Analysis

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Resources: Tricky investing amid high commodity prices

Key take-aways

- Going into 2020, the global resources sector was already tightening, with overall demand firm and inventories low, but miners struggled to ramp-up short-term supply due to their past underinvestment in capacity, pushing commodity prices higher.
- The Covid-19 lockdowns exacerbated supply shortages and logistical problems, sending commodity prices further skyward in 2021. Meanwhile, extreme weather further fuelled transport problems, as did labour shortages with the onset of the Omicron variant in late 2021.
- Resources companies have been enjoying high cash flows and margins, but at levels not likely to be sustainable. And forward valuations are not exceptionally elevated. This conundrum makes us cautious: in the sector we prefer exposure to those companies with sustainable earnings and attractive valuations.

Although it's well known that the global resources market moves broadly in cycles following global economic growth, in the last few years we've seen significant price movements. If we go back even before the Covid-19 pandemic and the Russia-Ukraine war to 2015, we can argue that some of the price impacts we are seeing now are due to supply and demand disruptions back then and the subsequent decisions made in the sector. As investment managers we seek to understand the drivers of these trends in order to better select which companies might add the most value to our client portfolios over time, and the Resources sector is particularly important here in South Africa given its outsize influence on the FTSE/JSE stock indices.

Here we offer a snapshot of conditions in the resources market in recent years, and how we have approached our clients' investment portfolios when it comes to exposure to the Resources sector. Current conditions are somewhat tricky: high commodity prices, company earnings and margins, and even valuations, are making the sector appear attractive, but we are continuously evaluating the sustainability of these favourable trends.

Background

Well before the Coronavirus crisis, we saw economic stimulus from China supporting rising demand for commodities and helping lift global commodity prices from their 2014-2015 slump. China is the world's largest importer of resources such as iron ore, for example, and the health of the Chinese economy is among the key drivers of global commodity prices.

Meanwhile, new supply has not matched rising demand. Mining companies have refrained from investing in new production capacity; they have been more selective about project approvals, instead prioritising shareholder returns via cash and share-buybacks. As a result, capital investment in the sector peaked in 2013.

Therefore, going into 2020 when the pandemic struck, the global resources sector was already tightening, with overall demand slightly higher than supply. Commodity demand was broadly firm, and prices had rallied as inventory levels were low and companies were struggling to respond to demand. They were unable to ramp-up production in the short term due to their underinvestment from the previous five years – on average it takes approximately seven years to bring new mine supply to the market.

Covid-19 arrives on the scene

From the onset of the Covid-19 lockdowns, the resources market suffered significant supply and logistical disruptions, the impacts of which are still playing through the market today. Mining activity and processing halted altogether, as did transport. Then, after the first round of lockdowns, most major markets unleashed significant economic stimulus programmes via both fiscal and monetary policies – especially China, but also in Western markets – which pushed demand to a higher level. Because supply could not keep up with demand, many commodity prices reached all-time highs in 2021.

For example, in the second half of 2021, an energy crisis developed in Europe and China as gas and coal prices soared: here again the underlying factors were underinvestment in fossil fuels compounded by logistical issues resulting from Covid, plus weather disruptions, which meant that supply could not meet rising demand in a timely fashion. In one of the more extreme cases, the shortage of truckers in the UK made global news headlines as fuel deliveries were curtailed and pumps ran dry.

At this point in 2021, the broad market view was that these higher energy and other commodity prices were likely to be short-lived, and their inflationary impacts would be transitory – as supply ramped up, it would meet demand. But given that the global lockdowns were unprecedented and such macroeconomic conditions never before experienced, investors, economists and business analysts all underestimated the deep dislocations experienced in companies, supply chains and every stage of the production process. At the same time, the unwelcome arrival of the Omicron variant of Covid-19 in late 2021 extended the disruptions even further.

The Russia-Ukraine war and inflation

Russia's tragic invasion of Ukraine in February 2022 caused another serious dislocation in resources markets, across both energy and metals, and later agricultural products as well, compounded by the widespread sanctions on Russia imposed by many countries. The initial shock in the market saw some commodity prices rise further on the recognition that there would be additional supply constraints, given that both Russia and Ukraine are large global exporters of commodities including diamonds, palladium, oil, gas, coal and agriculture products.

To date, the energy commodities – specifically oil, gas and coal – have experienced the most sustainable gains due to their supply fundamentals, but some metal prices have also risen, as have prices for fertilisers and grains. There has been a limited impact on the flow of goods out of Russia, given that only certain commodities (such as oil, gas and coal) are currently subject to sanctions that will only be fully implemented over the course of 2022, but many Ukrainian exports like wheat and corn have been blockaded in the country's ports, sparking fears of basic food shortages and rising global food prices.

Subsequent to the invasion, oil prices have risen to new multi-decade highs, and gas prices, which were already high, have also increased to even higher levels on a historic basis. We have also seen a similar pattern for coal. And while the war has been a big contributor to this latest round of price increases, the inability of energy suppliers from other regions to step into the supply breach has also played a large role. Other factors have included changing weather patterns, with rains impeding mining operations and logistics, and the ongoing Covid-19 pandemic.

As a response to Russia's aggression and its role as a major energy supplier to Europe, various European countries are initiating plans to become more self-sufficient. For example, in May 2022 the European Union (EU) introduced an ambitious and urgent plan called "REPowerEU" to "reduce dependence on Russian fossil fuels as soon as possible" through energy savings, diversification of its energy supplies and an accelerated roll-out of renewable energy sources. A month later, Germany announced its decision to fire-up idle coal-fired power stations to decrease its reliance on Russian gas.

Also since the invasion, in recent months economists, analysts and investors have become increasingly concerned that the effect of two-plus years of high commodity prices is starting to feed through to second-order inflationary factors such as demands for higher wages and rising inflation expectations. Goods prices are rising in sectors where inflationary increases can be passed on to consumers. Also, central banks have reacted by adopting more aggressive monetary tightening policies, with much higher interest rates now expected to weigh on economic growth, especially in the US. Equally, China's strict implementation of its zero-Covid policy from April 2022, including tight lockdowns notably in the key economic hub of Shanghai, has led to downward revisions to that country's growth forecasts.

What is M&G's view?

For mining companies, the prevailing high commodity prices have been extremely favourable for their cash generation and profit margins so far, but should inflationary pressures continue to rise from current levels, their own inputs are likely to become more expensive, resulting in margin compression and reduced cash generation. Slowing economic growth from higher interest rates and pressure on consumer demand in Western economies, plus ongoing Chinese lockdowns, is likely to lead to slowing commodity demand and lower prices at some point.

We acknowledge that while it is very difficult to forecast the future and we do not make any attempt to do this, we do spend a lot of time thinking about the economic cycles that various sectors are in, and where company valuations are. Our approach is to understand the fundamental drivers of company performance and to choose those with the most attractive relative valuations, while also taking into account the quality of earnings.

At this point, it is true that commodity prices and margins are relatively elevated compared to the past, making the chances of lower commodity prices more likely in the future, particularly for the energy sector (as we have discussed), as supply normalises and demand decreases over time amid the accelerating global move towards renewables. As such, we are somewhat cautious around our exposure to the broader sector since the current high company earnings are not likely to be sustainable over the medium- to longer term. At the same time, however, forward company valuations such as price-earnings and enterprise-value-to-sales ratios (assuming the same spot commodity prices going forward) are not elevated in our view. And at current commodity prices the companies are generating strong free cash flows. Given this tricky environment of mixed signals, we believe it prudent to hold those companies with attractive valuations that have supportive earnings. A few examples of our holdings in the sector include Northam Platinum, Exxaro and Sasol.

Resources exposure highlights

Our investment case for Northam Platinum is largely underpinned by the counter-cyclical capital investment that they embarked on from 2015 – they were among the few platinum miners to add production capacity when others refrained. Over the next few years the company's production profile will double as its new growth projects ramp up, giving it an advantage over many of its competitors.

While the market is concerned about the implications of Northam's recent purchase of a just-under-35% stake in smaller rival Royal Bafokeng Platinum (following Impala Platinum's 100% takeover effort), our view is that Northam's core business remains attractively valued.

Meanwhile, Exxaro's operations comprise a good-quality coal business, an associate stake in Sishen Iron Ore and a growing renewable energy business. The strong coal prices we are witnessing will be supportive for Exxaro's earnings and cash generation. At the same time, both the coal business' and the overall company's valuations are trading on very attractive multiples. Although the intent of this article is not to detail the ESG aspects of the business, these factors play a role in our investment decisions around the company. As Exxaro has completed all new investments into its coal business, going forward the cash generated from these operations will be distributed to shareholders and be reinvested into growth of its Renewables and Battery Minerals business. As part of our role as active shareholders on behalf of our clients, we are consistently monitoring its progress in meeting its stated goals and engaging with management whenever necessary.

Finally, Sasol's earnings are being supported by strong chemical and oil prices. Also strengthening the investment case is its improving balance sheet risk, with debt levels falling and cash levels rising due to the stronger commodity prices and its asset sales over the last few years. In our view, company valuations are still relatively attractive, even after its exceptionally strong share price gains since the worst of the Coronavirus crisis. Sasol is keenly aware of its greenhouse gas emissions and is undertaking a "Just Transition" approach, in which it is targeting to reduce its Scope 1 and 2 emissions by 30% by 2030 and reach net-zero by 2050. As with other holdings, we consistently monitor its progress, and engage with Sasol management to understand its challenges, options and decisions to help ensure that it achieves its goals. ☐

Aeysha joined M&G Investments in April 2013. As an Equity Analyst, she is primarily responsible for conducting research on the Mining sector. Prior to joining M&G Investments, Aeysha spent three years completing her articles at PwC, and currently has nine years' industry experience. Her qualifications include: B. Com Accounting; CA (SA).