Perspectives

Opus Investment Management, Inc., 440 Lincoln Street, Worcester, MA 01653, www.opusinvestment.com

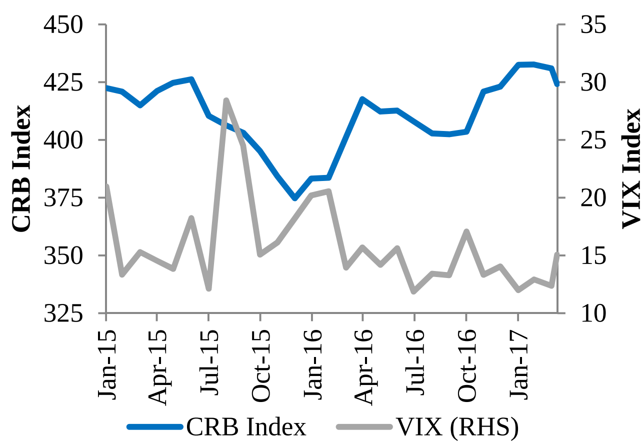
Commodity Recovery

May 2017

A little more than a year ago, the commodity sector became a focal point of markets as a major source of risk amidst a prolonged slump in prices. What has occurred since then to drive such a reversal?

After reaching a bottom in the first quarter of 2016, commodities represented by the Commodity Research Bureau (CRB) Index have since experienced a steady recovery that has buoyed markets and reduced overall volatility as measured by the VIX Index (Exhibit 1). The positive effect has spread beyond the immediate commodity sectors as the newfound stability has soothed fears surrounding China's economy, which accounts for approximately half of global demand for many bulk commodities. The resulting confidence has created a healthy demand environment as inventory restocking begins to occur throughout the supply chain.

Exhibit 1: Steady recovery in commodity prices has helped reduce equity volatility



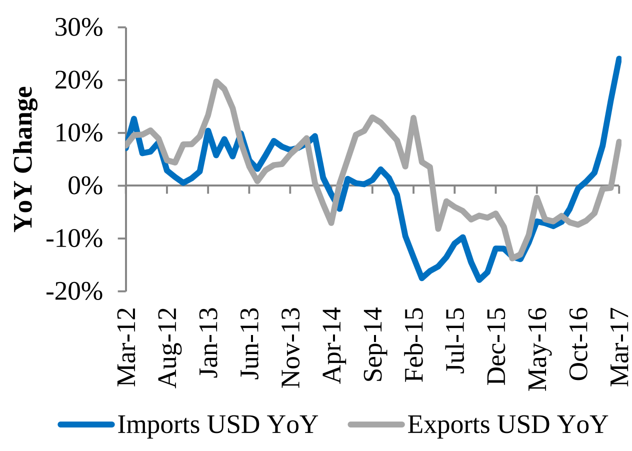
Source: Bloomberg

Supply side capacity restraint has made several major contributions to the commodity sector recovery. Early in 2016, Saudi Arabia began to lead negotiations to freeze oil output among major non-US producers. The discussions had the effect of reducing volatility in the near term and ultimately supported prices into 2017.

Around the same time, China rolled out plans to close excess coal and steel capacity over the next three to five years and established targets for year end. The move served the dual purpose of removing loss-making facilities and addressing the nation's pollution problem while helping spark a year-long 140% met coal rally in 2016. In the second quarter, regulatory pressure increased against cheap steel imports with both the US and Europe imposing anti-dumping duties on a list of producer nations. The net effect triggered a similar rally among benchmark steel prices.

Underlying demand has since recovered as well, with China unveiling renewed fiscal stimulus targeting infrastructure development that combined with capacity cuts to increase imports (Exhibit 2). The effect of the stimulus has spread well beyond its immediate demand implications as the industrial supply chain began to restock inventories amid renewed confidence and forecasts of rising commodity prices that became a self-fulfilling prophecy.

Exhibit 2: Chinese trade has rebounded, partly a result of government support

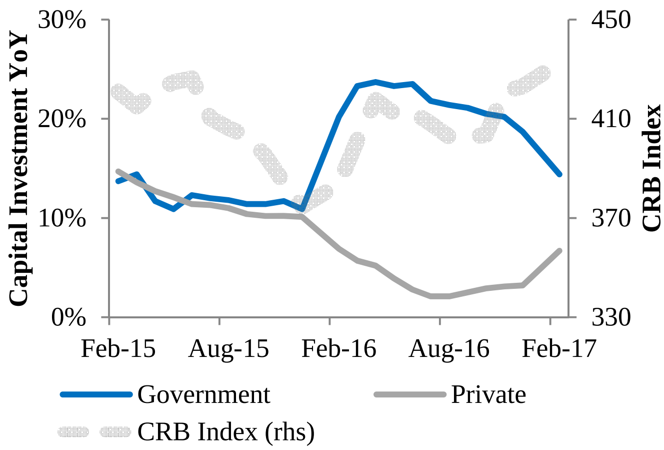


Source: Bloomberg

Just as it seemed the recovery had passed its peak, the election in November created market expectations of further fiscal stimulus from the US amid tax and regulatory reforms that triggered another surge in commodity prices. The recovery can have a circular impact given the intertwined relationship between the industrial sector and commodity producers as mutual suppliers.

Since the inauguration, risk has crept back into the market with broad indices having receded from a near term peak. In the near term, the difficulties encountered by the current administration in enacting their platform agenda have called into question the timing and likelihood of infrastructure stimulus or tax reform, while rising trade friction remains a possibility. The failure to bring a new healthcare law to vote at the end of March served as a catalyst for these concerns, precipitating a 3% decline in the CRB Index over the following three weeks.

Exhibit 3: Fiscal stimulus has supported Chinese growth and commodity prices



Source: Bloomberg

Over a longer horizon, there is some concern regarding the underlying sustainability of the fiscal stimulus supporting China's demand (Exhibit 3). Debt levels have steadily increased in China with total debt to GDP having risen from 161% at the end of 2008 to 258% at the end of 2016. This level of debt is comparable to that of other developed nations, but remains very high for a still-developing nation with a less stable growth trajectory.

Despite the concerns facing the commodity sector, some lasting positives have occurred among producers. Following the initial collapse in prices, nearly every major producer undertook deleveraging and restructuring programs that have strengthened balance sheets across the sector and lowered the cost of production. As part of these efforts, many firms have put in place more conservative management teams and adopted a more disciplined approach towards increasing capacity. Efforts to reduce debt were further accelerated as commodity prices recovered, generating higher levels of cash flow and expediting asset sales. These changes have been documented by the rating agencies, resulting in a series of upgrades throughout the sector over the past year.

Viewed as a whole, the commodity sector is carrying positive momentum into 2017 with fundamentals reflecting a state of cautious optimism. Despite these tailwinds, risks to the outlook persist within this cyclical industry, suggesting particular care be taken towards investment.

<u>Contact information</u>
Kevin Seabury
Director of Business Development
(508) 855-3112
kseabury@opusinvestment.com