The Long-term Outlook for Natural Resources

By Fred Sturm, CFA®

Since the early 1970s, cyclical economic forces, nature, and geopolitics have had large influences on natural resources markets. In the United States, investor enthusiasm for resources was inflamed by the oil supply shocks of 1973 and 1979, but it went dormant for two decades after the 1981–82 recession exposed demand destruction and excess productive capacity.

A question before us now in 2008—with oil more than $125 a barrel, China now an importer of coal, and gold nearing $1,000 an ounce—is whether the world again is at a cyclical peak in demand that will be followed by a period of stagnation, if not stagflation, in markets such as the United States. Does the current slowdown in developed markets point to another decade-long peak in natural resource sectors? In my view, the answer is a clear no. Emerging markets (some 3 billion people) either have been exposed to or have directly tasted a more luxurious life and they hunger for more. We must allow for natural cyclicality, but the secular demand for resources should continue well into the next decade. As part of the long-term uptrend underway, we expect the run-up in resources will spawn human ingenuity, which will temper the uptrend in commodity prices. A high-plateau price environment should hold until another round of scarcity concerns pushes prices beyond what we consider “high” today.

Cyclical and Secular Forces Are at Work

This year presents real challenges to the global economy and equity markets, but it is a reasonable expectation that global central banks will continue to respond by providing liquidity and lowering interest rates further. History strongly suggests that equities and developed economies respond well to rate reductions as long as a slowdown in growth can be contained. That’s the short-term, cyclical story.

The long-term story is different, and it is much more positive from an investment perspective. Supply systems largely were built to meet developed-economy demands, and frankly there is enough cushion of excess capacity that if this were the entire story, then investors should look elsewhere. However, what is different today compared with 25 years ago is that demand is much broader because the developing world now is the primary driver of secular global growth. Demand for resources outside the United States also likely will be a greater driver of the global economy’s cyclical direction, in our view, in part because of more direct ties between emerging-market countries. This long-term trend is creating a greater degree of economic decoupling between global gross domestic product (GDP) growth and U.S. growth. Infrastructure projects underway in the emerging countries have longer time horizons—a new highway reaching only half-way to the next city is not worth much, nor is a new airport half-completed. This gives us more confidence in the resilience of resource-company profits. More-muted cyclicality in profits should afford more market-like valuations over time, and in any case shareholders will be enriched over time by the accumulation of cash.

Global Rebalancing Supports Resource Markets

Growth in emerging markets’ resource demands has been underway for a generation, but it only has been since the 2001 technology bubble collapse that this trend has made a noticeable difference.
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A Lower U.S. Dollar May Be a Bridge to Future Resource Growth

If we put energy import dependency aside, the United States is not a resource-starved country. In fact, the structural decline of the U.S. dollar over the past six years has put U.S.-based resource companies in a stronger global position. Two good examples where domestic competitors are getting control of their industries are structural steel for building bridges and paper products. Paper and paperboard inventories are at multiyear lows. After many years of failing to earn the cost of capital, these areas may begin to gradually rebound, in our view. Steel companies are now seeing less competitive import dependency, and, increasingly, U.S. consumers. Let’s take a look back to see how far we have come.

Between 1960 and 1972, when the Bretton Woods exchange-rate policy was in place, the developed world accounted for 74 percent of global growth and the emerging countries accounted for 22 percent (the other 4 percent was accounted for by very underdeveloped nations). During the globalization period from 1985 to the present, the developed world’s contribution to global growth dropped to 45 percent, while the emerging countries contributed 52 percent.

To a large degree, we think further growth is likely to be self-financed rather than financed by developed-world investors. Brazil, Russia, India, and China now all hold financial assets in excess of their GDPs, providing them plenty of capital to acquire and consume resources for even more growth. The growth of foreign reserves in places like China, Russia, India, and Brazil—along with the sovereign wealth funds that they have created—not only will provide money for infrastructure investment in their home countries, but we think they may be investing in developed countries’ growing infrastructure replacement and repair needs. One by-product of this growth is that developing countries gradually have been moving from resource exporters to resource consumers as their economies have grown more sophisticated and as living standards have risen.

Between 1960 and 1985, commodities represented 60 percent of the emerging world’s exports—and their destination invariably was the developed countries for use as low-cost inputs into higher value-added manufactured products. In the past 20 years, commodities have dropped to only 17 percent of emerging countries exports.

With Greater Growth Comes Greater Responsibility

From a current cyclical perspective, slowing economic activity in the developed world clearly is spilling into, but in our view not drowning out, developing economy growth. Netting out the negative impacts of real estate and subprime challenges with a delayed boost from lower interest rates, demand for resources may feel sluggish compared with past years, but nonetheless should extend the global growth cycle that began in 2002. Iron ore, coal, fertilizers, and grains are good examples where we think prices may continue to trend higher in 2008 and over the long term. Uranium producers are another good example. This sector’s equities have had a 50-percent price decline, providing opportunity for investors who think nuclear power will play at least as great a role in meeting global electricity needs as it does currently. Also, natural gas prices continue to be undervalued relative to oil, in our view.

The current resource reality is that a substantial percentage of untapped reserves lies in areas of the world that are not governed by the long-established democratic systems that U.S. companies and investors are more comfortable with. Getting the real facts is a challenge where transparency is lacking. Common sense eventually will prevail, but not without some potential for supply disruptions and risk for investors. For all the global trouble visible through media reports, the situation is much more favorable than it has been historically. Consider that for much of the 20th century, nationalistic quests for resources by authoritarian regimes contributed to global hostilities. For example, consider Japan’s quest for resources in the Pacific in the months following a July 1941 oil embargo by the United States (an energy exporter during the first half of the 20th century). In this century it is going to be increasingly difficult for authoritarian, resource-rich regimes to adopt self-serving, hoarding behavior. We’re seeing that in global and regional reactions to recent actions in Venezuela. The lessons of history, coupled with the realization that stability can be highly profitable, may serve to temper potential abuse of energy resources in Russia, the Middle East, and eventually, Africa.

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Another potential positive long-term development for U.S. investors is leadership in the area of alternative resource capabilities. Our team has been early and steady supporters of alternative and renewable energy, as well as energy conservation. The United States has been a laggard but is catching up fast and is beginning to show leadership in several technological areas. Like any sector with large growth and rapid development, investors must be prepared for fits and starts. Looking into the next decade, investors should be excited by the potential returns created by human ingenuity.

Security Selection More Important than a Sector Bet

Individual security selection in natural resources is likely to take the stage from "big picture" trends. Emerging market over developed market, resources over financials, resource currencies over the U.S. dollar all have been pervasive trends that don’t seem ready to reverse just yet. However, relative performance has gone a long way toward levelling the playing field. We believe portfolios should be anchored in companies with superior franchises within their sectors and countries, especially companies that have identifiable long-term growth prospects.

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