

## Opinion

FROM THE CAPITAL

# Fresh strategies needed as stock prices hit new lows

Continuing down-trend in stock prices and some commodity prices forces rethink on investment plans

John Robertson

An unusually prolonged series of commodity-market adjustments has left mining stocks on a renewed search for a market bottom as fleeing investors push the sector toward a fifth year of cyclical decline.

The record 12.8% fall in Australia's small resources share-price index on the first trading day in December was reminiscent of price changes in 2008 as fears of financial crisis spread. By the end of the day, the index had fallen 37% since the beginning of 2014.

The small resources share-price benchmark comprises the 47 stocks just below the largest 11 miners and oil and gas producers listed on the Aussie market. It is the most representative of the indexes describing the investment performance of the Australian resources sector.

Rock bottom for the index had once appeared to be November 2008. What subsequently seemed like a cyclical low for the sector in June 2013 also proved illusory as several commodity prices, including iron ore and crude oil, had left some profits cyclically inflated. The June 2013 price was superseded this month by nearly 30%. Now, the market is within 15% of the 1998-2002 average.

Since mid-2013 and the end of September this year, equity returns in the sector seemed to resemble those in the late 1990s and early 2000s. This was a period of low volatility with overall modest sector returns that allowed those companies getting on with the job of successfully completing new projects to be rewarded with higher market values.

The dramatic shift in the price of crude oil following the recent slump in iron-ore prices has highlighted once again the tendency for commodity prices to gravitate toward marginal production costs if there is no countervailing market force, potentially rendering all but the most resilient in the sector unprofitable.

Their timing might have differed but, one by one, each of the major resource industry commodity prices has already reached or is heading toward marginal production costs.

Iron-ore prices are among the last, along with crude oil, to make the transition. Uranium prices, on the other hand, were among the earliest to adjust and have appeared to be turning with average prices in November 43% higher than in June 2014.



The loss of momentum in Chinese economic activity has been blamed for some of the change in recent fortunes. This reaction belies statistics on rates of metal usage. The International Copper Study Group reported that global copper usage over the first eight months of 2014 was 12.2% higher than over the same period of 2013 (including an estimated increase of 27% in China). The International Lead Zinc Study Group showed zinc usage up 7.4% over the first nine months and a 13.4% increase in China.

Accepting some qualms about the way Chinese statistics are collected, these outcomes are still consistent with a recovering global economy and markets pushing toward a rebalancing that will result in an eventual cyclical recovery. Other influences seem to have been overtaking China's activity rates in importance. Supply side influences are having an impact on falling iron-ore and crude-oil prices. Currency movements that are adding to investment risk are also discouraging capital flows into the sector.

As long as market prices are falling, investors will remain reluctant to participate, raising the likelihood of further market weakness. Typically, momentum plays a strong role with prices prone to keep falling until selling is exhausted. Stability then ensues and, gradually, investors return. This appeared to have been happening in the aftermath of June 2013, but the sector is confronting a repetition of this adjustment process.

These market dynamics prompt some thoughts about how investors might be able to respond. Contradictory or uncorrelated

commodity price movements reflecting different stages of market adjustments will most likely prevent a broad-based reappraisal of sector prices. Nonetheless, these timing differences might offer opportunities for marginal changes in portfolio weightings to capture differences in relative performance. The probability of firmer uranium prices at the year ahead while iron-ore prices edge lower is one example of this source of performance difference.

There are four remaining investment options confronting anyone thinking about how to approach the sector. Which choice makes most sense should be guided by the risk profile of individual investors. There is no solution that fits everyone's needs.

Reflecting the dangers encapsulated by the much-used falling knife metaphor, the first option is to just wait and see whether there is a level in the near term at which prices stabilise.

A possible second option is to focus on the largest stocks in the sector to take advantage of their branding prominence and the support they typically retain among institutional investors. This may offer some relative performance benefit.

Beyond these essentially defensive postures, a third choice rests on companies nearer the front of the development queue. They are the ones best poised for quick moves to production at the onset of improved market conditions. Namibian uranium mine developer Bannerman Resources is an example of a stock that fits here.

The fourth choice, and the one for the most risk-friendly of investors, is a focus on those companies most leveraged to an eventual cyclical recovery. One subset of this group are 'the cockroaches' - stocks that have miraculously escaped annihilation, still priced to fail but on the way to reinventing themselves with a new and viable asset.

Tangiers Petroleum, having come up penniless after a fruitless search for oil off the coast of Morocco, has been able to reinvent itself through a new working interest on the prospective North Slope of Alaska. Galaxy Resources is another that would fit this profile as it extricates itself from its Chinese production facilities in favour of reinventing itself as an Argentinean lithium-brine producer. Sometimes, the best returns may not come from the prettiest sources. ▼

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