

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

METAL PRICES: SOME THINGS DON'T CHANGE

Higher metal prices are a respite for mining companies but no escape from the long-term pressures dogging the industry. For some, rising prices are also a sign that the international economy is about to turn for the better. This interpretation of what is happening might be too optimistic.

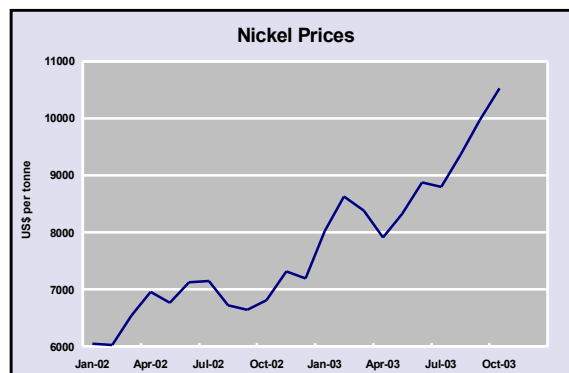
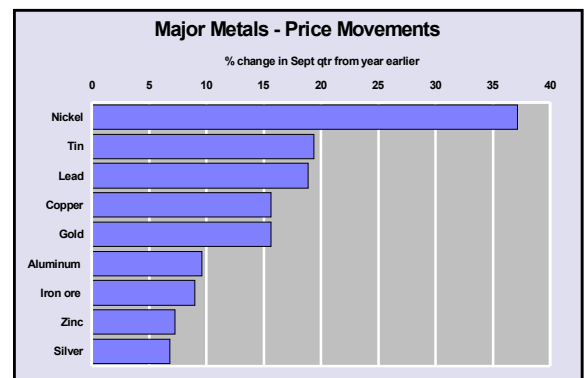
Most of the metal prices traded on international markets have risen in the past few months. The chart shows the change in prices between the September quarter and the corresponding quarter a year ago. There has been a general tendency to higher prices. Nickel has been the outstanding performer with a 37% rise over the period.

Metal prices depend on how demand and supply interact to affect stock levels. Higher demand on its own is not enough to induce a substantial rise in prices unless stocks have been run down to the point that the risk of shortage becomes meaningful for producers, users and speculators.

Similarly, reduced supplies can influence prices if production is curtailed to the point that the risk of shortage becomes more evident to all participating in the market.

A metal price cycle typically has six phases:

- Demand falls without any supply response causing a build up in stocks. At first, the price response might not be great.
- With continuing demand weakness, eventually stocks build to the point that no-one fears a shortage and the sentiment among speculators becomes distinctly bearish. At this point, prices change precipitously rather than gradually.
- Demand stabilises but stocks continue to build with producers reluctant to cut production because of the adverse impact of lower output on their unit production costs. Prices remain low.
- Production cutbacks begin as marginal producers are forced to close or, sometimes, lower cost producers decide to reduce output to bring about a change for the longer-term benefit of the industry. Stock levels are stabilized and then begin to fall. Prices remain low.

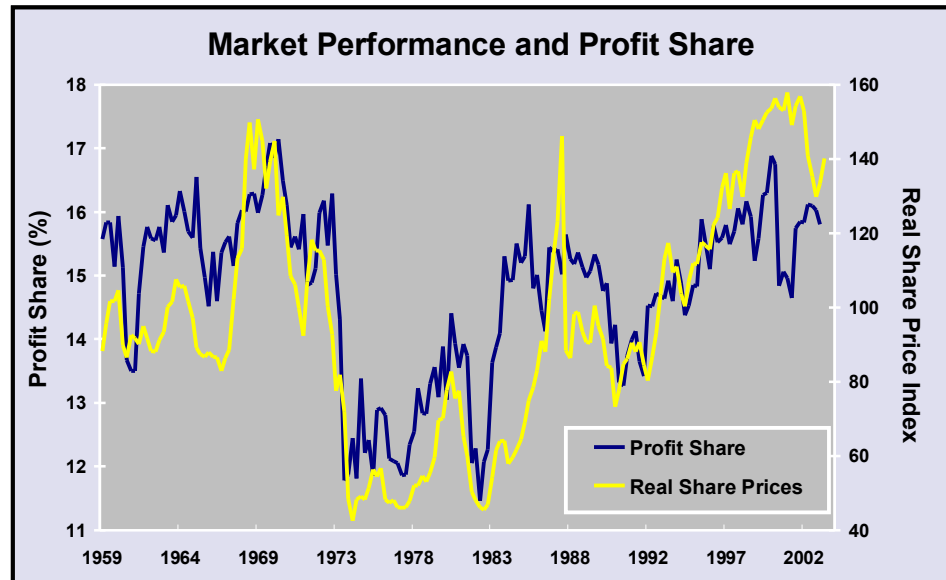


• As demand improves further, stocks are reduced to the point that the risk of shortages looms larger. There comes a point beyond which prices respond with often dramatic increases following even seemingly small changes in demand.

• Supplies are increased to take advantage of the higher prices and

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THE WEEKLY CHART SPOT



Source: Australian Bureau of Statistics, Standard & Poors and *thebigpicture* analysis

“...mining company investments offer few long-term attractions. There may be short-term opportunities to make money by riding the cycles but the long term offers a seemingly endless profit squeeze which makes it very difficult for miners to add value to the money shareholders might invest with them.”

The recent improvement in Australian equity markets seems to be anticipating something which is not yet evident in the macroeconomic data. There are three alternatives:

- data for the June quarter (and earlier) will be revised with the release of the upcoming September quarter statistics;
- the September quarter will show a robust improvement in business profitability; or,
- the market will weaken to reflect the current gap between stock market performance and economic outcomes.

The evidence from the reporting season points toward the second possibility. Even so, there is already a stretch between the market and business performance which would usually need to be closed before there can be more confidence of further market gains.

METAL PRICES: SOME THINGS DON'T CHANGE CONT'D

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on basic commodities becoming cheaper. International Monetary Fund analysis shows over 140 years of data that raw material real prices tend to decline by an average of 1% a year.

The chart of copper prices compiled by *thebigpicture* and shown on page 3 illustrates what has been happening over 200 years. Aluminium, a more modern metal, has tended to suffer the same fate over a shorter period as the second chart also shows.

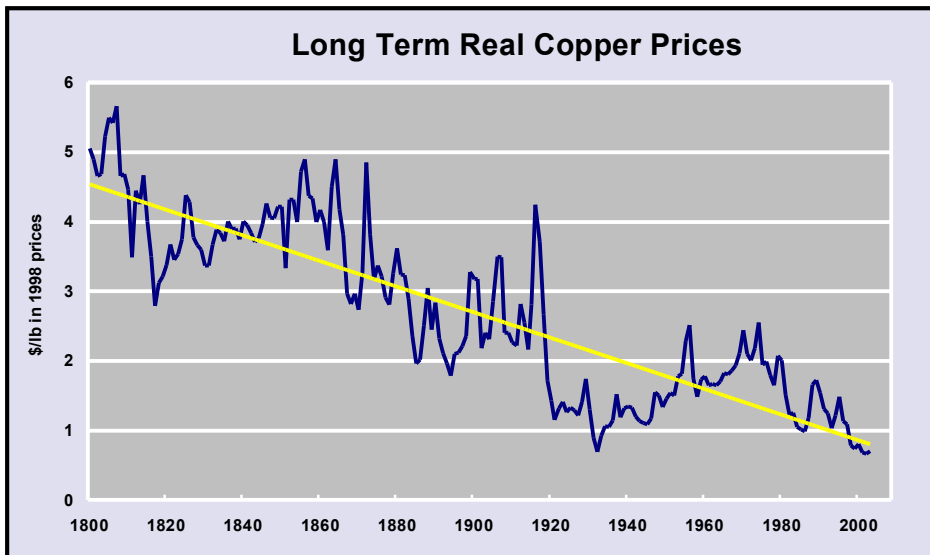
Miners are in a two-way profit squeeze. They face rising mine costs as their resources are depleted, on the one hand, and inexorably lower real prices, on the other. Occasionally, a production innovation might allow a step down in production costs but the reprieve is temporary at best. At worst, it simply helps to reduce the industry breakeven point, accelerating the rate of price decline.

In recent years, mining companies have been battling against this pressure as well as a prolonged slump in the economic performance of the western economies. Prices have been pushed well below their trend real values.

Being so low, there is scope for higher prices in the shorter term as the historical market imbalances reverse themselves. However, history says quite unambiguously that this will only be temporary and that the continuing cycle will force them down again.

For investors, such an outlook implies that mining company investments offer few long-term attractions. There may be short-term opportunities to make money by riding the cycles but the long term offers a seemingly endless profit squeeze which makes it very difficult for miners to add value to the money shareholders might invest with them.

METAL PRICES: SOME THINGS DON'T CHANGE CONT'D



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improved levels of offtake.

With this pattern well-established, the equity market treats higher prices with some scepticism. The equity market response is often muted and assumes that the higher prices will be short-lived.

Whether lower production rates or improved demand drives metal prices is a matter of conjecture: both blades of the scissors are necessary to cut the paper. The key determinant is how the market balance affects the level of available inventories. The inventory level is a measure of the risks for users, producers and speculators.

If production cutbacks are large or prolonged enough there might not be any need for higher demand to elicit an improvement in prices. To that extent, better prices may not signal any underlying improvement in demand or that general

economic conditions are on the up.

Currently, high prices reflect lower levels of capacity utilization among metal makers and the continuing strong growth in Chinese industrial output.

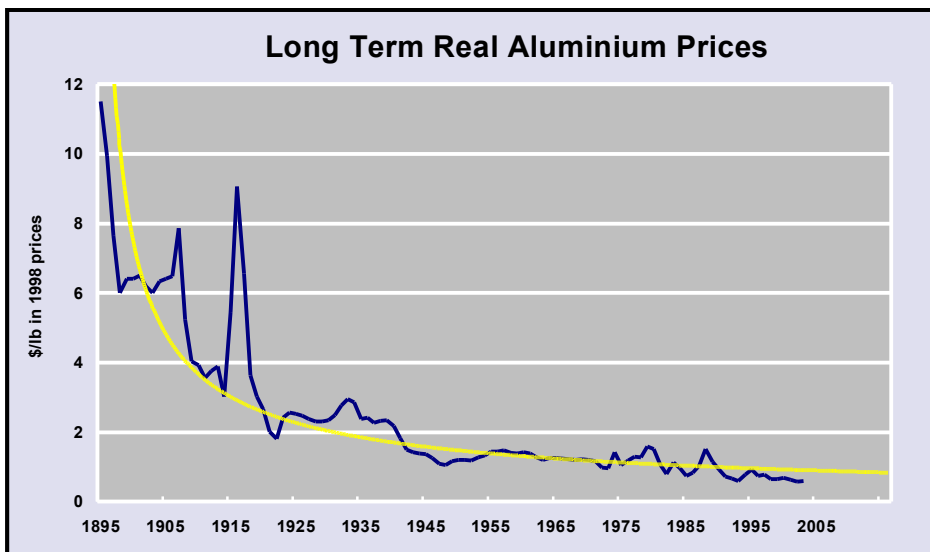
China has been able to achieve annual GDP growth consistently approaching 8%. Available supplies of metal are being exported to China to service this outstanding output growth depleting already low stock levels and placing upward pressure on prices.

In the short term, the improved prices will be beneficial to the mining industry. The improvement, however, will do little to change the long-term declining trend in metal prices faced by the industry.

That metal prices decline in value should be no surprise. Human progress depends

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HOUSING: MOVING TO THE COUNTRY

The solutions to rapidly rising metropolitan housing prices and diminishing populations in regional centres seem to be converging.

Ever since Lachlan Macquarie's day it has been progressively harder to get one's first choice housing location.

No doubt Bennelong's offspring would have lamented the Europeans blocking them from the shores of Sydney harbour where their parents had once settled. Similarly, some early European settlers would have complained at being forced to the outskirts of Parramatta, not being able to afford anything closer to the city.

Once private ownership of land was allowed, no government could guarantee that first home buyers would have access to a housing stock located with that of earlier generations. To even hint otherwise is misleading.

Nonetheless, the Productivity Commission has been given the job of inquiring into first home ownership with the hint that something can be done to avert these forces. The Commission has issued a discussion paper outlining some of the matters it thinks should be reviewed in the context of its enquiry.

The commission has quite correctly noted that affordability, however that might be defined, depends on preferences regarding the location, quality and size of dwellings that potential buyers might seek.

This leads to the fundamental question politicians have been ignoring. What do first home buyers want? Are they disadvantaged by the price of housing in the eastern suburbs of Sydney rising fourfold?

The Productivity Commission framed the relevant questions in this way: "Have first home buyers' preferences or aspirations changed concerning housing size, quality or amenity? Where are first home buyers purchasing? Do they still buy at the urban fringe?"

And, if they buy at the urban fringe, is there a need to worry about inner city prices (at least in connection with the plight of the first home buyer)? And might

not buying at the urban fringe simply reflect relative prices which are a direct consequence of private land ownership, something not about to be changed?

If relative prices do influence where first home buyers are likely to settle, does land in regional centres become progressively more attractive?

Australia has had a poor record of promoting non-metropolitan areas as residential centres. The last serious attempt at doing so was by the Whitlam government.

Here again, the Productivity Commission has flagged that it will venture over fundamentally important ground by raising some key questions:

- Could regional development policies improve affordability in metropolitan areas?
- What impact would improved transport links between cities and regional areas have on regional employment opportunities or in allowing employees to commute from regional areas to urban areas?
- What would happen to housing prices and affordability in the targeted growth areas?

Coincidentally, the Victorian state government has commenced a campaign this week to highlight the virtues of Victorian regional centres as places to live.

At the New South Wales state conference of the Labor Party, both state and federal leaders pledged a more concerted effort to rebuild regional Australia.

Anecdotally, there are also increasing numbers of people who are prepared to forsake the apparent benefits of city living for the 'sea change' of life in rural or regional Australia.

Personal preferences and price signals are coming together to force changes which might have been beyond governments alone. The key question now is whether the economic forces are sufficiently strong that governments are tempted to support the momentum to help recast the Australian demographic landscape.

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