

FROM THE CAPITAL

Cycle delayed but markets keep working

This time things could be different, but that doesn't necessarily augur well for 2015

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The year is ending on a disappointing note for mining investors who might have expected something better a year ago. This far into a cycle – 43 months after a cyclical peak – metal prices are usually on the rise. Since 1960 the average duration of a decline in the prices of the major non-ferrous metals from peak to trough has been 21 months, during which time the average fall has been 29%.

These statistics are based on a model that takes account of only aluminium, copper, lead, nickel, tin and zinc prices to capture short-term changes in conditions.

The first part of the current cycle was close to average. Prices were 27% lower after 19 months and were ahead of the average pace for several months after that, but the momentum could not be sustained. Prices are now 23% below the average for this point in the cycle. Three factors appear to have weighed down the recovery.

Firstly, growth in global output has failed to build momentum. Markets rebalance most quickly when growth is accelerating. Of the major economic regions only the USA has experienced a genuine recovery from recession and even there it has often appeared insufficiently robust to last for long.

Elsewhere – notably in Europe and Japan – recovery has failed. China's pace of growth has been decelerating and, among leading developing economies such as India, Brazil and Russia, growth has been slow where output has not actually contracted.

A second reason for the unusually slow cycle evolution comes from the supply side. In the early phases of the cycle, there had been signs of industry reacting more promptly than usual. While metal prices fell, the associated inventory build-up did not seem as severe as it had done in the past even hinting at a faster than usual recovery.

Unusually, however, production has kept flowing. Since 2010, for example, annual copper mine output has risen 2.6Mt, according to International Copper Study Group numbers, more than the output rise between 2000 and 2008. Zinc mine production in 2013 was 14% higher than in 2009. During 2000-03, in contrast, neither metal experienced any increase in production.

The reaction time outside the non-ferrous metal complex has been less prompt. The most recent weakness in oil prices, for exam-



US economic recovery continues while growth elsewhere has slowed

ple, has been partially driven by technology enabling production increases funded by cheap capital to run ahead of needs. Weaker iron-ore prices have also arisen because capacity expansions driven by corporate strategies have run ahead of what steelmakers want to buy.

A third reason for an unusually subdued cycle has been a shift in foreign exchange markets. The rise in the value of the US dollar has had a dampening effect on US dollar denominated commodity prices. In April 2011, just as metal prices were reaching heights never before achieved, the US dollar was lower than it had ever been before. Since then, the exchange rate has risen 21% and metal prices have fallen 37%, as measured by the International Monetary Fund metal price index.

As the old year draws to a close, the inevitable question arises: will 2015 be any different? A better outcome will require most, if not all three, of these dampening influences to change direction.

Importantly, prices are reacting as one would expect to changing market balances and exchange rates. Dramatic adjustments will frequently exceed conservative estimates of the likely extent of price shifts, but the forces behind the changes are the same as those that have driven markets as far back as we can see.

Increasingly impoverished investors and financially strapped companies may not take much comfort from knowing markets are working properly. Nonetheless, being able to

track historically proven guideposts leaves investors better able to respond when conditions warrant a change in attitude.

Today's economic weakness is also a source of tomorrow's strength. Policymakers do more to stimulate growth and businesses find new ways to enhance profits when times are tough. Consumers who have held back their spending eventually replace worn-out appliances. House builders have to make up for lost output to accommodate rising populations. Those populations also need more infrastructure to function effectively. There is some natural tendency to rebound.

Given some more time, markets should enforce tighter supply-side discipline. Either US oil producers will cut back their drilling commitments by enough or OPEC will cave in to compensate during 2015, for example. Someone will give ground in the iron-ore market, too. This would help sector sentiment more generally.

There is less scope for mining-industry optimism about the exchange rate. Recovery in Japan and Europe depends on regaining export competitiveness. At the same time, US monetary policies that exacerbated prior currency weakness are being decoupled from what is happening elsewhere. An ongoing rise in the US dollar could be in prospect for 2015 and 2016. While not entirely unthinkable, it would be highly unusual for metal prices to rise if the US dollar is also on an upward trajectory.

My own statistical modelling suggests that a 10% rise in the exchange rate in the coming year would result in an 18% fall in metal prices. Unanticipated strong growth in Japan or Europe from restored animal spirits could block the need for a material currency adjustment but, without that, prospects are dimmer.

There is one factor that is potentially different in this cycle, namely, China's disproportionate share of raw material use. In 1970, as the then largest copper and steel user, the USA accounted for 25% and 21%, respectively, of global demand. Today's largest user accounts for more than 40% of the demand for each of these commodities.

The imbalance in global usage rates adds unprecedented risk. The risk is not simply because of China's size. That is one element. The other is a growth goal for a maturing Chinese economy that may prove impossible to meet, heightening the risk of destabilising events triggering unanticipated volatility during 2015. ▼