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Bad timing for metal supply resurgence

Backed by tight inventory control, industrial metal prices have proven more steadfast amidst the widespread fear and panic presently infecting financial markets.

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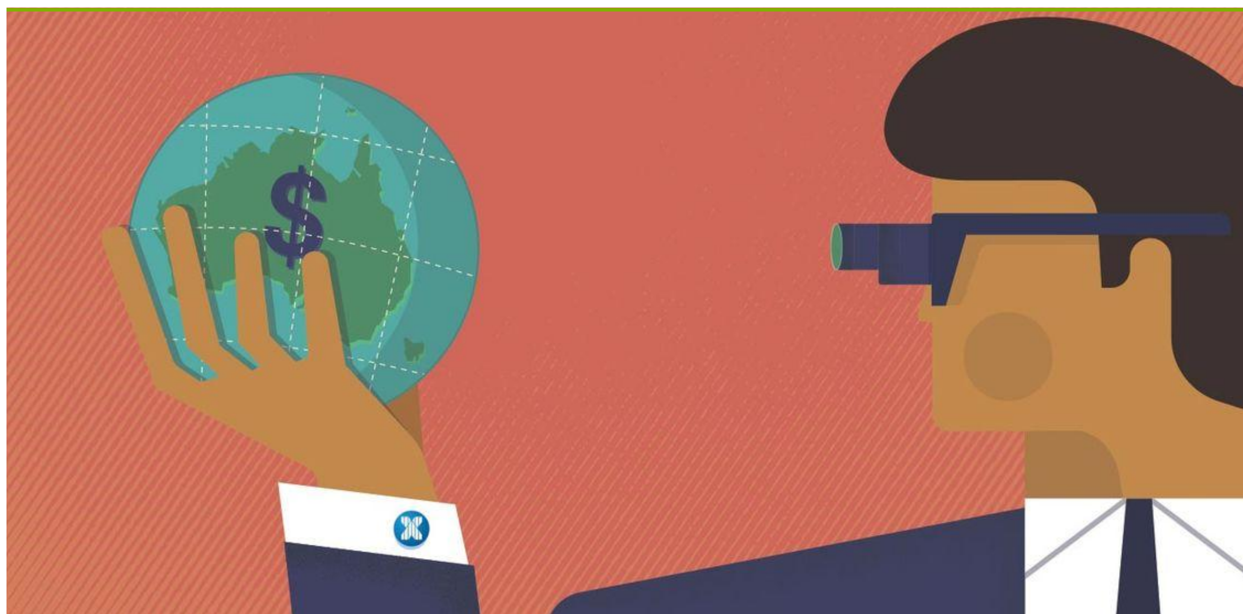

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Charts of equity price indices show precipitous declines over the past three weeks. In contrast, industrial metal price indicators have displayed a more moderate downward drift.

The dramatic flight from equities, and the rush of capital into safer government bonds, is being attributed to an unanticipated slump in global growth brought on by the rapidly spreading COVID-19 virus. Yet metals such as copper, aluminium, zinc, nickel and iron ore, supposedly among the most sensitive indicators of the global growth outlook, are reacting as though little of consequence has changed, at least so far.

A noticeable reappraisal of the growth outlook occurred within the metal markets a month ahead of the changed equity and bond market sentiment. In any event, the main nonferrous metal prices had been tending lower for the past year in response to weaker global growth conditions. Nickel aside, price volatility has been low.

Once again, mining stock prices have been more highly correlated with broader equity movements than with prices of the related commodities

Currently low volatility characteristics of the main daily traded nonferrous metals are similar to how they looked in 1997-2002, another period of global high drama. The Asian financial meltdown, the collapse of the Long Term Credit Management hedge fund and the Russian financial crisis peppered financial markets within a short span of years in the late 1990s. Then came the Al-Qaeda inspired attack on New York's World Trade Center. A US recession followed soon after.

In the late 1990s, as now, the metal markets were able to run on a separate track largely reflecting their own circumstances.

Prices of copper, zinc and aluminium are within 5% of their levels three weeks ago. Meanwhile, the EMIX global mining index has declined 20% since the latter part of February. The S&P/ASX 100 resources share price index has fallen 24% as has the small resources index. Both, at the time of writing, are pushing still lower. The median decline across an already deeply depressed landscape of all ASX-listed resources stocks has reached 20%.

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The apparent relative strength of the metal prices is consistent with a historically unusual set of market conditions. Over the past five years, according to the International Copper Study Group (ICSG), copper demand has grown at a historically low annual rate of 1.2%. The International Lead Zinc Study Group (ILZSG) has reported that zinc demand growth has stalled, having averaged just 0.1%.

At other times in the history of the industry, such paltry rates of growth would have driven large inventory accumulations and deeply depressed prices as producers, including government owned miners, pressed ahead with higher production rates to stem revenue losses.

Over the past five years, metal output has risen at an annual 1.2% rate, according to the ICSG. Zinc mine output has contracted at a 0.8% annual rate, limiting growth in metal production to 0.2%, according to the ILZSG.

The metal industries appear to have managed the weaker demand backdrop to their activities more effectively than in earlier years, albeit not always voluntarily. External funding limitations have curtailed exploration and stalled many development efforts.

Tighter metal balances than have occurred in past cycles contrast with the current experience in the oil market where conditions are more reminiscent of how metal markets behaved in the 1980s.

Extensive government involvement aimed at balancing the oil market has proven highly disruptive. Price support arrangements have attracted new production, especially among producers outside the influence of the OPEC cartel. Global production is running well ahead of demand.

After five years of unusually weak supply growth, metal output growth had been set to strengthen. The ICSG was forecasting a one million tonne output rise in 2020. A 4.7% hike in zinc mine output was forecast by the ILZSG.

Higher metal supply growth poses a challenge for markets over the next two years even if the COVID-19 outbreak is corralled in the coming few months.

For the reasons discussed in my February 20, 2020 'From the Capital' column, future global economic growth rates, kicked along by central bank and government stimulatory measures, are likely to be stronger than they otherwise would have been, adding to raw material demand.

Any number of supply and demand combinations remains possible as the full extent of economic losses from business closures remains unclear. Whatever happens, some near term losses in metal demand will result.

Let's assume, simply for illustrative purposes and without trying to forecast the course of the COVID-19 outbreak, that copper demand grows by an unusually high 5% in 2021 as economies recover and then 3% in 2022 after a decline of 1% in 2020. With mine output potentially growing at a 4% rate over the same three year period, inventories would potentially jump to the highest level in 40 years.

Even a brief coronavirus induced hiatus in global economic activity could have a profound longer term effect on market balances.

A possibly more optimistic scenario would require immediately holding back production and a sharper recovery path. The mathematics of relative growth rates implies potentially dramatic shifts in market balances if there are no changes in industry supply intentions or if demand falters more dramatically than assumed in the example.

Even in the event that copper demand grows more strongly in 2021 and 2022 than over the past five years, the market could experience inventory accumulations large enough to push prices lower over the coming two years. The same is true of zinc market balances.

The metal markets face a growing risk of deteriorating market balances, with a negative impact on price outcomes, in the next two years just as other markets are regathering their composure and beginning to reprice assets based on a more favourable view of the future.

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