Crisis of Confidence Once Again. The Investment Case for Natural Resources. Still the Case? Version II

CITY OF LONDON
Investment Management Company Limited

October 2011

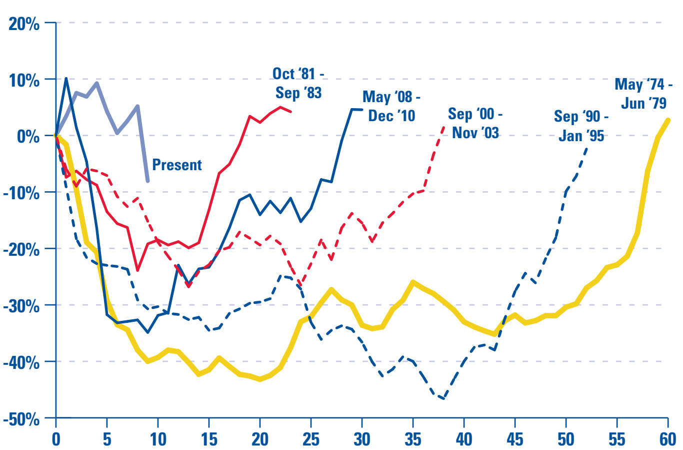
Investors are suffering a crisis of confidence as concerns escalate about the European debt situation and its implications for the global economy. Equity markets have been correcting for the past few weeks as government responses to the crisis have proven unsynchronized and disappointing. On the back of this, stocks related to commodities' production have suffered another strong correction. The major question for investors is whether the market correction has discounted most of these concerns or if this is the beginning of a major bear market.

Quick Review of the 2008 Collapse

During 2008, as the financial and housing crisis gained traction in the US and expanded to Europe and Australia, risk aversion significantly increased and global stock markets collapsed. On the back of the market's decline, investors' perception that the global economy was entering a prolonged recession deepened substantially, and the gloom was reflected in the prices of commodities and commodity-related stocks, which corrected sharply. Since the financial crisis began in May 2008, and even more markedly in the last quarter of 2008, commodity-related stocks strongly underperformed the underlying commodities.

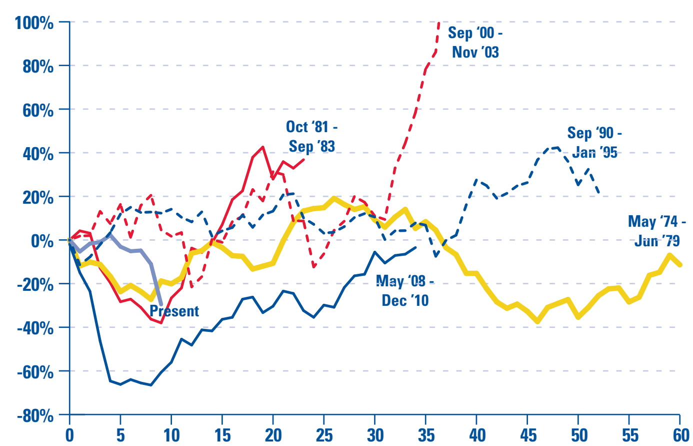
The following chart compares the magnitude of the 2008 crisis to previous major falls represented by commodities and commodity-related stocks. On the other hand, it also shows that the recovery in prices during 2009 and 2010 once the crisis was over was very fast, as in previous major bear markets.

Commodities (DJ-UBS Commodity Index, BMO Capital Markets Base Metal Index)



Source: Bloomberg, BMO Capital Markets Mining Research

Equities (HSBC Mining Index, S&P Materials Index)



Source: Bloomberg, BMO Capital Markets Mining Research

When analyzing the cause of the collapse, one part is naturally explained by the expected fall in demand, which triggers a fall in commodity prices which, in turn, translates into reduced investor appetite for commodity related stocks due to lower earnings expectations. But in 2008 there was an even larger component that explains such a sudden and violent fall: the gigantic de-leveraging process and forced selling caused by hedge funds' investor redemptions and margin calls that affected stocks in general and commodity-related stocks in particular.

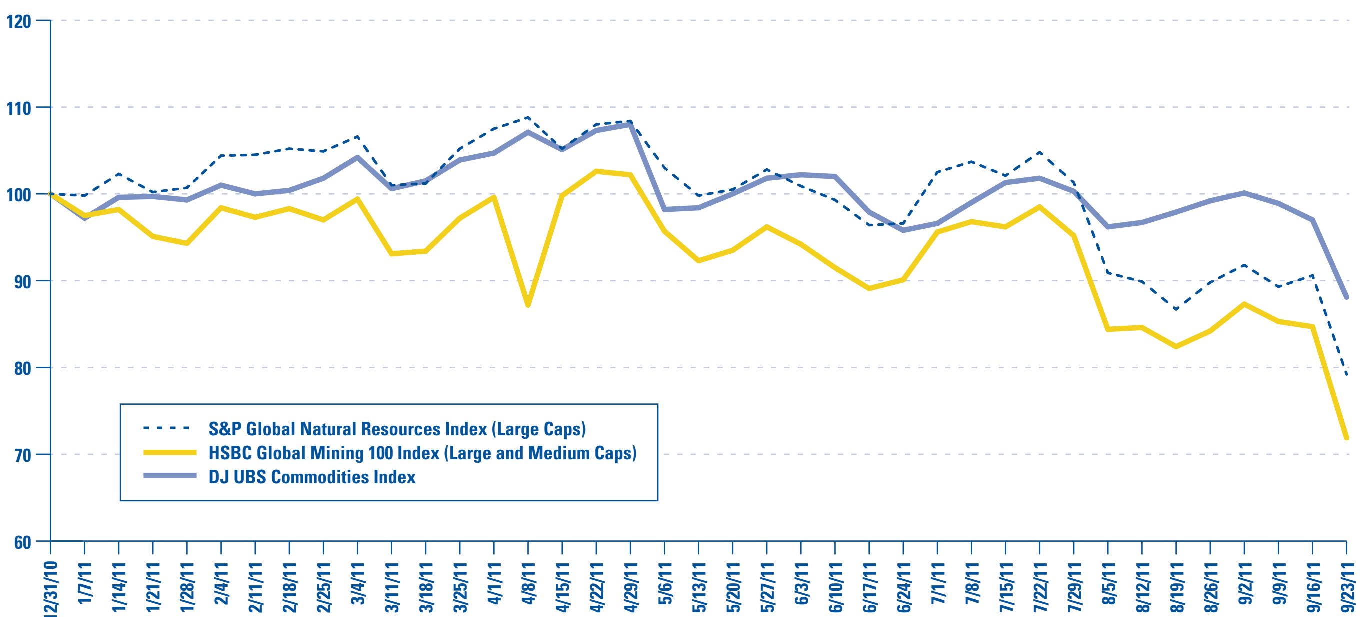
In this environment, medium and small caps, as well as companies operating in emerging markets, which are our main focus of investment, suffered more than the large companies in the commodity-related sector.

2011, Revisiting the 2008 Panic

The current year started with strong performance both from underlying commodities and stocks of commodity producers as the recovery in the global economy seemed on track, supported by better than anticipated industrial production figures from the US and Europe, coupled with very strong growth in the emerging economies. But a series of events threatened to affect that picture, starting with the geopolitical issues in the MENA region, followed by the disastrous earthquake and tsunami in Japan and further followed by worsened economic figures in the US and the Greek debt crisis. Up until June these events seemed both transitory and manageable. But the lack of leadership shown by both US and European politicians ended by generating a global panic and a sharp market correction as investors very quickly decided to liquidate positions and look for shelter in both US bonds and in safer currencies, such as the yen and the Swiss franc. The memories of 2008 are still very fresh, so the popular approach has been to sell first and then ask questions.

On the back of the market's decline, investors' perception that the global economy could be entering a double-dip recession deepened substantially, and the gloom was reflected in the prices of commodities and commodity-related stocks, which as in 2008, corrected sharply. Another example of the 2008 memories is the fact that this time again, commodity-related stocks strongly underperformed the underlying commodities, and small and medium caps underperformed the large blue-chips due to their lower liquidity and higher perceived risk.

Underlying Commodities vs. Large and Small Caps



Source: Bloomberg

Outlook for 2011 and Beyond.
Is the Secular Case for Natural Resources Over?

With regards to global growth and despite many arguments to the contrary, we believe for the time being that the global economy is not headed towards a recession, provided a rational approach is applied to the European debt crisis, which we would suggest is gradually being sorted.

There is a fundamental difference in the structural global situation today compared with that in 2008. The difference is that currently there are no fundamental excesses in the economy to correct. In 2008 the gigantic real estate construction bubble in the developed world, coupled with highly leveraged consumer and corporate balance sheets meant that the financial crisis and the consequent de-leveraging process brought global economic growth to a stop. Today most of those excesses have been or are in the process of unwinding. There has not been a build-up of inventories, wage pressures or capital expenditures to warrant an unwinding of the economy. Consumer debt is still elevated in some countries but corporate balance sheets are as healthy as they have ever been.

The challenges to the economy presented by government debt problems will likely manifest themselves in the form of slow growth as opposed to negative growth. On the other hand, the strong growth in the emerging economies in combination with the low interest rate environment set by the OECD economies has exacerbated inflation. Hence the reason several EM countries, including Brazil and China, have been tightening their monetary policy for the last two years. With the OECD economies tracking to a slow growth scenario and the cumulative effects of a tight monetary policy beginning to have an impact in the emerging economies, we expect inflation to slow in the coming year. While this would suggest a slower growth path for the emerging economies, the actual growth rate will still be relatively strong. The bottom line for the global economy is that growth will remain positive and that emerging economies will continue to be the engines of growth.

Most certainly, the wild card in the outlook is the debt crisis in Europe. The lack of a clear solution to the European debt crisis continues to be the main concern of investors. The debt issues in the developed world need to be confronted forcefully and immediately, though the effects will be protracted, with the likely impact of slower economic growth relative to what it would be otherwise. The recent announcement by several central banks to provide a short term financing package for Europe, whilst working towards a longer term solution is a good first step.

In conclusion, a logical base case for global growth is to expect a slow-down but not for a capitulation in activity. A default in Greece, Ireland and Portugal is part of the base case, but we do expect central banks to manage the contagion within interbank markets and for the fall-out to not be severely damaging to growth. Further policy easing from the ECB and the Fed should also help reduce the threat of weaker growth and rising financial distress.

In terms of natural resources, the outlook remains fundamentally strong. Europe-related turmoil certainly creates emotional concern, but any Chinese demand moves are much more significant (particularly for the metals and bulks space). Since the last sharp downturn in 2008, China has increased its average share of global consumption of metals/steel from 33% to 43% in the last three years. Looking over the past 10 years, China has driven almost 100% of incremental demand for many commodities (and more than that in some cases). China continues to dominate in terms of both existing consumption and, more importantly, growth, and is thus more important to the outlook than ever before.

It is also the case that China, as the elephant in the room, has acted along the last 10 years as the great stabilizer of commodity markets. Chinese apparent demand tends to be counter-cyclical to demand elsewhere. As growth elsewhere in the world tends to weaken, the Chinese call on supply from the rest of the world tends to rise and vice versa when demand weakens. The rationale for this inverse relationship is that when the rest of the world weakens, it in effect “exports” deflationary pressures to China in the form of lower Chinese export demand and also lower energy and other commodity prices. When inflationary pressures ease in China, the Chinese authorities have always eased monetary and fiscal policies, leading to a strong restocking and domestic demand recovery.

Recent data showing increased import levels in various commodities, mainly copper, seems to underpin the assumption that China may act again as a stabilizer. During 2011, Chinese apparent demand has been weaker than end use market growth. This suggests that there has been significant destocking of commodities within China. This has at least been partially involuntary, as credit restrictions have seen industrial users unable to access working capital to hold stock. Such a process, however, is finite, and eventually imports will have to rise just to ensure output levels are maintained. To put this another way, there is a decent degree of pent-up commodity demand in China. Thus, while growth in end-use markets may slow, it seems likely for some commodities that import demand will still rise into 2012 to slow the draw down in inventories. This situation could be particularly powerful if credit availability is eased into 2012, leading to a strong push in apparent demand. Should such a situation arise, the base metals are likely to outperform

On the supply side, in our view, the expected demand deceleration is only helping to disguise the real problem. Supply will again, as in 2009 and 2010, become the clear reason why natural resources are in a bull market. The situation is clear; for the last 10 years the speed of growth in demand has been faster than the rate of growth in supply. In the midst of all the turmoil, it is easy to forget that the current level of many commodity prices are currently at better than expected levels largely on the back of poor supply growth. Since 2001 commodities embarked on one of the most powerful bull cycles because it was brought to the forefront that supply was not able to cope with the magnitude of the nascent demand from emerging economies. Inventories were reduced to "just in time" levels and a series of obstacles were conspiring to increase structural supply at the same pace as demand was growing. Some of these obstacles included environmental issues, lack of skilled labor, cost increases, and nationalization processes in some countries. There is one further important factor: the low hanging fruit had already been collected, meaning that the large discoveries of the 70's were being depleted and, despite increased spending in exploration, no new major discoveries were being achieved.

The other issue impacting the resource sector is financing risk. The debt problems of OECD governments have cast a chill over any sector that is reliant on financial markets to advance its business objectives. In 2008, as financing became scarce and large commodity producers disciplined their capex commitments, many projects that were planned to start development were cancelled or postponed. We believe that the same dynamic could take place, with the effect of reducing the expected growth of supply. Nevertheless, the large companies today have large cash balances which will spawn an increasing amount of M&A activity as the stronger companies take advantage of the situation.

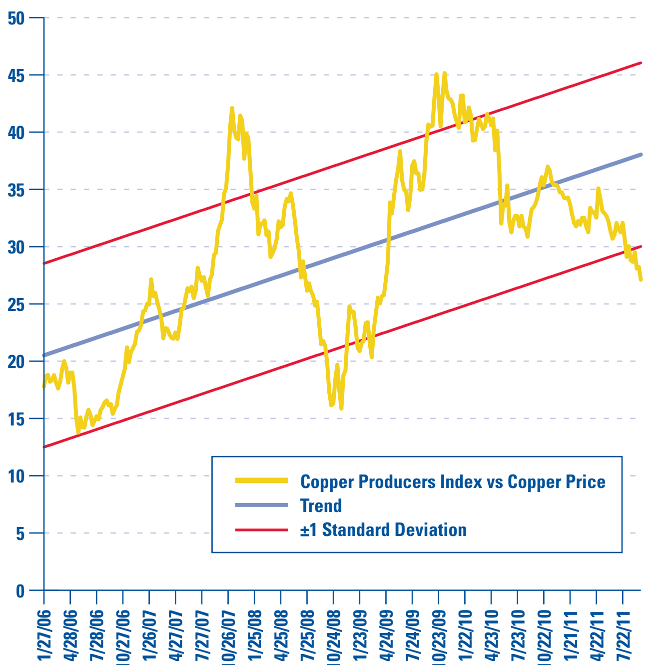
Natural Resources Stocks. Outlook and Portfolio Strategy

The sudden and violent correction in natural resource-related equities across the board during the last few months has left many companies trading at valuations that imply that investors and analysts are pricing in a global depression, including a very strong slow-down of the Chinese GDP. There are several companies that are trading below book value, replacement cost and even cash positions in their balance sheets.

As the graph on page 2 shows, natural resources' equities have correlated better with the general equity markets than with the underlying commodity prices, meaning that despite high commodity prices, the stock prices of commodity producers have fallen disproportionally. This dislocation can be violent and has happened in the recent past under panic market conditions, as was the case in 2008, but it tends to be relatively short-lived.

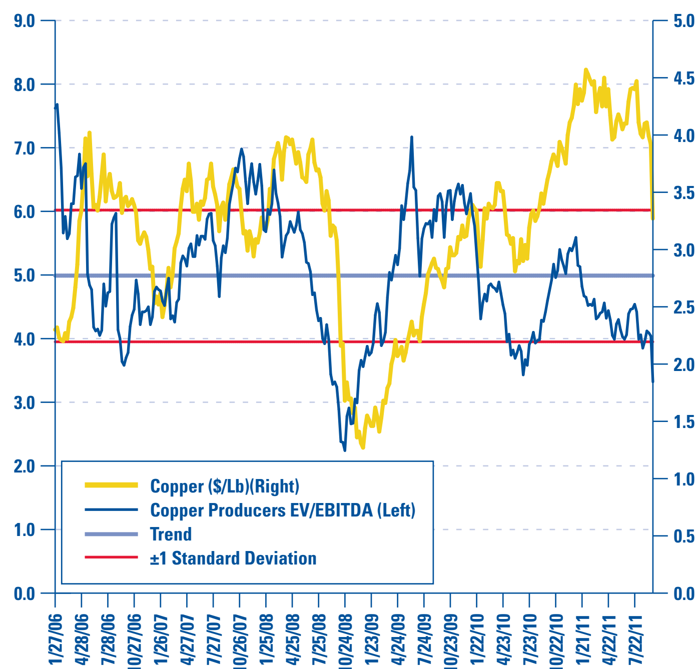
The graphs below show the relationship among the price of copper and the stock prices of copper producers. The first graph below shows clearly that copper producer' stocks tend to perform better than the price of copper, despite the higher volatility (with great contribution from the incredibly volatile markets in 2008 and 2011). It also shows that the valuation of copper producers relative to the price of copper has reached an undervaluation level (-1 std deviation to the mean) only seen in the financial crisis of 2008. The second graph below also shows that on a FV/EBITDA basis the stocks are trading at an extreme low, again only seen in occasions of distress which warranted strong recoveries.

Copper Producers Relative to the Copper Price



Source: Bloomberg

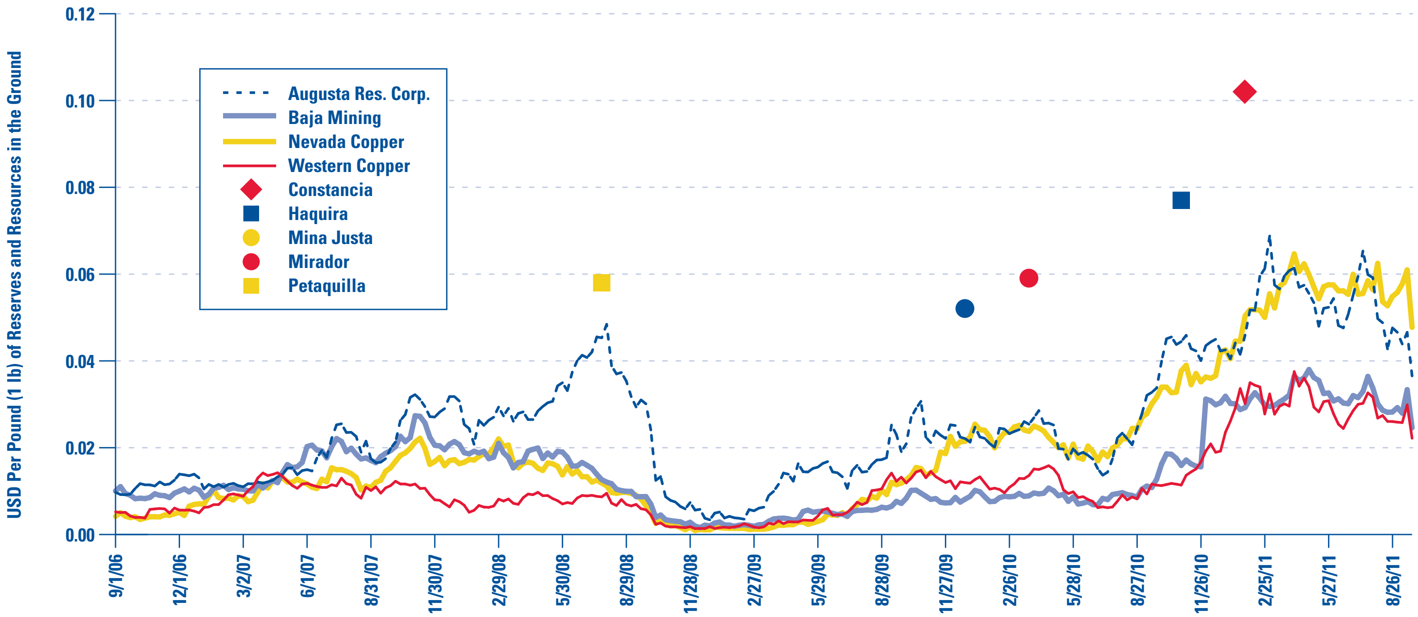
Copper Producers Valuation Relative to Copper



Source: Bloomberg

A clear example of the dislocation in values between what companies are willing to pay in a take-over compared to what investors are willing to pay for a stock in times of turbulence is shown in the following graph. Mina Justa (Chariot Resources Ltd.), Constancia (Norsemont Mining Inc.) and Haquira (Antares Minerals), mines in Peru, were recently taken over for an average $0.08/lb of copper in the ground, whereas stocks like Augusta Resources (Arizona, USA), Nevada Copper (Nevada, USA) and Baja Mining (Mexico) are trading at the equivalent of less than $0.04/lb of copper in the ground.

Satellite Holdings' Valuations vs. Recent M&A Transactions

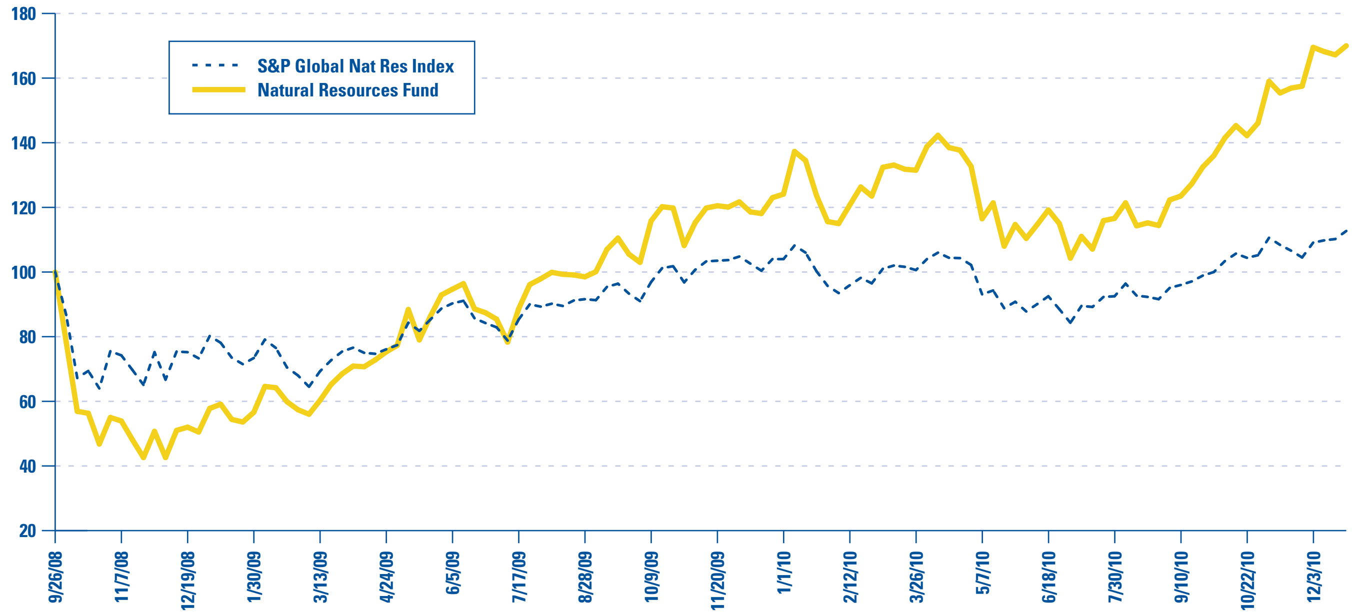


Source: Bloomberg, City of London

Our investment strategy, designed to take full advantage of the long-term structural bull case for natural resources, consists of taking positions in two areas of the investment universe: a) the large blue-chip producers which we call core positions and, b) a selection of small and medium companies, which we call satellite holdings, with very strong certified reserves in the ground located in geopolitically friendly areas. These companies also share other common characteristics, such as low production cost, solid management teams, strong balance sheets, access to financing and, finally, access to infrastructure. We select and invest in these companies not only because they have very strong growth rates but also because they are clear take-over targets for the cash-rich larger companies in search of readily available low-cost reserves.

This strategy has an embedded higher beta nature than a purely large-cap strategy and has proven to work well since inception as natural resources have been in a steady bull market, outperforming every year with the exception of 2008 and so far in 2011. Conversely, the strategy happens to suffer during periods of high volatility and emotional markets, because during periods of risk aversion, investors tend to bail out from any investment vehicle that is less liquid, irrespective of the fundamental strengths the vehicle may have. In essence, the baby is thrown out with the bath water. On the other hand, the strategy tends to recover quickly and outperform benchmarks with large caps as soon as the horizon looks stabilized. The following graph shows the negative performance of our fund compared to the S&P Global Natural Resources Index since September 2008, when the financial crisis accelerated, and also the strong recovery from November 2008 through December 2010.

Recovery after 2008 Crisis. Small and Mid-Caps Outperform Large-caps



Source: Bloomberg, BNYMellon

The equity market is extremely oversold and investor sentiment is approaching an extreme position which typically presents a buying opportunity. Equity market valuations are very attractive based on current earnings levels and corporate balance sheets remain very strong. We believe the combined risks of a liquidity crunch due to the debt problems and economic recession have to a great extent been built into the market expectations. If either of these risks turn out to be better than is currently feared, the market will likely have a strong rally.

Investor focus on the big picture means little attention is being paid to stock selection. While investors may continue to be quite risk averse for a while, we believe stock valuations and earnings multiples will turn around once markets start seeing better economic times ahead and firmer commodity and gold prices.

In terms of portfolio positioning, we are positive on the outlook for gold, copper, uranium and iron ore. We are still negative on zinc and nickel though fundamentals for these sectors are beginning to improve. We believe that commodity stocks offer excellent value, but selectiveness is crucial. In terms of stocks, we are identifying companies that we expect will lead the eventual recovery in equity markets. As such, we put special emphasis on solid balance sheets, ample reserves and resources, experienced management and projects in politically stable geographic locations. ◆

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