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Challenging 2019 ahead for mining equities

Mining stocks will have to demonstrate their own value attributes rather than rely on favourable macro forces over the coming year.

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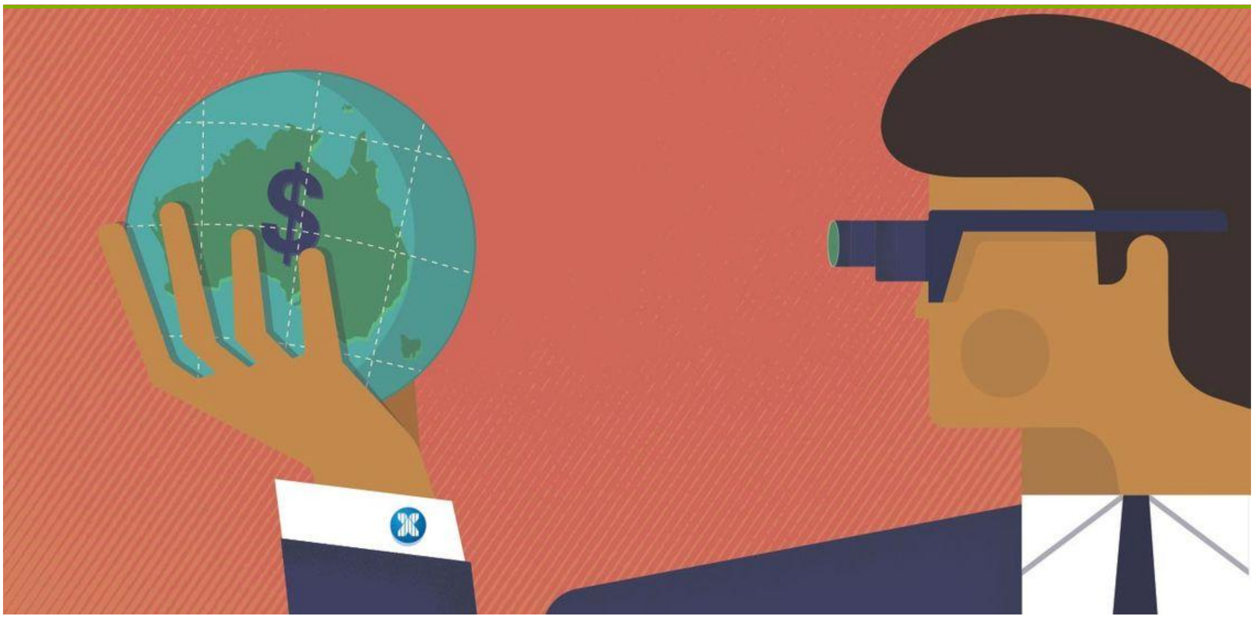

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The past two ‘From the Capital' columns have characterised slowing global growth and tightening monetary conditions as potent negative influences on equity prices generally and mining equities, in particular.

Prices of the principal daily-traded nonferrous metals have been falling since February. The pace of the price decline over the past nine months has been consistent with the average decline over the first nine months of all the cyclical adjustments over the past 60 years. Using this history as a guidepost suggests further declines over the coming 12 months with a negative impact on related mining stocks.

Funding conditions will have also deteriorated. The first stages of a tougher capital raising climate are already evident with yields on the riskiest corporate bonds rising steeply since the end of September. Generalised upside for mining stocks is hard to foresee as long as this sign of floundering risk appetite persists.

How investors should react to this combination of circumstances will depend on their target time horizons and broader investment objectives. For some, cash retention might be appropriate.

Those investors preferring to link a positive investment decision to a generalised commodity price leap may be forced to wait for signs of improving economic growth and greater willingness among policymakers to loosen monetary reins.

Neither of these important investment pre-conditions seems likely over the next 12 months although judgements on that point may change if growth slows more dramatically than currently anticipated, forcing a reversal in steps to push interest rates higher, with a subsequent beneficial growth impact.

Identifying preferred commodities based on shorter-term price disparities, however popular, is rarely helpful for longer-term investing because of strong mean reversion tendencies leading to highly correlated movements across different metal markets.

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Tin, with the worst-performing price among the six principal London-traded nonferrous metals over the course of 2017, has had the best performance in 2018, not because its price has risen but because the prices of other metals have fallen by considerably more. Its recently superior relative performance has not assisted the returns of tin-related equities.

Occasionally, a laggard commodity stands out. In the current market, that is uranium.

The recent disappearance of what seemed like a one-way bet among the momentum-oriented growth stocks leading the US market, such as Google parent Alphabet, Facebook, Apple, Amazon and Netflix, is a benefit for the mining leaders.

Investors exiting the best performing stocks of the past few years and looking to frame a more diversified portfolio might help mitigate mining investment losses, at least for the sector leaders with an institutional following.

In the broader market context, miners have been conspicuous laggards. The S&P 500 rise of 305% from its lowest point in March 2009 compares with a meagre rise in global mining stock prices of just 22% even after a 114% climb since January 2016.

The S&P/ASX 100 resources share price index, which includes market leaders BHP and Rio Tinto among its 11 mining constituents, is 99% higher in US dollar terms since early 2016. There is no comparable independently produced index measuring price action among the bulk of listed entities in the sector. My own PortfolioDirect index of 50 exploration stocks has increased at less than half the rate of the market leaders, with a 45% gain.

The absence of leverage among the smallest stocks in the sector to improved market sentiment has been a distinguishing feature of the recent market performance. The lack of response has been doubly troubling since the bulk of exploration stocks had previously fallen by over 80%.

The fear of missing out - an important investment driver for this part of the market - has largely been eradicated by underfunded exploration efforts and a poor discovery record. Too many companies fighting over a shrinking share of savings has left spending in the small end of the industry too thinly spread, delaying exploration programmes and, even among the most successful companies, extending the time taken to define adequate resources for development.

The prolonged period of underperformance leaves many of these early-stage companies with extraordinary leverage to discoveries or a generalised improvement in sentiment toward the sector.

Within the mining space, and against the macro backdrop described above, the exploration end of the market now offers some of the best risk-adjusted returns for investors, though this conclusion needs qualifying.

Having to periodically replenish exploration funding at historically low share prices is an ongoing risk to investment returns. Well funded, expertly led programmes in prospective regions should be the focus of attention. Adoption of those three criteria would quickly cull large numbers from a list of potential investments.

Longer-duration investments with a development orientation are plentiful and, in a cyclically depressed market, may suit investors with a multi-year investment horizon. Covering the consequential opportunity costs and risks presents a challenge in the most propitious of investment circumstances and requires even greater care in a transitional economic setting but is not insurmountable.

Gold-related equities remain a special category of mining stocks in how they interact with macro conditions. Changes in the momentum of economic growth is a less critical driver of returns. While rising interest rates, on their own, are not especially favourable for gold bullion prices, an inflation surge would most likely be a benefit.

In any event, investors with a longer-term perspective are going to be better off holding gold bullion rather than relying on gold miners' attempts to overcome cost pressures and depleting resources to sustain their value propositions. Gold-related equities struggle to match bullion moves in periods of declining equity price momentum.

Framed by an unhelpful big picture, mining investment success in the coming year will depend more than ever on individual corporate attributes underpinning a strong value orientation.

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