

# The Disruptive Discoveries Journal

**Weekly analysis of how disruption in commodities, geopolitics, and macroeconomics converge to create opportunities**

**December 14, 2015**

**By Chris Berry ([@cberry1](#))**

## **2016: There's Something in the Air**

As is the case this time of year, we start to close the books on 2015 and position for 2016. While we have effectively and indefinitely moved “to the sidelines” with respect to stock picking in the junior mining space, there were some notable successes, in particular with the merger between Western Lithium (WLC:TSXV) and Lithium Americas. This combination positions the new company in a unique strategic light as electrification, underpinned by the lithium ion battery, gathers steam in 2016. Galaxy Lithium's (GXY:ASX) restructuring is another positive development. We'll be watching the developments with these two companies closely.

In 2015, there was very little to be cheerful about in the metals markets and to be blunt, we expect this malaise to continue into 2016. China's RMB devaluation last summer and subsequent popping of its equity bubble opened many people's eyes to the extent of the structural issues both inside and outside the country. As we have written about many times before, these twin structural headwinds are excess capacity and slack (or slower) demand. We see no reason why China won't continue to export deflation all over the world and keep an effective “lid” on many commodity prices for the next two years.

On a positive note, producers do seem to be “getting religion” and making painful decisions around cuts in capacity, headcount, and dividends with Anglo American (AAL:LON) and Freeport McMoran (FCX:NYSE) serving as the two most visible examples. AAL's decision to reduce headcount by 85,000 is shocking but necessary to rebalance the metals markets and heal the damage done during the super cycle.

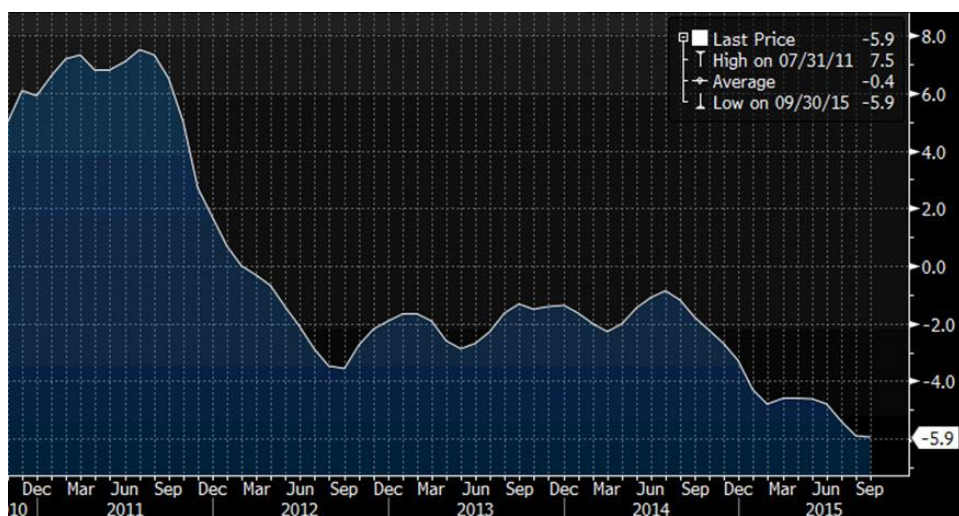
While we could go on about the many challenges in 2015, we prefer to look forward to 2016 and uncover situations to take advantage of or alternatively, landmines to avoid altogether. What follows is a quick take on some of the major themes we see playing out in 2016 and beyond. The title of this

note “There’s Something in the Air” is meant to point out both the positive and negative trends we see unfolding.

First, **the carnage in the metals sector isn’t over**, though the worst is likely behind us. While the moves by AAL and FCX mentioned above are good first steps, they are just that – first steps. It seems that metals producers both inside and outside China are finally ready to face the painful decisions to cut capacity, but this has yet to affect metals prices. With over 60% of the nickel cost curve underwater on a cash basis, this is unsustainable over the long term, but precisely when this will turn has many on Wall St, Bay St, and Mayfair scratching their heads. Junior mining survival strategies will be of paramount importance in 2016. We still firmly hold on to the conviction that in this era of excess supply and muted demand, only lowest cost producers warrant your attention.

We **expect deflation to become a more pervasive force in 2016**. While we have been very clear on this for several years, the tsunami of deflation being unleashed by China can no longer be ignored. An article in the Wall Street Journal earlier this year quoted UBS analysts stating that there was enough excess steel capacity in China to build 75,000 Eiffel Towers. This cannot change overnight.

The Producer Price Index (PPI) in China:



It would appear that **secular stagnation**, popularized by former US Treasury Secretary Larry Summers, is a force to be reckoned with.

The **uncertainty about China’s true growth rate** will also loom large over global growth in 2016. While it is true that the slower growth rate (6% perhaps?) is unfolding over a \$10 trillion economy, the excessive debt burden in the country, estimated at \$28 trillion, will act as a drag on this growth. We wouldn’t be surprised to see the Renminbi devalued in 2016 as Chinese economic policy makers begin to run out of policy tools to reinvent the economy. Further to this, the RMB inclusion in the IMF’s SDR currency basket is a symbolic first step in China minimizing its dependence on the USD.

The utter collapse in the oil market was certainly the story of 2015 and **we see the oil price staying range bound or heading lower** as OPEC and the US Shale industry continue their game of chicken. Additional supply from Iran ought to only maintain the downward momentum in the oil price. The IMF has reported that Saudi Arabia can withstand low oil prices for the next several years. Will the US shale business be able to do the same as much of it was financed with cheap debt? How much of the

US shale business is profitable at \$35 WTI? One facet of the oil market we'll be watching in 2016 is whether or not the US shale business really is the new "swing producer". Any uptick in the oil price ought to shed some light on this thinking. Should this be the case, OPEC's pricing power will certainly be greatly diminished.

**Central Bank policy divergence will be a major issue in 2016** as the Federal Reserve prepares for a short term rate hike while the rest of the developed and developing world takes a more dovish tone. Are Emerging Markets, saddled with USD denominated debt, prepared for liftoff? Only time will tell. The USD has likely plateaued here, and any additional strength will likely come more from weakness in other currencies (CAD, AUD, COP) rather than underlying strength in the US economy. One of the biggest immediate-term risks we see is the threat of increased financial markets volatility from any Fed rate moves.

**A wave of M&A in the mining space** ought to surface starting in 2016 making bankers happy and taking many long suffering shareholders out of their misery. This is all dependent on the direction and levels of metals prices, as well as the relative debt loads on various company balance sheets. Watching how the majors such as Glencore (GLEN:LON) or others we mentioned above de-lever and right size their businesses during this ongoing commodity rout will provide valuable clues to the depth and breadth of any M&A.

Despite the many issues listed above, there are several positives which offer opportunities in 2016.

We are comfortable stating that we believe that **2016 is the year that the lithium ion battery revolution gets underway**. We further believe that the next five years will determine how we generate, store, and use electricity for the next twenty five and this will put Energy Metals under the microscope. Lithium ion battery costs are decreasing by as much as 14% per year and this is due to a mixture of scale and technological advancement. We see no significant impediments to this trend currently.

Solar power is experiencing similar cost declines and this has us believing in a new model (solar plus storage) of energy generation and storage which will become more competitive with traditional fossil fuel generated power. The recently completed Paris COP21 negotiations act as a significant tailwind here though the dust is still settling how countries will shift to less carbon-intensive sources of energy. We don't expect to see 100% renewable energy anytime soon, but the momentum behind renewable energy is unmistakable.

Given this move, **we are focused on lithium, cobalt, and scandium and associated supply chains**. These metals are going to become increasingly crucial in next generation energy technology and we think you will do yourself a favor by learning as much as you can about the supply chains around these commodities. We will be writing much more about all three in 2016.

We're not as certain about graphite and uranium for separate reasons, but will be watching them for any signs of price increases nonetheless.

We **expect to see solar power deployment explode** (pun intended) in 2016 as the ITC, a 30% tax credit on residential and commercial properties in the US, potentially is scaled back. Additionally, with pollution in Chinese cities at unheard of levels, a more aggressive push towards solar (and other renewable sources) is obvious.

**We think that in five years, we'll look back and realize that 2016 is the year electrification took hold.** The numerous benefits and tail winds far outweigh the threats in our opinion and are setting 2016 up to be a pivotal year vis-à-vis global electrification. The opportunities which we see emerging in this admittedly giant space will be a major focus of our work in 2016. A deeper focus on lithium ion battery technology advances, new financing models for power generation and storage, and mineral bank models are three such areas. Until the metals markets recover, moving “up” the value chain will be prudent.

There is indeed “something in the air” in 2016 as the title of this note indicates. Despite the rather gloomy commodities markets and macro uncertainties, there are exciting opportunities within the theme of global electrification. More to come. In the mean time, we wish you all a healthy, happy, and prosperous 2016.

*The material herein is for informational purposes only and is not intended to and does not constitute the rendering of investment advice or the solicitation of an offer to buy securities. The foregoing discussion contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (The Act). In particular when used in the preceding discussion the words “plan,” confident that, believe, scheduled, expect, or intend to, and similar conditional expressions are intended to identify forward-looking statements subject to the safe harbor created by the ACT. Such statements are subject to certain risks and uncertainties and actual results could differ materially from those expressed in any of the forward looking statements. Such risks and uncertainties include, but are not limited to future events and financial performance of the company which are inherently uncertain and actual events and / or results may differ materially. In addition we may review investments that are not registered in the U.S. We cannot attest to nor certify the correctness of any information in this note. Please consult your financial advisor and perform your own due diligence before considering any companies mentioned in this informational bulletin.*

*The information in this note is provided solely for users’ general knowledge and is provided “as is”. We at the Disruptive Discoveries Journal make no warranties, expressed or implied, and disclaim and negate all other warranties, including without limitation, implied warranties or conditions of merchantability, fitness for a particular purpose or non-infringement of intellectual property or other violation of rights. Further, we do not warrant or make any representations concerning the use, validity, accuracy, completeness, likely results or reliability of any claims, statements or information in this note or otherwise relating to such materials or on any websites linked to this note. I own no shares in any companies mentioned in this note and have no financial relationship with any company mentioned.*

*The content in this note is not intended to be a comprehensive review of all matters and developments, and we assume no responsibility as to its completeness or accuracy. Furthermore, the information in no way should be construed or interpreted as – or as part of – an offering or solicitation of securities. No securities commission or other regulatory authority has in any way passed upon this information and no representation or warranty is made by us to that effect. For a more detailed disclaimer, please click [here](#).*