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Business pessimism retards cycle gains

Improved global growth in 2020 will give mining-sector investment sentiment a much needed fillip but the forces restraining a strong cyclical upswing remain firm.

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Views of global economic activity are in transition after all major economic regions and country groupings appear to have experienced slower growth in 2019.

Growth in 2020 should outpace the 2019 result despite a lower US outcome and China undergoing a structural slowdown. Euro-area growth should be slightly better. Emerging and developing Europe should show more substantial gains as should countries in Latin America and the Middle East.

Much of the growth improvement in 2020 will come from places that had underperformed so badly in 2019 that something better is hard to avoid. India, Brazil, Mexico, Saudi Arabia, Russia and Turkey are examples in this category.

The momentum switch already underway may largely bypass the most advanced and largest economies but will be important for sentiment insofar as generalisations about a slowdown will give way to generalisations about something better.

Supporting the improved sentiment, China and the US have appeared to defuse their trade tensions for the time being. A new North American free-trade arrangement is also being ratified.

The trade resolutions are not conclusive. China's government has formally agreed such bold targets for imports from the US that squabbles over whether it is meeting its promises could open the way for more US tariff threats by the end of 2020. Steps toward a so-called phase-two deal have barely started. European trade patterns also remain at risk until EU and UK governments have agreed long term arrangements.

On the monetary front, the US central bank appears to have resolved its internal debate about the most suitable policy settings in favour of giving markets the more supportive monetary conditions they craved, at least for the moment.

Business investment spending remains an important missing ingredient in the growth picture. As usual, corporate leaders are lagging in their recognition of the improved macro backdrop. In the past week, for example, international business consultancy PwC reported that surveyed chief executives expect growth in 2020 to be slower than in 2019.

> **"Historically depressed prices for exploration and early-stage development companies gives them strong leverage**

Despite their elevated positions, chief executives are rarely adept economic forecasters. This year's survey reports a record level of pessimism among corporate leaders just as conditions appear set to improve. The same survey two years ago revealed record levels of optimism about 2018 just as growth was beginning to slide from a peak in late 2017.

Sustainably higher growth will need greater business optimism about the value of capacity expanding investment. How quickly business attitudes change will largely dictate the extent of any investor-sentiment shift in favour of the mining industry in 2020.

The next stage in the evolution of investor sentiment will come when economic forecasters start to bump up their growth projections in response to building optimism. This will not necessarily occur in 2020 but is an important ingredient in the evolution of a market cycle.

Periods of accelerating economic growth are usually the times when growth in metal usage is at its strongest. Caught by surprise, industry is often unprepared to meet the surge in demand. Inventories decline and the risk premium embedded in prices rises. This is the normal cyclical sequence.

Added mine supplies appear more than adequate to meet likely usage increases for the main metal commodities in the near term. Despite funding difficulties, the industry has been able to eke out enough new production to cover slowly growing near-term needs.

Unusually, the risk of inventory accumulation is rising even as growth rates improve. A strong consensus that metal output will fall short in later years is, for the time being, of little consequence.

Over the past 60 years, the median duration of a cyclical downturn in metal prices has been 22 months, based on my metal-price tracking index. Time alone is not enough to dictate an economic turn but every cycle does have similar adjustments that take similar amounts of time.

As it happens, December marked 22 months since the most recent cyclical peak in prices and the low point in the index for the present cycle.

Another source of upside risk for miners comes from potential movements in the US dollar, which has remained persistently high relative to its historical range. Better growth outcomes elsewhere, including Europe, ongoing monetary accommodation by the US central bank and restoration of developing country trade volumes might take some support from the US currency.

On the flip side of the risk ledger, valuation risk in the US equity market has risen. With markets relying for new records on the momentum from a small number of high profile and increasingly expensive leading stocks, an ever-heavier burden is falling on central banks to underpin prices.

Higher growth might remain below the rates needed to support current stock valuations, especially in western Europe and the US, in the absence of currently favourable monetary settings.

The handful of leading mining stocks has been a prime beneficiary of the recent equity-market strength. The fortunes of BHP and Rio Tinto are now as much in the hands of the Federal Reserve as Apple, Facebook and Amazon.

The disparate performance between the leaders and the rest of the industry throws up some

correspondingly unusual investment choices. Still, historically depressed prices for exploration and early-stage development companies gives them strong leverage to any eventual change in cyclical sentiment but also less downside risk than the leading stocks in the sector.

Funding availability remains a source of negative risk for the sector. Just as equity markets are favouring index leaders, prices of high-rated corporate bonds have been outpacing the prices of bonds from more lowly-rated corporates.

Despite stronger growth, greater central bank support for asset prices and record equity price indices, financial markets are giving out ominous signs about the funding capabilities of aspiring mine developers and with that, their potential investment returns.

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