Commodity stocks for the long run: Now it's the supply side

Wenzel Analytics Inc

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(Copied and reformatted from Jubak's handouts at the Las Vegas Money Show.)

Commodities demand: It shouldn't be your big worry now

- A slowing U.S. economy hasn't been the disaster investors feared:
- EIA now projects U.S. 2008 oil consumption to fall by 330,000 b/day, yet oil has still climbed to $120/barrel
- Demand from China, Middle East, Russia, Brazil and India more than makes up the difference. Chinese demand projected to climb 400,000 barrels a day in 2008.
- Reasons: strong economic growth outside the U.S., rising incomes, rising consumerism (if you just bought your first car, do you really care what gas costs?), government subsidies and price controls. (sales of gasoline, diesel, and kerosene up 19% in China in first quarter, Middle East fastest growing consumption outside of China).
- Many commodities follow pattern of oil: Copper (U.S. consumption fell 20% in 2007, but global consumption climbed 4% thanks to 25% growth in Chinese consumption.)
- A few commodities seeing increase in global and U.S. demand: potash (fertilizer) demand up 4% in 2007 and 2008 ion growing demand from farmers driven up higher farm commodity prices.

It's a supply side game now: when will new production come on line?

- What are the inputs and who owns them? Nitrogen fertilizer (ammonia to urea) produced from natural gas. Cost of natural gas is 75% to 90% of the cost of ammonia. Saudi Arabia in particular and Middle East have huge unused reserve of cheap natural gas.
- What are the economics of building new production? Costs rising at 15% annually.
- What are the infrastructure barriers? Lack of electricity for Chilean and South African mines.
- What are the lead times for new production?
- What are the capital barriers? The more it costs and the longer it takes to build, the higher the required rates of return.
- What are the psychological barriers? Every commodity company CEO knows his/her company is operating in a cyclic industry.

What would you decide?

- Thompson Creek Metals (TC). Go or no go on developing the Davidson project?
- 10-year mine life with 4 million pounds of molybdenum a year in production.
- To get a 20% IRR before tax, requires average molybdenum price of $16.13 a pound.
- Molybdenum price is currently $32 a pound
- Forecast #1 shows molybdenum price rising to $35 in 2008 before beginning a decline to mid-$20s a pound.

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- Forecast #2 shows molybdenum falling to $12 a pound by $2011 and then to $9 after 2015.
- Davidson will cost $110 million in capital costs. (Increase from previous 2005 estimate of $60 million). Davidson mine would be able to use much of the infrastructure of nearby Thompson Metals mines.
- Estimate first production in August 2009 and full production in April 2010 .

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Projected supply picture: 5 metals

- Aluminum: a shortage of 140,000 tons in 2008 and 950,000 tons in 2009.
- Copper: a shortage of 50,000 metric tons in 2009
- Nickel: a shortage of 9,000 tons in 2008 and 13,000 tons in 2009.
- Zinc: surpluses in 2008 and 2009, and a gradual tightening through 2012.
- Iron ore: tight supply in 2008; supply and demand should level out through 2011.
- Uranium: a growing surplus from 2008 through 2010.

Fertilizer: the special case

- It's not just one market or product but three: potash, nitrogen and phosphorus ..
- Potash (the source of potassium) is mined. Canadian contains 56% of the world's proven potash. (In comparison, Saudi Arabia contains 60% of the world's proven conventional oil reserves.) It takes five years to open a new potassium mine and costs about $2 billion.
- Nitrogen is synthesized from natural gas (with air and steam) to produce ammonia to produce urea or ammonium fertilizers. Natural gas makes up 75% to 90% of the cost of producing ammonia-based fertilizer. A $1 per million BTU increase in the cost of natural gas produces a $32.50 increase in the cost of a ton of ammonia. Trinidad is the world's largest exporter.
- Phosphorus is also mined but phosphate rock is then crushed and combined with acids to produce phosphoric acid which is then used as a feedstock for fertilizers such as DAP and MAP. Phosphate deposits are widely dispersed with 15 countries producing 97% of the world's phosphate in 2006. 47% of global phosphate production is owned by government controlled and/or subsidized companies. Phosphate rock is 38% of the cost of production.

Oil and natural gas: a mismatch of capital and resources

- Russia, Mexico, Venezuela, Nigeria have the natural gas and oil but lack the capital to develop it. Largely a result of national politics. IEA estimates need at $22 trillion by 2030.
- Worldwide production from older existing fields is now falling each year by about 4.5 million barrels a day.
- Many major oil producers-Nigeria, Mexico, Russia--are still flaring off a big part of the natural gas produced along with oil because of a lack of spending on collection and processing facilities.
- The liquefied natural gas problem: demand is running well ahead- of supply. Global supply grew by just 4% in 2007. Hugely expensive and hugely complex projects lead to cost overruns and delays. Costs at Soyo in Angola now to $4 billion and final investment decision in December was a year behind schedule.
- Result has been bidding war with Asian consumers, especially Japan strapped for natural gas, outbidding U.S. for supplies. U.S. LNG supplies down 2/3 in 2007.

What stocks to buy #1: Picks and shovels

- Engineering and construction companies show the greatest revenue growth in the last half of the commodity cycle. As revenues rise, margins go up to about 4x trough level, according to Stifel Nicholas.
- Stock group up 127% in 2007 and then showed correction in first quarter on valuation. But cycle last comparable cycle ran 1965-1977. This one began in 2002 and should be good until 2010 to 2012.
- Stocks: Jacobs Engineering (JEC), Fluor (FLR), Foster Wheeler (FWL T), Shaw Group (SGR), Joy Global (JOYG), Bucyrus International (BUCY), Titan International (TWI) and Chicago Bridge & Iron (CBI).

What stocks to buy #2: Metals with infrastructure problems

- Copper is suffering from power shortages, rolling strikes from miners, and national governments determined to get more for their copper. Stock piles are low now. Production at disrupted levels looks unable to fill the gap. And sometime the U.S. housing industry will recover and build houses again. The pick is Freeport McMoRan Copper .& Gold (FCX).
- Iron is suffering from a decision by the big three producers (Rio Tinto, BHP Billiton, and Vale) to make acquisitions rather than expand production. Look for smaller producers such as Fortescue Metals (FSUMF) and Anglo American (MUK).

What stocks to buy #3: Oil and gas companies expanding production

- U.S. companies expanding production in the last quarter and year: Devon Energy (DVN), Ultra Petroleum (UPL), Murphy Oil (MUR), and Hess (HES).
- International companies expanding production:
- Petrobras (PBR), Suncor (SU), EnCana (ECA), Canadian Natural Resources (CNQ)
- U.S. utilities investing in production: FPL (FPL), Sempra Energy (SRE) (A LNG Investment)

Notes

- He is 40% in cash. He is nervous because commodities have been so rewarding. Cycles typically last between 7-15 years.
- Busts are not from a lack of demand, but from excess supply.
- Copper demand is down 20% in US because of decline in construction.
- New capacity is slow to come on in commodities, and the risk is that the prices will collapse before new production can come on.
- Oil reserves were once 80% controlled by US companies; now at 20%. Oil companies have nowhere to invest, and national companies are taking the profits and not investing in development.
- For fertilizer, there is a future for potash but not nitrogen.
- HES has holdings off Brazil near where Petrobras has most of its new development.
- Likes oil services such as Schlumberger and deep sea drilling companies.
- Likes PDE and the Norwegian STO (Contracting with Russia to drill in the Artic Ocean).
- Likes Chesapeake (CHK); CEO still buying his own stock.
- Likes natural gas; great transition fuel until nuclear and others come on line.
- Likes FCX more than PCU
- The dry goods shippers' prices fell because of misinterpretation of season data; good long-term holdings.
- Volero and independent refineries are challenged by Mideast buildouts of own refinery capacity. Not a buy and hold.
- Likes specialized steel, like Steel Dynamics.
- Pipelines are wonderful, but not TransCanada. Likes Enbridge and Northwest Pipe.

Why you must own financial stocks- and when to buy

Jim Jubak, MSN Money Money.MSN.COM jjubak@microsoft.com 14 May 2008

Financials: Want to buy a train wreck, anyone?

- The financial sector got hammered in 2007 by the collapse of the sub-prime mortgage market, by rising defaults on commercial loans and credit cards, and by the tumbling prices in derivatives so complex, it turned out, that nobody understood them.
- Shares of Washington Mutual, the biggest savings and loan in the country, plunged 70%. Countrywide Financial dropped 78%. Citigroup fell 47% in 2007, Merrill Lynch (MER) 41%, Bear Stearns (BSC) 450/0, and Bank of America 23%.
- The first four months of 2008 weren't any better. As of May 8, Washington Mutual was down another 19%, Citigroup another 5%, Merrill Lynch another 9%, and Bank of America another 6%. Bear Stearns tumbled another 88% and was bought by JP Morgan Chase. Countrywide Financial dropped another 44%, raising the possibility that Bank of America, which had decided to buy Countrywide, would either cut the price or drop the deal entirely
- Just in case you were thinking the worst is over, on May 9 American International Group announced that it would take another $15 billion loss on the falling value of its portfolio.

But the long term trends driving growth in this sector are intact

- First, in the developing economies rising global incomes are creating huge new markets for financial products such as credit cards and life insurance that we in the United States take for granted.
- Second, an aging global population of hundreds of millions of Baby Boomers in the world's developed economies and hundreds of millions of newly comfortable Indians, Chinese, Vietnamese, Russians, and Brazilians are socking away money for retirement and need somebody to manage it.

The developing economies are huge markets for financial services

- In China life insurance penetration trails both the world average and the Asian average. According to Swiss Re, the gross life insurance premium per capita in China is just $34 a year compared to $1,790 in the United States and $155 on average in Asia.
- Personal accident and casualty insurance shows the same pattern.
- Penetration in China is just 1.2% and the per capital premium is just $19. The per capita premium for this type of insurance in the United States is $2,134 a year.
- In India the total premium collected for life and non-life insurance soared by 83% from 2001 to 2004.
- In the Middle East, a region with some of the highest economic growth rates and youngest populations in the world, insurance premiums are growing at a 12.5% compounded average annual rate

Who's going to manage the money of a richer and aging world?

- In the developed world by 2040, 45% of the population in Japan, Spain and Italy will be 60 or older. Makes the United States where only 26% of the population will be 60 or older by 2040 seem positively childlike. Still that 26% figure for the United States represents a huge increase from 16.3% in 2000.

- In the developing world by 2025 the median age in South Korea, Taiwan, Thailand, Singapore, and Hong Kong will hit 40. The United States, in contrast, won't hit a median age of 39 until 2030. By 2020 China will have a population with 265 million 65-year olds.
- Nobody is prepared to finance an aging population.
- Frightening thought - the U.S. is comparatively in good shape. Social Security delays full retirement benefits for anyone born after 1960 until age 67, and 80% of workers save something for retirement, about $700 a month, is in the best shape.
- Europe is in worse shape. Europe's historically generous government retirement plans are cutting benefits and delaying retirement. European workers aren't used to saving much for retirement either. In France, Germany, and Italy the average is just $300 a month.
- It's worst in the developing economies. Very few workers are covered by any pension plan at all. Only 11% of Indians, for example, have any pensions at all. In China the percentage is a higher but still stunningly low 20%.
- Who's going to profit from those trends and who isn't? Financial stocks fall into four groups.

Group #1 : Avoid

- Avoid the banks that have been damaged to their core by the financial crisis that started with the meltdown of the subprime mortgage market in the United States.
- Why? Two reasons. First, the damage isn't over. Second, the business model at these banks has been so damaged that rebuilding the franchise will take years, years that will allow competitors to steal big chunks of market share.
- Avoid Citigroup (C), which is in the midst of dismantling its entire one-stop financial-supermarket business structure. The bank just announced that it will sell off $400 billion in non-core businesses. Think that might take some time and create some doubt in customers' minds?
- Merrill Lynch (MER) abandoned its strategy of overseas expansion to concentrate on building share in the U.S. capital markets. Now it's left to rebuild its presence in markets such as Japan.
- Wachovia (WB) and Washington Mutual (WM) bet on building up huge mortgage business. Wachovia spent $26 billion to acquire California mortgage machine Golden West Financial in May 2006.

Group #2: Speculative

- American International Group((AIG and HSBC Holdings (HBC) aren't out of woods but the franchise intact.
- HSBC is the largest bank in Hong Kong and owns a 60% stake in Hang Seng Bank, the third largest in the city. In India it is one of the biggest corporate lenders and a pioneer in wealth management for India’s growing middle and upper classes. Worldwide the private bank group had $333 billion under management at the end of 2006. But $53 billion in U.S. mortgages showed negative equity at the end of 2007.
- American International's American International Assurance Co subsidiary is the leading life insurance company in Southeast Asia. Other subsidiaries Nan Shan Life Insurance is Taiwan's second largest life insurer and The Philippines American Life and General Insurance Co. is the largest life insurance company in the Philippines In the life insurance and retirement services segment of the company's business about 73%, of revenue in 2007 came from overseas. And yes, $30 billion is a lot of money but only 2.8% of $1.05 trillion in assets.

Group #3: Buys in the U.S. sector

- US Bancorp, USB, a recent Jubak's Pick that announced fourth quarter numbers that showed the bank gaining market share because of the recent turmoil.
- Middleburg Financial, MBRG, a community bank in the very wealthy Northern Virginia horse country outside of Washington, D.C. The bank has a 16°k share of deposits in fast-growing Loudon County. I'd expect earnings to be roughly flat in 2008 with 2007 but for growth to resume in 2009.
- Northern Trust, NTRS. Northern Trust's private banking business serves roughly 20% of the Forbes 400 super-rich. I'm expecting that problems at competitors will lead to new business wins at Northern Trust. According to Standard & Poor, revenue will grow by 12% in 2008.
- Other names: State Street (STT), SEI Investments (SEIC), Toronto Dominion (TD) US Bancorp (USB), Wilmington Trust (WL).

Group #4: Buys in the developing markets sector

- HDFC Bank, HDB. Only the third largest bank in India, but the best run under managing director Aditya, the former CEO of Citibank Malaysia. Because HDFC's base of retail deposits--from a network of 746 branches in 329 cities serving 10 million customers--provides about 40% of the capital it lends out, the bank has been able to maintain a healthy net interest margin--2.32% in the fourth quarter of the fiscal year that ended in March 2008. A conservative approach to credit quality kept nonperforming loans to just 0.83%, of all loans in the fourth quarter. (It doesn't hurt, certainly, that bouncing a check remains a felony in India.) In the U.S. the stock trades as an ADR (American Depository Receipt), with each ADR equal to three Indian ordinary shares.
- Itau Bank Financial Holding (ITU), the second largest bank in Brazil, recently bought Bank of America's operations in Chile and Uruguay and is expanding into Argentina. The Brazilian market for auto loans and credit cards is still in its infancy, but Itau Bank already owns 25% of both markets to go with its 9% share of Brazil's bank deposits. Return on equity has averaged 29% annually during the last six years. I expect an appreciating Brazilian currency and rising interest rates to cut into profits across the Brazilian banking sector in 2008. Look to buy on weakness later in the year. In the United States the stock trades as an ADR (American Depository Receipt) with each ADR equal to one preferred share.
- Other names: Banco Santander (NYSE ADR: STD), DBS Group Holdings (OTC: DBSDF), ICICI Bank (NYSE ADR: IBN), United Overseas Bank (OTC: UOVGF)

Q&A Notes:

- Damage to financials not over, and probably won't be for another year; some won't recover.
- JP Morgan Chase is sitting in the catbird seat; it's virtue was in doing nothing and not acquiring. It has a good CEO who knows how to integrate acquisitions, which will be available cheap.
- Jubik owns USB and then suburban banks in Chicago, Marin County and DC.
- No one trusts the ratings now.
- There are a huge number of opportunities, but hard to evaluate.
- Wells Fargo is in decent shape and will pick up market share.
- [He carries an incredible knowledge base in his head.]