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Stagnation threatens without China substitute

Mining stock returns strongly resemble those in the 1990s but without the catalyst for something better on the horizon.

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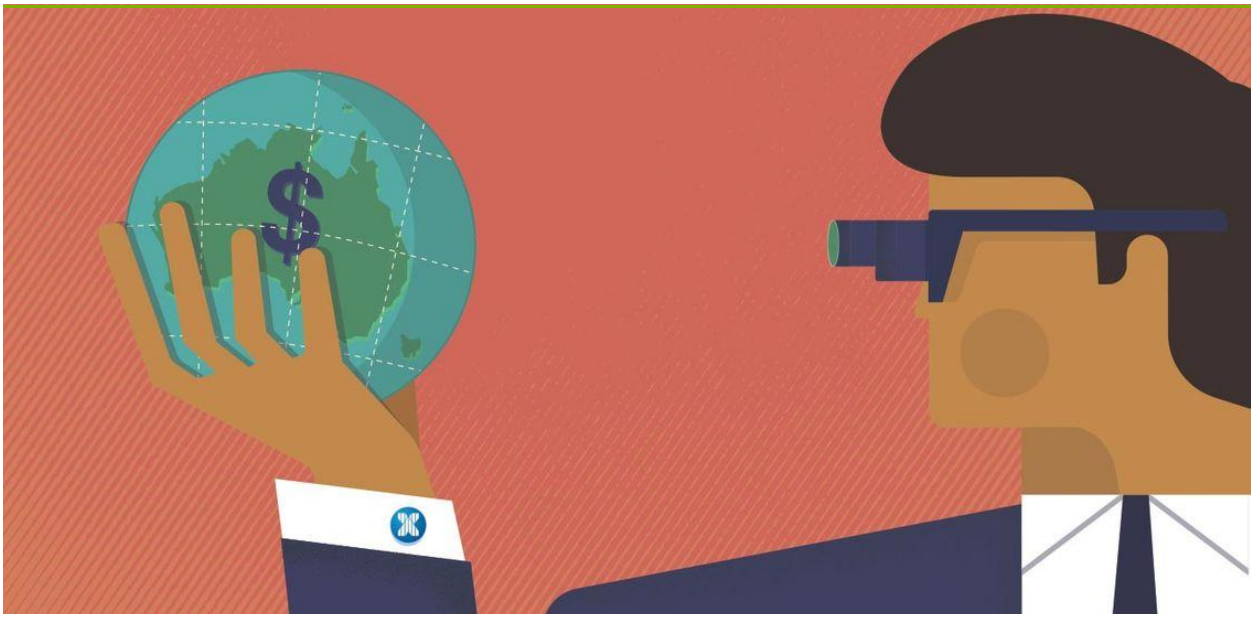

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Headline returns for the mining sector over the past eight years fall neatly into two phases. From early 2011 to late January 2016, prices were on the slide.

The EMIX global mining share price index fell 81%. The ASX index of market leaders - the S&P/ASX 100 resources index - declined 64%, at its worst. The more broadly based ASX small resource share prices index, reflecting price movements among third tier companies in or nearing production, lost 83%.

In the second phase, over the following three years, the global index initially clawed back 40% of its losses before losing ground during the latter part of 2018 for a net gain to date of 144% during this recovery phase. The Australian market leaders have made up three quarters of their losses in rising 135%. The small resources index has risen 122%.

While recent sector gains have failed to fully recover post 2011 losses, the Dow Jones Industrial Index and S&P 500 are both more than 120% higher than at the beginning of 2011. The MSCI world index is 69% higher.

The main sector indices are prone to exaggerate even the extent of the recent partial recovery. BHP and Rio Tinto have produced highly correlated Australian-dollar capital returns of 172% and 166%, respectively, since the start of 2016. While the index dominating duo have pushed higher in 2019, the small resources share price index is stuck below its 2017 closing level after a slump in the second half of 2018.

Within the entire universe of ASX mining stocks, the median return since the start of 2016 has been negative. Narratives about metal inventory declines, supply shortfalls and burgeoning use of metal in battery storage applications have done little to spur sustained investment interest. Exploration has gone unrewarded.

The longer-term picture remains favourable. Rising populations, pursuit of higher living standards and changed energy storage methods suggest an ongoing need for new mines to supplement depleting resources and provide for growth in usage.

> **Is there a catalyst on the horizon capable of duplicating the beneficial impact on the mining industry of China in the early 2000s?**

On the negative side of the balance, in the nearer term, global economic growth is slowing as countries have one-by-one narrowed or closed their output gaps, limiting ongoing growth to the result of population expansion and productivity improvements. The metal intensive investment that might support sustainably stronger rates of growth in the major economic regions, and draw investors to the mining sector, is absent.

One of the consequences of the now evident slowdown in growth is less restrictive monetary policy settings in the year ahead.

An end-of-2018 market panic at the prospect of higher interest rates in 2019 has strongarmed the US Federal Reserve into a policy pivot. Talk of further interest rate rises has quickly given way to speculation that a cut could be needed during 2019. The Fed's balance sheet rundown, which had begun to stress financial markets, is now set to stop this year.

The European Central Bank has also moved to slightly more supportive monetary conditions. So, too, have policymakers in China, though they are facing the challenge of a diminishing growth dividend for any level of central-government support as the beneficial effects from earlier economic liberalisation policies dissipate.

The recent trajectory of metal prices has provided more support for the mining sector than one might have expected against the backdrop of an unsteady growth outlook.

Optimism about the outcome from US-China trade talks appears to have bolstered near-term sentiment in metal markets, though the connection between slowing global growth and the trade dispute might have been exaggerated. The growth slowdown had much earlier planted and deeper roots. A trade agreement will probably not avert slowing growth outcomes over the next several years.

The overall picture clones the sectoral conditions that prevailed in the latter part of the 1990s and earliest years of the 2000s.

The ASX small resources share price index, the broadest indicator available for this period, had reached a peak level in August 1994. It quickly lost 30% but regained all the lost ground over the subsequent two years. Then, over the following 15 months, the index dropped 50%. That drop proved more long lasting and formed the base for future gains. Between August 1998 and April 2003, the index posted an annualised increase of 5.4%.

This lengthy period of modest gains was not uneventful. The upward drift in the market coincided with the collapse of Long-Term Credit Management, Asian and Russian financial crises, the so-called dot-com bubble, a US recession in 2001, and the terrorist attack on New York's World Trade Center.

A similar pattern of returns to those in the 1990s has been evident since 2008 when the small resources index peaked before falling a little over 60%. As in the 1990s, it clawed back those losses over the subsequent 24 months. Then, as in 1994-97, the index failed to hold and dropped as much as 70%. This was a more severe fall than in the mid 1990s but also provided a new starting point. Over the subsequent five years, the index has been on a gradual upward trend posting an annualised gain of 5.3%.

In other words, the 2008-2019 pattern of returns has been eerily similar to the trajectory of prices in 1994-03.

Of course, 2003 proved a breakout year for the sector. The building force of China was the catalyst propelling hitherto unimagined asset valuations.

So, is there a catalyst on the horizon capable of duplicating the beneficial impact on the mining industry of China in the early 2000s?

Without a well-founded and emphatic 'Yes' to this question (wishful thinking is not enough), the industry faces more time treading water, producing uncompetitive investment returns and relying on deteriorating returns elsewhere to attract funds.

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