REVIEW

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# Where's the smart money in commodities?

Up until fairly recently the answer to the question in the headline would have been somewhere else.

It was hard to find an asset class more unloved than natural resources, with many of the major commodities, such as crude oil, iron ore, coal, copper, aluminum and even gold trading near multi-year lows on the back of years-long losing streaks.

**Petra Commodities : the macro view dominates**

Macro factors are once again the main driver for the sector, with near-term risks been accentuated with declines in both euro zone and Chinese PMIs and continued uncertainty regarding upcoming BREXIT and the US elections. It appears unlikely that commodities can sustain a rally in the near term in the face of these conditions; our central view is that markets are likely to move broadly sideways in the near term on the back of the continued uncertainty and global economic volatility.

Of course, the gloom may well be punctuated by sharp short-covering rallies and things can change quite quickly, with the expectation of Chinese stimulus spending helping base metals and coking coal, and crude jumping on the back of some supply shutdowns and outages and improving demand.

Gold: the news is not all bad

Gold is shining in 2016 soaring 20 percent year to date and thrashing returns in major stock and bond indices, with Western buyers having returned to the precious metal as concerns over the global economy have intensified, and given these probably have further to run, gold's rally may have some legs left. In our view, the gold price is dictated first and foremost by investment demand, which is driven by two related factors: gold's perceived safe haven status, and its low correlation to other asset classes. Effectively, gold will do best when investors are worried about inflation or deflation, and when the global economy or the inflation outlook faces heightened volatility.

Emerging market central banks continued to accumulate gold at a steady pace last year, as did consumers in China and India, the two largest end markets for physical gold. Moreover, market sentiment is dour currently, with speculative long positioning at its lowest level since 2002. Such lopsided positioning makes the market vulnerable to sharp rallies, as we saw this year to date. Gold equities have been even stronger performers than the yellow metal, with Newcrest Mining jumping 47 percent since the start of the year and Barrick Gold Corp up a stunning 125 percent. Those gold miners that have worked hard to cut costs and have high-grade operations should start to see rising profits, perhaps justifying loftier share valuations.

**Iron ore and coking coal: bulking or balking?**

It's possibly a similar case for iron ore and coking coal, where the miners haven't enjoyed share price gains anything like that of the commodities they produce. Although QHD prices in China have remained relatively unchanged in recent months, China and regional coking coal prices both traded higher, with notable 13.7% and 15.5% increases since April. Similarly, spot iron ore prices have rebounded strongly from their recent low in mid- December to a 24% ytd price rally.

Rio Tinto is up around 7 percent this year in Australian dollars, while Asian spot iron ore has surged more than 40 percent, notwithstanding its recent pullback in the wake of Chinese efforts to curtail speculation on domestic commodity exchanges. Fellow Anglo-Australian miner BHP Billiton has gained just over 5 percent, although its share price has been adversely affected by legal action over the it's jointly owned Samarco mine in Brazil. However, BHP's own numbers show that for every $1 rise in the price of iron ore, $147 million flows to its bottom line. Iron ore averaged $53.20 a ton in the first quarter, more than $10 higher than what it did in the fourth quarter of 2015. This means that BHP profits have just received a $1.5 billion boost in just one quarter, and Rio Tinto is probably better off given its greater reliance on the steel-making ingredient.

Even if you don't believe that the iron ore rally is sustainable, and it most likely isn't, as long as it can hold onto most, or even some, of its gains this year, the profits at the miners will rise sharply, something that investors appeared not to have priced in as yet.

**Lithium: the "white petroleum"**

One commodity that looks "white hot" is lithium, the lightest metal on earth, is an essential component of modern batteries, which are expected to enjoy boom years ahead as electric cars become more commonplace. Tesla's CEO Elon Musk recently commented "In order to produce half a million cars a year…we would basically need to absorb the entire world's lithium-ion production".

Lithium, despite being a small market incapable of hosting the volume of companies touting themselves as lithium players even at projected capacity expansions, most have been able to attract funding for exploration. Problem is there isn't a traded market for lithium, and there are numerous grades of the metal as well, making it extremely hard to get direct exposure to its positive story. One specialist metal service reports lithium carbonate, which is used in batteries, has risen almost 80 percent in the past year.

But so far the main way to play lithium has been to look for the next big thing in mining, with junior miners enjoying spectacular gains just by mentioning lithium tenements in press releases.

While we are cautiously optimistic, we nonetheless remain vigilant given the broad range of risks that continue to confront us in 2016. When the commodity cycle swings up, that will change. Investors will get excited and the wider market will resemble the lithium space. C

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***PETRA COMMODITIES, is a boutique "merchant banking" and advisory firm dedicated to sourcing, investing in and executing the best natural resources deals in Asia-Pacific, with offices in Singapore, Jakarta and Sydney.***

***Petra Commodities was founded by Alberto Migliucci, an experienced investment banker and qualified geologist with more than 25 years' experience in the mining, oil and gas and investment banking sectors. PETRA COMMODITIES sources Asian natural resources projects of the highest calibre through an established network of corporate and ultra-high net worth individuals. PETRA COMMODITIES is also set up to take investment positions in select deals alongside its clients.***

***Alberto Migliucci is a regular contributor to Coal & Minerals Asia magazine, excerpts of this article originally appeared in FORBES Indonesia magazine (July 2015).***

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