Flooding and a cyclone in Australia have hit coal supplies and analysts could upgrade their forecasts for commodities

Coal position

MARKET VIEW

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The disruption caused by the extreme weather in many parts of Australia over the past few weeks has led to increased valuations for many global resources stocks. Companies are benefiting from the high prices that have resulted from the short-term difficulties in production and distribution of key commodities.

The Australian region worst affected by the weather has been Queensland, an important producer of coal.

The state supplies around 50 per cent of seaborne metallurgical coal. The heavy rains and subsequent flooding resulted in coal producers, including BHP Billiton, Xstrata, Anglo American, Rio Tinto and Macarthur Coal, declaring force majeure on shipments and prices for the commodity have risen considerably.

The surge in prices is now also affecting iron ore and copper and further earnings upgrades for selected global resources stocks look likely.

Consensus commodity price forecasts have been below spot prices for some time and analysts may look to upgrade their commodity assumptions.

In the meantime, the strength of the most recent Chinese import and export data suggests that, despite higher prices, demand for commodities remains buoyant. However, inflationary pressures are increasingly becoming a concern for the Chinese government and this may lead to additional uncertainty over China's future demand dynamics. This raises the probability of increased volatility in both commodity prices and stock prices in the latter half of the year.

It is anticipated that in 2011, Western demand will move from being unsustainable, supported by fiscal stimulus and restocking, to sustainable as it becomes driven by underlying economic growth.

In addition, the global financial crisis resulted in mining companies significantly reducing, if not entirely abandoning, capital investment initiatives.

The market anticipates that this lack of capital investment in 2008/09 will result in a number of key commodities being in deficit in 2011. The ability for governments to impart meaningful demand-side efficiencies gains that can impact near term demand is limited. Thus, the only route to tempering continued strong underlying demand in the short run is higher prices.

Cost inflation is also a key area of focus for 2011. Mining companies are already warning the market they will experience cost inflation this year, driven by rising labour, power, oil, steel and mining consumable prices. The expectation that local mining currencies, including the Australian dollar, Canadian dollar and South African rand, will remain strong could also have an impact on cost bases.

The strength of the underlying commodities during recent months has helped many companies build strong balance sheets. It is likely that excess capital will be used to fund new projects, undertake share buybacks or pursue acquisitions, providing opportunities for investors.

Subsequently, we continue to favour companies with strong balance sheets and the ability to generate cash.

Fundamentals underpinning global resources stocks remain supportive. The outlook continues to be positive as the level of mergers and acquisition activity remains healthy, fuelled by compelling valuations, low funding costs and high cash balances. Anticipation of continued corporate activity is also likely to support valuations in the short term.

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