The Collapse of Commodities and the Rising Risk of a New Financial Crisis

Description

We are witnessing the potential advent of a new financial crisis that has been triggered by the sharp collapse of global commodities markets because of slowing growth in China and declining global demand.

There are reports that the world's 10th-largest company, resources miner and commodities trader **Glencore PLC**, could be on the brink of collapse. This is bad news for economies dependent on commodities exports and investors in heavily leveraged miners.

Now what?

You see, Glencore is one of the largest miners of commodities, with operations spanning metals, energy, and agricultural products. It is saddled with over US$50 billion in debt, and if commodities continue their terminal decline, some analysts are concerned that Glencore won't be able to service that debt. This would leave it insolvent. If the worst-case scenario happens, it could potentially trigger a Lehman Brothers moment, precipitating the next financial crisis.

Glencore is not only a miner; it is also the world's largest trader of commodities, with links to trillions of dollars in derivative commodities trades across global markets. No one can say exactly what would occur or just how far Glencore's tentacles extend, but it is clear that global commodities markets would go into meltdown if the world's biggest commodity counterparty goes out of business.

A meltdown of these proportions would impact heavily leveraged mining companies, as well as those economies that have continued to survive on a mix of ultra-low interest rates and the desperation of central bankers.

An example is Brazil, which, like many South American economies, finds itself caught in the extractive trap. This is where countries become overly reliant upon the extraction and export of commodities as a means of generating economic growth, foreign investments, and hard currency.

After being touted as one of the greatest economic miracles of the last decade, Brazil's economy is on the verge of imploding. The fiscal situation has deteriorated significantly,, and the government finds itself burdened by what is fast becoming an unsustainable level of debt. One of its key sources of revenue, oil company **Petrobras,** is over levered and embroiled in a never-ending corruption saga.

So what?

This phenomenon isn't isolated to emerging economies, the oil rout has pushed Canada into a recession, and there are concerns over the health of some of the country's largest miners should commodities fall further.

The outlook for coking coal and base metals miner **Teck Resources Ltd.** (TSX:TCK.B)(NYSE:TCK) remains pessimistic. It has amassed over $8 billion in debt and is obliged to invest a further $1.8 billion in the increasingly uneconomic Fort Hills oil sands project.

Then you have **Suncor Energy Inc.'s** recent purchase of another 10% stake in Fort Hills for $310 million, effectively valuing Teck's 20% stake at $620 million, well below the $2.3 billion carrying value on its balance sheet. This could force Teck to incur a substantial impairment on the value of this asset, thereby jeopardizing its debt covenants.

There is also the risk of a looming cash crunch, with Teck battling declining cash flows and $2.4 billion of debt repayments on top of its $1.8 billion commitment to Fort Hills falling due between now and 2020.

While the risk of Glencore collapsing and the ramifications this may have for global markets could be overblown, it is clear that miners and the commodities sector will experience further volatility in the immediate future. For these reasons, commodities exposure should be avoided by investors until the situation becomes clearer.

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Date
2025/07/31

Date Created
2015/10/07
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