Should You Avoid Commodity Stocks in 2015?

Description

If the end of 2014 is any indication, 2015 is shaping up to be a more challenging year for the TSX thanks to commodity price weakness, including oil prices hitting a five-year low, coal prices dropping below their 10-year average, and base metal price weakness.

This presents a unique challenge for Canadian investors, since the commodity-heavy energy and materials sectors make up about 33% of the TSX (compared to only 11% of the American S&P 500). With the bull market for commodity prices seemingly over, should investors avoid these sectors and look elsewhere in 2015, and if so, where?

The commodity outlook for 2015 looks weak

The commodity super-cycle refers to a period from the late 1990s to present day where most commodities experienced double-digit growth rates. Oil prices rose 1,060% from the late 1990s to 2008, and coal prices appreciated 610% over the same period. The reason? Strong and steady economic growth by emerging economies, but most notably, China.

With China's economy growing at nearly 15% annually between 2002-2012, and China also consuming half of the global metals produced in 2012 (up from 4% in 1990), the commodity super-cycle was propelled by a level of growth and demand for industrial commodities not seen for over four decades.

Unfortunately, this massive demand growth from China seems to be slowing, with growth rates of only 5.5% between 2015-2019, and 3.9% between 2020 and 2025. The reason for this is that fundamental changes in China's economy are occurring, with the country switching from industrial investment to household consumption, which requires far less demand for industrial commodities like oil, coal, and copper. This does not appear to be a temporary transition for China, but a permanent one.

The result is the major price weakness in major commodities seen as of late. After a decade of ramping up productive capacity, there are enormous supplies of commodities, just as demand starts to slow from China and emerging economies.

This is only being made worse by the strong U.S. dollar, and for Canadian investors, this means weak commodity prices for 2015, and weak commodity stock performance. The U.S. Energy Information Administration anticipates WTI to average $63 per barrel in 2015, and the outlook for other commodities seems equally weak. Raymond James analysts estimate steelmaking coal prices to be about $130 per tonne by 2015 year end (up from $119 currently), and some analysts are predicting copper prices of $2.90 per pound (down from the above $3 range for most of 2014).

For producers like **Teck Resources Ltd.**, which depend heavily on coal and copper prices, and oil producers like **Canadian Oil Sands Ltd.** that have cash flows highly sensitive to the price of crude, it seems 2015 will be an underperforming year.

Where should you invest instead?

The TSX is anticipated to gain in 2015, although with weaker performance than previous years due to weak energy stocks. Thankfully, weakness in the energy sector creates opportunity elsewhere.

Low oil prices have resulted in lower gasoline prices, and this has benefitted stocks within the consumer staples sector immensely. As customers have more discretionary income, this will result in better sales for food distribution and grocery companies like **George Weston Limited** (TSX: WN), which has seen shares rise 10% since November.

Auto parts companies like **Magna International Inc.** (TSX: MG)(NYSE:MGA) will also benefit from lower gasoline prices, as well as from a weaker Canadian dollar, and there will also be greater demand for shares in well-established companies like Magna, as investors seek out alternatives to energy companies. Like George Weston, Magna has seen its shares increase 12% since November.

Although 2015 may be weak in the commodities space, there is plenty of opportunity in other sectors. Warren Buffett often avoids commodity stocks since they possess no pricing power, and for 2015, Canadians would be wise to do the same.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
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TICKERS GLOBAL

1. NYSE:MGA (Magna International Inc.)
2. NYSE:TECK (Teck Resources Limited)
3. TSX:MG (Magna International Inc.)
4. TSX:TECK.B (Teck Resources Limited)
5. TSX:WN (George Weston Limited)

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