

Rate hikes to hit miners

The US Federal Reserve has commenced pushing interest rates toward its longer term target in a concerted way for the first time since rates were slashed in 2009.

John Robertson* | 30 Mar 2017 | 7:42 | Opinion



The policy out of the US is likely to hurt the mining space

The FOMC, the Fed's policy making arm, had raised the Federal Funds rate on two prior occasions before the latest rise on March 15, but the first move in December 2015 was hesitant and not repeated for another 12 months.

Fed policy participants are now speaking openly about having three rate rises in 2017 and another three in 2018.

While the Fed's policy settings will most directly affect, and are in response to, economic outcomes in the US, the external effects of its actions have always been highly material for the mining industry.

Ignoring the US lead would redirect capital flows and risk economic dislocation for a large number of developing and advanced economies. In a highly integrated economic world, there is no escaping the impact.

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The backdrop to the present rate rises is historically unique.

On no occasion over the past 60 years has a sequence of rising rates got underway while global GDP growth has been as low as it currently is. Nor have rates started to rise while growth in advanced economies has been slowing.

When rates have begun to rise in the past, growth has been unusually strong and policy changes have been used to engineer a slowdown.

A turn in the interest rate cycle has normally coincided with the best of times for the mining industry.

"The current, more ambiguous mix of policies is added evidence for a historically lengthy cyclical trough for the mining industry"

The growth picture is vitally important for the prosperity of the mining industry. Demand for mine output grows most quickly in the acceleration phase of the economic cycle and is highly leveraged to any slowdown.

If history is repeated, a cycle of rate rises would initiate a decline in the rate of global GDP growth. Raw material demand would, consequently, grow less quickly and, depending on the speed of the slowdown, possibly contract.

Slowing demand for mine output is likely to result in inventory accumulation especially since demand growth is already running below historical rates. Lower metal prices would ensue.

To the extent that higher US interest rates contributed to a stronger US dollar exchange rate, the downward pressure on metal prices would intensify.

Of course, it is not the primary intention of the Federal Reserve to impact growth but, as in earlier cycles, negative effects on activity are the way in which central banks temper inflation pressures.

How much of a policy tightening the US economy can withstand before growth is affected adversely remains uncertain.

As usual, the Fed is emphasising that subsequent moves will be data dependent but, for the time being, the central bank appears intent on getting back to a more neutral set of policies.

Removing the monetary stimulation in place for the past eight years would extend beyond interest rate changes. The Fed is also committed to disposing of its unusually large holdings of financial assets, which have grown from US\$906 billion in May 2008 to US\$4.5 trillion as the bank has intervened in markets to purchase securities.

The Fed has emphasised, in kicking off its policy normalisation process, that changes will be gradual. This will be an important difference with how rate rises have occurred in the past.

Most often, policymakers have feared losing control and have reacted with more vigour than would have otherwise been needed. The suddenness of policy changes has damaged economic activity and contributed to mining industry cyclical conditions.

On this occasion, the Fed is working within a relatively benign framework. In pushing interest rates higher, it is looking for more future policy flexibility rather than trying to avert an imminent problem.

Right now, the Fed lacks the monetary firepower to respond to a cyclical slowdown in growth, if one arose, insofar as it is already so close to the lower bound of feasible interest rates.

By slowing the pace of rate rises and keeping to a well publicised policy path, FOMC members will be hoping for their impact on growth to be minimised, while keeping a lid on inflation expectations and improving their longer-term policy flexibility.

An important element in the current policy mix is the scope for stronger growth through productivity improvements.

One of the benefits of the commitment to increased spending on infrastructure by the Trump administration is the potentially favourable impact on national productivity, which is growing more slowly than at any time since the end of the second world war.

Stronger productivity growth would help lift wages growth. With employment incomes accounting for over half of US GDP, they are an important force for improved global growth as well as a source of higher US growth rates.

Anticipated tax cuts in the US could also be expected to spur growth through higher investment spending.

With luck, the Fed may have been conveniently sidelined by what is happening on the fiscal side of the US policy process.

Rate rises may be sufficiently gradual for government investment, lower taxes and lowered regulatory burdens to have more influence on private sector spending decisions.

But, as the recently failed attempt to reform US health insurance policies has shown, diverse political agendas could easily stymie action with adverse effects on investment and growth just as interest rate rises are pushing in the same direction.

The best course for the mining industry would have been for declining interest rates as government stimulus loomed. Then, policy would have been unambiguously propelling the cycle.

The current, more ambiguous mix of policies is added evidence for a historically lengthy cyclical trough for the mining industry.

From an investment decision-making standpoint, the consequentially elevated opportunity costs suggest a still cautious approach to the deployment of funds into the sector is warranted.

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