Why resource stocks haven't run their race

Over the past quarter, much of the small cap index outperformance over large caps has been due to the excellent returns of small resource companies. Given their cyclical nature, is that a reason to look elsewhere? The following note makes it clear that we think not.

The Flinders portfolio has been well represented in resources since inception (albeit usually underweight the index). To recap an observation from mid-2017, we remarked that as a group, resource stocks were more conservatively capitalised than industrial names (ie. when looking at net debt/market cap and other leverage measures) and carried more cash. In fact, the quality and financial strength of the small resources sector has not been as strong in over 10 years. In our view, this balance sheet strength means these companies as a group are well placed to sustain a downturn, and furthermore, worthy of investment provided that desirable growth attributes that we seek are present at an attractive valuation.

Although we are 'bottom up' investors (therefore our portfolio performance is derived through stock selection), our exposure to resources has been a positive contributor to performance. This has been particularly true in the last few months – see the move up in the Small Resources Accumulation index in Chart 1.

Chart 1

Source: Iress

While a significant move, the longer term chart of this index (Chart 2) shows that it is still at a relatively low level. Indeed, the relative performance between small resource companies and small industrial companies (Chart 3) is stark. The question of course is, can the recent rally in resources continue? And consequently, should we continue to have a meaningful exposure to the space?

Chart 2

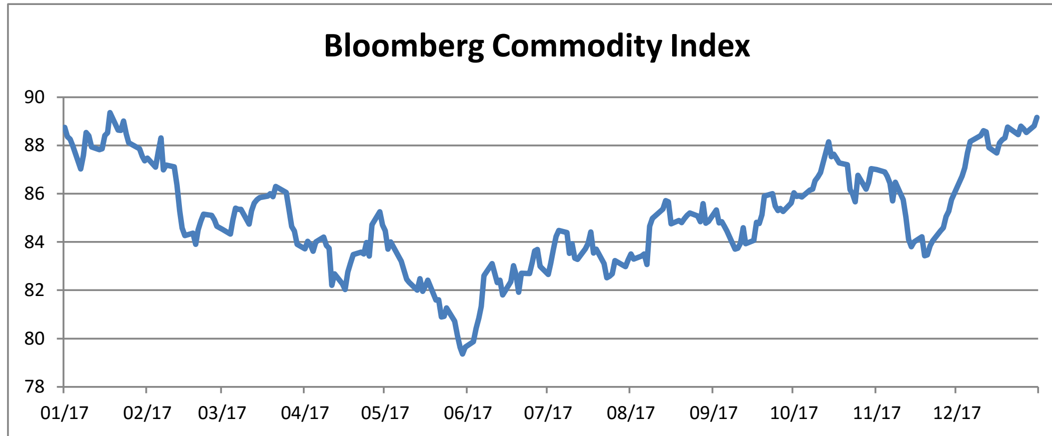
Source: Iress

Chart 3

Source: Iress

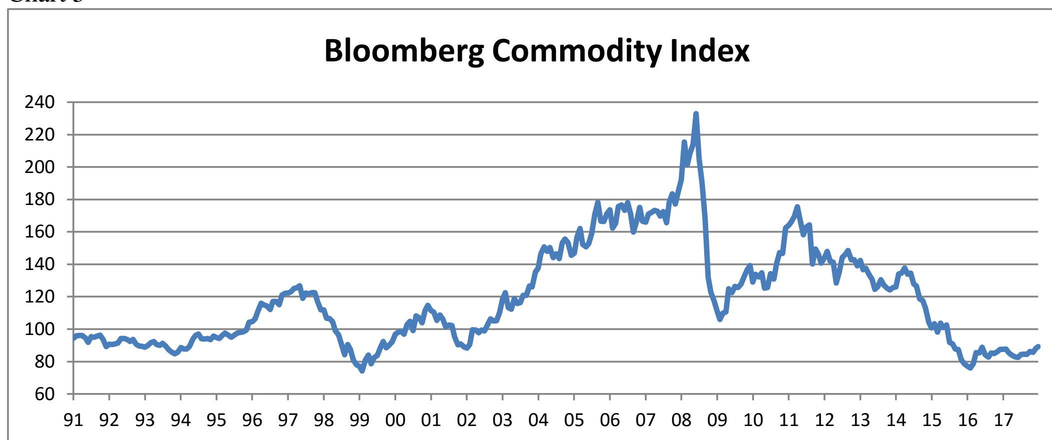
In answering the above questions, it's constructive to understand where we are in the cycle, and the drivers of performance. A key input and driver of resource company valuations is obviously commodity prices. While the Bloomberg Commodity Index (a broadly diversified commodity price index) in Chart 4 shows that commodity prices have bounced off their lows in recent months, the longer term view (Chart 5) highlights that the index has barely bounced in the context of the last 25+ years.

Chart 4



Source: Factset

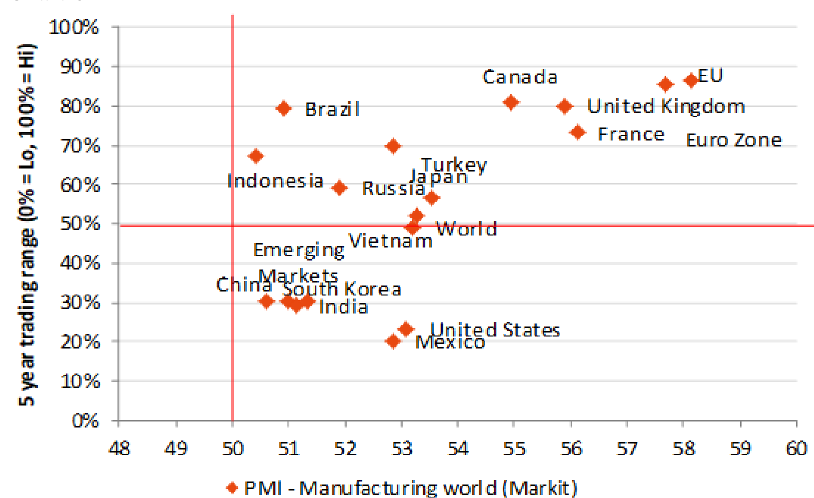
Chart 5



Source: Factset

The reason for recent commodity price improvements is reasonably clear. The economic backdrop is supportive with synchronised global growth for the first time in years. Economic reforms in China, and Trump's corporate tax cuts in the US help further. All major PMIs are in expansionary territory (Chart 6) – a reading >50. In this environment, demand for various commodities tends to be high, exerting upward pressure on prices.

Chart 6



Source: Shaw and Partners

The improvement in commodity prices has unsurprisingly coincided with the improvement in share prices of resource companies. Back to the question of whether the Small Resources index can continue to rally, we are of the view that it can. When considering that commodity cycles can last several years, and that commodity prices are reasonable from a long-term perspective (plus the valuation of resource companies are certainly modest compared to many industrial companies), we feel that a meaningful exposure to (growth oriented) resource companies is still warranted.

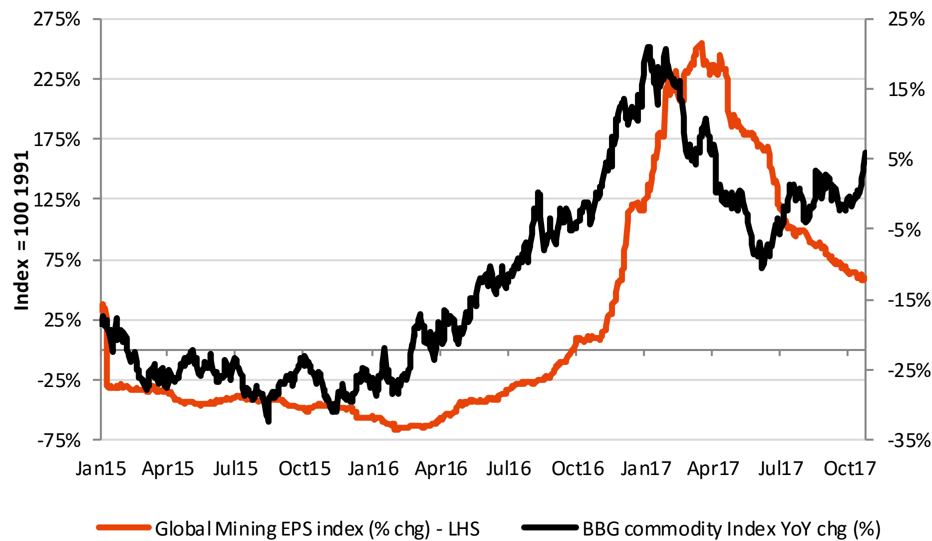
Finally, it's worth keeping in mind one of our favourite charts (Chart 7) which shows the relative performance of the S&P GS Commodity Index vs the S&P500. The chart illustrates that we are currently at a multi-decade extreme with commodities as an asset class having underperformed (US) equities for around a decade. This looks like a turning point with commodity prices in our view likely to outperform.

Chart 7

Finally, a brief comment on earnings. We believe that the next leg of a resources rally will require an improvement in earnings to justify further price performance. While this hasn't begun in a wholesale way, Chart 8 shows that the rate of decline in the Global Mining EPS Index has moderated. However, an improvement probably not too far away given recent moves in commodity prices (indeed, positive EPS revisions can be seen from the likes of BHP Billiton and Rio Tinto). Note that the Bloomberg Commodity Index (measuring commodity prices) year on year change in Chart 8 has recently started to show a positive return, again suggesting that meaningful EPS improvements are close. We would expect EPS upgrades to drive valuation metrics of resource companies higher, and thus continued share price performance.

As a side note on earnings for the several resource investments we have in the Fund, the current expectation is for 38% EPS growth in FY19 (based on Factset consensus data), compared to 23% for the broader Small Resources index. Furthermore the FY19 PE for these holdings is 8.9x, compared to 13.7x for the index. We continue to focus on companies with superior growth attributes without having to pay up.

Chart 8



Source: Shaw and Partners

The Fund has consistently had exposure to several growth oriented resource companies which has benefited performance. Given the backdrop described above, we continue to maintain a significant exposure to the sector (albeit currently a slight underweight to the index weight, which is ~24% at the time of writing).

Flinders Investment Partners
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