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# Explorers face asset price fallout

Fresh central bank liquidity will benefit the leading miners but bleaker prospects lie ahead for much of the sector.

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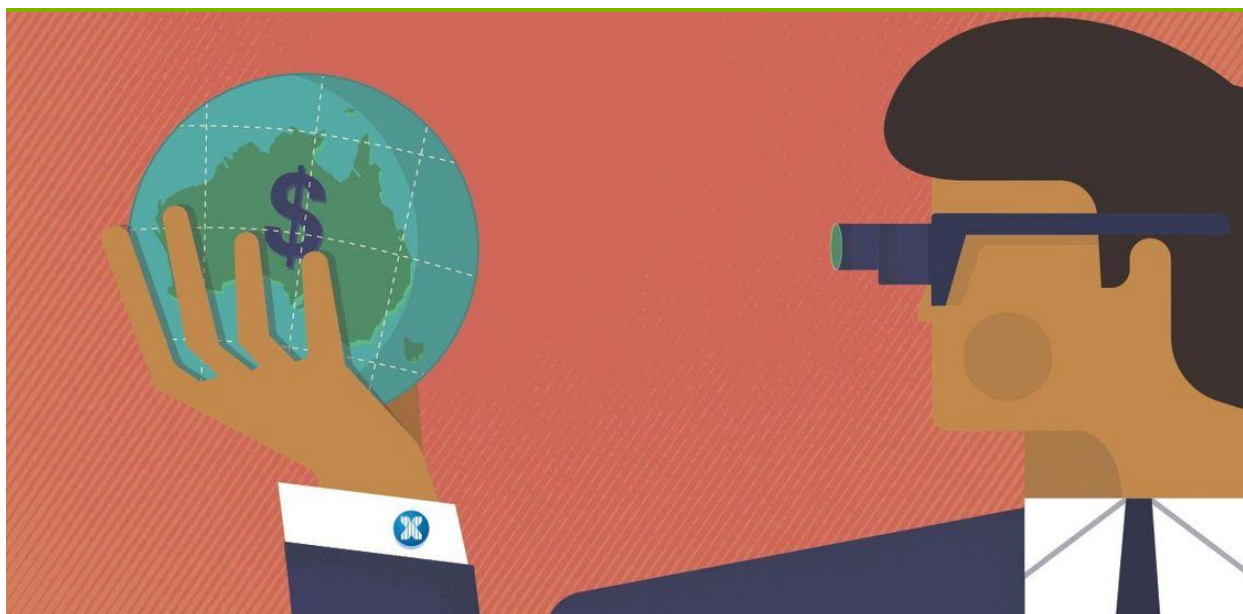

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Last week's 'From the Capital' column outlined a historically unusual macro backdrop, raising the possibility of central bank policies creating an asset price bubble.

With liquidity flows running well ahead of the needs of the real economy for the best part of a decade and highly competitive markets constraining product price inflation, asset prices have been a conspicuous beneficiary of US Federal Reserve policies.

An unsustainable US growth spurt, driven by large corporate and personal tax cuts, also contributed to stronger share prices in 2018 than would have otherwise been achievable.

Suddenly, late in the year, as the favourable tax effects on earnings diminished and interest rates were on the rise, anxiety about a growth slowdown finally took hold.

Fearing that prices had gone too far, nervous financial markets have since bullied the Federal Reserve into a stunning policy reversal.

Rather than restraining market exuberance, monetary policy is now being deployed in defence of already high asset prices.

For purposes of assessing what these macro conditions mean for mining investments, it is useful to divide the industry into three groups.

A handful of market leaders have been beneficiaries of the central bank policies.

Since the start of 2017, the S&P/ASX 100 resources index, essentially a proxy for BHP and Rio Tinto, has tracked the ebbs and flows of the S&P500, for the most part. An early 2019 rise in iron ore prices has only recently given the resources index a performance edge over the US stock benchmark.

The correlation between the two indices has been the strongest sign that the performance of the mining leaders is more leveraged to central bank policies than specific mining industry or corporate events.

**Explorers have shown themselves to be especially sensitive to changes in rates of real activity**

Despite iron ore prices taking another leap in the past few weeks, the stock price response has been unsurprisingly more muted. As cyclical earnings rise, investors become increasingly inclined to discount the sustainability of the higher prices. This now appears to be happening to the iron ore sensitive market leaders.

Looking ahead for this small group, investment returns are likely to mirror the returns in the broader market, as they have done before. These, in turn, are relying heavily on the support of the US central bank and, to a lesser extent, central banks in Europe, Japan and China.

Of course, the leading miners have now become more vulnerable to a near-term reversal in iron ore prices. That means an outlook that is little better than the S&P500 on the upside and something possibly worse, on the downside. The balance of risks is not especially attractive.

The second discernible group of stocks - those exposed to gold - are following a track driven by the monetary characteristics of bullion.

A 15% rise in US government debt prices since late 2018 and negative yields on swathes of global debt have given gold prices a shot in the arm.

Those traders intent on testing the upper bounds of the gold price trading range over the past six years have added to the leverage but, despite some wild-eyed commentary from familiar sources, bullion has so far moved within the bounds implied by changes in relative prices of financial assets.

In the event global economic conditions prove significantly weaker than anything currently anticipated, the upward pressure on bullion prices could intensify.

Equally, if the pessimism embedded in negative yields proves to have gone too far during the balance of 2019, the risk of recent gold price gains unravelling will have risen.

Investment returns from gold related equities now rely heavily on the financial markets not having been pessimistic enough about the course of growth and inflation. The flow of data suggests otherwise.

Another synchronised growth acceleration remains hard to discern presently but the worst of the global slowdown in activity appears to have passed. As usual, in the next phase of a cycle, conditions worsen less quickly over several months before starting to improve. That transition is already evident.

The third group of stocks, and the vast bulk of listed companies in the sector, are those primarily engaged in, or attempting to fund, exploration. This group has tracked an entirely different path since the start of 2017.

Even as the market leaders and the gold producers have been reaching new share-price heights, the explorers have been traversing historically low levels. Conclusions about 'the sector' based purely on the performance of headline stock indices almost certainly misconstrue what has been happening.

Since early 2018, my own index of ASX exploration stocks has been on a steady downward trajectory from its most recent cyclical peak. The index had made very strong gains - more than 90% - over the past four months of 2017, while global economic growth rates were accelerating and optimism was rising about the prospects for a lengthy period of globally synchronised growth.

The explorers have shown themselves to be especially sensitive to changes in rates of real activity. Well before the synchronised growth theme had been discarded by many market commentators, the explorers' brief time in the investment sun had ended.

Since bank lending limits have not been a drag on the US real economy, lowered interest rates alone are not going to boost growth sufficiently to restore the attractiveness of mineral explorers as an investment class.

The momentum of global growth is shifting in their favour but the speed of change is likely to bring little discernible benefit for several months.

Explorers will have to contend with poor growth signals continuing to dampen their investment returns as well as the rising risk of a financial crisis not that much further ahead, if asset price inflation elsewhere has gone too far.

Explorers could suffer the fallout of an asset price bust without having enjoyed a boom.

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