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Zinc damp squib persists

Superior Lake Resources director Grant Davey showed how easily false narratives based on obsolete data can drive investment views.

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Davey began a pitch to a gathering of investors in Melbourne recently by talking about the zinc market. The company's Pick Lake and Winston Lake projects in Ontario have a 510,000 tonne mineral reserve capable of producing 32,000t a year of zinc in concentrate for nine years, according to an August 2019 feasibility study.

Zinc production costs of $0.47 per pound and an initial capital commitment of $86 million could produce a discounted cash flow of $157 million from the mines, both shuttered since 1998 and acquired in 2018 by the $8 million market capitalisation company.

Underpinning his upbeat view of the outlook was Davey's assertion that zinc demand will continue to grow at the 3-5% rate it had registered in the past 10 years. Already low inventories would be further reduced by ongoing deficits. The resulting short-term price increase would reverse the currently poor investor sentiment, which was holding back funding.

Davey positioned Superior Lake as a cheap, low-risk option through which investors could take advantage of his bullish view about zinc market conditions.

Most investments hang on a single underlying assumption. As long as that critical assumption holds - think about forever rising real estate prices and the global credit crisis - the credibility of the investment remains intact. Once it fails, investors will scatter with potentially disastrous financial consequences.

Over the past 10 years, zinc usage has grown at an average annual rate of 1.9%, according to the International Lead Zinc Study Group (ILZSG), not 3-5%. That includes

a 16% jump in zinc usage in 2010 when a cyclically strong recovery from recession in 2009 helped drive spending on metal intensive consumer and industrial goods.

The long-term history of zinc use has come in four phases, according to the ILZSG data. Between 1960 and the early 1970s, growth averaged just under 5%. Growth in the next 19 years tumbled to a 0.7% average. Then, in a third phase lasting 20 years, the industry posted an average growth rate of 3.6%. This period coincided with the epoch-making arrival of China as an industrial power. The fourth phase has come since 2014 when there has been no growth in use.

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Nearly 60 years of history suggests that a prolonged period of 3-5% growth is no more likely than a decade or two of little or no growth. Assertions based on a wishfully impressionistic view of the historical data, can be dismissed as a wholly inadequate basis for an investment strategy.

The zinc investment theme has been a damp squib. Long-anticipated mine exhaustions failed to deliver a structural change in prices because metal use proved far weaker than an erroneous extrapolation of historically high growth rates had suggested. Investors have been left disappointed and sceptical.

Metal demand weakness has given the industry breathing room to rebalance without the price surge many had expected.

The ILZSG October 2019 forecasting round in Lisbon recently concluded the zinc market would record a deficit of 178,00t in 2019, equivalent to 1.3% of likely 2019 use. The industry market monitor also concluded inventory rebuilding would recommence during 2020 when a 192,000t surplus is being forecast.

A resurgence in output is the expected source of the changing balance. Mine output is expected to grow 4.7%. Refined metal production is expected to increase by 3.7%. After a fall of 0.1% in metal demand in 2019, the ILZSG is forecasting growth of 0.9% in 2020.

The world appears to have entered a period of low growth by historical standards. Trade polices have aggravated a slippage in the global growth trajectory but have not been the cause.

Advanced economy growth reached a cyclical peak in 2017. In China, audacious reforms that unleashed demand for raw materials have given way to more cautious economic management. Among developing economies that might have compensated for some lost Chinese momentum, idiosyncratic political headwinds have retarded progress.

India, often spoken about as the China substitute, is falling well short of official aspirations to grow at around 10% a year by expanding its role in global manufacturing supply chains and, in the process, demanding more metal.

In broad, the reforms and productivity enhancing technological advances that delivered relatively strong economic gains in the first decade of the 2000s are absent. In places, new technology is creating uncertainty leaving an already financially stretched motor vehicle industry, for example, wary of investment.

Well into 2018, commentators were talking about globally synchronised growth despite the evidence of peak growth having been reached in late 2017. Changed expectations so often lag the data as the Superior Lake example shows, at the micro level.

The next swing in momentum will be no different. Pessimism about growth nurtured by disappointing outcomes in the past year will persist past the point data suggest is appropriate.

Rising bond yields and a steepening yield curve are already signalling a change in tone. The leading economic indicators for the OECD and six major non-member economies have declined by just 0.05% between April and September 2019 after having fallen 1.3% over the prior 18 months.

Economic activity deteriorating less speedily sounds uninspiring but is usually an important investment signal for the year ahead.

The changing speed of change suggests that growth during 2019 will be at its weakest for the cycle. Better outcomes are looking more likely in 2020. That said, the amplitude of swings in activity has been narrowing, a negative for the strength of the mining industry's recovery potential.

If the past 10 years had produced 3-5% zinc demand growth, the argument for something similar in coming years might have been sustainable. Not only is the basic premise unfounded but the current macro backdrop makes 3-5% zinc demand growth improbable, in any event.

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