

Commodities & Mining Q&A

Headwinds from the Fed?

Equities

Global
Mining & Metals

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Q1. Is the Fed more hawkish than the market realises?

A1. UBS economists believe that the Fed is preparing the ground for a June rate hike and then sequential hikes thereafter. UBS is a little ahead the Fed's central tendency (dot plots). We believe the issue here is not that the Fed is getting more hawkish, but that the market seems to be a long way behind the Fed on the outlook for rates as we approach critical communication around the March 17/18th meeting (see chart below).

Q2. What are the implications for your call?

A2. Whether the Fed is wrong or right to raise rates, in the short term we view it as negative for gold. The Fed stance may also induce capital flows out of EM, including China, which would offset the impact of domestic stimulus and delay the prospective recovery that we discussed in our last note. The next issue is whether the Fed would be right in setting to raise rates into a sustainable US recovery. If it is, we believe it would be a sustained headwind for gold and industrial commodities on a two year view, as it would tighten international dollar liquidity, the primary driver of gold and industrial commodity price trends.

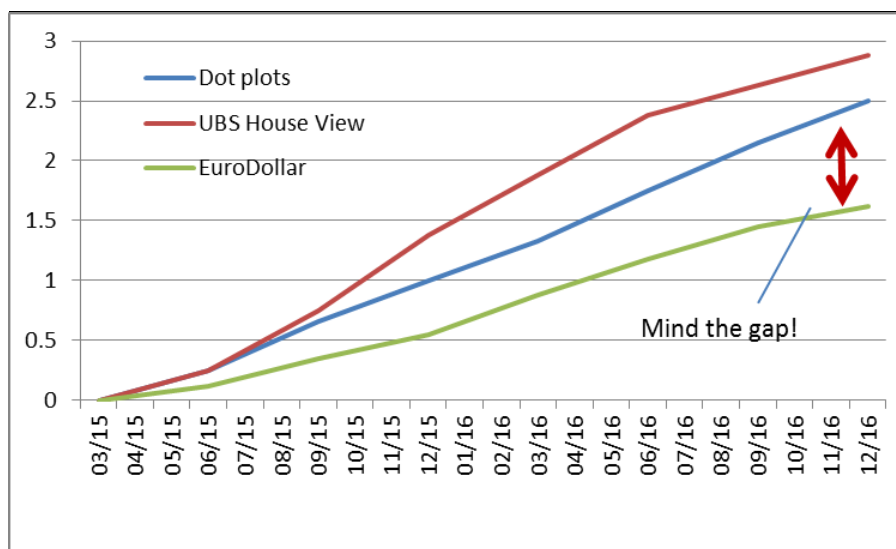
Q3. What if the Fed is misguided?

A3. In commodity strategy we are concerned that Fed hawkishness and any future rate hikes may constitute a policy error - because the Fed would be hiking into a late-cycle environment of deteriorating cashflow & deteriorating liquidity. If that is right the Fed may have to shift to a more dovish stance, which would create opportunities first to buy gold equities again in anticipation of improving global liquidity, and then in due course to buy industrial miners, in anticipation a more robust cyclical rebound in China.

Q4. What are your most and least preferred stocks?

A3. We prefer base metal exposure; Glencore (recently upgraded to Buy, PT £3.50) and Boliden (Buy, PT SEK170). Our least preferred is Anglo American (Neutral, PT £11).

Figure 1: Expectations of US rates %; UBS house view, the Fed's dot plots and market expectations as implied by the Eurodollar futures contract



Source: Bloomberg, Federal Reserve, UBS research

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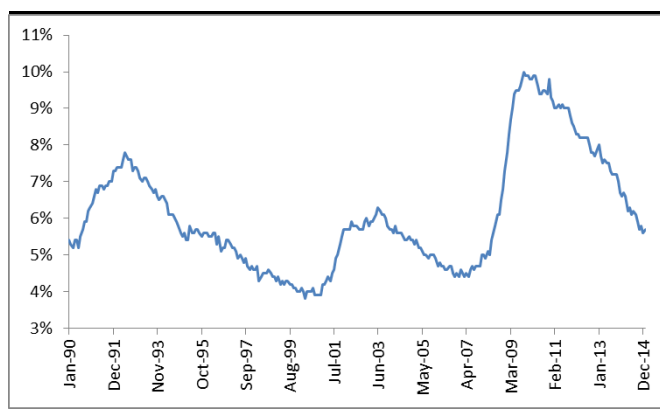
Commodities: Headwinds from the Fed?

Q1-3: Is the Fed more hawkish than the market realises? What are the implications for your call? What if the Fed is misguided?

A1-3: UBS economists believe that the Fed is preparing the ground for a June rate hike and then sequential hikes thereafter. UBS is a little ahead the Fed's central tendency (dot plots). We believe the issue here is not that the Fed is getting more hawkish, but that the market seems to be a long way behind the Fed on the outlook for rates as we approach critical communication around the March 17/18th meeting.

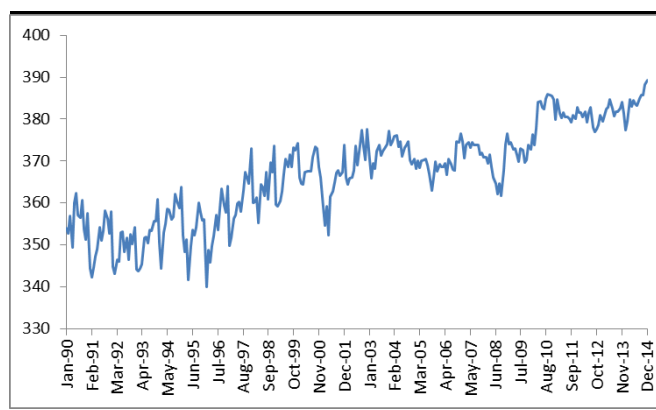
Central to the UBS & Fed views is the expectation that falling unemployment will trigger an acceleration in wage growth, a view that the fall in oil prices is a net positive for the US economy, and that the negative impact of oil on inflation will soon wash out of the data, with core CPI returning towards the 2% target over the next year or so.

Figure 2: US unemployment rate



Source: Bloomberg

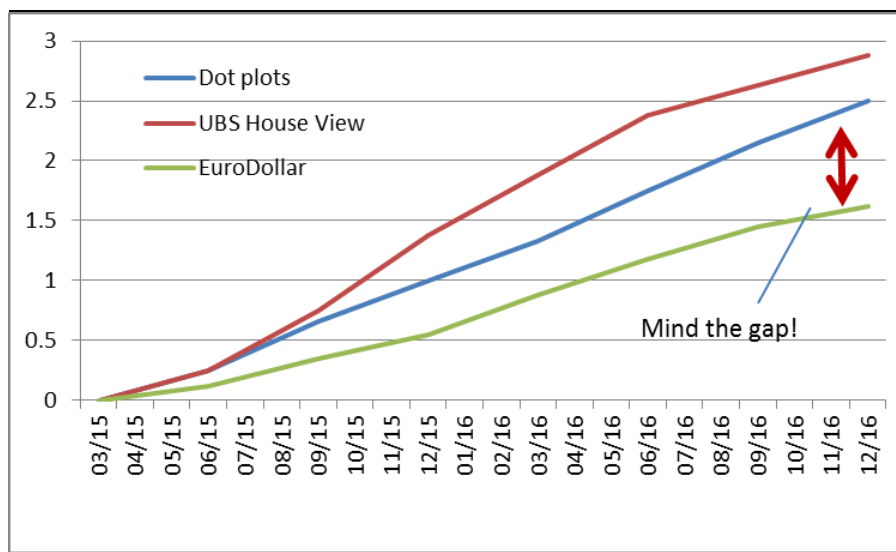
Figure 3: US weekly earnings in US\$ - goods producing



Source: Bloomberg

The market appears to be positioned very differently. The market has been pricing in a later start and a flatter profile into rate hike expectations.

Figure 4: Expectations of rate hikes; UBS, Fed & market



Source: Bloomberg, Federal Reserve, UBS research

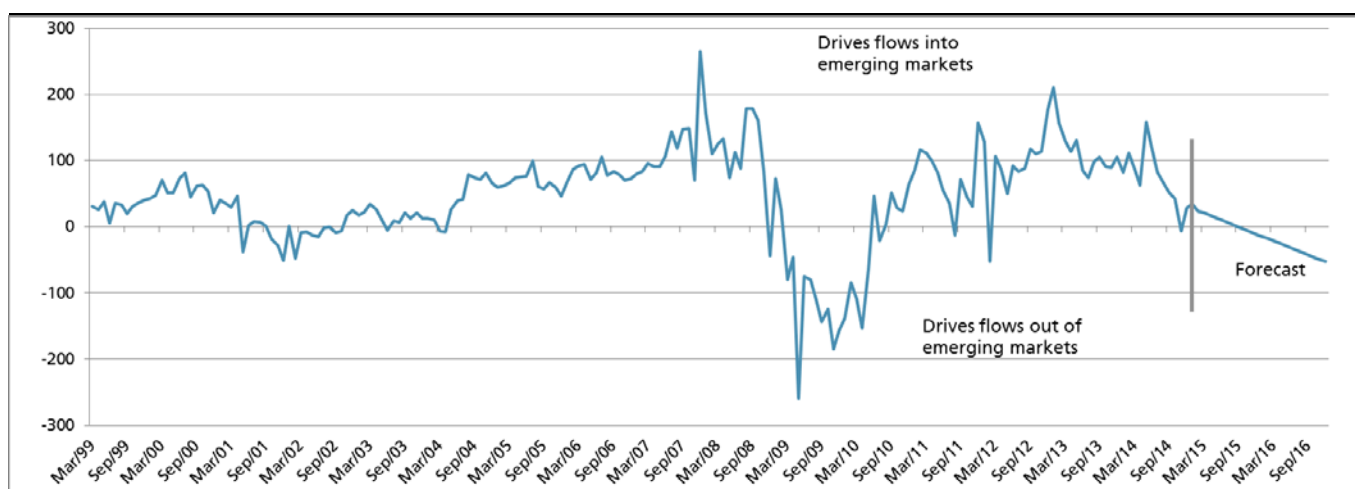
If the Fed and the house view are right on the two year view, we think it would be very damaging for both precious and industrial commodities in general.

That's because we believe it would stifle capital flows overseas, and exacerbate already tight international US\$ liquidity.

We highlighted in notes through last year (see 'I need a sinodollar' January 2014) that capital flows from the US to the rest of the world would weaken as the Fed tapered, as the US current account deficit shrank, and as regulators disincentivised banks' treasury purchases.

We have built a capital flow driver model to capture all three developments. It has declined sharply, and is forecast to continue to decline. If the Fed does follow the dot plots, the decline may be steeper than is currently forecast, not least because the reduction in liquidity may be more severe than the market currently realises.

Figure 5: UBS capital flow driver index



Source: UBS research, Bloomberg

We use this to get a lead on capital flows (proxied by FX reserves) – in our view the most important driver of commodity pricing. We showed in 'Deflation now,

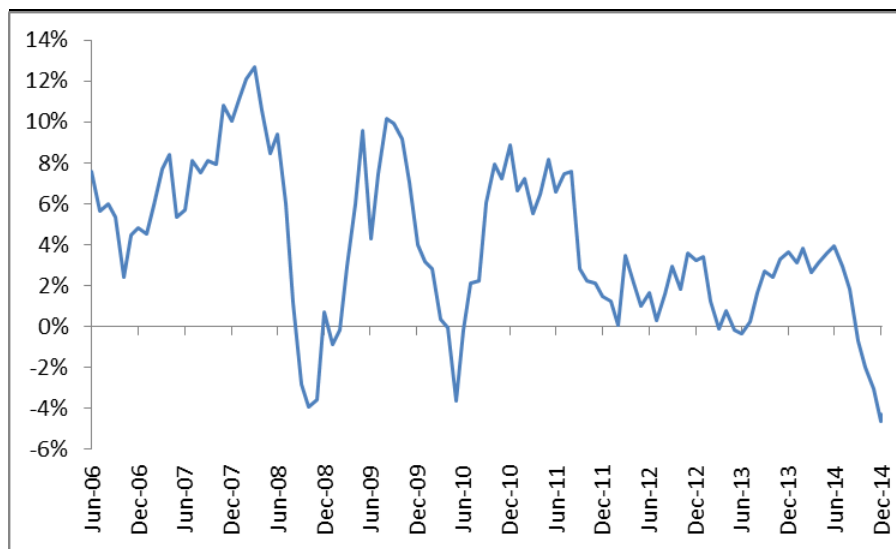
reflation later?’ (2nd February 2015) that FX reserves and commodities show an r-squared of 84%.

The impact of deteriorating capital flows is a decline in international US\$ liquidity.

That’s critical because international US\$ liquidity is the basis for the 90% of cross border lending which is done in US\$, including the significant majority of trade and commodity finance.

We measure this by taking money supply in the 15 biggest economies, and converting it into US dollars. The chart shows the deterioration is just as bad as during the recent financial crisis.

Figure 6: International US\$ liquidity index



Source: Bloomberg, UBS Research

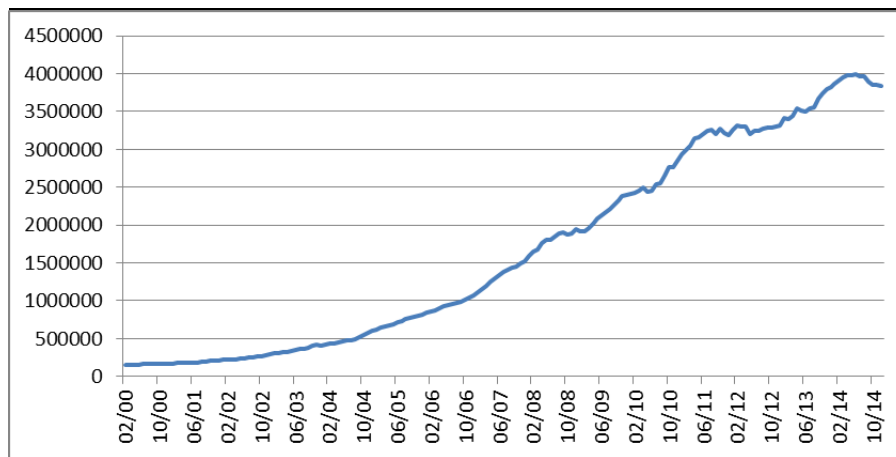
How does this affect your China call?

In our last note ‘China demand – will the structural downturn morph into a sequential improvement?’ (18th February 2015), we argued that domestic stimulus was helping commodity demand bottom out, after a sharp deterioration through 3Q14. We argued that the strength of any recovery would depend on:

- Housing sales
- Property developers reducing destocking.
- Restocking along the metal supply chain.
- The Fed turning dovish.

The first three looked promising. But we highlighted that the Fed appeared to be pointing in the wrong direction. That is critical, in our view – because with a hawkish Fed, it induces capital outflows from China, which in turn drain liquidity from the system and offset the impact of domestic stimulus. China is suffering capital outflows – as the deterioration in foreign exchange reserves demonstrates.

Figure 7: China FX reserves, US\$m – deterioration on a par with the financial crisis



Source: Bloomberg

So what happens if the Fed and the UBS house view is right? What happens if the Fed commits a policy error (our view in commodity strategy)? What happens if the data is ok but Fed follows the markets' concerns and pushes and delays and flattens the profile of hikes? And what happens if the data deteriorates substantially and forces the Fed to a more dovish tone?

And more important; how do we tell which path we're on?

The first thing to watch for is whether the Fed removes the word 'patient' from its post meeting statement.

We agree with Drew Matus, UBS research's Fed watcher, who argues that the Fed is now set to drop the word 'patient' at the March 17/18th meeting, in anticipation of starting its rate hike campaign at the June meeting ('Fed losing patience?' 24 February 2015).

The critical risk to the positive view on sustainable US growth is rebalancing.

While we were reading the latest UBS macro Q series - 'Where will US\$1trn per year in corporate cash go?', (Julian Emanuel, 23rd February 2015) we remembered a lecture we attended back in the late 80s by the late Wynne Godley, the Cambridge professor.

Godley made a profound discovery. All imbalances add to zero. A bit like putting wheels on suitcases, it was so obvious in hindsight, you wonder why no one discovered it before the '80s.

So to use the current example;

the government deficit + the current account deficit + the small household surplus + the corporate surplus = zero.

So far, so simple. But the power of the insight comes when you analyse it dynamically.

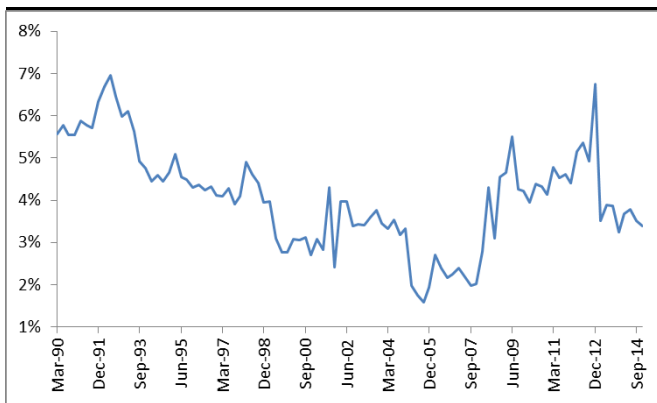
When corporates went into deficit in 2007/8, it forced households into surplus from deficit and the foreign sector into balance from deficit. Or, in plain English, when corporate profits buckled in the financial crisis, consumers raised savings and the current account deficit shrank - transmitting deflation to the rest of the world.

Of course, the trends can be self-reinforcing. Rising savings go on to undermine corporate profits.

The government then moved itself into sharp deficit, inducing the corporate sector to move back into surplus. So the government spending recovery in 2009 created a major boost to corporate profits. That was highly reflationary - corporate cashflow grew significantly, and credit fundamentals improved dramatically as a result.

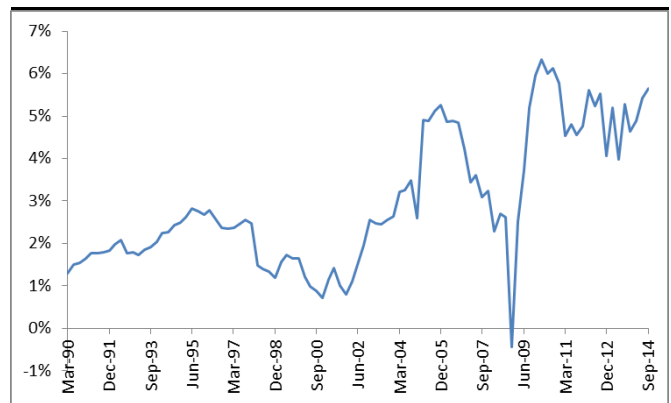
The transfer payments from the government helped households move from surplus to balance. And that induced the corporate sector into a greater surplus, and it pushed the foreign sector into deficit. Even better for cashflow, credit fundamentals and for equity.

Figure 8: US household savings, % of GDP



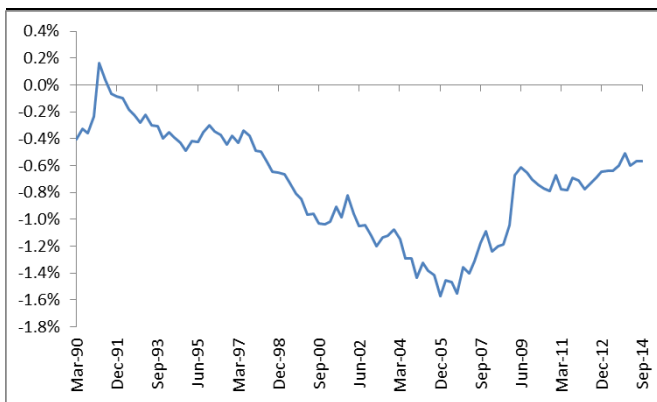
Source: Bloomberg

Figure 9: US corporate undistributed profits as % of GDP



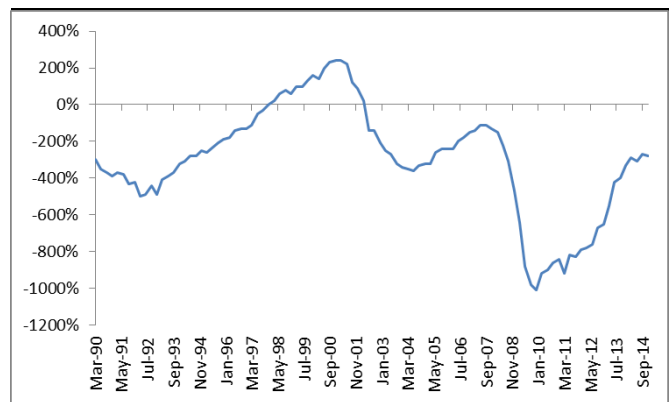
Source: Bloomberg

Figure 10: US current account deficit, % of GDP



Source: Bloomberg

Figure 11: US budget deficit, as % of GDP



Source: Bloomberg

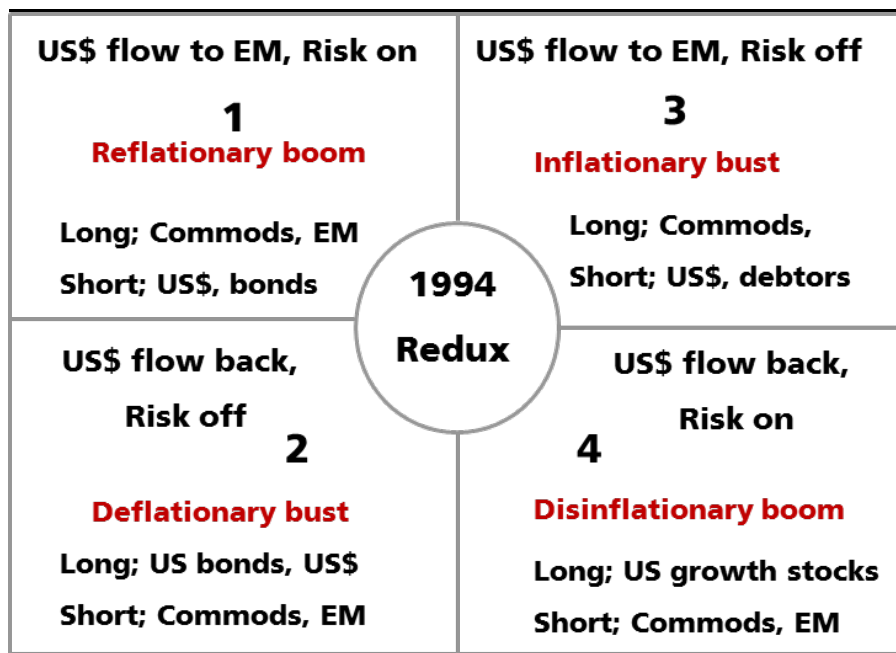
So now the government deficit is shrinking, the foreign deficit is shrinking and the household sector is pretty much staying still. What happens to the corporate sector?

We believe its surplus should contract, potentially very quickly. In other words, cashflow contracts. Credit fundamentals deteriorate. Liquidity dries up. Deflation rears its head.

As with all rebalancing, you should be careful what you wish for.

On our investment clock, we see several signs of a late cycle transition from a zone 4 disinflationary boom to a zone 2 deflationary bust.

Figure 12: UBS resources investment clock



Source: UBS research

In our view, what seems to be confusing analysts and the market is that it's happening without the usual acceleration in growth. It's been a very subdued cycle - with annual growth never exceeding 2.5% in the US in the five years of the recovery.

But that's what happens when you face secular stagnation - when debt levels have reached extremes across large portions of the global economy, and when the decline in productivity in the economy is concealed by deficit spending, and when the demand for that debt is covered by printing.

In commodity strategy, we suspect that the existence of these structural drags on growth mean that the economy has already passed 'takeoff speed' - and that it has been running at its maximum velocity over the past four years. And those four years have seen a build-up in imbalances which risk undermining growth.

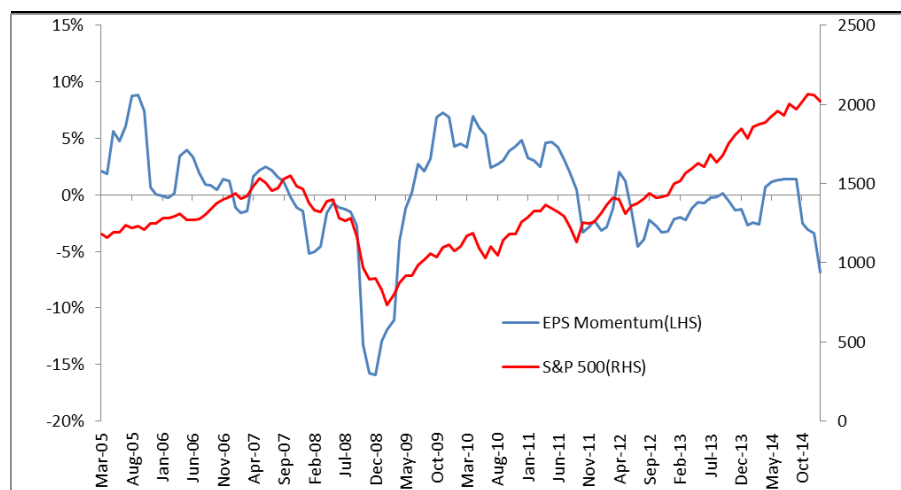
Early cycle (Zone 1) is characterised by easy Fed money, booming emerging markets and commodities, and a falling dollar.

Mid cycle (Zone 4) is characterised by tighter money, relative underperformance of emerging markets/commodities but healthy domestic US cashflow and credit.

End cycle (zone 2) is characterised by an excessively tight Fed, deteriorating cashflow/EPS momentum and deteriorating credit conditions.

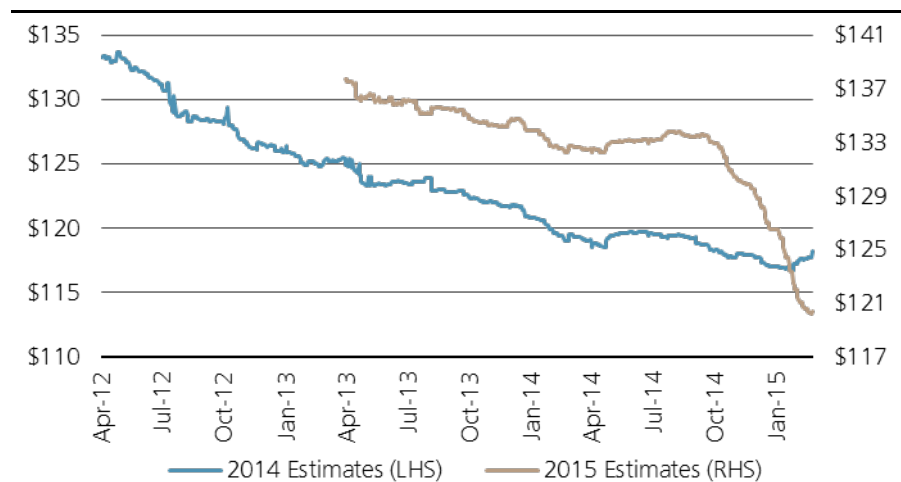
Our concern is that the rebalancing of the economy, driven by falling government and foreign sector deficits, and a household sector unwilling or unable to accelerate spending and to move into deficit - is that the corporate cash position may deteriorate rapidly. And, combined with a drying up of liquidity, that would allow much less scope for share buybacks. So, in commodity strategy, we are watching EPS momentum closely - as the primary signal that the cycle is rolling over.

Figure 13: 3-month US EPS momentum vs the S&P



Source: Bloomberg

Figure 14: US 2014 & 2015 consensus S&P EPS forecasts



Source: Compustat, Thomson Financial, FactSet, UBS

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Sell	FSR is > 6% below the MRA.	11%	21%
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Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

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Boliden	BOL.ST	Buy	N/A	SKr161.40	04 Mar 2015
Glencore Plc ^{2, 4, 5}	GLEN.L	Buy	N/A	283p	04 Mar 2015

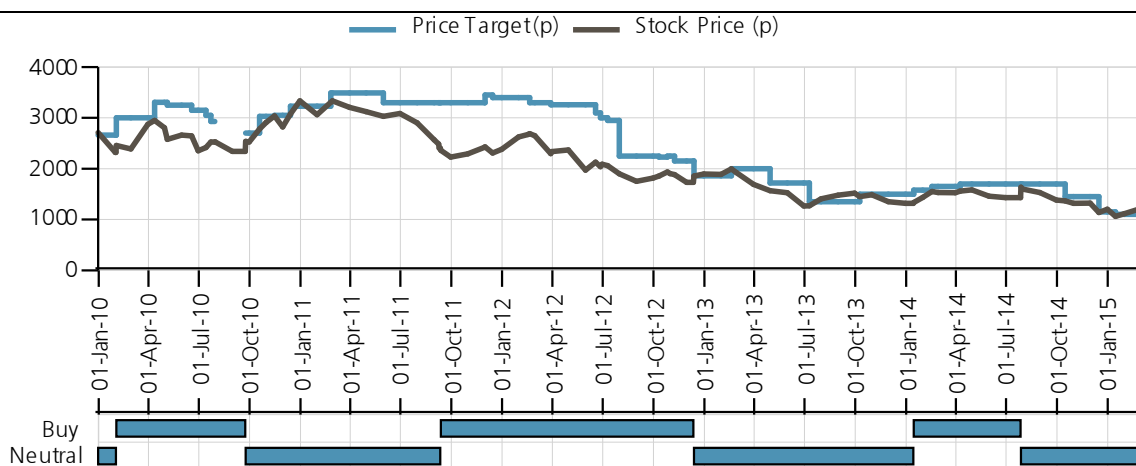
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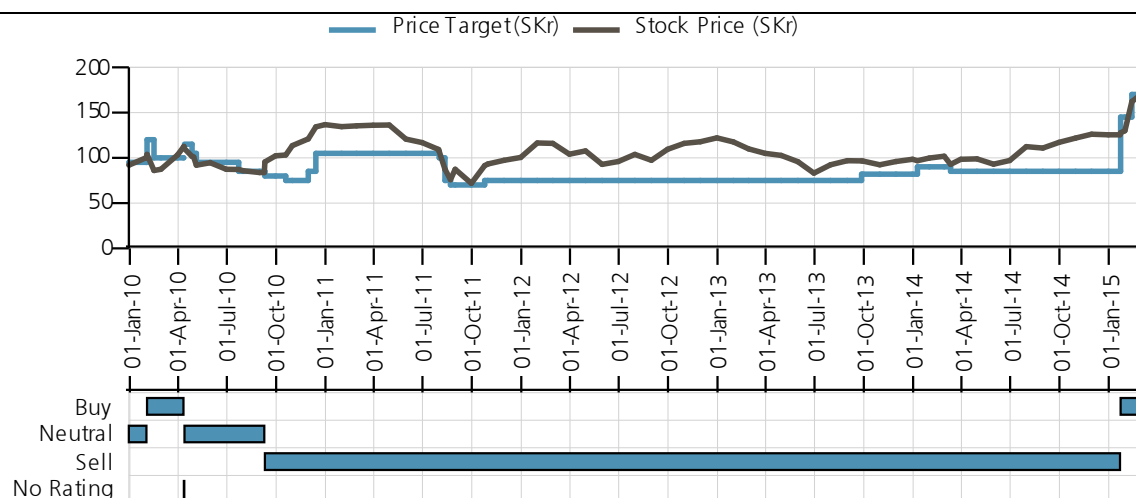
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Anglo American (p)



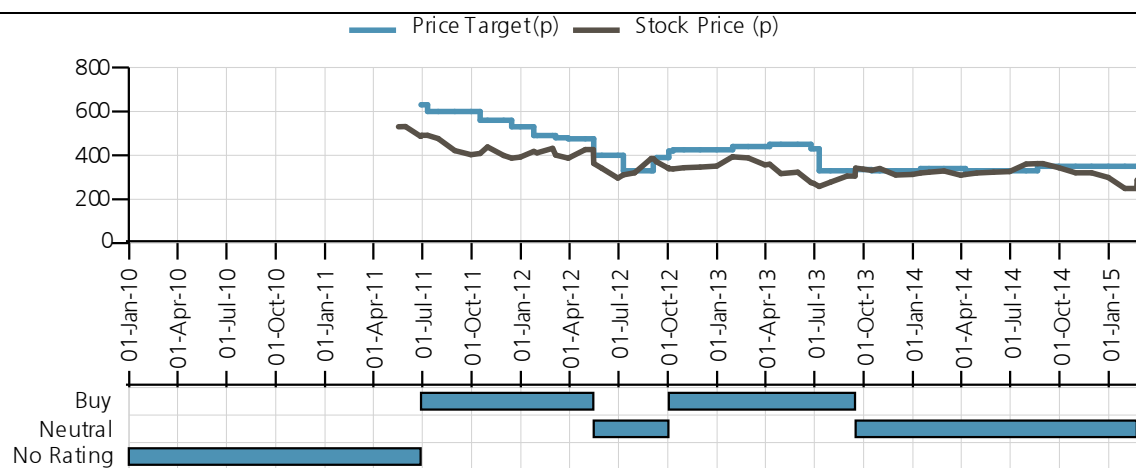
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Glencore Plc (p)



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