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COMMODITIES | FEATURE

# After 10 Years of Underperformance, Commodities Are Set to Boom. Here's How to Play the Rally.

By Andrew Bary Jan. 29, 2021 5:08 pm ET

Photograph by Hannah Whitaker; Prop Styling by Ed Gabriels

Commodities are starting to revive after a 10-year bear market. Natural resources like energy, metals, and agriculture look set for an extended run, and investors should get on board.

The recovery in commodity prices, Goldman Sachs analysts say, "will actually be the beginning of a much longer structural bull market" that could rival that of the 1970s, when gold rose 25-fold, and the mid to late 2000s, when oil peaked at over $140 a barrel.

Reasons to be bullish are ample. Global economies look poised to revive in the second half of 2021 as pandemic restrictions ease. And monetary conditions have rarely been so easy. The Federal Reserve may keep short interest rates near zero through 2023, while tolerating 2%-plus inflation.

"Commodities are set up for a significant period of outperformance after such a long period of underperformance relative to other asset classes," says Roland Morris, commodity strategist at VanEck Global. "There is a lot of fiscal and monetary stimulus being applied globally, and the dollar may fall as global growth rebounds. There are supply constraints and new demand drivers for industrial

metals from the electrification of the world."

The Goldman Sachs commodity analysts are bullish in part because of what they see as "structural underinvestment" in commodities, particularly in energy, following a decade of poor returns. While the energy-heavy S&P GSCI commodity index has rallied 66% from its April 2020 low, its total return has been negative 60% over the past 10 years against a 263% total return for the S&P 500 index.

Big, influential university endowments like Harvard's and Yale's have long had some investment in commodities to diversify their holdings and hedge exposure to equity investments and bonds. Individual investors may now want to do the same and increase their commodity exposure to 10% or more of their portfolios.

There are two main ways to play commodities: funds that hold physical commodities or futures contracts, and stocks of the producing companies.

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Commodities may not be top of mind for those investing with an environmental focus. Yet even in the "green economy," commodities are finding increased demand.

Take copper, which conducts electricity. There is no good substitute for copper wiring. Electric cars require four times as much copper as vehicles with internal-combustion engines. Onshore wind farms are four times as copper intensive per megawatt as traditional power plants.

The best copper play may be Freeport-McMoRan (ticker: FCX), which gets about 80% of its revenue from the red metal and has mines on several continents.

The knock against commodity producers is that supply eventually catches up with demand. Investing in the stocks of great businesses is better over the long haul than in the stocks of companies that own or produce hard assets, according to this view.

Yet a counterargument has emerged: The supply of many industrial commodities could be constrained in the coming years as mining behemoths like Rio Tinto (RIO) and BHP Group (BHP), which have more shareholder-oriented managements, rein in capital spending and emphasize dividends.

"Companies that a decade ago were focused on getting bigger are not spending money on new projects and are returning cash to shareholders," says Charl Malan, senior analyst for natural resources equity strategy at VanEck. Malan points to Rio Tinto, a VanEck holding, as well as BHP.

And environmental and political opposition to new mines has never been stronger globally, enhancing the value of existing ones.

Chris LaFemina, a Jefferies analyst, notes that developing a new copper mine can take a decade. “Several major commodities, including copper, are heading into a period of tighter markets and higher prices,” he says.

Rio Tinto yields almost 5%. Top gold miner Newmont (NEM) has a dividend of 2.5%. These yields stack up well versus the 1.5% on the S&P 500 and the paltry 1% yields on many Treasury and municipal bonds.

The mining industry is better managed than ever, and balance sheets are strong. There also is a new focus on environmental issues, as miners seek to minimize carbon emissions and waste. Some investors who are focused on sustainable investing are coming around to the view that mining is critical to the global economy and can be done responsibly.

There is also a case for energy stocks, despite the growth of renewable energy, because oil and gas will probably play a big role in powering the global economy for decades to come.

There are risks. China is a voracious consumer of commodities, including much of the world’s iron ore. Any major stumble in its economic growth would hurt commodity prices. Still, all the signs point to a coming boom in commodities. Here are some ways to play it.

## Direct Commodity Investments

Leading commodity ETFs include the Invesco Optimum Yield Diversified Commodity Strategy No K-1 (PDBC), Invesco DB Commodity Index Tracking (DBC), GraniteShares Bloomberg Commodity Broad Strategy No K-1 (COMB), and iShares S&P GSCI Commodity-Indexed Trust (GSG).

The Invesco Optimum Yield ETF is larger than the Invesco DB Commodity ETF, isn’t structured as a partnership, and is actively managed. The GraniteShares ETF has an annual fee of 0.25%, against 0.59% or higher for rivals.

“In commodities, there is no benchmark, no S&P 500,” says Will Rhind, the CEO of GraniteShares, which runs the GraniteShares commodity ETF.

Corn prices have risen 40% in the past 12 months.
Joe Raedle/Getty Images

There are two leading indexes—the S&P GSCI and Bloomberg—and the difference is their weighting in energy. The S&P GSCI has about 60% in energy, while the Bloomberg commodity index has a quarter each in energy and agriculture.

Invesco DB Commodity Tracking is about 55% energy, with the other 45% divided between metals and agriculture. Jason Bloom, head of fixed income and alternatives strategy for ETFs at Invesco, says the ETF helps diversify portfolios and provide an inflation hedge, since energy correlates most closely with inflation in commodity markets.

"Low fee, no K-1," is how Rhind sums up some of the benefits of the GraniteShares commodity ETF, referring to the annoying K-1 tax forms that some funds generate.

## Hot Commodities

To play a rally in commodities, investors can hold funds that hold the physical commodities or their futures contracts, or they can hold the stocks of producing companies. Here are some funds and stocks-in energy, metals, and agriculture-to consider.

| Commodity | Recent Price | 1-Year Return | 5-Year Return | Assets (mil) |
|---|---|---|---|---|
| BROAD EXPOSURE ETFS | | | | |
| Invesco DB Commodity Index Tracking / DBC | $15.42 | 2.3% | 4.4% | $1,400 |
| iShares S&P GSCI Commodity-Indexed Trust / GSG | 12.95 | -13.2 | -0.7 | 926 |
| GraniteShares Bloomberg Commodity Broad Strategy / COMB | 24.07 | 5.3 | -0.3* | 81 |

| Commodity | Recent Price | 1-Year Return | 5-Year Return | Assets (mil) |
|---|---|---|---|---|
| PRECIOUS METALS , OIL, AND AGRICULTURE ETFS | | | | |
| SPDR Gold Shares / GLD | $172.52 | 16.8% | 10.1% | $69,300 |
| iShares Silver Trust / SLV | 23.42 | 43.5 | 11.5 | 14,400 |
| United States Oil / USO | 35.50 | -60.6 | -14.4 | 3,300 |
| Aberdeen Standard Physical Platinum Shares / PPLT | 99.95 | 7.5 | 3.7 | 1,400 |
| Invesco DB Agriculture / DBA | 16.43 | 2.7 | -3.4 | 706 |

| Commodity | Recent Price | 1-Year Return | 5-Year Return | Assets (mil) |
|---|---|---|---|---|
| COMMODITY EQUITY ETFS AND FUNDS | | | | |
| VanEck Vectors Gold Miners / GDX | $33.74 | 19.8% | 20.1% | $15,100 |
| VanEck Vectors Junior Gold Miners / GDXJ | 48.01 | 21.2 | 22.6 | 5,600 |
| Global X Silver Miners / SIL | 39.61 | 33.4 | 20.0 | 1,000 |
| Energy Select Sector SPDR / XLE | 40.20 | -22.3 | -2.4 | 15,500 |
| SPDR S&P Oil & Gas Exploration / XOP | 66.84 | -13.6 | -8.0 | 2,600 |
| VanEck Global Hard Assets / GHAAX | 34.11 | 30.2 | 7.6 | 575 |
| Kopernik Global All-Cap / KGGIX | 13.00 | 41.2 | 19.4 | 1,500 |

The largest single-commodity ETFs are the $69 billion SPDR Gold Shares (GLD) which holds gold bullion; the lower-fee iShares Gold Trust (IAU); and the iShares Silver Trust (SLV). Other single-commodity ETFs include the United States Oil (USO), which tracks benchmark West Texas Intermediate crude, and the Aberdeen Standard Physical Platinum Shares (PPLT).

The advantage of commodity ETFs is that they give investors a pure play. A risk with commodity funds that use or track futures is that forward prices can be higher than spot prices, penalizing them when they roll forward their holdings.

## Energy

Energy is the world's most important commodity, and producers are finally showing better discipline on capital spending.

A new emphasis on renewable energy under President Joe Biden may dampen demand for oil and gas, but restrictions on drilling and pipeline construction could tighten supply.

'We may wake up in 25 years and everyone will be driving an electric vehicle, and

therefore gasoline will no longer be automotive cocaine," says Bill Smead, manager of the Smead Value fund. "But even if that's right, it's going to take a long time to happen, and you can make a lot of money selling gasoline over the next 25 years." Smead says that natural gas will play a critical role in generating electricity. His fund has about a 10% weighting in energy stocks, against 2.5% for the S&P 500.

Investors who want energy exposure should probably stick with companies like Exxon Mobil (XOM) and Chevron (CVX), which see a future for the industry, rather than the big European companies like BP (BP).

Under pressure from environmental activists and European investors, the European majors are de-emphasizing traditional energy projects, where they have a century of experience, and ramping up in renewable energy, where they have no demonstrated edge.

Exxon Mobil, whose output is expected to hold at around four million barrels a day over the next five years, has lately been winning over Wall Street as investors become comfortable that it can maintain its 7% dividend yield, given the rise in oil prices.

Morgan Stanley analyst Devin McDermott recently upgraded Exxon to Overweight from Equal Weight and set a price target of $57 on the stock (recently $46), citing an "improving outlook" for free cash flow and dividend sustainability.

Chevron, a favorite of Smead's, is in better shape than Exxon Mobil, has a solid 5% dividend yield, and exposure to both oil and the hot global market for liquefied natural gas.

Smead is also partial to Continental Resources (CLR), an exploration-and-development company in North Dakota's Bakken region. He says its oil and gas reserves are worth a multiple of its recent stock price of $21 a share, even when factoring in debt.

Long-depressed natural-gas prices could be buoyed by utility demand, as companies retire coal plants, and by growing overseas demand for liquefied natural gas derived from U.S. gas.

| Commodity Producers | Recent Price | 1-Year Return | 5-Year Return | 2021E P/E |
|---|---|---|---|---|
| ENERGY | | | | |
| Exxon Mobil / XOM | $45.35 | -24.3% | -5.7% | 22.6 |
| Continental Resources / CLR | 21.06 | -27.8 | 1.8 | 31.7 |

Among gas stocks, Cabot Oil & Gas (COG) is the blue chip with the best balance sheet, followed by EQT (EQT), the nation's largest natural-gas producer. More-leveraged producers Southwestern Energy (SWN) and Range Resources (RRC) are favored by Dave Iben, manager of the Kopernik Global All-Cap fund, who says both could double in price.

He is also partial to Russia's giant, Gazprom (OGZPY), which he calls the "largest, lowest-cost, and most powerful gas company in the world." Gazprom says it has massive proven energy reserves, mostly natural gas, that are equivalent to about 125 billion barrels of oil—compared with roughly 22 billion barrels for Exxon. That provides a margin of safety for buying a Russian company, Iben argues. Gazprom's U.S.-listed shares trade around $6 and yield 5%.

## Copper and Iron Ore

Two of the largest mining companies, BHP and Rio Tinto, are dominated by iron ore, whose price has doubled in the past year to $160 a metric ton. With mining costs under $40 a ton, both companies are gushing profits. BHP shares, at about $70, yield 3%, and Rio Tinto stock, at $79, yields 4.8%. Both trade for about 10 times projected 2021 earnings.

VanEck's Malan says the free cash flow yields of some of the big miners are above 10% and that dividends are likely to rise. VanEck holds Rio Tinto, Anglo American (NGLOY), and Freeport-McMoRan.

Copper price could go a lot higher, analysts say.
Courtesy of Anglo American

"These companies are so financially healthy that, as their yields rise and they

show capital discipline, they will attract a different shareholder base, and that will lead to a rerating of the shares," Malan says.

Jefferies' LaFemina is partial to international miner Anglo American. It is more diversified than either Rio Tinto or BHP, having a large copper business, as well as scarce platinum, palladium, and diamond assets, reflecting its ownership of De Beers.

"Anglo is unique among the diversified miners because it has growth," LaFemina says, pointing to a large copper project in Peru, one of the few new copper mines.

He also like the diamond business, which has recovered strongly after collapsing amid the pandemic last March. He has a Buy rating on Anglo American and sees about 25% upside for the stock—the U.S.-listed shares trade around $17.

| Commodity Producers | Recent Price | 1-Year Return | 5-Year Return | 2021E P/E |
|---|---|---|---|---|
| DIVERSIFIED MINERS | | | | |
| Freeport-McMoran / FCX | $25.79 | 128.2% | 43.2% | 10.7 |
| Rio Tinto / RIO | 78.69 | 52.5 | 35.6 | 8.5 |
| Anglo American / NGLOY | 16.10 | 24.3 | 56.6 | 7.8 |

Freeport-McMoRan is highly profitable, and it is projecting a doubling in cash flow this year. The reason? Copper prices are up about 40% in the past 12 months to about $3.60 a pound, while the company's costs are below $1.50 a pound. Freeport-McMoRan's strong free cash flow should allow it to pay down debt and possibly resume its dividend.

"Copper could go a lot higher given the supply/demand imbalance," LaFemina notes, adding that the price could top $5 a pound. He has a Buy rating and $36 price target on Freeport.

## Gold and Silver

Consolidation in the gold mining industry has resulted in two giants: Barrick Gold (GOLD) and Newmont. "The industry has never been as healthy as it is today," says Joe Foster, co-manager of the VanEck International Investors Gold fund (INIVX).

Both are very profitable, with gold trading around $1,850 an ounce and total operating costs under $1,000 an ounce.

Newmont, at $61, and Barrick, at $22, are down 20% or more from their August

highs and trade for about 15 times projected 2021 earnings. Newmont lifted its dividend in the second half of 2020 and now yields 2.6%. The company could raise the dividend further under a formula that links its dividend to the gold price.

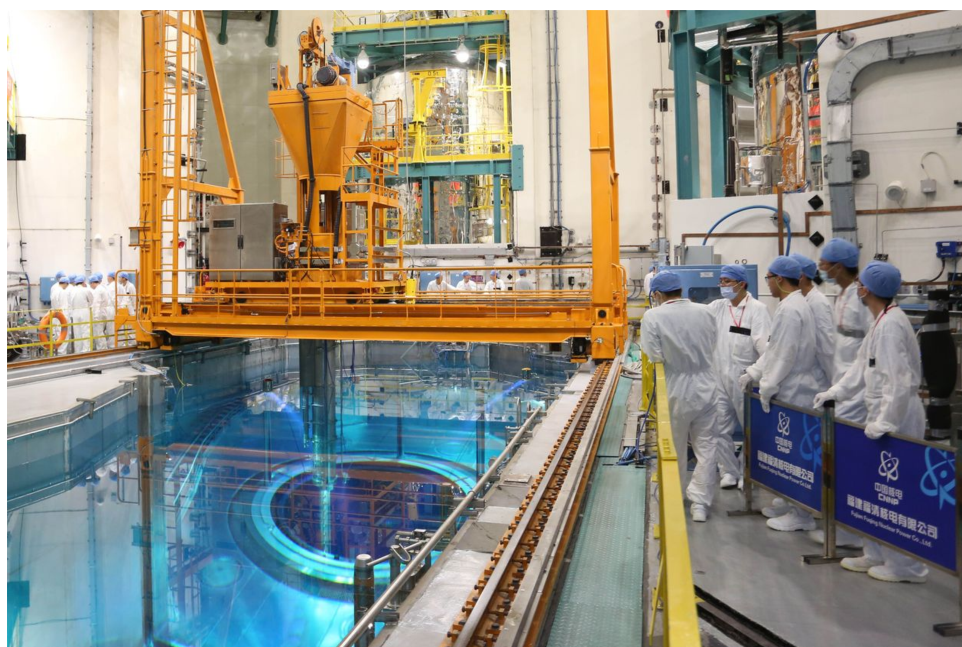
The two leading gold-mining ETFs are the VanEck Vectors Gold Miners (GDX), whose largest holding are Newmont, Barrick, and Franco-Nevada (FNV), and the VanEck Vectors Junior Gold Miners (GDXJ), which includes Pan American Silver (PAAS) and Gold Fields (GFI).

| Commodity Producers | Recent Price | 1-Year Return | 5-Year Return | 2021E P/E |
|---|---|---|---|---|
| PRECIOUS METALS | | | | |
| Newmont / NEM | $58.89 | 35.3% | 26.8% | 14.0 |
| Pan American Silver / PAAS | 28.12 | 29.7 | 35.3 | 16.3 |

Silver is getting a boost from usage in electronics and solar panels; its price is up 50% in the past year to $27 an ounce. With silver a byproduct of diversified mining operations, there are no large pure-play producers. One of the largest North American producers is Pan American Silver, but less than half of its reserves are silver.

The Global X Silver Miners ETF's (SIL) largest holding is Wheaton Precious Metals (WPM), which is a "streaming" company with the rights to gold and silver production from a group of mines around the world. This gives Wheaton exposure to precious metals, without the risks that come from mining.

## Uranium



Uranium demand is expected to rise 40% by 2040.
Chine Nouvelle/SIPA/Shutterstock

Uranium gets little attention from investors, but it appeals to Kopernik's Iben, who argues that the price, now $30 a pound, down from a peak of over $100 more than a decade ago, needs to "double or triple" to spur the development of new capacity to supply the needs of nuclear reactors around the world.

Uranium demand is expected to rise 40% by 2040 as new reactors are built, mainly in Asia. Unlike the U.S., where nuclear plants like Indian Point, north of New York City, are being shut down, China and India view nuclear power as an attractive source of carbon-free electricity.

| Commodity Producers | Recent Price | 1-Year Return | 5-Year Return | 2021E P/E |
|---|---|---|---|---|
| URANIUM | | | | |
| Cameco / CCJ | $12.62 | 52.1% | 2.7% | N/A |

E=Estimate. NA=Not applicable Note: Five-year returns are annualized.

Sources: Bloomberg; FactSet; Morningstar

Iben is partial to Cameco (CCJ), the Canadian uranium producer, whose shares now trade around $13. Cameco, which has closed a large mine because of low prices, amounts to an unconventional green-energy play.

## Agriculture

Weather and international demand drive U.S. grain prices, and both have been favorable in recent months. Dry weather in Brazil could depress its soybean crop, and Chinese demand for soybeans to feed pigs has been strong. U.S. corn, at $5.40 a bushel, is up 40% in the past year, and soybeans have risen 50% to nearly $14 a bushel.

The Invesco DB Agriculture ETF (DBA) offers broad exposure, led by a weighting of 12% to 13% in corn, soybeans, sugar, and coffee. At about $16.50, the ETF is up 23% from a June 2020 low, but it has had positive returns in just one of the past 10 years.

Deere & Co. (DE), the leading agricultural-equipment maker, has gained 80% in the past year to $290 on expectations of a more prosperous farm economy. It now trades for more than 20 times forward earnings. Other ag equity plays include CF Industries Holdings (CF), a major fertilizer producer, and Titan International (TWI), a maker of wheels for farm equipment and industrial vehicles. Both are up sharply from 2020 lows, with a financially leveraged Titan trading at $6.50, against $1 last March.

With inflation stirring and the Fed more dovish than it has been in more than 40 years, the outlook for commodities is favorable. Indeed, there's a good chance that this decade could resemble the inflationary 1970s, when commodities made historic moves.

**Write to** Andrew Bary at andrew.bary@barrons.com

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