BASE METALS –THE FUTURE

CAN PRICE RISES BE SUSTAINED?

by NORMAN MISKELLY

Worldwide patterns of economic growth are having a profound effect on the present and future prospects for base metals producers. Prices have risen, but can the rises be sustained?

To be able to appreciate fully where a sector of the economy is heading, it is important to know where it has been and where it stands now. Perhaps the best perspective on the mining industry was given by Mr Allen Sykes of Consolidated Gold Fields at the annual meeting of the Institution of Mining and Metallurgy in London during May this year. I quote quite extensively from the account of this meeting, given by the London based *Mining Journal*, because it puts the past into better perspective.

"For those longer-serving members of the international mining industry, the 1960s still offer fond memories since that was a decade in which the industry embarked upon its greatest period of expansion this century. Conventional wisdom today sees the 'Golden 1960s' as a period of continual expansion of the mining industry in sharp contrast to the conditions which have prevailed for the past 15 years or so.

"Without doubt, the 1960s were marked by rising demand for minerals, with world economic growth rates at their highest levels in recorded economic history as countries sought to make good the shortfall of the war years and satisfy the pent-up demand for consumer durables, houses and commercial and industrial construction. The decade was also marked by the emergence of giant natural resources and energy projects which were needed to meet the unprecedented demand. Unfortunately, this expansionary phase was brought to a grinding halt in 1973-74 with the first major oil crisis. Since then the international mining industry has virtually despaired of ever again witnessing the favourable business conditions of the 1960s.

"The foregoing will contain nothing new for those closely involved in today's mining/minerals business. It represents a summary of the introductory remarks made by Mr Allen Sykes of Consolidated Gold Fields at last month's annual dinner of the Institution of Mining and Metallurgy in London. However, the speaker went on to question this 'conventional' interpretation of events since 1960, noting that although the international mining industry was undoubtedly expanding during the 1960s, in real terms 'the prices for the majority of mineral products rose but little'."

Since the early 1970s, real prices of the major minerals have declined sharply (the recent surge excluded), whilst demand has grown slowly in most cases and actually fallen in some — tungsten and bismuth being two good examples. The point that Allen Sykes emphasised was that many have equated the prosperity of the mining industry in the 1960s with both rising real prices and rising real demand. This is not correct. Real prices did not rise very much — it was demand which was

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rising and it was this which brought prosperity to the market. For Australia in the 1960s the major feature of the mining industry was the opening of new mines to supply the burgeoning Japanese iron and steel industry — coking coal, iron ore and nickel.

The normal pattern of demand and supply is for supply to catch up fairly quickly on any prolonged consumption expansion — to have even stable prices, much less steadily increasing prices, is the exception rather than the rule. The cargo cult mentality which pervaded the thinking of many people in Australia, especially the politicians, over a decade ago is evidence this important axiom is often overlooked.

According to Sykes, and I'm sure any keen student of mining history would agree, in the 1970s and 1980s the world mining industry has been, and still is, experiencing the more normal pattern of falling real prices and precarious demand.

In a sense, the world economy is still suffering from the radical changes wrought on it by the unprecedented increases in oil prices in the 1970s and the consequent disruptions. Although most economies have recovered since then, the upswing has been uneven and patchy and mostly restricted to the US and its partner in recovery, Japan.

The Lesser Developed Countries suffered more than the OECD countries, due to their reliance on commodity exports. The great demand boost which was predicted in the 1960s for the rest of the century, as the poorer nations narrowed the gap in the economic growth race, just didn't occur.

In the OECD countries, the predominant consumers of metals through industrial production, low rates of economic growth compared with the 1960s, together with substantial substitution of new materials for the older traditional metals, combined to cause a virtual no-growth metal consumption scenario over the past 10 to 15 years.

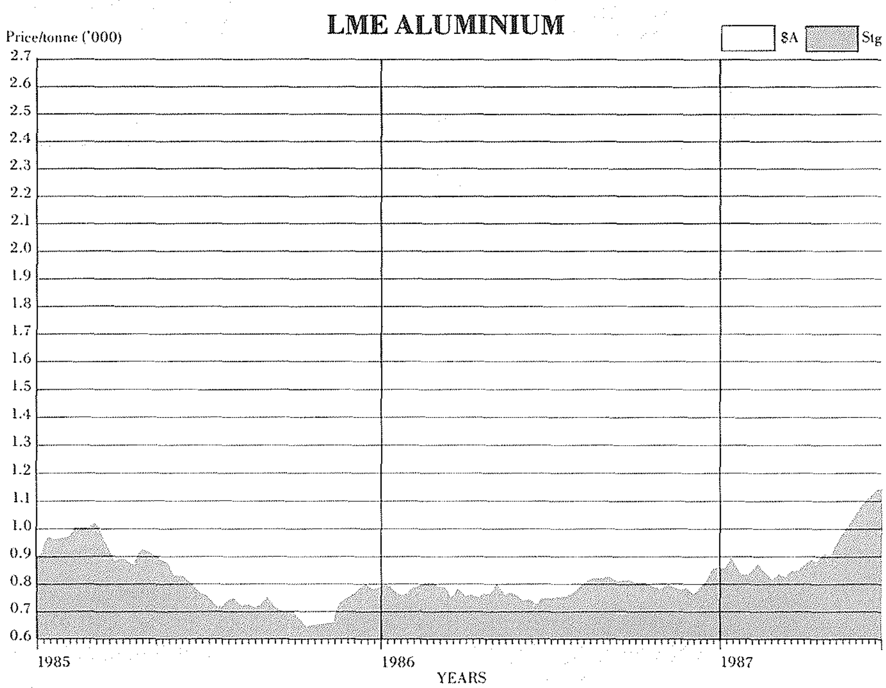
Furthermore, most of the growth in the OECD countries has been in the service industries, especially communications, technology and leisure, rather than in the "smokestack" sector, such that the intensity of use of metals has declined by perhaps around 20 per cent per unit of OECD GNP growth. Just-in-time inventory management exacerbated the consumption pattern to the detriment of metal producers.

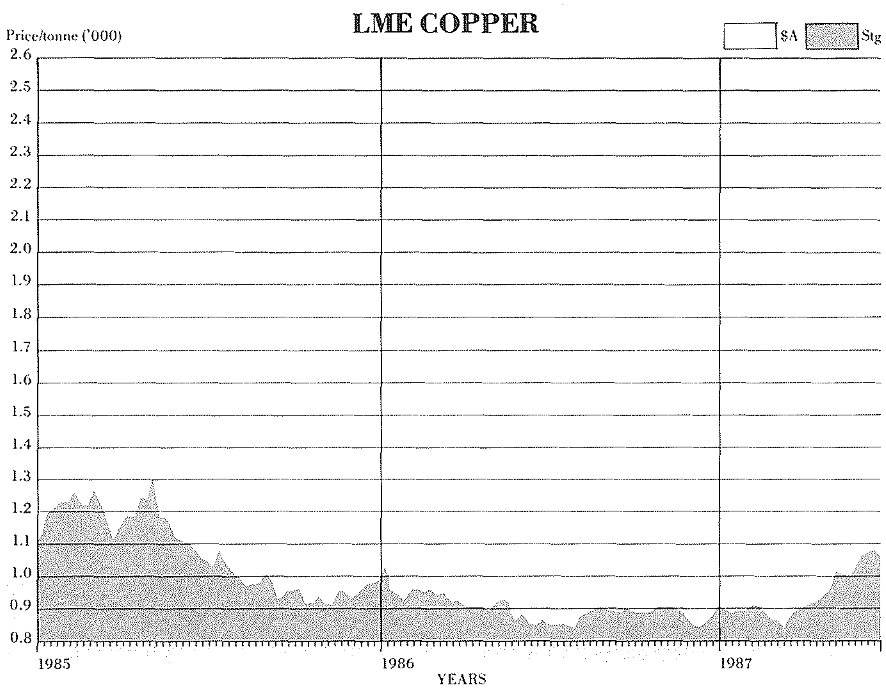
To quantify this, Metals and Minerals Research Services, London, in their *Metals Analysis and Outlook* last year pointed out that whereas OECD industrial production had increased by more than 25 per cent above the level recorded in 1973, before the first oil crisis, and by 13 per cent above the level of 1979, before the second, base metals consumption had increased just 5.5 per cent since 1973, and it was actually 2 per cent below that of 1979.

Metals and Minerals Research Services also calculated that in contrast, as a direct consequence of both high metal prices and strong demand in the mid-to-late 1960s, and subsequent periods (1973/74 and 1979/80) as well, primary base metals production capacity has increased by some 25 per cent since 1973.

With consumption lagging this by an ever-increasing margin, the metals industry has found it necessary to progressively reduce capacity utilisation rates in order to balance supply with demand.

Unfortunately, the western world producers have had to bear the brunt of the capacity cut-backs, since LDC





producers, especially in Africa and South America, for reasons relating to the need to maintain foreign exchange earnings and internal employment levels, have been insensitive to lower prices and have, contrary to economic rationality, usually responded by increasing production.

For some time now Ord Minnett's viewpoint has been that the world economy faces the prospect of an unavoidable and deep recession, although it is difficult to be precise on timing. This recession should arise out of the present circumstances in which current spending is being supported by consumption of wealth, especially in the United States. It will most likely represent a process of structural adjustment in the world economy, whereby spending is reduced to more tenable levels and resources are transferred to more productive activities. Accordingly, a recession should not necessarily be viewed as a "bad" thing in the present circumstances.

The factor which we see as forestalling the necessary and natural adjustment is the attempt by governments to maintain high economic activity through the use of stimulative policies. In addition to the usual politically-motivated desire for high economic growth, the rationale for stimulation is being reinforced by a fear that weaker economic activity could lead to debt-defaults. However, usually stimulative government policies lead to further wealth-consumption (including a build-up of the debt structure), making an adjustment in current spending levels even more imminent and desirable and much more painful.

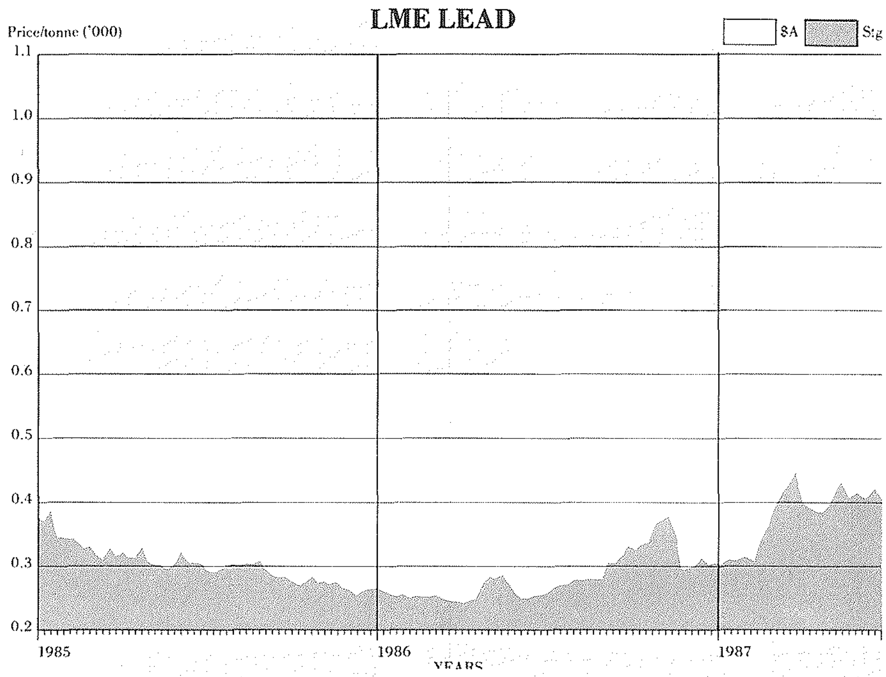
Politicians being as they are, there will be a tendency to pursue stimulative policies as long as politically feasible. The most obvious event which could turn up the pressure for a more restrictive stance is an escalation in measure price inflation and inflationary expectations. Indeed, we have already seen a marginal tightening in the US, following a rise in inflationary fears and $US weakness in April 1987, although this appears to have been compensated for by more stimulative policies in other nations. It is difficult to foresee *when* escalating inflationary expectations, or any other factors, will become sufficiently powerful to over-ride the aversion to policy-tightening, but this holds the key to the timing of the world recession we foresee. For the purposes of this report we will *assume* that developments along this line will occur in the *first half of 1988*. Below we outline the trends we see in some economic variables which are most relevant for the Australian economy, and the mining sector.

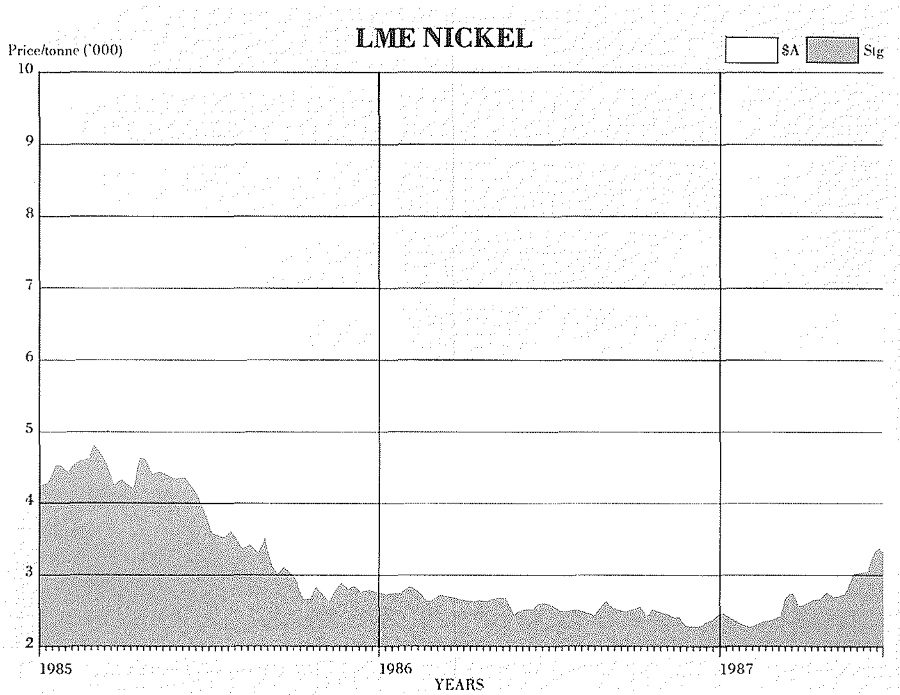
World economic activity is expected to grow at a slow rate of 1-2 per cent until the first half of 1988, then turning zero-to-negative into late 1988 and 1989.

OECD price inflation is forecast to accelerate from around 3 per cent currently to possibly the 5-8 per cent region by early 1988. However, at this time, further acceleration in inflation will threaten. The assumed move to a more restrictive stance could see disinflation resuming later in 1988.

Commodity prices could rise at rates of 10 per cent a year or so, up to the first half of 1988, with rising inflationary expectations overcoming structural oversupplies in some commodity markets. Commodity prices should enter again into a downtrend thereafter as the supply catches up.

Nominal interest rates are expected to rise into the second half of 1988, initially in tandem with increasing price





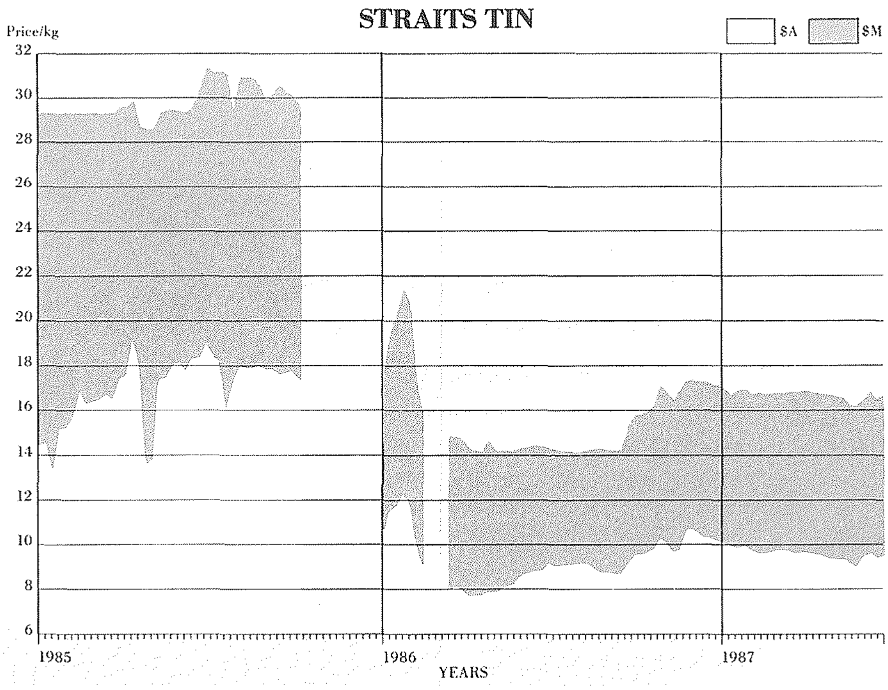
inflation, and then in response to an assumed tightening of monetary policy. Nominal rates could fall in 1989. Real interest rates are likely to jump in the first half of 1988 as policy is tightened and then decline gradually from late 1988.

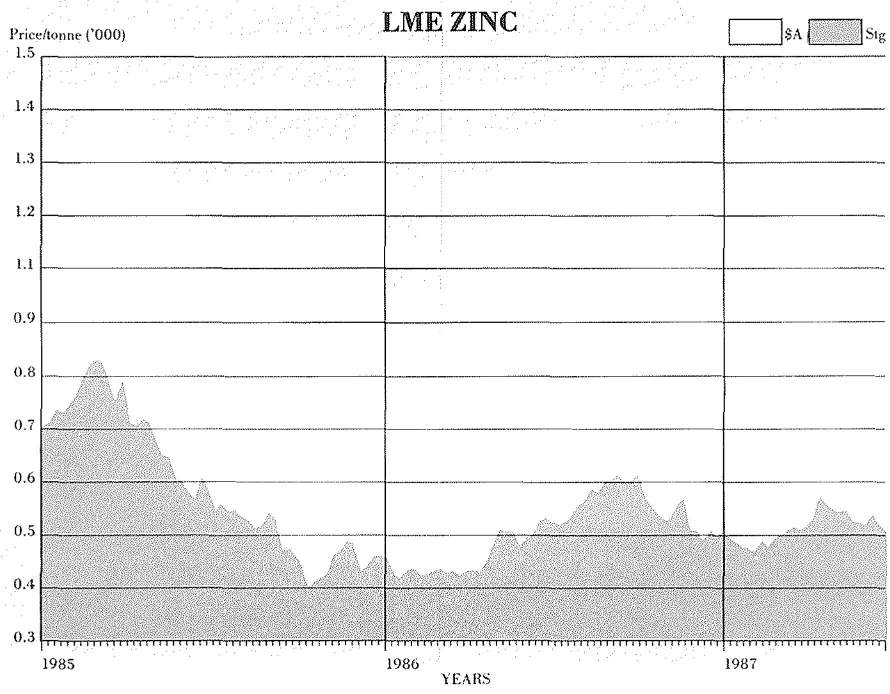
The $US is viewed as being in a secular downtrend, reflecting relative weakness in the US economy.

This concern we have seems to be shared by the Secretariat of the OECD. In its June 1987 *Economic Outlook* the Secretariat not only downgraded the forecasts it published last December, it also drew specific attention to the potentially damaging consequences of continuing massive trade imbalances, enormous swings in exchange rates and the absence of meaningful resolution to the problems of Third World indebtedness. The Secretariat is fearful that there will be an increase in protectionism, that capital investment will be discouraged by the uncertain economic environment and that, consequently, even its downgraded forecasts will prove too optimistic.

The OECD is justifiably concerned. Last year OECD Industrial Production (the economic indicator most relevant to metals demand), grew by just 1.4 per cent, less than half the rate recorded in 1985. The decelerating rate of growth continued throughout 1986 and into the early part of this year, with the 1987 first quarter being only 1.2 per cent above the comparable 1986 quarter.

Allowing for the improvement in Japan, and factoring in reasonable growth in Europe, and at least some growth in the US, OECD Industrial Production should increase by around 2 per cent this year, but no more. If our worst fears (and those of the OECD Secretariat) are realised, the outcome for 1988 will certainly be no better.





The projected low economic growth will occur against the background of higher inflation and a continuing vulnerable US dollar. Having increased only 2.6 per cent last year, the annual growth in OECD consumer prices has more recently approached 4 per cent, and the trend remains gently upward. By year-end, inflation rates of 4 to 5 per cent are likely to be the norm in most industrialised nations. Although the US dollar has been remarkably stable for the past four months, there is still no sign of any significant improvement in the US trade deficit. In fact, the OECD Secretariat does not anticipate any such improvement before 1988 at the earliest. With lax fiscal and monetary policies likely to prevail in the run-up to the Presidential elections, further dollar weakness is a decided possibility.

Since the beginning of the year base metal prices have risen by an average 34 per cent. The question is whether and for how long these price gains will be sustained.

Our overall view is that metal markets could hold their current tenuous price levels until the end of calendar 1987, whereas unless there is a dramatic turnaround in the world economic scenario, supplies could exceed demand in 1988, although this may not become apparent until well into calendar 1988. For the short term, prices of all metals could go higher in response to non-fundamental speculative activity.

Expansion of both production and productive *capacity* is unlikely until early 1988, so that the speculative enthusiasm is vulnerable only to a change in sentiment, not to significantly increased supplies coming on to the market.

In the subsequent individual metal forecasts, all prices are quoted in US currency.

ALUMINIUM

Aluminium had a record year in 1986, and demand has continued strong in 1987. In USA and Japan particularly, demand has easily outpaced sluggish economic growth, but pre-strike buying may have exaggerated the extent of this demand.

On the supply side, smelter closures continue to exceed new capacity additions to accommodate significantly higher demand. Inventories are still falling, but it can only be a matter of time before producer production restraint breaks down in response to higher prices.

Outlook: The fundamental aluminium price has risen by 27 cents a pound this year, in response to continuing supply shortage. While demand has been very strong, producers have been reluctant to rapidly increase production. Inventory cover is likely to remain tight over the next six months at least, but a surplus is unlikely until the latter half of 1988. Our forecast average for calendar 1987 is 66 cents a pound (all quotations are in US currency), increasing to 68 cents a pound in 1988. The current price is 81 cents.

In our view aluminium is fundamentally by far the best metal.

COPPER

Following a 2.5 per cent gain in 1986, demand should reach a new high in 1987; we estimate to 7.7 million tonnes. Demand from the construction industry, and for restocking, is outweighing stagnant demand from the motor vehicle sector. New capacity coming on stream from Chile and PNG (Ok Tedi), plus new supplies from leaching operations, suggests supply may well catch up with demand by the second quarter of calendar 1988.

Outlook: The LME copper price has increased by more than 17 cents a pound this year, due mostly to once-off rescheduling of Zambian exports, other than through South Africa.

While metal inventories are still on the low side, reactivation of capacity and new production coming on stream suggests a reversal in buoyancy by the end of the first quarter of 1988. We forecast an average copper price of 68 cents for calendar 1987, slipping to 67 cents next year. Current price is 78 cents a pound.

LEAD

Total demand appears to be well sustained, as limits seem to have been reached in terms of the decline in consumption attributable to usage in automative gasoline and lead batteries. However, automobile production is stagnating and 60 per cent of lead demand is attributable to automobile batteries. On the supply side, mine output, down 6 per cent in 1986, is continuing at low levels, while in 1987 primary supply has been subject to supply disruptions. On the negative side there is substantial spare mine capacity and there is the prospect of increased US mine output.

Lead has been one of the best price performers in 1987. Compared with an average price of 18 cents in 1986, the price has risen from 23 per pound in January to more than 30 cents now.

Outlook: While there is no doubting the potential for increased mine output, and while secondary supplies are on the increase, the market remains still in overall deficit. Inventory cover is now down to historically low levels and the market remains vulnerable to unforeseen supply disruptions. The longer-term outlook for lead demand is better now than for many years. Even if the market moves into surplus in 1988, inventory cover will remain modest and recent gains should be consolidated.

Our forecast average price for 1987 is 26 cents a pound, rising a little to 27 cents in 1988. Current price is 30 cents.

NICKEL

Significant increases in stainless steel output in all major economies in recent months has resulted in much-improved nickel demand, while the uplift in production of new commercial aircraft will assist super-alloy demand for the next few years. But nickel, as we all know, is highly cyclical and the rate of growth in consumption will tend to flatten out in 1988.

While mine closures are currently restraining production, there is still surplus capacity and exports from Russia and China will most likely increase.

Just when all observers thought nickel was in for continuing price weakness, it rose from $1.60 at the beginning of the year to $2.46 a pound currently. Far from a continuing surplus, producer restraint and an unexpected surge in stainless steel demand caused the supply/demand equation to move into deficit.

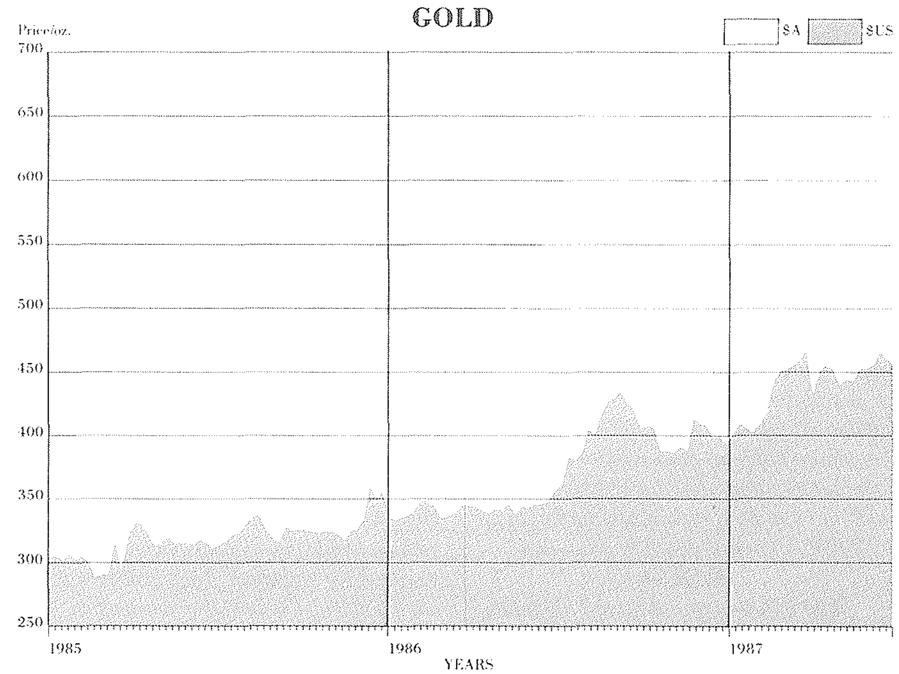
Outlook: It is unlikely the producers will resist the temptation to lift prices and this, coupled with the Eastern Bloc surplus, could see the market back into balance, or over ever-supply, in 1988.

Although inventory cover may not be excessive, some rationalisation in the industry, resulting in "permanent" closure of capacity, will be necessary for sustained higher profitability.

Forecast average for nickel is $2 a pound for 1987, and $2.10 for 1988. Current LME price is $2.40 a pound.

TIN

Tin is now highly price-competitive, as technological developments in can-making are warding off the longer-term



substitution trend against tin. However, there is little indication that lower prices are resulting in substantial lifts in consumption.

On the supply side, production is still falling, being down 13 per cent in 1986. A 10 per cent decline in 1987 is likely. There is little evidence of significant Chinese selling, but the US is still depleting its strategic stockpiles. A continuing destabilising factor is the threat of large sales from ITC creditors.

Outlook: Despite a rapid rundown in inventories, the tin price has not improved this year. This situation cannot last. Tin demand is rising, but primary production has collapsed. Mine output this year will not exceed 125,000 tonnes, which is 70,000 tonnes less than five years ago. By year-end some 75,000 tonnes of the surplus stock overhang existing in late 1985 will have been consumed.

In 1988 a shortage could develop unless prices rise. The tin price can only go one way — up. Our forecast average price for calendar 1987 is $3.20, rising to $4.20 next year (4,300 to 5,700 pounds a tonne). Current price is $3.00 (4,050 pounds).

ZINC

The underlying long-term demand trend remains positive. In 1986 there may have been some hedge buying in advance of strikes. Auto production remains sluggish and Chinese demand is still poor.

On the supply side, primary output continues to be affected by supply disruptions and rationalisation moves should stabilise supply patterns. In the short term mine output is recovering from earlier disruptions, secondary supplies are increasing and LME stocks appear to be rising.

Outlook: From its position as being one of the best price-performers in recent times, zinc has lagged price-wise and is back to its mid-1986 price level. The industry still has a sizeable surplus-capacity problem.

However, recent links between the major producers will undoubtedly result in more price-sensitive production rationalisation. Zinc prices should therefore hold up reasonably well. Our forecast average price for calendar 1987 is 36 cents a pound, remaining the same in 1988. Current price is 36 cents.

GOLD

We believe annual supply/demand equations are of less use than for base metals. Gold is mostly not used, it is bought and kept.

Generally investment demand is remaining firm, reflecting inflation, inflationary expectations and US excess money supply. For the immediate future there is little prospect of any material improvement in the US trade deficit, and a weakening US dollar. This is positive for gold.

Outlook: At worst, we foresee the price of gold being underpinned around $450 an ounce, or slightly lower. The prospects of the price reaching $500 by the end of calendar 1987 are less strong than they were say one month ago. We believe there is a greater chance of gold being closer to $500 than $450 within the next six months. Downside is limited.

THE OUTLOOK

In a sense, the mining industry is reverting to "normal" conditions. By that I mean that price trends for base metals will show the long-familiar pattern of six to twelve months of satisfactory, or even buoyant prices, following by declining or flat prices for some years as new capacity once again comes on stream, or is resuscitated in response to a more encouraging outlook.

Mining companies prefer stability in prices, hopefully in an improving trend. On the other hand, commodity speculators, and by inference "investors" in resource-linked stock market equities, prefer price *change*, since this creates greater short-term money-making opportunities. They, of course, do not have to run the companies, and cope with significant revenue fluctuations.

Over the next six months at least, both groups should be satisfied, since our crystal-ball-gazing suggests higher *average* prices for metal producers, while there will be *considerable price volatility* around these average fore-cast prices. Therefore, there should be good pickings and short-term trading opportunities for stock exchange investors.

For the mining industry as a whole, I cannot help but agree with Allen Sykes (again), who said management structure must be appropriate for the size of the company.

For the large mining companies, the day of the large, even giant, project will return, and the casualties of the 1970s, caused by inflation, high interest rates and radically falling demand, are unlikely to be repeated.

Medium-sized companies need the most imaginative and multi-disciplined management and generous incentives for managers (and workers) to perform well, and maximum use of outside consultants, but only as and when required. Goodbye the large head office.

The small mining groups will, in my view, provide the vigour and enthusiasm which the mining industry needs, and which the investment sector applauds. Witness the manner in which generally it is the smaller entrepreneurial companies which led the resurgence in the Australian gold-mining sector and gave a lead to the major companies.

Finally, as a single pointer to metal prices and base metal share prices, the rate of growth of excess money supply in the US will continue to be the best single indicator, as this, with the right adjustments, has a major impact on the price of gold and hence commodities and resource share prices generally. ☐

THE SWEDISH INFATUATION

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This analysis simply ignores the fact that British productivity has grown significantly throughout the Thatcher years. Moreover, during this period the number of individual shareholders has increased from two million to nine million — due to privatisation and the Conservative Government's encouragement of employee share ownership. There are now more share owners in Britain than there are trade unionists.

Mr Carmichael supports corporatist economies precisely because they enhance trade union power. He is opposed to workplace agreements of the kind that exist in, for example, the United State and Switzerland because they do not require the involvement of trade union bureaucrats.

In September 1983, Laurie Carmichael spelt out the details of his approach to industrial relations and why he supported a highly centralised wages system: "Those who have the idea that the road to socialism is made of individual wage struggles in half a dozen factories without mobilising all the workers, centred in the strength of all the workers of this country, have no bloody idea whatever what it's all about."

Those who oppose Australia proceeding down Mr Carmichael's road to socialism should vehemently oppose *Australia Reconstructed.* ☐