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Three cyclical scenarios

The metal price cycle over the coming year has three feasible trajectories, each with important repercussions for how investors should approach the sector.

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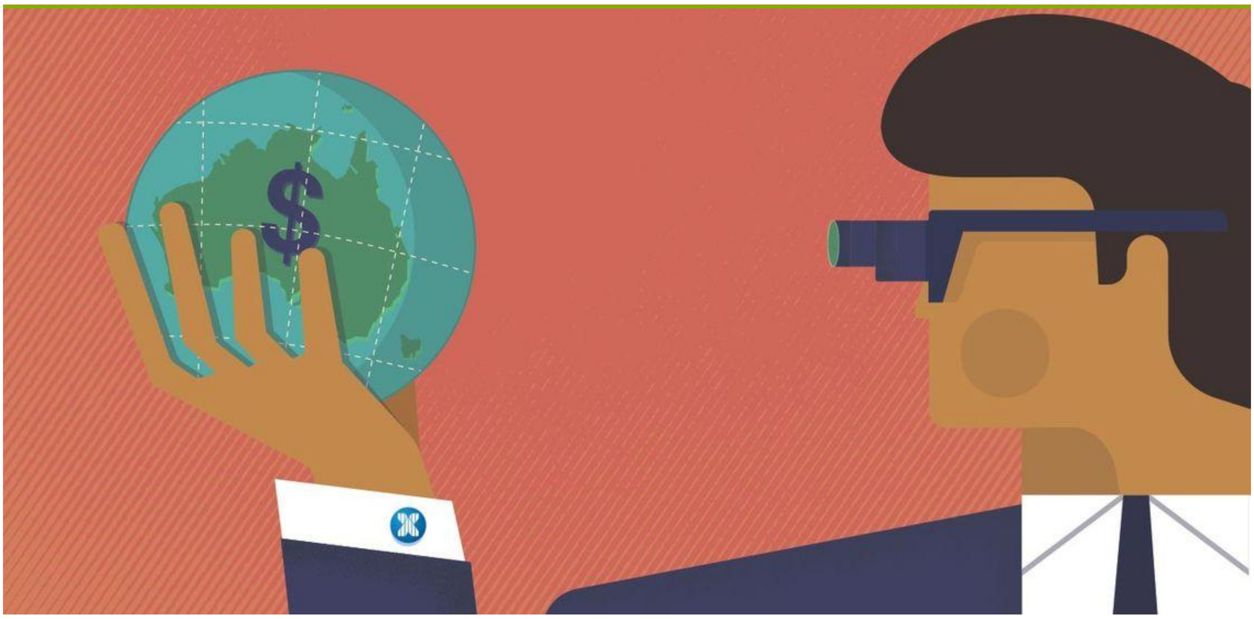

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The starting point is a cycle already mature by historical standards. Ebbing global growth momentum, less supportive monetary conditions and weaker constraints on supply add force to a change in direction.

London Metal Exchange prices are yet to retrieve losses made in March after peaking at their highest levels since early 2011.

Emerging markets have been trending lower since January. European and US markets, too, have seemingly started to discount the global synchronised growth theme that many investors had adopted through the second half of 2017.

Meanwhile, a poll of Mining Journal readers over the past three weeks offers an optimistic perspective on how these forces will play out. The vast majority of 566 respondents thought the metal price cycle has further to run.

Anyone in this camp will be relying on recently weak growth in metal demand returning to its historical path so as to absorb any increase in supplies hitting the market.

Policy and demographics are working against a repetition of China's impact in the first decade of the 2000s. Now, any resurgence in metal usage will probably depend on transport electrification and a shift to renewable sources of electricity.

Any reversion of the US dollar to its historical downward trajectory would also help

US-dollar denominated prices.

A scenario in which metal prices are on the rise for another year or more should produce solid double-digit equity price gains among the leading stocks in the sector and the best risk-adjusted returns.

An alternative scenario to the one contemplated by the Mining Journal readers is the historically typical end to a cycle in which monetary policy is tightened too aggressively, stalling metal demand as supply growth is accelerating.

> **Among the explorers, sustained leverage to discoveries is proving elusive without an infusion of new investors**

This second scenario looms as a possibility once again, as policymakers edge hesitantly toward so-called normal monetary policy settings without understanding fully how economies will react to the removal of an unprecedented monetary stimulus. Narrowing spreads between short-term and long-term government bond yields are a warning.

Believers in this second scenario should quit the sector entirely to not only escape falling prices but to also avoid underperforming other equity sectors.

A third potential scenario is one reminiscent of the latter part of the 1990s. Then, like now, policy challenges abounded. Asian and Russian financial crises destabilised markets and the occasional trading scandal added to worries of systemic risk. A 40% rise in the US dollar against a basket of major trading-partner currencies exerted downward pressure on metal prices. New technologies drove equity markets.

Between the end of 1994 and early 2000, the technology laden NASDAQ composite index had risen nearly sevenfold. The S&P 500 had gone up 230%.

Over the same period, metal prices had declined 10-12% and investor interest in mining equities had lagged well behind the broader market. The Australian small resources share price index was 40% lower, while the index of market leaders, more strongly correlated with the broader market, showed no net change.

As non-mining equity prices pushed the limits of credibility, investor sentiment toward the mining industry improved. Between a low point in August 1998 and before the major cyclical upswing attributable to China's growth began in early 2003, the Australian leaders share price index rose 64% while the S&P 500 shed 4%. The net lift in metal prices over the same timeframe was a gentle 0.5% a year.

Investors bought not because the metal cycle was on the up but because other assets had become so expensive and riskier than anticipated.

Any one of these cyclical scenarios - continuation of the 2017 metal price upswing, a policy induced slump or a 1990s style risk reappraisal amidst a flattish price trend - remains credible. Markets are critically poised to veer in any of the three directions.

The unusually gradualist approach to monetary policy changes being adopted by the US Federal Reserve favours the mining sector. The policy direction mitigates against metal price rises but the evident caution, if successfully applied, also suggests a cushioned decline.

Under these conditions, the largest stocks in the sector, namely BHP and Rio Tinto, will remain core components of any portfolio. Their size will make them beneficiaries of asset allocation decisions responding to relative risk and valuations favouring the sector.

Companies with long stalled projects such as Ironbark Zinc, Northern Minerals, Kasbah Resources and

Bannerman Resources, among many others, should do well, at least in principle, in the absence of marked cyclicality.

In practice, the propensity of companies at this stage to miss targets remains a bugbear for investors. Track records are sparse. The skill and experience base of the industry, stifled by tough cyclical conditions, remains too thinly spread to engender confidence. The best returns from companies at this stage will likely come from recoveries after missteps.

Among the explorers, sustained leverage to discoveries is proving elusive without an infusion of new investors to help keep prices aloft. Few have been rewarded for incremental advances in the understanding of their geological targets and barely any for the improved cyclical position of the industry.

Some deserve the lack of support but others like Impact Minerals, St George Mining and Stavely Minerals are operating in highly prospective regions, adequately funded and with experienced teams committed to the task at hand.

The longer a meaningful cyclical decline is averted, the greater the chance for this group of companies to capture marginal dollars from new investors allocating funds to the sector.

Being realistic, though, investments in explorers should probably not be held past the point of discovery or resource definition.

With average times from discovery to development edging beyond a dozen years and a full metal price cycle averaging around five years, holding an investment for the long haul comes with huge opportunity costs, however much company executives may encourage the strategy.

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