Prices Of Industrial Commodities Rebound On Strong Demand From China

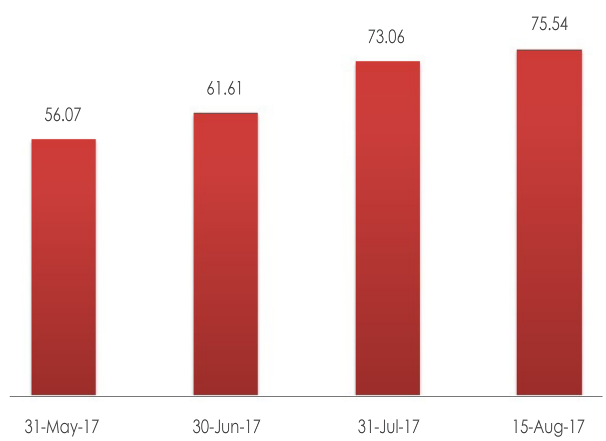
Prices of industrial commodities have rebounded in recent months on better than expected global economic growth, though they are still below the highs seen at the beginning of this year. Chinese demand remains the prime driver for most industrial materials, especially iron ore and copper. Expectations of additional infrastructure spending in China and other Asian countries should continue to support industrial commodity prices in the coming months. Prices could get a further boost if the Trump administration in the U.S. implements its promised $1 trillion infrastructure spending program. However, expanding supplies could cap potential price gains and restrict margins from widening further. The large producers that extracted meaningful cost efficiencies during the commodity price downturn appear better placed to boost cash flows during this rebound.

From multi-year lows seen at the beginning of 2016, prices of industrial commodities rebounded sharply as global economic growth gathered pace. However, prices corrected during the first half of this year on doubts about the sustainability of demand growth.

KEY TAKEAWAYS

Prices could get a further boost if the Trump administration in the U.S. implements its promised $1 trillion infrastructure spending program. However, expanding supplies could cap potential price gains and restrict margins from widening further.

***Iron ore prices have rebounded in recent months**



Data in USD per dry metric ton

Data source: Bloomberg Iron Ore Spot Price Index
*Iron ore spot prices in China

The U.S. economy appeared to be caught in a low growth phase and the much anticipated infrastructure boost from the Trump administration has not yet materialized. Chinese demand for materials was expected to cool as the country's government and central bank have been trying to prevent the property market from overheating. Though the Eurozone economy has seen healthier trends since the beginning of this year, government and private spending on construction as well as new capacity is still relatively low.

Nevertheless, the outlook for industrial commodities has changed appreciably with the faster than expected Chinese economic growth during the second quarter. Chinese demand for materials such as iron ore has exceeded expectations as higher product prices have made even inefficient metal manufacturers profitable. Industrial output in China has expanded at a robust pace during the first half of this year, further boosting the demand for materials. The recovery in global demand for manufactured goods continues to support this trend.

During the most recent down cycle, most large producers of industrial materials had focused their attention on improving their cost competitiveness. As a result, the cash breakeven levels for these producers have declined appreciably.

The U.S. government could expand fiscal spending on infrastructure later this year, or in 2018. The Federal budget deficit has narrowed in recent years and would remain within historical averages even if the government increases infrastructure spending by the promised $1 trillion. If aggregate U.S. growth continues to disappoint, as it did during the first half of this year, there is likely to be more pressure on the federal government to roll out fiscal stimulus measures. Low inflation also makes it less risky to implement expansionary fiscal policies.

However, expanding supplies are likely to restrict further price gains for industrial commodities from the current levels. Though capital investment in new projects has declined sharply in recent years, several large mining ventures initiated before the last cyclical downturn are now close to completion. These projects should expand supplies at a moderate rate for the next few years.

During the most recent down cycle, most large producers of industrial materials had focused their attention on improving their cost competitiveness. As a result, the cash breakeven levels for these producers have declined appreciably. This should give them a significant competitive edge over the smaller and less competitive producers. Expanding cash flows should allow these industry leaders to reduce debt levels and increase payouts to shareholders.

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— Thomas S. White, Jr., Portfolio Manager

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