments in the last decade to improve the risk return profile of their portfolios. However, their assumptions seem questionable in the light of new research on the long-term development of commodity prices. Therefore, a reversal of the flow of funds seems probable.
- The commodity markets mirror similar developments in other markets with temporary price bubbles such as sea freight rates or internet stocks. Hence, a strong correction in commodity prices seems possible in the future.

Have you heard of Pilbara? It's not an exotic paradise in the South Seas, but a region in West Australia where – with a production capacity of 290 million tonnes per annum – one of the world's largest iron ore mines is located. And Pilbara is going to expand. The mine operator Rio Tinto is planning to invest US$ 5 billion in order to extend its capacity to 360 million tonnes by 2015.

This plan has made the Australian-British mining group very unpopular with its competitors. Although demand from China and other emerging economies remains buoyant, the iron ore price came under pressure last year because increases in extraction capacity have resulted in supply growing more quickly than demand over the past years. The inevitable result of an additional rise in production would be a further drop in prices, which would hit the weaker mining groups hard.

However, Rio Tinto has refused to give in to the pressure from the others. And why should they? Other mining groups do not show the remotest bit of consideration for their competitors when implementing expansion plans.

The years 2002 to 2010 witnessed an upturn on the global commodities markets, eclipsing all cyclical increases over the past decades. This was due to a combination of unique factors:

- Economic growth in the emerging economies of Brazil, Russia, China and India triggered a considerable surge in demand for all kinds of basic resources. China, in particular, boosted demand for industrial metals with a boom of investments in infrastructure projects.
- The institutional investors started treating commodities as an investment class. Disappointed by the yields on the stock markets and seeking to further diversify risks, many major investors turned to the markets for resources, which seemed to offer steadily growing yields with a risk that seemed to be independent of traditional forms of investment such as shares and bonds.
- Initially, the leading companies in this sector were not tempted into making high investments at the onset of the boom, as had been the case in the past and had resulted in excessively high production increases. The rise in demand could therefore have full impact, leading to price increases.

Numerous analysts proclaimed a "supercycle" for all kinds of commodities. The prospect of steadily growing demand from developing countries resulted in a multitude of forecasts predicting a continuing rise in the prices of natural resources. After the 2008 financial crisis, the basic materials markets seemed to recover very quickly and perform exceptionally strongly again.

Development of selected commodity prices

Commodity:	Unit:	Change: 2002-2010	2010-Aug13
Precious metals:			
Gold	US $ per Troy Ounce	318,9%	0,3%
Silver	US $ per Troy Ounce	419,6%	-19,6%
Industrial metals:			
Iron Ore	US $ per Dry Metric Ton	1229,1%	-18,7%
Copper	US $ per Metric Ton	474,6%	-21,5%
Aluminium	US $ per Metric Ton	70,9%	-22,9%
Energy:			
Crude Oil Brent	US $ per Barrel	221,9%	20,9%
Coal(Austalia)	US $ per Metric Ton	382,8%	-34,9%
Natural Gas / Russi	US$ per Million Metric BTU	210,3%	25,7%
Natural Gas / USA	US$ per Million Metric BTU	-10,6%	-19,2%
Food:			
Wheat	US $ per Metric Ton	81,4%	-0,3%
Coffee (Arabica)	US cents per Pound	271,6%	-42,9%
Maize	US $ per Metric Ton	134,2%	-6,3%
Sugar	US cents per Pound	273,4%	-26,9%

Source: IMF

However, the upswing has faltered over the past two years. Although there have been price rises in individual sub-segments of the commodities markets, the prices have come under pressure across the board, but have not totally collapsed. In spite of economic problems, demand from China, India and other emerging economies is still very high. And it will remain so as these countries still have a lot of catching up to do.

Nevertheless, the prospects for the resources sector can no longer be described as particularly rosy. The primary reason for this is not the flagging demand, but the enormous capital investments that have been pumped into expanding production capacity, in particular in recent years.

Before 2008, the major companies were still self-disciplined and did not enter a self-destructive race to continually raise production capacity. It was clear that sooner or later massive increases in production would destroy the prices. But this discipline has dwindled away. An example of this is the figures from Australia, which show how drastically investments have risen.

Australia: Annual capital expenditure of private enterprises in the mining sector in bn Aus$						
Ø 1991/92 to 2001/02	Ø 2001/02 to 2011/12	2007/08	2008/09	2009/10	2010/11	2011/12
10,6	30,7	32,4	40,8	36,9	47,7	82,1

Source: bree.gov.au

In 2012/13 there has been a further increase in spending of approximately 20%. In addition, further investments of Aus$ 270 billion are planned. Currently 60% of all Australian investments are being injected into the mining sector; this figure was 30% in 2008 and between 10% and 22% from 1990 to 2006.

In the sea transport sector, a boom in freight rates resulted in shipyards being swamped with orders a couple of years ago, ensuring full utilisation of capacity for years. New ships are now being launched on a market that is characterized by massive overcapacities. This has resulted in a drop in freight rates, with newcomers on the market earning only very low margins, if anything at all. However, this disaster was foreseeable; people should have anticipated several years ago that plans to build new ships would impact total supply.

In the resource extraction sector, supply responds even more sluggishly than in the shipbuilding industry. It takes new mining sites 5 to 10 years after the beginning of investments to start selling production. This means that we will only start seeing a massive expansion in production in a few years' time, which is likely to put pressure on prices across the entire market.

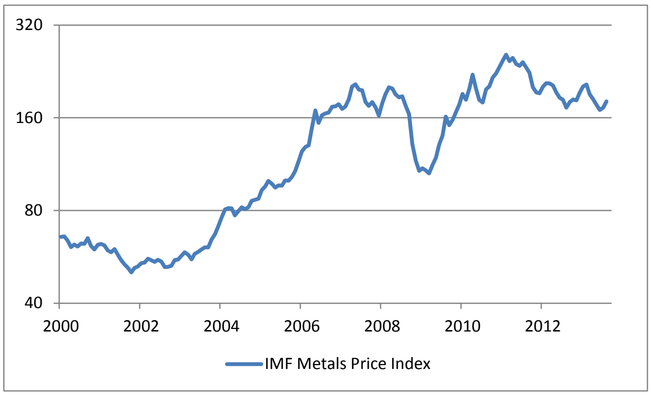
This is essentially good news for all European countries that are dependent on raw material imports and for developing countries that lack raw materials. For producers of commodities such as Canada, Australia, South Africa and Russia, however, hard times are imminent.

Professor José Antonio Ocampo from Columbia University has analysed the prices of commodities since 1865, reaching the conclusion that the current "supercycle" is actually only an upward movement within a long-term, cyclical trend for basic resources. Within this trend there are sub-cycles of approximately 30-40 years. Moreover, on balance, commodities have always lost more value in real terms – i.e. adjusted for inflation - during economic downturns than they previously gained. He has determined that on average the value has dropped by 50% in real terms since their peak in 1917.

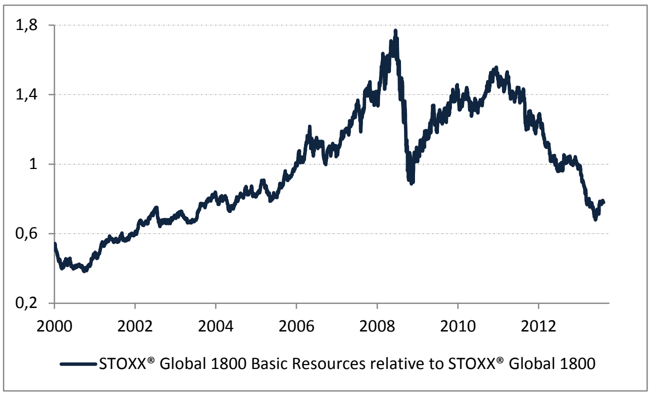
Nevertheless, many quantitative analysts and investment strategists continue to recommend investing in commodities, at least as a component in a portfolio. Their analyses and calculations are chiefly based on the period since the 1980s. They therefore only just include part of a sub-cycle, but not a complete one. Although this is grossly negligent, it is not the first time that investment bank analysts manipulate figures to support a marketing story such as the "supercycle". However, the trouble is that these dubious calculations have resulted in many global institutions massively investing in basic materials over the past years. If the prices decline, they might get nervous, slam on the brakes and withdraw from the market regardless of the impact on liquidity. This could trigger or massively reinforce a downward spiral, which would have nothing to do with the overall economic fundamentals.

Several weeks ago, JP Morgan, one of the largest traders in commodities, announced that they were withdrawing from the physical commodities business entirely – this is a clear warning. Interestingly, they plan to continue trading in commodity futures, so that they still have the possibility of selling commodities short and can therefore benefit from price losses.

Another alarming sign is that shares in companies in the basic resources sector have been drastically underperforming on the global equity markets for some time. It seems as if the stock market is anticipating a clear downturn in the prices of its products.



Source: IMF



Source: stoxx.com

Of course I don't know whether and when the slump on the basic materials market will come. However, in the light of the large increases in capacity and the high involvement of purely financial investors, one can't help being wary about how prices will develop in the future. The high level of exposure of private investors and institutions without industry expertise can also be seen as a warning sign. To a certain extent, their behaviour is similar to during the Internet bubble of 2000.

A super-crash with a sharp decline in prices seems possible, as witnessed for freight rates in the sea transport sector some time ago. If surplus production and sales of investors put pressure on the prices of raw materials, growing demand from emerging economies will not be able to compensate.

Curriculum vitae of the author:

Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlshochschule International University in Karlsruhe.

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Sources:

Rio Tinto's expansion plans in Pilbara were described in: Neil Hume: Rio Tinto chief defends $5bn expansion of iron ore project, Financial Times, May 9th 2013 (http://www.ft.com/intl/cms/s/0/2fd1e664-b876-11e2-a6ae-00144feabdc0.html#axzz2b0ctBlDj).

On the long-term development of commodity prices, see: José Antonio Ocampo: "SUPER-CYCLES OF COMMODITY PRICES SINCE THE MID-NINETEENTH CENTURY" http://www.imf.org/external/np/seminars/eng/2012/commodity/pdf/Ocampo.pdf. His speech is also available on video: http://www.imf.org/external/mmedia/view.aspx?vid=2260899208001.

On JP Morgan, see: "JPMorgan quits physical commodities business" on CNBC.com; (http://www.cnbc.com/id/100900230)

The data for the graphs was taken from these websites: http://www.bree.gov.au/index.html; http://www.imf.org/external/np/res/commod/index.aspx and http://www.stoxx.com/indices/byregion.html?superRegion=Global&subRegion=Global&superType=Sector%20Indices&subType=Supersectors

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http://www.long-term-investing.de/app/download/5795241623/Mit_ruhiger_Hand_5_08_13.pdf

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