

# China: how Jim Slate

One of the UK's most respected investors, and author of *The Zulu Principle*, explains why the case for investing in oil and mining companies is so compelling

IT ALWAYS MAKES SENSE TO HAVE A THEME AS A backcloth to your investment policy. The massive growth in demand for oil and metals from China, India and south-east Asia provides a tailwind of extraordinary force. I do not believe that we are in a typical three-year OECD cycle in commodities. I believe that we are in a super-cycle.

There have been two super-cycles during the past 120 years. The first, in the late 1800s/early 1900s, was powered by US economic expansion. The second, in 1945-1975 was powered by post-war reconstruction in Europe, followed by Japan's economic expansion. The best indicator of a super-cycle is high and rising intensity of the use of metals and oil – China's intensity is currently about three times that of the US.

In past super-cycles, supply has readily increased to meet higher annual demand. In the present cycle,

however, that increased supply will come at much higher relative costs due to increasing lead times, environmental problems, very heavy capital expenditure becoming the norm and a shortage of equipment and skilled labour.

Jim Rogers, the partner of George Soros of the Quantum Fund during its best early years, says: "If history is any guide, this bull market is going to last until between 2014 and 2022 and everything is going much higher. There has been no major oil discovery anywhere in the world over the past 35 years, and every oil field you know is in decline."

## CHINA'S GROWTH

It is difficult to comprehend fully the phenomenon of China's massive growth. China is now the number-one producer of liquid crystal display (LCD) screens and TVs. It manufactures 90 per cent of the world's toys, 70 per cent of photocopiers, 50 per cent of cameras, 40 per cent of microwaves, 30 per cent of handbags and suitcases and 16 per cent of clothing.

China annually consumes 47 per cent of the world's cement, 26 per cent of steel and aluminium, 33 per cent of iron ore and 22 per cent of copper. China was a net exporter of oil eight years ago, but today it is the fastest-growing importer and the second-

largest consumer. It is also the world's number one consumer of zinc, tin, rubber, cotton, wheat and, not surprisingly, rice.

The *Washington*

*Post* estimates that 80 per cent of the 6,000 factories in

Wal-Mart's supplier database are in China. There are now about 130 cities in China

with a population of one million or more, against only nine in the US.

The Chinese are building 50,000 miles of motorway, the equivalent of the entire US interstate network. It took the US 40 years to do this – the Chinese plan to build theirs in five.



# er plans to profit

Most people in China and India have no electricity, so their demand for energy should continue to grow rapidly. In addition, Chinese car production doubled during the past four years and there is still plenty of growth potential. China graduates 325,000 engineers a year which is five times the number in the US. English is China's second language; in the US, just 50,000 students are learning Chinese. Most important of all, the average labour cost in China is just 4 per cent of that of the US, which has never before had to deal with a competitor of such size and dynamism.

In comparison to China, Europe is a joke. Its politicians fiddle while its industries burn. They continue to tinker with a rapidly increasing number of bureaucratic regulations, coupled with demands for a shorter working week and further employee benefits.

## OIL AND MINERALS DEMAND

China, India and other developing countries in south-east Asia are building a new middle class, which will require urban houses, refrigerators, televisions, microwaves and cars. It is not surprising that their demand for oil and metals rises twice as fast as their gross domestic product (GDP).

Supply shortages are likely due to low stocks of four of the key base metals on the three leading commodities exchanges, aging mines with lower grades, strikes and a shortage of new mines coming on stream. For example, copper demand forecasts, allowing for reserve depletion, show that, by 2016, only 46 per cent of demand could be met by existing mines. Thirty new major mines will be required, but the region will struggle to provide three a year, even for the next three years.

China plans to move 300m people into new homes by 2020. To build the average house there requires 400lbs of copper and the average car requires 55lbs, with hybrid cars needing 100lbs. In the US there is, on average, one car per person, whereas in China, only nine out of every 1,000 people own a car. The energy and copper requirements will therefore be colossal. And bear in mind another startling statistic: compared with China's 22 per cent and the US's 12 per cent of the world's annual copper demand, India consumes just 1-2 per cent, although its GDP is growing at a heady 7.5 per cent a year against China's 9.9 per cent in 2005. Even today, China's GDP per head, at purchasing power parity, is less than one-sixth of that of the US, and India's is half of China's.

Commodity prices are quoted in dollars. The US currency is likely to continue to weaken as it inflates out of debt. Commodity prices have risen strongly in recent years, but many of the metals prices are still well below their previous highs after adjusting for

inflation. Gold is an obvious example and another is aluminium which, in 1988, hit a high of \$1.65 a pound. Adjusted for inflation, this is equivalent to \$2.73, compared with a recent spot price of just under \$1.20.

## MIS-PRICING OF OIL AND METAL STOCKS

Investors do not realise the unique merit of oil and mining stocks. They own the resources China, India and other south-east Asian countries must have. Miners and oil producers have pricing power unlike most other industries. Oil and metal production cannot be expanded easily. Finding new major deposits is the first problem, followed by environmental difficulties, massive and rising capital costs and shortages of new equipment and skilled labour.

Investors have not yet learned how to value oil and metals stocks properly. Commodity content is the key – not immediate cash flow. Wall Street and the UK still look on commodity stocks as if they are dependent on the short OECD cycle, while they value conventional stocks without taking sufficient account of the inexorable and growing competition from Asia. For example, the average UK retailer is on a prospective earnings multiple of 16.

DSG International (previously Dixons) with miniscule earnings per share (EPS) growth in the past four years and none forecast, is on a prospective multiple of 14.6. Compare this with Rio Tinto and BHP Billiton, both on about 11 times prospective earnings. Rio Tinto has increased EPS from 75p in 2000 to 208p in 2005 and BHP is forecast to increase EPS fourfold to 87.7p in 2006, from 21p in 2001.

Another helpful factor is that China and India are now bidding for overseas commodity assets and producers. This trend is very likely to increase and with the growing cash balances in the commodity companies, there should be more merger and acquisition activity as well as increased dividends.

The mis-pricing of commodity stocks is general. Most of them are in high single-digit to very low teen multiples, yet:-

■ Their EPS growth and prospects are better than the market.

■ They have strong links to China and India's future growth and own exactly what developing countries need.

■ There is an irreplaceable aspect to their very precious reserves.

■ Further drilling usually increases both proven and probable reserves substantially.

■ The market does not give a sufficient premium for unhedged reserves in politically secure regions.

In the US, the value of the 20 companies that produce the majority of freely available metals is only equal to the capitalisation of General Electric. Oil and service companies account for just 8.25 per cent of the S&P and metals stocks less than 1 per cent.

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**COPPER DEMAND FORECASTS,  
ALLOWING FOR RESERVE  
DEPLETION, SHOW THAT BY 2016,  
ONLY 46 PER CENT OF DEMAND  
COULD BE MET BY EXISTING MINES**

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## COVER FEATURE

In the UK, the position is better balanced. Oil and metals account for about 26 per cent of the FTSE, oils 20 per cent, and metals 6 per cent. Weighting is, of course, a very important factor: BP is 9.3 per cent, Shell 8.7 per cent, BG Group 1.4 per cent and Cairn just 0.2 per cent. In metals, Anglo is 2 per cent, Rio Tinto 1.9 per cent, BHP 1.6 per cent, Xstrata 0.5 per cent and Antofagasta only 0.1 per cent.

As metals account for so little of the overall market, a correspondingly small number of analysts cover mining stocks. Many of these analysts have not had much experience of real prices rising persistently so they tend to fall back on the old mantra of five-year averages not allowing sufficient weight for the exceptional demand coming from China, India and the like. They are therefore invariably behind the curve.

More brokers and banks are now joining the fold and strengthening their coverage. Credit Suisse is a prime example, with its new 108 page circular initiating coverage with 12 powerful arguments in favour of investing in metals and mining stocks.

### POSSIBLE HICCUPS

There will undoubtedly be hiccups. China, with 9.9 per cent GDP growth in 2005, has just overtaken the UK as the world's fourth-largest economy, and is likely to overtake Germany soon in third place. China's growth has been so strong for such a long period that a setback is likely. Possible causes are a global recession, the spread of bird flu and increased political tension in Iran and elsewhere. In China, the fragility of the banking system, overproduction and some bad planning are likely to slow down the growth rate. The long-term trend seems to be inexorable, though, and any setback (like this week's) should be viewed as a buying opportunity. It is worth noting that a major recession would affect the rest of the market to a much higher degree, particularly UK retailers on a lofty average earnings multiple of 16.

### INVESTMENT POLICY

If you agree with my arguments that "What China and India want" is an attractive investment theme for 2006, the next task

is to find the shares that provide the best cover. For oil, unit trusts investing in the smaller oil companies seem to me to be the optimum answer. Some of the junior oil companies operate in dangerous places politically, so a spread of investments is essential. It also adds to the possibility of benefiting from a major discovery, which can have a disproportionate effect on a small company's share price (witness Cairn Energy). There is also always a good chance of benefiting from a takeover – there were several last year.

I have an investment worth about £2.5m in the Junior Oils Trust managed by my son-in-law, Angelos Damaskos. The trust invests mainly in junior oil companies that are in production and have reserves, preferably with no interests in the Middle East. Junior Oils Trust is administered by Capita Finance and was up 64 per cent in 2005.

For coverage of gold, platinum, palladium, copper and molybdenum, I have a 10 per cent shareholding in Galahad Gold. Recently, I have been topping this up substantially with shares in BHP Billiton. This is

the world's second largest producer of copper, third in iron ore, largest in manganese, second largest in steaming coal, third in nickel, fourth in uranium and fifth in aluminium. It also has significant oil and gas interests and diamonds. You name it, BHP has got it.

BHP has trebled its earnings over the past three years and has a consensus forecast for 2006 of 87.7p a share against 58.6p last year. Cash flow is habitually very strong, so share buy-backs and higher dividends are probable. BHP is also quite likely to make an earnings-enhancing takeover.

BHP's shares trade on a prospective earnings multiple of 11 for 2006, with a prospective dividend yield of 1.8 per cent. To my mind, BHP is a classic and rare example of a company that has all the things that China and India want and can still be bought on very attractive terms. Further strong earnings growth with a surprise on the upside and a rerating are obvious possibilities.

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## CHINA WITH 9.9 PER CENT GDP GROWTH IN 2005 HAS JUST OVERTAKEN THE UK AS THE WORLD'S FOURTH-LARGEST ECONOMY, AND IS LIKELY TO REPLACE GERMANY SOON IN THIRD PLACE

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