The News Keeps Getting Worse for Teck Resources Ltd.

Description

Canada's largest diversified miner, **Teck Resources Ltd.** (TSX:TCK.B)(NYSE:TCK), continues to catch the attention of investors and analysts alike. This is because of growing speculation that as commodity prices firm, the company is positioned to bounce back while still being able to maintain its juicy 5% dividend yield. I don't believe this represents the full picture.

There is growing optimism among some market watchers about the outlook for metallurgical coal, which generates around a third of Teck's revenue. Many believe that as higher cost producers wind down marginal production because of the markedly softer prices we are witnessing, supply will fall, pushing prices higher. This, along with a resurgent U.S. dollar, will help to boost Teck's earnings.

However, I believe that this couldn't be further from the truth.

While there is no denying that a strong U.S. dollar is a boon for Teck because it sells its products in U.S. dollars and incurs expenses in Canadian dollars, the outlook for commodities is increasingly pessimistic.

The situation

You see, metallurgical coal is used in the manufacture of over 70% of the world's steel, and the single largest user of steel globally is China. In fact, China's construction sector is the largest user of steel in the country, and saying the outlook for that sector is ugly is an understatement. As of the end of December 2014, investment in real estate development had declined for the 11th straight month, and many analysts estimate that up to 28% of China's housing stock is vacant. This means that investment and construction activity in the housing sector can only continue to decline.

We've already seen China's demand for steel fall for the first time since 2000, dropping by 3.4% in 2014 compared to the previous year.

With construction activity set to contract further, the demand for steel, its key ingredients iron ore, and metallurgical coal will decline further, applying greater pressure to their respective prices.

Of even greater concern is that global coal supplies are set to grow, with a number of coal miners set to boost production. This includes the world's largest diversified miner, **BHP Billiton Ltd.** It has committed to boosting coal output in order to grow market share by pushing higher cost producers out of the market while boosting economies of scale to reduce costs.

Though Teck is a low cost producer, the declining demand for metallurgical coal and growing supplies certainly don't bode well for its price to appreciate any time soon.

The bad news for Teck's outlook doesn't end there

China's economic growth continues to slow, with 2014 GDP growth of 7.4% — the lowest since 1990

— and it is expected to fall further in 2015 to 6.8% forecast and 6.3% in 2016. This will have an impact on demand for not only metallurgical coal but also base metals, particularly copper, which has already touched a five-year low earlier this year. Both zinc and copper, which make up 30% and 37% of Teck's revenue, respectively, are important components in a number of manufacturing processes and housing construction.

For January 2015, activity in China's manufacturing sector contracted and continued its downward decline for the fourth successive month. This also bodes poorly for base metals demand.

Now what?

All these factors leave me extremely concerned about the outlook for metallurgical coal, copper, and zinc. When the bleak outlook for commodities and the risk of declining earnings and weaker margins are accounted for, Teck appears expensive. For these reasons, I don't share the optimism of other analysts regarding Teck's outlook and believe it is a stock that investors should avoid.

CATEGORY

1. Investing
2. Metals and Mining Stocks

TICKERS GLOBAL

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