

The Disruptive Discoveries Journal

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

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Emerging Markets at Stall Speed and the Silver Lining in Metals

As China's equity markets continue to sink, calling into question the ability of Chinese officials to prop up the market (and maybe the economy), it appears that collateral damage has already begun.

Both Kazakhstan and Viet Nam have devalued their currencies by 4.4% and 1% respectively in a bid to remain competitive with their Asian neighbors. The MSCI Emerging Markets Index has entered a bear market and a gauge tracking 20 currencies is in its longest slump since 2000, [according to Bloomberg](#). Emerging markets as a whole are dealing with a major slowdown in global trade and collapsing commodity prices and must confront the cheaper Chinese Renminbi as a threat to their balance of payments in the absence of structural reform. The performance various currencies from last week is shown below:



Source: Bloomberg

Earlier this week, copper futures fell below \$5,000 per tonne (\$2.27 per pound). The price has halved since its peak in 2011. While the majority of copper producers (about 75% by our estimates) can still produce copper profitably at these levels, the trajectory of the price decline is telling about the economic situation not just in China, but arguably all over the world. In other words, it's not just the developed world that should prepare for slow growth prospects going forward. WTI crude oil is down over 20%, gold and silver are down over 5%, copper is down 20%, and nickel has fallen 30% (all YTD and in USD according to Bloomberg).

So Now What?

This raises an interesting question around what exactly an "optimal" resources portfolio should look like in the current environment. Given the absolute bloodbath in the metals, is this even something worth considering at this point? It appears that overall demand will remain soft and the US Dollar will remain strong and possibly strengthen over the next six months as market participants try and get some clarity around what China's "new normal" will look like. I thought Ivan Glasberg, CEO of Glencore (GLEN:LON) summed it up nicely when he said, "No one in the mining industry can read China at the moment."

Additionally, I think the Federal Reserve could go either way vis-à-vis a rate increase in 2015, and the [minutes from their latest meeting](#) seem to indicate continued ambivalence. While it can be argued that much of the economic data indicates that they *shouldn't* raise short term rates (something I agree with), maintaining credibility and "sticking to their word" is important and so a chance for a rate increase exists.

I've said many times before that I think deflation as opposed to inflation is the predominant force and this thesis remains entirely credible. This implies continued slack in aggregate demand, continued pressure on commodity prices, and abnormally low interest rates. Could central banks have backed themselves into a corner in an attempt to ignite growth after 2008-2009? The USD appears set to remain the currency of choice and further weakness (and lower rates) is likely in traditional commodity currencies such as the Canadian Dollar, Australian Dollar, South African Rand, and Chilean Peso.

What About Equities?

The other day I was forwarded an email from a friend and the content of the email discussed gold stocks being "on sale" and implied high upside from here. Aside from being intellectually dishonest (and wrong in my opinion), it does raise a legitimate question: Is now the time to buy mining stocks?

The short answer, I think in general, is no.

While it is true that certain mining stocks, be they juniors, developers, or majors are cheap on a relative and absolute basis, this doesn't necessarily mean it's time to buy. Just because something is "cheap" doesn't mean it is valuable, as Warren Buffet has said (I'm paraphrasing here).

As an example, say I'm offered the opportunity to buy a beautiful boat on sale. The only problem is there is a huge, gaping hole in the hull. The boat may be cheap relative to other boats, but it is definitely not valuable. I view mining stocks (producers) in the same vein. Just because a mining

stock has a price-to-earnings (P/E) ratio of 7 when its peers have a higher P/E multiple doesn't necessarily make it cheap. What if the stock with a P/E of 7 has net debt which is double or triple its market value? This, sadly, is the case with many mining companies. The proverbial "hole in the hull" is the debt load on the balance sheet. Until this is rectified, mining companies should continue to underperform. One strategy could be buying some of the debt as long as it's secured by the mining company assets, but this would only likely be for the most patient of investor.

There's Always a Silver Lining

Despite the numerous macro headwinds, there is always a silver lining. Given the manifold challenges listed above, I think you're going to see more M&A activity in the mining space. I have made this call in the past (about a year ago) and it appears to have been too early. With metals prices in free fall, growth all over the world generally sluggish, and many mining companies in dire need of balance sheet repair, the timing for M&A seems propitious. One such example in the rare earth space is Lynas Corp (LYC:ASX) who, after restructuring its balance sheet, has publicly stated a buyout proposal would be "seductive" though no offers currently exist.

The name of the game remains productivity and which companies can enhance productivity to drive returns. This can manifest itself in a number of ways, but both balance sheet and project portfolio optimization are the two easiest places to start. In a macro sense, I still believe that productivity drives wages which drives growth. I see no real difference when applying this line of thinking to the mining industry.

Troubled mining companies are one day going to be the next market darlings as supply and demand equilibrate though we are a couple years away from this. Each metal has its own dynamic and as such each metal should be viewed individually. It is for this reason that lithium, cobalt, and scandium are particularly interesting while copper remains a longer-term favorite.

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