

Opinion

FROM THE CAPITAL

Metal price cycle timing needs rethink

Increased commitment of equity funds to mining sector may not be warranted until late 2016

John Robertson

The cyclical positioning of metal markets warrants some reappraisal. Another 24 months may be needed to get back to where we were in mid-2014 before the latest price slide began.

The mining industry needs stronger global GDP growth. Without a pick-up in growth, the prices on which the industry depends will not stabilise at levels that allow miners to finance new projects.

The meeting of G20 finance ministers in Ankara earlier this month optimistically declared that “we are confident the global economic recovery will gain speed”. The ministers’ optimism was hardly reflected in the remainder of their end of meeting communiqué. “Global growth falls short of our expectations,” they also said. Any expression of confidence seemed more like an obligatory affirmation of faith than a realistic assessment of what was happening.

Speaking after the G20 meeting, the International Monetary Fund managing director, Christine Lagarde, referred to the downside risks to growth as having increased, particularly for the emerging market economies.

Ministers described the need to boost actual and potential output growth as “a key challenge for the global economy”. Notably, it was not “the” key challenge. Tension between the growth objective and widespread electoral pressures has been increasingly evident. Policies for growth, the ministers said, would be tempered by “steps to promote greater inclusiveness, including to reduce income inequality”.

The G20 has held itself out as one of the few sources of policy capable of improving growth outcomes in coming years. The leaders meeting in Brisbane in 2014 had signed off on specific initiatives from each country to meet a targeted two percentage point lift in global growth by 2018.

Expectations of this goal being met were low from the beginning. Consequently, disappointment will not run high but solid follow through would have been – and could still be – a shot in the arm for the mining industry.

There is a glimmer of hope. Leaders will consider the first “accountability report” at their November meeting, chaired by Turkey, in Antalya. The report will have been prepared with the help of the IMF and OECD. Formal reporting on progress toward meeting individual country growth commitments from



Brisbane was designed to ensure maximum embarrassment for anyone failing to keep their end of the bargain.

A more positive outlook for the mining industry now relies heavily on the fulfilment of these commitments and how the leaders translate their assertion that “boosting investment is a top priority for us” into action.

The 2010 cyclical peak in metal market conditions was followed by a more or less typical cyclical adjustment as rising supplies ran ahead of slowing demand growth. My research commentaries had been describing the cyclical positioning of raw material markets as “trough entry” during 2013 and 2014 in the expectation of a conventional market balancing process which, over several years, would lead to greater stability in commodity prices before setting the scene for the “trough exit” phase of the cycle.

My modelling uses progress along this adjustment path as a primary guidepost to market riskiness and funds allocation to individual industry segments.

Until mid-2014, the process of adjustment had been broadly consistent with historical patterns. This would have led to sector markets becoming progressively more attractive toward the latter part of 2014 and the earlier months of 2015.

The uplift in the US dollar in the third quarter of 2014 took some steam from that process. A definite step down in prices that has now persisted for some 12 months has coincided almost exactly with the currency move.

The US dollar leap was at least partly connected to a rising risk aversion among investors fleeing struggling emerging economy

investments. Different growth trajectories also contributed. At the same time as the US economy was clearly pushing along an expansionary path, Europe and Japan were battling to escape recession.

Currency outcomes are inevitably a tug of war between competing economic forces. With US growth still running ahead of the pack and US interest rates set to rise as monetary policies elsewhere become more highly accommodating, forces contributing to a stronger US dollar remain more powerful than those operating in the opposite direction.

A clear demarcation in conditions dating from July 2014 is now evident. The change in market conditions justifies treating this point as the beginning of a fresh cycle with the accompanying need for a rejuvenated adjustment process.

The clearest consequence of this conclusion is on the timing of an eventual cyclical upturn. On average, from this point, a cyclical trough could be expected in another 10-12 months. Another 24 months would normally have to elapse to get market balances back to their mid-2014 positioning.

The funds allocation to the sector as a whole would be correspondingly affected. On my modelling of the historical patterns, lifting the commitment of equity funds to the sector would not be warranted until late 2016. At this stage of the cycle, the largest sector stocks – those able to offer a sense of safety due to their size and balance sheet capacity and most able to transcend cycles – would remain the most favoured.

The more development oriented companies – those whose access to capital dictates progress – would normally face intensifying negative pressures in these circumstances. Access to innovative sources of capital will distinguish companies, while capital remains scarce and expensive. Aggressively priced latter-stage project funding is likely to occur increasingly at the expense of early stage retail investors whose returns are likely to remain well below their cost of capital.

The duration of cycles varies and conditions may change more or less speedily than implied by the historical averages underpinning these conclusions. Technical equity and commodity market indicators will give some short-term guidance to likely deviations from the norm. At this stage, however, most of the key signs are negative with the macro landscape forming an unfavourable scenario for investment in the sector. ▼

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