UTEFA

Industry:

Metal & Mining

Metals and Mining

Disruption in metal supply, higher demand and weakened USD drove Metal Prices Higher.

Sep, 7th, 2020

Research Analysts:

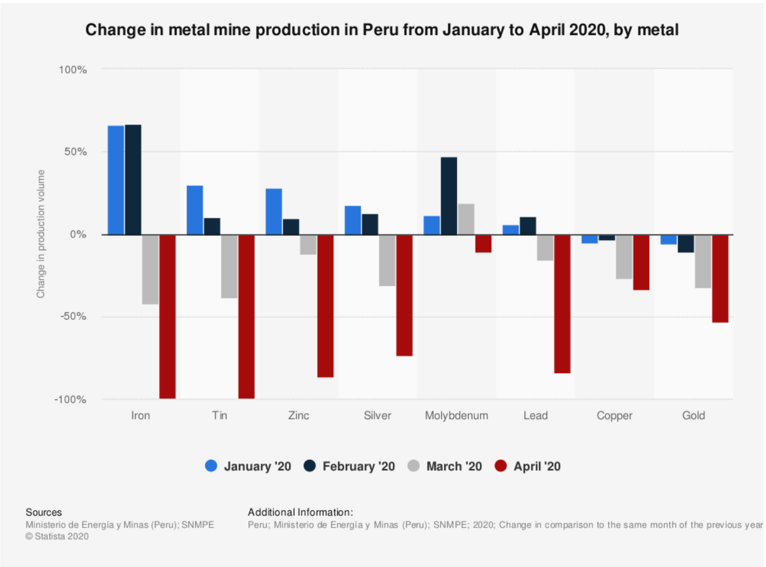
Ruei-Hung (Ray) Chen
ruei.chen@mail.utoronto.ca

Daniyal Adeel
daniyal.adeel@mail.utoronto.ca

Allen Xuan
zhenyu.xuan@mail.utoronto.ca

Summary: In 2020, the development of COVID- 19 has created lots of uncertainties all over the world and has resulted in major swings in the metal commodities prices and equities. Key drivers for the swings in metal prices include the **supply disruptions** due to the pandemic, **China's aggressive metal demand** and a **weakened USD strength**.

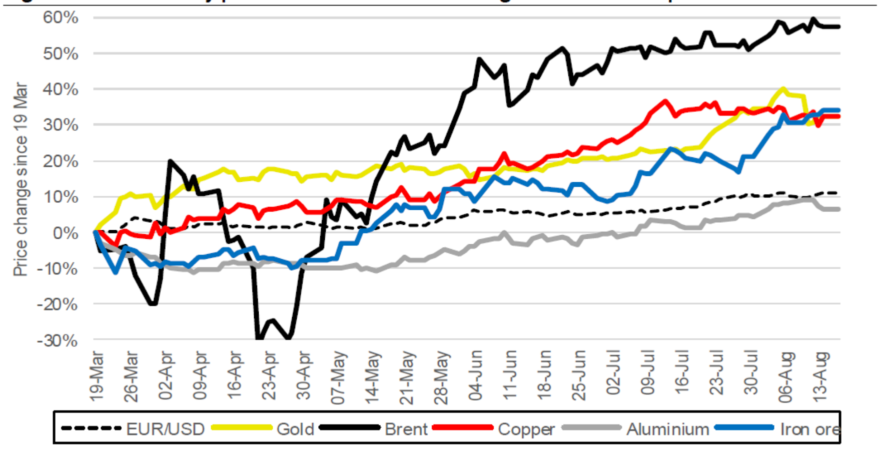
- **Supply of metals**:
  The commodity markets have been affected greatly by the COVID-19 crises. Company operations were disrupted by disease outbreaks and government-mandated shutdowns. Take Peru as an example, Peru's mining sector contracted 42.29% in April with production of Iron and Tin stopped completely, (Zinc production fell 86%, lead 84% silver 74%). The production of various metals was disrupted and affected, thus, driving the prices of metals to a higher level.



- **Demand:**
Demand for key base metals are at historic low in almost all countries with the exception of China. Just recently, Chinese government has initiated a $559 Billion USD worth of stimulus package to help the country's struggling factories and merchants. Infrastructure and real estate sectors especially have benefited disproportionately from the monetary stimulus. The stimulus helped boost the economic activities in China and also drive up the country’s demand for base metals.

- **Strength of USD**:
While both supply and demand of metals are taking major shocks, USD, the currency that most commodities trade in today, is also facing some volatile swings. Reasons like lockdowns, debt-funded welfare and zero interest rate policies all contributed to weakened the strength of USD and caused the USD to deteriorate.

Figure 1: Commodity prices and EUR/USD since gold and FX low point of 19 March



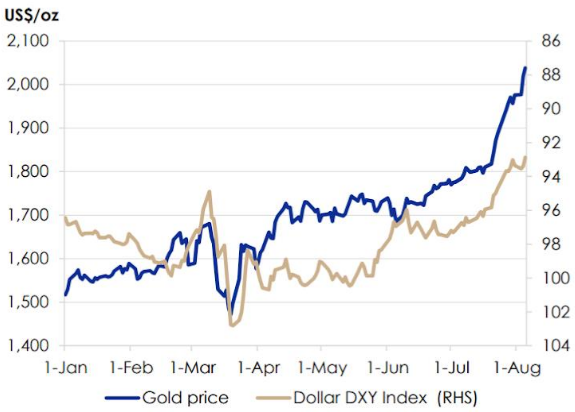
Source: The BLOOMBERG PROFESSIONAL™ service, Credit Suisse

According to the graph above, USD has declined 11% against the Euro since March 19th this year. Gold within the same period has climbed 32%. Consequently, the lower buying power of USD pushed the prices of metals even higher.

Gold:

The development of COVID- 19 has created lots of uncertainty all over the world and has resulted in major swings in both the stock market and the prices of precious metals. Given the uncertainty of the long-term consequences of COVID-19, many investors have switched to gold as a safer store of wealth than the global reserve currency. Thus, in the past few weeks, gold has reached its all time high at US$2065/ oz. The previous high was September 2011 at approximately US$1900 / oz. As of writing, the gold price is up about 30% YTD.

US dollar weakness the primary driver of gold price rally in this part of the cycle



Source: Bloomberg, CCBIS

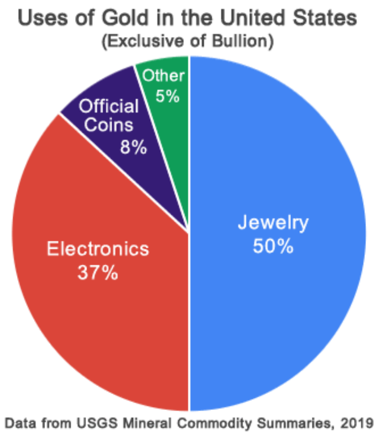
Dollar depreciation is also a propeller of copper and non-ferrous metal prices

Source: Bloomberg, CCBIS

As the graph shows, gold price has climbed from $1500 USD/ oz in January to above $2000 USD/ oz in early August. Forecasts for gold price in 2021 is raised to US$ 2500/oz (previously $1800/oz) and experts expect the gold price to average around $2000/oz for the remainder of 2020.

The macroeconomic factors remain supportive to the gold price. Specifically, the 10-year Treasury bond yield is -1%. The weakness of USD has also contributed to an increase in price and demand for gold.

In response to COVID-19 lock down, the US has taken unprecedented monetary and fiscal policies to increase the money supply in the US. There is now a widespread expectation on inflation which caused the investors to flee to buying more gold.



According to studies, 50% of gold uses are in the jewelry making industry.

In 2020, The World Gold Council reported a significant drawback in both the jewelry (down 50% YoY) and Central bank demand in their 1H20 recap. The investment demand for gold however was able to offset both the jewelry demand and central bank demand for gold and has pushed the gold price to an all time high. Thus, many expect gold prices to be pushed even higher when the demand for jewelry recovers as the GDP growth and central banks resume buying.

Steel:

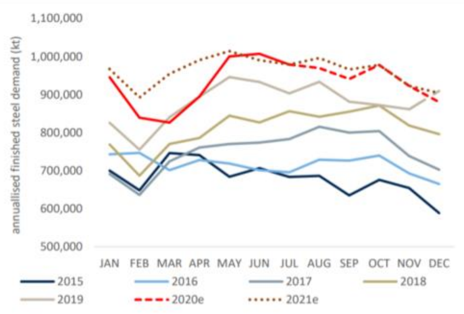
The devastating effect of the pandemic had a great impact on China’s first-quarter economic growth. China’s GDP shrank 6.8% YoY in the first quarter, the first contraction in decades.

However, the country has recovered from the crises successfully. China’s industrial production went up 4.4% year over year in May, the strongest pace since December 2019, with manufacturing seeing a 5.2% growth.

As the world’s top consumer in steel, China’s recovery in construction and manufacturing activities is the major driving demand for steel. In July, China saw a sharp increase in steel imports and a drop in steel exports, indicating a robust underlying demand. This also makes China a net importer of steel for the first time since 2009.

According to the World Steel Association (“WSA”), the recovery of steel demand would be more visible in the 2nd half of 2020, mainly driven by infrastructure initiatives put forward by the Chinese government.

Exhibit 16: We expect stimulus to keep demand strong



Source: RBC Capital Markets estimates, Bloomberg

WSA stated recently that they expect to see Chinese steel demand to increase by 1.0% in 2020. Furthermore, they expected the Chinese infrastructure projects initiated in 2020 to carry over and support the steel demand in 2021.

While China was able to come out of lockdowns ahead of others, most other countries are still struggling to recover from the pandemic. WSA expected steel demand in developed countries to decline by 17.1% and developing countries to decline by 11.6% in 2020 due to substantial job losses, bankruptcies and continued social distancing measures.

<u>Honourable mentions/ Recommendations</u>:

- **Rio Tinto** (NYSE: RIO, ASX: RIO):

  As one of the world leading iron production companies, Rio Tinto was able to keep up its productions and shipments of iron ore during the pandemic while other iron producers faced disruptions in supply due to COVID-19 related shutdowns. Attributed to the strong metal demands from China and the rising iron price, Rio Tinto's EBITDA for the first half of 2020 has increased by 2%. The shipments of iron ore has also increased by 3% compared to the first half of 2019 which indicates a strong performance in the iron ore excavations.

  Moreover, Rio Tinto's gross debt has decreased by 0.7 billion to 13.6 billion in the past few months, mainly attributed to the EUR 2020 bond redemption program. The company has benefited from the deleverage program financially and currently does not have any corporate debt outstanding with maturities due before 2024.

  Rio Tinto's liquidity remains strong and provides a consistent stream of dividend payouts. Hence, we believe that Rio Tinto is a healthy and well positioned iron company that can continue to do well in the second half of 2020.

- **Barrick Gold** (NYSE: GOLD, TSX: ABX):

  Barrick Gold is a mining company that produces gold and copper with 16 operating sites in 13 different countries. It is by production volume the second largest gold mining company in the industry.

  In the past years, Barrick Gold has already faced 2 Ebola outbreaks in their African operations, their experience in dealing with disease outbreaks prompted them to act early as the COVID-19 first outbreak early in the year. The implementations of social distancing, screening and contact tracing measures in all operation sites has helped them minimized the impact of pandemic. As a result, Barrick was able to deliver a strong operating cash flow: FCF increased by nearly 20% from Q1 to $522million in Q2. The sufficient liquidity in the company also allowed Barrick Gold to increase its dividend payout by 14% to $0.08, double to the dividend payout in Q2 2019, indicating a continued strong financial performance amid pandemic.

  Barrick's net debt has also decreased by 25% to 1.4 billion with no significant maturities until 2033. The strong financial strength allows them to endure any possible short-term impacts associated with the COVID-19 pandemic and further dispense their excess cash into further mine explorations.