Insight: From the capital

Iron ore forecasters struggle as Australia worries

Price plunge impact will transcend the mining sector Down Under

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Australia's iron-ore price forecasters are being put to the test as prices slump and the nation's disproportionate dependence on the steelmaking ingredient causes uneasiness in markets and policymaking circles.

Australia's iron-ore mines contributed A$69 billion (US$62 billion) to national exports in 2013, according to the Bureau of Resources and Energy Economics, to make up 22% of the total value of overseas sales from all parts of the Australian economy. Iron-ore miners also skew Australian stock markets, making up two thirds of the market value of the ASX100 resources companies.

For most of the world, falling iron-ore prices are an unambiguous benefit. They signal rising living standards. Not so in Australia. The state of the iron-ore market has direct and indirect linkages to regional development, employment, wages and tax receipts.

Less obviously, due to their impact on the balance of payments and exchange rates, iron-ore price movements can affect inflation, interest rates and the competitive positions of exporting industries or companies fighting imports for market share domestically. Ultimately, too, these outcomes affect the capacity of Australian financial institutions to borrow and, consequently, the availability and cost of credit for all sections of the Australian economy.

Anxiety about the industry became more pointed recently as benchmark iron-ore prices pushed toward US$80/t and two respected commentators took up opposite public positions on their future trajectory.

The more influential impact came from former BHP Billiton senior executive Alberto Calderon, who seemingly put a more objective view of the market than many with a clearer interest in the outcome.

Speaking in Melbourne at a gathering of Bloomberg clients, Calderon forecast a benchmark price of US$70/t with little prospect of recovery in the foreseeable future. He went on to argue that Australia needed to restructure its economy to produce more of the goods consumers with rising incomes wanted if the country was to sustain its standard of living.

Speaking at an industry gathering in Western Australia on the same day, the widely followed chief economist at Westpac, one of Australia's leading commercial banks, Bill Evans, forecast prices would rise above US$120/t over the coming two years.

Also speaking at the Bloomberg event, Joel Crane from Morgan Stanley opted for the middle ground with an US$85-95/t estimate of where the price would sit.

Everyone seems to agree on the ingredients in the mix. There is disagreement, however, on exactly how new output, demand, the emergence of scrap as a source of supply and the reaction of high-cost Chinese producers will interact to set future iron-ore prices.

Calderon's analysis emphasised three strategic influences led by the restructuring of the Chinese economy. With raw material intensive investment spending having already contributed up to 50% of GDP, steel usage rates are likely to fall as household consumption contributes more to growth and correspondingly less comes from investment.

Secondly, according to Calderon, the steel industry and the government have recognised that China's interests are best served by fostering excess iron-ore production capacity. The Japanese steel mills had done this when they dominated the buy-side of the industry. Calderon suggested the Japanese approach would be a model for future Chinese management of the market.

The third influence looming large in Calderon's thinking was the impact of scrap on raw-material sourcing. After a decade in which annual Chinese steel usage rose fivefold to over 700Mt, the amount of metal capable of being recycled will rise as obsolescence takes its course. Scrap as a proportion of total new metal production will push toward the recycling rates prevalent among more advanced economies, Calderon opined, reducing the amount of iron ore needed to meet any forecast level of steel production.

Those with a more bullish view are inclined to put more emphasis on the reaction of high-cost Chinese producers. Chinese production cutbacks as a result of lower prices reduce excess capacity, leaving sellers better positioned to negotiate higher prices. This was how prices firmed through 2012 after falling from more than US$140/t to less than US$100/t.

Market rebalancing from Chinese exits is likely to have only a short-term effect. The flattening in the cost curve implied by any permanent cut in Chinese output is likely to drag prices toward the lower marginal costs of production over the longer term. Occasional market uncertainty may disrupt this process, but the economic pressures are likely to prevail eventually.

Anyone with an interest in higher iron-ore prices needs the marginal Chinese producers to stay in the market as well as enough demand growth to soak up extra supplies. They also need capital markets to ration funding to others seeking to enter the market. This is the only combination that seems likely to foster a return to prices above US$100/t.

From an Australian investment market perspective, the effect of a decline in iron-ore prices will not be confined to the earnings of the major miners. The effect will transcend miners, retailers, manufacturers, financial institutions and service providers.

A weakening Australian dollar usually causes overseas investors, the critical marginal buyers of Australian stocks, to steer clear of the Australian market until the currency settles at a more sustainable level. This is another reason to be wary of the returns from the non-mining part of the market if iron-ore prices remain weak.

The segment of the equity market to be most affected will depend on how much of the iron-ore price impact has already been taken into account in share prices. There has been a 90 percentage point disparity in performance between the Australian banks, the largest component of the Australian market, and the large miners since the beginning of 2012. This difference might suggest greater market risk from a holding in the banks than from a mining industry investment whose valuation already anticipates a period of prolonged cyclical weakness.

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