

# CIO Monthly Note

March 2016

## Making sense of the 'bounce' in resources



The resource sector had somewhat of a bounce in February, but the big question is... is it sustainable?

The Resources sector delivered a strong 7.5% return during the month, which compared favourably to Industrials which declined 3.0%. So why the bounce in resources?

The sector rallied for a number of reasons. These included safe-haven flows supporting gold, additional central bank easing in Japan, and expectation of additional stimulus from Europe and China, combined with just the hint of potential supply cuts from OPEC. But the key underlying driver was the weaker USD which declined 1.4% in the month.

There are many reasons why the value of the US dollar has an impact on commodity prices, but the main one is that most commodities are priced in US dollars. So when the value of the US dollar drops, you can buy more commodities than you could before using your foreign currency.

As such, the outlook for the USD is critically important for the sustainability of the recent resources rally. Looking forward, I believe a structurally lower USD is unlikely and the recent bounce in commodity prices will prove temporary. Why?

Firstly, the US economy is in a much better shape than most other developed economies despite a recent softening in momentum. Growth in the US is expected to be around 2.5% in 2016 which compares favourably to 1.5% in Europe and 1.0% in Japan. Secondly, the US Federal Reserve only recently began

its tightening cycle and is unlikely to aggressively ease policy in the short term.

Although the Fed may have temporarily paused its tightening cycle, it's my view that it would take a substantial weakening of the US economy for the Fed to change course so soon after lifting rates for the first time in almost 10 years. The current economic pulse of the US economy does not suggest a recession any time soon. Also, if the Fed did reverse course, it would risk the bank's hard earned credibility which could be a serious problem in an economy where bond yields are at record lows.

When you compare this growth and policy outlook to Europe and Japan, it is not hard to see a scenario in which the USD appreciates. Both the BoJ and ECB are in aggressive easing mode with the BoJ recently pushing rates negative and the ECB likely to adopt additional easing policies at its next meeting.

However, as always, there are risks to this view. The chief among them is the outlook for China and the government's response to slowing growth. The core objective for the Chinese policy makers is to continue to focus on the country's new goal of sustainable growth and stimulate where appropriate. Therefore slower more sustainable economic growth and no hard landing for China is a reasonable expectation.

Given this outlook, our portfolios remain defensively positioned with an overweight to those industrial companies with solid business models and a sustainable dividend yield.

**George Boubouras**  
**Chief Investment Officer**  
**Contango Asset Management Limited**  
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