

Weekly Report



Microeconomic Analysis

Glencore and Rio Tinto: A deal transforming the landscape of the commodity industry

By Gabriele Zuo

After a \$46bn acquisition of Swiss mining company Xstrata last year, Glencore is now a leading multinational commodity trading and mining company. Glencore has very strong positions in copper, zinc, nickel, and coal. Company's market capitalisation is \$69.6bn. Ivan Glasenberg, diamond-hard Glencore's CEO, executed the highly successful acquisition of Xstrata and in July personally approached Rio Tinto.

Rio Tinto is a British-Australian mining giant with a market capitalization of \$88bn. It is also currently the largest producer of steel-making commodity in Australia as well as the biggest shipper of seaborne iron ore. Unfortunately, the company has been significantly hit by a slowdown in world demand for iron ore and slowing growth of steel demand in China. Price of iron ore is heading towards a five-year-low and still 90% of Rio's profits come from iron ore. Analysts predict that every dollar drop in the price of iron ore, leads to a decrease of \$1.5bn in Rio Tinto's asset value.

In July Glencore approached Rio Tinto to create the world's largest mining company, worth an estimated \$150bn. Unfortunately, Rio Tinto's board rejected the deal unanimously saying that the deal was "not in the best interest" of shareholders. Glencore would significantly benefit from this transaction by getting access to unlevered Rio Tinto's balance sheet and adding iron ore to its commodity portfolio. Lastly, both companies could save about \$500m by merging their coal operations in Australia.

Still, there are major obstacles that have to be overcome. First, these companies are perceived to be culturally very different. Rio Tinto is seen as a well-established and more conservative firm, while Glencore is considered to be a new and aggressive player in the industry. Secondly, Glencore would have to get an approval from antitrust regulators and China may force the new company to sell some of its copper and coal assets.

If the situation changes, Rio Tinto's shareholders would demand a huge premium. Immediately after receiving a rejection, Glencore approached Chinalco, Chinese state-owned aluminium corporation that owns 9.8% of Rio Tinto. Chinalco bought its stake in February 2008 for £60 a share and currently Rio Tinto is trading at £30. The potentially new company would transform commodity space by combining world's second and fourth largest miners and overtaking BHP Billiton. Under UK takeover rules Glencore is not allowed to make another bid until April. Glencore said that it is no longer actively considering a bid, but knowing Glasenberg's passion for dealmaking, it is doubtful. Glencore and Rio Tinto's merger may take time, but let's not forget that as Xstrata experience shows that such transactions may take more than 3 years.

Macroeconomic Analysis

Chinese attempts to boost markets with interest rate cuts

By Finn Bridges

Last Friday saw the Chinese government cut interest rates for the first time in two years in a surprising move that sent both international stocks and commodity markets higher. The world's second largest economy cut the one-year deposit rate by 25 basis points to 2.75% and the one-year lending rate by an even larger 40 basis points to 5.6% in response to a series of discouraging economic data. China is currently at its slowest growth rate in five years and there has been a recent increase in unemployment coming from the slimming of the country's key manufacturing sector. It is the first cut in the benchmark rates since July 2012, when the one-year deposit rate was cut by 25 basis points and the one-year lending rate by 31 basis points.

The new rates, which will be effective from Saturday, were announced after the close of the financial markets in China. However, as a result, the European stock markets climbed sharply, followed by an increase in commodity prices such as crude oil. The benchmark contract on the New York Mercantile Exchange rose by \$1.50 a barrel, its highest level in two weeks, and in Europe, the German DAX index grew by 2% and the FTSE 100 by 1%.

The Chinese central bank also announced that it was to give banks more control in the setting of their own interest rates raising the ceiling of deposit rates to 1.2 times the benchmark which was at 1.1 before the new rate was released. The People's Bank of China (PBOC) also provided additional comments to suggest that the move did not mean a change in monetary policy and that the economy required no strong stimuli to leave its current slump. Some are skeptical in how effective the new rates will be in reigniting markets due to interest rates having a different function in China's economy than in western ones, but the PBOC remains confident.

An Alternative View: Assessing the regulatory impacts of higher capital requirements

By Gustave Laurent

Recently, the Financial Stability Board (FSB), headed by current Bank of England Governor Mark Carney, announced what seemed to be the last wave of higher capital requirements for Global Systemically Important Banking Institutions (G-SIBs).

Introducing the 'total loss-absorbing capacity' program, or TLAC, the FSB document stated that the basic TLAC requirement would be in a range of 16-20% of a bank's Risk Weighted Assets (RWAs). However, when taking into account pre-existing and extra capital buffers, the ratio rises to 21-25% of RWAs! These higher capital requirements, also referred as 'Pillar I' within the Basel regulatory framework, have already been met by G-SIBs. Now however, national authorities can go further and apply 'Pillar II' regulations, involving the coverage of institution-specific risks, undermining banks' independence and possibly increasing costs. However it has been reported that the FSB, with the participation of the Basel Committee on Banking Supervision (BCBS) and the Bank for International Settlements, would only start their assessment of the new regulations' possible impacts in Q1 of 2015.

What do these drastic regulatory moves entail for banks and their activities? As Mark Carney bluntly stated, these new requirements illustrate "what ending too big to fail means". From now on, banks are no longer 'subsidised' by the state – read taxpayers –, and will have to drastically change their business model and approach to managing risk, thus entailing important costs and possibly diminishing earnings, thus reducing some banks' overall resilience. However, G-SIBs are behemoths and it might be argued that even these higher costs and corporate adjustments would not jeopardize the banks' overall stability.

However, one can be skeptical toward the belief of the end of the “too big to fail” dilemma. The interconnectedness between banks is likely to grow with their balance sheets as the world becomes more and more globalised – the increased interest in Islamic finance from Western institutions is a good example – and more and more people in the developing world gain access to financial services. This very process sustains the systemic nature of many institutions, which, in time of distress are likely to still be considered as “too big to fail”. Also, it may be that higher requirements will ultimately act as a catalyst for changes in lending practices, leading to increased activity in the shadow-banking sector where the costs to access to liquidity are much lower. However, it remains highly deregulated and prone to risky activities and could actually weaken the overall financial industry rather than strengthening it.

Although regulation is crucial to the success of the financial and banking industries in shaping behavior and setting the right incentives, higher capital requirements are not a panacea for all banks’ ills and should be scrutinized very carefully.

Events

Black Friday

By Thiyen Padiachey

As Americans gather with their friends and family to give thanks on the fourth Thursday in November, stores in the US and around the world are preparing for the onslaught of shoppers expected the next day; ‘Black Friday’.

An estimated 140 million shoppers are expected to hit stores in the street and online this weekend, for what retailers predict will be the best holiday season in three years. In the US, consumer spending (which accounts for about 70% of the economy) grew at a 2.2% annualised rate last quarter, with rising salaries, falling unemployment and lower gas prices putting an extra \$28bn into the pockets of consumers, according to Nomura. One of the key drivers is the price of gasoline dropping below \$3, the lowest level in four years which psychologically encourages consumers to open up their wallets.

But why is everyone so eager to spend? A survey by Deloitte showed that almost half of the US shoppers had not made their holiday purchases yet and that the average shopper was expected to spend an average of \$295 this weekend, a \$9 increase since 2013. However, the shopping madness is not only on American soil. With the rise of the internet, this trend of discounts commencing in the Christmas shopping season has become a worldwide phenomenon. Online marketplace analysts in London expect a sixfold increase in traffic outside of the US this weekend as consumers around the world are willing to disregard the extortionate shipping costs to simply take advantage of the deals offered by US ‘e-tailers’. British shoppers in particular are expected to spend £200m more on Black Friday than the average day, roughly 20% more than a typical December Friday.

So will this spending frenzy work wonders for the US economy? Not exactly. Chief Economist of Moody’s Analytics Mark Zandi feels that one cannot rely “on Black Friday to gauge how Christmas is going to turn out”. A worry that the ‘payroll tax holiday’, which reduced most workers’ income tax by 2% is set to expire at the end of the year. This is a headwind that is keeping hiring and growth far below desired levels. In addition to this, a key problem is that the overwhelming majority of holiday buying is on goods rather than services. Moreover, the U.S. economy and job market is far more dependent on services than manufacturing. According to Ian Shepherson, chief US economist for High Frequency Economics, retail spending only accounts for around 44% of total consumption. This raises the concern that if consumers choose to spend more on holiday gifts and less on discretionary services such as cinema tickets or restaurants, flashy sales numbers we see in the news headlines may overstate the bigger picture.

The Costs of Western Sanctions on Russia

By John Judeh

As a result of Russia's invasion of Eastern Ukraine and annexation of Crimea in March, the EU and US have imposed an array of sanctions on both Russian individuals and businesses. The sanctions have been introduced in phases, with the most recent phase announced on the 12th of September, which targets the powerful elite around president Vladimir Putin. The sanctions include: a blacklist of individuals and businesses with travel bans and frozen assets, state banks excluded from taking long-term loans from western capital markets, banned exports of equipment for military use and future EU-Russia arms deals, and major state oil firms cut off from importing oil industry technology.

Anton Siluanov, Russia's finance minister, has admitted the large cost of the western sanctions and the falling global oil price on the Russian economy while addressing an economic forum in Moscow last Monday. He estimated that the Western sanctions were costing the economy \$40 billion annually, while the falling oil prices would respectively cost \$100 billion. Accompanied by a devalued rouble, which has fallen by 30% against the US dollar this year, these factors have pushed the Russian economy to the brink of recession. The sanctions also appear to be fuelling anti-western sentiment in Russia, which has responded by implementing western trade embargos. The already fragile EU (which had trade with Russia worth nearly €270bn in 2012) will likely suffer more from the Russian embargo than the US; however, the two regions are standing firmly by their position against Russian intervention in Ukraine.



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