Riding the Metals & Mining 'Super-Cycle'

A LONG-TERM 'SUPER-CYCLE' combined with an extended current cycle will drive sustained earnings growth in the metals and mining sector and outweigh conventional sell signals in a maturing cycle, according to Alan Heap of Smith Barney (a division of Citigroup Global Markets Inc.).

Smith Barney believe that we are in an extended cycle, that, in turn, is part of a 'super-cycle' which will drive a sustained period of earnings growth and deliver a 'quality' of earnings not seen in the sector before. This outweighs more conventional sell signals that would apply at the maturing stages of a conventional cycle.

"Previously we have viewed the sector against a super-cycle background without fully embracing the quantitative implications in our commodity assumptions, and therefore our company numbers," says Heap. "We expect continued above trend growth, supported by China and the USA – even though the momentum of global growth is slowing and commodities demand has peaked."

A super-cycle constitutes a sustained period of trend increase in real commodity prices driven by higher trend demand growth as major economies industrialise and urbanise. Supply increases but not sufficiently to offset demand. Previous super-cycles occurred in the late 1800s early 1900s driven by urbanisation and industrialisation in the USA; in the 1940s and 1950s (post war reconstruction in Europe); and in the 1960s and early 1970s (the Japanese economic renaissance). "China is the catalyst for a similar cycle commenced in 2002. A clear conclusion is that long-term commodity prices should increase," according to Smith Barney. The current super-cycle entails:

- Higher trend growth in global demand, driven by materials intensive growth in an urbanising and industrialising China.
- Trend rises in real commodity prices, reversing the trend decline of the last 30 years.
- New supply from higher cost projects, which drives industry average costs higher.
- Long-term average margins will be broadly unchanged.

Smith Barney have increased their long-term price assumptions for most commodities driven by an expectation of trend increases in costs, sustained margins and stronger commodity currencies.

An Extended Cycle

Cycles are typically brought to an end by a downturn in demand. Excess capacity build also sometimes occurs, contributing to an extended commodity price recession (e.g. the mid 1990s). "However, in this cycle, demand for commodities is expected to slow from the cyclical peak in 2004, but remain above trend, driven by China and the USA. Furthermore, although a capital expenditure boom is underway there is no sign of excess capacity at this stage: Capital budgeting is more stringent and lead times are longer," says Heap.

Most of Smith Barney's forecasts for 2007 are higher than their long-term price assumptions (see table below).

The healthy financial position of metals and mining companies is also set to continue. Excess cash generated from superior earnings is likely to be distributed into capital expenditure with acquisitions less attractive than project development at this stage of the cycle. Despite this, acquisitions are more common at the peak of the cycle, because companies with few internal growth options are likely to pursue an acquisition strategy. Special dividends remain attractive in Latin America and Australia whilst share buy-backs are attractive in the USA and UK. Debt repayment remains unlikely given already under-geared balance sheets and the low cost of debt.

Smith Barney's preferred commodities are the bulks (iron ore, coking coal, alumina), aluminium, zinc and gold. "Our preference is for companies exposed to our preferred commodities and those with quality earnings, strong free cash flow, growth, and capital management potential."

A key implication of the super-cycle is that higher rates of long-term demand growth will prompt increased supply. However, Smith Barney believe that additional supply will only come at higher cost and that although prices will rise, margins will not expand significantly. "In certain commodities however (most notably the bulks) we now believe margins will be retained at recent higher levels in order to stimulate the necessary investment."

Riding the Super-Cycle: Smith Barney Global Equity Research: Metals & Mining, 2005.

Key Commodity Price & Exchange Rate Changes

		2005e			2006e			2007e			Long-term		
		New	Old	Change	New	Old	Change	New	Old	Change	New	Old	Change
A$/US$		0.80	0.80	-1%	0.80	0.80	0%	0.70	0.75	-7%	0.70	0.65	8%
US$/ZAR		5.93	6.76	-12%	6.32	7.33	-14%	6.77	7.89	-14%	9.00	9.00	0%
Aluminium	US¢/lb	88	85	3%	82	80	3%	75	78	-4%	70	65	8%
Copper	US¢/lb	130	118	10%	115	110	5%	100	105	-5%	95	85	12%
Nickel	US$/lb	5.60	4.98	12%	4.00	4.00	0%	3.50	3.75	-7%	3.50	3.25	8%
Zinc	US¢/lb	58	52	11%	55	50	10%	48	49	-2%	50	45	11%
Lead	US¢/lb	40	37	7%	32	30	5%	23	27	-15%	27	25	8%
Oil - WTI	US$/bbl	36	36	0%	28	28	0%	28	28	0%	28	28	0%
Iron Ore	% chg	+45%	+30%		0%	0%		0%	0%		45*	35*	29%
Coking Coal	US$/t chg	+71	+38		+10	+10		+0	0		62**	48**	29%
Thermal Coal	US$/t chg	+12	+12		-5	-5		+0	0		33**	30**	10%

Note: Although we have not changed our LT Rand, we no longer depreciate it at 2%/yr (the inflation differential we assume between South Africa and US); * US¢/Fe unit; ** US$/t Source: Smith Barney estimates.