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Cycles dominate investment decisions

Investors need to take only one substantial decision every two or three years to maximise their returns from the cyclical shifts in metal prices that dominate sector equity returns.

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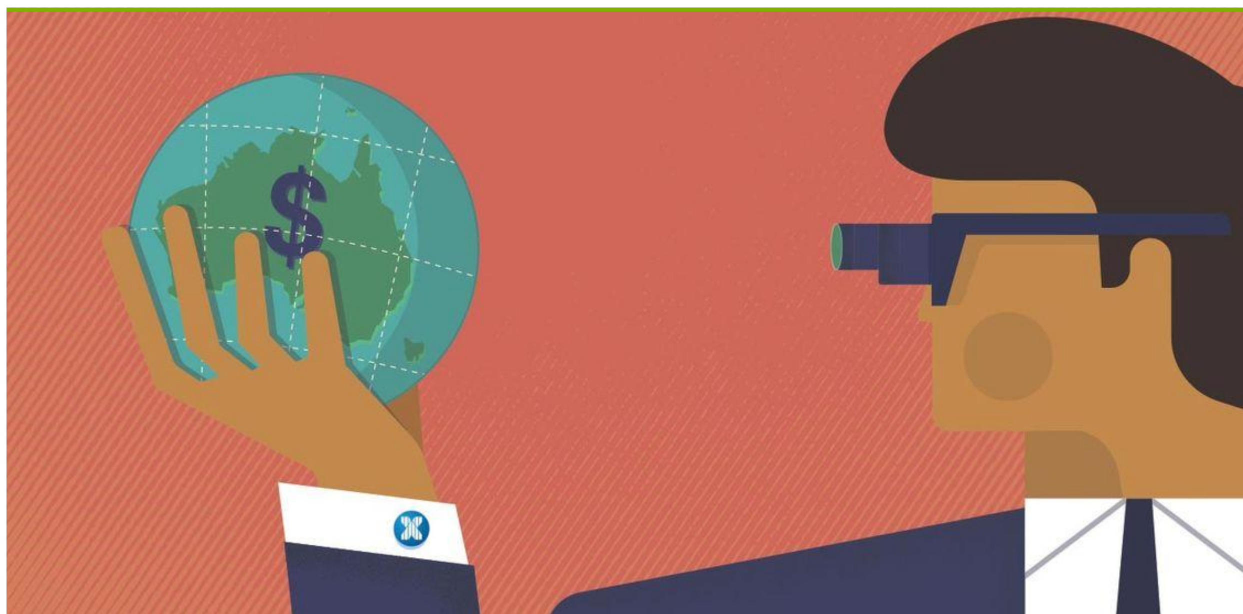

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The first two columns in this series of three about metal price cycles discussed their historical duration and economic sources. This column highlights the connection between movements in metal prices and returns from investing in mining equities.

A correlation of 0.93 over the past six decades suggests mining sector equity prices have generally mirrored the cyclical ebbs and flows of metal prices.

The equity-price indicator used for comparison here is the monthly S&P/ASX 200 resources index, the current Australian sector benchmark, linked to relevant benchmarks in use prior to its introduction to form a series going back to 1960.

In these past 700 months, mining-equity prices and metal prices have moved in the same direction in 414 months or 59% of the time.

The converse of this statistic is that monthly equity-price movements have diverged from the direction of metal prices a sizeable 41% of the time.

Importantly for investment timing decisions, divergences have tended to occur in isolated months rather than systematically over sustained periods and never for more than four months in a row.

Misalignment of metal price movements and equity returns has been less frequent in the past decade. Since the end of 2008, 32 months were out of line but there was only a single example of two successive months of equity prices being at odds with

the direction of commodity price movements.

The 14 occasions on which a divergence has extended for three or four months, totalling 44 months, occurred before 2008.

In the only two instances over 60 years in which price movements were out of line for as long as four consecutive months, mining equities were rising while metal prices fell. Both occurrences were during the unusually protracted 57% decline in metal prices which began in 1989 and continued for 56 months. Both times, the relative strength of mining equities occurred while the Dow Jones Industrial Average and the S&P/ASX 200 industrials indices rose by 5-10%.

Policy rates have risen relative to long-term rates in the lead-up to a cyclical peak in metal prices

In the majority of instances (70%) in which monthly metal prices fell and equity prices rose, at least one or other of the international or non-mining Australian equity market indicators had risen.

Likewise, when the disparity has been in the opposite direction - rising metal prices and falling mining equities - the broader market prices have been negative in the majority (67%) of instances.

Mining equities have lined up with either the direction of commodity prices or broader equity market outcomes in 87% of the monthly returns since 1960.

The temptation to invest as though the sector is able to sustainably buck the macro trends is born from misplaced optimism about the sector's fortunes. Even for the most skilful, the opportunities are infrequent.

One important qualification to these conclusions is worth recording. The direction of returns may be ordained by the prevalent macro forces but the size of returns within the sector can vary considerably across categories of stock.

Since the end of 2015, for example, the index of the 16 largest resources stocks trading on the Australian market has risen by 80% while the so-called small resources share price index, currently measuring performance among the next largest 39, has risen 125%.

This latter group of sometimes less financially robust companies, often displays greater leverage to improvements in business and market conditions. They are also prone to lose ground more quickly when background conditions falter.

The PortfolioDirect index of 50 exploration companies, based around some of the lowest-priced stocks in the sector, has risen 62% over the same timeframe.

Weakly capitalised explorers - mostly trading at a small fraction of their peak prices - should display especially strong leverage to improved conditions in the early stages of a cyclical upturn.

Returns among the explorers - and the entire universe of ASX-listed companies in the sector - are presently languishing 63% below the highest prices reached over the past year on average, suggesting a distinct inability to sustain price gains and little cyclical impetus. In contrast, industry leaders are trading within 5% of their peak prices.

Whether the small end has missed the opportunity to recoup historical losses will depend to a large extent on the durability of the current cycle.

More often than not, policy is the deciding influence. This is of particular importance presently as all the major economies are moving through historically significant policy transitions.

US Federal Reserve governors expect to raise interest rates two or three times during the balance of 2018. Without a change in longer-term bond yields, markets will be closing in on an inverted US-government bond yield curve by the end of 2018.

While the precise consequences of inverse yield curves remain the subject of some debate, there is ample evidence of them being harbingers of recession and falling equity prices.

Since 1960, short rates have fallen relative to rates on long-dated securities prior to the commencement of a metal-price upswing in all but one instance. The minor exception was in the mid 1960s.

In every instance since the 1960s, policy rates have risen relative to long-term rates in the lead-up to a cyclical peak in metal prices.

A presently low inflation threat does not require imminent or aggressive action. Policy adjustments in accordance with explicitly outlined plans extending over several years should help avert the pitfalls from hurried changes evident in earlier cycles. At least that is the intent.

It is tempting to say that this time could be different, even as the interest rate gap is narrowing once again.

Miners have traversed a period in which physical balances have played an important role in progressing cyclical conditions. Investment fortunes are now moving increasingly into the hands of central bankers who, following a long tradition, have the final say in how long cycles last.

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