

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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A VERY STRANGE RESOURCES CYCLE

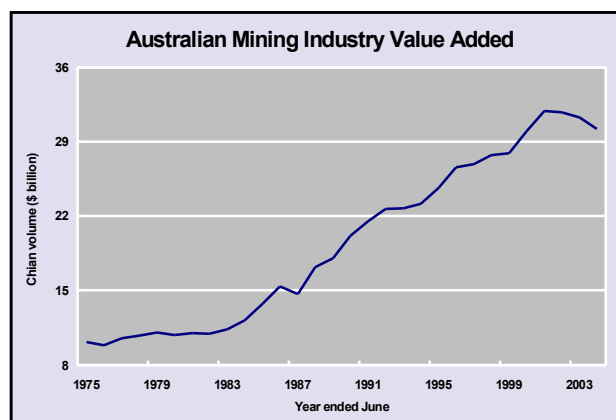
The structure of the current resources cycle is unusual and more risky for investors than the typical pattern has been. China is on its own as a driver of demand and, in Australia, there is little overall industry growth to create value for investors.

Resources sector cycles follow a well-worn series of steps reflecting the positive impact of a global economic cycle.

- Demand rises reducing industry excess capacity but with little price impact initially.
- Further increases in demand begin to deplete accumulated inventories but as long as they remain high, the price impact is still quite muted.
- Further increases in demand begin to push inventories lower until they reach a critical point at which the perceived risk of shortages rises. At this point, the price response might be quite dramatic. This is the cyclical upturn.
- Time elapses as plans for new capacity are dusted off and companies (and banks) begin to feel comfortable about financing new projects. Exploration spending is stepped up, old operations are resurrected and secondary material is attracted from old uses by higher prices.
- With these supply side adjustments being largely uncoordinated, they exceed what would have been required to meet additional demand.
- The cycle begins to reverse as fears of shortages dissipate and a slight hint of inventory accumulation causes speculators to flee and prices to drop precipitously.
- Inventories continue to build. Most of the price fall has probably occurred but there might be a prolonged period of oversupply with prices hovering around the industry's average costs of production.

“...investors will have to choose stocks more carefully than usual to ensure access to the growth oriented producers that are adding value”

Some are suggesting that this cycle will be different because China has emerged as an industrial power. However, the current resources cycle is not as simple as China being overlaid on a global economic upturn, as some commentators are suggesting when they draw the analogy with Japan in the 1950s and 1960s supplementing post war growth in Europe and the USA.



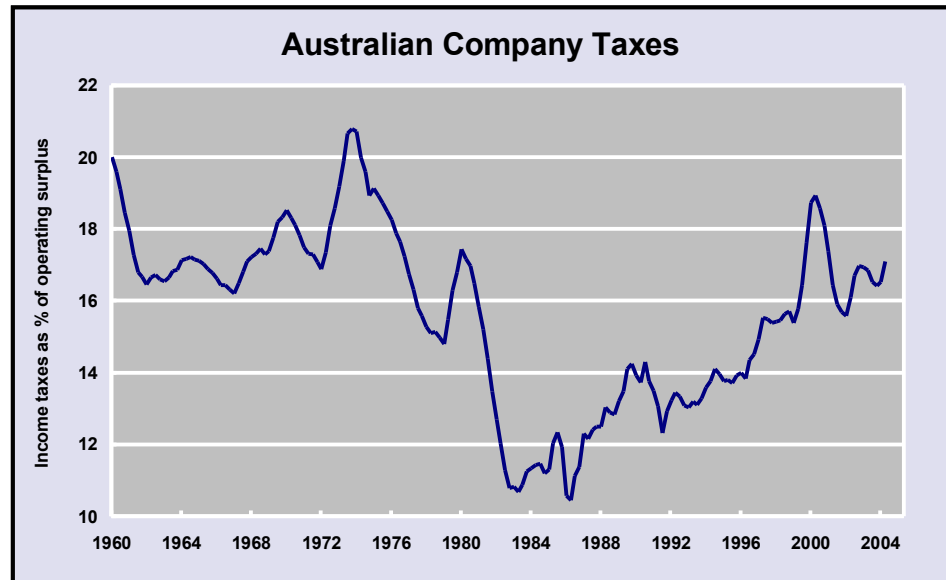
We are in the midst of a highly unusual cycle with global investment weakness and a China overlay.

The International Monetary Fund estimates that China now accounts for 13% of world output compared with the 21% contributed by the USA and the 56% contributed by the 29 advanced economies.

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THE WEEKLY CHART SPOT

Australian companies have been paying a rising proportion of income as taxes since the relatively depressed days of the mid 1980s. Cyclical recovery and more aggressive policing of tax compliance have raised the take and helped to support government budgets. However, without a rise in the tax rate - which no-one is seriously suggesting - there will be a ceiling to the share of income going in taxes. With growth in taxes more closely matching income growth, some of the easy revenue opportunities for government budgets will have been lost.



Source: Australian Bureau of Statistics

GOOD NEWS FROM THE RESERVE BANK CONT'D

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higher interest rates will have to move. Of course, the higher they are pushed the more extensive will be the economic damage in terms of capital and labour unemployment.

In Australia's history, until the current cycle, the economic damage associated with policy adjustments was often considerable.

The chart illustrates the growth and inflation pattern which has dominated economic policy in the past four decades.

The yellow line measures the difference between actual GDP and what GDP would have been if it had grown at the long-term trend rate of growth. A declining number means that the economy is growing below trend and potentially creating excess capacity. A positive number suggests that the growth rate is moving at an unsustainably fast pace.

The blue line is the rate of consumer price inflation over the same 45-year period. Early 1970s capacity constraints translated into an inflation environment which persisted through most of the following two decades. A prolonged and arduous adjustment culminating in the policy induced excess capacity of 1990-91 brought inflation to heel.

The second and far less dramatic adjustment route is for domestic demand growth

to moderate and re-align itself to the growth in capacity in the way foreshadowed by the Reserve Bank Governor. This would be unusual and only likely to happen if the prospect of higher prices is quickly recognised as a signal to cut back on demand. This might be the case if business and consumers felt they would not be able to get higher incomes to compensate for higher prices. In other words, their expectations would be radically different from what they might have been in the 1980s.

There have been some significant changes since the last occasion when capacity constraints were a serious topic of conversation in Australia. Critically, the wage fixing system is less likely to facilitate a hike in inflation expectations. Goods markets are also more competitive with fewer trade restrictions.

With these changes, the emerging capacity constraints might not represent a threat to economic stability of the sort Australia has seen before but, consistent with other changes in the Australian economy, might be an automatic braking mechanism.

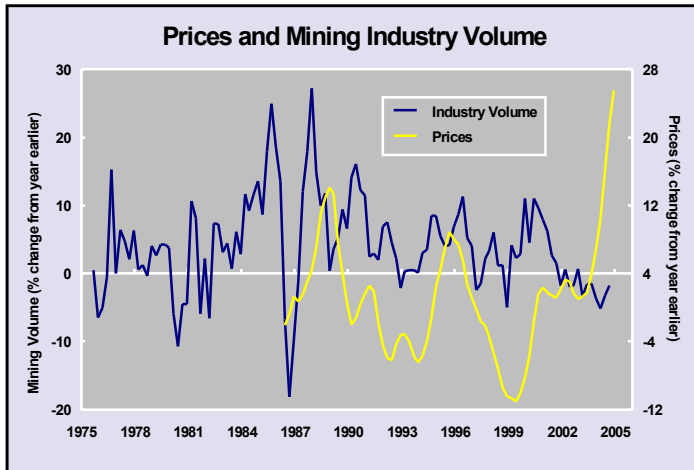
The Governor hinted at this possibility, comments. If this optimistic view is right, investors would be able to look through the impact of a limited rise in interest rates and focus on the longer-term value impact on companies having the benefit of such a benign economic environment. ■

A VERY STRANGE RESOURCES CYCLE CONT'D

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While it remains relatively small, China's growing economic clout is just sufficient to offset the marked investment weakness apparent in the more advanced countries.

When Australia had more locally based large resource companies, they might have also been more focussed on expanding the local industry. They were actively looking for growth opportunities to fund and would typically make large commitments to infrastructure developments to ensure that mines and processing initiatives could proceed. Often financial returns were inadequate. Nonetheless, the development culture which supported investment was more obvious.



The dependence on a sole driver in this cycle makes it more risky than others which have typically had a broader global base.

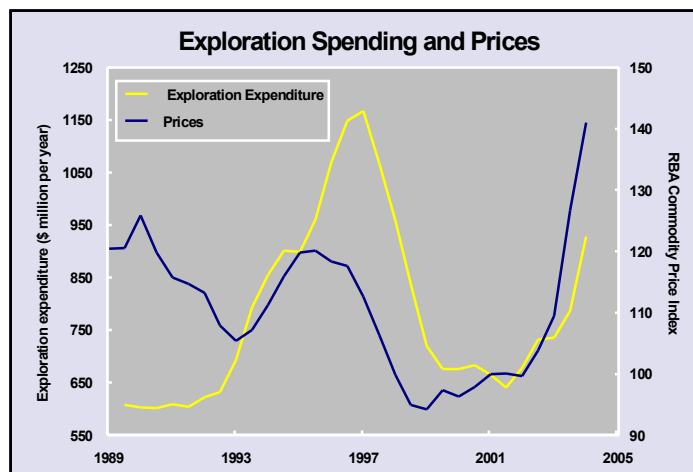
Another reason this cycle is more risky for investors is the subdued organic growth profile of the industry in Australia. In the 20 years after 1980, mining sector value added grew at an average annual rate of 5½%. However, it was 6½% lower in the September quarter of 2004 than it had been in mid 2002.

The recent divergence between prices and output illustrated in the chart is surprising in an industry which is usually more nimble in responding to short-term price signals.

There are some conspicuous examples of companies expanding their output but there are also some influences reflecting structural changes in the industry and limiting the speed of the responses.

With fewer large companies listed in Australia, new developments are now dependent on smaller companies with less financial firepower. Without existing banking facilities to fund new production, for example, it is not surprising that the response is slower.

Exploration expenditure has begun to increase, signalling that a supply adjustment is happening. According to the last survey by the Australian Bureau of Statistics, the industry thought mineral exploration spending in the six months to December 2004 would reach \$521 million. If that has happened it would be the highest level of spending since the six months ended December 1997 and a 37% rise over the ac-



tual December 2003 expenditure.

Against this backdrop, it might be tempting for an investor to rely on the two most prominent but risky parts of the sector, namely, early stage explorationists where there are already clear signs of activity or companies with little organic growth but benefiting from the windfall which comes with cyclically high selling prices.

To mitigate these risks, investors will have to choose stocks more carefully than usual to ensure access to the growth oriented producers that are adding value through expanding production. ■

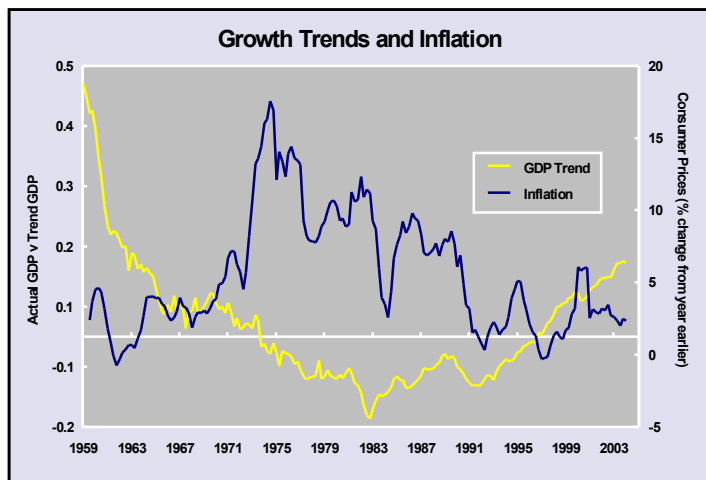
“While it remains relatively small, China’s growing economic clout is just sufficient to offset the marked investment weakness apparent in the more advanced countries.”

GOOD NEWS FROM THE RESERVE BANK

The Australian economy is approaching a critical junction. Something has to change. Growth in demand must fall to better reflect the capacity of the economy to deliver. Otherwise, interest rates have to rise.

The Governor of the Reserve Bank flagged a change in the economic landscape on Friday when he testified at a meeting of the House of Representatives Standing Committee on Economics, Finance and Public Administration. He suggested Australian economic growth is likely to be slower and inflation faster than we have been experiencing in the past few years.

The Bank expects growth to be a percentage point or so lower than it had been and inflation to be at the upper end of the 2-



3% targeted band in the coming year.

Such a switch to lower growth and higher inflation could have set off alarm bells. However, There was nothing at all alarmist in the Governor's conclusion that "demand has already started to slow somewhat and it is getting closer to the growth of output". In observing that "GDP is also starting to slow under the constraints imposed by capacity limitations", he seemed to be taking the change very much in his stride.

The Governor did not say this but such an outcome could be a particularly good backdrop for equity investors. A lull in growth might allow a comfortable eco-

nomie transition as business expands capacity through new investment and labour training. Having done so, growth could possibly accelerate, all without the need for any substantial policy adjustment.

In other words, interest rates would not be far from their cyclical peak at the moment and earnings growth would accelerate again after only a brief lull in the year ahead, if this view was correct.

This somewhat sanguine view of the world is very different from the way Australia typically made the transition in the past. Generally, there are two ways to proceed and the first bumpier route has been the one more frequently travelled by Australia.

Typically, if domestic demand growth exceeds output growth, additional supplies would be brought from offshore. That would mean a higher balance of payments deficit. If Australia is unable to attract enough capital to fund the shortfall, eventually there would be some downward pressures on the exchange rate. In theory, the exchange rate could fall until it stifles the excess demand or makes exporting sufficiently attractive to redress the payments imbalance.

The lower exchange rate would make imported goods more expensive and potentially raise the rate of inflation. Depending on what this does to inflation expectations, the change might encourage people to seek higher incomes (wages or profits) to compensate for a still higher rate of inflation. There might come a point at which the expectation builds and it becomes more and more difficult to restore some form of acceptable equilibrium

At this point (or even earlier), interest rates would have been pushed higher to stifle domestic demand. The later this step is left the harder it will be for the policy change to have an impact and the

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