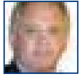
Old metals to slow as China restructures

IMF sends warning to investors in mining majors



John Robertson
Melbourne, Victoria

The latest International Monetary (IMF) Fund World Economic Outlook proffers some important macro guideposts for resource sector equity prospects but raises questions about the wisdom of relying on copper and iron ore for business growth.

The latest half year economic review produced by the IMF includes a slight downgrade to its previous global growth forecasts. The fund continues to expect world output growth to speed up through 2014 and 2015, but at a slower pace than it had thought likely at the time of its interim forecast changes in January.

There is no change to the IMF's view about growth in the advanced economies, which are forecast to expand at 3.6% and 3.9%, respectively, in 2014 and 2015, but the emerging market and developing economies are continuing to disappoint.

The biggest downward revisions have come from Russia, Brazil and sub-Saharan Africa. Growth prospects in these regions have been cut back for both years. The emerging market and developing economies are expected to grow by an average of 5.1% to 2015.

"The IMF's analysis… suggests the largest companies in the sector have left themselves vulnerable to China's changing pattern of economic activity"

Like most forecasters, the IMF tends to trail the flow of data in their ongoing interpretation of economic trends. Since global growth peaked in 2010, the fund has had to downgrade its forecasts repeatedly to take account of weaknesses in Europe and, more recently, momentum losses suffered in many of the developing economies.

The IMF forecasts are worth keeping an eye on for the signs they give out about momentum changes. At some point, the sequence of downward revisions will be overtaken by a subsequent sequence of upward revisions as economic outcomes start to supersede expectations. This would normally be a critical point of inflection for markets.

The transition from downgrades to upgrades would signify greater confidence about the prospects for the global economy and scope to up the level of risk in investment portfolios.

Behind the headline growth numbers, the investment intensity of the growth outcomes is on the rise, according to the IMF. It is forecasting that the proportion of investment in total world output will continue to recover from a low point of 22.4% in 2009 to 26.1% in 2019. It is estimated to have been 24.5% in 2013.

Among the developing economies, the share of investment has been rising since 2000. The critical change comes from the chance that advanced economy investment spending is about to start going up in a sustained fashion.

The IMF numbers imply an acceleration in growth accompanied by a rising investment-GDP ratio, the two critical drivers for raw material consumption growth.

This does not imply an imminent cyclical upturn. Nonetheless, a higher investment component should mean a faster cyclical adjustment than would otherwise occur. It raises the likelihood that new metal supplies will be used up more quickly. It possibly brings forward the time when an inventory run down might start. In other words, the necessary building blocks for an eventual cyclical recovery are being put in place.

Genuine cyclical moves usually require an unanticipated change in the balance of markets such as from a surge in growth that exceeds what forecasters had thought likely. Australia's federal treasurer, in his capacity as the current chairman of the G20 finance ministers, poured cold water on this likelihood while speaking in Washington at the April ministerial meetings of finance ministers coinciding with the release of the IMF's revised outlook.

At an earlier meeting in Australia, ministers had signed onto a plan to boost GDP by 2% over five years. This was to be over and above what countries had already set in place by way of existing policies.

With fiscal and monetary policies already at the bounds of policy prudence, there has been considerable scepticism about how this higher growth target could be achieved. Australia's Joe Hockey confirmed that barely 10% of the target was being met by new commitments. In short, the productivity enhancing and trade liberalising policy reforms that would boost growth beyond the current trajectory are not being made.

A warmer embrace of these policy options appears necessary for a speedier onset of the raw material price cycle than currently appears likely.

Amid these pressures, the mining industry must also be mindful of underlying changes to the Chinese economy that might result in lower rates of raw material consumption. This has been the subject of some fresh analysis published by the IMF in its April Outlook.

The IMF has a relatively optimistic view of the extent to which China will become a less raw-material intensive economy. It has found the pattern of China's commodity consumption closely follows the earlier paths of other rapidly growing Asian economies. China's commodity consumption is unlikely to have peaked at current levels of income per capita, according to its analysis.

The IMF has concluded that per capita demand for metals will eventually fall when critical income levels are reached, but this is not an imminent threat. More ominously, it has highlighted the importance of drawing a distinction between what it refers to as low-grade and high-grade metals in coming to conclusions about the longer term metal intensity of the Chinese economy.

Fund researchers have identified key income levels at which a switch in the mix of commodities used can be expected. According to the IMF, demand for basic and low grade commodities, including copper and iron ore, will start to grow more slowly to be replaced by metals like zinc, aluminium and tin.

Albeit inadvertently, the IMF's analysis throws doubt on some of the thinking in investment markets about strategic positioning. Its work suggests the largest companies in the sector have left themselves vulnerable to China's changing pattern of economic activity as they focus on iron ore and copper and downplay the role of less appealing metals. ▼

John Robertson is a director of EIM Capital Managers, an Australian-based funds management group. He has worked as a policy economist, business strategist and investment market professional for nearly 30 years after starting his career as a federal treasury economist in Canberra, Australia