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Catalyst needed to bust mining funk

Investment returns outside the leading miners have hit an invisible barrier since mid-2016 suggesting a fresh catalyst will be needed for improved outcomes in 2017.

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The money brought home in US wages may provide the spark smaller miners need to break their lethargy

Australia's small resources share-price index – the most representative of the ASX benchmark indicators for the sector – is little changed since July 2016 and stuck around the same levels as in July 2013 and July 2014.

Index volatility, having peaked in July 2016, has been falling steadily and is now near the lower end of the range in which it has moved over the past 15 years.

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Daily movements in the index have been less than 2% for 29 consecutive days and in 85 of the last 100 trading days – the narrowest range of outcomes since the third quarter of 2014.

The directionless track of the small resources index is at odds with outcomes among the largest companies in the sector. The BHP Billiton and Rio Tinto-dominated S&P/ASX 100 resources share price index has gone up 66% in a largely unbroken rising trend since changing direction in January 2016, including 32% since June 2016.

Relative price movements coincide with the three strata of the market.

The handful of giants at the pinnacle is doing best. A larger number of well established but smaller companies produced strong returns in the first half of 2016 but, as a group, nothing since. Those often tiny companies needing exploration discoveries or a generalised embrace of risk for investment success have lagged both.

The median return among all companies in the sector since early July 2016 has been zero.

Benefits from the flow of funds into the larger end of the market may trickle down to the second-tier companies but, for the most part, the professional managers leading the charge into the majors steer clear of direct contact.

Outside the market leaders, investors have been cautious and prone to anchor their expectations to historical values as they take profits quickly in the event of higher prices.

Extremes in volatility – currently being experienced at the low end – usually signal imminent turning points.

The ASX small resources indicator has already fallen short of the gains implied by financial markets.

Yields on lower-rated corporate bonds have been falling steadily. The Merrill Lynch index of yields on bonds rated CCC or lower has more than halved in falling from 22% in February 2016 to 10% this week.

While the small-resources index had been tracking movements in bond prices for the prior three years, rising bond prices have failed to drag prices of mining stocks along the same path over the past four months.

The emerging disparity in performance between stocks and bonds suggests a possible break to the upside in the lagging equity prices.

Of course, finance is an enabling factor and cannot compensate for the absence of the stronger demand which drives cycles.

Stabilised global output growth seems more robust than in late 2015 but sources of stronger growth are hard to discern.

Chinese growth, for example, is holding up because the government there is not pursuing its structural adjustment policies as aggressively as it had foreshadowed. By design, the growth risks are on the downside as the government puts the economy on a more sustainable path.

European growth remains mired in a nasty combination of systemic financial risks, government debt burdens and institutional inertia.

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"Maintaining the current rate of growth in US employment incomes for three years would be equivalent to a 60% increase in the size of the UK economy"

Japan's past glories cannot be recaptured without more supportive demographics.

Among the developing economies outside China, India's growth is a bright spot but probably pushing toward its upper limit, while the economy's size is presently insufficient to make a global difference.

Meanwhile, the likes of Russia, Brazil and Turkey face structural impediments as well as formidable political distractions preventing them from maximising their potential economic contributions.

Perhaps, against this background, it is simply too early to speak of a cyclical upswing but there is one source of global growth not usually connected with the fortunes of the mining industry capable of accelerating the cyclical push during 2017.

In the year ended December 2016, employment income in the US totalled US\$10.1 trillion, according to the US Department of Commerce, making up 54% of US GDP.

Movements in personal labour payments are a dominant influence on US GDP outcomes and, because of the size of the US economy, one of the more important identifiable contributors to global growth.

Maintaining the current rate of growth in US employment incomes for three years would be equivalent to a 60% increase in the size of the UK economy.

Hourly earnings of private sector employees increased by just 2.5% over the 12 months ended January 2017, down a full percentage point on the growth prior to 2008.

Upward pressures on wages are intensifying. Last week, the number of new claims for unemployment benefits fell to the lowest level since the early 1970s when the US employment base was half today's size.

Policy settings are favourable with president Donald Trump and Federal Reserve chair Janet Yellen an unlikely pairing in pursuit of higher wages.

The Federal Reserve statement following its February meeting reiterated that "the stance of monetary policy remains accommodative, thereby supporting some further strengthening in labour market conditions".

The still uncertain impact of the Republican political ascendancy in Washington is more than likely to add to the building pressures through efforts to rejuvenate infrastructure and tax incentives to encourage manufacturing. Done well, the resulting boost to productivity will underwrite higher wages.

Higher US wages and the signs from bond prices that financial markets will fund riskier businesses are where miners should keep a watchful eye over coming months to judge whether the sector can break the invisible price barrier presently hindering performance.

**John Robertson is the chief investment strategist for PortfolioDirect, an Australia-based equity research and resource stock rating group. He has worked as a policy economist, business strategist and investment professional for nearly 30 years, after starting his career as a federal treasury economist in Canberra, Australia*