Our Outlook for Basic Materials Stocks

Uncertainty surrounding OECD recovery prospects and China's breakneck growth promises big stock volatility in the third quarter.

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- European fiscal tightening casts doubts on the strength of the OECD recovery.
- China's efforts to cool its property market could hamstring demand for some industries.
- Pending government tax, trade, currency, and regulatory decisions will play a decisive role in picking the winners and losers in this highly uncertain time.

Most basic materials equities declined from post-crisis highs in the second quarter, as investors grew increasingly skeptical of a v-shaped global economic recovery. Mounting bearishness largely stemmed from the sovereign debt crisis in Europe and the knock-on effects a tighter fiscal policy would have on European demand for basic materials ranging from copper to cement to paper. Meanwhile, Chinese government officials have grown increasingly vocal about the need to clamp down on the country's real estate boom, prompting investor worries that one of the biggest demand drivers during the past several quarters would be cut-off at the knees before OECD demand had recovered to precrisis levels. On the flip side, China's recent statement that it intends to relax the yuan's peg to the dollar could augur well for Chinese basic materials demand because a stronger yuan would mean increased purchasing power for Chinese importers.

We expect the European and Chinese macro stories will continue to dominate headlines for the basic materials sector in the third quarter, as many of the big questions driving the uncertainty remain decidedly unanswered: Will the European Union need to undertake a Greece-style bailout for much-bigger Spain? Will government belt-tightening across Europe lead to a double-dip on the continent? Just how tough will the Chinese government get in its efforts to clamp down on surging real estate development? How much will China permit the yuan to move?

The central role of government in the second half of 2010 will extend beyond these economy-wide questions and into industry-specific issues. In the event of a slowdown (or deceleration) in domestic Chinese demand, the nation is likely looking at significant overcapacity in industries ranging from steel to paper. Excess output will need to find a home, which would put China increasingly at loggerheads with U.S. and European trade officials looking to safeguard the health of nascent recovery in their domestic industries. In the mining sector, governments of resource-rich countries ranging from Australia to the Democratic Republic of the Congo are increasingly in disagreement within the industry over the rents generated by highly prized mineral deposits.

Industry-Level Insights

Mining

During the past several quarters, metals markets have behaved like a man with a broken leg, leaning heavily on the crutch of Chinese demand while waiting for OECD demand to heal. The biggest concern facing metals markets today is that someone will come along and kick the crutch out from under him before the leg has healed. Reflecting this growing concern, as well as worries that the leg isn't healing as fast as hoped, is that metals prices have fallen quite a bit from their 2010 highs. As of June 18, 2010, copper traded at $2.86 per pound, down 21% from its $3.61-per-pound high. Nickel has dropped 30% to $8.86 per pound. And spot iron ore is down 22% to $146 per metric ton from $186 per metric ton.

Despite recent declines, metals prices remain well above prior-year levels, resulting in rapid cash accumulation at many mining companies. Initially, much of the windfall was applied toward shoring up liquidity and paying down debt loads accumulated in the 2007-08 boom. Going forward, barring a precipitous drop in metals prices, most miners will continue to build cash, in some cases potentially in excess of total outstanding debt. What, then, to do with the cash build? With balance sheets in relatively strong shape, shareholders should expect better dividend payouts. For example, we think investors in Freeport-McMoRan FCX and Xstrata XTA could see a dividend hike in the coming quarters.

Also, many companies may be tempted to return to the deal market. Thus far, deal-making has paled in comparison with what we saw in 2007 and 2008, likely a function of lingering doubts about the strength of the recovery and concerns about mounting government efforts to claim a larger share of the rents produced by mining assets. Government actions have run the gamut from Australia's much-discussed Resource Super Profits Tax , which, if implemented, would deliver a blow to the bottom line of miners with major Australian assets such as BHP Billiton BHP, Rio Tinto RTP, and Xstrata, to the Democratic Republic of the Congo's efforts to expropriate copper mines from midsized Canadian miner First Quantum FM.

Steel and Aluminum

The first half of 2010 was bright for the global steel sector, with steel prices catching up to higher raw-material costs, inventories staying low, and noticeable signs of strengthening demand, particularly in the automotive and appliance sectors. The tide may be turning in the third quarter however, as the European debt crisis and China's measures to cool its property market are damaging the demand outlook, leading to the announcements of planned or potential steel output cuts for the third quarter by Severstal, ArcelorMittal MT, and Chinese steel mills. The signs of weakness come at a troubling time for steelmakers, who are trying to manage the recent surge in key raw-material costs.

Meanwhile, oversupply concerns are building in China, as Baosteel and other major Chinese producers have announced steel price cuts for July. Steel production in China fell in May after hitting new monthly records for the first few months of the year. We believe the country is opting to rein in output rather than face global criticism by exporting any oversupply. Chinese steel exports reached their post-recession high in May, and we expect to see declines going forward. By contrast, steelmakers outside China such as ThyssenKrupp TKA, ArcelorMittal, and Posco PKX have actually announced price increases for the third quarter. By keeping the supply/demand equation in balance, these major players are hoping to pass on the soaring input costs to their customers.

A similar dynamic is playing out on the aluminum front, with lower output an even stronger possibility in the near term. Aluminum prices have slumped around 20% since the upward surge reversed in April. Many aluminum producers were not able to restart capacity as the steelmakers did in late 2009/early 2010, with aluminum prices just barely at the cash cost of production for many of the high-cost smelters previously idled. The pullback in aluminum prices is now causing further delays of restarting capacity in the developed world, while rising energy costs in China are likely to force significant smelter closures in the latter half of the year. The price of aluminum is still some 40% below the 2008 peak, and we expect the closure of these high-cost smelters will keep the supply in check and prevent further price declines.

Coal
The coal industry was rocked in April by the Upper Big Branch mine explosion, the deadliest mine disaster in decades that left 29 miners dead. Massey Energy MEE, the mine's owner, and the entire Appalachian coal industry was thrust into the spotlight. We think the accident could have far-reaching consequences for the coal industry. After previous deadly disasters, which did not come close to the scale of this one, the government created rafts of new rules regarding miner safety and mine construction that added greatly to the industry's cost structure.

We think history is likely to repeat itself here, which would probably decrease Appalachian margins and production levels in the long run. However, ironically, that possibility has receded somewhat in recent weeks, as BP's BP Deepwater Horizon disaster took over the airwaves and headlines. Upper Big Branch has, for better or worse, receded in the public's (and Congress') mind for the time being. Furthermore, if oil exploration and drilling in the Gulf of Mexico is banned for a significant period of time, the U.S. may become more dependent on domestic coal, which is, all else equal, a mild positive for coal prices.

Paper and Packaging
Things have certainly improved for North American containerboard companies during the first half of 2010. Corrugated box shipments have increased approximately 3% year to date versus 2009. However, shipments are still down about 10% compared with average shipments seen during 2006-08. Corrugated packaging firms have been disciplined in regard to running their plants; a mere 3.6 weeks of containerboard supply is in the supply chain, the lowest level seen in more than a decade. Thin inventories coupled with increased fiber costs have helped the industry push through 20%-plus price increases since the fourth quarter of 2009. These price increases should help expand operating margins in the second half.

Engineering and Construction
Engineering and construction companies in our coverage universe had fared reasonably well after this downturn, mostly because of their high backlog and record level of cash balances. We expect them to have stable revenues generated from existing long life-cycle projects and a slight uptick in new orders because of relatively healthy key commodity prices and government stimulus funding.

However, companies with more diversified project portfolios including work in the government, infrastructure, mining, and energy industries, will improve faster than companies that are heavily concentrated in commercial and residential construction areas. The leading indicator of the U.S. construction industry, the Architectural Billing Index published by American Institute of Architects, was still declining in May, reflecting crimped demand in the marketplace.

Our Top Basic Materials Picks

The stock price retrenchment we saw in the second quarter has made many basic materials names more palatable from a valuation perspective. We've included a potpourri of undervalued stocks that we think merit consideration, ranging from a domestic coal miner to world's largest steel producer.

Top Basic Materials Sector Picks

Company	Star Rating	Fair Value Estimate (USD unless noted)	Economic Moat™	Fair Value Uncertainty	Consider Buying
ArcelorMittal	★★★★	53.00	Narrow	High	26.50
Cloud Peak	★★★★	24.00	Narrow	High	12.00
Monsanto	★★★★★	74.00	Wide	Medium	51.80
Nucor	★★★★	61.00	Narrow	High	30.50
Vulcan Materials	★★★★★	68.00	Wide	Medium	47.60

Data as of 6-21-10.

ArcelorMittal MT

ArcelorMittal is well positioned relative to other European steelmakers for the pending upturn because of its vertical integration and high degree of operating leverage. With a flexible operating network, the company is slowly ramping up production in line with rising shipments while cautiously reinitiating key growth projects. Strong emerging-market exposure will prompt a quicker sales recovery than at many of the company's competitors, as steel demand in the developed world is likely to recover at a slower pace.

Cloud Peak CLD

Historically, Cloud Peak had been one of the less disciplined producers. For example, it barely reduced production in 2009, even though demand plummeted because of a poor economy and low natural gas prices. We suspect that a poor alignment of management incentives discouraged such discipline. Now, as a public company out from under the direct control of global mining giant Rio Tinto RTP, management will be receiving large amounts of restricted stock, and other compensation will be much more closely linked to Cloud Peak's performance, not Rio Tinto's. If we are right, then increased discipline should lead to higher prices and margins for all players in the basin.

Monsanto MON

Monsanto's shares have suffered this year as the Roundup business is resetting to a much lower level of profitability as the tight supply and demand balance that sent prices soaring in 2008 has abated and the industry is now struggling under the burden of an inventory overhang and chronic overcapacity. In our view, the current share price now seriously understates the growth and profit potential of the company's market-leading seed and genomics segment.

Nucor NUE
Nucor's highly variable, low-cost structure and flexible production process combined with a diversified product portfolio should help the company achieve a dramatic recovery in earnings in 2010. Demand for Nucor's long products is likely to remain anemic in the near term because of the depressed state of the U.S. construction markets. Meanwhile, momentum is building in the sheet, plate, and scrap segments, with volume and prices up significantly from 2009. Competitor blast furnace restarts have brought 6.5 million tons of capacity back on line so far this year. But with U.S. imports at manageable levels, we believe Nucor is poised to capture more than its share of domestic demand growth in the next year.

Vulcan Materials VMC
Vulcan Materials is a leading provider of aggregates in the United States and enjoys a wide economic moat. Vulcan's collection of quarry assets benefits from high barriers to entry and forms the basis of the company's economic moat. The firm's shares have taken a beating because of the cyclical downturn in construction and infrastructure spending, but we continue to believe Vulcan's network of attractive assets will allow the company to sustain its wide moat and benefit from positive secular trends in the long run.

Daniel Rohr, CFA, does not own shares in any of the securities mentioned above.