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What's ahead in 2018?

A loss of macroeconomic momentum is a worrying sign for mining investment returns moving into 2018.

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Growth out of China cannot be relied upon to drive equity values higher this time

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Miners are in a better cyclical position as 2017 ends than they were a year ago.

The Euromoney Global Mining Index is up 21%. The prices of the largest of the ASX-listed resources stocks are 16% higher.

Cyclical gains are now filtering into the lower ranks of the sector. With a 32% gain in 2017, the PortfolioDirect index of 50 ASX-listed explorers has been closing its performance gap with the larger companies in the industry.

Buoyant commodity prices underpinning the gains in 2017 have been a product of lowered risks to global GDP growth, a historically unparalleled expansion in monetary conditions and a tumbling US dollar.

At any time in history, such a combination would have underwritten higher commodity prices. At the same time, global equity price indicators are generally at or approaching unprecedentedly high levels. Risk appetite has been strong. The corporate cost of capital has fallen with interest rate spreads suggesting higher-risk borrowers have not had it so good for decades.

The only surprise in this context has been how little mining equities have responded.

Despite the upward trajectory of sector equity prices in 2017, returns for all but the previously lagging explorer group are set to decline this year.

While gains over the past two years have eased the capital market pressures on hundreds of companies struggling to develop new properties, sector price indices have only partially recovered losses sustained in 2013-2015. The Euromoney index has made no net gain over the past three years.

> **Supply side constraints may prove temporary but lowered inventories will have a permanently beneficial effect on markets**

With US, UK, German and Japanese markets having risen 20-40% since then, the opportunity cost of an exposure to the mining sector has been high.

The industry's equity price action resembles what occurred through the latter part of the 1990s when the miners also underperformed broader market indicators.

Over 86 months prior to mid-2003, the S&P/ASX 100 resources share price index produced a zero net return. The small resources share price index had a zero return over 67 months. The Euromoney index made no net gain over 10 years.

Subsequently, China drove a cycle for which there is no equivalent force presently.

China carried markets well beyond the average cyclical move. It upped its steel production by 640 million tonnes a year between 2002 and 2013 but output has not changed significantly over the past four years.

Since mid-2016, China's manufacturing sector has been expanding again but economists have a near unanimous view, endorsed by high level administration and party officials, that China must constrain its domestic lending to avoid a systemic financial failure.

Signs of slackening momentum partly linked to China can be seen elsewhere, too.

The latest International Copper Study Group metal usage numbers are suggesting that per capita global consumption has been essentially static for the past four years. A similar inference can be drawn about demand for zinc.

The metal price cycle is now 23 months past its cyclical low point in January 2016 and within 5% of the prior cyclical peak in July 2014 before a historically strong appreciation in the US dollar precipitated an 18 month slump in prices.

Over the past six decades, nonferrous metal prices have taken 20 months, on average, to move from a cyclical peak to a cyclical nadir. The following 28 months has been enough time for the necessary adjustments to permit prices to recover to within 5% of the previous peak, on average.

In other words, today's markets are within three-to-six months of historical price recovery patterns and, as in the past, increasingly in need of a macro-generated fillip if they are to move further ahead.

Accelerating GDP growth inducing stronger investment spending is critical to higher growth in metal usage, tighter market balances and higher prices.

Global output growth has been stronger in 2017. The International Monetary Fund (IMF) is expecting GDP to expand by 3.6% this year compared to 3.2% in 2016. The first concerted global expansion in decades is underway but the results have been relatively modest.

Across advanced economies, productivity growth has slowed with little sign of governments being prepared to take the necessary action to improve the outlook through more effective microeconomic management.

With lowered productivity comes subdued wages growth, less strong consumption spending and lost motivation within business for capacity expanding investments to keep pushing raw material demand higher.

The IMF itself is projecting that Europe, Japan, the USA and China - the key drivers of the global economy - will be expanding more slowly in 2021 than they are today.

With monetary conditions in every major economic region becoming less supportive, GDP growth generally tapering off, a weakening US dollar largely in the past, and China now contributing to the status quo, where do investors look for solace in the year ahead?

While metal demand growth has been modest so, too, has output growth. In keeping markets better balanced than might otherwise have been the case, sentiment sapping inventory rises that typify weakening market conditions have been negated.

Supply side constraints may prove temporary but lowered inventories will have a permanently beneficial effect on markets and help sustain higher 2018 market values than might have otherwise occurred.

A long pipeline of development opportunities dating from seven-to-10 years ago may also offer a different type of momentum. Many of the next generation of projects from which investors can benefit will have had their genesis in 2007, not 2017. They will reflect the trend for prolonged development paths to straddle multiple cycles.

The industry's relatively poor performance against major international investment benchmarks may also become an asset.

With markets still awash in funds, and with investors having had their fill of increasingly pricey technology and finance exposures, capital could come looking for the lagging mining industry, a potentially important theme for 2018 on which the sector may have to rely for positive returns.

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