Q&A

Commodities: The Age of Constraint *not* Scarcity

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*In this Q&A, **René Ledis**, Senior Research Analyst at Western Asset, talks about the multi-faceted tug-of-war that has enveloped commodities in the global arena as well as current trends that are likely to persist. Market participants have taken the availability of resources for granted; the implications are widespread, ranging from more competition for reserves and production to higher cost structures that ultimately lead to higher prices. Ramifications are lasting and likely to affect current and future generations, and thus have implications for government and corporate investment decisions. These implications create opportunities for investment.*

Q: Commodities have always been an important consideration in respect to economic development. What would you say are the primary drivers in the current environment?

A: When we consider drivers for commodities, the initial focus certainly involves a conversation about demand. I want to defer this conversation for the moment and concentrate on supply, which has long been overlooked, yet has driven many decisions over the past decade already. Specifically, the issue of supply security and access to resources should be at the forefront of investors' thinking. These constraints will still be evident even in the absence of demand. Lower demand only serves to push out any form of resolution or alleviation of tight supplies to some point further in the future.

Q: What are the reasons behind the supply growth constraint?

A: The supply growth rate across commodities has been constrained for many reasons that have not been resolved over the shorter term. The commodities industry has been suffering from accelerated decline rates, declining ore grades in the case of metals, and new discoveries located in land-locked emerging regions that lack the necessary infrastructure to transport product to markets, potentially exposing foreign producers to increased political risks. Couple these factors with an aging skilled-labor force, plant and equipment shortages, and a slow pace of technological innovation, and we are confronted with a recipe for continued supply tightness. The trend is unlikely to abate over the near term as the industry has experienced years of underinvestment. The global financial crisis only exacerbated the situation as projects were canceled or postponed, with management making liquidity preservation and debt reduction the priorities over larger capital investments that could be deferred; management is simply choosing to live for another day.

Q: Does this mean that supplies are scarce?

A: No. We have to dispel this notion, as scarcity implies a limited or known finite quantity, while we know as an industry there is untapped resource potential. Rather, the notions of "access" and "supply security" are better descriptors. I have observed that returning capital to a project or development that has been deferred does not restore the project to the point when the capital stopped flowing. Given the nature of the investments, project restoration requires re-evaluation. Consequently, the development of new reserves and production are pushed out years, not months. In recent times, many people have confused these supply constraints with scarcity. To unlock the resource becomes a question of technological ability, innovation and cooperation on domestic and international levels, and across both governments and the private sector. The most recent example of such technological innovation is hydraulic fracturing in the US shale natural gas industry.

Q: What part does demand play in respect to commodity consumption going forward?

A: We have to look at this from both the developing and developed economy point of view. First, the developed world has historically dominated the thirst for commodities—both industrial and energy. However, the landscape continues to change and evolve now that the pendulum has swung to developing nations, where demand has reached critical mass, and the intensity of commodity use has both increased and is set to continue on its upward trajectory as higher standards of living drive per capita consumption upward. A theme of urbanization and industrialization has gathered momentum and is difficult to stifle let alone reverse. As the investment-led phase transitions to consumption-based growth, the changing global demographics are likely to continue exerting longer term upward pressure on demand. China has long been considered the support for such demand, particularly over recent years, but other developing countries are emerging from the shadows—namely India, Brazil, Russia and the "next-eleven" nations.

Second, we should consider the return of the developed-world economies following a period of duress. During this time, more accommodative fiscal and monetary policies were established and are still being filtered through the system. Not unlike the urbanization and industrialization theme in the developing world, the developed economies' directed efforts to "replace and upgrade" existing infrastructure is further underscoring demand. Any return of normality only adds another element to future demand.

It is clear that the potential for a significant increase in future raw material demand should intensify competition for resources and resource access.

Q: How do you see the commodity story developing?

A: We characterize the changes occurring as more secular than cyclical, although we will continue to experience cyclicality within the trend. The hurdles to reserve growth and production growth as well as other technical challenges that face this naturally depleting industry all raise the competitive stakes. Larger investments have been required to produce the same product yield from existing assets, so generally management has been looking internationally to negate the steepening cost curves. The location of "new" resources favors developing-market economies. The private sector has long endeavored to secure access to these resources by establishing and nurturing relationships, including the establishment of social-reform funding in the form of commitments to building schools, hospitals, roads and railways. Organic growth and development of new resources have been complimented by increased M&A activity. Growing the asset base affords players the opportunity to recognize the benefits of geographic and product diversity and to take advantage of changing trends, enabling competition with other participants while reducing the risk of organic development. It has been proven over the past cycle that large, diverse operators are more resilient.

Q: Where do you see the competition taking place?

A: Competition for resources has not been restricted to the private sector. Over recent years, governments and state-owned enterprises are more involved in the competition. Governments recognize that establishing the security of resource supply is paramount to satisfying domestic policies and agendas. We have noticed the increase in activity as it relates to windfall taxes, royalties, ownership rights and trade policies. Governments have the ability to review or renegotiate existing contracts, change mining laws and increase regulation (industry and environmental) in order to extract greater value from the resource base. One observation is clear: this activity is not restricted to developing nations but is open to any nation with natural resources, e.g. Australia. However, in any cyclical downturn, the increased government involvement has implications for ongoing investment given the balance needed between competing policy agendas. Governments cannot afford inhibiting future foreign direct investment and further development of natural resources.

Q: What implications do you therefore see here?

A: Costs to develop are being driven higher and potential exists for greater volatility in an already cyclical sector. The upward trajectory in costs is expected to continue as a greater proportion of the resource pie is shared with host nations, and as underlying capital costs for development increase. The prospect of higher floor prices in the future is real as cost structures rarely revert back down to their prior levels.

The upward price trend for commodities becomes a self-fulfilling prophecy as geopolitics, urbanization and industrialization, resource supply constraints, and producer policies will continue to manifest as higher prices. The supply side is much more susceptible to disruption, which only biases the price expectations higher in markets where supply is already tighter than historic levels.

The ramifications go beyond a single industry, propagating throughout industries and economies, resulting in wealth transfer effects and non-OECD economies growing political and economic influence with the potential to alter trade flows.

Regardless, the tug-of-war dynamic is certainly expected to continue as economic development rolls forward.

Q: As an investment manager, how do you incorporate these views?

A: A discussion of commodities can be complex and taken in any direction from the micro level to a macro theme. Peoples' perspectives on supply and demand differ depending on their location and assignment. As a result, we seek to construct a robust and holistic view of this complicated subject by utilizing our global platform and the experience and expertise of our 28 analysts. We have investment-grade, high-yield and emerging markets analysts collaborate on a point of view, distilling market developments, headline shocks and noteworthy events as they do so. This gives us a competitive advantage; it would not be prudent for one sector team or one analyst to ponder and develop what would ultimately be a biased view of this asset class.

As an analyst working in the US investment-grade team, focused on commodities and utilities industries, I stay in close contact with the high-yield and emerging-market teams to perform the due diligence that is required for the companies I follow. Our access to senior company management enhances our qualitative assessment of issuers and complements our fundamental quantitative analysis for a well-developed investment thesis reflected in our portfolio positions.

Long gone are the days when analysts covering commodity and utilities companies could pursue a silo-oriented approach in this space. The globalization of economies and financial markets has amplified benefits and risks, and commodity prices are one of the main transmission channels of global risk. Because of its importance as a source of critical input to corporate valuation, commodities demands true global focus and requires sharing ideas and concerns, all with the intent of piecing together a mosaic that will continue challenging both passive and active participants in this space for the foreseeable future.