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Rising macro complexity hits miners

Weak global growth with deflation threatening? Sell mining equities. Robust global growth and rising inflation? Sell mining equities. Hmmm.

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The influences on global metal and metal equity markets make for a cocktail of volatility in 2018

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Market volatility is usually a reaction to new information. And so it has been over the past two weeks after US wages growth in January forced a rethink about future monetary conditions.

My February 23, 2017, column highlighted the importance of wages growth to US GDP outcomes and, because of the size of the US economy, to global growth.

Subsequently, my July 20 column concluded that the acceleration in wages growth expected by the US Federal Reserve would come with higher interest rates but, at the same time, underpin stronger global demand for raw materials.

Stronger wages growth in advanced economies remains a vital ingredient for a stronger cycle.

The US labour market report for January released early this month appeared to confirm the anticipated wages growth acceleration but almost instantaneously destabilised equity prices.

Rather than being seen as a clear-cut mining industry benefit, the switch to a higher wages growth trajectory precipitated a slump in mining share prices that came despite only minor changes, and even some initial rises, in key commodity prices.

The Euromoney global mining index fell 8%. The S&P/ASX 100 resources index declined 6% and the ASX small resources share price index dropped 7%.

Highly correlated movements in mining equity prices have been consistent with the findings of Gary Gorton and K. Geert Rouwenhorst published in a paper entitled ‘Facts And Fantasies About Commodity Futures' (Yale ICF Working Paper No. 04-20, February 2005) and updated with Geetesh Bhardwaj in May 2015 (Yale ICF Working Paper No. 15-18).

> **The mining industry's macro risk profile now contains a more complex mix of forces over which policymakers have less direct control**

Gorton and Rouwenhorst found across a 41-year spread of data that correlations between paired equity and related commodity investments were lower than correlations of commodity company stocks with the S&P500.

Mining company stock prices behave more like the prices of other stocks than like commodity market investments, the economists found.

While this month's equity market sell off coincided with the January US labour market report, ominous signs preceded the panic.

For a start, markets were pushing to new records in the first few weeks of 2018 with unprecedented performance gains. Exceptionally low measures of implied volatility suggested investors had been dangerously discounting any disruption to their sanguine view of the future.

At the same time, US and European government bond yields were creeping higher signalling a gradual but increasingly evident reappraisal of the likely speed of monetary policy tightening during 2018.

Coincidentally, the US Congress was committing to a new spending bill. The bipartisan agreement between the House of Representatives and the Senate was designed to avert more unseemly government closures but signalled to financial markets that politicians had all but given up on deficit reduction and debt control.

The near simultaneous change in US Federal Reserve leadership with confirmation of a hefty fiscal stimulus for an economy already pushing the bounds of full employment added to market precariousness.

By the time the labour market data hit the news on the morning of the first Friday of the month, equity markets had been primed to react badly.

What should have been good news for the mining industry became, at best, a mixed blessing.

For a decade, global monetary policies had been set to support higher asset prices as a step toward raising demand and creating stronger employment markets. Although monetary accommodation remains historically strong, the emphasis on these policies is being reduced.

The planned winding back in monetary support in the US, Europe and elsewhere will exert downward pressure on metal prices, probably with a lag of several quarters and without posing an imminent threat, if all goes to plan.

After the announcement that US hourly wages growth accelerated in January 2018, panicky investors and their increasingly autonomous machines acted as if the US central bank will abandon its carefully cultivated forward guidance for a more aggressive anti-inflation response.

Higher wages growth does not necessarily herald a need to counter higher inflation. An inflation impact depends on whether accompanying productivity growth is sufficiently strong to compensate employers for wage increases.

Moves to historically low US productivity growth have coincided with a dramatic shift in the national employment mix toward low productivity services jobs. Services jobs have increased 30 times faster than manufacturing jobs over the past 70 years making growth from productivity tougher to achieve.

Competitive forces on employers in the services sector could still avert an inflation problem and a need for a monetary policy response. Tracking that will prove an important preoccupation during 2018 and one likely to contribute volatility as each new piece of inflation-relevant information is pored over for a fresh insight.

As some of the most favourable monetary conditions in modern history are wound back and the fortunes of the mining industry rely more heavily on industrial production growth, the willingness of Messrs Trump, Xi, May, Macron and Abe to raise global growth potential by fostering stronger productivity outcomes will become more important.

Global growth rose through 2017 but the positive momentum on which strengthening growth in raw material demand relies is fading.

Among advanced economies, according to the October 2017 IMF World Economic Outlook, growth is expected to be 0.5 percentage points lower by 2022 than in 2017. Chinese growth is expected to decline by a full percentage point.

The more recently released World Bank growth forecasts for 2018-2020 portray a similar picture. The bank foresees no difference between growth over the coming three years and the average over the past eight years.

After shifting favourably, the mining industry's macro risk profile now contains a more complex mix of forces over which policymakers have less direct control.

The optimum combination for the industry - stronger growth in personal incomes driving a cycle which investors take as a green light for higher equity prices even as interest rates go up - is just one of many feasible outcomes.

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