FROM THE CAPITAL

Global slowdown forces market rethink

Darkest before the dawn?

John Robertson

The macro picture for the mining industry has grown bleaker in the past few weeks as lowered growth expectations take their toll on prices.

Since the beginning of June, precious-metal prices have fallen an average 13%. Copper prices have also dropped 13%. The average decline across the six main nonferrous metals traded on the London Metal Exchange has been 10%.

The extent and timing of the falls is historically unusual. Since 1960, the average base metal price decline from peak to trough over nine cycles has been 28%. The average duration of these cyclical moves has been 22 months. Currently, prices are 48% below their peak and 52 months into the cycle. On both measures, the positioning is now extreme.

One unusual source of weakness has been the strength of the US dollar. Since the start of the 1970s, the US dollar has been trending lower with occasional periods of strength, as in 1980-85 and 1995-2002. In both cases, these upward moves were more than reversed to support a general lift in prices.

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The inability of global growth to push higher is also taking a heavy toll. Typically, growth in raw material usage will be strongest in the earliest phase of the economic recovery. In the current cycle, that was in 2010 when growth across a range of industrial commodities averaged over 12%.

Since then, growth rates have been easing off. Zinc consumption growth, according to the International Lead Zinc Study Group, was running at 4.5-5% in 2013 and 2014, but is down to 2.6% over the first five months of 2015.

The International Copper Study Group has estimated a 3.8% contraction in copper usage over the first four months of 2015 after an average growth rate of 4.8% between 2011 and 2014.

The steel sector tells much the same story. Global steel production, which had grown at

an average rate of 3.4% during 2011-2014, has fallen by 2.4% during the first six months of 2015, according to the World Steel Association.

While growth rates are clearly stalling, analysts continue to talk heroically about demand outstripping the amount being produced in the not too distant future. In some instances, this conclusion rests on an erroneous extrapolation of average growth rates, which are not being sustained. In other instances, circumstances peculiar to individual commodities underpin the demand expectations.

Uranium and lithium are outstanding examples of commodities whose markets rely less heavily on global growth conditions for their incremental demand and more on technological changes and, in both cases, pursuit of more efficient energy usage.

Financial and securities markets are showing little confidence in the inadequate supply thesis that underpins investment interest in commodities such as these.

The price of the Global X lithium exchange traded fund has declined by 21% since the beginning of 2014 and, within that timeframe, by 18% since the beginning of May this year.

The price of the equivalent uranium tracking fund has fallen by 47% since the start of 2014, including a steepening 31% fall since the beginning of May 2015.

Securities markets are supposed to be discounting likely improvements in future conditions. In contrast to the outlook mapped by analysts, markets are implying a definite deterioration.

Some reappraisal of the outlook may have been warranted where inferences about future growth had been based on overly optimistic extrapolation of unsustainable early cycle growth rates as well as faulty analyses of the macro environment.

An emerging structural element to the growth picture needs considering in assessing the outlook. The International Monetary Fund, for example, has characterised the world as facing a slowdown in its potential growth which cannot be averted without explicit (and unlikely) moves by governments to change the trajectory.

Under this slower growth scenario, GDP in advanced economies would grow at around 2% while emerging economy GDP runs at 4%. Over the 10 years prior to 2008, the average rate of output increase within these two economic regions was 2.8% and 5.8%, respectively.

A slower growth rate cuts back on the tonnages of metal needed and affords more time for the supply side of the mining industry to adjust to demand growth.

The strongest price cycles occur when the industry is caught by surprise and unable to adjust quickly to a change in market conditions. Relatively modest rates of growth reduce the potential for surprise and imply that the usual market balancing required before a cyclical uplift in prices is going to take longer.

Markets almost always look bleakest as they are about to turn, just as, in much the same way, some of the most euphoric expectations occur at the top of a market.

On 1 March, 2009, *The Wall Street Journal* ran the headline 'Even the 'value' investors can't beat this bear'.

The accompanying article lamented how "the risk of buying cheap stocks is that they can just keep getting cheaper". Within five days, the market had touched bottom and the S&P 500 has, more or less, kept rising since.

No doubt, something similar will happen when it comes to defining a bottom to the current metal-price cycle. Forecasts of what metal demand may be in 2020 or any other future date will largely be irrelevant to an assessment of when a turn in markets is likely to happen.

A turn in commodity prices will come after the last exhausted investor is removed and all will have seemed lost. The sooner that happens the better.

A necessary condition for this transition in market mood will be a change in economic momentum. The current deceleration in growth will have to give way to stability and then some signs that the balance of risks has tilted to the upside. Until then, no matter what market balances might be in 2020, little improvement in investment outcomes may be evident. ▼

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