EQUITY

Digging for Natural Resource Opportunities in 2014

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Fred Fromm
Vice President, Research Analyst
Franklin Equity Group®
Portfolio Manager, Franklin Natural Resources Fund


Steve Land
Vice President, Research Analyst
Portfolio Manager, Franklin Gold and Precious Metals Fund
Franklin Equity Group®

The natural resources sector has been through a period of transition in the past year, one which has pushed many companies toward cost reduction and greater capital discipline amid an environment of rather sluggish global economic growth. Franklin Equity Group® Analysts Fred Fromm, Stephen Land and Matthew Adams think an improving economic outlook could set the stage for potentially stronger commodity demand going forward, and see healthy potential demand growth for energy in particular. They share their outlook for the natural resources sector in 2014, and where they are finding opportunities.

In our view, 2013 was a year of transition for the natural resources sector as commodity-related markets sought balance in an environment of slower global economic growth and growing supply for several key raw materials. In response, many companies aggressively cut costs and deferred or cancelled projects to stem cash outflows and repair balance sheets. Although this was not a surprise for some industries such as gold mining, which had experienced rising costs and a significant decline in the price of gold, the trend of greater capital discipline was also evident among companies still enjoying relatively stable conditions. Such a shift typically occurs during more difficult times and could have important investment implications longer term. In some cases, shareholder activism played a role as various companies responded to a rising drumbeat of shareholder demands for stronger returns and return of capital through higher dividends and share repurchases.

Although our outlook for natural resources sectors is varied across related industries, we believe the trend of cost reduction and capital discipline should ultimately be positive as most companies would be in stronger financial positions to weather prevailing market conditions while spending reductions could be sowing the seeds of tighter supply-and-demand balances in the future. Ultimately, we believe improved cost positions combined with the potential for slower supply growth, resilient demand and rising commodity prices could lead to the potential for rising equity values. In addition, we are encouraged by investors' renewed interest in companies with stronger long-term growth opportunities as opposed to their focus on income and near-term cash flow that was prevalent over the past couple of years.

Looking to 2014, we have been tracking several trends we believe could translate into the potential for attractive equity performance for investors in the natural resources sector. We think an improving global economic outlook has set the stage for potentially stronger commodity demand, particularly from the US and Europe, which have had little, and in some cases a negative, influence on commodity markets in the recent past. Although supplies have been expanding for some commodities, production disruptions and curtailments may help limit the impact on commodity prices, while what we think could be stronger-than-expected demand could absorb some additional capacity, as was the case for some commodities in 2013. However, our strategy does not primarily rely on general trends in commodity prices and instead seeks to generate performance by identifying companies we believe possess the ability to grow earnings and cash flow in a normalized commodity price environment, or one in which prices trade near the marginal cost of production.

In energy markets, we expect healthy demand growth from developing markets while developed countries may show greater demand stability. Surprisingly, even US petroleum-product demand has been showing signs of life after a couple years of stagnation or outright declines, and although we do not expect demand from the US or Europe to grow significantly, we expect them to be less of a drag on global consumption growth than in recent years.

Importantly, the US economy has been undergoing a dramatic shift toward energy self-sufficiency through rapid crude oil and natural gas production growth driven by the application of new drilling technologies and methods to extract previously untapped resources. This “energy renaissance” is likely to have broad implications for the US economy and global politics, in our view.

At the company level, many US energy exploration and production companies have been moving from the assessment stage to the production of unconventional resources, which includes shale development. We believe this move has the potential to translate production growth into cash flow and improved equity valuations as producers could benefit from development-related efficiency gains. Oilfield equipment and services providers are a key component of this trend, in our view, as they strive to leverage increasingly efficient development and extraction techniques. Notably, unconventional resource development has begun in many other countries, potentially creating new markets for US companies.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Investments in the natural resources sector involve special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector.

Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign securities, including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity.

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