Why the Commodity Boom of the 2000s Is About to Make Comeback (and How to Play it)

Description

It has been an excellent year for most commodities: WTI oil prices are up 31%, Henry Hub natural gas is up 32%, gold is up 19%, and the RBC Commodity Index (which contains a basket of 24 commodities) was up 23% year-to-date at the end of September.

With 20% being the threshold for a bull market, commodities are in a bull market with certain major commodities (natural gas, oil, zinc, metallurgical coal) up well over 30% in some cases. This is fairly large change in trend, since the last few years saw nearly every commodity stuck in historic bear markets (the RBC Commodity Index dropped in half between mid-2014 and early 2016).

How much farther does this bull market have to run? The last two commodity bull markets have been massive; after the financial crisis, commodities rallied 85% between 2009 and early 2011. From the early 2000s to 2008 (a period known as the commodity super-cycle), commodities showed exceptional double-digit, inflation-adjusted annual growth with some commodities showing triple- and quadruple-digit returns over the period (oil rallied over 1,000%).

The previous super-cycle is unlikely to repeat—it was largely due to record growth from emerging economies and China, which purchased 40% of all commodities between 2000 and 2012 and grew its GDP by over 10% annually between 2003 and 2007. Strong demand growth prompted managers in industries from oil to agriculture to invest aggressively in a supply response over multiple years.

Over the past few years, however, China has seen its GDP growth fall as its debt growth exceeded its economic growth, while developed countries recovered slower than expected from the recession. The supply response from producers (in particular in the energy space) was also much more effective than ever hoped; for example, high oil prices and debt prompted heavy investment into fracking in the U.S., which led to U.S. production growing by over one million bpd annually.

This led to the price rout of the past several years in most commodities, and it is precisely this which will spark another multi-year bull run in many markets. The excessive price declines seen over the past several years has led to dramatic cutbacks in investment (oil, for example, saw its capital that was supposed to be spent between 2015 and 2020 cut by $1 trillion).

At the same time, companies are still holding high debt levels. Interest and debt repayment are priorities for many firms as prices rise, and capital investment will be secondary. This coincides with a new conservatism among many managers; the focus is not on aggressive growth, but rather on cost cutting, debt repayment, and free cash flow generation.

As long as global demand remains steady, over two years of under-investment will catch up with markets and lead to supply deficits in several markets.

Here is the best way to gain exposure to this trend

Oil is the top way to gain exposure to rising commodities

While investors would be wise to invest in many commodity stocks (gold and natural gas in particular), the above factors are probably most evident in oil. Oil demand is set to grow steadily by 1.2 million bpd for the next several years, and, at the same time, global production naturally declines by 3.3% annually (about 2.8 million bpd). This means three million bpd of production growth will be required globally to keep the market in balance.

With $1 trillion in capex cut out of the market, a supply shortfall is inevitable. Looking around globally, it is difficult to see where this growth can come from. Many point to U.S. shale, but U.S. production will likely only be able to grow by 1.4 million bpd between 2018 and 2020, according to research firm Hedge Fund Insights, which even factored in $70 oil.

These are ideal conditions for price growth, and investors can play it with **Canadian Natural Resources Limited** (TSX:CNQ)(NYSE:CNQ). Canadian Natural offers investors exposure to oil as well as natural gas (about 35% of production), which is broader commodity exposure. At the same time, the firm has reasonable debt levels and plans on growing production from 800,000 bpd this year to over one million bpd in 2019.

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Date
2025/08/03
Date Created
2016/10/31
Author
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