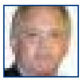
Back to 1990s for equity returns

Immediate past could signpost the future for mining equities, big and small



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History is on the side of the mining industry as it hopes for a bounce in investment returns, but the late 1990s might be the best guidepost to the immediate future before a reversion to the norm in pricing at a later date.

The difference between success and failure for an Australian equity investor can boil down to two key judgements: whether banks are going to outperform resources; and whether, within the resources segment of the market, the handful of big miners are going to do better than the hundreds of small to tiny participants.

These market calls mirror the pronounced historical tendency for returns in its two principal sectors – banks and miners – to revert to the norm through the course of a cycle.

Between 1992 and 2010, the average annual capital return from the Australian bank stocks was 10.6%. The price index for the miners in the S&P/ASX 100 rose at 11.4% and the price indicator for the mid-size miners (the small resources share price index) rose at an 11.8% rate.

"Relative stability could prove an acceptable second best outcome"

Differences in stock volatility and the flow of dividends are left out of this comparison. Both favour the banks as investments. But the comparison gets the more important point across. There is little in their longer term capital gains histories to differentiate these key components of the Australian market.

A snapshot of the present is a sharp contrast to this history of convergent investment outcomes. Since 2010, the banks have averaged gains of 12.5%/y. The large resources stocks have fallen at a 9.2% rate and the smaller resources stocks have fallen in value at a staggering 30.4% annual pace.

There was a 44 percentage point spread between the 12-month performance of the banks and the small resources share price index at the end of March. A year earlier, the difference had been as much as 90 percentage points.

There is little doubt about how investors

The mining equities sector experience in the late 1990s could be the best current guide to what happens next

would have been best positioned. That much we know. The tantalising question now is whether historical tendencies to convergence are intact or whether price dynamics across the market have changed.

At some point, if not already, market strategists will start concluding that the re-pricing of bank and resources stocks has gone so far that the balance of risks needs redressing. This might prompt some portfolio reweighting at the margin even without any widespread reappraisal of the outlook for commodity related investments.

Any portfolio reweighting prompted by a reappraisal of risks is most likely to assist prices of the larger resource stocks, at least in its initial stages. In due course, some trickle down to the rest of the sector could occur.

Any genuine reversion to the norm in equity pricing will not be a wholly Australian phenomenon. In so many respects, the mining sector is a leveraged play on economic conditions around the world, but especially in the developing economies.

Between 1992 and 2010, the monthly correlation between the MSCI emerging market share price index and the Australian small resources share price index was 0.97. Since the beginning of 2012, as the momentum in the emerging markets has subsided, Australia's small resources index has declined by 55%. The performance gap between the two indices is 61 percentage points. Here is another potentially overstretched relationship ripe for reversion.

Strengthening emerging market equity conditions would signal a similar appetite for risk as that needed to attract investors into the resources sector. Australian resources equities could again outpace the emerging market benchmark as they did in 1992-2010 by 7% to 14% on a currency adjusted basis.

Each of the major developing economies faces peculiarly structural problems that need addressing at a domestic level to restore sustainably higher growth outcomes.

Growth in developing economies is also partly the lagged effects of previously slow growth in advanced economies. More buoyant advanced economy growth rates should eventually translate into faster growing output and investment spending in the developing economies.

Improved momentum on this front, even before domestic policies are reframed, could be a cue for further rehabilitation of interest in the mining sector.

Already, the volatility in sector returns has fallen. For the best part of a year, there has been a degree of stability absent during more than a decade of cyclical gyrations.

The sector experience in the late 1990s could present the best guidepost to what happens next. The late 1990s and early 2000s was a period of unsettled macroeconomic conditions during which time the Asian and Russian financial crises destabilised financial markets and the collapse of overly inflated asset values eventually led to a US recession in 2001.

Despite such unfavourable background conditions, sector market values stabilised after a cyclical downturn during the middle years of the 1990s. In the five years after 1997, returns were contained within a +10% to −10% range in every year for an average gain of 0.9%.

The industry would prefer a full-blown cyclical recovery in prices to blow away the accumulated cobwebs of the past few years, but the macroeconomic backdrop to the sector suggests this might be some years away from happening – just as it was in 1998.

Relative stability could prove an acceptable second best outcome. It suggests a chance for companies genuinely adding value through exploration or development success to see their share prices move higher if the aggressive re-pricing of the sector that typified the past three years has run its course.

Importantly, this opportunity for selective re-pricing of stocks was the experience in the late 1990s and early 2000s, even as headline sector performance measures showed little change. ▼

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