The Disruptive Discoveries Journal

Weekly analysis of how disruption in commodities, geopolitics, and macroeconomics converge to create opportunities

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Is This the Final Leg Down in the Commodity Cycle? – How Much Lower for How Much Longer?

If anything is clear after the start of 2016, the global economic rebalancing that central banks around the world are trying to engineer is not proceeding according to plan. The circuit breaker fiasco in the Chinese equity markets is the latest example giving investors pause with respect to what is truly “going on” in China. The Shanghai composite equity index has lost almost 15% of its value YTD and few see good reason for this slide to halt aside from intense government support and RMB devaluation. Money continues to flow out of China as we speak.

This drains China’s FX reserves – a tool the Chinese need to manage a weakening RMB, a headache with global repercussions. Additionally, it appears increasingly likely that the US Federal Reserve just raised short term rates into a weakening US economy (December jobs growth not withstanding). When the central banks of the world’s two largest economies are losing credibility, it’s no wonder financial turbulence has increased.

Various geopolitical tensions such as an intensifying Saudi-Iran face off and North Korean nuclear test are the “cherries on the geopolitical sundae”.

These increased geopolitical and financial stresses have served to absolutely crush commodity currencies such as the CAD, ZAR, and RUB with the USD as the beneficiary (though this USD strength may turn out to be a phyrric victory). It appears that all commodities are headed lower, and the “lower for longer” mantra should only be ignored at your peril. We may or may not be at the bottom, but how long we stay here is the crucial question to answer. The continued collapse in oil with WTI and Brent currently below $32 per barrel and copper trading below $2.00 per pound currently are but two examples.

Give these disparate issues, we think that the final leg down in the commodity cycle has begun. While we have been debating the subject of the inflation/deflation tug of war frequently since late 2012, it now appears obvious that deflation will remain the predominant force to be reckoned with until economies can adequately de-lever and start a new credit cycle. Inflation, as measured by central banks is almost non-existent anywhere you look. The Atlanta Federal Reserve now sees 1% GDP growth in the US and this forecast has been falling. There are more data points we could list, but why add insult to injury?

Until the world's economies can generate a new credit cycle, you can expect weak commodity prices, a stronger USD, and low bond yields as the flight to safety intensifies. Just about any macro data we look at, from bond yields, to commodity prices, to PMI data continues to send a powerful signal – and that is one of sluggish growth. If these deflationary forces are indeed taking hold, settling debts and hoarding cash are likely the two best courses of action.

The 71% decline in silver, a crucial technology and monetary metal over the past five years, speaks volumes:

Source: stockcharts.com

This is occurring against the backdrop of a long-term global economic rebalancing in the wake of the Global Financial Crisis. As Michael Spence says in his excellent book "The Next Convergence":

"In a low growth environment, the rising tide that lifts all boats, stops rising."

This is a key statement to ponder as governments search for growth strategies in a global economy drowning in debt. With central bank monetary policy ineffective (interest rate cuts, QE, etc), fiscal levers are realistically all that can be pulled at this point and their effectiveness in a global environment with excess supply of multiple commodities and a mixed-at-best demand picture is an open question.

Energy Metals as an Opportunity

Despite the turbulence in financial markets, we still believe that select Energy Metals opportunities offer the potential for higher risk-adjusted returns relative to other commodities. One of the main reasons for this is that we view most Energy Metals as “late cycle” commodities. As China continues its transformation to a consumer-oriented economy, coupled with seemingly daily technological advances pushing down prices, opportunities in metals such as lithium or cobalt should remain prevalent for the foreseeable future. Two opportunities in the mining space, Western Lithium (WLC:TSX, WLCDF:OTCBB) and Galaxy Resources (GXY:ASX) are deserving of further study given their competitive advantages relative to much of the space.

To be clear, while we don’t view Energy Metals as a place to hide from global financial turbulence, the deflationary forces in the global economy will ultimately bode well for select plays in this emerging and dynamic space. Lithium prices have spiked alarmingly of late and this gives us pause as historically any parabolic price spike typically ends in tears for investors. That said, while prices could soften somewhat, strong demand and increasing questions around supply lead us to believe that lithium price downside is limited.

We think that energy innovation will be the next great opportunity and this is why we have and will continue to focus on the space despite the sub optimal economic backdrop. In short, in a world choking on supply, those companies focused on efficiency through advancing low cost technologies or assets will stand the best chance of weathering the unwinding of the current credit cycle.