Mining Journal

Central banks to move markets

Central banks kill the metal price cycles on which project funding for new mines and sectoral equity performance depend.

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Last week's 'From the Capital' column characterised the combination of slowing global economic growth and tightening monetary policies now evident as the worst of circumstances for stock markets. The eventual magnitude of the market reaction will depend on how much growth slows and how much tighter monetary policy becomes.

As it looks presently, growth will moderate rather than drop sharply, though the balance of risks is tilted to the downside. US sustainable growth potential sits around half the fiscally stimulated recent outcomes of around 4%. China is battling the negative consequences for growth of a transitioning economic structure. Europe, having been overly focussed on institutional arrangements and now confronting the consequences of having neglected productivity-enhancing policies to improve growth potential, will be lucky to dodge a post-Brexit activity slump.

More broadly, a range of influences, some idiosyncratic and some systemic, leave developing economies on a dangerous precipice from which they can easily tumble. Not helping is the US attempt to grab a larger share of world trade, even at the risk of shrinking volumes.

Superimposed over these worrying - but not necessarily decisive - influences is a group of independently-minded central bankers with the proven power and willingness to dictate the fortunes of the mining industry.

The accompanying table tells the tale of how monetary conditions have interacted

with metal price trends over the past 50 years. During this timeframe, there have been seven identifiable cyclical upswings in the prices of the six London-traded nonferrous metals critical in defining equity market conditions.

The magnitude of the price rises has varied from the relatively modest gain during 1999 and 2000 to the unprecedented uplift driven by Chinese industrialisation during 2002-2007.

The hypersensitivity of central banks to inflation pushing above their targets paints an uncomfortable picture for mining-related equity returns

Without exception, these cyclical moves in metal prices were accompanied by a tightening in global monetary conditions. The table uses inflation adjusted OECD money supply (M1) data to indicate the changing policy position over the duration of each cyclical metal price uplift.

In 1993-1995, for example, metal prices were rising 66% while money supply growth rates were pulled back by 9.6 percentage points. Broadly, the larger the cyclical upswing, the more determined has been the monetary response.

Central banks are not anti-mining. It just happens that changes in raw material prices and the surrounding circumstances inform their judgements about inflation expectations and the need for policy adjustments. The impact on the mining industry is given little weight.

Whatever the intent, the result for the mining industry has been emphatically similar. Price cycles have been cut short in every case with three years being the shortest time taken for prices to regain previously lost ground.

Impact of Money Supply on Metal prices

	Metal Price	Money Supply*	Months to recovery
1972-74	+133.2%	-9.6	56
1978-80	+64.9%	-11.4	98
1987-89	+96.7%	-12.8	202
1993-95	+66.2%	-9.6	107
1999-00	+35.5%	-6.3	37
2002-07	+455.1%	-11.4	?
2016-18	+62.6%	-5.8	?

* Change in inflation adjusted OECD money supply (M1) growth (percentage points) over period of metal price upswing.

The most recent metal price cycle appears to have peaked in February 2018. During the period of the upswing and consistent with previous experience, money supply growth was cut back by 5.4 percentage points. Since February, metal price movements have almost exactly replicated the 60-year average decline in prices during the first nine months following a cyclical high point.

At this point in earlier cycles, the decline in money growth rates will have already started to reverse. In contrast, since February, the money supply growth rate has been cut by a further 1.4 percentage points, with more to come.

The most recent projections by the US Federal Reserve, for example, suggest another four interest rate rises over the coming 12 months with continuing liquidation of the Fed's holdings of financial securities adding to the unwinding of historically unprecedented monetary support for asset prices. In Europe, the timing of policy changes is lagging those in the US but, as things stand, a process of monetary tightening is set to persist for several years.

Against this background of slowing global growth and tightening monetary policies, the prospects for generalised mining equity gains are dim.

This conclusion is at odds with forecasts of prolonged physical market deficits for several individual metals implying that cyclical conditions are on track to strengthen, ushering in an extended period of prosperity.

Focussing solely on changes in individual metal market balances fails to take account of the bigger

picture.

If only a single metal was displaying favourable market balance characteristics, the anticipated benefits would most likely flow to companies with the related exposure. If, on the other hand, all, or the majority of, metals are moving in concert through such a cycle, central banks will react - as they always have.

A correlated upswing in the prices of multiple metals will be ended prematurely by central banks paying little attention to the impact of their actions on the mining industry as they police 2% inflation targets.

The hypersensitivity of central banks to inflation pushing above their targets paints an uncomfortable picture for mining-related equity returns.

There is one important qualification to this conclusion, namely, the possibility that the central banks are wrong in their belief that prospective growth and inflation outcomes warrant higher interest rates.

A policy misjudgement would not be unusual. Many can be cited. With global growth slowing, central banks may decide to put the brakes on plans to push interest rates back to historically normal levels. The US Federal Reserve will be especially sensitive to the flow of data over the coming six months as it seeks to fine tune its judgements about what constitutes a ‘neutral' policy setting.

A loosening of the monetary reins would be essential for an upward swing in mining equity prices with enough power and longevity to lift the small end of the industry.

A policy reversal of this nature would first require compelling evidence of the need to change direction. Confirmation of the need for a policy shift will be a double-edged sword for the mining industry, implying worse news before something better is forthcoming.

The second quarter of 2019 could be a watershed for judgements about which way these pressures push decision makers.

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