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SE Smart Money

HD **Commodities on the cheap**

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Equities With prices down, it looks like a good time to buy resource stocks, but is this the bottom of the market? Vesna Poljak reports.

The plunge in the price of key commodities – from **iron ore** to **oil** – has shaken faith in the resources sector, which is on track for losses of 13 per cent this year, the worst since 2011.

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Some experts say there could be further woes to come, arguing analysts are too optimistic about the outlook for commodity prices and that earnings forecasts beyond the 2014-15 year count on a recovery in traded prices.

But as stocks slide, others are convinced signs of value are emerging.

The giants of the Australian resources sector, BHP Billiton and Rio Tinto, are in a process of transformation to become more friendly to investors who desire higher and more stable dividends, a shift away from high-stakes exploration. But they too have been vulnerable to the downturn and have respectively shed 12 per cent and 13 per cent of their value this year .

Nor is anyone convinced **mining** companies are the new breed of defensives.

"I think the DNA of most resources companies is around growth," says Goldman Sachs**equity** strategist Matthew Ross. "I think there will still be a bias to reinvest, as opposed to focus entirely on capital management." Partly this is because the miners have pushed hard at expanding their production, which comes with higher maintenance bills.

"Clearly they won't be investing as aggressively as they had in the past decade," says Ross, who has an "underweight" recommendation on **mining** equities but is neutral towards **energy** stocks. He believes the popular view, that there will be a drive to return cash rather than reinvest it, could be overstated. "I'd probably have a healthy dose of scepticism."

The dominant miners have promised to increase dividends to win back investors deterred by the **billions** in write-downs on underperforming projects and uneconomic investments. The standout example is Rio Tinto, which this year washed its hands of the disastrous $3.9 **billion** Riversdale **Mining** **acquisition** by selling the business for $50 **million**.**China**'s winter

The downturn in the commodity cycle is getting in the way of resource **company** plans to repay investors with more compelling dividends because lower commodity prices hurt the bottom line and earnings downgrades cannot be ruled out.

Iron ore is down 41 per cent to $US79.09 a tonne after reaching a five-year low. Other bulk commodities have been dragged down too, with **copper** down 7.4 per cent (although nickel is up 12.7 per cent).

RBC Capital Markets analyst Chris Drew is not as bearish as most of his peers on the outlook for iron ore, the key ingredient in steel making.

"We are less negative than the general view but it's certainly looking like the days of $US110, $US120 iron ore prices are over," he adds, citing $US80 to $US90 as a more practical range.

"Right now we think we are oversold as the market is working through the significant increase in supply delivered this year and demand is seasonally weak," Drew says.

"But we are starting to see some production come out of the market in China … that should start to support pricing. We're also watching for China's winter when domestic production slows aggressively and there is potential for weather-related supply disruption from Australia and Brazil."

His view that the market is too negative on iron ore is one of the reasons BHP and Rio offer an attractive entry point at current prices for a medium-to-long-term investor. On Friday BHP shares were trading at $33.57 and Rio at $59.57. They were as high as $39.79 and $71.30 in 2014.

"We have a preference for Rio, and that's predicated on our view for iron ore being a little bit more optimistic than what the market's factoring in at the moment," Drew says.

"BHP's under a bit of pressure with the oil price coming off recently, but we saw them clearly reiterate their commitment to the progressive dividend as well as their targets around cost-out and reduced capex at the investor briefing this [past] week which was positive.

"BHP is a more diverse, larger-scale, less volatile mining exposure –so if you're looking for income from a mining stock, that would be a low-risk easy way to play it. Generally the mining sector is going to remain volatile, though."Bellwether

RBC is also positive towards nickel, singling out Western Areas and Sirius Resources as standout stocks.

Crucial to the outlook for the resources sector is what happens to economic growth in China, the world's second-largest economy and a fervent consumer of Australia's resources exports.

Third-quarter growth in China was slightly better than economists had anticipating, coming in at 7.3 per cent.

What is becoming increasingly clear is China is less interested in making infrastructure-heavy stimulus efforts to boost its output, shifting towards more targeted easing measures.

ANZ economists believe China will meet its 7.5 per cent growth forecast for 2014, slowing to 7 per cent in 2015 and 2016.

ANZ commodities analyst Mark Pervan says the Chinese property market is critical to framing the outlook for demand for bulk commodities.

"The Chinese property market is the bellwether for demand," he adds. "Not just China, but Chinese property. The Chinese steel market, which produces 55 per cent of the world's steel, actually consumes 75 per cent of the world's iron ore exports.

"Also, in that steel market in China, half of it goes to Chinese property or real estate."The bottom

This downward cycle in the commodities market has dragged on longer than the usual three to four years, he says, because of the China effect.

"We've definitely been on a downward path since early 2011 … that was at the time the Chinese started to tighten monetary policy. We're close to the bottom. I'd say the cycle [is going to hit the] bottom in the next six months."

The second half of 2015 looks more optimistic for key commodities, pe predicts.

ANZ is upbeat on energy, where the supply side looks to be addressed by expected OPEC cutbacks and seasonality in prices will kick in.

The decimation of the oil price has been one of the most surprising turns of this year, with WTI crude falling to $US80.95 a barrel from $US92.72 at the end of December. Oil equities have not all felt the pain, with Woodside Petroleum up 2.1 per cent.

Still, there are winners to be found.

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Within this year's top 10 performers for the All Ordinaries Index, there are some miners and **energy** stocks. These include No. 1 performer Liquefied Natural Gas up 1200 per cent, Western Areas up 84 per cent and Indophil Resources up 68 per cent.

CO bkhlp : BHP Billiton Ltd | bltplc : BHP Billiton PLC

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