

# Have patience with commodities

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By Editor [Merryn Somerset Webb](#) Oct 28, 2008

Anyone who thought the path of the commodities 'supercycle' would be a smooth one would have been in for a shock this year. Just look at the performance of the miners.

At their peak, back in May, shares in Xstrata traded at £44. Around the same time, BHP Billiton hit £22. And Rio Tinto, £71. They now trade at £8.40, £8.20 and £22.40 respectively. Nasty isn't it? So much so that even those who were muttering about how overvalued the miners were six months ago are now talking about it being time to buy in. My guess is that they'll be sorry if they do so. The truly horrible recession (or depression) ahead of us means that there is every chance that commodity prices – and hence mining profits – will go much lower before things get better.

Not only is demand falling off all across the West (who needs materials to build houses in the US these days?) but Chinese demand – the one thing that the bulls always saw as their 'get-out-of-jail-free' card – isn't holding up that well, either. Both BHP and Rio have admitted that demand is stagnating in China and there is good reason to think it will continue to do so. Falling exports will hit the non-domestic part of the Chinese economy hard; while domestic demand for commodities will be hit by slowing urbanisation, falling house prices and the conservative consumption habits of the middle classes. Add that fall-off in demand – which will get worse in the medium term – to the fact that inventories of many commodities are rising fast, and you can see why it makes sense to assume that prices will keep falling for some time to come.

Not everyone appears to get this yet. There are clear signs of economic disaster everywhere – for evidence, just look at any page in a newspaper. But check consensus forecasts for 2009 and you'll see that the average analyst is still forecasting rising earnings for the miners. That suggests that commodity-related equity prices haven't quite hit bottom yet.

And here's the interesting bit. The severity of this downturn is planting the seeds for the next massive upswing in commodity prices. Remember the reason we all bought into the idea of a commodity supercycle in the first place? We saw demand rising as living standards in the developing world started to catch up with those in the West. At the same time, we also saw that after a 20-year bear market in commodities, characterised by practically no new exploration and no new mines, the supply simply wasn't there to meet the demand.

So, bearing in mind that it can take anything from four to ten years to get a new mine up and running (and that's after you've found something to mine), we figured there would be quite a bull market in everything from oil to copper. And so there was.

Sure, there was massive speculation in the prices of most commodities towards the end – the base metals and oil in particular – but, like all good bubbles, the commodities bubble started out as a perfectly sensible boom. Note that the prices of things you can't speculate in – iron ore, for example – soared alongside the likes of copper and oil.

The point is that, on the supply side, nothing much has changed. The boom – which really only started in earnest a few years ago – hadn't been going on long enough for much new capacity to come on. Much was planned, but planning isn't the same as producing. So the supply of most commodities isn't that much higher now than it was five years ago.

The way things are going, it won't be any higher five years from now, either. Big mining and oil companies are tripping over themselves to 'review' their expansion plans as falling prices destroy their justification, while smaller companies are pulling projects simply because they have no choice.

Run a medium-sized mining company and need a little extra cash? Forget it. You aren't getting it from the equity markets – investors aren't in the mood. And you most certainly aren't getting it from the mining finance teams at the big financial institutions. They may have been willing to chuck almost any

sum your way in late 2006 and early 2007, but these days you'd be lucky to get a meeting out of them.

Also worth noting is that most commodities are now trading at prices not far off their marginal cost of production – that suggests that if prices keep falling, we will see cutbacks and mine closures. The result? When demand returns to the markets, which it will at some point (the world has not actually ended), we'll be exactly where we were back in, say, 2004: there just won't be enough supply to meet the demand. Then we'll be off again.

I am not suggesting for a second that you buy into the commodities markets right now. This is a very nasty bear market and in bear markets there really isn't much point in holding anything at all. What I am suggesting is that as soon as the world looks like it is on the turn back to growth, you pile up your portfolio with miners. BHP Billiton's share price rose 370% between 2004 and mid-2008. It'll do at least the same again next time around.

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