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Nasty choices to dictate industry fate

The toughest public policy challenges since the second world war will confront governments in the next few months, as they strive to save lives while simultaneously restarting shuttered economies.

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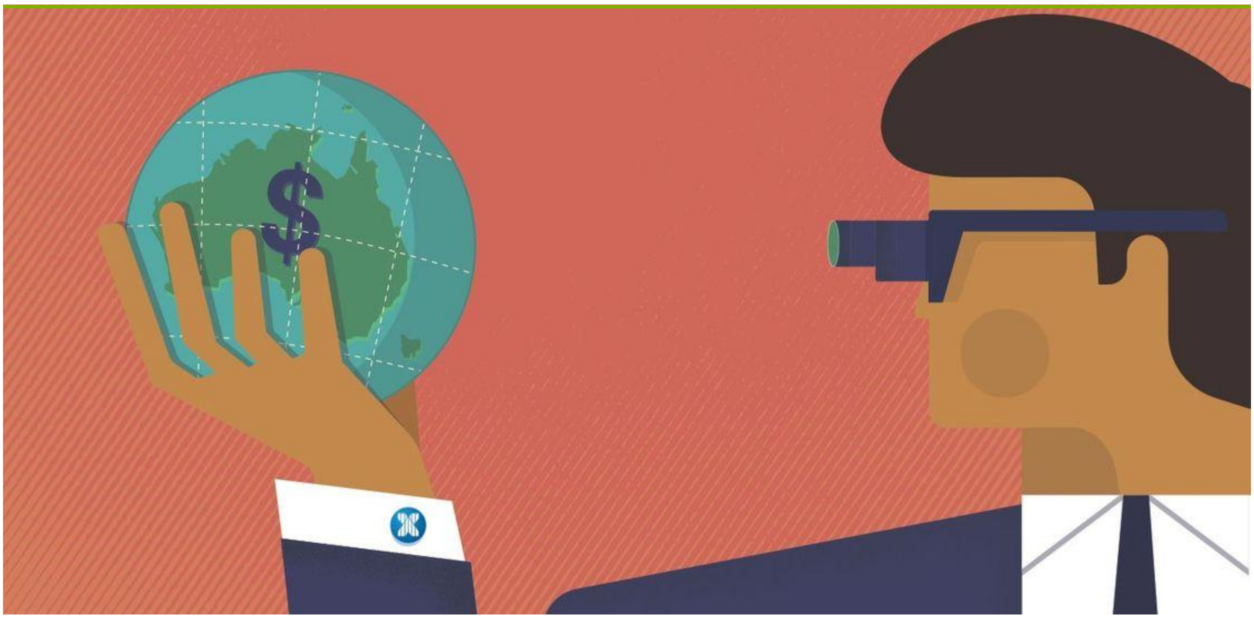

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'From the Capital' columns over the past two weeks have outlined three scenarios for how the world might exit the horrors of the COVID-19 crisis.

The most optimistic of the three scenarios involves an imminent return to work, albeit phased, as governments gain confidence that infection rates are within the bounds of hospitals to manage.

Departing from the most rigorous social distancing practices to reopen locked down businesses and resume normal commercial activities runs the risk of reenergising the pandemic.

While recognising the risk, political leaders in advanced economies are having to balance the pleadings of their public health officials for caution with potentially permanent losses in living standards and evident reticence among voters to stay at home.

In the second scenario, prematurely reopened businesses are forced to close again, others are shuttered for longer and incomes take another blow as a fresh wave of infections hits.

Prolonging the economic contraction would lengthen the duration of high unemployment and jeopardise the strength of any ultimate recovery. With more serious damage to business and consumer confidence, the effectiveness of fiscal and monetary policies aimed at bridging income losses will diminish.

Emergence of scenario two would force an equity-market retreat. Both earnings, already under a cloud of uncertainty, and valuations would be downgraded. Mining-sector equity prices would be dragged lower in concert with multiplying broader market losses.

With expectations of business resumption dashed, weakening equity markets could persist for as long as social distancing policies are required.

Many more months of lowered rates of economic activity would further depress raw material usage, opening the prospect of very large inventory accumulations or lowered rates of capacity utilisation. Metal prices well below current marginal production costs could persist until markets are rebalanced.

> “ **Miners will find a stiffened resolve among host governments to extract more value from resource development**

The industry's access to capital will suffer as its inventories mount, national savings are depleted, government debt balloons and borrowing costs escalate for riskier investments.

Under scenario two, numbers of early-stage participants in the industry are likely to be severely culled. The best-funded companies in the sector will be given the chance to take over the most attractive exploration efforts or those projects most likely to succeed.

The third scenario implies an even bleaker set of outcomes in which the COVID-19 disease envelops regions with the least adequate public health resources, ineffective quarantine arrangements or living conditions which prevent social distancing.

Evidence of the disease passing through unpoliced borders or refugee populations will compel more effective international efforts, necessitating funding from economically advanced countries, however desperate their financial circumstances.

Scenario three would involve more severe and prolonged regional and international travel restrictions. For the mining industry, the benefits of working in relatively remote sites will have been eroded as global business restrictions are intensified to cope with infections in previously isolated localities.

Shutdowns under scenario three would last until a vaccine can be deployed globally, posing a multi-year threat to the viability of even the most financially secure producers in the mining industry. Mine closures will impede inventory accumulation but industry capacity will remain well ahead of global needs for many years.

Gold's safe haven reputation is one ray of hope for many in the industry and, by extension, some who might divert their efforts to precious metal discoveries to support their survival.

The most recent rises in gold prices have largely reflected moves in government bond prices, as one would have expected in an orderly financial market. Gold prices are still lower than they were eight years ago despite expectations of the most disastrous economic outcomes in 90 years. Zoom Video Communications has proven a far safer investment haven.

The February 13 ‘From the Capital' column described how gold prices have risen most dramatically in periods of rapidly rising wealth or large shifts in the distribution of wealth in favour of investors with a higher propensity to hold gold as a financial asset.

A prolonged period of widespread wealth destruction is the worst backdrop for investment in gold. Scenario one, of the three presented here, offers the best chance of higher gold prices.

Energy storage innovation had been an important source of industry optimism before the onset of COVID-19. The extent of the climate change threat driving the move to renewable energy sources might not change greatly if scenario one eventuates.

The substantially lowered rates of economic activity in scenarios two and three would make climate change a less urgent policy priority. The possibility of oil shortages driving a shift in energy use will have disappeared. Large numbers of unemployed will be less willing to sacrifice the prospect of future income for improved environmental outcomes. The financial wherewithal to embrace new power sources will have been damaged irreparably.

Motor car manufacturers, already struggling to fund retooling, will support a slowdown in electric vehicle adoption. In any event, demand for transport services, and the related metal usage, will have been greatly reduced.

The COVID-19 pandemic raises the prospect of governments taking a more active role in the sourcing and pricing of goods deemed important for supply chain security. Miners of some commodities, most typically metals whose supplies are now dominated by Chinese producers, may benefit from government encouragement.

Overall, though, miners will find a stiffened resolve among host governments to extract more value from resource development. In the midst of historically high unemployment, widespread business closures and decimated tax bases, the mining industry will have little support for retaining above normal profits in the event raw materials are in short supply.

In short, the rationale for investing in the mining industry - leverage to improving economic activity leading to periodic super profits - will have largely disappeared for a decade or more under any economic outcome more severe than in scenario one.

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