thebigpicture

guideposts for the private investor

Week Commencing 5 July 2004

COMMODITY PRICES: 'THE QUICK AND THE DEAD'

High commodity prices have raised expectations about the performance of resource sector equities. However, some forecasters are expecting commodity prices to weaken in the 12 months ahead. This is the riskiest part of the cycle for equity investors despite company earnings looking so buoyant.

The Australian resource sector has long been used as a leveraged play on global commodity prices. Interest in using it for this purpose remains despite its relative importance halving to just over 15% of the Australian market's capitalization over the past decade.

The Reserve Bank's US dollar base metals commodity price index has risen by 33 percent during the past year and the prices of the resource stocks in the Australian S&P 300 have risen by 35 percent. Within the commodity sector, stand-out products such as nickel and thermal coal have risen by much more than the averages with increases of 66 percent and 132 percent, respectively, over the year.

An equity investor needs to judge:

- how long commodity prices will stay high; and,
- how much of the higher prices has already been embedded in company share prices.

"An investment in a commodity producer faces a long-term value squeeze with output prices being pushed lower at the same time as company costs are rising…."

Macro Indicators

On the first point, there are usually two ways to proceed. One is to use general macroeconomic indicators as proxies for industrial raw material demand and try to forecast commodity price changes by forecasting changes in the momentum of economic activity.

One such relationship is illustrated in the first chart which shows movements in the OECD's composite leading indicator (yellow line) and movements in the International Monetary Fund's metal commodity price index (blue line).

The leading indicator, designed to anticipate changes in economic conditions six to nine months ahead, has peaked in this cycle pointing to a downturn in economic activity during the second half of 2004.

Given the relationship between the two series, history would also suggest a high probability of the activity downturn being accompanied by a commodity price downturn.

Using this indicator, an investor would have been seeking to increase exposure to commodity prices in the first quarter of 2003 and would be looking to begin reducing this exposure now.

Micro Indicators

One shortcoming of this approach is that it does not take account of movements on the supply side of commodity markets. Confronted by the same set of macroeconomic circumstances, aluminium prices, for example, have risen by only 16 percent over the past year, just a quarter of the nickel price gain. One of the reasons for the performance differential is that aluminium production rose strongly as demand was rising while the supply response within the nickel industry, faced with a similar increase in demand,

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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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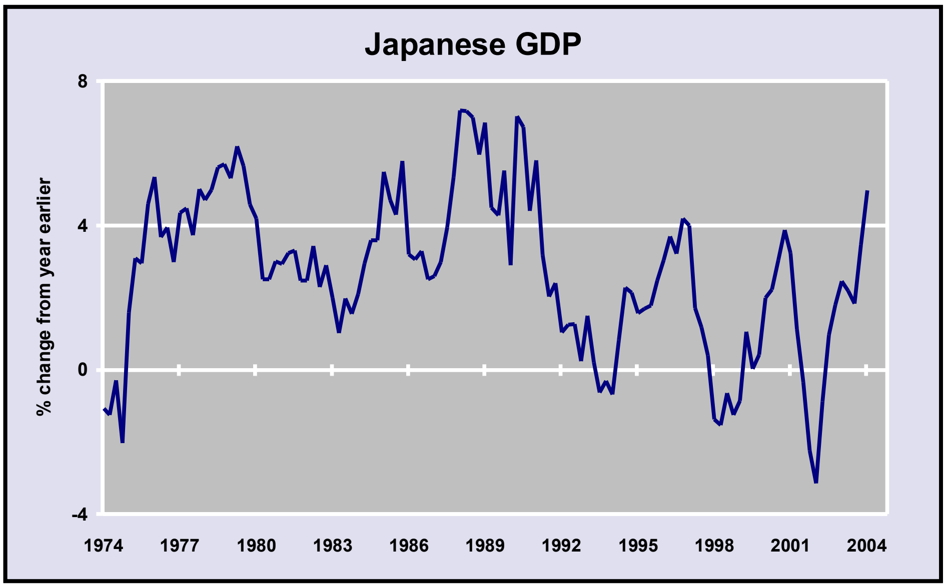
The Weekly Chart Spot



Source: Japan Cabinet Office

Good economic news out of Japan has been rare but there have been signs of a recovery in activity over the past 12 months. GDP grew at 5% over the year to the March quarter. However, the growth upturn is eerily similar to others in the past ten years which have quickly dissipated contributing to a dismal record of three recessions in a decade. We need to see some more evidence through the door before concluding that Japan has overcome the constraints on its growth and is able to lock onto a sustainable growth track.

Commodity Prices: 'The Quick and the Dead' cont'd

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was more muted.

The response difference affected the level of inventories which is the critical guide to commodity price movements at the individual product level.

Inventory levels indicate the ease with which users of commodities can gain access to material when it is needed. They are a measure of market risk. When their levels are very low relative to total demand, the riskiness of supply disruption rises. This risk factor is reflected in short term prices.

When inventories are already low, small reductions can elicit a disproportionate price response as users panic, speculators are attracted to the market and the risk premium adjusts.

When inventories are relatively high, on the other hand, even large falls might not cause any significant change in prices since the likelihood of supply disruption is not changed greatly. The price response curve is highly non-linear.

China: Over-rated?

In this cycle, there has been widespread discussion about the role of China. The Chinese economy has been expanding at an average rate of eight per cent a year for the past five years. Industrialization has created demand for raw materials which cannot be satisfied from Chinese internal sources. In some commodity markets such as coal, of which China is a significant exporter, its exports have been curtailed to meet domestic demand.

The strength of the Chinese expansion has been reflected especially in coal, iron ore and alumina shipment growth by Australian companies.

The Chinese influence is important but risks being overstated.

The upsurge in Chinese demand has influenced prices in part because the mining industry had not fully anticipated the extra demand which would be generated from Chinese industrialization and had underinvested when prices were lower.

Even if Chinese raw material demand continues to grow, as it is likely to do, the pressure on prices could be easing as the industry supply response catches up and the risk to material availability is reduced.

Nonetheless, the combination of strong shipment growth and higher prices is supporting strong earnings growth for Australian commodity producers. For example, consensus earnings growth rates for BHP and Rio, Australia's two main listed diversified resource houses, are an average 51 percent and 49 percent, respectively, over the coming two financial years.

Commodity producers will only be able to achieve a sustainable income gain, however, to the extent they can deliver against

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COMMODITY PRICES: 'THE QUICK AND THE DEAD' CONT'D

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the higher volumes demanded by the Chinese users. High short term prices will pose an ongoing risk that investment in additional capacity will be attracted and that increased supplies will place downward pressure on prices as they have done in past cycles.

ABARE Forecasts

The Australian Bureau of Agricultural and Resource Economics (ABARE) deploys considerable manpower in analyzing these markets and forecasting prices. Two weeks ago, it published an update of its commodity price forecasts and a detailed review of the impact of China on these markets.

In general, it expects prices to be lower in 12 months time than they are now.

Underpinning this view is an assumption that the global economy will be growing less strongly than it has been. Included in that is a slowdown in China where authorities are expected to curtail activity to prevent continuing strong growth from raising inflationary expectations.

The impact on overall demand is not expected to be great since ABARE is anticipating only a relatively modest slowdown in activity. However, it is occurring at a time when prices will be at their most responsive to any change in inventories.

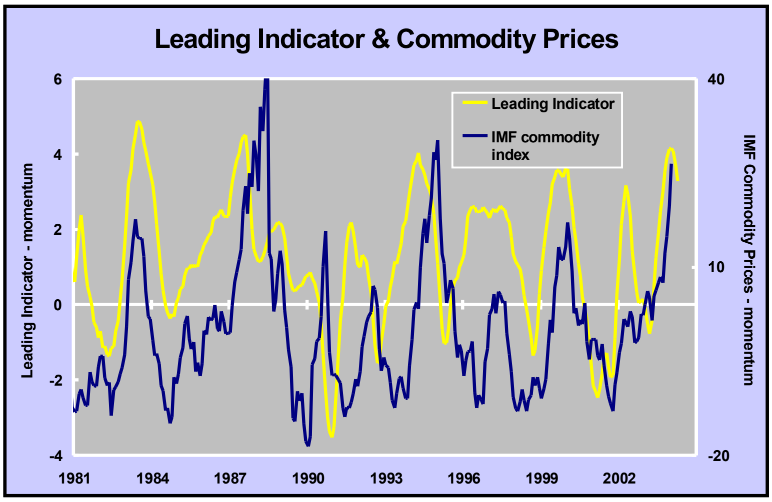
That said, ABARE does not expect all markets to be equivalently balanced. The nickel market is the one ABARE foresees as having the tightest inventory position. Despite ABARE suggesting that nickel prices are going to be lower in the year ahead, only small changes in assumed conditions could mean that prices are sharply higher and ABARE has signaled this as a risk for the next several months.

In the case of nickel, a 20-30 per cent rise in price in the short term might be plausible and still consistent with the price ending the next 12 months lower than it currently is. Given how responsive prices are to changes in the market balance, the chance of a price fall is also higher than usual. In fact, the riskiness could almost be symmetrical with an equivalent probability of a 20-30 per cent price fall.

Market Value Impact

These possible outcomes imply a probability adjusted expected return from an investment in nickel of zero. Under these circumstances, equity investors are placed in an especially awkward predicament.

Equity values generally do not reflect the full upside potential in commodity prices (just as they do not reflect the full downside at the other end of the cycle). Markets implicitly normalize cycles when they are valuing commodity stocks by pricing in what are regarded at the time as sustainable product prices.



The difference between spot prices and sustainable prices can be seen in the difference in cash and forward prices quoted on the London Metal Exchange, for example.

On 2 July, the cash settlement price for nickel was at a 56% premium to the 27 month forward price for the commodity. The cash price is only relevant for someone seeking to buy metal for use now. The market is saying that it expects conditions to ease over time as supply adjusts to the higher spot prices.

This explains the tendency for price-earnings ratios among resource companies to be relatively low near the top of a cycle and to be relatively high at the low point in the cycle. At the peak in the cycle, prospective earnings will always be thought likely to fall.

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"Investors should, therefore, be cautious about initiating positions in companies based on commodity price movements in the latter stages of a cycle no matter how bullish some of the commentaries appear to be about the underlying commodity markets."

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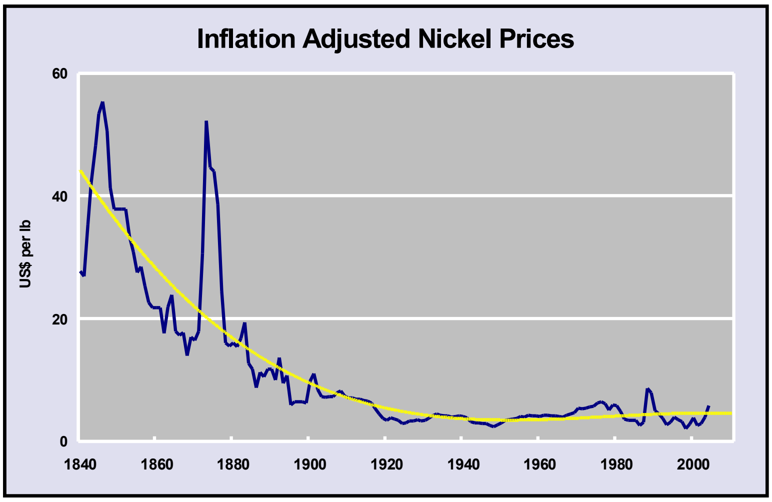
In contrast with industrial company investments, it is often more appropriate to sell low p/e resource stocks and to have bought when the p/e's were high.

Investors should, therefore, be cautious about initiating positions in companies based on commodity price movements in the latter stages of a cycle no matter how bullish some of the commentaries appear to be about the underlying commodity markets. Just remember, a turning point always occurs when market participants have been at their most bullish.



The psychology in approaching a commodity-related market needs to be different to the approach one takes in the equity market when valuing industrial or finance companies.

Equity prices tend to rise as industrial company profits grow over the longer term. Losses from a poorly performing investment in the short term can often be recouped with the passage of time since profit growth will carry equity values higher.

For commodity prices, however, the pressures are in the other direction. Commodity prices tend to fall over the long term. ***thebigpicture*** has reviewed lengthy histories (e.g. 200 years of copper prices) to verify this. There is also research from economists at the International Monetary Fund[1], for example, with the same conclusion.

As an illustration, the chart shows inflation adjusted nickel prices over the past 165 years. Even in the context of currently bullish sentiment about the nickel market, nickel prices are still in a long-term downtrend.

A misstep at the top of the price cycle will not be bailed out over time in the same way an industrial company investment might be saved.

An investment in a commodity producer faces a long-term value squeeze with output prices being pushed lower at the same time as company costs are rising due to the depletion of its resource base.

An investor in resource sector equities has three forces heightening the risk in the latter stages of a commodity price cycle.

- Share prices will not fully reflect the peak in commodity prices since the market tends to discount their sustainability.
- Commodity prices are prone to be more volatile as the end of the cycle approaches.
- Even apparently high current prices are within a long term trend for real commodity prices to be declining as production costs rise.

At this stage of the cycle, there might be scope for the deft speculator to take advantage of the inherent volatility in equities and commodities. However, there are only two types of participant here: the quick and the dead.

An investor, on the other hand, needs to be more focussed on risk management with decisions reflecting the probability and risk attaching to the possible outcomes.

"The upsurge in Chinese demand has influenced prices in part because the mining industry had not fully anticipated the extra demand which would be generated from Chinese industrialization and had underinvested when prices were lower."

1. "The Long-Run Behaviour of Commodity Prices: Small Trends and Big Variability", IMF Staff Papers, Vol. 49, No. 2, International Monetary Fund.

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