



IAN WOODLEY | PORTFOLIO MANAGER

MINING OUTPERFORMS DESPITE SLOWING GLOBAL GROWTH

Traditionally, the threat of a trade war between the world's two largest economies and an economic slowdown, at least partially induced by that threat, would have investors running for the mining sector exit door. However, the mining sector has comfortably outperformed both the financial and industrial sectors of the JSE over the past 12 months. In fact, the platinum group metals (PGM) sector was the best performing sector on the JSE, up 116% over the period.

In the South African context, this could be ascribed to the fact that although the global economy is forecast to slow, with the OECD projecting GDP growth of 3.3% in 2019 and 3.4% in 2020, it is still easily above any projections for the South African economy over the same time period. Nevertheless, a similar profile of outperformance can also be seen when comparing the mining sector performance in the UK and Australia. There is obviously something else going on here.

In my view, there are two specific events to consider, and then one general observation.

ABOUT THE AUTHOR

Ian is the analyst responsible for the diversified mining companies and the non-mining sectors, such as construction and forestry & paper. He is the portfolio manager of the Old Mutual Mining and Resources Fund.



KEY TAKEOUTS



- PMGS BENEFIT FROM CLIMATE CHANGE TARGETS
- COMMODITY SHORTAGES ARE DRIVING PRICES HIGHER
- MINERS ARE TAKING A CAUTIOUS APPROACH TO CAPEX
- FUTURE SUCCESS DEPENDS ON COMMUNITY ENGAGEMENT

1. AUTOMAKERS DRIVE DEMAND

Following the discovery that Volkswagen (and subsequently most of the other car companies) was manipulating its emission test results – the so-called “Dieselgate” scandal – the car companies have come under increasing pressure to actually meet the emission standards of the territories where they sell cars. Compliance is being enforced using real-world tests, backed up by some fairly hefty fines for those companies that fail to meet the standards. With



a fast-approaching deadline (2021) to meet these targets, and therefore limited time to do research into alternative methods of reaching these standards, the car companies are being forced to make do with what they know. What they know is that increasing the amount of platinum group metals (PGMs) in the coatings of autocatalysts in the cars' exhausts will work to reduce the overall emissions. This has particularly benefited the palladium and rhodium markets. The palladium market has been operating in a deficit for a number of years now – the deficit being supplied from stockpiles that were unsubstantiated, but obviously large to begin with. These stockpiles have been steadily eroded and the market is becoming increasingly tight, as seen in the market price for palladium running away over the past 12 months. Rhodium has also benefited from the same dynamic. While the platinum price has been left behind somewhat, the degree of interchangeability of the PGMs offers hope that the runaway palladium price will force some manufacturers to look at platinum as an alternative.

2. DAM DISASTER LEADS TO SHORTAGE

The other specific event was the collapse of the Brumadinho tailings dam in Brazil used to store mine by-products, and which claimed the lives of hundreds of people. In addition to taking out the production directly tied to the dam, the increased scrutiny of Vale's environmental practices (and a lack of faith in some of the results) has led to substantial reductions in supply to the international iron ore market. The price has benefited accordingly, as no other producer is able to make up that production shortfall in the short term. In addition, some cyclone activity around the major exporting Australian ports also gave the price a bit of a push, emphasising just how tight the market has become.

In general terms, commodity markets are still benefiting from the unusual amount of restraint that has been shown by the major mining houses over the past three to four years. Despite the markets turning positive in 2016, there hasn't yet been the gut-wrenching splurge of activity and capital expenditure on new projects that traditionally follows the change in the cycle. This relative

restraint has led to most metal markets being relatively tight, with prices well supported by the fundamentals. In effect, this has allowed markets to see through the current uncertainty about US-China trade relations. Although there have been more announcements in the second half of 2018 – notably Anglo American's new copper project underway in Quellaveco, Peru – the new metal will not impact on market conditions for a few years and markets are likely to remain tight.

Looking ahead, provided global economic activity is maintained at a reasonable rate, market tightness should be sufficient for commodity prices to be stronger than seen during 2018. However, the economic outlook is clouded by a number of issues, including: What will be the outcome of the trade wars? Is China slowing down structurally? Can the US continue to grow after the tax stimulus seen last year? What impact will Brexit have on Europe?

Longer term, when the politics have been bedded down successfully, the market should adjust to the tighter supply side and, provided demand continues at a reasonable level, there is every expectation that another major upcycle is probable, albeit not at “super cycle” type levels.

SOCIAL LICENCE TO OPERATE

This is a phrase oft used by the mining sector and brought into focus for the general investing public following the collapse of the Brumadinho tailings dam

earlier this year. The failure of Vale to engineer a sufficiently robust structure, despite (reportedly) prior warnings, led to the disaster. Notwithstanding the obvious and horrific consequences of this failure, the social licence to operate incorporates more than just being a safe operator.

Mining companies can get regulatory permission to operate by fulfilling their statutory requirements, but a “social licence” is a more abstruse concept. Essentially, it means getting the approval from the local, regional and national stakeholders to build and operate in their area. There is no pre-assigned checklist of issues that can be addressed, although common concerns will exist. Issues that frequently emerge are jobs for the local community (both directly and indirectly), ensuring that environmental issues will be addressed and the ethics, transparency and accountability around any operation.

A process of engagement and discussion with all stakeholders should be followed so that impediments to the success of an operation can be debated, with major concerns aired and discussions initiated. Importantly, this is not to say that mining companies should give in to every request, but points of concern should be talked through. Where the communities' requests are reasonable, measures should be taken to accommodate them; when these requests are unreasonable, it should be explained why this is so.

