M&G **Insights**

M&G Investments

Aeysha Samsodien
Equity Analyst

VIDEO | Rising risks and costs weigh on Resource companies

Following the latest round of company results announcements from JSE-listed Resources companies covering Q2, several trends have emerged that are impacting on the future direction of earnings in the sector and been source of both concern and reassurance. For now, in our view, earnings risks look to be weighted to the downside for many companies, although this depends very much on the length, breadth and depth of the (now very likely) global recession in 2023.

The major trends now prevalent in the sector include increasing operating costs, rising capital costs, ongoing restraint in capital investment spending (capex), and the rising risk of a recession driven by the energy crisis in Europe, a very subdued Chinese economy and rising global interest rates. Currently, most commodity producers are experiencing lower profits than the super-normal levels seen earlier in the year, as global commodity prices have fallen from their March 2022 peaks on the back of slower global growth. Energy prices have been more resilient, while metals prices in particular have suffered, more specifically as a result of China's subdued economic activity and weak property sector. For the second quarter of 2022, the country posted GDP growth of only 0.4% y/y, and is widely expected to fall short of the government's 5.5% growth target for 2022.
Despite this, commodity prices are still relatively well supported by supply constraints, due to global producers having invested little in capacity expansion over the past seven years.

A closer look at China

While we know that expectations of slower growth globally have weighed on commodity prices, China remains the overall kingmaker when it comes to the nearer-term direction of the Resources sector. The country continues to play an outsized role in commodity markets, given that it is the single largest source of demand for many commodities.

Changes in China's growth are highly correlated with moves in commodity prices, particularly metals prices. Its weak Q2 GDP figures, continued harsh social and economic crackdowns as part of its zero COVID-19 policy and ongoing outbreaks of the virus have all stoked concerns around growth, aided by the rising risks in the property market. Beijing's fiscal and monetary stimulus efforts have so far proved ineffective in the face of strict and sweeping closures of major cities faced with even only a handful of Covid infections.

As part of the re-election of Secretary General Xi for a third five-year term during China's 20th Communist Party Congress in October, it was obvious that the government was still focused on boosting economic growth, but not at the expense of spreading Covid – analysts expect restrictions to continue for the foreseeable future, with a possibility of them being eased somewhat after the National People's Congress in March 2023. However there is a clear risk that the current policy will stay in place for longer, given Xi's touting of

its success in reducing deaths. He cannot risk being seen to be “wrong” about such a major issue, despite growing public discontent. For Xi, national security and social stability remain of paramount importance. This dichotomy has the market worried, since his approach is like driving a car with one foot on the accelerator and the other on the brakes. We expect more detail on short-term policy at the Economic Work Conference in December, and a subdued recovery in the second half of the year, supported by piecemeal easing measures.

Gold

Normally an environment characterised by high by macroeconomic risk (inflation), geopolitical risk (Ukranian invasion and energy crisis), and financial risk (Chinese property sector) is positive for gold, given that it considered by many as a safe-haven asset.

However, due to the sharp interest rate hikes in the US and its relatively resilient economy compared to many others, the US dollar has been quite strong against most other currencies. This has presented a headwind to the US$ gold price. Gold has an inverse relationship with real interest rates – the higher interest rates rise, the more attractive interest-paying investments become relative to gold, which does not pay out an income.

Platinum group metals (PGMs)

PGM commodities are predominately used as auto catalysts in internal combustion engine vehicles. Slowing global growth has caused a weaker demand for vehicles, putting downward pressure on PGM prices. However, the sector may now have passed its lowest point, as data continues to suggest that risks to global auto production are easing, albeit from still “above-normal” levels. The latest IHS reports also show that auto production estimates are being revised higher.

In China, Covid lockdowns caused some very low output for April, but this seems to be recovering strongly now. Analysts expect to see a normalisation in production, which will support PGM demand. However, the risk of demand destruction from weak consumer sentiment, inflationary costs, and higher rates remains elevated.

Base Metals
Over the medium to longer term, base metals – copper, nickel and zinc – will experience growing demand due to their use in the transition to cleaner energy sources, creating automatic support for their prices. A key example is their increased use in batteries, for both electric vehicles and energy storage. However, because these commodities are easily and widely traded on exchanges, they are subject to market sentiment and their prices relatively volatile. Over the last few months, poor market sentiment has resulted in a fall in prices.

Iron ore
Iron ore is the key commodity used in the steel-making process, and its price is primarily driven by China. As discussed previously, China is facing headwinds from its strict zero-Covid policy and property sector weakness, which have caused economic growth to slow notably and weighed on the demand for steel. If the Chinese government and People's Bank of China push through meaningful stimulus and this increases steel production, it will be supportive for the price of iron ore going forward.

Energy commodities
So far in 2022, energy commodities including natural gas, coal and oil have been the outperformers in the sector when it comes to price, fuelled largely by shortages arising from the Russia-Ukraine conflict. Their high prices reflect the significant roles played by both Russia and fossil fuels in global energy markets, causing the energy crisis in Europe.

Looking at coal, European demand has underpinned its price in the face of serious shortages of natural gas from Russia, with coal-fired power stations being re-commissioned for the coming winter. This has countered the growing trend away from coal amid the global transition toward greener energy solutions, and is likely to support coal prices until European countries can secure other energy sources.

For oil, meanwhile, the price has experienced downward pressure from expectations of slower global growth over the near term, but OPEC+ supply reductions have lent support, as has little spare capacity among the oil cartel. This should see the oil price remaining around its current levels for the foreseeable future.

Looking ahead

Given this environment, for the Resources sector over the near term we could expect energy commodities and producers to continue their outperformance of other commodities – in the absence of a resolution to the Russia-Ukraine war and its associated sanctions. For other commodities, much will depend on the length and severity of the global growth downturn, and the economic stimulus measures coming out of China. The persistence of Covid19 in that country is worrisome in that it could exacerbate the already-weak economic conditions there and lead to a more severe downturn than would be expected. Commodity markets are likely to remain volatile, as are share prices – investors should be prepared for more uncertainty ahead.

https://www.mandg.co.za/insights/articlesreleases/video-rising-risks-and-costs-weigh-on-resource-companies/