

# The Disruptive Discoveries Journal

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## A Key Question in the Commodity Rout

To anyone at all involved in commodities, the events of the past two weeks should make one thing abundantly clear: a new paradigm in commodity investing is in play. The most recent iteration of the commodity super cycle (2001-2011) was unlike anything many of us had ever seen. Unfortunately, the aftermath (2011-????) and subsequent correction may also be unlike anything we've ever seen (at least in terms of duration and intensity). I'm fully aware of the cyclical nature of the commodities business, but clearly the greater the bull market, the more severe the bear market.



Source: [Bloomberg.com](#)

The Bloomberg Commodity Index (down over 28% in a year) demonstrates the relentless downward pressure on just about all commodities - hard, soft, or liquid since late 2011. It seems everyone hates commodities these days and has soured on China, with Ray Dalio, head of the world's largest hedge fund Bridgewater Associates and a China bull [recently stating](#) (paywall), "There are no safe places to invest." (Though they have backtracked somewhat recently).

It is all but obvious that multiple issues have conspired to hammer commodity prices. These deflationary headwinds should not be foreign to regular readers of this note and include:

1. Excess supply and slack demand
2. A stronger USD
3. A presumed increase in short term interest rates in the US making Emerging Markets investments (and hence commodity demand) less appealing
4. Decreased confidence in China's leaders to safely transition the economy to a more sustainable growth model
5. The need for continued deleveraging of both sovereign and company balance sheets.

Much of the attention recently has focused on the collapse in China's equity markets and has raised a fundamental question:

**How connected is the collapse in China's equity markets with the slowdown in its overall economy?**

With demand slackening and faster economic growth necessary to service an increased debt load, one can see why China's leaders are urgently trying to transition to an alternate growth model not wholly reliant on exports and internal infrastructure. Sometimes, cause and effect can be hard to discern. Was it the equity rout in Chinese shares that has accelerated the commodity price decline? Or was it the sudden realization that the main engine of global growth – China – has stalled and forced Chinese equity investors to run for the exits, pushing down share prices? Though Chinese share prices are still up YTD and are among the best performing equity markets globally, the rate and severity of the decline has almost everyone shedding commodity exposure as the conventional wisdom believes that the plunge in China's shares is a valid indicator of Chinese economic performance.

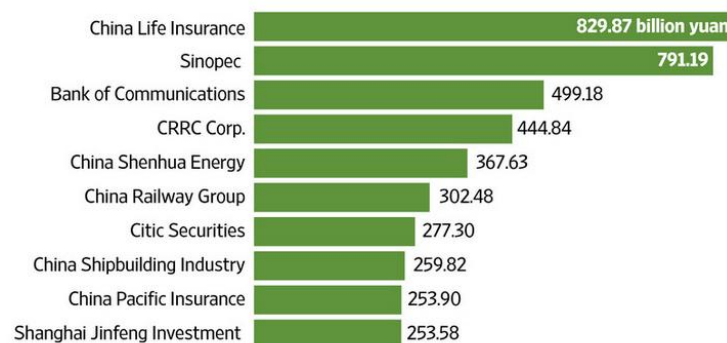
**Sliding Again**

Shanghai stocks resumed falling Monday, suffering their biggest one-day drop since Feb. 27, 2007.

**Shanghai Composite Index**



**10 biggest companies by market cap to fall 10%\* in Shanghai trading Monday**



\*China limits daily rises or falls on its domestically listed stocks to 10%.  
Sources: WSJ Market Data Group (index); FactSet (market cap)

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I actually disagree with this line of thinking. Given the amount of control China's leaders hold over the domestic equity markets (1,400 companies halted, short sellers threatened with jail, no selling by large shareholders allowed), it would appear that the equity performance, both on the way up and the

way down, are more driven by speculation and margin calls than economic fundamentals. The real key here is to determine the implications from a negative wealth effect. As stock prices have collapsed and wiped out a portion of the savings of the average Chinese investor, this could undermine confidence in not just China's capital markets, but the ability of the Communist Party in China to maintain control of the economy and engineer a "glide path" for slower but more sustainable growth.

What ought to worry everyone the most about China is the increased debt load the country must shoulder as economic growth moderates. Of the points listed above regarding downward pressure on commodities, this one is arguably the most important.

China's debt-to-GDP ratio of 282% (according to McKinsey) is likely the most glaring example of a country taking on excessive leverage to sustain growth. However, this ratio doesn't even place China in the top ten countries globally when measuring total debt to GDP. That may be an indictment of other countries policies to grow their respective economy, but with China as the second largest economy in the world, the 282% can't be ignored and must ultimately be reckoned with. For the sake of perspective, China reported \$7 trillion in debt in 2007 and \$28 trillion in 2014, a CAGR of approximately 19%. The Chinese economy grew at nowhere near the same rate. The aggregate debt level, and not GDP or any other economic metric, is the most important data point to focus on. As credit is the lifeblood of an economy, when the credit dries up, a negative effect on economic growth is a given.

As issuing debt to fund growth continues to lose its effectiveness, watch for the PBOC to push for a weaker Yuan as well as lower domestic interest rates. This won't solve China's problems, but will buy them time and is also sure to raise geopolitical and geoeconomic tensions.

With respect to companies deleveraging, we will be following up after earnings season with a note on the current state of select company balance sheets and how sustainable they are given lower commodity prices. Initial results aren't encouraging with Freeport McMoran (FCX:NYSE), Barrick Gold (ABX:NYSE), Glencore PLC (GLEN:LON), and Anglo American (AAL:LON), maintaining total debt levels well in excess of their current market capitalizations, even after billions of dollars of write downs and rounds of cost cuts. To be fair, there are a number of different ways to gauge balance sheet health and we will examine them in due course.

Lost in all of this doom and gloom is the reality that while emerging market growth has slowed, the longer term thesis of more individuals joining the global middle class remains intact. The idea that if economic growth slows this leads to people not wanting "things" which enhance their quality of life is ridiculous on its face. It is undeniable that excess capacity in a number of commodities, from copper to crude oil is likely to remain in place for the next several years. This fact is why we've been outspoken in searching for opportunities "further up" the value chain as mining - from exploration to production - is likely to produce below average returns. This isn't the case for all commodities as some exhibit less elasticity of demand than others. This is one of the reasons we're bullish on lithium.

Until then, the rut in commodities still very much hinges on China's attempts to engineer growth and curb malinvestment.

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