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Metal price forecasters bet on reversion to mean

The pattern of investment bank metal price forecasts is biased to mean reversion with less emphasis on likely movements in market balances.

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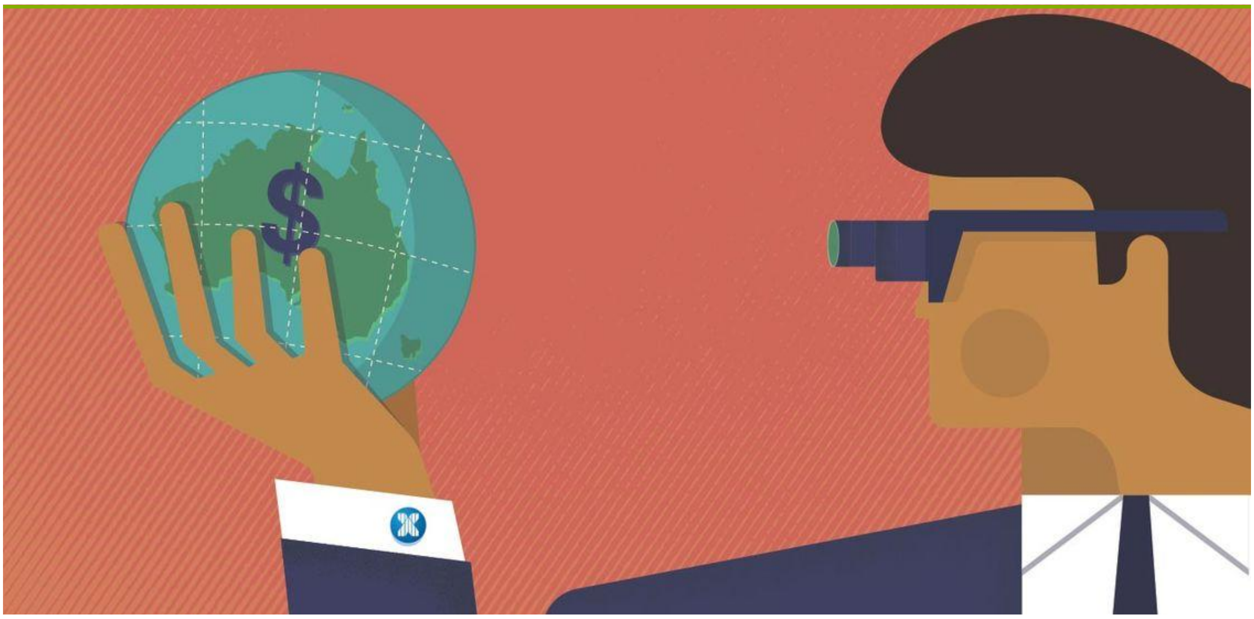

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Investment bank metal price forecasts are influential. They frame expectations for investors. They also dictate what companies should assume about the future viability of projects.

Despite the inherent volatility of commodity markets, left field or controversial forecasts are surprisingly infrequent. A natural human tendency to base expectations about the future on the most recent experiences fosters conservatism.

Behavioural tests have shown how biased mindsets can distort analysis. People shown the numbers 1-10 in ascending order and asked to add them up will more often than not come up with a lower total than people shown the same set of numbers in descending order, whatever their backgrounds. The starting point dictates the outcome.

Metal price forecasts linked to formal macroeconomic frameworks also contribute to conservative forecasting. Later year GDP growth forecasts among financial institutions typically converge on steady-state outcomes which abstract from destabilising events. Cyclicality is implicitly removed. Correspondingly, the potential for structural shifts in metal use is downplayed.

Swings in sentiment about near term prices in reaction to recent moves may make little difference to project economics. And, yet, the definition of project targets, the pace of development and access to working capital are overwhelmingly driven by views about what will happen in the next few months.

For mining industry executives, with project developments extending over many years, metal price consensus forecasts are of especially dubious value.

S&P Global Market Intelligence has published consensus forecasts, as at April 30, 2020, for 13 industrial metals which play important roles in the mining industry. S&P has recorded price targets from the contributors to its survey for the current year and for each of the four subsequent calendar years to 2024.

> “ **The consensus for 2021 looks too strong, even in the event of greatly improved activity rates**

In a clear sign of the dominant mean reversion mindset, unusually high prices are expected to decline. Unusually low prices are expected to go higher.

Of the 13 metals surveyed, only gold and palladium prices were higher than their 10-year average values, at the end of April. Prices of the two outperforming precious metals were expected to decline over the four years to 2024.

Prices of all the other metals, with the exception of iron ore which has shown surprising strength in 2020, were slated to rise. Expected increases over four years range from 20% for silver to 67% for cobalt.

While such increases would be a welcome relief, they would be spread over four years. In the context of a highly cyclical industry, such gains would be nothing special. Moreover, about half the anticipated four year increase occurs between now and 2021 leaving quite modest gains over the following three years.

The forecast prices suggest imminently stronger economic activity will drive market balance improvements. In subsequent years, the pace of price increase is expected to slow, suggesting that an ongoing supply side reaction will be sufficient to meet growing market needs.

Analysts are pointing to a weaker recovery than normal from depressed conditions. In the case of copper, as an example of historical price patterns, the average four-year price movement in a strengthening market since 1980 has been 82%. The S&P consensus numbers have copper prices rising 33% over four years, including a gain of 15% in the first year.

Financial markets have generally taken a positive view about the economic outlook despite the huge hole punched in economic activity by anti-coronavirus measures in the past few months and the unprecedentedly large funding task now faced by many western governments.

If correct, GDP growth in the year ahead is set to accelerate dramatically. The distinction between growth and the level of activity will be important in understanding market conditions. Even an unprecedented surge in growth could leave the level of GDP below 2019 outcomes until late 2021 or even 2022, so great have been the production losses this year.

A full recovery in the amount of metal used while global output struggles to regain previous heights would be an imaginative stretch.

Meanwhile, price forecasts for 2021 would encourage resumption of metal production as soon as government-mandated lockdowns are removed. New sources of supply, already in the pipeline, would also be free to start.

Rising inventories of base metals in 2021 with consequent downward price pressures is a plausible scenario implicitly ignored by the current consensus.

What happens beyond 2021 will depend heavily on whether world economic growth can continue at higher than previously expected rates or whether it falls back to the 3-3.5% path anticipated before the coronavirus pandemic hit.

The slower growth outcome might mean little change in metal usage. Market outcomes similar to those in the 1980s could prevail when miners suffered for prolonged periods from high inventory accumulation and prices below marginal costs of production.

More optimistically and if financial markets are correct, low rates of industrial capacity utilisation and high unemployment could set the stage for relatively strong growth over a prolonged period as national and regional output gaps are narrowed.

Corporations rejigging their supply chains in the aftermath of the COVID-19 pandemic might contribute to better than previously expected growth outcomes. So, too, would monetary policies helping to sustain inflated asset prices.

The metal price pattern, in this case, would differ markedly from that implied by the current consensus. Rather than price gains being biased towards 2021, the strongest gains would occur thereafter and possibly over an extended period. The upswing would start later in 2021 rather than being imminent.

In short, the consensus for 2021 looks too strong, even in the event of greatly improved activity rates. Much of that strength can be attributed to the mean reversion mindset. Meanwhile, the post-2021 numbers could prove too low and the speed of acceleration too muted if higher graoth rates are sustained beyond 2021.

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