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Barron's Cover

Time to Buy Commodities

Sentiment on energy and gold -- and oil and metals stocks -- may be nearing capitulation. Now is a good time to lean against the wind and start to buy.

By
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It's time to consider commodities. While the Standard & Poor's 500, Nasdaq Composite, and other key equity indexes are near record levels, commodity stocks, including energy shares, are way below their peaks. Commodities are probably the most out-of-favor industry group in the stock market.

Photo: shotbydave/iStock

"The commodities space represents great value versus the rest of the market," says Roland Morris, a commodity strategist and portfolio manager at Van Eck Global, a New York firm with most of its investments in commodity-related stocks. "There has been no place to hide -- gold, industrial metals, and energy have all been weak. The underperformance versus the broader market has been dramatic. Unfortunately, he adds, "that doesn't tell you when it will change."

Energy giants such as ExxonMobil (ticker: XOM), Chevron (CVX), and Royal Dutch Shell (RDSA) now trade at multiyear lows. Chevron has been hit hard after a disappointing earnings report in July. Down 24% this year, to a recent $85, it is the worst-performing stock in the Dow Jones Industrial Average.

OIL HAS TUMBLED 25% since late June, to $45 a barrel, and is off 55% in the past year. Gold has dropped below $1,100 per ounce, down 8% this year and 43% below its 2011 high of $1,900 an ounce. Silver, copper, iron ore, and natural gas all are in bear markets, with "Dr. Copper" -- so-called because of its predictive value for the economy -- hitting a six-year low of $2.30 a pound last week. Iron ore, at about $55 a ton, is down 70% from its 2011 high. The energy-heavy S&P GSCI commodity index is less than half of its 2011 peak, and the Bloomberg commodity index is below its 2009 low.

The consensus view is that there is no rush to buy because commodity prices will be "lower for longer." Reduced production costs are cutting break-even prices, and demand is being dampened by slowing economic growth in China and much of the rest of the formerly commodity-hungry developing world.

A strong dollar is helping commodity producers outside of the U.S., because their revenue is usually in dollars and their costs are in local currencies. Many say commodities won't rally until the dollar weakens and the U.S. economy's stronger performance compared with other developed countries makes the prospect of a dollar decline less likely.

WHILE CALLING A BOTTOM is dangerous, we think it's prudent to start adding commodities to your core portfolio at these prices. And we're not alone in saying it's time to lean against the wind.

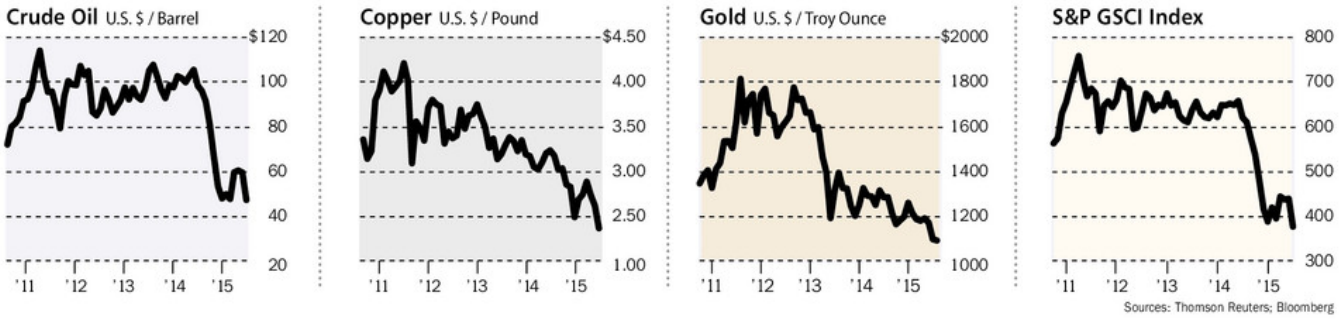
"Investors finally appear to be capitulating on energy for the first time since energy prices started falling," says Gina Adams, equity strategist at Wells Fargo Securities. "Investors had been trying to time a bottom and found themselves riding a steep downward slope." She says the recent selloff could be a sign that a bottom is near. She also cites fund flows into energy and resources mutual funds, which have turned negative in recent weeks after steady positive flows earlier this year.

Says Scott Colyer, chief executive of Advisors Asset Management in Monument, Colo. "Now is the bottom of the commodity cycle. Nearly every central bank in the world is stimulating and trying to create inflation. That suggests it's time to be a buyer of the asset class and not a seller."

Others aren't so certain. Goldman Sachs commodities analysts, who were correctly bearish earlier this year, remain cautious, writing in a report last month that what they call "the 3Ds" would likely keep a lid on prices: deflation in costs "following a decade of investment in commodity productive capacity"; divergence in growth between a stronger U.S. and the rest of the world, which lifts the dollar and pressures commodity prices; and deleveraging, as emerging economies focus more on balanced economic growth than on commodity-heavy expansion pegged to areas such as infrastructure spending and housing.

Bear Market

Most major commodities have been hammered in the past year. Oil prices are down over 50%, and the energy-heavy S&P GSCI index is at a four-year low. With many commodities trading below the all-in cost of producing them, the markets may be nearing a bottom.



"We have remained firm that long-term surpluses in most commodity markets require prices to remain lower for longer to balance both the near-term physical supply and demand," the analysts wrote.

The counterargument is that pain is being felt by commodity producers, and supply will be constrained. "We're in the process of a meaningful supply response across most commodities, but that takes time. This sets the stage for the next cyclical rally," says Morris of Van Eck.

U.S. oil production may finally be set to decline after a relentless, multiyear rise due to the shale boom. Most oil production isn't profitable at current prices. Global oil demand, meanwhile, is estimated to have risen this year by more than a million barrels a day owing to lower prices. Morris is encouraged that most commodities are below what he calls their sustaining cost, which reflects operating expenses and capital investment.

The integrated oil companies are the largest and most defensive energy investments because their commodity exposure is balanced by other businesses, including refining and chemicals, that tend to benefit from lower energy prices. But sharply lower oil prices are overwhelming other factors.

That has served to push dividend yields to levels rarely seen relative to the overall market. ExxonMobil yields 3.7%; Chevron, 5%; Royal Dutch Shell, 6.4%; and BP (BP), 6.7%. The S&P 500 yields just 2%.

Dividends paid by the majors could be vulnerable to reductions -- with the probable exception of industry leader ExxonMobil -- if current energy prices persist. The integrated companies aren't currently generating sufficient free cash flow to support them.

Barron's has written frequently about commodities and energy stocks in the past nine months. We had a well-timed article early this year ("Big Oil Stocks Are Still Too Pricey," Feb. 16), when the integrated stocks were 10% to 30% above current levels, but we were wrong with a bullish article on commodity exchange-traded funds last fall ("Commodities: Buy When the World Is Selling," Nov. 3) and a bullish cover story last winter ("Five Oil Stocks to Buy Now," Dec. 22).

THERE ARE MULTIPLE WAYS to play energy and other commodities (see tables below). They include the major energy stocks; U.S. exploration specialists like Anadarko Petroleum (APC) and EOG Resources (EOG); Canadian oil sands producers such as Suncor Energy (SU); diversified global miners like BHP Billiton (BHP); and now-hated gold miners such as Barrick Gold (ABX), Newmont Mining (NEM), and Goldcorp (GG).

Investors also can buy ETFs tied to equity and commodity indexes. There's the Energy Select Sector SPDR (XLE), which owns the energy stocks in the S&P 500 index, and the Market Vectors Gold Miners ETF (GDX), which holds the leading gold producers. Open-end equity funds include Vanguard Energy (VGELX), run mostly by Wellington Management, and Van Eck Global Hard Assets (GHAAX). There also are resource-oriented equity closed-end funds like Adams Natural Resources (PEO) and BlackRock Resources & Commodities Strategy Trust (BCX), which trade at double-digit discounts to their net asset value.

Yield Plays

The integrated energy stocks yield as much as 6.7%, as investors worry about dividend security. But Chevron, Exxon, and Royal Dutch take dividends seriously.

Company / Ticker	Recent Price	12-Mo. Change	Market Value (bil)	2015E EPS	P/E	Dividend Yield
Int'l Integrated						
BP / BP	$35.88	-25%	$109	$2.28	15.7	6.7%
Chevron / CVX	85.19	-32	160	3.89	21.9	5.0
ExxonMobil / XOM	78.09	-21	327	4.24	18.4	3.7
Royal Dutch Shell / RDSA	58.59	-28	186	4.20	14.0	6.4
Independents						
Anadarko Petroleum / APC	$76.15	-29%	$39	-$1.62	NM	1.4%
Apache / APA	46.60	-53	18	-0.90	NM	2.1
EOG Resources / EOG	77.68	-27	43	0.18	431.6	0.9
Occidental Petroleum / OXY	69.42	-27	53	0.80	86.5	4.3
Suncor Energy / SU	28.63	-27	41	0.78	36.8	3.1
Diversified Miners						
BHP Billiton / BHP	$38.92	-46%	$101	$0.95*	41.2*	6.4%
Rio Tinto / RIO	40.27	-30	62	2.85	14.1	5.7
Gold Miners						
Barrick Gold / ABX	$6.88	-63%	$8	$0.42	16.4	1.2%
Newmont Mining / NEM	16.36	-37	9	1.14	14.5	0.6
Goldcorp / GG	13.50	-52	10	0.33	40.9	1.8

E=Estimate NM=Not Meaningful *Based on June 2016 earnings estimates. Source: Thomson Reuters; Bloomberg

The largest ETF in the group is the SPDR Gold Trust (GLD), whose assets, at $23 billion, are down 70% from their 2011 peak, reflecting investor redemptions and the weak gold price. The PowerShares DB Commodity Index fund (DBC) is one of several ETFs keyed off commodity indexes. The energy-heavy PowerShares ETF is off 16% this year, to $15, and is at its lowest price since its inception in 2006. Investors who want direct exposure to energy can buy the U.S. Oil fund (USO), which has fallen 27% this year, to $15, or U.S. Natural Gas fund (UNG), now around $13.

THE BULL CASE on the integrated companies is that they're now investing heavily in long-lived projects, such as gigantic liquefied natural-gas facilities, which will have useful lives of 20 years or more. That capital, now unproductive, is weighing on returns but ultimately will yield paybacks despite weakness in oil and global LNG, which usually is linked to oil prices.

"The oil majors have between 30% and 40% of the capital on their balance sheets tied up in projects that aren't producing revenues," says Matthew Quigley, an analyst with Pzena Investment Management in New York. "When these projects start up in the next three years, we expect them to be accretive to cash flow and return on capital independent of the energy price."

Pzena holds Exxon, BP, and Royal Dutch. "Exxon stands to benefit from a prolonged oil-price decline because of its relatively unleveraged balance sheet and its ability to acquire attractive assets at a discount," he says. Pzena's firm called Royal Dutch a "compelling investment opportunity" in a recent report, noting it is "poised for a surge in cash flow and improved returns as a recent wave of capital spending comes on-line."

Chevron isn't covering its dividend from free cash. Reflecting this, it passed on a dividend increase earlier this year and has eliminated its stock-buyback program.

Morgan Stanley analyst Evan Calio, who has argued that the major oil companies need to change their business models to address falling production and rein in capital expenditures, projects that Chevron won't come close to covering its dividend in 2016, based on an assumption of $60 Brent crude, the international benchmark.

Chevron shares, however, may be near a bottom. They yield 5%, and the company still is projecting a 20% rise in energy output by 2017 as new projects come on-stream. Management also sees moderating capital expenditures. All this should ease pressure on the dividend.

A Tempting Menu

Commodity mutual funds and exchange-traded funds are all out of favor; many are trading at multiyear lows. Investors can buy funds with exposure to stocks, indexes, or individual commodities.

Open-End

Fund / Ticker	12-Mo. Return	Assets (bil)	Comment
Vanguard Energy / VGELX	-30.1%	$9.5	Sizable stake in integrated companies
Van Eck Global Hard Assets / GHAAX	-37.7	2.7	Owns Glencore, First Quantum
T. Rowe Price New Era / PRNEX	-25.1	3.3	Pioneer Natural Resources in No. 1 holding

Equity ETFs

Fund / Ticker	Recent Price	12-Mo. Return	Comment
Market Vectors Gold Miners / GDX	$13.36	-49.5%	Owns leading miners like Goldcorp, Newmont
Energy Select Sector SPDR / XLE	68.28	-27.8	Owns S&P 500 energy stocks; Exxon, Chevron

Commodity ETFs

Fund / Ticker	Recent Price	12-Mo. Return	Comment
SPDR Gold Trust / GLD	$104.39	-16.1%	Largest gold ETF; assets down 70% from peak
iShares Silver Trust / SLV	13.99	-26.8	Silver ETF is off 68% from 2011 highs
PowerShares DB Commodity Index / DBC	15.49	-38.5	Largest broad commodity ETF; 50% oil weighting
U.S. Oil Fund / USO	14.87	-58.4	Tracks crude price; down 25% so far this year

Closed-End

Fund / Ticker	Recent Price	12-Mo. Return	Dividend Yield	Discount to NAV	Comment
Adams Natural Resources / PEO	$20.19	-28.0%	2.0%	-16.1%	Largest holdings are Exxon, Chevron, Schlumberger
BlackRock Resources & Commodities / BCX	8.17	-24.1	9.6	-16.8	Big Oils, Monsanto are largest investments
Voya Natural Resources Equity Income / IRR	6.42	-32.7	15.7	-15.4	Uses option strategy to boost income

Sources: CEF Connect, Bloomberg, Morningstar

Exxon's second-quarter earnings of $1 a share were about a dime below the consensus. With its triple-A-rated balance sheet, Exxon is the only oil major repurchasing stock, but its buyback program continues to get scaled back, dropping to a projected $500 million in the current quarter from $1 billion. This underscores the unfortunate tendency of big oil companies to repurchase stock when earnings are strong and stock prices are high, and cut back or eliminate buybacks when stock prices are low and earnings depressed.

CALIO PREFERS WELL-RUN U.S. independents like Anadarko over the major integrated oils, because the independents have been more aggressive in cost reduction and therefore are making themselves more competitive in a world of low oil prices. The independents are achieving 20% to 30% reductions in drilling costs while the majors are lucky to be getting 10%. "Being an independent makes these companies feel the stress of commodity prices more palpably," he says. U.S. shale oil producers have some of the lowest production costs in the world.

Anadarko, for instance, is drilling double the number of wells in the Wattenberg region of Colorado with the same number of rigs as a year ago. Calio calls Anadarko a "best-in-class operator" in both offshore drilling and shale formations in the U.S. Its shares are down 8% this year, to $76. Anadarko, like other exploration-and-production companies, looks rich based on adjusted earnings, which were just a penny in the latest quarter, but more reasonable based on cash flow and asset value. The company owns a stake in two limited partnerships it created -- Western Gas Equity Partners (WGP) and Western Gas Partners (WES) -- that is worth about $25 a share. Anadarko has long been rumored to be a potential takeover target for Exxon, which doesn't have scale in U.S. shale.

EOG Resources "has the best suite of onshore assets" with holdings in two of the best oil-producing regions, the Bakken in North Dakota and the Eagle Ford in Texas, says Jeff Hales, a portfolio manager with Alignvest Capital Management in Toronto. EOG was early into both regions and controls some of the best acreage.

Suncor is the largest Canadian integrated energy company and the biggest producer of crude in Alberta's oil-sands region. It also has sizable refining operations that balance its crude business. Suncor's recent earnings release cheered investors and prompted a 12% rally in its shares, to $28. JPMorgan analyst Phil Gresh wrote that the earnings handily beat Street estimates as the company "raised production guidance, cut capex, increased the dividend, and reinstituted a $500 million share buyback." Suncor's operating costs are low at about 30 Canadian dollars ($23) a barrel, giving it staying power with its long-lived reserves. The stock yields 3%.

GOLD-MINING STOCKS have been crushed, with the Market Vectors Gold Miners ETF -- whose largest holdings are Goldcorp and Newmont Mining -- down 27% in 2015 and 80% from a 2011 high. Former industry leader Barrick, at $7, is off almost 90% from its 2011 peak and is back where it stood in the early 1990s, when it was a much smaller company and gold stood at a third of the current price of $1,100 an ounce. The stocks have underperformed the metal in recent years, reflecting dubious capital allocation, resource nationalism in the developing world, and a preference of many investors for the metal or gold ETFs.

"Investors are shell-shocked," says John Bridges, the precious-metals analyst at JPMorgan. "We've lost the generalist investors." Most holders are specialists such as gold funds, which have been seeing redemptions.

One negative: Unlike other commodities, gold is seldom consumed. The above-ground supply of the metal is estimated at 170,000 metric tons, or six billion ounces, and new production adds 1.5% a year to the total. As a result, the price, which is still above the all-in cost of production, could fall further.

Still, the amount of new gold pales in comparison with the amount of money being printed by global central banks.

Bridges favors Goldcorp and says the company has "gone for quality over quantity" with low-cost mines mainly in Canada and Mexico. It is known as a "growth gold," with production rising 40% in the latest quarter. He carries an Overweight rating on the stock and a $25 price target, 92% above the current quote of $13. Barrick is a turnaround story, as it sells mines to cut debt and lower operating expenses. Under a new CEO, Barrick is being run in a more entrepreneurial fashion with fewer layers of management. It may have the most leverage to higher gold prices among the major miners.

From energy to gold, prices are down across the board -- and so are the stocks. Now may be a good time for investors to get in.