Are Weak Commodities Prices the New Normal?

Description

Recent rallies among mining stocks have captured the attention of investors with companies such as **Teck Resources Ltd.** (TSX:TCK.B)(NYSE:TCK) and **First Quantum Minerals Ltd.** (TSX:FM), which have rallied strongly for the year-to-date. Teck is up by a massive 137%, while First Quantum's stock popped by an impressive 62%.

Along with an increasingly optimistic outlook for commodities, especially for coal and base metals, this has led to some analysts claiming that both stocks will continue to rally.

In fact, some analysts have gone as far as to claim that Teck's price could even double over the course of 2016, making now the optimal time to invest. While there have been some positive developments for both companies and other mining stocks, the outlook is not as rosy as some analysts would have you believe.

Now what?

The key driver for both of these companies' recent rally and improving outlook is the price of commodities.

Teck is highly dependent on the prices of metallurgical coal and copper to drive its financial performance. It obtains two-thirds of its revenue from those products. The surge in its share price can be explained by the price of metallurgical coal rising by over 20% in recent months and copper firming by 2%.

This has also been of considerable benefit for First Quantum; it earns 80% of its revenue from copper.

Nevertheless, the real driver of the outlook for the prices of these and the majority of other commodities is China, which emerged in the last decade to become the largest consumer of coal, base metals, and steel globally.

There are signs that the recent rally in coking coal, which occurred because of an uptick in construction activity and China’s declining steel inventories, is about to come to an abrupt end.

You see, China’s steel industry is still facing an overcapacity issue and, despite a growing global supply surplus, China’s steel industry is refusing to curb output. This means that the global supply surplus will continue to apply pressure to steel prices over the long term.

Meanwhile, there are signs of declining economic growth and industrial activity in China, and this is despite Beijing instituting a range of stimulus measures in recent months. China’s first-quarter GDP growth rate of 6.6% was a seven-year low, and there are signs that growth will continue to decline.

The all-important construction industry remains caught in a terminal decline; China massively overbuilt during the boom years. Then there is falling manufacturing activity; the April 2016 Manufacturing Purchasing Managers Index fell compared to March. This is of considerable concern for miners because construction and manufacturing are the largest consumers of steel and base metals in China.

Beijing is also determined to transition China’s economy from one focused on economic growth through investment-led infrastructure development and exporting manufactured products to growth that’s driven by domestic consumption.

These factors certainly don’t bode well for the long-term outlook for commodities and will place further pressure on prices, impacting the share prices of miners such as Teck and First Quantum.

Teck is also under pressure because of sharply weaker oil prices. It’s on the hook to make an additional $1 billion investment in the Fort Hills oil sand project. While it has sufficient cash on hand to make this investment, there are signs that project will remain uneconomic until oil hits US$90 per barrel, according to Citigroup Global Markets.

So what?

It is difficult to see any further long-term upside for mining stocks despite the short-term improvement in the outlook for commodities. As China’s economy continues to slow and is rebalanced by Beijing driving growth from domestic consumption, the country’s demand for commodities will continue to fall. This will drive down prices over the long term as commodities adjust to a new normal.

CATEGORY

1. Investing
2. Metals and Mining Stocks

TICKERS GLOBAL

1. NYSE:TECK (Teck Resources Limited)
2. TSX:FM (First Quantum Minerals Ltd.)
3. TSX:TECK.B (Teck Resources Limited)

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