

Understanding super cycles

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JOHANNESBURG (Mineweb.com) -- In January this year, the Citigroup global metal and mining team put it riotously: “A flood of investment funds is driving base metal prices much higher than can be supported by fundamental analysis of supply and demand. It’s a bubble which could grow a lot bigger before bursting.”

That warning preceded by months the savage profit taking that attacked metals, commodities and mining equities last week, and is yet to show signs of abating. Citigroup’s warning, however, is based on deep research that can be most recently traced to January 2005 when a big Citigroup team, lead by Alan Heap out of Sydney, published a 260-page report titled “Riding the Super Cycle.”

Heap, a veteran and possibly guru investment analyst, has been more often on than off the money. In January 2005, the dominant theme in Citigroup’s huge report was that “a long-term super cycle combined with an extended current cycle will drive sustained earnings growth and outweigh conventional sell signals in a maturing cycle.” To be sure, metal and commodity prices moved from one record to another, reaching multi decade highs in the past few weeks.

For some investors, the warnings had been there for months. In January this year, as mentioned, Citigroup published its report “Beyond fundamentals - the funds phenomenon,” where it warned about a bubble in metal and commodity prices, and thus mining equities. The report reminded that commodity markets have “always been strongly influenced by speculation.”

There is nothing new in sudden frenzied investment activity in commodity markets; a very early example was the infamous Dutch tulip bulb craze of the 1630s. Far more recently, surging investor demand contributed to the 1994-95 boom. In the current cycle, Citigroup warned, funds deployed are perhaps double the previous high. Indeed, since early 2004, when the current investment cycle really found itself with power tailwinds, funds invested have tripled. Not only that, but in this cycle, all classes of commodities – base and precious metals, energy and “softs” (agricultural goods), have enjoyed substantial price gains. For many months Heap has believed in a trend rise in real commodity prices, reversing the trend decline of the last 30 years.

Beneath the bubble, and this point is critical, fundamentals remained supportive. Increased fund investment and price increases were occurring against a fundamentally robust environment: strong global demand and a supportive macro economic environment, along with constrained supplies, and low inventories.

The problem, such as it can be described, is that investors have taken metal and commodity prices too high on a short-term horizon. In reaction to the recent sharp full-fledged speculative melt-up, another Citigroup analyst, John Hill, noted out of New York investors “gleefully taking direction from asset allocation-driven investment inflows and white-hot wave of mergers and acquisitions.”

When prices settled down, so the argument would logically go, such prices would have established a higher longer-term equilibrium level. Under the bubble, there was a

solid new era. In April this year, in a paper presented at the Mineral Economics & Management Society Annual Conference, in Washington, Heap again emphasized the belief that a super cycle was underway, driven by intensive economic growth in China.

Heap defines a super cycle as a prolonged (decades) trend rise in commodity prices, driven by the urbanization and industrialization of a major economy. “There have been two super cycles in the last 150 years,” says Heap. The first, driven by economic growth in the US, straddled the late 1800s-early 1900s. The second was seen in 1945 through 1975, prompted by post-war reconstruction in Europe and Japan’s later, massive economic expansion.

For Heap, high and rising intensity of metals use is the most useful indicator of a super cycle. In China, intensity of use is currently three times that of the US, with demand-driven urbanization, industrialization and fixed capital formation.

“Importantly,” argues Heap, “the domestic market drives China’s demand, not exports. In past super cycles, supply has increased to meet demand growth. In the present super cycle, increased supply will translate into relatively higher costs. Lead times are also increasing, contributing to extended periods of market tightness.”

There is no doubt, of course, that the supply response will fuel ongoing increases in production – but, as mentioned, at higher costs. In past super cycles, expansions in metals and commodity production were not sufficient to offset stronger demand growth. In the present super cycle, Citigroup believes that both capital and exploration expenditure are increasing - but not to the extent of resulting in oversupply.

All told, Heap believes that in making forward calculations, higher long-term metal and commodity prices should be used. Hill notes the combination of 15 years of under-investment in metals; thorough-going corporate consolidation; mounting regulatory/NGO pressure, and input cost escalation conspiring to prevent the industry from mounting a meaningful supply response to “peak-peak” prices.

“The masking effects of the Asian crisis of 1998,” argues Hill, “and the technology shakeout of 2001-2002 on metals demand help explain why the ‘production gap’ is so intractable. This is amply demonstrated in copper, nickel, and coal. Aluminum may well be headed along the same path.

“This does not imply perpetual levitation for mining and metals prices, but rather, first, sustainable ‘higher lows’ in metals and commodities pricing and company earnings; second, financial catalysts in the form of balance sheet repair, common/special dividend hikes, and share buybacks, and third, equity multiples re-rating as mining and metals names are invited to join ‘polite cyclical society.’ ”

Even those investors who agree with the super cycle theory will find that investing decisions remain tough. The metals and commodities super cycle is peppered with surprises, such as a sudden big exploration find, along with numerous other risks. Idiosyncrasies on both the supply and demand side are likely to conspire from time to time during a super cycle, creating volatility. Finally, there are speculators as never before; in this era, they are organized gangs of suits dressed up as hedge funds.