Perspectives

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Commodity Price Plunge

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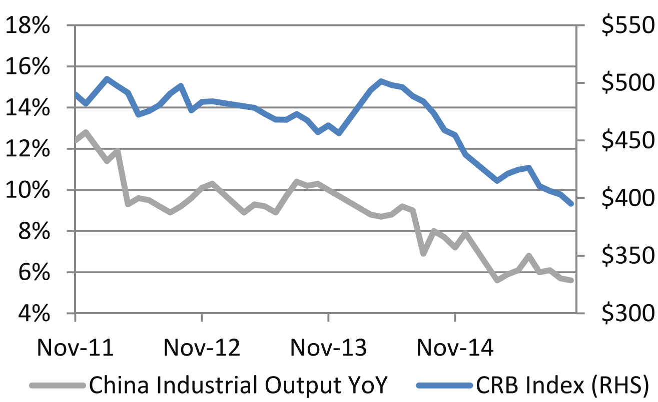
Since the start of the year, commodity prices have plummeted, partly due to the shifting pace and composition of Chinese growth and partly due to other supply and demand factors unique to the oil industry. Market volatility has increased alongside falling commodity prices (Exhibit 1) as participants struggle to define new forward expectations and separate the impacts of supply and demand, an increasingly important topic since China accounts for 40% to 60% of global demand for most bulk commodities.

Exhibit 1: Falling commodity prices alongside Chinese industrial output

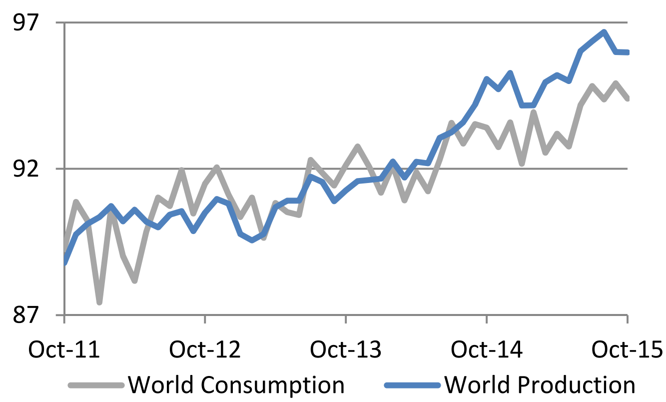


Source: Bloomberg, Opus

On the supply front, last year's move by Saudi Arabia to increase oil output even as US producers have increased production through fracking techniques have resulted in a glut of oil on the world market (Exhibit 2). On the metals side, surging levels of debt-funded expansions within the mining sector have had a large impact on global supply over the last few years since China's voracious demand for industrial metals seemed limitless.

Meanwhile, with respect to demand, the IMF has twice reduced its 2015 world economic growth forecast since the start of the year as economic activity has trailed expectations. US GDP growth has also been weaker than expected, stemming from less oil and gas activity and a stronger dollar hurting US exports, offset by strength in the services sector. In China we see similar behavior, with contraction in the manufacturing sector but decent growth in the services segment. This growth differential persists globally, consisting of both cyclical and structural factors and challenging policy across Asia and the emerging markets.

Exhibit 2: Global liquid fuel production and consumption in millions of barrels per day

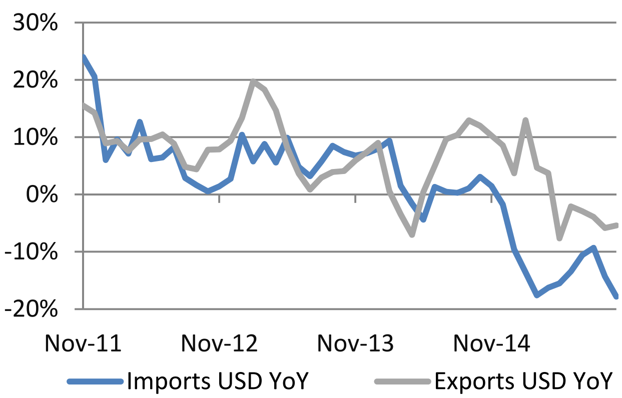


Source: Bloomberg, Opus

In the more consumer-driven economy which China is attempting to create, commodities tied to capital investment such as steel, iron ore and metallurgical coal may play a smaller role in future growth which suggests some of the slack in demand may be structural or permanent. The weaker Chinese demand being witnessed across the commodities sector and the impacts of state support can best be demonstrated by an example from the steel market. In 2014, Chinese annual crude steel consumption declined by 3.4% over the prior year, ***the first decline in three decades*** and a signal indicating that China may have reached peak steel demand. In

September, China's year to date crude steel consumption declined by 5.6% while Chinese production had only fallen 2.1%, driving up steel exports by 35% over the prior year as loss-making producers rely on state subsidies to maintain production by flooding foreign markets. This initial reluctance by China to allow market forces to reduce high cost domestic production creates further downside for commodity prices as Western trade cases begin to take hold. These moves also conflict with the intended goals of China's leadership by increasing reliance on external demand instead of decreasing the export-based focus. This trend exists across China's commodities sector and magnifies the pain felt by other emerging market producers who supply China's imports (Exhibit 3).

Exhibit 3: Chinese trailing quarter USD import and export trade growth over the prior year



Source: Bloomberg, Opus

The resulting impact of state subsidies and expansion of Chinese production has weighed on global commodity prices and profit margins by shifting responsibility for supply reductions to lower marginal cost producers and further delaying supply cuts. However, recent government actions including October's allowed default of state-backed steel producer Sinosteel indicate the government may now be more willing to allow some necessary closures to occur.

Taken as a whole, the divergence that exists between the industrial and consumer sectors has created heightened uncertainty that has been driving recent market volatility. Investment within the commodity sector is plunging as producers struggle to correctly anticipate demand. Both structural and cyclical factors play a role in the current stage of the commodity cycle, with commodity producers experiencing ongoing growth in mined supply against weaker industrial demand while attempting to invest through the cycle using defensive positioning.

The investment implications from this dramatic shift in commodity prices are being actively evaluated but corporate bond spreads, which reflect investor sentiment on risk, have moved wider for the entire energy, mining and minerals complex. Several companies have seen their ratings downgraded and more will likely follow. These conditions dictate caution be exercised in portfolio positioning: opportunities will emerge, but it may be too soon to take advantage since commodity prices still appear to have more downside than upside over the next year.

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