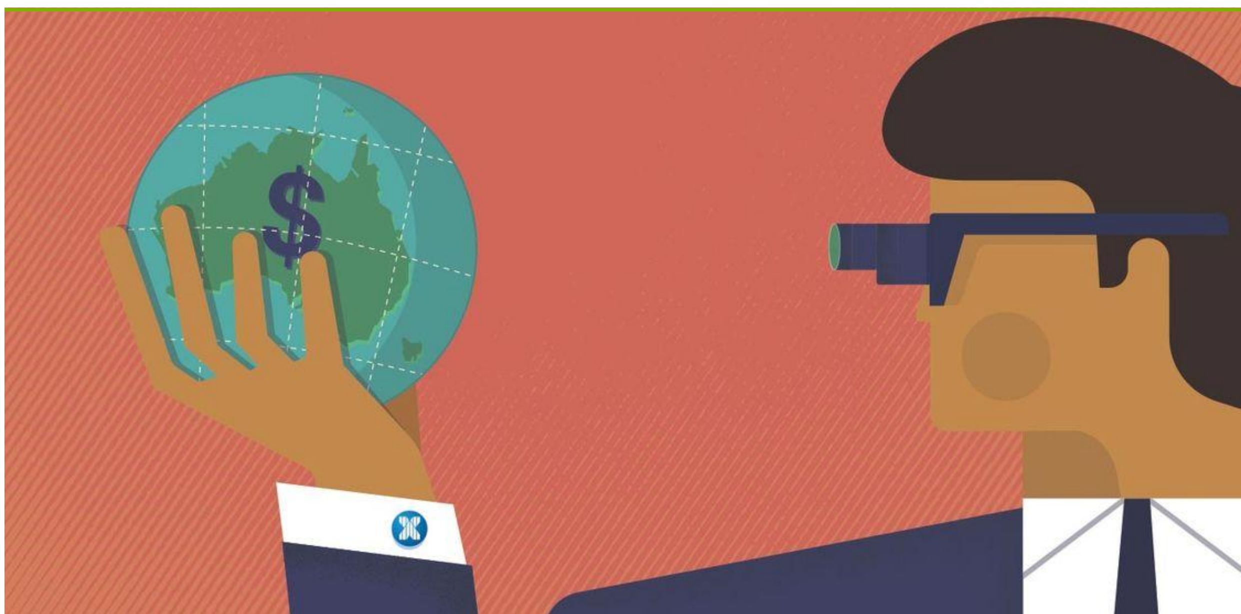
MiningJournal

Falling inflation risks benefit miners

Buying mining equities to take advantage of an inflation surge is an idea anchored in the 1970s with dwindling relevance to 2020s investment outcomes.

John Robertson*



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Global money supply growth rates have rocketed as governments respond to the economic consequences of the COVID-19 pandemic.

The OECD's 37 members expanded their money supplies (M1) by 25% over the year to June. Over the 50-year history of the data, money supply growth has never been stronger.

In the 1970s and 1980s, an acceleration in money supply growth was typically accompanied by a surge in metal prices. The positive mining company earnings response created opportunities for the mining industry to produce outsized absolute investment returns as well as highly competitive relative gains.

After a 15% leap in OECD money supply in mid-1973, base metal prices kept going up until early 1974. By then, a 17-percentage point decline in inflation adjusted money supply growth rates was underway. The same pattern was reproduced on several occasions over the following 20 years. Metal price cycles topped out again in February 1980 and February 1989 after growth rates of 16% and 13%, respectively, in money supply. In each case, as soon as the monetary screws were tightened, metal prices suffered.

Since laxer monetary conditions and rising raw material costs were also a precursor to noticeably higher inflation in those days, many investors have mentally linked mining investments with changing inflation expectations.

The responsiveness of metal prices to changes in monetary conditions appeared to diminish through the 1990s but the underlying impression, that metal prices were

more likely to rise when central banks were opening the monetary spigots, remained.

The experience of these earlier years, taken at face value, suggests an imminently strong metal price cycle. Investment returns from metal related equities, on this view of the world, are set to explode. For many, the potential for an inflation upsurge adds to the investment appeal.

Forty years ago, the policy response to double-digit inflation rates was relatively straightforward. Cutting back money growth did the job. Recession, high unemployment, lowered living standards and greater income inequality resulted but inflation was suppressed. And, from a mining industry perspective, cycles became more pronounced while financial losses mounted.

> “ **The prospect of a sustained build-up in economic activity, without inflation anxiety causing central banks to pull the rug from under economic growth, is a silver lining to the dark coronavirus pandemic cloud**

Today's central bank economists face a different policy quandary, flummoxed at their powerlessness to influence consumer prices through monetary policy changes.

The idea of too much money chasing too few goods now barely resonates. Consumers, not economists, manage the money supply. Households use credit availability to buffer spending decisions. Significantly lowered interest rates might be used as an opportunity to reduce previously incurred debts rather than spur more spending. This year's emergency government spending measures in the US have resulted in higher savings rates, not the quick surge in spending many policymakers had anticipated.

Speedy, cheap and direct access to capital markets has blurred the distinction between consumer goods and financial assets. Speculative intensity in many financial markets has spiked with the coronavirus lockdown and clamps placed on consumer spending. Modern inflation statistics should be placing more emphasis on the Tesla share price and less on the price of bananas.

Liberalised global trade has eliminated localised production capacity limits as a driver of price pressures. Present pandemic constraints aside, a pair of sneakers can be delivered promptly to Melbourne from the UK or China if it is not immediately available from a distributor in Sydney. The pricing power balance has irreparably altered.

Unprecedentedly high worldwide rates of excess production capacity now add a further dampener on generalised price rises for goods.

Without generalised price inflation, pressures to change policy are removed. The US Federal Reserve chairman has said explicitly that he expects interest rates to be low for years, reducing the urgency to buy goods now. Surges in consumer demand which accompanied earlier periods of cheap money and which contributed to inflation are less likely to eventuate.

The prospect of a sustained build-up in economic activity, without inflation anxiety causing central banks to pull the rug from under economic growth, is a silver lining to the dark coronavirus pandemic cloud.

While generalised price pressures may not eventuate, relative price movements are becoming more important market signals. Businesses with weak outlooks are being weeded out more ruthlessly as new businesses bloom more quickly. Zoom, Peloton, Netflix and Tesla are ascendant. Macy's, British Airways, General Motors and Kodak are dying.

Relative price signals are working their way through the mining industry, too. The last two From the Capital columns have discussed the changing profile of Australia's mining industry. The absence of highly correlated price gains across multiple commodities is contributing to the change. Relative price changes, based on conditions in specific market segments, will become more important drivers of investment outcomes.

The emergence of new mining industry leaders is made more likely by relatively stable economic conditions which give newly developing companies the breathing space to get the job done in response

to relative price signals.

Less chance of unanticipated demand swings, of the sort that produce cycles, makes business planning simpler. With project gestation times lengthening, companies need longer periods between directional changes in policy for success. The absence of generalised price rises brings that need closer to reality.

Gold, too, is widely thought of as a beneficiary of money supplies exceeding the needs of the real economy. As a competitor to cash and bonds as stores of value, gold's relative appeal grows with falling interest rates, as it has done in the past year.

Gold might also benefit from a bout of unusually high inflation. As long as inflation has run at 1-5%, the inflation-gold price correlation has been close to zero. The largest US dollar denominated gold price rises have occurred when US price inflation has been intolerably high.

For the rest of the mining industry, and for gold miners in the longer term, any uncontrolled outbreak of inflation during the 2020s will be just as damaging to the industry's prospects as it was 50 years earlier. Thankfully, that possibility is receding.

**John Robertson is the chief investment strategist for PortfolioDirect, an Australia-based equity research and resource stock rating group. He has worked as a policy economist, business strategist and investment professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia*