Shifting Fundamentals in Several Commodity Markets

Around the end of the third quarter (Q3), North American stock markets became significantly more volatile. Many high-quality companies have experienced small fluctuations in their share prices that are not really noteworthy in the context of long upward trends. On the other hand, sentiment about commodity-producing companies has become quite bearish. Many of those companies' shares have declined sharply, raising big-picture economic questions and possibly leading to future buying opportunities.

As of October 8, the publication date of this Q3 edition of The Armstrong Schmidt Perspective, our direct exposure to commodity industry sectors was approximately 26% in the Total Return Portfolio (23% energy and 3% precious metals) and approximately 21% in the High Yield Portfolio (21% energy and 0% precious metals). We are comfortable with those allocations, as we view them in the context of diversified portfolios under active management.

Interestingly, we are seeing some real benefits from diversification in the past month, as the performance of different industry sectors has diverged. Some of the fundamental factors hurting our commodity-producing investments are helping other investments. For example, the rally in the U.S. dollar is helping our U.S. investments perform better than many Canadian stocks. Also, the potential interest rate increases in the U.S. could enhance the earnings power of some of our financial sector investments.

We believe that we are well equipped to manage client portfolios through a variety of near-term scenarios. We have significant weightings in cash in both portfolios (18.6% in the Total Return Portfolio and 19.7% in the High Yield Portfolio) that we would like to deploy into new positions if we can find bargains that meet our criteria. And if the current decline in stocks reverses rapidly, we have plenty of exposure to companies with good appreciation potential.

We usually devote a lot of space in our newsletters to discussions of portfolio changes; however, in Q3, we had minimal turnover, other than a profitable sale of SNC Lavalin Group Inc. (TSX:SNC) out of both portfolios in August at a price of $56.69. Since the commodity price declines currently taking place are interesting and relevant, we are going to use this edition to focus on that topic from a few different angles.

Shifting Supply and Demand Dynamics

Most commodities are priced based on simple global supply and demand. When supply of a commodity rises faster than demand, prices will typically decline. The iron ore market serves as a good example. Major mining companies such as BHP Billiton Ltd. (NYSE:BHP) and Rio Tinto PLC (NYSE:RIO) have recently been increasing their output of iron ore (used in steelmaking) from low-cost sources. This has put intense pressure on smaller competitors, and has driven some of them completely out of the market. The iron ore price has fallen around 40% so far this year.[1] We do not see any compelling reason to allocate capital to iron ore producers at this time. We have not owned any iron ore producers since the sale of Vale S.A. from the Total Return Portfolio several years ago.

The global supply and demand picture for crude oil is also shifting. We have owned a significant allocation to high quality Canadian oil producers for many years, including Canadian Natural Resources Ltd. (TSX:CNQ), Cenovus Energy Inc. (TSX:CVE) and Suncor Energy Inc. (TSX:SU). These companies have a high degree of long-term investment appeal, as they have production growth potential, dividend growth, and reasonable valuations. Even so, we may need to temper our short-term expectations for share price performance.

The International Energy Agency recently cut its global oil demand forecast for 2015. Demand is now expected to increase by a moderate 1.2 million barrels a day, or 1.3%, to 93.8 million barrels a day next year.[2] On the supply side, U.S. oil production achieved its highest July level in 28 years, and U.S. oil imports declined to their lowest July level in 19 years.[3] The production gains are being driven in part by fracking technology. With U.S. oil imports declining, the oil that is no longer being shipped to the U.S. is heading elsewhere and pushing prices downwards. Even the various negative geopolitical events in oil-producing nations during the past six months have failed to hold up prices, which may be evidence of the changing supply and demand dynamics.

One of the longer-term bullish arguments for oil that is still convincing today is the point that much of the new oil production globally is coming from relatively high-cost sources. Any serious oil price correction could render some of the new production uneconomic and take it out of the market.

For another interesting example of changing commodity supply and demand dynamics, we will turn to agricultural commodities. Since our sale of Agrium Inc. (TSX:AGU) out of the Total Return Portfolio several years ago, we have had no direct exposure to agricultural commodity prices. Wheat, corn and soybean prices have declined sharply over the past 18-24 months, and this has taken some investors by surprise.

One cause of the decline is the rise in global inventories (supply), which has been aided by good growing weather and strong crop yields. Several years ago, when prices for these commodities were at their peak, some pundits downplayed their cyclicality, citing population growth, rise of the middle class in emerging markets, and insufficient arable land as bullish arguments. These arguments have not been invalidated by the recent supply increases. Rather, they will be proven true or false over a longer time horizon.

On October 7, we noted that farm machinery maker Agco Corp. (NYSE:AGCO) cut its earnings guidance sharply due to weaker than anticipated levels of demand for its products.[4] Shares of competitor Deere & Co. (NYSE:DE), maker of John Deere farm equipment, dropped to a 52-week low in sympathy. If agricultural commodity prices continue dropping, we might be able to find some bargains in this sector.

Weak Global Economic Growth

The International Monetary Fund (IMF) recently cut its global growth forecasts for 2014 and 2015 and warned that the world economy may not return to the pace of expansion seen before the financial crisis of 2008-2009. The IMF now expects global growth of 3.3% in 2014 and 3.8% in 2015, but acknowledged the risk that its predictions could once again be too optimistic.[5]

Narrowing our focus to the specific country that has the strongest influence on many commodities, China is expected to achieve GDP growth of 7.4% this year, 7.2% in 2015 and 7.1% in 2016.vi By the standards of more mature economies, these are impressive numbers, but they represent a disappointment to many investors, as they are beneath expectations. There is recent evidence of slowing in the property and construction sector as well as underwhelming industrial output.

The Chinese construction industry has been intensively consuming commodities like copper and iron ore for years. The country is the world's largest copper consumer, having accounted for almost 40% of world consumption last year.vii The country's steel consumption recently declined on a year-over-year basis for the first time in 14 years. viii Many commentators have argued for years that China has been overbuilding both residential and commercial real estate, boosting GDP in the short run, but creating the risk of a downturn. Weaker than expected growth around the world, especially in China, is certainly contributing to current commodity price declines.

U.S. Dollar Strength

The U.S. dollar has been strong recently, rising against other currencies, including our own. U.S. dollar strength weighs against commodity prices in the short term because they are typically quoted in America's currency.

One reason for the U.S. dollar's strength is the expectation that U.S. interest rates will rise in June 2015 or earlier. America's September jobs report was stronger than expected, with the headline unemployment rate coming in at only 5.9%.ix Despite this data, we believe there is still a fair bit of slack in the U.S. labour market – wages are unlikely to rise rapidly. That said, interest rates remain at ultra-low "emergency" levels, and that may no longer be warranted.

We would actually welcome interest rate increases, if they become necessary due to strength in the U.S. economy. An environment of moderate rate increases combined with positive economic data over an extended period could be a healthy environment for stocks. Unfortunately, in recent years, it seems like every time this scenario appears possible, some area of economic weakness inevitably arises and rate hikes are delayed.

Conclusion

Thank you for taking the time to read this Q3 edition of The Armstrong Schmidt Perspective. The current commodity price declines are both interesting and relevant to the portfolios we manage. We are diversified and also have significant cash positions in the portfolios, which may help us benefit from this market turbulence.

Portfolio turnover was very low this quarter in both portfolios as we are generally very pleased with the companies we own. Performance year to date has been decent. Our big-picture expectations are for continued moderate upside in stocks over the medium term as global economic growth continues in a somewhat sluggish fashion.

As always, we thank you for your business, and invite you to contact us with any questions or comments.

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1 http://www.telegraph.co.uk/motoring/car-manufacturers/toyota/10594637/Toyota-still-the-worlds-biggest-car-manufacturer.html

2 http://www.nytimes.com/2014/02/26/automobiles/lexus-ranked-no-1-on-consumer-reports-annual-brand-report-cards.html?_r=1

3 http://www.marketwatch.com/story/toyota-reveals-fuel-cell-vehicle-sedan-2014-07-23

4 http://www.entrepreneur.com/article/235646

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