Equity

# We keep on riding our young Materials race

## Our young Materials race is still on track. But now we are riding on both horses – chemicals and miners.

In mid-July we have upgraded the materials sector to overweight after a long period of neutral weighting. This upgrade was mainly based on the metals-and-mining subsector which we upgraded already a month earlier. We believe that the sector has successfully undergone a restructuring and shown surprising capital discipline. Balance sheets have been repaired and are now strong enough to increase or re-start meaningful pay-outs. This self-help story is meeting benign market conditions. The U.S. dollar weakness and macroeconomic stability in China have both contributed to the recent recovery in commodity prices. The solid reporting season has confirmed this positive picture. While the sector has gained more than 50% since its recent low in January 2016, it still trades 32% below its peak from 2008.

These numbers, however, become much more impressive when looking at the subsectors of the materials index we are using. In the MSCI ACWI Materials Index, the chemical subsector accounts for more than half of the index's market capitalization, and the metals-and-mining subsector for roughly one third. Considered highly cyclical itself, the volatility of the chemicals pales in comparison to that of metals and mining. The latter has lost more than 80% since its peak and only reached its trough last year while chemicals already troughed in 2009. Since January 2016 the metals-and-mining index more than doubled in value, which still leaves it more than 60% below its 2008 peak. The chemicals index, on the other hand, currently trades at record highs, 22% above its 2008 peak. This further illustrates the discrepancies within the materials sector. In fact, the correlation coefficient of those two subsectors has been a meager 0.57 over the past 20 years. That number increases to 0.86, however, if only considering the last two years.

Since our upgrade, the metals-and-mining subsector has performed particularly well. Combined with some cyclical short-term headwinds that we see arising, this makes the subsector vulnerable to temporary setbacks, notwithstanding our positive mid-term view. Chemicals, on the other hand, have shown a strong set of second-quarter figures and are benefiting from increased corporate activity. As prices and hence valuations of some of our preferred names especially in Europe have come down since mid-June, we now see this subsector as an equally strong driver of the materials sector as metals and mining.

With metals and mining being the real swing factor of this sector, however, this is where we will put the focus on in this report. Chemicals, as a side note, have performed well over the past years, but almost exactly in line with global stock markets, when looking at the past nine years.

Andre Koettner
Global Co-Head of Equities

Thomas Schuessler
Global Co-Head of Equities

**In a nutshell**

- Our July upgrade of the materials sector was mainly based on our previous call on metals-and-mining companies. We are now basing our call on the chemicals subsector as well.
- While the miners' restructuring story is intact, we see potential headwinds in the short term. After their strong recent rally, the sector might be vulnerable to disappointments.
- Chemicals have recently shown strong results. Some of our preferred European names have retreated enough in the past two months to make valuation interesting again.

## Metals and mining – a typical boom-and-bust industry

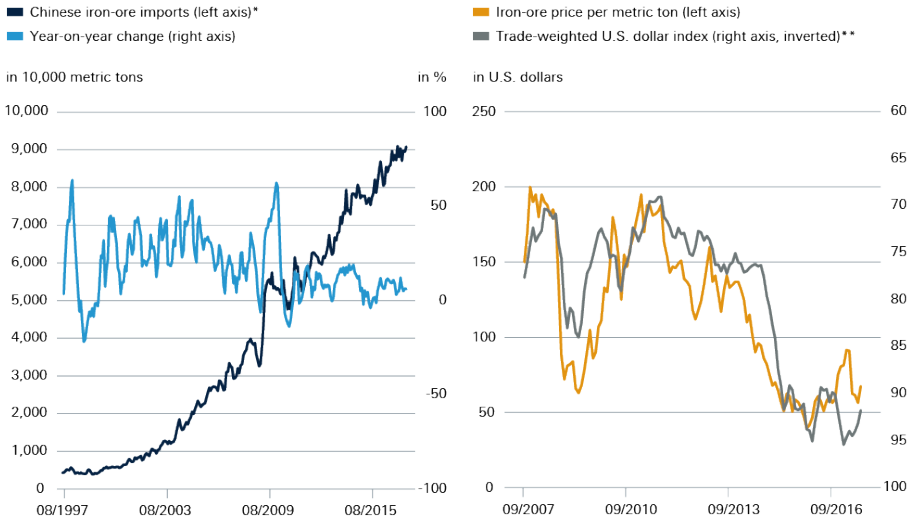
The metals-and-mining subsector is a perfect example of an industry that is not only prone to cyclicality but also to full-blown boom-and-bust cycles. This comes as a result of the price-driven commodity sector with high capital intensity and long capital-expenditure (capex) cycles. When demand and prices are rising, the companies typically increase their capacities to capitalize on this rise. With new projects/mines taking up to 7 years to be established, capacity built in a high-demand environment could end up entering production when this demand cools off. Excess capacity in a declining market exacerbates the price decline which in turn leads to sharply reduced capex or even players leaving the market altogether. Once demand picks up again eventually, as a result of the sharp decline in prices, it meets an underinvested supply side that might need years to add necessary demand. In the meantime, commodity prices explode.

Parallel to normal cycles, many commodities also experience so-called super cycles, sometimes stretching over several decades. Typically, a super cycle is prompted by a large demand shock combined with a delayed response on the supply side. The most recent, prominent and still all-apparent demand shock was the rapid industrialization of China which resulted from major economic reforms and began in the late 1990s. The rapid economic growth led to huge increases in the demand and prices for most base metals. Even the global financial crisis seemed to only temporarily stop this demand surge as the price for iron ore, for example, almost regained its pre-crisis level as soon as 2010. Unsurprisingly, this environment helped little to stop the subsector's appetite for heavy investing and mergers and acquisitions (M&A). Eventually, this appetite ended in the "bust" part of the boom-and-bust cycle, as high capacity and stretched balance sheets met with declining prices: iron ore lost three quarters of its value between 2011 and 2015 (we take iron ore as a proxy for most major commodities, as commodity-price patterns are similar and iron ore is the dominant commodity in our mining universe).

With the subsector scaling down investments from 2013 onwards and demand from China holding up well, prices found their bottom at the beginning of 2016. Currently accounting for over half of the global iron-ore demand, China is the dominant force not only for iron ore but also for most other major commodities as well.

Before we delve into China's economic prospects, we also need to discuss the U.S. dollar's impact on commodity demand and prices. Like for most commodities, iron-ore prices are often quoted in U.S. dollars. Hence, a strengthening dollar usually leads to a reduction of the buying power of foreign buyers, which in turn can weigh on overall demand and hence on prices. The relationship between price and dollar strength has been particularly pronounced in the past ten years, as the right chart below shows. The end of the dollar rally in 2015 and its recent weakness have certainly contributed to the sector's turnaround.

## China's steady-paced demand growth and the dollar's hold on commodity prices




Source: Thomson Reuters Datastream; as of 8/15/17
*Three-month moving average
**Trade-weighted average of the U.S. dollar relative to other major currencies

On the demand side, China now towers aloft the world's iron-ore demand: compared to just 18% in 2002, China accounted for roughly 50% of the world's demand of iron ore (and most other base metals) in 2015.[1] As iron-ore imports show, Chinese demand has slowed from the high growth rates seen until 2010 but has nevertheless still achieved decent rates since 2011. Strong trade data in June and July show iron-ore imports beating consensus expectations. This leads us to believe that China's overall iron-ore demand in 2017 is well under way to exceeding 2016's record-breaking 1bn tons (t). Overall, infrastructure construction seems robust and fixed-asset investments continue to paint a stable macroeconomic environment for now. In the long term, however, we, as well as most investors, expect levels to normalize as China might not be willing and able to keep this pace of investments.

On the supply side, China dominates some commodities as well, most notably iron ore, where it accounts for roughly half of global capacity. The Chinese government's closure of illegal mining-and-production sites since the beginning of this year has taken out capacity. This could prove beneficial for the subsector as the targeted steel mills use scrap metal as the cheaper but lower-quality substitute for iron ore. Nonetheless, there is still a continued increase of scrap-metal usage, which in the longer term might weigh on iron-ore prices.

## Our economic and market forecasts

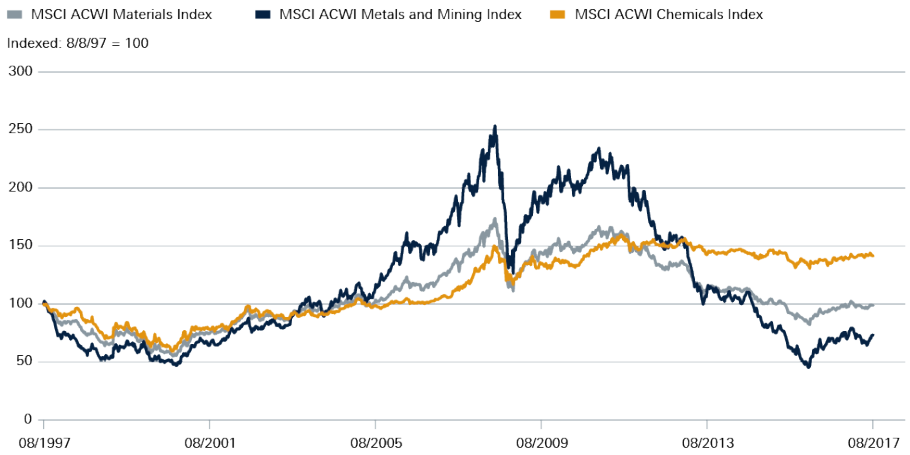
We have a positive view on global growth as we see a clear acceleration compared to 2016. Our forecast stands at 3.5% for 2017 (after 3.1% in 2016), and 3.7% for 2018. Emerging markets should continue to grow at a faster pace of around 4.9%. We were surprised by China's strong performance in the first half which led us to increase our full-year 2017 gross-domestic-product (GDP)



[1] Bank of Canada, *Commodity Price Supercycles: What Are They and What Lies Ahead?*, Bank of Canada Review Autumn 2016. Data in report from: World Bureau of Metal Statistics, US Geological Survey, Haver Analytics and Bank of Canada calculations, as of 2015

growth forecast from 6.3 to 6.5% in June. We might have to lift this figure up on the back of continued strong numbers pouring in from the Chinese economy, boding well for iron-ore demand. We expect the price to average around $60/t for 2018 – less pessimistic than consensus expectations.

**Relative performance vs. MSCI AC World Index**




Source: Thomson Reuters Datastream; as of 8/15/17

Our equity outlook for the next twelve months remains constructive, as we still struggle to see meaningful factors that could end the current cycle. We have a bias towards cyclical sectors (next to materials we also like financials and technology) and towards Europe and emerging markets. The above chart shows three things: 1. Periods of out/underperformance can spread over many years. 2. While chemicals almost moved in line with the global equity market, metals and mining proved to be an extremely-high-beta subsector. 3. Metals and mining started their comeback in early 2016, but experienced a major setback in the first half of 2017. The impressive performance over the past weeks has prompted us to become a little cautious in the short term as we believe that further setbacks are possible. In the medium term, however, we expect the sector to further outperform the market mainly as a result of strengthened balance sheets and cash flows as well as an improved supply-demand profile. Operating profit margins (EBITDA) of key metals-and-mining companies for example are well under way to reach their 2011 levels again. Profitability was further enhanced by the resurgence of iron-ore prices. The current price of $73/t (Bloomberg Finance L.P., as of 8/16/17) compares to average cash costs of around $30/t for the largest players. Resisting old habits, miners have nevertheless shown a surprising spending discipline: Over the same period, combined capex of the key miners has fallen significantly from $63.4bn in 2012 to an expected $23.8bn for the current year.[2] Next to increasing cash flows as well as the potential for payouts, these improved metrics might also reduce the subsector's risk premium, as the decreased leverage might also decrease its beta.



[2] Morgan Stanley Research, as of 7/27/2017

## Valuation

We believe that for tactical considerations valuation is not the dominant share-price driver for a cyclical subsector such as metals and mining. Our positive mid-term outlook for the sector, however, is underpinned by favorable valuations and an improving payout profile.

The World Datastream Mining index's price-to-book ratio currently trades at 75% of the Datastream World Index ratio. This compares to the long-term average of approx. 110%. This is, however, less attractive than it seems, as when it comes to the return on equity, the miners' discount to the world index is even higher. The relative price-to-earnings (P/E) ratio doesn't qualify as an immediate trigger, either, as it stands exactly at its long-term average of 100% to the global index. Compared to its own P/E history (back to 1987), the subsector trades at its long term average as well.

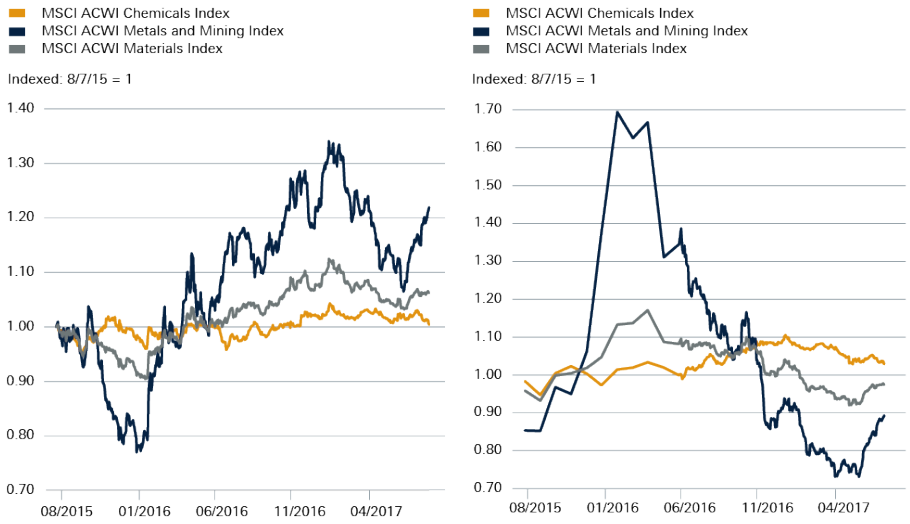
Our favored measure, however, is the free cash flow (FCF) yield. At current iron-ore spot prices, this year's FCF yield could reach 13%. This figure is more than twice the current dividend yield, illustrating the sector's potential for further dividend increases. In fact some major companies have announced plans to resume or increase dividend payouts as well as share buybacks in the most recent reporting season.

In the short term, we see a mixed picture for the miners. While positioning of professional investors is favorable – they still avoid the sector[3] -, we see some headwinds: the sector's strong absolute and relative performance over the past two months; still high iron-ore stock levels in China; a stabilizing U.S. dollar, and Beijing's moves to curb speculation in commodities. The latter could seriously weigh on iron-ore prices as we believe that speculation has played an important part in the sudden price recovery since mid-June. These are the main reasons why we do not favor this subsector over chemicals any more.



[3] BofA Merrill Lynch Global Fund Manager Survey of July 2017

**Relative performance (left) and relative P/ E ratio (right) vs. MSCI AC World Index**




Source: FactSet Research Systems Inc.; as of 8/9/17

We are maintaining our overweight on the materials sector, however, as chemicals have shown a better-than-expected second quarter. Next to benefiting from the cyclical acceleration of the global economy, chemicals also profit from increased M&A activities as well as from growing interest from activist investors. Furthermore, the recent drawback especially of some of our preferred European names have made valuations more reasonable again. The Stoxx Europe 600 Chemicals has lost 7.3% between its peak on June 19th and August 17th. We believe investors could be positively surprised by the operating-margin development in the second half of the year. By then, chemical companies could have passed through to customers the raw-material price increases they endured in the first half of the year.

## Conclusion

"If history teaches us one thing, then that history teaches us nothing." One has to believe in these words from Peter Ustinov in order to stay positive on metals-and-mining companies in the longer term. Past years' capex discipline as well as recent discussions with company leaders give us some comfort that the sector has learned from past mistakes and that it will therefore not embark on another spending spree should demand and prices stay elevated. This belief, however, will encounter its first real test in 12-24 months' time, when miners (as we expect) are sitting on such an amount of cash that expansion and empire building could be the ever more tempting things to do. But, as our colleague Stephan Werner, global sector head of materials, puts it: "One might hope that the animal spirits will not kick in as usual as everyone should fear the end of China's super investment cycle. Then again, this development has been feared for years already but failed to materialize. For the next couple of quarters, however, we are confident that the CEOs will stay focused on keeping their house in order and investors happy."

Any signs of the Chinese investments tumbling, or the dollar strengthening significantly would of course be bad news that the sector's leaders could neither control nor escape.

# Glossary

### Capital expenditures (capex)

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

### Free Cash Flow (FCF)

**Free Cash Flow (FCF)** is a measure of financial performance calculated as operating cash flow minus capital expenditures. It shows how much cash a company is able to generate after deducting the money required to maintain or expand its asset base.

### Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

### Mergers and acquisitions (M&A)

**Mergers and acquisitions (M&A)** are the two key methods of corporate consolidation. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

### MSCI ACWI Materials Index

The **MSCI ACWI Materials Index** captures large- and mid-cap companies classified in the materials sector across 23 developed- and 24 emerging-market countries.

### Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

## Risk warning

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