Why Commodity Stocks Are Unlikely to Rise Anytime Soon

Description

The massive decline in nearly every major commodity may be starting to look like the investment opportunity of the decade. According to the Bank of Canada's commodity price index (which tracks prices of 24 major commodities), commodity prices are at levels not seen since early 2009 when commodity prices bottomed. In fact, July has been one of the worst months since then.

The last time commodity prices hit these levels, key commodities like oil, coal, and copper proceeded to more than double in value, taking shares of companies supplying these commodities to record highs. Does this mean it's time to pick up shares in stocks like **Canadian Oil Sands Ltd.** (TSX:COS) or **Teck Resources Ltd.**(TSX:TCK.B)(NYSE:TCK)?

Both of these companies are trading at multi-year lows, and most importantly, at near-record discounts to their net asset values. These companies are also deeply leveraged to prices of their respective commodities, and would be poised for huge upside in the event of commodity prices rising. What's the problem? Commodity prices are almost certain not to rise like they did after the last crash—if at all. Here's why.

A maturing Chinese economy will weigh on demand for commodities

Why have commodity prices performed so well over the past decade? It comes down to, quite literally, one word—China. From the late 1990s to near the present day, most commodities saw explosive growth, sometimes over 1,000%, and this period was known as the "commodity super cycle."

As millions of Chinese citizens moved from farms to newly built cities to pursue work in China's rapidly growing industrial sector, China saw its GDP grow by an astounding 10% annual average (hitting as high as 15% some years). Then in 2008 China began an investment binge, pumping billions into infrastructure and real estate, resulting in an enormous 49% of China's GDP devoted to investments. The end result is that China is the world's economic engine, and today China consumes more steel than the nine next-largest steel-consuming countries combined, and half the world's base metals.

Things are changing now for good. China is maturing into a consumption-based economy rather than an investment-based economy, and it is seeing its GDP growth slow. The country is seeing its supply of surplus labour dry up as its working-age population peaked in 2012, and Chinese investment, already at record highs, is declining annually as the country faces a massive oversupply of real estate and large amounts of debt.

The end result is that China's economy is going to see its annual GDP growth fall from double-digit highs to 4% by 2025. The end result is that the primary force that drove commodity prices higher in the past is now gone.

A strong U.S. dollar and low inflation will also keep commodity prices down

While slower growth from China will work to prevent a recovery in commodity prices, there are other forces holding prices down. Firstly, the U.S. dollar is currently at record highs, and since commodities are priced in U.S. dollars, this dries up demand for commodities as it results in countries with weaker currencies needing to spend more to buy commodities.

Low inflation is also putting a damper on demand for commodity prices. Inflation typically drives commodity prices higher, which in turn, creates more demand for commodities since they are appreciating. With inflation very low, commodity prices should stay down for the foreseeable future.

What should you do?

For now, avoiding commodity-based stocks like Teck Resources or Canadian Oil Sands is wise. These names may become more attractive once the U.S. dollar weakens, inflation improves, or more growth is seen from emerging markets. While the upside is certainly limited for these companies, it is important to remember that there could be significant downside left as well. Teck, for example, is currently trading at about $9.50, but fell to nearly $4 during the last commodity price rout.

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1. Editor's Choice

TICKERS GLOBAL

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